REDWOOD TRUST

One Belvedere Place
Suite 300
Mill Valley, CA 94941

PHONE 415.389.7373
FAX 415.381.1773

June 11, 2012

VIA EMAIL: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Elizabeth M. Murphy, Secretary
cc: Randall W. Roy, Assistant Director, Division of Trading and Markets

Re: Release No. 34-64456; File No. 4-629

Ladies and Gentlemen:

Redwood Trust ("Redwood") submits this letter in response to the request for comments made by the Securities and Exchange Commission (the "SEC") pursuant to Release No. 34-64456; File No. 4-629 (the "Release")[1], to assist it in carrying out a study on, among other matters, the feasibility of establishing a system in which a public or private utility or a self-regulatory organization ("SRO") assigns nationally recognized statistical rating organizations ("NRSROs") to determine credit ratings for structured finance products. The study, and a resulting report to Congress, are required by Section 939F ("Section 939F") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 939F requires the report to describe the findings of the SEC's study and any recommendations for regulatory or statutory changes that the SEC determines should be made to implement the findings of the study, and that the report be submitted to Congress not later than twenty-four months after the date of enactment of the Dodd-Frank Act, or July 21, 2012.

Redwood notes that, pursuant to the Release, the SEC called for comments to be submitted on or before September 13, 2011. Nonetheless, Redwood is hopeful that the SEC will consider these comments at this time. Redwood is in a unique position, as the predominant issuer of non-government guaranteed and publicly-rated residential mortgage-backed securities ("RMBS") over the last three years, to provide insight on the ratings process in the current environment, and to address what appear to be misunderstandings that are driving the regulatory process.

Overview

Redwood respectfully submits that, for the reasons summarized below and described in more detail in this letter, it is not necessary or appropriate in the public interest or for the protection of investors to establish a system for the assignment of NRSROs to determine the initial credit ratings of structured finance products.

[1] See http://www.sec.gov/rules/other/2011/34-64456.pdf.

- While the current ratings process is far from perfect, Redwood believes that other regulations adopted pursuant to the Dodd-Frank Act address the conflicts of interest associated with the issuer-pay and subscriber-pay credit rating models without creating the difficulties that are created by the system proposed in Section 15E(w), as described below.
- Redwood believes that Section 939F does not by its terms require the SEC to establish a system for the assignment of NRSROs to determine initial credit ratings of structured finance products.
- Based on Redwood's experience issuing publicly-rated RMBS in the "post-financial crisis" environment, we are concerned that Section 15E(w) has a number of fatal flaws that would impede recovery of the private RMBS market, and unnecessarily drive up the cost of credit to borrowers.

If the SEC determines nevertheless that a rule to establish a system for the assignment of NRSROs to determine the initial credit ratings of structured finance products is appropriate, Redwood requests that the SEC consider an alternative approach whereby an issuer would be precluded from engaging an NRSRO to rate more than three consecutive securitization transactions of the issuer or one of its affiliates within a specific asset class.

Section 939F Requirements/Credit Rating Agency Board

Under Section 939F, the SEC is required, "by rule, as [it] determines is necessary or appropriate in the public interest or for the protection of investors, [to] establish a system for the assignment of nationally recognized statistical rating organizations to determine the initial credit ratings of structured finance products, in a manner that prevents the issuer, sponsor, or underwriter of the structured finance product from selecting the nationally recognized statistical rating organization that will determine the initial credit ratings and monitor such credit ratings."[2] In issuing such a rule, Section 939F requires the SEC to give thorough consideration to the provisions of section 15E(w) of the Securities Exchange Act of 1934 (the "Exchange Act"), as that provision would have been added by section 939D of H.R. 4173 (111th Congress), as passed by the Senate on May 20, 2010 ("Section 15E(w)"), and that the SEC implement the system described in such Section 939D unless the SEC determines that an alternative system would better serve the public interest and the protection of investors.

The system contemplated in Section 15E(w) would have established a "Credit Rating Agency Board" which would be responsible for assigning "qualified" NRSROs to provide initial credit ratings for structured finance products. An issuer seeking an initial credit rating for a structured finance product would have to submit a request for an initial credit rating to the board, and would not be able to request an initial credit rating directly from an NRSRO.

Current RMBS Rating Process

The process by which NRSROs determine an initial credit rating for RMBS is a multi-staged process that occurs over several months. The process involves three phases:

- *Collateral review:* a submission of the loan-level attributes and due diligence results for the mortgage loans to be included in the securitization.

[2] §939F, Subtitle C, Title IX of the Dodd-Frank Act, Public Law 111-203 (July 21, 2010).

- *Originator and servicer reviews:* while each NRSRO has a different timetable for when these must be conducted, each requires some level of in-depth discussion (and usually an on-site visit) for the mortgage originators and servicers of a significant percentage of the mortgage pool. In general, these reviews can take several weeks to complete.
- *Documentation review:* a thorough review of the securitization documents.

In the current environment, this process can take between six weeks (for an NRSRO that has already performed its required originator/servicer reviews) to several months. Unless all qualified NRSROs review all of the information provided for every deal, which would be financially burdensome and therefore not practical for them, it will take an NRSRO more time to complete its review if it did not rate a recent previous transaction. Stated another way, some degree of continuity in the use of particular NRSROs by an issuer results in economic and operational efficiencies in transactions. As evidenced by the fact that NRSROs have not generally taken advantage of Rule 17g-5 of the Exchange Act[3] to provide unsolicited ratings of structured finance products, it appears clear that NRSROs will not be willing to devote the time and resources necessary to review information for every deal free of charge.

Other Regulations Address Conflict of Interest Issue

The regulations required under Section 932 of the Dodd-Frank Act address conflicts of interest, and therefore obviate the need for an assignment system by a "Credit Rating Agency Board."

- Section 932(a)(4) of the Dodd-Frank Act requires the SEC to issue rules to prevent the sales and marketing considerations of an NRSRO from influencing the issuance of credit ratings. In response, the SEC proposed Rule 17g-5(c)(8), which would prohibit NRSROs from issuing or maintaining a credit rating if a person who participates in sales and marketing of a product or service of the NRSRO also participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating, including qualitative or quantitative models.[4]
- Section 932(a)(4) also requires an NRSRO to put in place procedures designed to address conflicts of interest that may arise when an employee of an issuer, underwriter, or sponsor of a security or money market instrument subject to a credit rating had previously been employed by the NRSRO and participated in determining a credit rating of that entity during the one-year period before the rating action.
- In addition, an NRSRO would be required to report to the SEC, and the SEC would be required to disclose to the public, when an individual who had been an employee of the NRSRO within the previous five years becomes employed by an obligor, issuer, underwriter, or sponsor of a

[3] Based on our experience complying with Rule 17g-5 of the Exchange Act, we would suggest that the information required to be posted on a website at the same time it is provided to the hired NRSROs should not include information with respect to originators and servicers. We believe that this requirement inhibits the flow of information to an NRSRO, because as a practical matter it is not economically or logistically feasible to produce certain information, in particular information from an on-site visit, simultaneously on the website. Since NRSROs do not generally avail themselves of the information on these websites, the time and expense spent posting such information outweighs any potential upside.

[4] See Nationally Recognized Statistical Rating Organizations, Release No. 34-64514, Fed. Reg. Vol. 76, No. 110 (June 8, 2011) 33420, available at http://www.sec.gov/rules/proposed/2011/34-64514fr.pdf.

security or money market instrument that was rated by the NRSRO during the twelve months before the employee transitioned to his or her new position.

- Rules proposed pursuant to Section 932(a)(8) of the Dodd-Frank Act would require an NRSRO to disclose information on initial credit ratings and subsequent ratings changes "for the purpose of allowing users of credit ratings to evaluate the accuracy of ratings and compare the performance of ratings by different [NRSROs]."[5]

Unlike the system proposed in Section 15E(w), these rules address conflicts of interest without endangering the viability of the system they are meant to protect.

No Rule Required Under Section 939F

Section 939F does not by its terms require the SEC to adopt a rule establishing a system whereby an NRSRO is assigned to determine an initial credit rating for a structured finance product.

Under Section 939F, the SEC is mandated to perform a study on, among other things, the *feasibility* of establishing such a system, considering such factors as the extent to which the creation of such a system would be viewed as the creation of moral hazard by the Federal Government and any constitutional or other issues concerning the establishment of such a system. These facts evidence awareness by Congress that such a system may in fact prove not to be feasible or, indeed, constitutionally sound. Whatever the merits of a challenge would be, the very possibility of a constitutional law challenge to the limitations that would be imposed by 15E(w) could delay or derail implementation of the rule.

In addition, under Section 939F, the SEC must submit to Congress a report that contains *any* recommendations for regulatory or statutory changes that the SEC determines should be made to implement the findings of the study. Accordingly, the SEC may recommend that no regulatory or statutory changes need to be made. Finally, after submission of the report, the SEC is required, by rule, *as it determines is necessary or appropriate in the public interest or for the protection of investors*, to establish such an assignment system.

Redwood believes that the SEC is therefore mandated to first determine whether a rule establishing an assignment system is necessary or appropriate in the public interest or for the protection of investors. Only if the answer to this inquiry is affirmative, must the SEC then consider the system put forth in Section 15E(w) and adopt that or an alternative system.

The System Proposed in Section 15E(w) is Flawed

Redwood believes that a government-mandated Credit Rating Agency Board, as described in Section 15E(w), has the following fatal flaws:

- As written, there will be a general perception in the investor community of a government-backed ratings process. As the SEC raises in its Release, investors could view credit ratings determined through the assignment process as having a "stamp of approval" by the board and, by extension, the Federal Government, which could result in increased investor reliance on such

[5] *Ibid.*

credit ratings. An alternative but equally undesirable result would be that investors view the credit ratings as advancing the Federal Government's perceived agenda, rather than as objective indicators of credit quality. Redwood believes that these are realistic and not just theoretical considerations to be taken into account.

- Investment guidelines currently in place for many investors permit the investors to purchase securities only if they are rated by specific NRSROs. Selection by the board of a rating agency that is not on the investment guidelines list would preclude these investors from participating in an offering. This is a very significant concern.
- Even though Section 15E(w) provides for the board to select qualified NRSROs with respect to each category of structured finance products, there will still be inevitable differences in the capabilities of the qualified NRSROs to provide credit ratings on RMBS. The credit rating of one NRSRO in any particular asset class does not necessarily carry the same weight as that of another. Also, investors are more comfortable with and have a better understanding of the procedures and methodologies of certain NRSROs. Therefore, the assignment of certain NRSROs to a securitization transaction could have a substantial impact on investor interest in a particular deal, and in turn could make it uneconomic to issue the securities at all.
- The system provided for under Section 15E(w) does not account for the time and expense necessary to provide a credit rating. As discussed above, the rating process for RMBS is comprised of several stages occurring over the course of several months. NRSROs need detailed information about the residential mortgage loans included in the securitization pool and about the originators, servicers and other transaction parties. Redwood is concerned that the expense of staying current on all of the necessary information in order to be in a position to provide a credit rating under an assignment system would be prohibitive, not only to the NRSROs, but to the issuers tasked with keeping each qualified NRSRO up to date with the information they need and responding to questions and requests. Keeping every NRSRO up to date with the most current information and collateral mix so that it is prepared for an assignment to a securitization would be paralyzing.
- While under Section 15E(w), the board may consider evaluations of an NRSRO and feedback from institutional investors in determining a method of assigning NRSROs to securitization transactions, it is by no means clear that such factors will be taken into account or, if so, to what extent. In addition, Redwood is concerned that the process for evaluating NRSROs may be faulty, or may result in NRSROs employing criteria or methodologies as closely aligned as possible with the factors used in the board's evaluation. NRSROs might also apply excessively conservative criteria to try to ensure positive evaluations, which could lead to prohibitive transaction costs to the issuer and, correspondingly, to lenders and borrowers.

Given the fatal flaws listed above, if the SEC determines that it must adopt an assignment system pursuant to Section 939F, it is imperative that an alternative to the system described in Section 15E(w) be put forward and adopted.

Proposed Alternative

It has generally been Redwood's view that in difficult situations, the simplest approach is usually best. As an issuer, we expend a great deal of resources ensuring that the selected NRSRO has all of the information necessary to provide a rating. Continuing to ensure that such information is provided, and that such information is accurate and complete is very time consuming, given the inevitable ongoing

changes in the composition of the mortgage pool, and the fact that more information about originators and servicers with a greater concentration of mortgage loans in the mortgage pool is necessary.

A simple solution would mirror the rules of some NRSROs with respect to their ratings analysts. These NRSROs will not allow an analyst to rate more than three consecutive securitizations from a single issuer. After that analyst rates three consecutive deals, he or she must recuse himself or herself for a certain number of securitizations before being allowed to rate another by the same issuer. This system seeks to minimize the potential "cozy relationship" that may arise between an individual at the NRSRO and an individual at the issuer. Similarly, on May 21, 2012, the Council of the European Union agreed to a draft proposal that would introduce a mandatory rotation rule requiring issuers of structured finance products, in certain circumstances, to switch rating agencies every four years.[6]

Our suggestion is to implement a similar "term limit" on a broader scale. Specifically, once an NRSRO engaged by an NRSRO has rated three consecutive securitization transactions of the issuer or one of its affiliates within a specific asset class, the issuer would be precluded from engaging such NRSRO to rate the next securitization transaction of the issuer or one of its affiliates within that asset class.

Building upon the approach of the European Union, we would suggest that an exemption be provided for small NRSROs so that they can gain a foothold in the market. Additionally, some form of exemption would be needed for situations where only one NRSRO was available to rate a particular asset class. Exemptions would also be permitted as necessary, at the discretion of the SEC. Redwood believes that this system would address the concerns that Section 939F is meant to target. It would also provide the issuer with the necessary lead time to ensure that alternative NRSROs have the information required to provide a rating. The issuer could also work to ensure that the alternative NRSROs would have the market acceptance to provide the rating requested, an essential ingredient for a robust securitization market and an efficient secondary market for mortgage loans.

Redwood appreciates the opportunity to weigh in on this important matter. We would be happy to discuss our comments and proposed alternative further. Please feel free to contact me at (415) 380-3590 or at andy.stone@redwoodtrust.com with any questions or should you need any additional information.

Sincerely,

Martin Hughes
Chief Executive Officer
Redwood Trust, Inc.

[6] See Release dated 21 May 2012 of the Council of the European Union, "Credit rating agencies: General approach agreed ahead of talks with EP," available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/130297.pdf.