December 3, 2012

Office of Strategic Initiatives
Federal Housing Finance Agency
400 Seventh Street SW, Eighth Floor
Washington, D.C. 20024

Re: Building a New Infrastructure for the Secondary Mortgage Market

Ladies and Gentlemen:

Pentalpha Surveillance LLC ("Pentalpha") is pleased to submit this letter in response to the request of the Federal Housing Finance Agency ("FHFA") for input regarding the White Paper titled "Building a New Infrastructure for the Secondary Mortgage Market" (the "White Paper"). Pentalpha and its affiliates have been involved in the maturation process of real estate finance for over 18 years, and we are independent trust governance experts for real estate, corporate and consumer loan pools.

As stated by the FHFA, "The purpose of the White Paper is to describe a proposed framework for both a new securitization platform and a model Pooling and Servicing Agreement…." The proposed framework was first introduced in February 2012 in the FHFA's *Strategic Plan for Enterprise Conservatorships* ("Strategic Plan"). The Strategic Plan envisions the building and use of a new infrastructure by Fannie Mae and Freddie Mac (the "Enterprises") as an "efficient, logical extension of existing FHFA initiatives aligning the standards and practices of the Enterprises." As stated in the White Paper, one of the goals of the proposed infrastructure is to "establish a framework that is consistent with multiple states of housing finance reform, including greater participation of private capital in assuming credit risk." This letter sets forth Pentalpha's view with respect to the FHFA's proposal.

In summary, Pentalpha strongly believes that a new securitization platform should incorporate better securitization governance for both pre-closing and post-closing matters, such as those related to improved rep and warranty compliance and workout oversight by the loan servicers. Further, the new securitization infrastructure should include an independent party to perform these tasks.

A. Poor Governance in Some Securitization Trusts Contributed to the Financial Crisis

With the benefit of hindsight, we know that the systemic breakdown of the structured finance markets was a key contributor to the financial crisis. As stated in the Financial Crisis Inquiry Report:

> Put simply and most pertinently, structured finance was the mechanism by which subprime and other mortgages were turned into complex investments often accorded triple-A ratings by credit rating agencies whose own motives were conflicted…When the bubble burst, the complexity bubble also burst: the securities almost no one understood, backed by mortgages no lender would have signed 20 years earlier, were the first dominoes to fall in the financial sector.

The financial crisis demonstrated that there were deep structural problems in some securitization trusts. These structural problems related to poor rep and warranty enforcement mechanisms, conflicts of interest (or the perception thereof) by parties, and a lack of transparency across many levels of the collateral and structure. These problems were further compounded by the structural flaw in securitization that an independent party was not included in transactions with "teeth" to oversee and monitor these

structural problems on behalf of all investors. Bad loans were put in trusts and they never came out via the rules in the documents. After the financial crisis, the securitization markets recognized the need for an independent party to provide oversight of the structural problems mentioned above, and thus, in non-agency securitizations (where more credit risk exposure is present), the market has introduced some improvements related to better oversight—although this role varies greatly from transaction to transaction and collateral type and its functionality has weakened over time.

We believe securitization trusts should have an independent board of director-type that is consistent with many but not all tasks found in corporate finance. This party should be a limited overseer of various trust parties and be required to give guidance when certain issues arise. This role is about improved governance over approved vendors, not micromanagement to override the vendor on a loan-by-loan basis (as seen in master servicing).

The cornerstone of well-designed governance is that investors are able to trust the independence of the oversight party. Like a corporate board member, complete independence allows investors to trust the judgment and recommendations of the oversight advisor as being free of conflicts of interest. Without independence being firmly rooted as a requirement at all times, investors are likely to distrust the structural design of the governance advisor in stressed environments.

B. The Core Functions of the Proposed Securitization Platform Should Include the Role of an Independent Party to Provide Oversight

The FHFA White Paper provides that the proposed securitization platform has four core functions: issuance, disclosure, bond administration and master servicing. We believe that in addition to, or incorporated within, these four core functions should be the role of an independent party to provide oversight of rep and warranty enforcement mechanisms, conflicts of interest (or the perception thereof) by parties, and transparency across many levels of the collateral and structure. In recent industry discussions, this party has been referred to in a number of ways, including, in the RMBS arena, Trust Oversight Advisor ("TOA") and Credit Risk Manager ("CRM"), and, in the CMBS arena, Senior Trust Advisor ("STA") and Operating Advisor ("OA"). In order to merge these concepts, we propose calling this newly enhanced party the Operating Advisor regardless of asset class.

The OA concept is born out of the fundamental governance concept used by publicly-held corporations, which is that the business and affairs of the organization should be overseen by a body independent from management. This body, known as the board of directors, not only provides strategic direction for the firm, but also serves as a check-and-balance on the day-to-day operations of management. The directors, in turn, inform, and are overseen by, the owners of the firm, the shareholders.

By way of example, public mortgage real estate investment trusts ("REITs") buy and service mortgage loans. As public companies registered with the SEC, they typically have a board of directors and sell equity and various levels of debt. Among other things, the board members are charged with various duties. Many times, the board is supposed to provide assurance to financial stakeholders that all of the operations related to acquiring and managing loans are in compliance with the company's stated practices and applicable laws and regulations.

The board members also stand by to address exceptional situations. Subordinate investors in these REITs buy their bonds based on the knowledge that the board of directors has certain roles and responsibilities in normal and exceptional situations. Mezzanine class investors who lack loan-level oversight infrastructure need the advocacy provided by board members if the financial interest of

subordinate investors, who bring unique governance infrastructure themselves, is ever eliminated due to credit losses.

While being a board member of a corporation is a privilege, it carries weighty responsibilities. Typically, board members focus on governance matters related to the stated policies of the company. Independent board members rarely come from a competitor of the company due to confidentiality and competitive concerns. Board members do not hold themselves out as experts in every detail related to the business. However, they have obligations to do some testing as a result of their duties. If they do not have expertise in a certain matter, they typically have the company engage outside sources to comfort them. REIT board members do not usually focus on every nuance of each loan; they make sure the operators (e.g., originators and servicers) are doing their job to the standard that the stakeholders agreed to upfront. Board members act like an owner's representative. They are paid by the company and are under a fiduciary duty to focus on the interests of the company or its stakeholders as a whole over the more parochial interests of the management or individual stakeholders. Not only are board members investigators, they are decision-makers and guides to management as the business environment and rules of play constantly change. Importantly, the board is a meaningful contributor to the company's market capitalization. Adhering to the highest of all laws, regulations and industry protocols is a key focus for board members. Failing to comply with applicable laws, to the letter, is not an option.

Why, then, is it that real estate, corporate and consumer loan securitization trusts and pools of whole loans do not have a similar party to fill this role? As in public market REITs, subordinate investors sometimes provide a portion of this role, but their interests are limited to their investment and not the interests of the investors collectively. Once their interest is reduced to zero due to credit losses, there is no advocate for the mezzanine investors and the more senior investors. This has resulted in many losses and a lack of confidence in the past.

The securitization trustees frequently say they are not fiduciaries for securitizations. So who is? Would the rating agencies penalize a public REIT's debt, in terms of its debt rating, if it did not have a board to step in when things went wrong? If each subprime residential securitization trust had an entity akin to a board of directors that was charged with making sure the trust was not a "dumping ground" for less desirable loans, would it have reduced the financial debacle of 2007 and 2008? If each subprime residential securitization trust had proactively provided oversight of loan servicers, many of them operationally distressed or at or near bankruptcy, would it have reduced the financial debacle of 2007 and 2008? We believe that the answer is emphatically "YES" to each of these questions.

Governance is not about a master servicer watching over a special servicer. It is about ongoing governance, systematic compliance testing and delegated authorities to be used in exceptional circumstances. Master servicers tend to focus on individual loan issues over long periods of time rather than on the trust as a whole. Governance experts make more holistic decisions about the strengths and weaknesses of a servicer and move to new operations vendors when necessary.

Governance is also not about servicers watching over other servicers. This is like Coke being asked to watch over Pepsi, or in the mortgage industry like subprime originator #1 watching over subprime originator #2, or vice versa. A system in which competitors watch over each other is not a best-in-class solution. In CMBS, we are seeing investors and servicers reaching out to specialty governance firms, not other special servicers, to arbitrate CMBS 1.0 servicing problems. There is a reason: conflict concerns with other parties.

While we believe the analogy between a corporate board member and an OA is appropriate in some respects, we wish to emphasize we are not suggesting that an OA be a fiduciary to the trust. The

trustee is already tasked with serving this role to the trust. We propose a bifurcated role between the OA and the trustee who will continue to handle all cash, reporting and voting management.

We propose a combination of governance and operational enhancements that collectively seek to act as volatility-mitigating tools for structured finance products. The goal is to provide confidence to bond investors that new structured finance deals will have adequate backstops built into their structures when needed. This confidence will be critically important if the Enterprises wish to transfer the credit risk to investors or other third parties. Working with subordinate investors is an art, but we see many grounds of cooperation.

We agree with some in the market that introducing this party may help private label RMBS trade at spreads more in line with corporate bonds, which in turn, will help restart the private label RMBS market and cultivate the transition from an Enterprise guarantee model to the type of new securitization platform envisioned by the White Paper.

The concepts described herein incorporate a few new corporate-like features into the existing and well-proven securitization trust mechanics. These concepts are not intended to be a wholesale rewrite of trust governance; rather, they supplement the existing protocols.

We believe a new securitization platform should consider having the OA be an integral part of the team of vendors in a trust from the beginning. If there is a trustee included, there should be an OA. We are encouraged by growing market acceptance of this new role in private and government securitizations (including RMBS, ABS, and CMBS), pools of whole loans, and in post-litigation settlement and regulatory compliance situations, among others.

We agree with the White Paper that "the securitization platform must be flexible enough to adapt to the evolving standards…." In this respect, it is virtually impossible to predict the future and devise a set of policies and procedures that will work perfectly to operate a securitization trust in all environments. A standby specialist engaged by the trust with governance and workout experience is needed. This specialist should not only be empowered to address and repair issues that have negative consequences for the trust but also be subject to certain constraints, to assure all investors that it will not introduce new risks.

We encourage the FHFA to look at this new role as a tool to supplement the fiduciary role that trustees are not designed to fulfill. With that said, legal protections are needed to ensure that the OA does not become a litigation target as it tries to do the "right thing." Such protections have been provided to arbitrators in the securities disputes through federal law and FINRA. Similar protections may be applicable here. Due to the ground breaking ideas in this concept, independent insurance is not currently available in the private market.

Our perspectives and opinions are formed with one clear objective in mind: to provide balanced oversight of trust activities so that all investors, regardless of the size or seniority of their stake, can be assured of having fair representation when collateral or operational matters deviate from contracted obligations. The recent history of (1) large scale rep and warranty settlements within the RMBS arena; (2) lawsuits against transaction underwriters; (3) sanctions against residential mortgage originators and servicers for faulty practices; (4) growing concerns about rating agency effectiveness; (5) recent findings of meaningful inconsistencies in new deals; and (6) incomplete disclosures by servicers, and a host of other past activities, buttress the notion that focused oversight could have helped to defray much of the damage that is still being experienced today. We ask the FHFA to keep this in mind as it constructs a new securitization platform for the Enterprises.

C. Incorporating an Independent Oversight Role is Consistent with Proposed Federal Regulations and Current Best Practices

As the examples below demonstrate, since the financial crisis, the securitization markets and regulators have widely accepted the benefits of having an independent party to serve in an oversight role.

- In April 2010, the Securities and Exchange Commission ("SEC") proposed to require as a condition to shelf eligibility that the PSA for the securitization contain a specified provision to enhance the enforceability of the reps and warranties. The specified provision would require that, if a breach of a rep and warranty was asserted and the obligor denied the claim, the obligor would be required to furnish an opinion from an independent third party that the asset did not violate a rep and warranty contained in the PSA.

- In July 2011, the SEC re-proposed the shelf eligibility criteria to include a requirement that the PSA require that the trustee appoint an independent credit risk manager to review the underlying assets upon the occurrence of certain trigger events and provide its report to the trustee of the findings and conclusions of the review of the assets. In addition, the PSA would be required to include certain provisions in order to resolve rep and warranty disputes, such as through arbitration.

- In March 2011, the Federal banking agencies, the FHFA, the Department of Housing and Urban Development, and the SEC jointly proposed the risk retention rule under Section 941 of the Dodd-Frank Act. Included in the risk retention proposal was the requirement that, in certain situations, an independent "Operating Advisor" would be required to be in the transaction in order to monitor activities related to special servicing.

- In August 2011, the American Securitization Forum released its Model Repurchase Principles, which recommended, among other things, the role of a new "independent reviewer" that would have access to the files of applicable mortgage loans to determine if a breach has occurred and a mechanism for the investigation and resolution of disputes regarding breaches of reps and warranties.

- Since 2009, private label CMBS conduit transactions have included an Operating Advisor as an additional party to the PSA with responsibility for oversight of special servicing for the benefit of all investors.

D. The Importance of Independence

The cornerstone of well-designed governance is that investors are able to trust the independence of the oversight party. Like a corporate board member, complete independence allows investors to trust that the judgment and recommendations of the oversight advisor are free of conflicts of interest. Without independence being firmly rooted as a requirement at all times, investors are likely to distrust the structural design of the governance advisor in stressed environments.

We believe that independent oversight goes hand-in-hand with enhanced transparency, as improved transparency only occurs if investors are able to trust the disclosure they are provided. In an improperly designed oversight structure of questionable independence, investors may not trust an OA's opinion regarding a breach of a rep and warranty or servicing failure because that OA's affiliate performed due diligence on the collateral prior to the securitization. Similarly, investors may not trust the OA's review of the repurchase request if its affiliate or related party is a competitor of the obligated party.

Therefore, we are writing to strongly encourage the FHFA to include robust independence requirements for a party to be qualified to serve as an OA. To provide our specific recommendation, we suggest that the new securitization platform include the following independence criteria for a party to be eligible to serve as an OA:

> The Operating Advisor should neither (1.) be affiliated with, (2.) have a material relationship with, nor (3.) have a material financial interest in, any sponsor, originator, depositor, servicer, pool asset, investor, or obligor of a pool asset in the securitization. Further, the Operating Advisor should not be engaged, or through an affiliate be engaged, in the business of a depositor, originator, servicer, sponsor, or collateral due diligence provider.

A "material relationship" could include (i) providing audit services to, (ii) having an active and/or material ongoing referral relationship with, (iii) having a principal investment in, (iv) providing legal services to, or (v) being an active principal trading counterparty with, a participant or pool asset in the securitization. Also, with respect to a pool asset or obligor of a pool asset, a "material relationship" could include maintaining servicing responsibility or engaging in pre-closing collateral due diligence services on the subject pool asset (such as by providing pre-closing collateral due diligence for the sponsor, originator, any prospective and/or actual investors (regardless of whether such prospective investor consummated an investment), etc.), or having an ownership interest in any such pool asset or obligor, such as through ownership in another part of the capital structure in the reference deal or CDO/re-REMIC aggregation activities.

Further, if an OA is affiliated with an investment manager who runs positions in both the senior and/or junior levels on a securitization, this situation could also create the appearance of conflicts of interest when certain putbacks or workouts are high profile. In addition, collateral due diligence firms typically have strong financial relationships with parties related to a trust (creator or investor) on other matters and they may have biases based on other business flows. The OA should be as independent as possible from the securitization assets and the entities that are involved in creating or buying any related interest.

We believe the above independence requirement is critical to help ensure that investors and other market participants have confidence in the party serving as OA in stressed environments. Because bonds frequently change hands over time, we must anticipate that the initial parties are only the first step in independence.

E. Trustees and the Role of the Operating Advisor

While it may be possible in some circumstances to assign OA tasks to the role of the trustee, we are skeptical that the trustee market would be willing to perform these additional tasks given the hesitancy of trustees to engage in these types of activities. In particular, it is relevant to review the Trust Indenture Act of 1939 and relevant statutory and case law to understand why structured finance bond trustees have shied away from providing these kinds of services in the past. Therefore, we suggest requiring that the independent party actually be independent of the trustee, or in the alternative, provide the trustee with the authority to hire an independent party to provide these services, similar in many respects to the ability of the trustee to hire outside counsel to opine on certain matters.

F. Summary

In conclusion, Pentalpha firmly believes that a new securitization platform should incorporate better trust governance practices for both pre-closing and post-closing matters, such as those related to improved rep and warranty compliance and workout oversight by the servicer. Further, the new securitization infrastructure should include an independent party to perform these tasks.

*   *   *   *

Pentalpha has been a thought leader in the design of better trust governance since the financial crisis, and we very much appreciate the opportunity to provide the foregoing comments. To supplement our letter and to provide additional specifics of OA tasks, we have attached our recent Discussion Paper titled, "Best Practices in Trust Governance." Should you have any question or desire any clarification concerning the matters addressed in this letter or in the attachment, please do not hesitate to contact me at (203) 660-6112 or james_callahan@pentalphaglobal.com, or Pentalpha's outside counsel on this matter, Jay Knight of Bass, Berry & Sims PLC at (615) 742-7756 or at jknight@bassberry.com.

Sincerely,

/s/ Jim Callahan

Jim Callahan
Executive Director
Pentalpha Surveillance LLC

Attachment: Discussion Paper

DISCUSSION PAPER

Presented by

Pentalpha Surveillance, LLC

Best Practices in Trust Governance

Minimizing Systemic Risk By Building Confidence: A New Model for the Operational Oversight of Pools of Loans

Proposed Governance Enhancements to Improve the Performance of Loan Pools Collateralized by Real Estate, Corporate and Consumer Debt Obligations

Applicable to Origination, Servicing, and Disclosure Oversight of:

Existing and New Securitizations (Private and Government)
Collateralized Short Term Loan Agreements
Covered Bonds
Pools of Whole Loans
Post-Litigation Settlement Monitoring

Monitoring of Critical Vendors Working for Originators and Servicers

September 2012

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Note to Trade Associations

Pentalpha Surveillance, LLC and its affiliates actively participate in numerous collateral segments. As the concepts in this discussion paper span many collateral segments, many trade associations are involved. Therefore, we have presented this broadly to the investment and banking communities (including some regulators) and not through one specific association. We look forward to working with the various industry associations and all participants in the various collateral segments to enhance these trust governance concepts. We would welcome an opportunity to participate in special subgroups on trust governance, if requested.

Section V outlines some more specific thoughts on how we could best work with trade associations and other interested parties to see if these proposed concepts should be implemented. We believe that the industry associations could provide material value in discussing, and possibly helping implement, the items outlined herein.

Preamble

With the benefit of hindsight, we know that the systemic breakdown of the structured finance markets was a key contributor to the financial crisis. As stated in the Financial Crisis Inquiry Report:

> Put simply and most pertinently, structured finance was the mechanism by which subprime and other mortgages were turned into complex investments often accorded triple-A ratings by credit rating agencies whose own motives were conflicted…When the bubble burst, the complexity bubble also burst: the securities almost no one understood, backed by mortgages no lender would have signed 20 years earlier, were the first dominoes to fall in the financial sector.

After the financial crisis, market participants in all collateral segments underwent a thoughtful and reflective process in order to learn from the mistakes that led us to the brink. The results of these efforts have been greatly improved trust governance concepts. We are pleased to have been a part of these efforts and to be a leader in many trust governance services.

Recent developments in trust governance practices, such as the weakening role of the Operating Advisor ("OA") in commercial mortgage-backed securities ("CMBS") transactions and the increasing concerns related to OA independence, have called into question the positive governance strides that the markets have made in the last few years. We think it is time to learn from our mistakes and create a top-down work plan to make sure the markets do not repeat these mistakes again. It is through this lens that we present in this Discussion Paper important governance improvements that could be introduced in all collateral segments to help restart the markets and cultivate a sustainable structured finance system through multiple economic cycles.

The concepts outlined in this Discussion Paper are born out of the fundamental governance concept used by publicly-held corporations, which is that the business and affairs of the organization should be overseen by an independent body from management. This body, known as the board of directors, not only provides strategic direction for the firm, but also serves as a check-and-balance on the day-to-day operations of management. The directors, in turn, inform, and are overseen by, the owners of the firm, the shareholders.

By way of example, public mortgage real estate investment trusts ("REITs") buy and service mortgage loans. As public companies registered with the SEC, they typically have a board of directors and sell equity and various levels of debt. Among other things, the board members, in their capacity, are charged with various duties. Many times, the board is supposed to provide assurance to financial stakeholders that all of the operations related to acquiring and managing loans are in compliance with the company's stated practices and applicable laws and regulations.

The board members also stand by to address exceptional situations. Subordinate investors in these REITs buy their bonds based on the knowledge that the board of directors has certain roles and responsibilities in normal and exceptional situations. Mezzanine class investors who lack loan-level oversight infrastructure need the advocacy provided by board members if the financial interest of subordinate investors, who bring unique governance infrastructure themselves, is ever eliminated due to credit losses.

While being a board member of a corporation is a privilege, it carries weighty responsibilities. Typically, board members focus on governance matters related to the stated policies of the company. Independent board members rarely come from a competitor of the company due to confidentiality and competitive concerns. Board members do not hold themselves out as experts in every detail related to the business. However, they have obligations to do some testing as a result of their duties. If they do not have expertise in a certain matter, they typically have the company engage outside sources to comfort them. REIT board members do not usually focus on every nuance of each loan; they make sure the operators (e.g., originators and servicers) are doing their job to the standard that the stakeholders agreed to upfront. Board members act like an owner's representative. They are paid by the company and are under a fiduciary duty to focus on the interests of the company or its stakeholders as a whole over the more parochial interests of the management or individual stakeholders. Not only are board members investigators, they are decision-makers and guides to management as the business environment and rules of play constantly change. Importantly, the board is a meaningful contributor to the company's market capitalization. Adhering to the highest of all laws, regulations and industry protocols is a key focus for board members. Failing to comply with applicable laws, to the letter, is not an option.

Why, then, is it that real estate, corporate and consumer loan securitization trusts and pools of whole loans do not have a similar party to fill this role? As in public market REITs, subordinate investors sometimes provide a portion of this role, but their interests are limited to their investment and not the interests of the investors collectively. Once their interest is reduced to zero due to credit losses, there is no advocate for the mezzanine investors and the more senior investors.

The securitization trustees frequently say they are not fiduciaries for securitizations. So who is? Would the rating agencies penalize a public REIT's debt, in terms of its debt rating, if it did not have a board to step in when things went wrong? If each subprime residential securitization trust had an entity akin to a board of directors that was charged with making sure the trust was not a "dumping ground" for less desirable loans, would it have reduced the financial debacle of 2007 and 2008? If each subprime residential securitization trust had proactively provided oversight for loan servicers, many of them operationally distressed or at or near bankruptcy, would it have reduced the financial debacle of 2007 and 2008? We believe that the answer is emphatically "YES" to each of these questions.

Governance is not about a master servicer watching over a special servicer. It is about ongoing governance, systematic compliance testing and delegated authorities to be used in exceptional circumstances. Master servicers tend to focus on individual loan issues over long periods of time rather than on the trust as a whole. Governance experts make more holistic decisions about the strengths and weaknesses of a servicer and move to new operations vendors when necessary.

Governance is also not about servicers watching over other servicers. This is like Coke being asked to watch over Pepsi, or in the mortgage industry like subprime originator #1 watching over subprime originator #2, or vice versa. A system in which competitors watch over each other is not a best-in-class solution. In CMBS, we are seeing investors and servicers reaching out to specialty governance firms, not other special servicers, to arbitrate CMBS 1.0 servicing problems. There is a reason: conflict concerns with other parties.

In the pages that follow, we present the case for a new paradigm of securitization and other loan pool performance: that of an enhanced role for a party that, at the current time, has been engaged to do some, but not all, of what we are asking the industry to consider. In recent industry discussions, this

party has been referred to in a number of ways, including, in the residential mortgage-backed securities ("RMBS") arena, Trust Oversight Advisor ("TOA") and Credit Risk Manager ("CRM"), and, in the CMBS arena, Senior Trust Advisor ("STA") and Operating Advisor. In order to merge these concepts, we propose calling this newly enhanced party the Operating Advisor regardless of asset class.

We believe the OA's oversight function to date has been lightly valued by some industry participants and sub-optimally compensated. However, if the points contained in this Discussion Paper are adopted, in part or in whole, enhanced levels of oversight and dispute resolution will result, with a commensurate but well-deserved increase in compensation for the providers of this service.

While we believe the analogy between a corporate board member and an OA is meaningful to the reader, we wish to emphasize we are not suggesting an OA be a fiduciary to the trust. The trustee is already tasked with serving this role to the trust. We propose a bifurcated role between the OA and the trustee who will continue to handle all cash, reporting and voting management.

We propose a combination of governance and operational enhancements that collectively seek to act as volatility-mitigating tools for structured finance products. The goal is to provide confidence to bond investors that new structured finance deals will have adequate backstops built into their structures when needed. We want structured finance products (such as asset-backed bonds, mortgage-backed bonds, whole loan pools, insurance-like contracts, etc.) to trade at spreads more in line with corporate bonds, which in turn, will help restart international asset financing and a more robust economic recovery. The concepts provided herein incorporate a few new corporate-like features into the existing and well-proven securitization trust mechanics. These concepts are not intended to be a wholesale rewrite of trust governance; rather, they supplement the existing protocols.

We believe industry leaders should consider having the OA be an integral part of the team of vendors in a trust from the beginning. If there is a trustee included, there should be an OA. We believe this new role is applicable in private and government securitizations (including RMBS, ABS, and CMBS), pools of whole loans, and in post-litigation settlement and regulatory compliance situations, among others.

Overall, the governance enhancements introduced by the Federal Reserve Banks and Federal Deposit Insurance Corporation ("FDIC") as well as the enhancements introduced by the CMBS industry (including the CRE Finance Council, JPMorgan Chase, Wells Fargo, and others) are meaningfully better than historical practices. However, more governance improvements are needed in order to reduce systemic risk and build investor confidence. These enhancements should be developed in concert with these other regulatory and industry enhancements.

It is virtually impossible to predict the future and devise a set of policies and procedures that will work perfectly to operate a securitization trust in all environments. A standby specialist engaged by the trust with governance and workout experience is needed. This specialist should not only be empowered to address and repair issues that have negative consequences for the trust but also be subject to certain constraints, to assure all investors that they will not introduce new risks. The corporate debt market has devised a way for all of these participants to work together as a team. The spreads on corporate bonds generally trade tighter than option adjusted spreads on structured finance bonds for a reason: better governance and better confidence. Now is the time for the structured finance market, which is materially larger than the corporate debt market, to incorporate the same parallel governance features.

Enhanced governance is critical to the future success of all types of U.S. and international real estate, consumer and asset-backed securitizations. The underlying collateral type should ultimately not cause quality governance standards to vary for structured products. Enhanced governance needs to be adopted for all product types, deal structures and asset classes—whether closed-end or revolving trusts, large loans or conduits. There is not one "macro" solution to create improved trust governance. There are a host of small individual improvements that are needed.

Regulators are encouraged to look at this new role as a tool to supplement the fiduciary role that trustees are not designed to fulfill. With that said, legal protections are needed to assure the OA does not become a litigation target as it tries to do the "right thing." Such protections have been provided to arbitrators in the securities disputes through federal law and FINRA. Similar protections may be applicable here. Due to the ground breaking ideas in this concept, independent insurance is not currently available in the private market.

Additionally, the enhancements suggested herein do not seek to replace the credit risk retention proposal jointly issued by the federal regulators or the "shelf eligibility" proposal issued by the SEC. Instead, these best-in-class recommendations seek to act like another "first loss protection" and to complement these regulatory reforms. Collectively, this is a best-in-class solution.

Our perspectives and opinions were formed with one clear objective in mind: to provide balanced oversight of trust activities so that all investors, regardless of the size or seniority of their stake, can be assured of having fair representation when collateral or operational matters deviate from contracted obligations. The recent history of (1) large scale rep and warranty settlements within the RMBS arena; (2) lawsuits against transaction underwriters; (3) sanctions against residential mortgage originators and servicers for faulty practices; (4) growing concerns about rating agency effectiveness; (5) recent findings of meaningful inconsistencies in new deals; and (6) incomplete disclosures by servicers, and a host of other past activities, buttress the notion that focused oversight could have helped to defray much of the damage that is still being experienced today. We ask readers to keep this in mind as they explore the body of this document.

We recognize that throughout this document there are individual components the reader may take exception with given the diversity of the markets and collateral type. Nonetheless, we encourage the reader to look at the broader intent and principles of these concepts and what they are intended to accomplish in their totality.

We would be most pleased to discuss these concepts with interested parties. To do so, please contact James Callahan, Executive Director of Pentalpha Capital Group, at (203) 660-6112 or james_callahan@pentalphaglobal.com. We welcome your feedback.

Executive Summary

Section I presents recommended OA tasks that we believe are best practices in trust governance and oversight. These tasks are divided into transaction pre-closing tasks, post-closing tasks related to collateral quality review, and post-closing tasks related to servicing operations oversight. As this Discussion Paper is intended to provoke thoughtful collaboration on concepts, the tasks are generally principle-based. This section also provides practical examples of how these tasks could be incorporated into current deals.

The following are our recommended OA tasks for optimal trust governance:

- Pre-Closing Tasks:
    - Duty to review applicable transaction documents with a view toward enhancements, such as operational process deficiencies, rep and warranty compliance procedures, and ambiguous or missing definitions.
- Post-Closing Tasks Related to Collateral Quality:
    - Duty to conduct collateral quality reviews, including sampling loans in the pool for rep and warranty compliance;
    - Duty to refer potential rep and warranty violations to the trustee and/or servicer;
    - Duty to oversee disclosure to investors of OA rep and warranty referrals; and
    - Discretion to recommend to the trustee that it initiate binding arbitration on put-back demands that are not resolved timely.
- Post-Closing Tasks Related to Servicing Oversight (using CMBS as example):
    - During a Subordinate Control Period-
        - Duty to conduct periodic face-to-face meetings with the servicer;
        - Duty to monitor the monthly Early Payment Default (EPD)/watch list loans;
        - Duty to review certain specific reports, including final asset status reports;
        - Duty to prepare an annual report to investors setting forth the OA's assessment of whether it believes, in its sole discretion exercised in good faith, that the servicer's performance on a "platform-wide basis" complies with the servicing standard as defined in the governing documents with respect to the resolution and liquidation of specially-serviced loans; and

        - Discretion to put servicer removal to an investor vote. (During the subordinate control period, the OA would not have prior consultative rights with respect to special servicing decisions.)

    - During a Co-Consultation Period-

        - OA continues to have the duties from the Subordinate Control Period, plus-

        - Duty to consult with the servicer and subordinate investor with respect to the servicer's resolution plan reports for individually troubled loans. The servicer would not be obligated to act on the OA's recommendations; and

        - Duty to review and recalculate the servicer's net present value (NPV) calculations for numerical accuracy and reasonableness of assumptions.

    - During a Senior Control Period-

        - OA continues to have the duties from the Subordinate Control Period and Co-Consultation Period, plus-

        - Duty to consult with the servicer in the creation and implementation of an individual loan's workout plan, including approving all major servicing decisions.

- Post-Closing Tasks Related to Investor Information:

    - Duty to submit required annual assessment on Reg AB compliance with applicable servicing criteria;

    - Discretion to hold semi-annual conference calls with investors arranged through the trustee; and

    - Discretion to answer one-off inbound calls to OA at any time.

In Section II, we set forth our recommended OA qualifications, both in terms of independence and in terms of depth of experience. We believe some of these criteria are so critical to the function of the OA concept that, if not already incorporated into regulation, we encourage their implementation by rulemaking initiatives (e.g., risk retention rulemaking, SEC shelf eligibility standards, GSE initiatives, etc.) after interaction with industry representatives. With respect to other criteria, we encourage their adoption through industry best practices and other market initiatives.

We recommend the following minimum regulatory requirements for the OA to be qualified to perform the services described above:

- In an SEC-registered transaction, the OA must be Reg AB compliant and provide an attestation report from a registered public accounting firm on the OA's compliance with Reg AB's applicable servicing criteria; and

- The OA should not be affiliated with, nor have a material relationship with or material financial interest in, any sponsor, originator, depositor, servicer, pool asset, or obligor of a pool asset in the securitization, nor be engaged, or through an affiliate be engaged, in the business of a sponsor, originator, depositor, or servicer.

In addition to the regulatory requirements set forth above, we suggest for industry discussion the following best practices for OA qualification: (A more detailed list with analysis is found in Section II.)

- The OA should be free of competitive conflicts;

- The OA should have an established history of analyzing defaulted loans on a large scale basis and making operational decisions and recommendations on how to proceed in a disputed situation, and working with servicers in a mutually respected, non-adversarial fashion that improves collateral performance;

- The OA should have significant experience reviewing rep and warranty compliance as well as defaulted loan workouts made by others to understand the tolerances of the applicable standard;

- The OA should maintain an active practice of evaluating loan originators and servicers for compliance purposes via detailed onsite interviews and other analysis;

- The OA should possess a reputation of holding well-administered auctions of loans and/or REO property for owners of challenged loans with established lists of direct investor contacts;

- The OA should be capable of performing the required tasks without significant outsourcing;

- The OA should be committed to the loan surveillance business as a core business;

- The OA should have written operating policies and procedures consistent with federal guidelines, such as FINRA standards (or better), regarding tools to reduce the risk of insider trading conflicts, confidentiality breaches, email retention policies, and bond market trading practices; and

- The OA should have the technological systems necessary to fulfill its duties.

Section III anticipates industry discussion on these topics and presents our answers to various questions that a reader may ask. For example, why should issuers embrace these recommendations? In response to this question, we say that issuers should embrace these concepts because we believe they will create more confidence in the structured finance markets, which will lead to more demand for the product, which will lead to more deal volume, which will lead to more secondary trading opportunities.

Or, in the words of an economic aphorism, “a rising tide lifts all boats.” Thus, the idea is that improvements in the general structured finance market will benefit all participants in the market, including issuers, originators, servicers, dealers, trustees, operating advisors and investors.

In Section IV, given the variable nature of OA services, we suggest for industry discussion a movement toward a variable fee framework for OA compensation. We believe this will better align the OA’s financial interest with those of stakeholders, especially toward the end of the deal’s life. The idea is that compensation should consist of a modest fixed fee for easily determinable work such as annual reviews and monitoring certain current loans, but when the OA is required to perform additional work, its compensation should be adjusted accordingly. We believe a best-in-class model would take the form of a fixed fee framework for pre-closing tasks and a variable fee framework for post-closing tasks such as representation and warranty compliance-related work and servicing operations oversight. With respect to servicing operations oversight, the compensation structure we propose is divided into four categories: (1) fixed monthly services, (2) defaulted loan servicing oversight, (3) special projects, and (4) Reg AB compliance. We also discuss the appropriate adjustments to the recommended compensation framework to reflect differences in CMBS, RMBS and ABS oversight.

Finally, Section V presents our conclusion and a call to negotiate with those interested in improving trust governance. This is a discussion paper and not a specific proposal. Importantly, we appreciate that each international collateral sector has its own technicals and deserves specialized modification to these base concepts. We hope the reader embraces the goal of the concepts and provides constructive feedback on the collateral-specific technical components so that workable solutions can be acceptable to the relevant parties.

Section I: Recommended Operating Advisor Tasks

These concepts are suggested as best-in-class governance recommendations that would be complementary to the existing regulatory language and industry recommendations that have been proposed. It is not a replacement of them.

The following proposed tasks are based on a two-tiered system of individual loan performance items and, to assure basic trends are also addressed, pool-level activities. This is an important differentiation. Sometimes rules at the loan-level are insufficient, and pool-level items must also be incorporated as a backstop.

Importantly, these recommended tasks relate to best practices in trust governance and oversight (i.e., similar to the oversight function of a director). They do not relate to the master servicing function, which is materially different. The distinction is critical as the OA framework is premised on the notion of oversight of the entire trust, whereas the master servicer serves the function of day-to-day operations related to individual loans. Many deals had master servicers and still failed.

While we appreciate that not all parties may embrace all of the proposed concepts herein, we are trying to be leaders in our thinking. The result will be a reliable financing tool for lenders and investors.

1. Transaction Pre-Closing Tasks

a. Affirmative pre-closing duty to review transaction documents with a view toward enhancements

As the OA will be responsible for interpreting transaction documents and overseeing other trust vendors' compliance to such, it is in the best interest of all parties that the OA ensures the trust's legal documents can be "operationalized" with identified timelines and free of operational ambiguity. To ensure this, the OA should be hired before the trust is legally established or shortly thereafter. Before investors are offered any securities, the OA should review all relevant transaction documents (Offering Memorandum ("OM"), Free Writing Prospectus ("FWP"), Pooling and Servicing Agreement ("PSA"), etc.) and seek to enhance, where needed:

i. Operational process deficiencies;

ii. Rep and warranty compliance procedures;

iii. Ambiguous or missing definitions, especially with regard to the definitions of the fair value standard, the origination standard or the servicing standard, and the specifics of the OA's required tasks. We recommend the leading OAs work with the industry associations to do this. It is highly technical work that has not been satisfactory to all parties to date;

(1) The fair value buyout provision in older CMBS deals is a classic example of this ambiguous provision because the underlying PSA failed to provide a precise definition of "Fair Value." There were hundreds of billions of

those deals done. We continue to see unintended ambiguities in deals that could be very problematic in the future.

b. Other potential pre-closing duties for industry discussion are as follows:

i. Create financial incentives or disincentives if certain reports (appraisals, rent rolls, etc.) are not posted by the servicer on a timely basis with agreed upon granularity.

(1) Investors have suggested a fee holdback to the appropriate party (servicer, special servicer or trustee) if asset-level reports are not posted on the trustee's website on a timely basis. (The OA could be compelled to ask the trustee to hold back payments if certain items are not disclosed on a timely basis). Another concept is to require the servicer or trustee to pay penalties to the trust if such party does not report on time. However, discretion must be available, as the borrower could be responsible for many delays.

ii. Minimize the risk that affiliates of the servicer or the special servicer can be additionally compensated through affiliated transactions or rebates. While these arrangements may ultimately prove to be beneficial to the trust, any such non-arms-length transactions need to be disclosed and monitored to assure there are no conflicts or disincentives.

iii. Review rep and warranty procedures to assure that special, one-time incentive fees paid to the servicer to successfully put back "bad" loans (i.e., representation and warranty flawed) are greater than potential delinquency fees paid to the servicer if it waits for the loan to default. This affects performing and non-performing loans. Certainly, watch-list loans in the initial 24 months are candidates for special review for origination flaws. Simply being placed on a watch list does not necessarily imply they are rep and warranty violation candidates, but the loans should be checked by an independent party who has a financial incentive to make sure it is not a "bad" loan.

Note*:* We have recently engaged industry leaders to improve certain watch list definitions and criteria so that loans are not put on the watch list erroneously.

iv. Oversee the selection of the rating agency on behalf of investors if a workable voting mechanism can be established.

v. Ensure the custodian and servicer agree to a complete list of items that are needed in each loan file for the file to be considered "full." Experience has shown that foreclosures have been stalled due to improper upfront loan documentation, validation and storage.

(1) Collateral file completeness check

(a) Review the custodial agent's check-in of all loan and servicer file documents.

(i) Discuss any shortfalls with the master servicer so that it can put back deficient loans to the seller or direct an immediate repair.

(ii) Confer with the trustee to consider available legal actions if resolution by the servicer is not finalized in a timely fashion. Mandatory binding arbitration is a possibility if agreed upon upfront.

(b) The OA could seek a final tie-out letter by the custodian by the 180th day of the trust's life. Any loan that is not 100% populated with the required items would be presumed to be a put-back candidate. (There could be legitimate reasons for a waiver of an incomplete loan file, especially for performing loans, but logic suggests nothing should go longer than 180 days).

(2) Legal file completeness check

(a) A legal file checklist facilitates collateral quality compliance testing. What are the necessary items relative to the representation and warranty that was given? Divide the tasks between the origination process and the bond offering disclosure process. These are two very different representations and warranties.

(b) Make sure there is synchronization among the various documents as to key definitions and operational procedures to check and rectify a problem. The OA community should agree to meet with the industry associations to devise a best practices document on this subject. As an example, there needs to be clarity whether an 81% LTV loan should be put back if it is represented to be 80% LTV in the closing documents. The focus should be on the "tolerance" or standard of care within each type of representation and warranty including:

(i) Stated representations;

(ii) Materiality representation; and

(iii) Knowledge qualifier representation.

2. Post-Closing Tasks Related to Collateral Quality Review

Despite the daily reminder of widespread rep and warranty breaches in past RMBS deals, the market has yet to develop a best practice that satisfies senior investors and regulators for checking whether loans in the pool actually meet the reps and warranties in the deal documents. In fact, some recent deals have even expressly warned investors that no party to the PSA is under a duty or obligation to review the mortgage loans to determine whether the reps and warranties made by the loan seller are actually true. Moreover, the governing documents in past residential deals were woefully designed to practically address rep and warranty problems even when breaches were discovered. In some cases, the provisions of such documents were actually internally inconsistent.

The lack of a clear resolution process for rep and warranty violations has led to billions of dollars of unresolved repurchase claims remaining on the books of the country's largest banks for months and years. To date, there still has not been a workable solution proposed for such repurchase claims. We must learn from our mistakes or else we are bound to repeat them.

The following subsections provide our recommended solution and rely on the OA as a key participant in collateral quality reviews.

a. **Affirmative post-closing duty to conduct collateral quality reviews**

While the servicer is usually required to put back any flawed loans it uncovers as part of normal servicing operations, servicers are not always incented to actively look for flaws and effectuate the put-back process. In reality, many servicers are affiliates of the depositor (the party making the representation), and thus, are not interested in putting back a loan to its affiliate. Therefore, we recommend the OA perform sampling on a pro-active basis as a secondary filter behind the scenes to determine if the loans in the pool are consistent with the representations made in the offering documents. The following can be viewed as a new "multi-tiered sampling and dispute resolution process" regarding loan quality:

i. Rep and Warranty Compliance Sampling: Two different groups of samples should be made: (1) a fixed percentage selected randomly, and (2) a larger sample based on delinquent loans early in the trust's life, if any.

(1) Fixed percentage random sampling: At a minimum, the OA should re-underwrite, or cause the trustee to hire an approved third party to re-underwrite, a small fixed percentage of the critical elements of the loan information (that vary by collateral type) for compliance with the loan tape included in the offering document information.

(a) The only reason the trustee would be asked to hire an outside vendor is to follow existing governance protocols found in the corporate market where the company hires certain vendors to satisfy the board, if the board has a concern. With the exception of spot checking to identify if a concern has basis, the "board" should review vendor work product as opposed to being the source of the analysis.

(b) Even though the subordinate investor in CMBS usually does similar work, best practice calls for the OA to perform its own review and not solely rely on reviews conducted by subordinate investors. Some subordinate investors do not review certain loans because of technical reasons, and long term relationships with parties in the trust can create conflicts of interest. Additionally, subordinate investors can adjust their purchase price lower and accept less desirable loans, which may not be picked up by the rating agencies.

(c) Each collateral segment will have its own technicals, and adjustments should be made depending on the pool collateral. For example, there are material differences in the OA's rep and warranty sampling duties when the pool assets are three commercial real estate loans versus 2,000 residential loans.

(2) <u>Delinquent loan sampling</u>: The OA should re-underwrite, or cause a third party to re-underwrite, a meaningful portion of all loans that go 60+ days delinquent for a set period of time. For example, the OA should cause:

(a) A review of 100% of 12 month Early Payment Defaults (EPD) for residential loans and 50% of 24 month EPD/watch list loans for commercial real estate loans. To facilitate this review, the transaction documents must clearly define these terms. The OA should look for specific underwriting and servicing errors, such as but not limited to:

(i) Borrower qualification and loan closing process breaches;

(ii) Collateral value concerns;

(iii) Excessive use of manual exceptions to the loan underwriting policies (special attention should be given to this issue, which is clearly a major concern in residential loan origination); and

(iv) Other tasks as may be dictated by individual deal idiosyncrasies.

(b) As a backstop, if 10% of loans in the adverse selected pool are found to be "flawed," then the OA should instruct the trustee to engage a third party due diligence firm to re-underwrite a higher percentage of the portfolio, perhaps as much as an additional 15-20%. Like a corporate board member that is not responsible for covering the cost of engaging third party services, this expense should be paid by the trust similar to other variable expenses.

(i) The initial sampling should be done by the OA using in-house resources. If the pool appears problematic to the OA based on its sole discretion exercised in good faith, then the OA should direct the trustee to hire an independent third party vendor to perform additional due diligence. This would effectively separate the OA from being the "investigator" versus the "prosecutor."

b. **Affirmative duty to refer potential rep and warranty violations to trustee and/or servicer**

i. If the OA finds that the flaw is systematic or crosses a certain threshold (as set based on collateral segment), it would have an affirmative duty to refer the potential rep and warranty violations to the trustee and/or servicer. The trustee or servicer may act on this referral, decline to take action, or may call an investor vote to decide the issue.

c. **Affirmative duty to oversee disclosure of rep and warranty referrals to investors**

i. All OA recommendations on put-back matters to the servicer and/or trustee should also be disclosed to investors so that they are aware of the issue. Disclosure could be made via the monthly distribution report.

d. **Discretion to recommend to trustee that it initiate binding arbitration on put-back demands that are not resolved timely**

i. If a put-back demand is not resolved in timely fashion, the OA should have authority to recommend that the trustee initiate binding arbitration. The trustee may accept this recommendation, decline to take action, or may call an investor vote to decide the issue.

ii. With respect to whether a dispute is resolved in a "timely fashion," we note that the SEC proposed a 180-day period its shelf eligibility proposal in July 2011. We believe this proposed time period is reasonable.

iii. As a best practice, the OA should not request that the trustee initiate binding arbitration unless it is deemed a last resort because direct communication with the seller to resolve the difference has failed.

iv. If the dispute concerns less than 2% of the loan count, we suggest the OA could act as the mutually agreed upon arbiter, provided there are no conflicts of interest in acting in this capacity. Otherwise, the trustee could follow a framework based on FINRA's arbitration policies and procedures.

(1) Binding arbitration is an established practice in the securities industry. The broker-dealer affiliates of large banks typically require it. Why not in loan-level disputes related to securities? FINRA offers a useful long-standing securities dispute arbitration function that is accepted by virtually

all top tier banks. The same process should be utilized in loan-level disputes. To satisfy the interests of different parties, we believe one arbiter should come from the investor community, one should come from Wall Street (e.g., issuers and underwriters), and one should come from the borrower advocacy community (where possible).

v. There has been industry discussion about holding back up to one point of the depositor's issuance proceeds for the first 12 months as a fund the OA could tap when a rep and warranty deficiency is identified. In the residential subprime world, this would have been woefully small. We believe binding arbitration is a better solution on a time/cost basis.

vi. If the put-back request is unsuccessful, the cost of arbitration should be borne by the trust. Otherwise, if the put-back request is successful, the cost of arbitration should be borne by the rep writer as part of the damages.

3. Post-Closing Tasks Related to Servicing Operations Oversight Throughout a Deal's Life

In this period of the trust's life, we propose an increasing level of collections oversight service. If the pool deteriorates, as evidenced by delinquency levels or losses (a very important distinction), the OA should be called upon to do more and more to ensure that deterioration is not attributable to servicing operational flaws (as opposed to credit or economic-related issues). Each collateral sector would have its own technicals on how to flag that growing change in tasks. There are, however, core tasks that should be performed independently of pool performance and should be in effect on day one.

While our best-in-class proposals below envision an increasing level of oversight service, we acknowledge that the credit risk retention proposal issued jointly by regulators did not propose a tiered approach to the OA's level of oversight service in CMBS. Rather, the regulators proposed that the OA's consultative role in all major special servicing decisions be in full effect on day one. This framework would be consistent with the OA's role immediately after the financial crisis when it was conceived. As the market has evolved since the OA's inception, however, the powers granted to the OA have also evolved and weakened in some respects, and those powers currently increase based on credit-performance and controlling class events.

While we support the enhanced model that the regulators proposed, the framework we outline below is premised on improving current market practices and bridging the gap. Therefore, consistent with current CMBS market practices, we outline our best practices approach for the OA framework in CMBS transactions under the model of three "control" environments: subordinate control period, co-consultation period and senior control period. (In the event only two "control" environments are used, the framework below should be adapted by merging the co-consultation period tasks into the senior control period tasks, resulting in only a subordinate control period and senior control period.)

It is important to remember that the following example is based on the CMBS asset class. Each collateral segment will have its own technicals. To the extent a CMBS task could equally apply in other asset classes, we have designated such task as a "core task." Also, affirmative OA duties and discretions are **bold** for clear presentation.

a. Subordinate Control Period. This period is negotiated between sellers and subordinate investors, but it is often defined in the PSA as the period when the subordinate investor's initial position, after giving effect to appraisal reductions, is at least 25% of its initial principal balance.

> Note: In periods of high general economic, collateral or operator stress, this period could be very short, and the OA must get very actively involved.

OA Tasks During the Subordinate Control Period

i. **Duty to conduct periodic face-to-face meetings with management of the servicer (core task);**

   (1) This creates institutional knowledge that can be used efficiently if an operational problem arises in the future. Specifically, we suggest annual face-to-face meetings to discuss underperforming loans, suboptimal operating practices and disclosure issues along with the subordinate investor, with more frequent phone meetings.

ii. **Duty to monitor the monthly EPD/watch list loans (core task);**

   (1) This allows the OA to remain current on the developing credit trends in the pool so that it is well equipped to take over as the consultation specialist with the servicer when control triggers change in the future.

   (2) Some deals give the OA authority to work on watch list loans but this is fading in recent deals as well. We suggest this authority is re-introduced and "teeth" are provided to effect change if watch list loans are listed in error or not properly. This responsibility will require monthly interface with the servicer to insure the OA is fully aware of the underlying credit risk associated with each watch list loan.

   (3) The OA should be given access to all information available to privileged persons in order to conduct its review.

iii. **Duty to review certain specified reports (core task);**

   (1) The OA should be required to review the trustee's monthly report and various servicer's reports (e.g., final asset status report, appraisal reductions and net present value ("NPV") calculations), and calculations related to delinquent and defaulted loans. Also, it should consider monthly servicer tape "tie-outs."

iv. **Duty to prepare an annual report to investors setting forth the OA's assessment of whether it believes, in its sole discretion exercised in good faith, that the servicer's performance on a "platform–wide basis" complies with the servicing standard as defined in the governing document with respect to resolution and liquidation of specially-serviced mortgage loans (core task);**

(1) This report should be posted promptly on the trustee's website. It should also include an analysis of any disclosure items.

(2) Some recent CMBS deals have had an annual report requirement, but this is seen less and less in the market today. We believe an annual report should be done no matter what, with compensation modified to reflect that burden on the OA.

(3) To account for nuances in federal, state and local laws, the OA, like the trustee, should have the authority to obtain legal advice, if needed, from outside counsel in the interpretation and application of the definition of servicing standard, with cost reimbursement provided by the trust.

v. **Discretion to put servicer removal to an investor vote (core task); and**

(1) From the transaction's inception, if the OA does not believe the servicer is operating in compliance with the servicing standard as it determines in its sole discretion exercised in good faith, the OA should have the authority to put the removal of the servicer to an investor vote. To help alleviate some of the problems related to investor voting (or lack thereof), we recommend reducing the quorum requirements and setting approval as a majority of the quorum based on par value.

vi. **During the subordinate control period, the OA would not have prior consultative rights with respect to special servicing decisions.**

b. <u>Co-Consultation Period</u>. This new level of responsibility is triggered by certain items outlined in the deal documents. Those triggers tend to be sometimes inconsistent deal to deal and negotiated between sellers and subordinate investors, but it is often defined in the PSA as when the subordinate investor's initial position, after giving effect to appraisal reductions, is less than 25% of its initial principal balance.

<u>*OA Tasks During the Co-Consultation Period*</u>

i. **OA continues to have the duties from the Subordinate Control Period, plus-**

ii. **Duty to consult with the servicer and subordinate investor (the "directing holder") with respect to the servicer's resolution plan reports for individually troubled loans, but the servicer would not be obligated to act on the OA's recommendations; and**

(1) The OA would have the ability to comment or propose a different course of action where the OA feels there is meaningful added value.

(2) To assure timely, thoughtful and objective work on a workout, we recommend that the OA physically visits every underlying mortgage property for loans over $35 million in CMBS and $1.5 million in RMBS (or other thresholds as determined by industry associations).

iii. **Duty to review and recalculate the servicer's NPV calculations for numerical accuracy and reasonableness of assumptions.**

(1) If the OA believes the NPV calculations or other proposed actions of the servicer are erroneous or not in compliance with the servicing standard as defined in the governing document, it can refer the matter to the trustee, which will determine what action, if any, is to be taken. Giving the OA certain powers at certain times could be an alternative that is a cost effective tool.

Note: Many CMBS deals have the OA acting as an overseer of the special servicer's loan resolution process to devise the best workout plan. The OA's task is a workout-strategy oversight function within the PSA definitions. In current deals, the OA is not charged with the task of monitoring the execution of the servicer's previously approved plan. These are two very different tasks and timelines. In terms of confidence of the servicer executing its responsibilities, the investors should be comforted by the Reg AB requirements surrounding the servicer's operational controls to execute the agreed-upon resolutions. We are not currently aware of any industry concerns in that regard. The potential conflicts among the parties usually arise in devising the work-out plan, not in executing it. We can see merits in the OA monitoring the execution of the plan for an added fee. One operational challenge is determining when to send back an existing plan that may not be going perfectly to the OA for revision. This should be clarified in the governing documents.

c. Senior Control Period. This period is negotiated upfront between sellers and subordinate investors and changes from deal to deal, but it is often defined in the PSA as when the subordinate investor's initial position, without regard to appraisal reductions, is less than 25% of its initial principal balance. Due to the subordinate investor no longer having a controlling class interest, the OA is no longer interacting with the subordinate investor. Instead, the OA is now speaking directly with the servicer.

Note: This issue of appraisal reductions versus realized losses is an important issue and worthy of further analysis because instances of very high delinquencies without realized losses could materially delay the starting point for the OA's powers to kick in. We recommend that this percentage be reduced from the existing industry norm of a 75% erosion to reflect the fact that once the subordinate investor has taken any actual loss at all, it might very well see upcoming losses to be inevitable, so to speak, and may lose interest in further oversight of the portfolio. One could advocate that in this scenario the hands-on involvement of an independent OA is absolutely necessary to protect the interests of the senior bondholders because big losses may be coming (based on high delinquencies).

OA Tasks During the Senior Control Period

i. **OA continues to have the duties from the Subordinate Control Period and Co-Consultation Period, plus-**

ii. **Duty to consult with the servicer in the creation and implementation of an individual loan's workout plan, including approving various decisions (including all major servicing decisions) involving proposed foreclosures, modifications, consents, sales of defaulted loans, and releases/substitutions of collateral, among other items.**

Note: There are tasks that the servicer does on performing loans during its life. These include but are not limited to collateral substitutions, ownership changes, etc. To our knowledge, investors generally do not appear to have concerns with these activities. As such, at this time we do not see any value added in the OA getting involved in that process, but the OA could if the investors see incremental value in the service.

4. Post-Closing Tasks Related to Investor Information

a. Investors should be entitled to receive periodic reports/communications as defined within each deal's documentation. The OA report/communication provision could include:

i. **Duty to submit required annual management assessment with Reg AB compliance (as noted above);**

ii. **Discretion to hold semi-annual conference calls with investors arranged through the trustee; and**

(1) Investors could recommend the OA investigate certain aspects of the trust's performance. However, the OA could not provide any confidential information to investors. The OA, like a board member, would not be able to provide loan-level insights or answer loan specific questions, but the OA should endeavor to have the servicer, special servicer, payment administrator, or trustee communicate the appropriate party's response to such questions after the call.

iii. **Discretion to accept one-off inbound calls to OA at any time.**

(1) This should be discretionary because it is difficult for the OA to entertain due to the potentially large volume of issues with treating all investors equally, including legal concerns. The OA is usually not providing an equal opportunity for all to hear the same question and response. Also, it is difficult to determine the OA's compensation for this service because of the variable nature.

Section II. Recommended Operating Advisor Qualifications

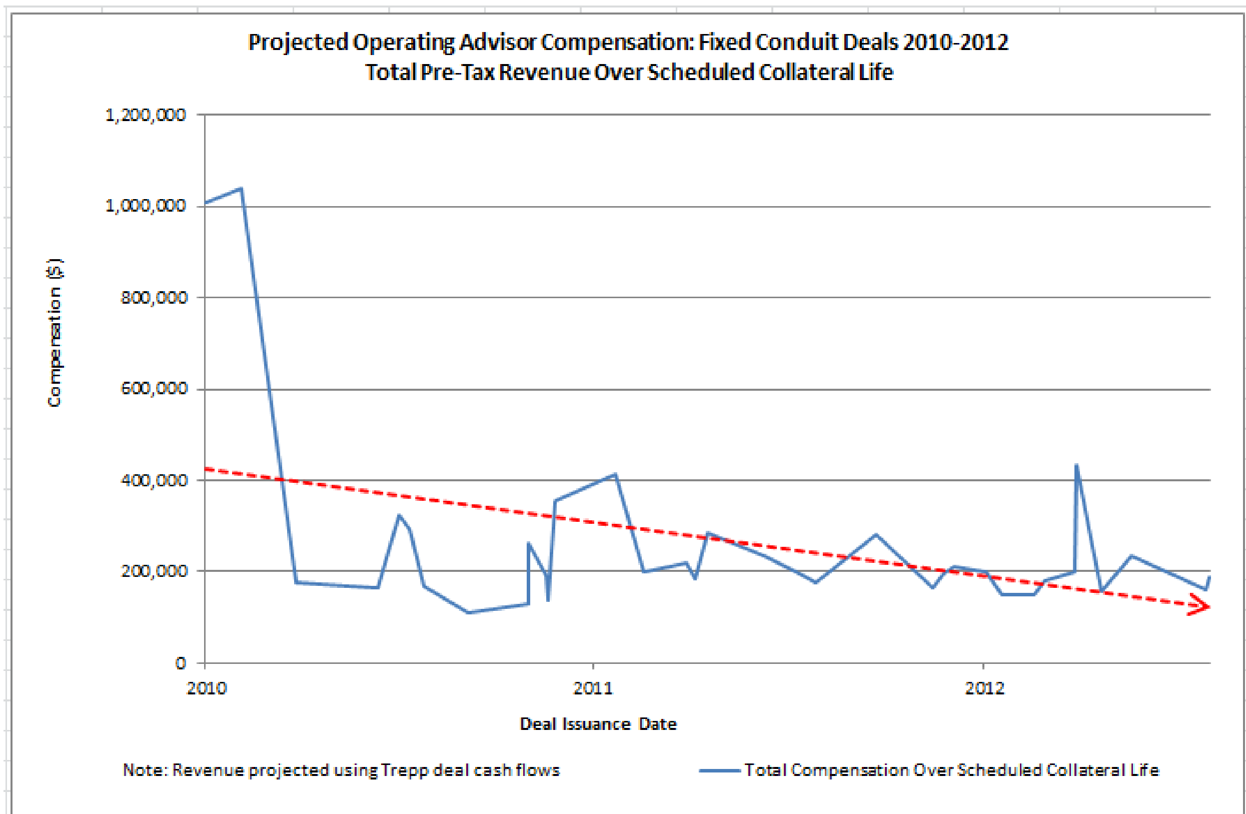
A qualified and independent OA focused on building investor confidence is critical. This is a governance function, not a master servicer function. Independence is essential in order for the OA to properly fulfill its trust oversight role, as it tasked with more just servicing oversight.

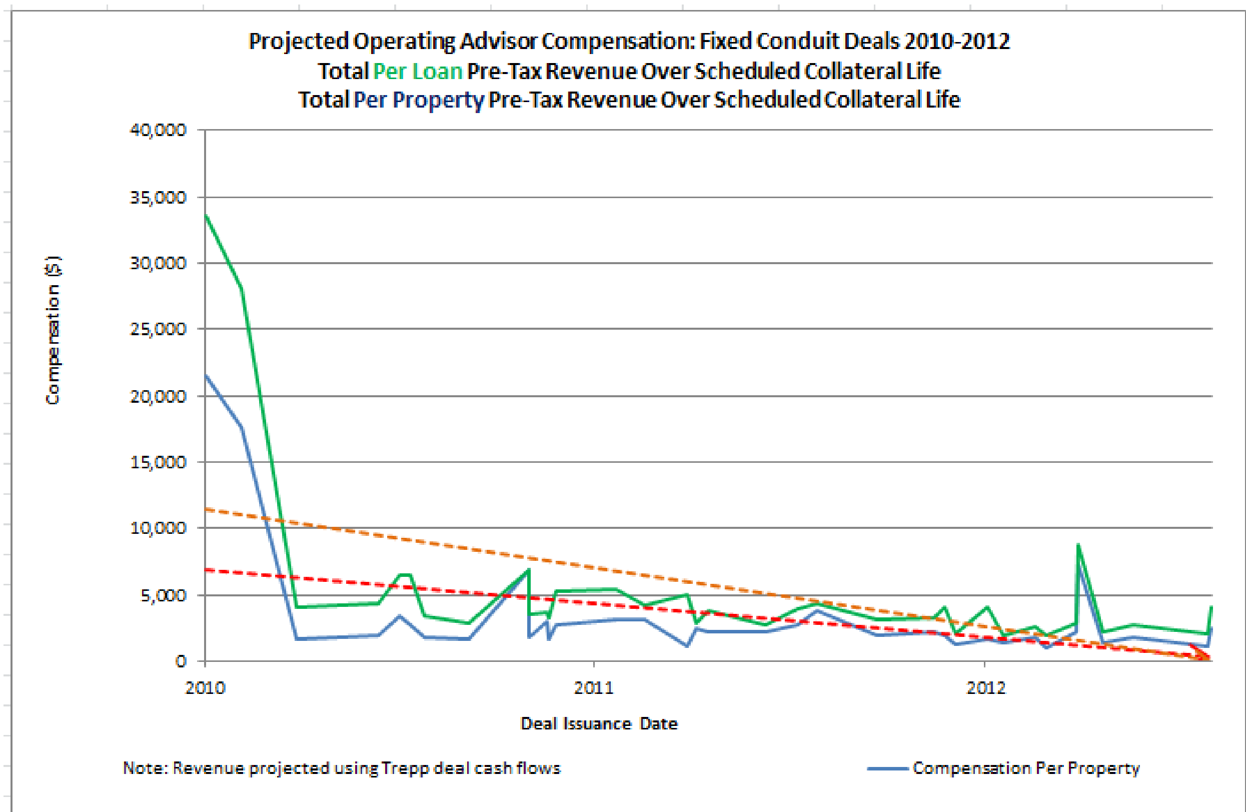
We appreciate that some in the structured finance markets believe that the OA should still be qualified even when potential conflicts of interest are present, so long as the OA discloses to investors all of these potential conflicts. We respectfully disagree with this approach. If the OA is supposed to serve an independent role and make the tough calls when no one else will, it must be free of potential conflicts of interest. Disclosure is not enough.

The issue of securitization conflicts of interest was such a concern after the financial crisis that Congress even included a provision in the Dodd-Frank Act related to it. Specifically, Section 621 of the Dodd-Frank Act bans underwriters and sponsors from engaging in transactions for a period of one year after the closing date that "would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity." Thus, when faced with the question of whether disclosure of conflicts was enough, Congress said no. Given the OA's governance role in the transaction, it should be held to an even higher standard (and certainly not a lower standard).

Additionally, investor experience with master servicers watching special servicers in the past has not kept deals from having material cash flow and confidence problems. Even though some may view the master servicer as watching over the special servicer in CMBS, investors still have concerns of conflicts of interest and effectiveness. The existing protocols and players are not satisfactory to all of the constituents. This is why the OA's independence was fundamental when it was developed in 2009, and why it is important for the market participants to build and improve upon this foundation. As the title of this Discussion Paper indicates, we believe enhancing trust governance (such as OA independence) will further minimize systemic risk in the financial system because investors will have confidence in such independent oversight.

There is growing concern among some industry representatives that without best practices for the OA's independence and experience, the OA selected for investors will increasingly become a reflection of the lowest cost provider for the service, without regard to the OA's potential conflicts of interest or experience. To emphasize this point, we present the following two charts that demonstrate the downward compensation trend of OA's since the inception of this governance concept. The first chart below shows the total projected OA compensation on a large selection of fixed conduit deals from 2010 to 2012. The second chart further breaks down this information by showing it on a per loan and per property basis. We present this information because we believe it demonstrates that less independent and less experienced OAs are entering the market and gaining market share predominantly by price, without regard to potential independence or experience concerns. Many investors recognize this concern, but because of the low interest rate environment, the pressure to find bonds with attractive yields and declining portfolio sizes these investors have not been able to materially impact OA qualification requirements. Moreover, non-governance specialists are entering the market and accepting weaker OA roles; thus, pushing OA prices lower and lower and creating a "race to the bottom" effect.


Projected Operating Advisor Compensation: Fixed Conduit Deals 2010-2012
Total Pre-Tax Revenue Over Scheduled Collateral Life
1,200,000
1,000,000
800,000
600,000
400,000
200,000
0
Compensation ($)
2010
2011
2012
Deal Issuance Date
Note: Revenue projected using Trepp deal cash flows
Total Compensation Over Scheduled Collateral Life


Projected Operating Advisor Compensation: Fixed Conduit Deals 2010-2012
Total Per Loan Pre-Tax Revenue Over Scheduled Collateral Life
Total Per Property Pre-Tax Revenue Over Scheduled Collateral Life
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
Compensation ($)
2010
2011
2012
Deal Issuance Date
Note: Revenue projected using Trepp deal cash flows
Compensation Per Property

The OA concept focuses on governance concepts on a macro-level, not servicing only. A best-in-class OA framework needs minimum standards of independence and governance experience in order to ensure the OA can actually perform its duties. Otherwise, the OA could potentially become just another passenger in a crowded boat, instead of the life preserver that was promised. Thus, best practices and regulatory solutions are needed in order to strengthen the qualification criteria.

To ensure that the OA is qualified, independent and focused on governance, we recommend the following best-in-class criteria. We believe some criteria are so critical to the function of the OA that, if not already incorporated into regulation, we encourage their implementation through rulemaking initiatives (e.g., risk retention rulemaking, SEC shelf eligibility standards, GSE initiatives, etc.) after interaction with industry representatives. With respect to the remaining criteria, we encourage their adoption through industry best practices and other market initiatives. We look forward to engaging with industry in this process.

1. Minimum Regulatory Requirements for OAs

a. Requirement currently in effect

i. Reg AB. In an SEC-registered transaction, the OA must agree to comply with the requirements of Reg AB, including the servicing compliance assessment. Written OA policies and procedures are usually required in order to comply with Reg AB. Investors should appreciate the fact that an independent auditor has reviewed the OA's activities on an ongoing basis to assure the OA is actually doing the work outlined in the PSA and in compliance with existing Reg AB requirements.

b. Independence requirements that are not currently in regulation but should be to ensure the OA can perform its delegated tasks without conflicts of interest or bias

i. To remove the real or potential conflicts or bias due to other business interests, the OA should not be affiliated with, nor have a material relationship with or material financial interest in, any sponsor, originator, depositor, servicer, pool asset, or obligor of a pool asset in the securitization transaction, nor be engaged, or through an affiliate be engaged, in the business of a sponsor, originator, depositor, or servicer.

Note: A "material relationship" could include (i) providing audit services to, (ii) having an active and/or material ongoing referral relationship with, (iii) having a principal investment in, (iv) providing legal services to, or (v) being an active principal trading counterparty with, a subject participant in the securitization. Also, with respect to a pool asset or obligor of a pool asset, a "material relationship" could include maintaining servicing responsibility or engaging in due diligence services on a pool asset, or having an ownership interest in such pool asset or obligor, such as through ownership in another part of the capital structure in the reference deal or CDO/re-REMIC aggregation activities.

Note: We believe preventing the OA from also being an originator or servicer or being affiliated with either is an important independence

requirement, and assures investors the OA is capable and willing to recommend to investors the servicer's removal in the event the OA believes such action is necessary. It also ensures a cordial environment for the OA and special servicer to interact without any underlying competitive concerns. For further thoughts regarding this concept, refer to "Why shouldn't servicers be vendors for the OA function?" beginning on page 26.

2. Best Practices Criteria for Industry Adoption

We believe the following criteria should be implemented by market participants in order to build confidence and ensure the proposed governance enhancements outlined in this Discussion Paper are not undermined by OA conflicts of interest or lack of experience. We also suggest certain criteria be implemented through statutory or regulatory rulemaking to further industry adoption. Failure to include the qualification, responsibility and fee recommendations in this Discussion Paper as a collective whole could be extremely problematic in stressed market periods.

a. Free of Competitive Conflicts. The OA should be free of competitive conflicts of interest. For example,

i. It should not be a competitor of the enterprise it is charged with overseeing. (Competitors should not be overseeing competitors. Cordial communication is critical.)

ii. It should not be the financial auditor of or strategic advisor to the enterprise it is charged with overseeing or to an obligor (Note: servicing can be transferred over the life to new parties that may not be formed yet);

iii. It should not have any ancillary business relationships that would likely cause potential conflicts or the appearance of such, including:

(1) Maintaining ongoing relationships (contracted or not) that source or trade first lien, mezzanine, or B note interests to/with the depositor or dealer (or other related party).

(2) Maintaining active relationships (contracted or not) that provide diligence or other related vendor services to/with the depositor or dealer (or other related party) that are put into the subject or other similar transactions over the prior 12 months to a trust's creation.

b. Depth of Experience. Without a doubt, trust governance through an OA works only if the OA can adequately and fully perform the tasks to which it is assigned. Therefore, it is vitally important that the market develops best-in-class experience standards. We propose the following experience standards for industry discussion:

i. The OA should have an established history of analyzing defaulted loans on a large scale basis and making operational decisions and recommendations on how to

proceed in a disputed situation, and working with servicers in a mutually respected, non-adversarial fashion that improves collateral performance;

ii. The OA should have significant experience reviewing rep and warranty compliance as well as defaulted loan workouts made by others to understand the tolerances of the applicable standard;

iii. The OA should maintain an active practice of evaluating loan originators and servicers for compliance purposes via detailed onsite interviews and other analysis;

iv. The OA should possess a reputation of holding well-administered auctions of loans and/or REO property for owners of challenged loans with established lists of direct investor contacts. This is helpful in directly double-checking a servicer's loan auction activities as a tool to optimize proceeds;

v. The OA should have the ability to perform the required tasks without the need to outsource. When using numerous outsourced specialists in an aggregated form, the OA could have undisclosed conflicts at its sub-levels during the life of the collateral pool;

vi. The OA should be committed to the loan surveillance business as its core business. (Loan-level operations oversight is materially different than bond oversight skills and resources);

vii. The OA should have written operating policies and procedures consistent with federal guidelines, such as FINRA standards (or better), regarding tools to reduce the risk of:

(1) Insider trading conflicts,

(2) Confidentiality breaches,

(3) Breaches of email retention policies, and

(4) Bond market trading practices;

viii. The OA should employ staff with technical expertise relevant to the industry it is overseeing. For example, with respect to residential and/or consumer loans, it should employ real estate collateral specialists that have provided loan-level oversight services on individual defaulted real estate and/or consumer finance loans for at least five years (loan origination, appraisal, and actual servicing workout experience is preferred, not just bond investment activities). Additionally, it should employ staff with expertise in rep and warranty provisions and enforcement and the loan servicing industry with default management specialists. It also should employ staff with significant conflict management resolution expertise (arbitration certification is preferred) including, but not limited to:

(1) Courtroom testimony experience and willingness to proactively testify in any court for any material proceedings involving the trust or any transaction parties related to the OA's contracted tasks;

(2) Documented experience in providing expert testimony regarding real estate, consumer and/or corporate loan operations conflicts in a federal, state and/or arbitration setting and willingness to do so as a corporate policy, if appropriate;

(3) Skilled professionals with extensive lending, default servicing, portfolio management and secondary loan and bond trading experience;

(4) Formal arbitration or mediation training by government enterprises or other authorities; and

ix. The OA should have the technological systems necessary to fulfill its duties. For example,

(1) It should have the ability to maintain and monitor large-scale databases and quantitative loan performance analytics;

(2) It should maintain the necessary systems and data for the role that is housed in a SAS 70-Level II compliant environment or better, with active backup. To ensure that the OA can deal with scale, we suggest that the OA should represent that it has the capacity to oversee at least $100 billion of loans on its systems; and

(3) Possess internal systems that have been proven to be highly secure and customizable for rep and warranty compliance as well as servicing-centric analysis and reporting.

As previously stated, we encourage industry adoption of the above best-in-class OA qualifications. Independence is central in order for the OA to properly fulfill its trust oversight role. We hope our recommendations engage dialogue among industry participants in this regard, and we look forward to engaging with the industry in this process.

Section III: Frequently Asked Questions

1. Why should issuers embrace these recommendations?

Issuers should embrace these concepts because we believe they will create more confidence in the structured finance markets. This, in turn, will lead to more demand for their product, which will lead to more deal volume, which will lead to more secondary trading opportunities. Or, in the words of an economic aphorism, "a rising tide lifts all boats," which is associated with the idea that improvements in the general economy will benefit all participants in that economy.

We acknowledge the perception by some issuers that the OA function favors triple-A investors or that it was only needed immediately after the financial crisis as a bandage to help restart the market. We appreciate this argument, but respectfully submit that it risks following the same path that led us to 2008-2009. Now is the time to refine the OA concept to learn from what has worked over the past few years and from what has not. We have attempted to do this reflective exercise with the concepts in this Discussion Paper.

2. Who is watching over the OA?

In simple terms, like directors in a corporation that must answer to its shareholders, the OA must ultimately answer to all investors collectively. To the extent investors are dissatisfied with the OA's performance, they should have the ability to remove the OA by investor vote. To facilitate investor voting, we recommend lowering the quorum requirement and setting approval as a majority of the quorum based on the par value of the securities outstanding. The periodic communication duties undertaken by the OA should keep investors regularly informed of the OA's activities.

Additionally, the OA would be monitored by an independent registered public accounting firm because of the OA's obligation to be Reg AB compliant. This requires the OA to provide an annual report on its assessment of compliance with applicable Reg AB servicing criteria for an OA and obtain an attestation report from an independent registered public accounting firm on its assessment of the OA's compliance.

3. Why shouldn't servicers be vendors for the OA function?

1. Competitors should not be watching each other to gain competitive advantage in the other's business matters. Further, there is little likelihood to have free and candid communication between competitors on a contested topic. The goal is to improve performance, and a lack of full and open communication will not serve that goal. The OA's role is about ensuring the originator's, depositor's and servicer's compliance with the operational standards outlined in the PSA on a select few items and using its technical expertise to oversee and identify the best operational vendors. We believe this is not micromanagement of underperforming vendors on individual distressed assets, although the latter should be pursued actively until the servicing is moved to a new qualified vendor. There is a difference between bad loans and bad servicers, and the OA needs to manage accordingly.

2. Servicers rarely are in the business of entering their competitor's premises and interviewing other servicer's employees during a trust's life to create benchmark perspectives and interviewing them when servicing transfers might be necessary.

3. Some servicers are rightfully very sensitive to disclosing their loan-level proprietary negotiation-style secrets to their competitors, especially if that oversight party is working out a loan across the street from the subject property, and they are actively engaged in soliciting tenants from other parties to fill the building they are servicing. This could create communication problems between the servicer and OA that could compromise loan performance. The servicing standard is usually fairly broad. Some servicers have a unique style that may be acceptable to the industry, but different than the operating practices of the servicer that is acting as an OA.

4. Some servicers have advanced defaulted loan systems and dislike giving access to their system to their competitors. Limiting the OA's access to the servicer's full computer systems with timely information can have a negative impact on the servicer's as well as OA's activities and the resulting loan performance of the trust.

5. Many industry participants believe servicers are not motivated to fight for clear operational rules related to the "servicing standard" in trust documents upfront because clarity is not always good for the servicing industry as a whole. Clarity could introduce heightened compliance and disclosure requirements and litigation risks that may prove to be onerous and costly. <u>Some servicers have stated in public forums they do not like their competitors overseeing them for fear they will be falsely accused of not performing to the prescribed standard</u>. Why introduce this conflict surrounding relationships?

   - For example, a few years ago virtually every large special servicer signed on to CMBS deals with fair value purchase options by the special servicer, but these servicers intentionally never advocated at transaction inception to define what "fair value" meant.
   - When closing a deal, the OA should use its position as signatory of the PSA to require greater clarity on operational matters and definitions on defaulted loans, so the OA's work can be carried out without objection in the future.

6. There has been a growing use of experienced CMBS operations arbitrators by the servicing and trustee community to resolve pending disputes and possible future ones. They have chosen specialist firms like the ones meeting the qualifications recommended herein, NOT servicers. Servicers do not want to tip information on the subject item to their competitors. We should learn from that.

7. In the residential subprime industry, many servicers did not survive the financial crisis. The servicing business is getting more demanding and less financially lucrative in many collateral classes. Transferring servicing is a defensive option to maximize loan performance when operators are stressed. We are unaware of the last time a servicer independently investigated and effectuated a servicing contract move from their competitor to another competitor. Servicers are loan operations specialists, not trust governance specialists. The goal is to find a new servicing vendor if there are concerns that the existing servicer is not meeting PSA expectations.

- A hypothetical residential mortgage example might occur when the biggest subprime firm acts as an OA in a bond deal, oversees the second largest firm and interviews the third, fourth, etc., as possible replacements while all of them are failing (as they were in 2007). It is also important to recall that during the height of the real estate boom the number one subprime firm used to provide liquidity to the number two subprime firm and vice versa in their loan trading areas, so they may have been less inclined to annoy each other because of the need for liquidity in these other departments.

8. There could be potential conflicts of interest when working on a distressed loan.

- A CMBS example:

  i. Office Building A loses a key tenant and defaults. The operator works with a servicer to increase occupancy. The local market is weak with more office space supply than rental demand. The only way to fill up the building is to attract tenants from a nearby building (Building B) with attractive tenant incentives, which will temporarily hurt the near term cash flow of Building A: a big operational bet.

     Before the servicer approves the operator's plan, the securitization documents require the servicer to get guidance from the OA due to previous heavy credit losses. When the servicer contacts the OA, the OA says they cannot help. The OA is conflicted because it is the servicer for Building B, which also has occupancy problems. As such, it is unable to provide independent guidance because of the conflict. Furthermore, the OA now knows the loan it is overseeing (Building B) is a target, and therefore, may work with Building B's operator to act defensively. (Many servicers are affiliates of investors.)

- A re-REMIC or CDO example:

  i. A servicer's bond investment affiliate buys low cost bonds in resecuritizations and obtains the right to control servicing authority on the various underlying securitization trusts. In addition to principal and interest collections from the low cost bonds, it may also be interested in servicing operating company fees because, in some instances, the servicing fees on the underlying trusts could dwarf the principal investment in the CDO bonds by a material margin. When this occurs, senior investors may believe that long delays in resolving loans are the result of the special servicer seeking to generate servicing fees to the detriment of senior investors, notwithstanding the special servicer's obligation to comply with the servicing standard. Further, if the servicer of choice for the CDO manager was the OA on an underlying bond deal, the perception of a conflict of interest could arise and such perception could hurt trading prices on the component and/or re-REMIC/CDO bonds.

9. To demonstrate to the reader the potential conflicts of interest inherent when servicers act as trust advisors, we present below a risk factor that is becoming increasingly common in CMBS transactions:

> The trust advisor serves as special servicer in other commercial mortgage securitization transactions and has advised us that it intends to continue to serve, or reserves the right to serve, as a special servicer with respect to existing and new commercial and multifamily mortgage loans for itself and its affiliates and for third parties, including portfolios of mortgage loans similar to the mortgage loans included in the trust fund. These other mortgage loans and the related mortgaged properties may be in the same markets as, or have owners, obligors or property managers in common with, one or more of the mortgage loans in the trust fund and the related mortgaged properties. As a result of the investments and activities described above, the interests of the trust advisor and its affiliates and their clients may differ from, and compete with the interests of the trust fund.

The discussion above demonstrates the potential conflicts of interest when servicers act as operating advisors and the risks to investors inherent in this arrangement. We believe the OA should not be in the same primary business as the entities it is watching over, which includes loan underwriting as well as servicing matters. Allowing this is not independent governance. Furthermore, we believe the OA is not supposed to act like a servicer or micro-manage the servicer on each loan unless the deal deterioration contractually warrants them to be involved on this level. If the servicer is “bad,” this loan-level oversight should be done on an interim basis until servicing is moved. However, if the servicer is “good” but the loan is “bad,” the commentary should be more advisory as opposed to critical micro-management. (At that point, some form of more intensive management by the OA is appropriate.)

We believe the OA should employ individual specialists to perform loan-level checking and offer loan-level guidance to ensure confidence in the servicer’s operational abilities. The OA either determines that the servicer is in compliance with the servicing standard or it recommends replacing the servicer because it is not meeting the standard described in the governing documents. The OA can make asset-level recommendations and recommendations about staffing size and quality, but the bondholders should find a new servicer if they see repeated asset-level operational problems. We have clearly seen this in the subprime world. The goal is for the OA to work with the servicer as a business partner to repair issues; moving servicing is a last option. Even if the OA recommends a servicing transfer, it is still incented to assure that the new servicer will follow the standard described in the governing documents because failure to do so will once again burden the OA with more loan-level oversight challenges.

The oversight party should oversee and govern from a position of independence, not be a potential conflict risk. Even in CMBS 1.0, the conflicts outlined earlier could occur for any servicer due to the size of its existing book of exposures. To respond, servicers have historically set up information walls (and sometimes deal-slowing special legal teams) to address this, but the OA is supposed to operate under a higher standard. The goal is to minimize any slowing of the approval process and the introduction of loan resolution risk.

4. *What about possible OA vendor conflicts?*

There has been some discussion regarding explicit or perceived conflict risk when the OA is asked to make a tough decision. Some have recommended the OA provide a "conflict-free" letter every time a decision is requested or periodically. We believe this is an interesting disclosure request but could open the trust to unnecessary risks. For example, if 20% of the loans do not pay off in a CMBS trust on the balloon date and IMMEDIATE loss resolution answers are needed from the OA who says "I am conflicted," then what? Realizing that OA fees are usually based on loan balance, there may not be sufficient cash paid to a replacement OA to motivate a new vendor to step in (or the time to source with a qualifying vendor). Simply saying they are conflicted is not a workable solution. <u>Disclosure of conflicts is not enough when the goal is building confidence</u>.

It is important to recall that the subordinate buyer (which could be up to AA when supporting a AAA bond) does not have a restriction to sell their subordinate bonds at any time. Assuming the subject bond is the lowest outstanding at the time, these bonds usually include the right of the new holder to move the servicing to their servicer of choice, subject to minimum standards that are administered exclusively by the rating agencies. If a subordinate bond was traded in the secondary market, there is a risk that the OA could be an affiliate of the new control investor or new servicer. As such, we suggest the OA has limited affiliations to principal investors, servicers, and advisory firms that coach defaulted borrowers. Future bond trades cannot be anticipated.

5. *Should there be information walls to reduce conflict exposure?*

In the asset management, trustee and Wall Street dealer communities, there have been numerous business practices established over many years to avoid conflicts. Most of the practices we have observed are insufficient in the unique and important operating oversight role of the OA. The OA needs to have technical expertise but without a conflict of interest. This is a difficult challenge. <u>There must be a higher standard of care because the OA should be conflict-free to suggest initiating litigation and offering to be a testifying expert against a party in a court, where appropriate</u>. This could be a multi-year battle. It is unrealistic to think the OA would be a party against their affiliate or client regarding the actions they have taken. It is one thing not to transact with an OA affiliated party for a short period of time. It is another thing to proactively support initiating litigation proceedings against an affiliate or its funds that could span many years. Lawsuits heighten the need for independence.

As the finance industry consolidates, it is logical to expect that conflicts of interest on some matters will arise. In that instance, the focus should be the issue of materiality of the potential conflict. Simply having two divisions of the same company in different buildings is an insufficient separation to comfort investors when one division is recommending that the trust initiate multi-year litigation (and provide related facts, analysis and testimony) against the other division residing in another building. Think of what investors would say in that instance. This does not build investor confidence in the market.

6. *Why shouldn't fiduciaries such as investment managers or their affiliates provide OA services?*

1. Appearance of "conflict of interest" risk.

a. The governance issue deserves the highest level of care. It is not like walling off private and public investment teams. Ugly disputes usually last for years and are frequently on the cover of The Wall Street Journal or The New York Times. Imagine in the CMBS world, the Stuyvesant Town workout or General Growth Properties, where the investment manager may be in the courtroom representing multiple pension fund investors on multiple securitizations issued by these parties. In this situation, if the OA is the affiliate of the investment manager, it could be testifying and participating in a multi-year litigation against its own pension fund clients' interests. What if the OA's investment management affiliate:

   i. Owned the sub-bond in one fund as well as;

   ii. Owned the mezzanine bond in another fund as well as;

   iii. Owned the senior bond in another fund, and then worked on litigation that could impact them materially?

   Other issues could arise in a re-REMIC/CDO case if the OA's investment manager also was the collateral manager.

b. Walling off teams is an understood industry practice where the typical resolution to a distressed asset is to sell the position. It is a different issue when a potential multi-year litigation requires intensive active participation with lawyers and negotiation in the workout. It is naive to think the OA is not going to be involved in litigation on behalf of the trust if it sees something wrong. Lawsuits do happen.

c. Investment managers continue to grow through acquisitions. What if they bought a servicer in the future? Quite a few fund managers have bought or built servicers. What if they bought the subordinate bonds in the future?

2. There is a reason why there is an industry practice of broker-dealers and investment managers precluding their staff from accepting board seats on public companies as individuals where the broker-dealer or investment manager may have significant trading or financial involvement with that company or its competitors. It creates potential conflicts or the appearance of such. Best-in-class governance is about independent oversight; independence is critical.

3. Most investment managers are bond experts, not loan operations experts. In the 2005-2008 period, many of these managers bought massive amounts of bonds that have since seriously underperformed because they did not understand credit and operational risks. The intricate operations of loan origination and loan servicing should be managed by "hands-on" credit and operational experts. Loan-level workout expertise is highly specialized. There was a reason an investment manager was not hired to liquidate Lehman Brothers, Madoff, etc., even though some investment managers knew the assets better than the parties ultimately selected to liquidate the estates—they owned massive holdings in corporates, consumer and mortgage assets.

7. Why shouldn't a rating agency provide OA services?

The OA is required to make loan-level resolution and servicing transfer decisions that could impact ratings. This would create a conflict of interest for both the OA and the independent ratings agency. The OA could suggest certain actions to impact ratings that may not be consistent with certain investor interests as it seeks to optimize the collateral for the trust as a whole. Additionally, the ratings agencies could be hired to rate the bonds initially or in the future if hired by investors.

8. Why shouldn't independently-held structured finance workout firms provide OA services?

1. Some structured finance workout firms are currently in the business of advising stressed borrowers on how to minimize their losses by "gaming the system" in a defaulted loan workout, or they have provided such services in the past. The OA would not look good if it provides services to other parties for and against trusts. Those borrowers could come back for further assistance and the subject loan/property/operator could be in the trust. Thus, the structured finance workout firm could have a conflict of interest to the extent it is the OA for the trust and the firm's other clients are seeking workout advice on similar or related pool assets. It is not a best-in-class solution to have loan-level workout advisors for borrowers or collateral owners provide the OA service.

2. Their financial footings may not be "significant" relative to others, so the reasonableness of the OA pricing of the service is critical to ensure their long-term financial health or transferability to a new party, if desired.

   a. Private individuals frequently act as "trustees" for overseeing the liquidation of extremely large bankrupt companies. (For instance, to our general knowledge, Richard Breeden, former SEC Chairman, acted as a liquidating trustee for large resolutions after he left the Commission. Arthur Levitt, former SEC Chairman, has provided distressed situation oversight after he left the Commission as well.) In these examples, there is substantial corporate experience such that an investment grade entity is not necessary to provide proper oversight in addressing challenged situations.

3. They may have key person risks, so succession plans may be appropriate. However, this could be less of an issue as the business grows.

As seen in the Madoff situation, massive bankruptcy restructurings, liquidations, and other large "challenged situations" like Enron, GM, etc., there is a significant precedent for independent individuals, specialty workout firms and law firms to take a leadership role in optimizing all collateral and claims to the benefit of the creditor and equity constituents. While creditors could challenge the motivation and scalability of an individual or specialized services party to take on such assignments, it is done actively and frequently with significant success in the corporate market. The liquidation trustee template should be considered as an interesting comparison when outlining the OA's roles and responsibilities. In some cases, the liquidating trustee is provided with a compensation system that includes a percentage of the liquidation proceeds to ensure optimal pricing. For the OA, we do not propose such direct compensation, but the variable fee matrix supplied in Section IV provides a partial equivalent. Of note, the liquidating trustee of a bankruptcy estate is rarely considered a product expert or financially well-

footed organization. If one can be found, that is a welcomed "bonus." For the limited OA tasks outlined herein, the OA is a technical resource and the trustee is the boss. They should work as a team. The OA is not intended to be the fiduciary because there are so many tasks the OA does not participate in. A fiduciary is the party with a more global function within the trust's activities, namely, the trustee.

9. Why shouldn't an accounting firm provide OA services?

They may audit the servicer, an insurer, a trust party or an investor, or they may work for a company that buys the servicer in the future. These trusts have long lives. Auditors usually do not like to make conclusive decisions that can upset large institutions who are current or potential clients. Liability exposure is a large concern for them. Many of the accounting firms audit the originators as well. Some people question if they, as OA, would really demand a repurchase from an audit client.

10. Why shouldn't collateral due diligence firms provide OA services?

1. An OA should have a fresh perspective on the loans in the pool, and a collateral due diligence firm would not be able to bring an independent perspective if it was connected to the initial due diligence on the pool. For example, what if the diligence provider said a loan was non-compliant when they had looked at it previously for another party, yet the depositor put the loan in the trust anyway? If any deposited loan (no matter how few) has been reviewed by a collateral due diligence firm, that diligence firm may not be an objective and independent OA firm.

2. What if a collateral due diligence firm is paid a material sum to perform other services for a party to the trust, such as an originator, depositor, etc.? Will they really turn a blind eye on gray items even though they technically are following the agreed upon review standards? The magnitude of "other business" is very relevant. An OA with this potential conflict of interest may not be the most objective OA to protect investor interests.

3. Loan testing now has detailed work flows, and attestations are necessary. Just as servicers should not be watching over other servicers for conflict reasons, the same applies in the loan diligence business. Loan-level due diligence incorporates some subjective thinking and one diligence firm could criticize another diligence firm simply for competitive reasons. They could also aggressively initiate put-backs for personal gain as well. Best practice would not involve introducing this potential conflict of interest.

11. What is the recommended OA responsibility to effect change?

For most existing CMBS 2.0 pools of loans, the OA has been focused only on the defaulted loan population. In some trusts, it is an after-the-fact review related to analyzing the reasonableness of a loan's loss severity. While better than historic practices, this process is still insufficient to create meaningful "lift" (a.k.a. confidence) for all investors up and down the capital structure. There are limited "teeth" in after-the-incident actions. The OA should observe actively during the resolution process, not read the "report for the file." The OA of the future should have responsibilities while loans are current and on the watch list (or while loans are showing some other undesirable trends).

We think the OA should have a growing list of specific powers if the deal deteriorates. This could include a delegated authority mechanism. As a benchmark, there have been some FDIC deals in

2011 and 2012 that include such features, as the FDIC has been a thought and implementation leader in trust governance.

For a complete discussion of our viewpoints on this question, please refer to "Section I: Recommended Operating Advisor Tasks" beginning on page 9.

12. What is the proper role of the OA in representation and warranty compliance testing and damages reimbursement?

In most securitizations, the primary party responsible for representation and warranty compliance is the loan servicer, and we recommend this continues, provided the servicer is additionally compensated and scrutinized to perform the task efficiently. As a backstop, however, we recommend the OA check certain populations of loans away from those identified by the servicer. This is a governance check to ensure the servicer is correctly reviewing loans for representation and warranty violations despite potential servicer conflicts such as an alliance with the representation and warranty provider. The servicer's failure to proactively analyze and put back loans could be a cause of termination.

For a complete discussion of our viewpoints on this question, please refer to "Post-Closing Tasks Related to Collateral Quality Review" beginning on page 12.

13. What is the liability exposure of the OA?

Many of the ongoing operational practices of a securitization trust are related to the resolution of defaulted loans, and the servicer performs its work in reference to the "servicing standard" in the governing documents, which is usually less than a page long. In overseeing the servicer, this frequently puts the OA in a difficult position of interpreting and possibly enforcing "vague rules." Many of the operational rules are not clear and the vertical nature of the OA's services does not allow it to rely on the findings and recommendations of other professionals who have performed work previously. Disagreements related to the OA's final decisions could easily arise. For example, is the downgrading of a servicer by a rating agency cause for moving servicing to a new party? Also, is there a "tipping point" in servicer performance that compels the OA to recommend moving servicing or other remedial actions?

Due to the confluence of the sometimes vague operational rules as well as the OA's one-stop analysis and judgment service, the OA could easily become a target of litigation complaints that assert damages that far exceed the OA's income on the related deal. Errors and Omissions insurance does not always cover claims of small errors in judgment. In highly complex workouts with crafty or sophisticated borrowers, the risk of unintentional error could be material. This legal risk could create a significant disincentive for the OA to make tough decisions when needed. Balanced protection for the OA is appropriate. (There is a reason trustees are not advertising their services as fiduciaries any longer.)

To motivate a party to take on OA responsibilities and limit the probability of frivolous litigation, we recommend the following:

1. Since the OA is acting in a contractual rather than a fiduciary capacity, its "standard of care" and powers should be clearly defined in the transaction documents. Remember, the OA is a checker of other people's work, not the primary performer of the work. We appreciate there is a

difference between making decisions in a fast moving matter (so-called "battlefield" conditions) versus a more stable and "clean" environment (so-called "operating room" environment). The OA's standard of care needs to reflect that level of data, time, specific decision-making authority, etc. For instance, someone could claim that the OA was "negligent" for not staying current on a sidewalk hole on a property that was collateralizing the last loan in a trust. Is that OA negligence? OA gross negligence? The result could be a lawsuit against all of the trust parties including the OA when there would be no more trust assets to indemnify the OA.

2. The OA's actions should be subject to a gross negligence and willful misconduct standard of care. (There have been several recent CMBS deals to this standard). This is intended to reduce the "sue everyone on the transaction" risk that is periodically found, and it also protects the OA when making tough judgment calls so long as it is performing its duties in good faith and with appropriate diligence. Remember, the OA is focused on assessing compliance to a standard that is Reg AB tested, not doing individual servicing activities. The OA's fees are a fraction of the primary vendor's fees for a reason. The litigation risk/reward needs to be balanced. It is important to remember that the trustee, OA and servicer often are working on the last loan in the trust. In this case, the indemnification offered by the trust to them is essentially worthless because there are no more assets in the trust to generate cash to protect them. Thus, the standards proposed herein are needed to protect the OA when indemnification provisions are worthless. Servicers make millions to accept this risk, not the OA.

3. Actions or inactions that are based on the judgment or belief of the OA (such as servicing removal recommendations) should be in the OA's "sole discretion exercised in good faith." This was the standard included in transactions during the formation of the OA model (such as in TALF transactions), and it is the standard proposed by the joint regulators in the credit risk retention proposal issued in March 2011. If needed, triggers can be adjusted to say when the OA has this power.

4. The party asking for an OA's decision on a loan must present its findings and recommendations in a concise package. If the OA feels that the facts and circumstances regarding an "issue" have not been presented in a thorough fashion by the presenting party, the OA should not be obligated to render an opinion. The OA should not be obligated to make a decision based on incomplete information unless the standard of care takes such circumstances under consideration.

5. The OA's litigation defense expenses should be fully borne by the trust, on a run-rate basis and paid pari passu in the waterfall with the servicer's fee, unless the OA has been held in breach of its contractual standard of care in a final decision in the court of law.

6. With regard to the OA's possible role as an arbitrator on a three-party panel if requested and when there are no conflicts of interest, the contractual arrangement should be consistent with typical arbitration language and provide for immunity from prosecution in most cases.

7. Realizing the OA's income is one of the lowest of the trust vendors coupled with a large and long litigation exposure after the last loan is extinguished from the trust, there is concern about the willingness of vendors to provide such service. As indicated above, there are no assets to indemnify the OA once the last loan leaves the trust and the statute of limitations starts. It is possible that the resolution of the last loan could have a huge impact to remaining holders. We

suggest that regulators and industry participants consider an OA dollar amount liability cap written into each trust's documents on litigation exposure once the unpaid principal balance of the loan pool is less than a certain amount (e.g., only 30% of the original UPB remains). For discussion purposes, this liability cap could be set at 100% of OA fees for the past 12 months. This is not a "get out of jail free" card for the OA; it is simply logical risk/rewards in a highly litigious world.

8. Another possible concept is strengthening the indemnification provisions such that the OA, like the trustee in some circumstances, would be indemnified by other parties to the transaction (e.g., the securitizer). Broader indemnification provisions could ensure adequate protection for the OA's tail period risk, as well as serve to ensure the party providing the indemnification, such as the securitizer, has incentive to select well-qualified and reputable OAs in order to mitigate their contingent risk. We certainly welcome all discussions on this, as we do not want to give the appearance that we are advocating that the OA skirt its responsibility.

14. Why haven't trustees taken a more proactive role?

It is relevant to review the Trust Indenture Act of 1939 and relevant statutory and case law to understand why structured finance bond trustees have shied away from providing these kinds of services in the past. There may be lessons that can be learned that can provide confidence to possible vendors providing OA services in the future. Some of the legal protections provided to arbitrators via Congressional law should be considered as an example. Also, like large investment managers, trustees probably do not like initiating lawsuits against large clients and related parties.

15. How could independent collateral appraisals better protect investors?

The CMBS industry in its 2.0 series has created a valuable tool regarding control rights. Through the use of a well-established property appraisal process (which the OA can run, if desired, for a fee) and related decision-making, the subordinate investor could lose its control rights in periods of high delinquencies and impaired collateral values. Effectively, this pushes control "up" the capital structure. This has many desirable features to avert possible self-dealing tactics by the subordinate holder (or the image of such), but most importantly it gives senior investors more proportionate rights when borrowers are not paying and the collateral looks impaired.

As an example, there are many seasoned subprime securitizations outstanding where delinquencies are massively high, and one could conclude it is only a matter of time until subordinate bonds will be extinguished by losses. Until then, however, many of the existing RMBS voting regimes do not facilitate the senior investors' ability to undertake certain investigation and collections oversight projects to minimize their losses. If the CMBS appraisal reduction process, or the like, can be applied to RMBS deals, this could provide material comfort to RMBS senior investors who own the majority of the capital structure. If the delinquencies are high due to non-property value decline issues, the subordinate investor will retain its rights.

No matter what the delinquency rate is, the OA should do its job. <u>Importantly, the OA is also indifferent to the dollar price of where investors have bought their interests</u>, which is a notable issue for some bond investors.

As part of improving investor voting qualification and related rights issues, special attention should be given to the process of how subordinate investors lose their control and voting rights. In CMBS, a new positive trend is developing, but there are some important details to consider. Specifically, control shifts are based on an "independent" appraisal that is obtained by the servicer (who may be getting direction from the subordinate investor). This process could cause some conflicting actions depending on the appraised number. Realizing that collateral appraisals can vary dramatically and large loan appraisal differentiations could cause material changes in bond class controls, we recommend that the process of hiring an appraiser and related quality control work be reviewed and ultimately approved by the OA in all environments. The servicer would still lead the process, and the review should not create material delays. The OA would simply review.

The OA should not say what the appraisal amount should be unless the OA is paid a supplemental fee to perform the task pursuant to the transaction documents. Instead, the OA should ensure that the appraisal process utilized responsible third parties unaffiliated with the servicer, subordinate investor or other related party, and that the appraisal was conducted on a timely basis. Variable fees for the OA should apply to provide this service.

16. What went wrong with RMBS governance?

While the RMBS markets have introduced the concept of a credit risk manager, the focus in RMBS 1.0 deals has historically been related to ongoing servicing matters and not upfront rep and warranties matters on origination quality items. Sadly, many of those deals still had upfront collateral quality problems that trumped the servicing issues. RMBS 1.0 was the first wave of securitization governance improvements. There are two general reasons (in addition to many others) why the 1.0 governance improvements did not work to everyone's satisfaction:

1. The pools were filled with many loans that were inconsistent with the original bond offering documents and early period losses overwhelmed the servicers. In this regard, there are numerous allegations of questionable (i) borrower qualification activities; (ii) collateral valuation methodologies; (iii) loan origination procedures; and (iv) loan document retention activities.

2. The servicing standard changed significantly as federal, state and local laws materially altered servicing practices.

    a. The ongoing monthly servicing information provided to the credit risk manager was limited to the environment when the pools were first securitized. In many instances, the data only allowed the credit risk manager to do a post-loss loan review instead of working more proactively on sub-performing current loans or early stage delinquent loans to minimize loss frequency.

In RMBS, we recommend a more proactive role by the OA while a loan's resolution is still underway. We suggest a special RMBS delegated authority matrix that requires the servicer to interact with the OA on some predefined issues based on pool-level performance matrices as well as certain loss mitigation matrices. This enhances servicer/OA communication and can be done in a fashion that does not slow the loss mitigation process materially. See Section I for our specific recommendations relating to OA tasks in RMBS.

17. What if the OA needs to be replaced?

Like shareholders in a challenged company where there has been management or board errors (or the perception of such), the corporate market is a good template to follow. We advocate the following backstop features if the stakeholders are not comfortable with the OA's performance and a new OA cannot be hired at the agreed upon fee structure:

1. Investors need to have the right to review loan files and servicing comments. They can hire a new vendor to do that work (payment in or out of the waterfall), or they can use a back-up OA who has already signed confidentiality and indemnification agreements upfront and there is an established payment mechanism. These special projects would be priced on an as-needed basis.

2. Investors need to have voting rights that cause subordinate investors to lose their controlling class voting power like the ASR concept in CMBS.

18. Why haven't ratings agencies given credit for governance improvements?

We think rating agencies are not giving proper weight to trust governance and should reconsider their position. In this regard, we note the issue of better oversight of pool assets and related OA tasks has been recognized by the SEC as a mechanism for ensuring higher quality securities. For example, in a recent SEC proposal on shelf eligibility rules for ABS transactions, the Commission stated that an appropriate partial replacement for investment grade ratings is to "better strengthen the enforceability of contract terms surrounding the representations and warranties regarding the pool assets," which in turn would "incentivize obligated parties to better consider the characteristics and quality of the assets underlying the securities[.]" Thus, it is clear that the SEC recognizes that improved governance surrounding trust oversight is an indication of higher quality securitizations.

The June 2011 settlement of $8.5 billion is evidence that securitization governance did not work in vintage RMBS deals. If the trusts had used a better operational process to effect rep and warranties compliance, as well as other ongoing operational items, billions of dollars of losses may have been avoided. We do not understand why the rating agencies do not consider these settlement payments as evidence that they should consider giving lower subordination credits on future securitizations deals when proper governance backstops are not included up-front. Again, this is different than the master servicing function.

Separately, there is talk that some rating agencies seek to rate Operating Advisors. We think this is premature. The industry and regulators must settle upon a macro oversight template that has consistency from deal to deal. The current deals simply have too much operational variability. In the meantime, investors should be comforted that Reg AB attestations by third party auditors are required on the OA in new deals. OA best practices have not been agreed upon yet. Once these are agreed to, an independent review may be warranted, but pricing for this review is a focus item given the OA's expense-adjusted income.

19. What are some OA limitations?

Even after many years of discussion and documentation improvement, structured finance documents are not consistent from issuer to issuer. Additionally, key terms are still not defined well. An example is the "servicing standard," which is the foundation of the operational function of the trust,

but usually is defined in less than two paragraphs in a 100+ page document. This creates a significant challenge to the OA who is asked to enforce operational practices to the originator's or servicer's "standard." Furthermore, the standard has a "living" concept to it, so the standard on the issuance date and the standard on the reference date could be notably different. This rolling nature exposes the OA to criticism even when the best of intentions are made.

Due to the lack of well detailed operating "laws" and an established book of "case law" or "appeals" as it pertains to the originator, issuer and servicer practices, we should not expect the OA to be a one-stop solution for everything. However, given the amount of outstanding disputes in the RMBS area, we suspect some helpful case law may develop in the next 12 months.

20. How should the OA be selected?

In the corporate finance world, it is considered an honor to be on the board of a public company. It is not uncommon that company officers and existing board members select new board member candidates based on numerous criteria. Rarely is a director hired because they are willing to do it at the lowest price. In structured finance, governance has historically been selected based on the lowest priced vendor with the expectation that all of the candidates were generally the same. We believe competitive pricing is good for the OA market just as it is in any other market. However, minimum standards of OA qualifications are necessary to ensure the OA selected can actually perform its affirmative duties.

Minimum standards are common in capital markets in order to ensure an efficient market. For example, look at the minimum standards governing boards of directors, banks, investment banking, hedge funds, trustees and originators. Without OA minimum standards, the OA could potentially become just another passenger in the boat, instead of a needed life preserver when things go wrong.

Under the new fee structure outlined in Section IV, there is a concern that a vendor candidate could bid a very small fee (close to zero) and investors would worry that the OA may not work hard. As such, a selection process is necessary that is not based solely on price. We believe investors should have material input in the selection of the OA. Please see our website www.pentalphaglobal.com/notices and paper titled "Memo to the Rating Agencies to Improve Investor Confidence in the Selection of Rating Agencies" dated May 2008 where we proposed a process for investors to choose a rating agency. We think there are derivations of that process that could work in selecting an OA.

Looking at the fees paid to some OAs lately on some deals, it is extremely difficult to imagine a new OA would step in to replace the old OA in the tail period of a pool, if the old OA failed to perform. This suggests immediate change.

21. How can data received by the OA be responsive to evolving needs?

Servicing practices continue to evolve. In order for the OA to do its job in this ever-changing world, data disclosures between the trust vendors and OA need to be revised during the life of the trust to allow for responsible auditing to the revised standard. For instance, in RMBS 1.0, the monthly dataset provided by the servicer was established upfront and would have been insufficient to identify robo-signing, foreclosure delays due to missing loan documents or calling campaigns where the borrower is never found. If the OA is to have any "teeth," it needs access to improving data and the dataset needs to grow as operating practices and economic conditions change. Fortunately, the envisioned OA is intended to be a signatory to the transaction documents upfront, so confidentiality

should not be a problem. The issue is providing language in the documentation upfront so that the servicer is obligated (for an additional fee) to deliver additional data if requested, within reason (reason being the operative word). We appreciate that the servicing industry is not in the information dissemination business, but balance is needed.

In RMBS 1.0, servicers have resisted giving certain data to operating advisors or investors because it may contain personally identifiable information. There needs to be a solution to respect these rules but still allow investors and their agents to do their job as outlined in the trust documents.

22. Should OAs be required to be Reg AB compliant?

We applaud OAs being Reg AB compliant. This provides investors with assurance the OA is meeting its operational obligations (e.g., controls, guidance turn-around efficiency, recordkeeping, etc.).

At a minimum, all deal documents should include provisions that provide the OA with reasonable access to copies of all loan files and servicing items such as servicing comments. These could be material items to establishing potential damages and claims.

Importantly, Reg AB requires the trustee and servicers to do more as they supply data access and answers to the OA. We strongly believe these vendors should be paid more responsibly to provide such information. We want them to be competent and helpful and not be concerned with additional expense.

23. Should originators and servicers be paid more to respond to these new OA tasks?

This Discussion Paper suggests additional reviewing and other tasks by the OA that likely expand during the trust's life as changes in the industry and the collateral pool occur. This will likely burden the information provider (i.e., the servicer) in terms of management time, database expense and investor reporting staff. It is unrealistic to add these OA tasks without compensating the originator, servicer, and dealer to interact with the OA. Simply giving the OA more and more data is insufficient for the OA concept to work. There must be dialogue between the parties and each party must assign a relevant and talented person to respond to an OA inquiry. <u>This will cost money</u>. <u>Pay the servicers modestly more to interact with an OA.</u>

24. Should the OA be allowed to call an investor vote?

It is contemplated the OA will make decisions based on certain authorities outlined in the trust documents. The threshold for those authorities should be clearly outlined in the documents and generally consistent deal to deal. In reality, the OA may observe items that were not contemplated in the original documentation that warrant discussion at the stakeholder level. As such, we recommend deals have provisions that allow OAs to request the trustee to hold a vote, pursuant to pre-determined and agreed protocols, if it deems it appropriate in its sole discretion.

25. What is the OA's role in a transfer of servicing, if deemed necessary?

There has been industry discussion regarding servicing transfers and the authority given to the OA in that regard. Transferring servicing is a material undertaking and the authority may be different based on who initiates it.

- If the subordinate investor requests the servicing change, assuming that a rating agency's no-downgrade-letter was already received from the relevant rating agency, the PSA should clearly outline upfront what additional minimum criteria (operational, financial, reputational, etc.) the OA must further consider before consent can be given, if any. A lack of guidance regarding additional OA testing requirements over the rating agency activities could make the OA's response look inconsistent. Can the OA just rely on the rating agency's letter?
- If the OA suggests moving the loan servicing, we recommend the OA be responsible for analyzing, proposing, and overseeing the servicing transfer process but only if stakeholders approve it via a vote. The number of votes necessary to affect a vote should be clearly outlined in the PSA upfront as well.

In general, because of the importance of loan servicing and the rights of various parties, we believe a servicing transfer initiated by the OA should only proceed if authorized bondholders agree with the assessment. The OA should generally not take that responsibility independently.

26. What stops the OA from moving servicing in an erratic and unjustified fashion causing price damage to one or more bond classes?

As noted in the answer above, we believe the OA's power to transfer servicing should only be effected through a stakeholder vote. The OA should not have unilateral authority to move servicing, so long as a stakeholder vote on the matter can be effected. This checks-and-balances approach ensures the OA is not delegated more authority than appropriate, and it is also consistent with the corporate world framework where fundamental corporate actions must be approved by shareholders. To remedy the historical problems and difficulty surrounding bondholder voting, we believe a solution is to lower the quorum requirement and set approval as a majority of the quorum based on par value. If the vote is unable to be conducted because of a lack of bondholder quorum (as opposed to a rejection by stakeholders) and the discretion to move servicing is given to the OA as a backstop, the subordinate investor should still have confidence in the fairness of the process because the OA, if it fits the criteria outlined in this Discussion Paper, would be a truly independent and qualified party. Therefore, its motivation for moving servicing would not be out of self-interest. Additional protections that should mitigate the concern of an unjustified servicer removal are as follows:

1. The OA framework outlined in this document is a best practices approach that is inspired by the framework of an independent director in the corporate world, which has proven itself to be the foundation of best practice governance for many years. The OA framework is not based on the master servicer / special servicer framework, which serves a limited oversight function rather than a broad governance function. There are material differences between the two frameworks.

2. The OA would not be a competitor of the servicer or subordinate investor, and therefore, improper motivation for removal should not be a concern. If a competitor servicer is the OA, we understand why the servicer or subordinate holder would be concerned. If the OA is not a competitor of the servicer, why should the OA want to do something erratic?

3. The OA would be subject to reputational harm and brand destruction. In other words, if the OA moves servicing in an erratic and unjustifiable fashion, they likely would not be used in future deals.

4. Under the framework outlined in this document, there would be no economic incentive for the OA to move servicing unless it is justified. It costs time and money for the OA to move servicing.

5. Under the OA framework proposed in this document, the OA would have the flexibility to contact the servicer and give them notice and opportunity to cure the issue before recommending a vote to investors to move it.

6. A best practices framework includes the power of investors to remove the OA (e.g., erratic OA behavior is threatening a downgrade).

7. There are plenty of existing industry protocols where loan servicing can be pulled at the sole right of a more senior investor besides the subordinate owner. Subordinate investors have committed massive amounts of capital with the risk of servicing being pulled. For example, see GSE deals (residential, FNMA DUS, and Freddie Mac K series deal), FDIC securitizations and monoline insured transactions.

27. What deals should have an OA?

1. We believe the OA concepts outlined herein are applicable to any loan securitization transaction (domestic or international) where a trustee is involved, whether it is CMBS, ABS, RMBS, as well as covered bonds and pools of whole loans. This is not just a U.S. real estate loan issue—it applies to consumer finance and corporate finance as well. As a six-year credit risk manager veteran for RMBS and a market leader in the trust oversight advisor role in CMBS 2.0, we have come to the informed conclusion there is a critical need for neutral and highly experienced parties who can be relied upon when inevitable credit and operational challenges occur. We believe the new model for the operating advisor role is one in which the OA is empowered to bring about positive results through a variety of means, including general monitoring, decision-making pursuant to specific delegated authorities, and the power to recommend removal/replacement of various vendors under certain pre-determined circumstances.

2. All securitization trusts must include improved governance standards, no matter what the collateral type is, whether single borrower financing, conduit, or master trust. While some constituents may feel that enhanced governance controls may not be necessary on certain collateral types, or low leverage transactions, the most recent large settlement in the RMBS area suggests there are flaws in the existing securitization template as a whole and a new set of standards are needed. Hundreds of billions of dollars as well as investor confidence are at risk in this very large international market.

3. Additionally, these oversight items are not only applicable to securitizations. A version of these best practices could be used to facilitate post-settlement litigation or regulatory compliance needs. Litigation stakeholders and regulators should embrace this oversight and governance process and imbedded infrastructure as a low cost tool.

28. Can arbitration be utilized to efficiently resolve structured finance disputes?

Binding arbitration is a tool actively used in resolving securities industry disputes. Virtually all of the large banks require their broker-dealer affiliates to demand this dispute resolution process from

their new clients. Many if not all of these securities arbitration tools should be utilized in the securitization governance process regarding loan-level disputes and operational disputes. We should embrace these protocols and incorporate them (after being adjusted for loan industry matters) into structured finance transactions and trusts. Additionally, as more case law develops over time, arbitrators will have the ability to utilize this precedent in their decisions, which will lead to faster resolutions.

The following arbitration issues are worthy of consideration:

a. The three arbitrators (individuals) used in securities matters tend to have their personal liability limited by federal law so that they are free to make "tough calls." We understand that these protections are notably better than the laws effecting indenture trustees. We suggest the arbitrator protocols and protections are considered in resolving loan-level disputes in securitization trusts. The OA can then be a trust advocate to get disputes resolved in a timely fashion using this tool.

b. FINRA has an operational process in place that is efficient and time tested to administer disputes via arbitration. FINRA should be approached to see if they would consider helping on loan-level and operational disputes related to the securities their constituents are creating and transacting in.

29. Why bring up improved governance issues now?

1. There is a massive amount of real estate, consumer and corporate debt that will be rolling over (maturing) the next five years. Let us set up the proper trust governance practices now.

2. The rep and warranty settlements related to origination issues as well as ongoing servicing faults in the residential market are large. Much can be learned from them. Why wait?

3. The market is shrinking in outstanding loan and bond supply due to declining asset values and lower leverage multiples.

    a. Investors need to invest money in a shrinking product sector. They will accept suboptimal structures out of necessity.

        i. If investors buy today and swap into a new bond in 12 months, the initial investor will likely see limited need for advanced trust governance and compliance protection. They will not "pay up" for these costly governance additions (in the form of tighter bond spreads at issuance) because they will not likely own the bonds at the period when default risk rises.

        ii. Some investors are confused on the attributes of the concept. This is not a servicer micro-management tool for individual loans or additional data vendor; this is a low-cost governance backstop provided by a specialist firm with technical insight and scalability. Is the servicer doing its job to the standard described in the documents? If not, the OA should coach the servicer to repair the issue or recommend to investors that servicing be moved to another servicer.

b. Some investors think many loans in recent securitizations are better than before. We disagree. As a generalization, the properties and operators have not changed much—the leverage is simply lower. Additionally, some loans in less liquid markets are projecting very stable occupancies reflecting, in our opinion, continued aggressive underwriting assumptions in CMBS.

c. Numerous trade associations have made disclosures that they support the governance oversight idea generally as seen by the amount of coverage the concept received in their recent conferences and in their communications with regulators.

4. Structured finance bonds trade at wide spreads to corporate bonds on an option adjusted spread ("OAS") basis for a reason. Investors are not 100% as confident in the product. The corporate bond products are easier to understand, and there is confidence that the corporate governance will work in stressed periods. Structured finance needs to provide that same confidence in the stressed environment.

5. The rating agencies have not yet begun to require governance improvements.

a. Ironically, the rating agencies have not demanded governance improvements since the large RMBS settlements started. From what we can tell, there is no quantitative "lift" on their models for enhanced trust governance. It appears they assume everything runs in the trust perfectly throughout its life (including representations and warranties maintenance and servicing operations). We disagree, but to date they have not given credit for enhanced governance in the form of lower subordination levels upfront or adjusted downgrade actions. We think they are very remiss in this regard.

6. Deals are still being closed with no one assigned to actively pursue representations and warranties compliance requirements with <u>material</u> motivating compensation. The OA, in this role, would be a valuable asset. We think the servicer should be the primary rep and warranty "cop" and the OA should act as a backstop if the servicer fails to perform, sort of like the state police backing up the local police.

7. A select few traders of Wall Street firms are resisting these new governance items even though their banking division associates were promoting the concept just a few months ago.

a. The traders do not see a return on their investment in better governance (via tighter spreads) because investors have optimistic views of collateral performance and scarcity of supply. While most investors say they see the benefit of improved governance, some may believe that the upfront investment is not worth it if they plan to sell their bonds in a few years anyway.

b. Traders find it hard to explain variable costing for this concept to IO investors even though variable fees are paid to servicers under current pricing regimes.

8. There needs to be a universal set of standards defining the proper governance mechanism managed by the OA. Some issuers are incorporating the OA role. However, to reduce expenses, the issuers are watering down the functionality of that role.

a. Due to the reduction in service requirements and a speculation that the trust's losses will be nominal, low cost OA vendors are winning assignments at fees that barely pay the airplane bill for an annual review. We should look at current pricing as an indicator of service levels.

9. Loan servicing is the center of all trust activity and the financial picture for loan servicers is not positive.

   a. There have been developing stories that some servicers are seeking to supplement their income by opening new divisions to provide certain services that are provided traditionally by third parties (property sales, property maintenance, valuations, etc.). The result is a possible loss of objectivity related to the use of third party vendors, as well as new compensation motives that may be in conflict with the incentive compensation initially established. However, we are okay if servicers do this if it was agreed upon upfront or such practice becomes industry standard.

30. Are there other topics to consider?

1. Some subordinate investors do not see value in the OA's functionality. As a generalization, they believe the OA does not provide any value to them. Effectively, they "tolerate" the OA's involvement while the subordinate investor is involved in the trust. Once the subordinate investor is gone, they really do not care how much functionality is added to the OA's responsibility card. Based on our experience as an OA, we have seen subordinate investors miss some very important servicer and trustee errors. Some subordinate investors are entrepreneurial companies with limited operational policies and procedures; they are not perfect. It would be naive to think they all provide the same level of care in their oversight. Instead of the subordinate investors precluding the OA from taking leadership on meaningful tasks, we encourage the subordinate investors to embrace the functionality of the OA on certain tasks so the subordinate investor can selectively reduce its operating expenses and benefit from the scale an OA can provide. It is illogical to think subordinate investors could not abdicate some basic functions to the OA with the goal of working together and not in opposition to each other.

2. A few bond trustees recently approached us about some new programs they have created to identify bondholders for the purposes of facilitating investor-voting activities. We applaud those efforts and suggest OA tasks be crafted in concert with that new technology. If better voting can really be implemented, the OA's tasks should change and be enhanced to reflect this new technology. We believe such technology could be particularly relevant in rep and warranty lawsuit items and servicing transfers.

3. In CMBS transactions, controlling class designation may move up the capital stack to new holders multiple times throughout the life of a deal. This often happens when junior interests are wiped out through losses. Thus, special servicing could be frequently transferred, with little servicing work getting done effectively. The OA would be taxed with this constant moving, but it would remain the common asset in its oversight of the loan pool.

Section IV: Recommended Operating Advisor Compensation

The goal of adjusting existing compensation methodologies should be to better align the OA's financial interests with those of stakeholders throughout the trust's life. Like the board member of a corporation or the liquidity agent of a problem situation, if the OA is required to do more work, then it should be compensated more. Normal compensation should consist of a modest fixed fee in dollars for easily determinable work such as annual reviews and monitoring certain current loans, rather than calculated based on a fixed basis point model based on the unpaid principal balance ("UPB") of the collateral.

The reason that the UPB-based pricing model does not work is because it fails to account for the "tail period" of a deal. In the tail period, the UPB is small and declining but the tasks for the OA are fixed regardless of the UPB of the collateral. Many investors believe the tail period is when the most work for the OA would be necessary. Moreover, there may be delinquent loans that need special attention by the OA. This is not a best-in-class OA framework because it could create a material misalignment of interests at the end of the trust's life.

It is counter-intuitive to have the OA provide a variable governance service (based on unhedgeable macro and local economic factors) for a fixed fee. As with a special servicer's fee in CMBS, the OA's fee structure should be variable in nature and done in a way that is REMIC and regulatory accepted. The current pricing paradigm for OA tasks in CMBS 2.0 is a fixed fee for variable services. This OA pricing paradigm should be changed to a variable model to better align financial interests.

It is important to recall that the OA provides a highly customized service with challenging scalability. Experienced people are clearly preferred to perform the task as the complexity of the loan workout situation grows. Assuming no fraud issues, CMBS defaults and losses tend to occur later in a pool's life, while RMBS losses tend to occur in the middle to later periods. As such, back-ending the OA's compensation assures that a new party would be willing to take over if the OA role needs to be transferred to another party due to an OA covenant breach.

Many of the tasks outlined herein are consistent from collateral type to collateral type. We call these "base governance services." Other tasks are specific to collateral type and deserve special pricing. In addition, while this Discussion Paper advocates introducing the OA into the deal while it is being conceptualized (not days before printing the deal document), there are circumstances where the OA may enter later and thus, not all the tasks outlined in Section I and all the fees outlined in this section would be applicable. For example, the pre-closing tasks and related fees would not apply. Also, depending on the entry timeframe, many if not all of the post-closing collateral quality tasks would not apply.

The pricing suggestions provided below are based on current triggers found in CMBS 2.0 deals as an example. If the responsibility triggers change from deal to deal due to changing industry preferences, so too should the OA's compensation. If the higher workload triggers become easier to get "in the money" (because they are struck lower or the collateral is riskier), the OA would be operationally stressed soon after the deal is closed and higher fees than those proposed below may be appropriate. The inverse applies as well. Effective pricing would reflect the specifics of the deal collateral and deal structure. It is difficult to arrive at a "one-fee-fits-all" compensation approach for so many different risk and performance issues, though we recognize some tasks may have fees that are "generic" rather than

"custom." In addition, securitizations with frequent issuers using basically the same bond documentation and services should result in generic pricing on many elements of the fee structure.

The following fee amounts are provided as a way to open up discussion. They are effectively copied from the trustee and special servicing community and represent a modest total cost related to macro trust expenses. The cost of the OA is a fraction of the cost of a servicer, and it should remain this way. The recommendations provided below are intended to better match OA compensation to OA tasks. We ask the reader to focus on the concepts rather than the specifics.

1. Pricing for Upfront Tasks for All Collateral Types (During the Transaction Pre-Closing Period)

a. A one-time fixed fee paid at closing to perform the OA's pre-closing duty to review transaction documents with a view toward enhancements (as described in Section I).

i. This is a very time-consuming process because issuer documentation varies so widely. At a minimum, the size of the OA's first year fee should be equal to the outside legal fees the OA must pay. Whittling down these OA upfront fees to nearly zero does not accomplish the goal of having the OA reading and fighting for clarity in the deal documents. In fact, depending on the quality of the transaction documents, the OA's unreimbursed legal bills could be higher than its first year income. (See the protocols done in the corporate market for underwriter's and other trust vendor's counsel fee reimbursement.)

2. Pricing for Post-Closing Tasks

The fundamental change from current market practice that we propose is for the OA's compensation structure for post-closing tasks to be variable in nature to account for springing responsibilities rather than fixed to UPB. In simple terms, pay little if everything is fine; pay more if things deteriorate, and the OA's work load grows accordingly.

a. Pricing for Post-Closing Collateral Quality Review (for upfront representation and warranty compliance-related work, no matter what the collateral type)

i. A per loan review fee in dollars would apply. (UPB does not usually have a bearing on the size of the loan file review task.) Triggers (such as identifying how many loans to review) would be established based on collateral type.

ii. To the extent the OA refers a potentially defective loan to the trustee or servicer and/or engages in other put-back related activities, the OA should be compensated on an hourly fee basis.

b. Pricing for Post-Closing Servicing Operations in CMBS transactions (ongoing fees to compensate the OA for ongoing operational oversight). We note the following pricing discussion is based on the OA's tasks in a CMBS deal. ABS and RMBS differences are described in the next subsection.

i. Concept – The proposed OA compensation structure herein is more detailed than current market methodologies. There is a reason. We suggest the OA is paid a fee based on up to six relatively small revenue sources with the goal of them being collectively balanced so the OA is not incented to direct or influence operations activities in a certain way that creates an unintended financial windfall to the OA. For discussion purposes, the compensation structure can be divided in four categories: (1) fixed monthly services, (2) defaulted loan servicing oversight, (3) special projects, and (4) Reg AB compliance and other items.

(1) Fixed Monthly Services. The OA would be paid a fixed monthly fee in dollars over the life of the deal for reviewing all upfront compliance and EPD/watch list loans, attending annual meetings, writing annual reports and responding to inbound investor inquiries, provided that after the first twelve months of the deal the monthly fee would be decreased to reflect that most of the upfront compliance testing and put back activity would have ceased. The OA would also be reimbursed for out-of-pocket costs incurred in connection with performing its duties.

(a) This fixed monthly fee in dollars would grow once a Co-Consultation Period occurs (with the controlling class advisor rising to pay for added variable services the OA is providing).

(b) The fixed monthly fee in dollars would grow again once the Senior Control Period occurs and the OA is responding to more issues on current as well as delinquent loans.

Note: Many corporate board members are paid a more significant amount per month but do not provide the significant resources such as systems and people that are required of the OA.

(2) Defaulted Loan Servicing Oversight.

(a) A small basis point fee paid monthly on the balance of specially serviced loans, similar to variable special servicer fees seen in CMBS. In this regard, large loans tend to have more complex capital structures and collateral as well as more sophisticated borrowers. The goal is to align the timing of the OA's income commensurate to its level of involvement. This fee would be "nominal" during the Co-Consultation Period and would grow once the subordinate investor is gone (i.e., the Senior Control Period). In both instances, to assure investors that the OA is not incented to have defaulted loan resolutions drag on, there would be a declining basis point scale, meaning the OA compensation would decline over time. Additionally, there would be a per loan cap in dollars per month (to assure large loans do not generate undue profits to the OA) as well as a monthly floor for small loans.

(i) During the Co-Consultation Period

(A) Per annum (bp) fee paid monthly on the UPB of each specially-serviced and/or delinquent loan as per industry convention, for the first 12 months, <u>subject to a per-loan floor per month</u>, then a basis point fee thereafter, subject to a floor per month, no matter how long the delinquency is outstanding.

(ii) During the Senior Control Period

(A) Per annum (bp) fee on the UPB of each specially-serviced and/or delinquent loan for the first 12 months, <u>subject to a floor per month</u> and a reasonable and mutually agreed-upon cap on a per loan per month basis.

(B) Per annum (bp) fee on the UPB of each specially-serviced and/or delinquent loan for the next 12 months, subject to a similar but lower (e.g. 25% reduction) floor and cap structure as described above.

(C) Per annum (bp) fee on the UPB of each specially-serviced and/or delinquent loan thereafter subject to a similar but lower structure as described above (e.g. 10% further reduction).

(b) A loan resolution fee similar in concept to a servicer incentive fee to resolve a loan. This fee would be paid at the same time the servicer is paid.

(i) Re-performing fee subject to a mutually agreed-upon cap; and

(ii) Foreclosure and collateral sale fee subject to a mutually agreed-upon cap.

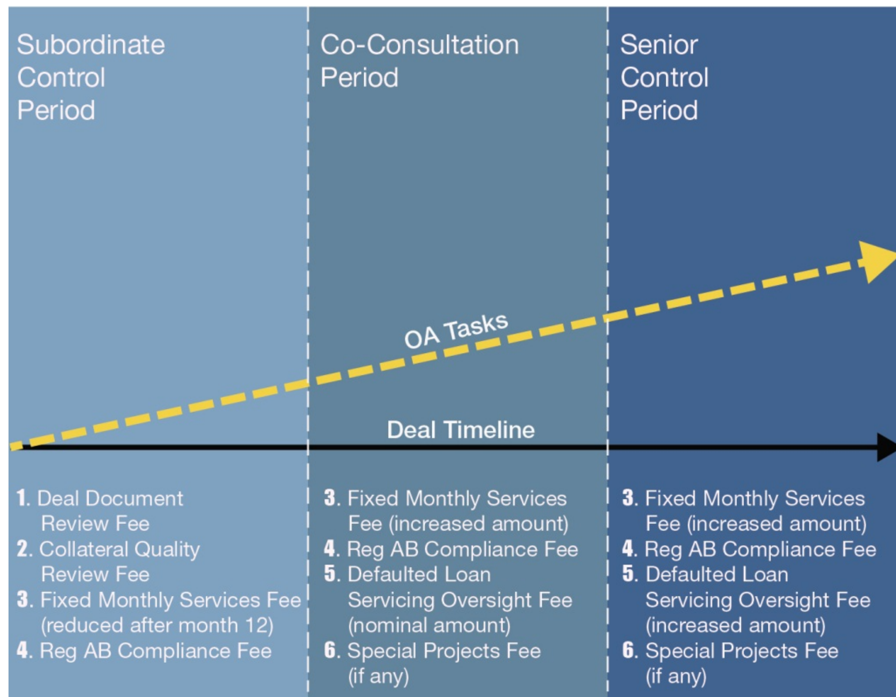
(c) A fixed rate fee to successfully close a servicing transfer. (No success fee if the resolution fails to close.)

(3) <u>Special Projects</u>. An hourly fee to do special projects requested by the trustee that are in the scope of the trust's capabilities but outside of the OA's specific responsibilities outlined in the PSA (including testimony time in court, if compelled). For transactions where the OA is directed to attend any court hearings or other in-person meetings to speed the servicer's decision-making, this hourly fee would apply then as well. This

includes travel time and related expenses. (We note that fast moving bankruptcies would probably benefit from the OA being in court to opine on workout strategies.)

(4) Reg AB Compliance and Other Items. Reimbursement for marginal out of pocket Reg AB variable expenses, for reasonable and necessary legal expenses, and for travel expenses related to annual site visits and other approved travel.

The following graphic helps illustrate the CMBS compensation concepts described above.



There has been industry discussion recently by investors and others that a component of the OA's compensation takes the form of a vertical interest in the deal. This could be implemented by structuring the OA's compensation as economically equivalent to a percentage interest in each class of security issued to investors. As such, the OA would be subject to the same credit, prepayment and other risks that impact the entire collateral pool. The purpose would be to further ensure that the OA's compensation is aligned with all investors and that it has "skin-in-the-game" when making decisions. We support this idea, which could be incorporated into the compensation concepts described in this section either by replacing or supplementing the fixed monthly services fee.

While we support a vertical interest compensation component, we do not support OA compensation through a horizontal form of retention. We believe this has the potential to create misalignment of interest between the OA and more investors, as a horizontal interest could be extinguished by the time most of the OA's powers kick in. Therefore, we believe any skin-in-the-game interest paid as compensation to the OA should take the form of a vertical slice of the deal, not

horizontal. Like the fixed monthly services fee, a vertical slice would ensure the OA is entitled to receipt of compensation so long as securities remain outstanding.

In considering a vertical interest compensation component, it is also important that care be taken not to disadvantage the OA by structuring it such that the OA would be taxed upfront for its receipt of this interest. We are optimistic that this can be accomplished and simply note the issue for those considering the subject.

c. Pricing for Post-Closing Servicing Operations in ABS and RMBS transactions Ongoing ABS and RMBS oversight is different from CMBS oversight for many reasons including, but not limited to, the smaller loan size and the lack of the master servicer/special servicer relationship frequently seen in CMBS. Consequently, the compensation structure for the OA's oversight of servicing operations in these asset classes should be appropriately tailored as follows:

i. The base and variable fees outlined in the CMBS section above apply but Section 2(a) (pricing for post-closing collateral quality review) and Section 2(b) (pricing for post-closing servicing operations) should be amended to reflect the technical issues related to the ABS and RMBS markets. As stated earlier, we think the OA's role should change from a passive role to a more active role once certain pool-level performance triggers are hit, like in CMBS.

(1) The OA's fee per delinquent loan should be based on the amount of OA oversight per loan. If the oversight level is "active" and the servicer is not proceeding with certain actions unless it is given advanced approvals by the OA (subject to a delegated authority matrix outlined in the PSA), the charges should be higher than if the OA is doing a post-review action only. For "active" reviews that require preapproval, the OA must have phone-ready staff available to constantly respond to a variable amount of inbound approval requests from the servicer. This costs the OA more money, and therefore, it should be compensated accordingly. If it is a "passive" review, the OA can plan better and provide the service for a lower cost because the review is after the fact. Like the OA framework outlined in Section I, the OA's role in ABS and RMBS would shift from passive oversight to active oversight based on credit performance events.

(a) Active reviews: Per annum (bp) fee on the UPB of each loan, subject to mutually agreed-upon floor and cap per loan.

(b) Passive reviews: Per annum (bp) fee on the UPB of each loan, subject to mutually agreed-upon floor and cap per loan.

(c) Provisions for passing reasonable travel and other "reimbursable" expenses along to the trust so that the OA is able to perform incremental activities on an unencumbered basis as demands may be placed upon them.

Compensation Summary

We recognize the compensation suggestions described above will be subject to intense scrutiny and will, accordingly, be the topic of negotiations for each deal. Ideally, however, the thought process proposed, if executed, can assure investors that the OA constantly has a vested interest to perform its services throughout a deal's life and that other interested parties may be able to step in at any time if it ever becomes necessary to replace an OA. The OA's fee should be enough to motivate a third party to take over the OA's responsibilities if the OA fails for any reason. Low OA fees in the tail years of a pool's life could create OA transfer problems, if needed. This is definitely a risk in the current CMBS 2.0 fixed pricing model based on UPB. Monthly floors for OA compensation are appropriate.

> Note: Many traders agree with the variable fee OA compensation concept (like CMBS special servicers), but dislike its deal engineering complexity. When the trust pays the variable fee, the dealer may be required to:

1. Explain credit risk-based fees to interest-only ("IO") investors who may be modestly short-changed when these fees grow in deteriorating deals (just like a special servicing fee).

2. Explain and estimate the size of the variable cost to the rating agencies as they size credit support.

3. Explain the monthly flow amount that is paid in the back years and the rationale and impact on bond cash flows.

Separately, instead of the trust paying for the higher OA's fee to address the specified issues, it may be possible to have the OA's marginal loan-level fee written into the loan document upfront. Effectively, have the borrower pay for the expense if they stop paying their bills, instead of the bond investors. If the subject loan documents can be written upfront to obligate that the OA's variable fee be paid by the borrower, then the investors tend to be less focused on the cost of the OA's fees, even though it possibly has the same impact on the loss severity, where applicable. If it is not written in the loan document upfront, there is concern the OA would never get any of the fee due to the lack of servicer enforceability, so investors may give a low value added to it. (And servicers should not be required to advance the OA fee.) Also, some borrowers would not complain about this arrangement because they would be confident in their ability to pay their obligation.

The trustee should oversee the OA's request for cash compensation above a fixed amount and approve it before the payment administrator makes any payment to the OA for supplemental services. (The trustee should be compensated for this added role.)

We believe the OA task should not be bid out, nor should regulators or even trade associations dictate fees, but we believe they can give guidance so there is a consistent paradigm for all securitizations. Issuers should be able to negotiate fees with the OA vendor that they feel optimizes the cash flow and transparency of the deal.

The OA should be invited by stakeholders to represent their interest on some select items like a board member. Awarding of the business should be based on the OA's qualifications and its service

level and past performance. This is consistent with corporate market protocols. Rarely is a board member hired because they are the lowest price.

We urge market participants to embrace these compensation concepts because doing so would further enhance the OA's alignment of interest and thus, create a more efficient market and minimize systemic risk.

Section V: Conclusion—A Call to Negotiate

This Discussion Paper is not a manual to cure everything that may be in need of fixing within loan pool management. It is our best practice recommendation at this time for improving trust governance and transparency.

There are many items discussed in this Discussion Paper related to trust governance that deserve consideration from a broader audience, including trade associations and regulators. As a generalization, we hope the relevant trade associations can devise workable solutions to the items outlined herein so that the regulatory community can undertake its actions based on a strong and informed industry foundation. On behalf of numerous large industry leaders, Pentalpha is an active and paid "architect" in creating new governance and control procedures.

Separate from design activities, we also provide these oversight services on many existing securitization trusts collateralized by numerous asset types. We welcome the opportunity to join interested parties to devise an optimized governance solution for the industry and regulatory community. As one of many leaders in developing the historical Trust Oversight Advisor (TOA) role, we applaud the work on the many concepts brought to the table and implemented to date. However, we believe many more tasks, responsibilities and authorities should be added to the existing OA role to create a best-in-class process and a new financial paradigm. Again, we do not believe the master servicing protocol is sufficient. Different skills are needed.

We prefer a market-based solution to the concepts discussed above. However, our experience in the capital markets industry suggests the market's activities do not always result in best-in-class procedures. As such, some modest regulatory involvement with industry input may be helpful.

This document is intended to promote thought by industry leaders and regulators with a goal towards minimizing losses and reducing volatility in trust cash flows so that structured finance bonds trade at a closer spread to corporate bonds. Seeing that many large banks have agreed to multi-billion dollar settlements related to failed reps and warranties as well as operating flaws and conflicts of interest in old securitizations, and that these proposed best practices would have materially limited those losses had they been implemented in old deals, it is fair to say these best practices could have multi-billion dollar impacts that far outweigh the marginal cost to include these protections.

Not all participants in the structured finance industry (e.g., some subordinate investors and dealers) will actively support these governance concepts, and their reasons may be varied. We respect that different parties will have different perspectives and motivations. As a generalization, many do not embrace change or perceive a value to enhanced trust oversight. They effectively believe in self-regulation by market participants, including trust vendors.

Also, in CMBS (one of the largest debt classes in the world), unlike in the residential sector, industry participants have generally not experienced the massive losses resulting from collateral and operational challenges. Thus, except for a few CMBS leaders, many CMBS industry participants have had little concern for contingency planning in the event a trust has material collateral or operational challenges after the trust is initiated and the original trust participants are gone. There is a balance in gaining CMBS investor acceptance for governance improvements in this regard, and this Discussion Paper seeks to respect their concerns while still protecting investors in a best-in-class fashion. Senior

investors will likely say these enhancements are not enough, while subordinate investors will say they are too restrictive.

It is important to note the phrase "except for a few CMBS leaders" in the prior paragraph. In the fall of 2010, two Wall Street dealers (JPMorgan and Wells Fargo) proactively took a leadership role in improving CMBS governance after Goldman Sachs and the Federal Reserve Bank of New York worked closely on the governance mechanisms built into the 2009 DDR CMBS transaction. Commensurately, the FDIC came out with material leadership on trust governance issues and incorporated strong trust oversight and investor protections in its transactions. These depositors and underwriters made significant financial investments to "do-the-right-thing" in this regard but were unable to recover some of their costs because the initial investors for the offered bonds were confident that they could sell their bonds before the enhanced downside protection was ever needed. This "liquidity confidence," the idea investors can sell before problems arise, caused a lack of tighter bids due to improved governance and control by certain investors.

Those dealers, followed by several others, have retained the operating advisor concept anyway, probably because they know it is a logical addition to trust. To reduce costs, however, the dealer community as a whole has subsequently watered down the oversight task by a meaningful amount. We are not entirely critical of this trend, but there needs to be a balance. Overall, most issuers want to improve their brand issuance and believe proper trust governance is responsible transaction engineering.

We are a vendor for this service. We look forward to providing our unique expertise to current valued and prospective clients in future transactions containing the enhancements recommended herein, including compensation schemes that take into account the different tasks that have been identified as crucial to the success of the securitization and its many investors. In essence, we do not believe the new OA paradigm is a "Zero Sum Game." We believe the new paradigm allows for a "Win-Win" for everyone—securitization issuers, through tighter spreads to corporate bonds and lower cost financing; borrowers and consumer advocates, through lower borrowing rates as a result of tighter spreads; investors, through more predictability and less price volatility in distressed times; and operating advisors, through fair compensation for value provided

We would be most pleased to discuss these concepts with interested parties. To do so, please contact James Callahan, Executive Director of Pentalpha Capital Group, at (203) 660-6112 or james_callahan@pentalphaglobal.com. We welcome your feedback.

About Pentalpha Surveillance, LLC

Pentalpha Surveillance, LLC and its affiliates ("Pentalpha" and "we") have been involved in the maturation process of consumer and real estate finance for over 18 years. We are independent trust governance experts for real estate, corporate and consumer loan pools. The Pentalpha organization is:

- Committed to the operational compliance of loan originators and servicers. As loan and collateral experts, improving operation performance before a problem occurs is our core business, not our side business.

- Actively engaged by government entities and trustees to oversee loan origination and servicing compliance and liquidation optimization strategies.

- Capable of expert testimony services provided in court related to our findings and resolution recommendations.

- Dedicated to improving securitization trust governance and ongoing oversight.

- Operations testing experts with specialized systems to detect operational problems.

- Reg AB compliant for Operating Advisor roles.

- Not competitors to the originators and servicers we oversee, nor do we have future flow arrangements.

- Not affiliated with investors that buy related debt or equity.