MEMORANDUM

Date: May 31, 2016

To: Stephanie Heller, Esquire, Deputy General Counsel and Senior Vice President, Federal Reserve Bank of New York

From: ULC Electronic Residential Mortgage Note Registry Committee

Re: Comments on the March 11, 2016 Draft of the National Mortgage Note Repository Act of 2016

Dear Stephanie:

Thank you for the opportunity to comment on the Federal Reserve Bank of New York's March 11, 2016 Draft of the National Mortgage Note Repository Act of 2016 ("Draft"). Thank you also for your understanding in allowing us to submit these comments several weeks beyond the established deadline. Again, we apologize for the delay.

Our Committee was fortunate to have the JEBURPA comments on the Draft available to us in conducting our own review of the Draft. Because the JEBURPA comments are so thoughtful and thorough, we have been able to keep our separate comments to a minimum. In general, the issues discussed below are only those that we felt a need to particularly emphasize or with regard to which we had something additional to contribute beyond the JEBURPA comments.

1. The Gateway Concept

   (a) Risk Allocation

We agree with JEBURPA that the gateway concept is not worth the complexity and obfuscation that it adds to the statute, particularly in light of the fact no one so far has indicated a willingness to serve as a gateway. We believe the comments on this issue that JEBURPA has made regarding relevant sections throughout the Draft demonstrate the difficulties the gateway concept creates in this regard.

In addition to our skepticism as to its workability, we also believe that the fact the gateway concept is such a departure from the current model for risk allocation through warranties argues against its utilization. Allocation of risk through warranties traditionally has been through a "direct seller" model – a person warrants their own actions (and those of previous transferors who have given them warranties) in connection with a transaction in which they are directly involved and in which they have a direct financial interest. The transfer warranties of UCC 3-416 are the classic example of this "direct seller" model. By contrast, under the "insurance" model established by the gateway concept, the gateway gives warranties with regard to the actions of third parties regarding an instrument in which it has no interest and concerning transactions in which it played no part.

It is our understanding that warranties given under these two disparate models of risk allocation are intended to function together in the context of the repository – submission warranties given by gateways would allocate loss in connection with certain issues in connection with submission, while transfer warranties would allocate loss in connection with transfers both before and after submission of a mortgage note to the repository. We suspect that some interesting coordination issues will arise in determining how these two sets of warranties will work together to set up a comprehensive scheme of risk allocation in the context of the repository. It seems those issues will be more easily resolved if the two sets of warranties are based on the same model of risk allocation.

For these reasons, we think that risk allocation through warranties in the context of the repository should be structured under the "direct seller" approach rather than the "insurance" model represented by the gateway concept. The mortgage industry is familiar with "direct seller" warranties and has developed methods to structure transactions to address any concerns those warranties raise for them, and those methods can be adapted for use in connection with a "direct seller" model for repository warranties. The integrity of the repository can be protected through the standards it establishes for its use.[1]

(b) Structure of Submission Warranties

Section 8(d) sets up a complicated structure with regard to both what submission warranties are given and to whom they are given. Under subsection 8(d)(1), fewer warranties are given with regard to a mortgage note submitted to the repository within 10 business days of execution and never transferred than are given with regard to other notes. What is the rationale for this distinction? All of the warranties appear relevant without regard to when the mortgage note was submitted. Similarly, under subsection 8(d)(2), the beneficiaries of the various warranties differ depending on which warranty is at issue and whether the mortgage note was executed before or after the repository system began to accept submissions. Why is this distinction among beneficiaries made? Won't these requirements make it more difficult to make a warranty claim, even for those who are beneficiaries of the particular warranty involved? If the purpose of these various distinctions is to limit the exposure of the gateway, isn't this another example of how the "insurance" model complicates the Draft?

Can a gateway disclaim the submission warranties?

2. Treatment of Registrant as the Person Entitled to Enforce ("PETE")

Section 8 seems to say that, while only a PETE is eligible to submit a mortgage note to the repository (8(b)), if a person other than a PETE does submit a note and is listed as the registrant on the repository system, then that person is the PETE (8(c)(3)(B) & (c)(1)(B). Isn't this rule too broad? It would give PETE status to a thief who stole order paper and forged the true PETE's indorsement. What is the purpose served by giving PETE status to a wrongdoer? Isn't the purpose of the repository to resolve the

[1] We note that other warranties in the Draft (e.g., the section 10(d) modification warranties) appear to use the "direct seller" model.

evidentiary problem created by the failure of persons who were in fact entitled to enforce to obtain the indorsements that would allow obligors and others to easily determine that status? Doesn't a rule that a PETE can evidence the entitlement to enforce by being listed as registrant address that problem? Certainly, extending PETE status to a thief of order paper does not appear to be necessary to address that issue.

This rule also does not appear to be necessary to protect borrowers. Section 9(b)(2)(D) provides that a borrower is discharged with regard to any payments made to the person listed as registrant on the repository before the borrower is served with a court order, even if an adverse claimant has a superior claim to that of the registrant.

It appears that the only innocent persons protected by this rule would be transferees of the wrongdoer. Under the rules of Article 3, a thief of order paper cannot give its transferee the right to enforce, as the thief has no enforcement rights to give. Presumably, the enforcement rights given by Section 8 could be transferred to subsequent registrants.

We find it difficult to believe, however, that protection of these transferees is a sufficient reason for giving PETE status to a thief and forger. First, it is our impression that this issue will arise in very few cases in the context of residential mortgage notes submitted to the repository. Therefore, few innocent transferees are at risk of finding themselves without PETE status. Second, transferees in the registry will be sophisticated buyers who have already developed practices to deal with this risk under the current rules. Third, the protection given innocent transferees by this rule is fairly limited. While, under this rule, the thief could transfer the Section 8 right to enforce, it appears that the current law regarding holder status still applies, and, therefore, the forger could not make its transferee a holder of the note. The transferee thus could not be a holder in due course, and would be subject to the claims of an adverse claimant. These same factors suggest that the rule of Section 8 also will not increase the integrity of the repository to any significant degree.

The Committee believes that whenever possible the same substantive rules should apply to mortgage notes without regard to whether they are in the repository. The repository is voluntary; the decision as to whether to use it should be based on factors other than whether on a particular substantive issue its rules are perceived as more or less favorable than the rules applicable outside the repository. Applying the same rules will avoid confusion and potential unfairness, and facilitate the integration of the repository into the body of existing law. We also believe that, as a policy matter, it is better not to create rules that can be seen as facilitating fraudulent activity. Unless there is some important justification that we have missed for the significant departure from the current law on this issue, we think the current rules with regard to PETE status should apply with regard to notes in the repository.

3. Adverse Claimants

(a) Definition of "adverse claim"

We think the definition of “adverse claim” in Section 3 of the Draft should be consistent with the meaning of that term in UCC Articles 3 and 8. Although UCC Article 3 does not expressly define the term “claim in recoupment,” it is understood that the relevant claims are those of a right to the instrument that is superior to that of the person currently in possession. Similarly, UCC 8-102(a)(1) defines “adverse claim” with regard to a financial asset as “a claim that the claimant has a property interest *in a financial asset* and that *it is a violation of the rights of the claimant* for another person to hold, transfer, or deal with the financial asset. The requirements that the claim be to a property interest in the electronic mortgage note (rather than simply “with respect to it” as Section 3 currently states) and that the claim be superior to that of the registrant should be added to the definition.

(b) Limits on Available Actions

It is not clear to us exactly what remedies are available to an adverse claimant under the Draft. Section 9(b)(2)(C) states that “the only relief available to an adverse claimant is that of Section 20, and the deposited mortgage note is not subject to the torts of conversion, trover, detinue, replevin, or other common law property torts.” Does this subsection mean that an adverse claimant does not have an action for breach of the gateway warranties in Section 8(d)? Among the gateway warranties are warranties that the person submitting the note is an eligible submitter (which would include being the PETE) (8(d)(1)(A)), and that “there is no adverse claim to the mortgage note” (8(d)(2)(C)). At least in some situations, the beneficiaries of these warranties include “any person damaged by the breach of warranty,” which would seem to include an adverse claimant. Is Section 9(b)(2)(C) intended to take away this remedy? If so, why?

Further, although we can understand why the listed remedies (trover, etc.) that would allow the adverse claimant to recover the physical note would not be available, we are puzzled as to why the adverse claimant apparently is denied the right to seek monetary relief in an action for conversion against the registrant.

Section 20(d) provides that “[t]he relief for an adverse claim shall be injunctive, ordering the repository operator either to freeze transfers during the pendency of the action or to change the identity of the registrant to that of the adverse claimant at the conclusion thereof.” What happens if the registrant against whom the adverse claimant has a claim is no longer the current registrant, having transferred the note to someone else who became the holder, and took for value, in good faith, and without notice of the adverse claim? Would normal holder in due course rules apply, so that the new registrant takes free of the adverse claim? If so, then presumably the adverse claimant would have lost its right to have the repository change the identity of the registrant to that of the adverse claimant. Under current rules, the adverse claimant still could bring an action for conversion against the wrongdoer. Section 9(b)(2)(C), however, seems to eliminate that action (as well as the ability for the adverse claimant to recover its loss based on the gateway warranties). What is the rationale for this result? Is it possible that the Section 9(b)(2)(C) limit on actions is only intended to be a limit on the types of actions that can be taken against the repository?

(c) Treatment of Notice of an Adverse Claim

Section 20(a) provides that "[n]otice to the repository operator of an adverse claim against … an electronic mortgage note shall not be effective and the repository operator shall not recognize such adverse claimant unless said adverse claimant obtains a restraining order, injunction or other appropriate court order effective against the repository operator." As discussed above, if the normal holder in due course rules apply, the adverse claimant will lose the section 20 remedy if the registrant transfers to a holder in due course before the adverse claimant can get a court order. Further, given the speed with which transfers will be completed on the repository, it seems entirely possible that a registrant subject to a claim will be able to transfer to a holder in due course before the adverse claimant can get a TRO prohibiting transfer. In light of this, would it not be appropriate to provide for a brief period during which notice alone to the repository would be effective, so that the adverse claimant will have a reasonable opportunity to obtain a TRO?

Section 19(a)(1) provides that, in the case of multiple submissions, the repository operator will treat the first person to have submitted the note as the registrant unless it, *inter alia,* receives a court order to the contrary, but will not effectuate a transfer of the note for ten business days after the repository gives notice to the competing registrants. Presumably, the purpose of this 10 day period is to allow a determination to be made as to which registrant in fact has the superior right to the electronic mortgage note. If a 10 day freeze is appropriate for this type of adverse claim scenario, why is a similar freeze period (or perhaps a period measure by the time it takes to get the TRO, but not exceeding 10 business days) not appropriate with regard to other adverse claims?

4. Choice of Law

Section 22 states that (with exceptions not relevant to this discussion) "nothing in this Act shall affect the rules used to determine . . . applicable law." Section 9(d)(2), however, provides that an electronic mortgage note is located in the jurisdiction of the repository operator, a rule that will in effect decide the choice of the applicable law in certain situations, and influence that determination in others. We are concerned that stating this rule in such a broad fashion could lead to unintended consequences. If the purpose of this rule is to facilitate the operation of certain rules in UCC Article 9 that depend on the location of the collateral, then we think it would be preferable to state a location rule limited to that narrow context. Indeed, the bracketed language in Section 12(b)(1) already does this, providing that the location of a mortgage note in which a security interest has attached at the time of submission and conversion is determined by its location immediately before submission.

Further, if a general rule regarding the location of electronic mortgage notes is needed, we do not understand the rationale for choosing the location of the repository operator. We believe that a rule providing that an electronic mortgage note is located in the jurisdiction where the debtor is located is by far the preferable rule. The debtor's jurisdiction not only has an interest in application of its law to its resident, but is also likely to be the jurisdiction in which the real property securing the electronic mortgage note is located and the jurisdiction in which the original loan transaction took place.[2] Location of the debtor is the traditional rule with regard to the location of debt.

5. Scope of Regulatory Authority

(a) Scope of the Act with Regard to Guarantors

Our Committee believes that decisions as to the scope of the repository should be made by Congress rather than by the regulator. This is particularly true because of the preemptive impact on state law of the repository with regard to matters within its scope. Successive drafts of the repository statute have made significant steps to reduce the authority of the regulator with regard to determinations as to the scope of the repository, setting out the intended coverage of the repository rules in the statute instead, where we believe they belong. In light of this, we are puzzled as to why the question of whether or not guarantors of mortgage notes will be covered by the statute continues to be left to the discretion of the regulator.

The definition of "Borrower" in Section 3 of the Draft states that "[e]xcept as provided in regulations, this does not included guarantors." As guarantors per se are not addressed in any provisions of the Draft, the import of this language is to leave the determination as to whether guarantors are covered by the Act for determination by the regulatory authority.

The rules with regard to guarantors of mortgage notes currently are found in state law. If a party assumes the liability of a guarantor by signing a note subject to UCC Article 3 as an accommodation party, those rules are found primarily in UCC 3-419. If guarantors are not within the scope of the federal act, state law will continue to govern; if guarantors are included, then state law is subject to preemption to the extent federal rules are created for guarantors. We believe that whether guarantors are within the scope of the Act should be stated in the statute, and, if guarantors are included, that the substantive rules with regard to them also should be found in the federal statute. Neither of these issues should be left to regulatory discretion.

(b) Conditional Preemption

Section 5(a)(9) provides that "[t]he regulator shall issue regulations pursuant to the Administrative Procedure Act . . . [(9) limiting the application of Sections 9 and 12 in any State that adopts revisions to the UCC in a form approved by the ULC and ALI, and that the regulator deems to be substantively identical to the specific provisions in Sections 9 and 12 at issue]." We greatly appreciate your

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[2] The JEBURPA comments suggest that the rule should be that the electronic mortgage note is located in the jurisdiction where the real property securing the note is located. We agree that this rule – which will in most instances point to the same jurisdiction as a location of the debtor rule -- also is far preferable to a rule based on the location of the repository. The Co-Chair of JEBURPA, however, is a member of our committee, and stated after our discussion of this issue that he thought JEBURPA would agree that the best rule would be the location of the debtor rule.

continuing willingness to work with the ULC and the ALI on a conditional preemption approach that would allow the substantive commercial law rules necessary to support the registry ultimately to be included as state law in the UCC. We also appreciate the express statement in Section 5 making it clear that actions on the topics listed (including conditional preemption) are subject to the Administrative Procedure Act.

Subsection (5)(a)(9) provides a good starting point for discussion regarding a conditional preemption approach. We do not think it necessary to make extensive comments on its language or content at this time, particularly in light of the fact that the Joint ULC/ALI Committee to Revise UCC Articles 1, 3 and 9 has just been created, but we do have two general comments. First, although we recognize that some conditional preemption schemes have given to a regulator the determination as to whether a state law meets the standard that will allow it to apply in lieu of federal law, we note that ESIGN did not take this approach, leaving that determination instead to the courts. Second, while the provisions in Sections 9 and 12 are the most obvious candidates for a conditional preemption approach, we think it probable that there will be substantive commercial law rules in other sections that should be included. We believe that these are among the considerations that should be taken into account as discussions regarding conditional preemption continue.

Thank you again for agreeing to give the conditional preemption approach a try. We look forward to seeing how the concept develops as the UCC 1, 3, and 9 Committee moves forward.

(c) General Preemption

Section 21 expressly states the intended scope of preemption of state law by the provisions of the repository statute – state law, defined broadly to include statutes, regulations, orders and interpretations, is preempted only "to the extent that any such provision of law is inconsistent with the provisions of this title, and then only to the extent of the inconsistency." We appreciate this express statement of a fairly narrow standard with regard to the intended scope of preemption of state law. So many federal statutes have failed to expressly consider this important issue.

Like Section 5 with regard to the conditional preemption determination, Section 21 gives the regulator the authority to make the preemption determination -- "[a] determination regarding whether a statute, regulation, order or interpretation in effect in any State is inconsistent with the provisions of this title may be made by the regulator on its own motion or in response to a nonfrivolous petition initiated by any interested person." Section 5(a) makes it clear that the regulator's determination is made by issuance of a regulation subject to the Administrative Procedure Act. A similar statement in Section 21 seems appropriate. Would it also be appropriate to make it clear that the provision allowing an interested person to obtain a determination from the regulator is not intended to place any restriction or pre-condition on a person with regard to choosing to file a court action instead?

6. Securities Law Exemption

Section 9(d)(1)(A) provides that an electronic mortgage note is not a security for purposes of federal or state securities regulatory laws. Mortgage notes can be considered securities in some circumstances under current law. What is the rationale for this change in existing law?

Thank you again for allowing our Committee to submit comments on the Draft. We look forward to our continued participation in this project.