Comment Letter to the Securities and Exchange Commission

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Prohibition Against Conflicts of Interest in Certain Securitizations

Background and Basis of Interest

This comment letter focuses exclusively on the treatment of the Government Sponsored Enterprises (GSEs), Fannie Mae, and Freddie Mac, under the proposed rule, implementing Section 621 of the Dodd-Frank Act. The author has no direct financial interest, but rather a specific and unique policy background and experience. In addition to having served as Director of the Federal Housing Finance Agency, which acts as conservator to the GSEs, the author also served as the primary Senate Committee staff responsible for the negotiating and drafting the Housing and Economic Recovery Act of 2008 (HERA), which created FHFA and the conservatorship framework.

I write in particular concern that, as structured, the proposed rule works against the Congressional intent of both HERA and the Dodd-Frank Act. If adopted as written, the proposed rule would likely undermine financial stability by continuing to leave market participants with an expectation of government support behind the GSEs, which has no basis in statute, and is in fact, contrary to statute.

Having managed the conservatorships of the GSEs, I can state without any doubt, that conflicts of interest, in relation to securitization at the GSEs, did not end or disappear with the establishment of the conservatorships. I am unaware of any factual basis for assuming otherwise.

Textual errors in proposed rule

On page 35, the rule suggests that the United States government bears the credit risk of GSEs MBS/ABS. This statement is, as a statutory matter, incorrect. The "temporary" authority for discretionary purchases of GSE securities by the Treasury, under Section 1117 of HERA, expired on December 31, 2009. Even if that authority somehow continued, the authority is clearly discretionary. In no way, does Section 1117 of HERA create an explicit government guarantee of GSE MBS/ABS. Continuing to lead market participants to believe such, as would be the impact of the rule, would greatly reduce market discipline, leading to excessive risk-taking in our capital markets.

To remind the Commission, Section 1117 of HERA, upon which the PSPAs are based, states:

> (a) FANNIE MAE.—Section 304 of the Federal National Mortgage Association Charter Act (12 U.S.C. 1719) is amended by adding at the end the following new subsection:
>
> ''(g) TEMPORARY AUTHORITY OF TREASURY TO PURCHASE OBLIGATIONS AND SECURITIES; CONDITIONS.—
> ''(1) AUTHORITY TO PURCHASE.—

> ''(A) GENERAL AUTHORITY.—In addition to the authority under subsection (c) of this section, the Secretary of the Treasury is authorized to purchase any obligations and other securities issued by the corporation under any section of this Act, on such terms and conditions as the Secretary may determine and in such amounts as the Secretary may determine. Nothing in this subsection requires the corporation to issue obligations or securities to the Secretary without mutual agreement between the Secretary and the corporation. Nothing in this subsection permits or authorizes the Secretary, without the agreement of the corporation, to engage in open market purchases of the common securities of the corporation.
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> ''(B) EMERGENCY DETERMINATION REQUIRED. — In connection with any use of this authority, the Secretary must determine that such actions are necessary to— ''(i) provide stability to the financial markets; ''(ii) prevent disruptions in the availability of mortgage finance; and ''(iii) protect the taxpayer.

The plain language of HERA makes clear that any assistance is discretionary on the part of Treasury, but only upon the determination of an emergency. To the degree that Section 1117 is limiting, it limits the ability of Treasury to provide assistance. Nothing in Section 1117, or HERA, or any other statute I am aware of, provides for a federal government guarantee of GSE securities.

I do recognize that following Congressional intent in regard to the lack of any express guarantee behind GSE securities could have significant market impacts. First and foremost, the potential for such an impact was weighted by Congress. I am unaware of any provisions in either Dodd-Frank or HERA that would suggest the Commission is authorized to include such considerations in reversing the clear intent of Congress. I will remind the Commission that a central purpose of both HERA and Dodd-Frank is to eliminate the perception of an implicit guarantee behind our largest financial companies, including Fannie Mae and Freddie Mac.

On page 38, the proposed rule suggests that the United States government provides a "full" guarantee behind GSE MBS/ABS. Even if Treasury authority to purchase GSE securities had not expired, the current Preferred Share Purchase Agreements (PSPA) have explicit dollar limits. In a 2008 scenario, at least one of the GSE would be almost certain to pierce those limits. Let me again state, there is no government guarantee behind GSE MBS. As is clearly demonstrated in FHFA's "living will" rule, any resolution planning on the part of the GSES cannot include an expectation of government support.[1]

On page 39, the proposed rule suggests, "While the Enterprises are in conservatorship, due to the unique nature of the authority and oversight of FHFA over their operations as a result of such status, the Enterprises are not expected to act in a manner that would result in conflicted transactions that would benefit private parties, and, thus, are not expected to engage in the adverse selection of assets for their ABS." As a matter of fact, this is simply false. FHFA's conservatorship authorities are not unique. They closely parallel both the conservatorship authorities of the Federal Deposit Insurance Corporation, as well as the resolution authorities under Title II of Dodd-Frank. In several instances, such as the treatment of qualified financial contracts, the conservatorships borrow from long established practices

[1] See 12 CFR Part 1242, or RIN-2590-AB13, https://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Resolution-Planning.aspx

under the bankruptcy code. As one of the drafters of FHFA's conservatorship provisions, there is almost nothing "unique" in those provisions.

As Director of FHFA, and conservator of the GSEs, I, on multiple occasions became aware of actions that resulted in "conflicted transactions". For instance, on one occasion, I was made aware that a senior GSE executive, with responsibility over the selection of underwriters, held equity in one of the selected underwriters. The description of the GSE conservatorship presented in the proposed rule is a fiction. I appreciate that this issue is outside the expertise of the Commission, which is, of course, why I am providing you with such expertise and first-hand experience.

Again, on page 40, "the investors in ABS fully insured or fully guaranteed by an Enterprise would not be subject to credit risk so long as an Enterprise's guarantee is backed by the full faith and credit of the United States." This statement is simply false. Investors in GSE MBS are subject to credit risk. At a minimum they are subject to risk beyond the hard dollar limits stated in the PSPAs. And again, any assistance under the PSPAs is discretionary, not mandatory. As then FHFA Director, and conservator of the GSEs, I had no intent of ever agreeing to a PSPA draw to protect GSE creditors. Under my supervision, FHFA and the GSEs, conducted resolution exercises assuming no government support. FHFA has established procedures to resolve a GSE without government support. Congress and FHFA have expended considerable energy and time to reducing perceptions of government support behind the GSEs. The proposed rule undermines that important work.

As a reminder to the Commission, a conservatorship (or receivership) is essentially an administrative bankruptcy. I see no exemption for other companies in bankruptcy. If the exemption is due to the length of the GSE conservatorships, I will remind the Commission that our nation has seen railroad bankruptcy proceedings that rival in length the current GSE conservatorship. Yet, there is no suggestion that companies under the supervision of a bankruptcy judge, who presumably would not approve conflicted transactions, should be exempt from Section 621. I will also remind the Commission that the conservator/receiver provisions of HERA are based directly upon those of Sections 11 and 13 of the Federal Deposit Insurance Act. Yet, I see no suggestion in the proposed rule for the exclusion from Section 621 of insured depositories operating under a conservatorship, or for financial companies operating under a Dodd-Frank Title II resolution. Of course, I am not suggesting that the Committee provide such exemptions, I am simply suggesting that the Commission's logic, especially as applied on Page 39, applies to these other instances as well. Certainly, under a Title II resolution there is the possibility of capital support for a failing institution, in a manner quite similar to that asserted under the PSPAs. Yet, the Commission offers no legal or even logical explanation for treating Fannie Mae and Freddie Mae as "special".

This author is well aware that Congress has, on occasion, exempted the GSEs from aspects of our nation's securities laws. Congress, has not, however exempted the GSEs from **all** securities law. For instance, the GSEs are now under the 1934 Securities Act, as well as the Sarbanes-Oxley Act. It is my understanding that Congress debated and rejected excluding the GSEs from Section 621 of Dodd-Frank. The proposed rule acts in direct contraction of the Dodd-Frank Act, as it relates to the GSEs.

Section 621 of the Dodd-Frank is rather short, so it must be unlikely that the Commission missed the rule of construction stating that "This subsection shall not otherwise limit the application of section 15G of the Securities and Exchange Act of 1934." I will remind the Commission that Section 15G explicitly and clearly states, under (3)(c)(B) Other federal programs:

> This section shall not apply to any residential, multifamily, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, which is insured or guaranteed by the United States or an agency of the United States. For purposes of this subsection, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal home loan banks shall not be considered an agency of the United States.

In case this isn't clear enough, Section 15G states that the GSEs are NOT agencies of the United States. Section 621 of the Dodd-Frank Act is clearly structured to complement Dodd-Frank's Section 941 ("risk retention"), not neuter it. The Commission's attempt to use the cover of conservatorships to transform the GSEs into government actors, when Dodd-Frank so clearly treats them otherwise, is a disturbing trend. Such a clear contraction with the plain statutory language puts this entire rulemaking at risk.

As a general rule for the Commission, Congress has demonstrated a clear ability to provide the GSEs with certain exemptions from law, including our securities laws. Where Congress has not provided such an exemption, as under Section 621, the basics of statutory interpretation would dictate that Congress did not intend for such an exemption to exist.

While there are no statutory guarantees behind GSE MBS/ABS, it is essential that the Commission clarify that GSE Credit Risk Transfers (CRT) are not exempt from the rule. As the Commission is aware, CRT are not in any way backed by the GSEs or the federal government. The GSEs also play a very active role in picking which loans are referenced by the CRT. There are perhaps no significant volume transactions in our capital markets today that resemble ABACUS more than do GSE CRT. These are exactly the sort of transactions that Congress created Section 621 to cover. Make that clear, please.

Questions for Comment

15. The proposed definition of "sponsor" should cover Fannie Mae and Freddie Mac, regardless of whether they are in conservatorship or not.

20. Fannie Mae and Freddie Mac should be considered a "sponsor" for both their MBS and CRT. Congress did not create an exemption from Section 621 for the GSEs. In addition, the overwhelming majority of court cases have ruled that the GSEs are "private companies" while in conservatorship, not government actors. Excluding the GSEs as sponsors would also harden perceptions that the companies are backed by the federal government, which is contrary to the primary purposes of both Dodd-Frank and HERA.

21. In the mortgage arena, only GNMA securities are fully guaranteed by the United States government, MBS/ABS from Fannie and Freddie are not. Even that said, issuers of GNMA MBS have considerable discretion over which loans to include. Therefore, while GNMA itself should not be viewed as a sponsor, GNMA issuers should.

22. While investors in Fannie/Freddie MBS are in fact exposed to credit risk, the recent failure of Silicon Valley Bank demonstrates, there is significant interest rate and prepayment risk associated with Fannie/Freddie MBS. As different loan characteristics can, for instance, influence prepayment risk, Fannie/Freddie have some discretion, as do GNMA issuers, over which loans enter MBS. Accordingly, these risks should be factored into the coverage of who is a sponsor and what are their responsibilities.

24. As mentioned, there is no statutory basis for excluding the GSEs from the definition of sponsor while they are in conservatorship, so there clearly is no reason to extend such beyond a conservatorship. The use of the phrase "capital support" is also incorrect and misleading. To the degree that any statutory authority remains behind the PSPA, it serves as a line of credit. Please drop that phrase.

25. There is no statutory basis for excluding Fannie and Freddie from Section 621, either in conservatorship or out. Such directly conflicts with the clear Congressional intent behind both Dodd-Frank and HERA. An additional reason to not exclude the Enterprises, even in conservatorship, is that such an exclusion creates political pressure to not release the Enterprises from conservatorship, as is required under statute.

27. Again, there is no statutory basis for excluding the Enterprises from the definition of sponsor, nor is there any statutory basis for excluding any of their security issuances. Investors in Enterprises MBS/ABS/CRT are all at risk of credit loss.

Concluding observations

A useful exercise for the Commission is to the go back through the proposed rule and replace the phrases "enterprises", "Fannie Mae", and "Freddie Mac" with the name "Citibank". If after doing so, the proposed section still makes sense, then proceed. If, however, the Commission would not exclude an entity like Citibank, also widely believed to be implicitly backed by the federal government, then such an exemption does not make sense for Fannie or Freddie.

Respectfully, one of the biggest obstacles to implementing HERA, and overall reform of the Enterprises, has been the Commission's long running treatment of the Enterprises. Yes, where Congress has provided an explicit exemption, then implement such. The Commission must, where Congress has not provided such an exemption, honor Congressional intent that no such exemptions exist. A primary purpose of both Dodd-Frank and HERA is to eliminate implicit guarantees behind our largest financial companies. The proposed rule, as written, works against that intent.

Thank you for your consideration. I stand ready to provide any clarity to the responses above.

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