CRE Finance Council
WHERE CAPITAL AND IDEAS MEET

August 8, 2011

VIA ELECTRONIC FILING – rule-comments@sec.gov
Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: Proposed Rules Pertaining to Nationally Recognized Statistical Rating Organizations, Release Number 34-64514; File Number S7-18-11

Dear Ms. Murphy:

The Commercial Real Estate ("CRE") Finance Council® appreciates the opportunity to comment on the proposed rules to implement a requirement added by Section 932 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that issuers and underwriters of asset-backed securities ("ABS") make publicly available the findings and conclusions of any third-party due diligence report obtained by the issuer or underwriter.[1]

The CRE Finance Council does not oppose the concept of third-party asset review and disclosure. As such, CREFC® will focus its comments on the need for certain clarifications and modifications regarding disclosure requirements and logistics, including: (1) the scope of due diligence reports that must be disclosed; (2) the mechanics of submitting the disclosures; and (3) the form of the disclosures.

The CRE Finance Council is the collective voice of the entire $3.5 trillion commercial real estate finance market, including portfolio, multifamily, and commercial mortgage-backed securities ("CMBS") lenders; issuers of CMBS; loan and bond investors such as insurance companies, pension funds and money managers; servicers; rating agencies; accounting firms; law firms; and other service providers.

[1] Nationally Recognized Statistical Rating Organizations, Proposed Rules, 76 Fed. Reg. 33420 (June 8, 2011) (hereafter "Proposing Release").

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

Our principal functions include setting market standards, facilitating the free and open flow of market information, and education at all levels, particularly related to securitization. Securitization is one of the essential processes for the delivery of capital necessary for the growth and success of commercial real estate markets. One of our core missions is to foster the efficient and sustainable operation of CMBS. To this end, we have worked closely with policymakers to educate and inform legislative and regulatory actions to produce efficient and practical regulatory structures. We look forward to continuing to work with policymakers on this effort. We also continue our ongoing work with all market constituencies to develop industry standards which provide marked improvements in the CRE finance arena. Prime examples of our work include enhancements of both the CRE Finance Council's "Annex A" initial loan-level disclosure package and the Investor Reporting Package ("IRP")™ for ongoing disclosures and surveillance by investors.

I. <u>Overview</u>

As we have noted in previous comments,[2] the CRE Finance Council does not oppose the concept of third-party asset review and disclosure. Furthermore, we recognize and appreciate that the Commission has considered concerns expressed by the industry in our previous comments, particularly those pertaining to the scope of third-party diligence reports that must be disclosed, and the definition of an "issuer" that would be responsible for making the disclosure.

As such, CREFC will focus its observations on the need for certain clarifications and modifications regarding disclosure requirements and logistics, including: (1) the scope of due diligence reports that must be disclosed; (2) the mechanics of submitting the disclosures; and (3) the form of the disclosures.

<u>Scope of Due Diligence Reports:</u> We appreciate the Commission's effort to clarify that the scope of the disclosure obligation extends only to the types of reports that are done for the purpose of determining credit ratings. However, we believe that the examples provided by the Commission of the types of reports that would fit this description, especially the "catchall" category of third-party reviews of "any other factor or characteristic of the asset that would be material to the likelihood that the issuer of the…ABS will pay interest and principal according to its terms and conditions,"[3] remains too vague from the CMBS perspective. A possible remedy is for the rule to be modified to require disclosure of third-party reviews related to other factors or characteristics that are both (1) provided to the Nationally Recognized Statistical Rating Organization ("NRSRO") performing the credit rating and (2) material to the credit rating of the ABS.

[2] *See* CRE Finance Council Comments re: Issuer Review of Assets in Offerings of Asset Backed Securities, File Number S7-26-10, available at http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Regulation/CREFC_SEC_Issuer_Review_Underlying_Assts_Comments.pdf.

[3] Proposing Release, 76 Fed. Reg. at 33473.

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

Mechanics of Submitting Disclosures: Our members also have concerns regarding the mechanics of submitting the disclosures, and the form of the disclosure. While the Commission has suggested that NRSROs might submit the disclosures on behalf of issuers, and seeks comment on whether NRSROs might perform such a function, we are informed by a number of our NRSRO-members that NRSROs would be unwilling to take on an obligation of this nature. The CRE Finance Council suggests that the rule allow NRSROs and underwriters to rely on disclosures made by issuers.

The Form of Disclosures: The Proposing Release indicates that with respect to the form of the disclosure, the Commission intends to require the third-party reviewer to describe the steps it took in performing the review, including information on the type of assets reviewed, the asset sample size, and how the sample was determined. The Proposing Release seeks comment on whether the Commission should impose more prescriptive requirements, such as requiring particular types of samples or a minimum sample size.[4] The CRE Finance Council believes such prescriptive requirements would be tantamount to regulating the substance of a third-party review, and objects to regulation of the substance of the third-party review because the substance can, and should, vary depending on the asset class involved. Additionally, disclosures of third-party reviews by an issuer in compliance with SEC Rule 193 (to the extent that such reviews also happen to be within the scope of the proposed rules) should be sufficient to meet these disclosure requirements.

Our specific comments regarding the Proposing Release are below, and we include a brief background discussion on the current state of the CRE market in Appendix A.

II. Scope of Due Diligence Reports That Must Be Disclosed

In our comments on the initial proposal,[5] the CRE Finance Council observed that the Commission appeared to focus on third-party asset review practices of the residential mortgage-backed securities ("RMBS") market. More particularly, CMBS sponsors generally do not hire third-parties to perform due diligence in the manner that RMBS sponsors do. Thus, we noted that the scope of the third-party review and disclosure obligations for CMBS was unclear, and disclosure should not apply to all third-party reviews of assets.

We appreciate the Commission's effort to clarify that the scope of the disclosure obligation extends only to the types of reports that are done for the purpose of determining credit ratings. More specifically, the Proposing Release would require disclosure of any third-party due diligence report for ABS that is being rated by a NRSRO for the purpose of determining credit ratings. "Due diligence report" is defined as "any report containing the findings and conclusions of any 'due diligence services.'"[6] The Proposing Release further defines this term to encompass any review of the assets underlying an ABS for purposes of making findings with respect to:

[4] *Id*. at 33476.

[5] *See* note 2, *supra*.

[6] 76 Fed. Reg. at 33538.

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

- The quality of the information about the assets;
- Whether the origination of the assets deviated from underwriting guidelines;
- The value of the collateral;
- Whether the originator of the assets complied with applicable laws; and
- Any other factor material to the likelihood that the issuer will pay interest and principal according to its terms.[7]

The Proposing Release indicates that the Commission intends the first four categories of review mentioned above to describe current due diligence practices for the issuances of RMBS, and the fifth category is designed to be a "catchall" for due diligence services used for pools of other asset classes, such as commercial loans, corporate loans, student loans, or credit card receivables.[8]

It appears that the Commission's intent is to ensure that there be public disclosure of information provided to rating agencies that are used in making their ratings determinations. And we anticipate that the Commission sought to address such concerns by adding a "materiality" component to the catchall category. However, we believe that "catchall" category remains too vague from the CMBS perspective to meet the Commission's intent, and may inadvertently capture disclosure of information that is not pertinent to an ABS credit rating.

For example, an appraisal of the value of a commercial property may, in the broadest sense, have a bearing on whether CMBS bond payments could ultimately be made, since an overvaluation could theoretically lead to overleverage and difficulty in servicing the debt on a property. Appraisals are not, however, obtained for the purpose of determining credit ratings for CMBS; on the contrary, appraisals are obtained as part of the loan underwriting process.

In addition, we are concerned that the first category related to information quality could inadvertently include an accounting firm's Agreed Upon Procedure ("AUP") engagements as part of the public disclosures. AUP engagements are done primarily to help an underwriter satisfy its obligations under the Securities Act of 1933 with respect to disclosures in the registration statement and prospectus for the protection of investors. AUP engagements generally focus on the accuracy of disclosures in the offering document. AUP reports have historically not been provided to NRSROs for use in the ABS ratings process as the engagements are not performed in contemplation of providing the results to NRSROs to facilitate a credit evaluation. A major part of the AUP work that is performed on CMBS deals is to compare data on an electronic data file to corresponding information in the loan files. This type of diligence provides CMBS issuers comfort that the loan level data which is disclosed to investors is correct. However, if AUP work is included in the scope of the Proposed Regulation, then accounting firms would be prohibited from disclosing the results of the AUP reports, as the standard would violate American Institute of Certified Public Accountants ("AICPA") standards for AUP reports that restrict the accountant's report of findings to only those parties who have taken responsibility for the sufficiency of the procedures performed. This restriction is intended to

---

[7] *Id*. at 33472-73.

[8] *Id*. at 33472.

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

prevent other parties from placing reliance on the report for purposes other than those specifically intended by those who engaged the accountant and determined the nature and scope of the procedures.

Unfortunately, such an outcome would significantly impact an issuer's ability to provide accurate information to CMBS investors, where the loan file due diligence is such a large part of the CMBS offering document preparation process. In these cases, issuers may also use AUP work as part of meeting its own due diligence review obligations under SEC Rule 193.

Recommendation: The CRE Finance Council believes that the rule can be modified to be both workable for the marketplace and meet the Commission's intent by requiring disclosure of third-party reviews that are both (1) provided to the NRSRO performing the credit rating and (2) material to the credit rating of the ABS.

III. <u>Mechanics of Submitting Disclosure</u>

The Proposing Release would require the issuer or underwriter to furnish form ABS-15G, including any necessary disclosures regarding third-party due diligence review, five business days prior to the first sale in the offering. The issuer or underwriter would not be required to furnish this form if the issuer or underwriter receives a representation that can be "reasonably relied on" that the NRSRO will disclose the information through a form generated pursuant to Rule 17g-7(a)(1).[9] If the NRSRO makes this representation but still fails to disclose the information within five business days of the first sale under the offering, the Proposing Release would require the issuer or underwriter to furnish Form ABS-15G two business days prior to the first sale.[10]

As part of this proposal, the Commission seeks comment on several "fundamental questions," such as how a provider of third-party review services would know the identities of the NRSROs providing credit ratings so that the third-party's reports could be provided to the appropriate NRSRO. Since CMBS are typically rated by at least two NRSROs, we would add another question, which is how the NRSROs themselves are to know who among them would make the disclosure.

Even more fundamentally, the Proposing Release asks whether NRSROs would agree to make the disclosure.[11] In response to this question, a number of the CRE Finance Council's NRSRO-members have expressed an unwillingness to take on an obligation of this nature for several reasons: (1) an NRSRO is not the entity that engages a third-party for due diligence review, and therefore, NRSROs are concerned that they would lack sufficient information to assure themselves that all required reports have been received; (2) NRSROs do not dictate the date of first sale, and therefore, will not necessarily be aware of the date that triggers the

---

[9] *Id*. at 33467-68. Rule 17g-7(a)(1) identifies for disclosure a number of factors related to the NRSRO's methodology, the limitations of its analysis, potential conflicts of interest, and its conclusions.

[10] *Id*. at 33468.
[11] *Id*. at 33470.

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

obligation to submit the reports; and (3) as a matter of administrative efficiency, many issuers will likely choose simply to routinely furnish Form ABS-15G themselves five business days prior to the first sale anyway, in order to avoid the necessity of having to monitor the NRSRO's compliance with any representations that it will furnish the third-party reports rather than the issuer.

Recommendation: For the reasons mentioned above, the CRE Finance Council believes that the proposal to allow NRSROs to furnish the reports will be unworkable in the marketplace, and we suggest that it be replaced by a rule that allows NRSROs and underwriters to rely on disclosures made by issuers.

IV. Form of the Disclosure

The Proposing Release would require the third-party reviewer to describe the steps it took in performing the review, including information pertaining to the type of assets reviewed, the asset sample size reviewed, and how the sample was determined. While the Commission acknowledges that sampling may not be performed for all asset classes, it has requested comment on whether its rules governing the form of disclosure should be more prescriptive, such as requiring particular types of samples or a minimum sample size.[12]

As the SEC acknowledges,[13] in CMBS transactions, the review of assets may involve an examination of each asset in the pool. In contrast, review of each asset typically is not practical in an RMBS issuance because there are thousands of loans in the pool. And in still another example, a different type of review would be necessary for ABS with revolving assets in the underlying pool, such as credit card receivables. Finally, the nature and level of review within an asset class may differ, depending on other circumstances, such as the degree of continuing sponsor involvement.

Because so much variance is possible across asset classes, and there can be further variance within an asset class depending on the particular circumstances for an issuance, we believe the SEC should refrain from promulgating more prescriptive rules governing the form of disclosure. As a matter of principle, a one-size-fits-all approach would run counter to the rationale for the tailored regulatory approach that Congress directed agencies to take in the risk retention context, which was echoed by the Federal Reserve in its report on the effect of risk retention mandates on the securitization market. In that regard, it was recognized that the simple, uniform application of rules is "unlikely to achieve the stated objective of the Act—namely, to improve the asset-backed securitization process and protect investors from losses associated with poorly underwritten loans,"[14] and that regulations should "recognize differences in market

[12] *Id*. at 33476.

[13] *Id.*

[14] Report to the Congress on Risk Retention, Board of Governors of the Federal Reserve System (October 2010), at 3 (available at http://www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf).

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized."[15]

Furthermore, we note that issuers may incorporate third-party reviews into their own due diligence obligations under SEC Rule 193. While the Proposing Release makes clear that such reviews do not automatically meet the criteria for disclosure under the proposed rules, it is possible, nevertheless, that such reviews might meet these criteria. When that is the case, it would be duplicative and confusing to require disclosure under both Rule 193 and proposed new Rule 15Ga-2.

Recommendation: The CRE Finance Council objects to regulation of the substance of the third-party review, because the substance can, and should, vary depending on the asset class involved. The CRE Finance Council therefore opposes any substantively prescriptive requirements for third-party review, including requirements for particular types of samples or a minimum sample size.

Furthermore, when disclosure might otherwise be required under both the proposed rules and Rule 193, the CRE Finance Council believes that the Rule 193 disclosures are more transparent because of their appearance in the prospectus under the revised Item 1111 of Regulation AB. These disclosures would also be more complete in that they represent the entire context of the issuer's due diligence efforts. Therefore, the CRE Finance Council recommends that when disclosures under both Rule 193 and the proposed rules might otherwise be required, the Rule 193 disclosures should suffice for both purposes.

V. Conclusion

The CRE Finance Council appreciates the Commission's consideration of our comments regarding disclosure of third-party diligence reports. We stand ready to provide any additional assistance that may be helpful.

Respectfully submitted,

Stephen M. Renna
Chief Executive Officer
CRE Finance Council

[15] *Id.*

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

Appendix A

Background: Current State of CRE Market

Given that we provided detailed information concerning the state of the CRE market and CMBS in comments we previously submitted in this proceeding, we will simply summarize and update that information here.[16] As emphasized in our previous comments, it is imperative that regulations impacting the securitization market not be considered in isolation. Because of the important role that commercial real estate plays in the economy, and the critical role that securitization, in turn, serves in commercial real estate,[17] potential rules should be considered in the context of the impact they could have on the securitization market and the economy, so that a balanced and practical approach can be developed that meets Dodd-Frank objectives while minimizing unintended consequences that could significantly restrict the amount of capital that is available in the CRE finance market.[18]

Commercial real estate continues to be adversely affected by the prolonged economic recession, particularly the fundamental metrics such as poor consumer confidence and business performance, high unemployment, and depreciation of property values. At the same time, the CRE industry faces an increasing number of mortgage maturities for which capital will be required, either in the form of debt or equity, to avoid further declines in commercial property values. Through 2017 for example, approximately $600 billion of CMBS loans and more than $1.2 trillion in outstanding commercial mortgages will mature. Borrower demand to re-finance these mortgages will be at an all-time high.

The CMBS market continues to show slow progress toward revitalization, unlike some of the other categories of asset-backed securities. There was $12.3 billion in CMBS issuance in 2010. And $30-$40 billion in issuance is expected in 2011. While these figures are small compared to the $238 billion in issuance in 2007, the progress is timely given the number of CRE loan maturities in the next few years. But future issuance will depend on economic conditions and, importantly, the outcome of numerous proposed regulatory and accounting changes. There are serious questions about the viability of the CMBS market when considering the combined impact of reforms on the market, including the credit risk retention rules the Commission is jointly considering with the federal banking and housing regulators,[19] as well as

---

[16] *See* note 2, *supra*.

[17] Both the previous and current Administrations share the view that "no financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small." Remarks by Treasury Secretary Timothy Geithner Introducing the Financial Stability Plan (Feb. 10, 2009) available at http://www.ustreas.gov/press/releases/tg18.htm.

[18] "[T]he Commission has a unique obligation to consider the effect of a new rule upon 'efficiency, competition, and capital formation….'" *Business Roundtable v. SEC*, No. 10-1305 (D.C. Cir. July 22, 2011) (slip op. at 6)(quoting 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c)).

[19] Proposed Rule, Credit Risk Retention, 76 Fed. Reg. 24090 (Apr. 29, 2011).

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org

other requirements imposed by Dodd-Frank such as the asset review requirements addressed in the Proposing Release.

In recommendations to Congress, the Federal Reserve included an admonition that the totality of the regulatory changes that are being put into motion – including the various new disclosure and credit rating agency reform provisions included in the Act, the securitization accounting changes that must be effectuated, the new Basel capital requirements regime, and European Union Solvency II risk retention requirements – should be considered to develop a rational overall framework for appropriate alignment of risk.[20] While the Federal Reserve made this observation in the context of discussing risk retention rules, it is no less applicable here: new regulatory requirements that will impact the securitization markets should appropriately take into account the regulatory framework as a whole, investor needs, and market realities.

[20] *See* Board of Governors of the Federal Reserve System, Report to Congress on Risk Retention (October 2010), at 84, available at http://federalerserve.gov/boarddocs/rtpcongress/ securitization/riskretention.pdf ("[R]ulemakings in other areas could affect securitization in a manner that should be considered in the design of credit risk retention requirements. Retention requirements that would, if imposed in isolation, have modest effects on the provision of credit through securitization channels could, in combination with other regulatory initiatives, significantly impede the availability of financing.").

CRE Finance Council 900 7th St. NW Suite 820, Washington, DC 20001
Tel: 202.448.0850 Fax: 202.448.0865 www.crefc.org