



March 27, 2023

Prohibition Against Conflicts of Interest in Certain Securitizations
File Number S7-01-23

Dear Securities and Exchange Commission:

The Security and Exchange Commission's repropoed Rule 192, goes far beyond the intent of Dodd Frank Section 27B, and will severely limit the normal, non-malicious activities of participants in securitization.

I am Andrew Davidson, President of Andrew Davidson & Co., a leading provider of analytics for the mortgage-backed securities market. We also provide advice to firms on risk management in conjunction with securitization, including the use of credit risk transfer transactions. I am the co-author of several books on Securitization. I was retained by the Securities and Exchange Commission as an expert in the ABACUS case.

Background

Many if not most securitization transactions are created to reduce risk. Generally, a firm has originated or acquired a set of financial contracts, such as mortgage loans, auto loans, credit card receivables, etc., and wishes to reduce their exposure to the risks and funding requirements of those assets.

In the course of originating or acquiring the assets for the proposed securitization a firm will engage in a variety of risk reduction activities. These activities are generally designed to benefit from a decline in value of the assets and can include funding strategies, sales of similar assets, short positions in similar assets, interest rate hedges, insurance, and other contracts to mitigate losses.

Investors in asset backed securities transactions understand that securitization participants engage in these activities and consider these to be necessary to the ongoing activities of the originator or aggregator.

The proposed rule limits normal activities

Section 2320.192(a)(3)(iii) which defines a range of transactions that are conflicted transactions appears to limit these risk mitigating activities. Each of the listed potential conflicted transactions is likely to occur under standard operations.

For example, under (A) Adverse performance of the asset pool: Most securitizations will have a servicer or other participant who is responsible for managing the assets in the securitization. They may receive fees that increase when loans become delinquent or default. They may also enter into other transactions to offset the increase in costs associated with the adverse performance of the asset pool.



Under (B) Loss of principal, etc.: Credit risk transfer securitizations are specifically designed to provide cash flow to the entity holding the risk of default on the underlying loans. Other transactions allocate losses between various bonds and the allocation of losses to one bond may be seen as a benefit to another bond or class of securitization. For example, the write down of an asset could produce a prepayment to a bond holder. If that bond was purchased at a discount, then the prepayment will produce a benefit to that bond.

Under (C) Decline in the market value of the relevant asset-backed security: Activities of the firm that originated or aggregated the assets supporting the securitization are likely to engage in a wide range of activities associated with a decline in the market value of the relevant asset-backed security. This could include interest rate hedges, short selling of securities with similar risk characteristics, or other instruments that have performance that would offset the decline in value of the securitized assets.

The rule provides that the prohibitions are offset by (b) excepted activity. While the prohibitions are overly broad, the exceptions are excessively narrow, essentially limiting hedging to specific activities that are closely tied "specific, identifiable risks arising in connection with and related to identified positions, contracts, or other holdings of the securitization participant."

This is an unrealistic standard for most participants. Generally, a firm will enter into risk mitigation activities on a portfolio, rather than on "identified" positions. For example, in hedging a mortgage pipeline an originator does not know which loans will close and enters into hedges for an anticipated closing percentage of the loans. That hedge is not associated with specific loans. Even after a loan closes, there may be several possible execution strategies for those loans. Firms may keep an overall hedge position to protect the value of their portfolio and may not adjust the hedge at the completion of each individual transaction. Therefore, it is possible that a firm would place an asset in a securitization and if the market declines prior to the "recalibration" the firm would benefit from the hedge when there is a decline in value of the ABS. It would be difficult and costly for a firm which engages in overall portfolio hedging to avoid this outcome.

Comparison to ABACUS.

These conflict-of-interest provisions are likely derived from a desire of Congress to prohibit the types of activities associated with the ABACUS – 2007 AC1 Transaction. At the time the SEC wrote:

The product was new and complex but the deception and conflicts are old and simple," said Robert Khuzami, Director of the Division of Enforcement. "Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio, while telling other investors that the securities were selected by an independent, objective third party.



The essence of the complaint in the ABACUS case was that the offering documents contained false statements about how the portfolio was constructed. In fact, my understanding is that if the same transaction had been created purely synthetically without SEC registration, there would have been an implied expectation that the parties had adverse interests. The egregious nature of ABACUS was the deliberate attempt to deceive the investors coupled with the use of SEC registration to create an expectation of the validity of claims in the offering documents. While it may make sense to extend the protections provided by SEC registration to similar transactions which are currently not registered, it is not necessary to create an entirely new set of draconian restrictions on securitization as ABACUS was already in violation of the law even without Section 27B.

Recommendations:

In the Notice of Proposed Rulemaking, the SEC writes

Clause (iii) of the proposed definition of “conflicted transaction” would capture the purchase or sale of any other financial instrument or entry into a transaction the terms of which are substantially the economic equivalent of a direct bet against the relevant ABS.

Clause (iii) achieves this goal not by narrowly targeting “direct bets” but by targeting any and all transactions that could have an economic effect that is opposite to any change in value or performance of the relevant ABS. In doing so, the SEC has crafted a rule that is well outside of the intention of Section 27B.

As the NPR states:

Senator Carl Levin stated that the “conflict of interest prohibition . . . is intended to prevent firms that assemble, underwrite, place or sponsor these instruments from making proprietary bets against those same instruments.

The question the SEC now faces is how to craft a rule that prohibits the egregious actions in ABACUS, while not limiting the necessary activities required to originate and securitize assets.

To achieve this goal the SEC should narrow the definition of conflicted transactions in (a)(3)(iii) and expand the definition of excepted activities in (b). While changing the focus of the rule would require a substantial re-write, I will discuss a few specific items.

For example (a)(3)(iii)(C) could be changed to “A significant decline in the market value of the relevant asset-backed security relative to similar asset backed securities”

and (b)(1)(ii)(A) could be changed to

~~At the inception of the hedging activity and at the time of any adjustments to the hedging activity,~~ the risk-mitigating hedging activity is designed to reduce or otherwise significantly mitigate one or more ~~specific, identifiable~~ risks arising in connection with and related to



~~identified positions, contracts, or other holdings of the securitization participant, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof;~~

and (b)(1)(ii)(B) should be deleted and conforming changes made to (b)(1)(ii)(C).

In addition, credit risk transfer transactions should be specifically exempted or evaluated against a separate set of rules that ensures that the synthetic transaction is not designed to adversely select loans within broad categories that are clearly communicated to investors.

These are just a few of the significant changes to the rule that are required to limit the application of the rule only to prevent proprietary bets against ABS and not to substantially all risk mitigation activities of participants in securitization.

Summary

Protecting investors from nefarious activities such as those surrounding the ABACUS transaction is not just a requirement of Dodd Frank, but also is a laudable goal. It is appropriate for the SEC to extend the protections provided by registration against false and misleading statements about conflicts of interest to non-registered transactions. It is also appropriate for the SEC to prohibit transactions that are "substantially the economic equivalent of a direct bet against the relevant ABS." However, the proposed goes too far and prohibits a wide range of risk reduction activities that are well understood by market participants and are necessary for the proper functioning of securitization markets. The Proposed Rule should be withdrawn and repropose.

Thank you for your consideration,

A handwritten signature in black ink, appearing to read "Andrew Davidson", written in a cursive style.

Andrew Davidson