June 7, 2023

VIA EMAIL (rule-comments@sec.gov)

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Reissued and Revised Proposed Rule – File No. S7-01-23
Prohibition Against Conflicts of Interest in Certain Securitizations

Secretary Countryman:

With apologies for the tardiness of this letter, Americans for Financial Reform Education Fund ("AFREF") respectfully express strong support for and suggests enhancements to the proposed rule, revised and reissued pursuant to Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), implementing the prohibition on conflicts of interest in the asset-backed securitization ("ABS") industry.[1]

AFREF is a nonpartisan, nonprofit coalition of over 250 national, state, and local groups who have joined together to help lay the foundation for a strong, stable, and ethical financial system that works for all Americans. Members of AFREF include consumer, civil rights, investor, retiree, community, labor, faith-based and business groups along with prominent independent experts.

This is a very important proposed rule addressing conflicts of interest in the securitization markets that harm investors, and we urge the Commission to finalize a rule that will be as robust as possible in protecting borrowers from such conflicts of interest as these markets continue to change and evolve. The rule must not be an invitation to evasion through the creation of new securitization products with the same serious information asymmetry and conflicts of interest problems but slightly different details.

Securitizations and the Great Financial Crisis of 2008

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 sec. 621, § 27B, 124 Stat. at 1631-32 (codified at 15 U.S.C. 77z-2a).

It is well known that, on two successive days in late September 2008, the Federal Reserve bailed out the world's largest insurer (AIG)[2] while allowing the collapse of the country's fourth-largest investment bank (Lehman Brothers).[3] In the ensuing Financial Crisis and Great Recession[4]—the second-worst financial disaster in US history— Wall Street's misdeeds punished the American people with 10% unemployment and the loss of nearly $10 trillion in wealth as the values of their homes and retirement accounts collapsed.[5]

But much of the blame can be placed on securitization run amok. Economist John Maynard Keynes' famous over-generalization—that "remoteness between ownership and operation is an evil"—applies here with specificity, for that type of remoteness is the essence of the complex, opaque, and conflict-riddled securitizations that were designed and sold by Wall Street in the run-up to the Great Recession.[6]

The concept of a securitization is straightforward: A financial firm acquires hundreds to thousands of assets—ranging anywhere from home loans, auto loans, to corporate loans— and then pools them all together. That firm then divides up the cash flows from the pool into distinct tranches with varying degrees of risk and maturity. The most common such securitizations are mortgage-backed securities (MBS) or collateralized loan obligations (CLO).[7]

Securitizations suffer from an inherent principal-agent problem since the goals of the original lender to make as many loans, and the issuer of the securitization to source as many loans to issue as many securitizations as possible to collect fees, are significantly different from those of end investors finding a high returning asset differ significantly from one another.[8]

The securitization model has also been referred to as "originate-to-distribute" since many home mortgage lenders leading up to 2008 knew there were banks and securitizations eager for more loans to securitize, and so started focusing on originating as many mortgages as possible without adequate regard to basic standards of accuracy or whether borrowers would be able to repay.[9]

Levin Hearings and Dodd-Frank Securitization Reforms

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[2] Charles Boyle et al., "2008: A Year of Financial Storms," *Insurance Journal* (December 21, 2008).
[3] Andrew Ross Sorkin, "Lehman Files for Bankruptcy; Merrill Is Sold," *The New York Times* (Sept. 14, 2008).
[4] John Weinberg, "The Great Recession and Its Aftermath," *Federal Reserve Bank of Richmond* (Nov. 22, 2013).
[5] Renae Merle, "A Guide to the Financial Crisis—10 Years Later," *The Washington Post* (Sept. 10, 2018).
[6] John Maynard Keynes, "National Self-Sufficiency," *The Yale Review*, vol. 22, no. 4 (June 1933).
[7] Martin Neil Baily, id.
[8] Paligorova, Teodora. Bank of Canada. Agency Conflicts in the Process of Securitization. Nov 18, 2009. https://www.bankofcanada.ca/wp-content/uploads/2010/06/paligorova.pdf
[9] Federal Deposit Insurance Corporation. Originate-to-Distribute Model and the Subprime Mortgage Crisis. August 2010. https://www.fdic.gov/analysis/cfr/2010/wp2010/2010-08.pdf

The late US senator Carl Levin built a team that found significant and intentional conflicts leading up to the 2008 financial crisis where investment banks intentionally misled their customers buying securitizations and even celebrated such behavior.[10]

The report described how Goldman Sachs knowingly packaged poor-quality mortgages into securities, sold those securities to clients, and profited from betting against those … securities" by short selling them.[11]

But Goldman Sachs was hardly alone. For example, one Chicago hedge fund (Magnetar Capital) invested in 30 Collateralized Debt Obligations (CDOs) from 2006 to 2007 where it served as an anchor investor by purchasing the riskiest, junior-most equity tranches which take the first losses (thus helping more CDOs to be created) while also influencing the portfolio managers of the CDOs to intentionally select undesirable assets. This would make little sense, except that – as it was later revealed - Magnetar was also betting against the CDOs using credit default swaps.[12] Multiple banks and asset managers in the ensuing years would pay millions to settle with the SEC for misleading investors by failing to disclose Magnetar's role in adversely selecting assets.[13]

Lawyers for Bank of America, which in 2013 (as successor to Merrill Lynch) paid the SEC $131 million to settle charges related to faulty disclosures around the Octans I CDO and Norma CDO I,[14] commented to the Financial Crisis Inquiry Commission (FCIC) that it is "common industry practice" for the junior-most equity investors to have input during the collateral selection process.[15]

Just three months after public hearings on Goldman's ABS conflict of interest atrocities, the Dodd-Frank Act was enacted. Its set of financial reforms included Section 621, which aims to prevent the types of abusive conflicts of interests in securitizations that contributed to the 2008 financial crisis and directed the Commission to promulgate rules to implement that intent.

<u>The Commission's Reissued and Revised Rule</u>

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[10] Elise J. Bean, *Financial Exposure: Carl Levin's Senate Investigations Into Finance and Tax Abuse* (Palgrave Macmillan 2018).

[11] Id.

[12] Eisinger, Jesse and Bernstein, Jake. ProPublica. The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going. Apr 9, 2010. https://www.propublica.org/article/all-the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble

[13] Currier, Cora. ProPublica. The Magnetar Fallout: Who's Been Charged, Has Settled, or is Now Being Investigated? Jul 19, 2012. https://www.propublica.org/article/the-magnetar-fallout-whos-been-charged-settled-or-is-being-investigated

[14] Securities and Exchange Commission. SEC Charges Merrill Lynch With Misleading Investors in CDOs. Dec 12, 2013. https://www.sec.gov/news/press-release/2013-261

[15] Eisinger, Jesse and Bernstein, Jake. ProPublica. New Documents Show Hedge Fund Magnetar Influenced Deal, Despite Denials. https://www.propublica.org/article/new-documents-show-hedge-fund-magnetar-influenced-deal-despite-denials

The Commission's 2011 proposed rule[16] prohibited activities—like betting against the ABS you created—that create a conflict of interest between the securitization's issuer or underwriter and its client. The revised rule retains that basic prohibition to protect investors.

We strongly support that prohibition as issuers should never be taking advantage of a lack of transparency to secretly engage in conflicted transactions against their customers, but also recommend loosening some of the revised rule's scope restrictions to make it harder for Wall Street insiders to 'innovate' their way around an excessively narrow rule.

We support the Commission's proposal to restrict underwriters, placement agents, initial purchasers, and sponsors as well as their affiliates from engaging in a transaction for up to a year after closing where a relevant party would benefit from the securitization's price declining in value. This is sensible safeguard to protect investors against the dangers of unknowingly investing in transactions where the deck is stacked against them from day one due to the information asymmetry between the issuer and themselves.

Today's securitization market is noticeably different from the market leading up to the Great Financial Crisis of 2008, but this proposal remains relevant. Developments in corners of the securitization market such as Commercial Real Estate Collateralized Loan Obligations (CRE CLOs) make that case very vividly.

CRE CLOs (unlike their corporate credit counterpart) are already unique in that they tend to invest in more challenging commercial real estate loans that do not qualify for inclusion in the more actively issued Commercial Mortgage Backed Securities (CMBS) market.[17]

Even though most CRE CLOs are sponsored by Qualified Real Estate Investment Trust (REIT) subsidiaries who retain the non-investment grade tranches and first-loss equity pieces of their CRE CLO,[18] many relevant parties can still utilize an assortment of derivatives to take on proprietary bets against very similar commercial real estate assets.

In addition, there have already been notable instances of hedge funds using credit default swaps referencing commercial real estate indices such as CMBX to wager on declining commercial mortgage bond prices.[19]

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[16] Commission File No. S7-38-11.
[17] Balkwill, Iain. Reed Smith LLP. CRE CLO versus CMBS – two peas in a pod? Mar 10, 2022. https://www.structuredfinanceinbrief.com/2022/03/cre-clo-versus-cmbs-two-peas-in-a-pod/
[18] Gianou, Nickolas et al. Skadden Arps Slate Meagher & Flom LLP. Considerations for Commercial Mortgage REITs in a Market Driven by COVID-19. Apr 3, 2020. https://www.skadden.com/insights/publications/2020/04/considerations-for-commercial-mortgage-reits
[19] Hudson, Erin and Callanan, Neil and Gittelsohn, John. Bloomberg News. Hedge Fund Trader Who Gained 119% on Mall Short Targets Offices. Mar 9, 2023. https://www.bloomberg.com/news/articles/2023-03-09/hedge-funds-bet-against-offices-using-tactics-that-big-short-s-burry-made-famous

Other novel securitizations have also been devised since 2008 such as those on fast food franchises,[20] cell phone towers[21] and insurance securitizations of catastrophic climate events.[22] These novel securitizations – which are sure to be joined by still more exotic variations - underline how critical it is that the Commission's rulemaking be sufficiently broadly drawn.

The Commission may have identified some of Wall Street's newest schemes for dodging the Dodd-Frank Act's ABS conflict prohibitions and included targeted shut-downs in the revised rule. But the Commission can never know or anticipate all of those schemes. To properly implement the statute the Commission should adopt a rule that can be read broadly enough to prohibit new variations of customer-cheating, market-threatening, conflict-ridden financial products or abusive practices.

To ensure the ongoing vitality of the proposed prohibition, we urge the following approaches:

<u>Covered persons</u>—underwriters, sponsors, and other ABS players —should be broadly defined as any party that makes a material contribution to an ABS' economic structure, composition, management, or sale.

<u>Covered products</u> should not be limited to the Securities Exchange Act of 1934's definition of ABS.[23] The definition should include any product that creates an economic exposure equivalent to any type of ABS—cash, synthetic (value derived from assets outside the collateral pool), or hybrid—whether registered or unregistered.

<u>Conflicted (prohibited) transactions</u>—activities that bet against the client—should be defined in terms of the economic substance, rather than the form or label of the transaction.

<u>Start time</u> for prohibitions should be the earliest moment that a covered person could reasonably foresee a conflict of interest with investors, but not later than the first transaction made in anticipation of the securitization.

<u>**Materiality and Time-Limited Market Exceptions**</u>

Because the proposed rule creates exceptions that securitization participants may be able to circumvent, we urge the following approaches to prevent manipulation.

<u>Materiality</u>: Neither intentional fraud nor "designed to fail" should be required elements; harm to the client should encompass adverse performance; no actual cash loss need be suffered;

[20] New England Asset Management. Whole Business Securitization – The Power of Structure. Aug 3, 2016. https://www.neamgroup.com/insights/whole-business-securitization-the-power-of-structure
[21] Cadwalader. Potential Impact of New SEC Rules on Cell Tower Securitizations. Sep 30, 2014. https://www.cadwalader.com/resources/clients-friends-memos/potential-impact-of-new-sec-rules-on-cell-tower-securitizations
[22] Schwarcz, Steven L. Duke University School of Law. Insuring the "Uninsurable': Catastrophe Bonds, Pandemics, and Risk Securitization. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3712534
[23] 15 U.S.C. 78a *et seq.*

"benefit" to the Wall Street insider should be left broad. Disclosure of a conflict must not eliminate the prohibition.

Positions before, during and after the offering period: Risk-mitigating hedges, liquidity commitments, and market-making activities must not be excepted from the conflicts prohibition before, during or after the offering period closes. Those positions must never be greater than the actual exposure from holding the assets. Shorting the ABS position—a significant element of Goldman's strategy—must never be allowed because it is not a hedge; it is taking a position in direct opposition to the client.

Inherency: There must be no exception from the prohibition for a conflict activity simply because that conflict may be considered "inherent" to the securitization markets.

Conclusion

The inherent informational asymmetry between securitization issuers/underwriters and investors as well as the growth in all sorts of novel securitizations that do little to address these problems warrant the prompt issuance of a strong rule under Section 621 to stop securitization issuers and underwriters from unfairly taking advantage of investors and possibly once more endangering the financial system.

Thank you for considering this comment. Should you have any questions, please contact Andrew Park at [redacted].

Sincerely,

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cc: Benjamin Meeks, Special Counsel, and Brandon Figg, Attorney-Adviser
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