PENTALPHA

March 27, 2023

By email: rule-comments@sec.gov

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

Re: Prohibition Against Conflicts of Interest in Certain Securitizations (Rel. No. 33-11151, File No. S7-01-23)

Dear Ms. Countryman:

Pentalpha Surveillance LLC ("***Pentalpha***" and "***we***") is pleased to submit this letter to comment on the proposed rule titled "Prohibition against Conflicts of Interest in Certain Securitizations" (the "**Proposed Rule**"). The Proposal re-proposes a rule that the Securities and Exchange Commission ("**Commission**") initially proposed in September 2011. The Proposed Rule would implement Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") prohibiting an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security ("**ABS**") (including a synthetic asset-backed security), or any affiliate or subsidiary of such entity, from engaging in certain transactions that would involve or result in certain material conflicts of interest.

As background, Pentalpha and its affiliates are governance specialists with a pointed focus on conflict management matters. We are primarily dedicated to providing independent oversight of the upfront closing and ongoing operations associated with individual loans and loan securitization trusts. We have been engaged by individual securitization trusts, financial institutions, institutional asset managers and agencies of the U.S. Government. In addition, our principal, James Callahan, served as Co-Chair of the U.S. Treasury's Deal Agent Committee, which was an informal working group of industry representatives who participated in a series of discussions facilitated by the U.S. Treasury as part of its Private Label Securitization ("***PLS***") Initiative. The Treasury's PLS Initiative provided a forum for a large number of industry participants (investors, mortgage originators and aggregators, mortgage servicers, trustees, potential Deal Agents and rating agencies) to address several life-of-trust topics, including: conflicts, loan quality representations and warranties enforcement, loan collections supervision and the role of the trustee. Our comments below are informed by those investor and other participant comments as well as our experience since that initiative was concluded.

We applaud the SEC's continued focus on modern governance protocols within public and private sector securitized instruments. We agree that this product sector is complex and exceptions for certain parties and activities may be logical. Our comments here relate to parties and activities that do *not* get permitted exceptions in your final rule although they could have application to those as well.

Overall, our comments are focused in further refining the proposed rule in order to (1) help ensure investors are adequately protected from material conflicts of interest, which are strictly prohibited under the rule, and (2) introduce a low-cost solution to help ensure the deal parties do not run afoul of the rule inadvertently. Conflict management is a small part of modern "good governance" principles. The securitization markets can be a leader in the "G" of ESG for debt products, but much work needs to be done. Conflict management is a positive step in that direction.

Recommendation

Questions 32-38 in the SEC's proposing release accompanying the Proposed Rule ("**Proposing Release**") seeks comment on whether information barriers could be designed to effectively mitigate prohibited conflicts of interest and provide adequate protection in this context, whether the use of such barriers would effectively implement Section 27B, and whether internal information barriers are vulnerable to breach. Specifically, it provides:

> "[S]hould there be an exception for an affiliate or subsidiary of an underwriter, placement agent, initial purchaser, or sponsor of an ABS if each of the following conditions is satisfied: (1) the underwriter, placement agent, initial purchaser, or sponsor of the ABS establishes, implements, maintains, enforces, and documents written policies and procedures to prevent the flow of information to and from the affiliate or subsidiary that might result in a violation of the re-proposed rule; (2) the underwriter, placement agent, initial purchaser, or sponsor of the ABS establishes, implements, maintains, enforces, and documents a written internal control structure governing the implementation of, and adherence to, the written policies and procedures; ***(3) the underwriter, placement agent, initial purchaser, or sponsor of the ABS obtains an annual, independent assessment of the operation of such policies and procedures and internal control structure;*** (4) the affiliate or subsidiary has no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) in common with the underwriter, placement agent, initial purchaser, or sponsor of the ABS, and was not involved in the creation or distribution of, or otherwise involved in providing services with respect to, the related ABS; and (5) a person may not rely on the exception if, in the case of any specific securitization, the person knows or reasonably should know that notwithstanding satisfying the conditions, a transaction would involve or result in a material conflict of interest? How would this exception be consistent with Section 27B?" (emphasis added)

For parties and activities that do not get the benefit of an exception, we encourage the adoption of an information barrier exception (3 above) as well as the inclusion of a condition that such participant obtains an annual, independent assessment of the operation of such policies and procedures and internal control structure. The exception you identified can be effective, low cost and help grow confidence in the securitization markets which in turn reduces borrowing costs and maximizes pensioner investment returns. We would add on one additional feature, however; *trust but verify* against *actual securitizations* (i.e., ensure the assessment is with respect to a specific deal's characteristics rather than solely on a corporate platform basis).

Importantly, we focus on timing. A securitization's closing and distribution event is one day in the 10,000-day life of a low coupon residential mortgage securitization. Good governance principles could suggest conflict evaluation, supervision and management may be beneficial more than just the first day of the securitization. The Commission's proposed 365-day extension past the closing date is a good start but may benefit from additional consideration. As a reminder, success for a party exposed to a securitization is achieved over immediate-, short-, medium- and long-term periods. A focus on the immediate issuance activities is only one piece.

Much of the rulemaking commentary in the Proposing Release focuses on the community or parties outside of the securitization's operational infrastructure. In fact, a securitization has two communities of high stakes participants; the external sponsor/distributor/investor "village" and the life-of-trust operating/vendor "village." For the low coupon RMBS example above, they are joined together until 2051 via 5,000 pages of signed contracts (source documents).

From an operations perspective, it is helpful to recall that a securitization is not a "thing" but rather a living / breathing operating enterprise. There could be more than 1 million separate cash movements. Additionally, the mosaic of sponsor, borrower, investor and operator changes daily as some buy/sell/resign or are replaced. When the ever-evolving sub villages are combined as a whole to address special situations without back up provisions, the conflicts can multiply exponentially (e.g., LIBOR). Analyzing the behavior of the investment community without consideration on how it intersects with the deal's signing and vendor parties may benefit from additional analysis especially if one or more parties owns pieces of both. Good governance suggests any conflict analysis must start with reading the source documents (as opposed to the summarized offering document) to assess who *may* have conflicts upfront and over time. Each sentence in the source documents was written for a purpose.

Over the life of a securitization, it is reasonable to expect that some of the investors will recover their investment through P&I collections but many others will rely on market confidence to cause new secondary investors to purchase their at-issue investment at attractive prices. As seen in the recent banking industry challenges, it is the confidence component that drives so many investments total returns (P&I (dividends) + liquidity price). Governance that includes modern upfront and/or life of vehicle conflict management tools drives strong secondary bidding support. Strong bids usually generates lower debt coupons and higher investor returns in the future.

We emphasize that the Commission's rules already recognize the importance of independence oversight of certain portions of securitizations. For example, the "Operating Advisor" in the risk retention rule provides conflicts of interest oversight with respect to special servicing.[1] In performing its duties in certain instances, the Operating Advisor provides annual reports of its findings and makes attestations related to its ongoing independence. Additionally, the "Asset Representations Reviewer" on Form SF-3 provides conflicts of interest oversight services in connection with representation and warranty matters.[2] These are deal signing parties,

[1] Regulation RR: "The appointment of an operating advisor (the Operating Advisor) that: (A) Is not affiliated with other parties to the securitization transaction; (B) Does not directly or indirectly have any financial interest in the securitization transaction other than in fees from its role as Operating Advisor; and (C) Is required to act in the best interest of, and for the benefit of, investors as a collective whole."

[2] Form SF-3: "(A) The selection and appointment of an asset representations reviewer that is not (i) affiliated with any sponsor, depositor, servicer, or trustee of the transaction, or any of their affiliates, or (ii) the same party or an

with duties to investors, not vendors with duties to the party that they are evaluating. Importantly, there are escalation provisions if the OA/ARR find actual or potential breaches to the specified standards.

Summary

We applaud the Commission's continued focus on modern governance protocols within public and private sector securitized instruments. With respect to the Proposed Rule, we recommend that in order to satisfy the information barriers exception, the independent party providing the assessment:

- Should be independent of other deal parties to the securitization transaction, including audit and legal firms, other than the SEC's Operating Advisor and Asset Representations Reviewer;[3]
- Should not have a financial interest in the transaction outside of its independent oversight role;
- Should not be the same party or an affiliate of any party hired by the sponsor or the underwriter to perform pre-closing due diligence work on the pool assets; and
- Should be required to act in the best interest of, and for the benefit of, investors as a collective whole.

Additionally, for the reasons articulated above, the assessment would be with respect to actual individual securitizations. This would ensure the assessment is with respect to the specific deal structure (including its collateral influences) rather than solely on a participant's platform basis.

We greatly appreciate the Commission's consideration of this important disclosure / governance issue. If the Commission or its Staff desires, we would be happy to discuss further any of the points in this letter.

Sincerely,

Don Simon
Chief Operating Officer
Pentalpha Surveillance LLC

affiliate of any party hired by the sponsor or the underwriter to perform pre-closing due diligence work on the pool assets."

[3] In light of their existing independent oversight role, we believe the Section 621 oversight party should be permitted to also serve as the OA and ARR because these roles are already independent of deal parties and charged with acting in the best interest of investors.