American SECURITIZATION FORUM®

October 21, 2010

VIA E-MAIL: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
Attn: Elizabeth M. Murphy, Secretary

Re: Implementing Section 621 (Conflicts of Interest) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Ladies and Gentlemen:

The American Securitization Forum ("ASF")[1] appreciates the opportunity to submit this letter to express our views relating to the implementation of Section 621 (Conflicts of Interest) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") in connection with the Securities and Exchange Commission's (the "Commission") rulemaking process. ASF supports appropriate reforms within the securitization market and we commend the Commission for seeking industry input prior to proposing rules on this critically important issue. Over the past decade, ASF has become the preeminent forum for securitization market participants to express their views and ideas. ASF was founded as a means to provide industry consensus on market and regulatory issues, and we have established an extensive track record of providing meaningful comment to the Commission and other agencies on issues affecting our market. Our views as expressed in this letter are based on feedback received from our broad membership, including our issuer, investor and financial intermediary members.

ASF strongly supports the intent of Section 621 to eliminate incentives for market participants to intentionally design asset-backed securities to fail or default. An asset-backed security that is created primarily for the purpose of entering into another, more lucrative

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

transaction that will provide a material financial reward upon the failure or default of the same asset-backed security, creates a clear material conflict of interest, and sponsors and financial institutions that are responsible for the creation and/or distribution of such asset-backed security should be prohibited from entering into those other transactions. Any rules implemented by the Commission for this purpose, however, must be crafted so as to prohibit the situations that result in such material conflicts of interest without causing unnecessary adverse impacts on the markets for asset-backed securities. As further discussed below, we believe this can be achieved by clearly identifying the activities that would constitute a "material conflict of interest" and the parties subject to the restriction.

United States Senators Jeffrey Merkley and Carl Levin introduced what is now Section 621 on May 10, 2010 as an amendment to Dodd-Frank (the "Merkley-Levin Provisions").[2] Section 621 evolved as a result of the findings of the Senate Permanent Subcommittee on Investigations, chaired by Senator Levin, after it conducted four hearings relating to the financial crisis.[3] The Merkley-Levin Provisions were intended to stop what Senator Levin called "one of the most dramatic findings of [their] subcommittee hearings, that of firms betting against financial instruments they are assembling and selling."[4] Senator Levin later noted that "sponsors and underwriters of the asset-backed securities are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail" and stated that the intent of Section 621 is to "prohibit underwriters,

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[2] The Merkley-Levin Provisions also include what is now Sections 619 and 620 of Dodd-Frank, but for purposes of this letter, we are only addressing Section 621, which relates to material conflicts of interest in securitization transactions. Section 621 of Dodd-Frank ("Section 621") states, in pertinent part:

> (a) IN GENERAL.—An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities and Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.
> * * * * *
> (c) EXCEPTION.—The prohibitions of subsection (a) shall not apply to—
> > (1) risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or
> > (2) purchases or sales of asset-backed securities made pursuant to and consistent with—
> > > (A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or
> > > (B) bona fide market-making in the asset backed security.

[3] *See* 156 *Cong. Rec.* S4058 (May 20, 2010) (statement of Sen. Levin).

[4] 156 *Cong. Rec.* S3470 (May 10, 2010) (statement of Sen. Levin). *Also see* 156 *Cong. Rec.* S4058 (May 20, 2010) (statement of Sen. Levin) where Levin further reiterated this point that the Senate needed to act to put an end to the conflict of interest that exists when firms sell asset-backed securities to investors and bet against them and considered such action one of the most "dramatic findings" of their subcommittee.

sponsors, and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures."[5]

Senator Levin also explained what Section 621 is *not* intended to do:

> [Section 621 is] [n]ot intended to limit the ability of an underwriter to support the value of a security in the aftermarket by providing liquidity and a ready two-sided market for it. Nor does it restrict a firm from creating a synthetic asset-backed security, which inherently contains both long and short positions with respect to securities it previously created, so long as the firm does not take the short position.[6]

Senators Levin and Merkley further clarified the intent of Section 621 in a letter to various heads of government agencies charged with implementing Dodd-Frank, including the Chairman of the Commission.[7] The Senators state in their letter that the objective of Section 621 is to "end the conflicts of interest that arise when a financial firm designs an asset-backed security, sells it to customers, and then bets on its failure."[8]

Accordingly, any rules implemented by the Commission should be crafted so as to prohibit the situations that result in the material conflicts of interest identified by the Senators without causing unnecessary adverse impacts on the markets for asset-backed securities. A broad interpretation of "material conflicts of interest" — prohibiting *any* transaction relating to an asset-backed security by which a party might receive a potential profit upon failure or default of the security — would not only be contrary to the intent of Congress but would inhibit many activities currently undertaken by market participants. For example, many underwriters[9] of asset-backed securities or their affiliates provide transaction sponsors with short-term funding facilities such as "warehouse" lines, variable funding notes and asset-backed commercial paper, whereby the underwriter or its affiliate provides financing to the sponsor to fund asset originations or purchases of assets. These facilities provide essential liquidity until the assets can be packaged through a term securitization and sold into the debt capital markets. As the proceeds from the securitization are used to repay the financing, a broad reading of "material conflicts of interest" could prohibit this funding tool, essentially cutting off one of the only available sources of credit in today's constrained market. Similarly, a broad interpretation of "material conflicts of interest" could prohibit servicers of

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[5] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin). Both Senators Merkley and Levin have focused on designing an instrument to fail, likening the practice to someone who sells cars without brakes (or a mechanic servicing a car designed to fail) and then takes out life insurance on the owners. See 156 *Cong. Rec.* S3469 (May 10, 2010) (statement of Sen. Merkley), 156 *Cong. Rec.* S4057 (May 20, 2010) (statement of Sen. Levin) and 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).

[6] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).

[7] *See* Letter from Senator Merkley and Senator Levin dated August 3, 2010 addressed to, *inter alia*, the Honorable Mary Shapiro, Chairman of the Securities and Exchange Commission regarding the Implementation of Merkley-Levin Provisions.

[8] *Id* at page 2.

[9] For ease of reference, we use the term "underwriter" interchangeably with a placement agent and an initial purchaser in a Rule 144A transaction.

mortgage loans, auto loans, credit card receivables and other assets who are affiliated with the sponsor of a transaction from pursuing customary servicing activities. Especially concerning would be a servicer's inability to exercise loss mitigation activities, such as loan modifications under the Home Affordable Modification Program ("HAMP") or the servicer's internal guidelines, or conduct short sales and short refinances under the Federal Housing Administration's Short Refinance Program. This restriction would effectively prohibit sponsors and their affiliates from servicing the loans that they originate, requiring costly servicing transfers that will decrease efficiency and potentially lead to confusion for consumers and disruptions in the servicing of assets.

Additionally, natural conflicts of interest exist between classes of securities that are commonly issued in a single asset-backed securities transaction to accommodate the varying demands of investors and provide the greatest possible liquidity. For example, holders of senior and subordinated classes of securities and interest-only and principal-only classes of securities may have opposing interests with respect to the rate of prepayments in a transaction. Similarly, even though the interests of holders of time-tranched securities may be aligned with respect to the overall credit performance of a pool, such securities may receive distributions at different times and be subject to different risks. An overly broad reading of the Merkley-Levin Provisions could effectively prohibit the issuance of these securities (and numerous others), especially given the requirement contained in Dodd-Frank and other regulatory proposals[10] that a securitizer retain a portion of the securities issued in a transaction. Further, many investors in asset-backed securities seek interest rates or currencies that differ from the underlying assets, which require that the structures employ interest rate or currency swaps. These swaps are standardized and bid out to various market participants, including affiliates of the underwriter of the asset-backed transaction. An expansive interpretation of "material conflicts of interest" could prohibit an affiliate of the underwriter from providing such a swap, potentially depriving investors of the best possible execution. Such outcomes would be outside the Congressional intent of Section 621, which sought to eliminate the improper incentives to issue asset-backed securities designed to fail, not to prohibit the creation of asset-backed securities that allocate identified and disclosed risks between or among separate parties.[11] A broad reading of Section 621 could effectively lead to a contraction of available credit for consumer finance and small business, where securitization has provided a significant source of funding, including mortgage loans, auto loans and leases, student loans, small business loans and credit cards.

Consistent with the legislative intent, the regulations issued by the Commission should be specifically tailored to prohibit transactions that create a material incentive to intentionally design asset-backed securities to fail or default. Specifically, the terms "underwriter, placement

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[10] A risk retention requirement is also contained in the Federal Deposit Insurance Corporation's recently published "safe harbor" and the Commission's recent proposed revisions to Regulation AB.

[11] We note that Senator Levin believes that disclosure alone may not cure material conflicts of interest in all cases, such as in situations where "disclosures cannot be made to the appropriate party or because the disclosure is not sufficiently meaningful." We further note that Senator Levin does not believe that disclosing that the underwriter of an ABS "has or might in the future bet against the security" will cure the conflict of interest arising if the underwriter takes a short position in a synthetic transaction that references the ABS. However, in situations that are clearly not instances of an asset-backed security being designed to fail, ASF believes that effective disclosure would remedy perceived conflicts. *See* 156 *Cong. Rec.* S5899 and S5901 (July 15, 2010).

agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an asset-backed security" as used in Section 27B of the Securities Act of 1933, as amended by Section 621, should be defined by regulation to be workable — able to be implemented and monitored by the regulated entities and monitored by the applicable regulators. We propose that the Commission define these entities as "Restricted Parties" and include only affiliates and subsidiaries that have a material interest in the asset-backed security. Similarly, the definition of "material conflicts of interest" should prohibit those types of transactions identified by Senators Merkley and Levin that create conflicts of interests by creating intentionally flawed asset-backed securities. Accordingly, we propose the Commission define "material conflicts of interest" as follows:

> "A "material conflict of interest" shall exist if, other than for hedging purposes or as permitted by Section 27B(c) of the Securities Act of 1933, (i) a Restricted Party participates in the issuance of an asset-backed security that is created primarily to enable such Restricted Party to profit from a related or subsequent transaction as a direct consequence of the adverse credit performance of such asset-backed security and (ii) within one year following the issuance of such asset-backed security, the Restricted Party enters into such related or subsequent transaction."

By clearly identifying (i) principles upon which market participants can determine what activities would constitute a "material conflict of interest" under Section 621 and (ii) which parties are subject to such restriction, the Commission can effectively eliminate the practices identified by Senators Merkley and Levin without risking unintended consequences to the efficient functioning of the capital markets. Finally, we note that Section 621 includes exceptions for risk-mitigating hedging activities, bona fide market making, and commitments to provide liquidity and strongly agree with Senators Merkley and Levin that appropriate hedging, market-making and liquidity commitments are necessary and proper for the development of a healthy asset-backed securities market.

ASF very much appreciates the opportunity to provide the foregoing views in connection with the Commission's rulemaking process. We are available at your convenience to discuss our proposed language and how it might be applied to various transactions in the market. Please do not hesitate to contact me at 212.412.7107 or at tdeutsch@americansecuritization.com, Evan Siegert, ASF Associate Director, at 212.412.7109 or at esiegert@americansecuritization.com, or ASF's outside counsel on this matter, Eric Burner of Hunton & Williams LLP at 212.309.1186 or at eburner@hunton.com and Edward Douma of Hunton & Williams LLP at 804.788.8320 or at edouma@hunton.com should you have any questions or desire any clarification concerning the matters addressed in this letter.

Sincerely,

Tom Deutsch

Tom Deutsch
Executive Director
American Securitization Forum