FannieMae

Stephen H. McElhennon

Vice President and Deputy General Counsel
Legal Department

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
202 752 2793
202 752 4493 (fax)
stephen_h_mcelhennon@fanniemae.com

January 17, 2012

**By E-Mail: rule-comments@sec.gov**

Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attn: Elizabeth M. Murphy, Secretary

**Re: Release No. 34-65355; File No. S7-38-11**
**Comment Letter – Prohibition Against Conflicts of Interest in Certain Securitizations**

Ladies and Gentlemen:

The Federal National Mortgage Association ("Fannie Mae") is submitting this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comments regarding Release 34-65355; File No. S7-38-11, proposed on September 19, 2011 (the "Proposing Release"), relating to material conflicts of interest in connection with certain securitizations. Fannie Mae appreciates the opportunity to comment on the Proposing Release.

Introduction

The Commission has issued the Proposing Release in accordance with Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). Proposed Rule 127B (the "Proposed Rule") prohibits certain persons who create and distribute an asset-backed security, including a synthetic asset-backed security, from engaging in transactions, within one year after the date of the first closing of the sale of the asset-backed security ("ABS"), that would involve or result in a material conflict of interest with respect to any investor in the ABS. This prohibition would apply to both registered and unregistered securities. The Proposed Rule would except from the prohibition certain risk-mitigating hedging activities, liquidity commitments and *bona fide* market-making.

Analysis

The Commission has stated its conclusion that Section 621 of Dodd-Frank was not "expected to alter or curtail the legitimate functioning of the securitization market" and has also stated that the Proposed Rule should be construed in a manner that does not unnecessarily prohibit or restrict the structuring and offering of an ABS.[1] The Commission also asks in Question 39

[1] Proposing Release, p. 36.

whether the Proposed Rule should be limited in some manner so as only to affect ABS that are "intentionally designed to fail" or are "intentionally flawed." Both the American Securitization Forum ("ASF") and the Securities Industry Financial Markets Association ("SIFMA") have recommended this approach.[2]

Fannie Mae believes that Rule 127B, as currently proposed, is too broad and may call into question many legitimate transactions entered into in good faith in the secondary market for residential mortgages. Consequently, Fannie Mae endorses the approach recommended by ASF and SIFMA. This approach would exclude from the scope of the Proposed Rule the sort of activities that fall within the legitimate functioning of the securitization market. We believe that the final rule should seek to prohibit only those activities that parties may engage in to profit at the expense of unwary investors.

Should the Commission not adopt this approach, many normal business activities of Fannie Mae could be viewed as violations of Rule 127B, as currently proposed. We believe that these activities are critical to the smooth functioning of today's secondary market for residential mortgages and are among the legitimate transactions that the Commission wishes not to hinder. Accordingly, we have set forth in this letter a summary of Fannie Mae's securitization business, which differs significantly from that of issuers of private-label mortgage securities, but is similar to that of the Federal Home Loan Mortgage Corporation ("Freddie Mac")(Fannie Mae and Freddie Mac hereinafter referred to as the "GSEs"). If the Commission does not adopt the approach recommended by ASF and SIFMA, Fannie Mae respectfully requests that the Commission clarify that Fannie Mae's activities discussed in this letter are not prohibited by the Proposed Rule.

Fannie Mae's Securitization Business

Fannie Mae's primary securitization activity is effected through guarantor swaps, in which a seller (which is not necessarily the originator) of single-family or multifamily residential mortgage loans sells mortgage loans owned by it to Fannie Mae in return for a mortgage-backed security ("MBS") backed by those loans. The seller may retain the MBS or sell them in the open market. Multiple sellers can also sell mortgage loans to Fannie Mae in return for an undivided interest in an MBS backed by loans sold to Fannie Mae by multiple sellers. Fannie Mae may also purchase loans from sellers for cash and later form an MBS. Monthly payments of principal and interest on MBS are funded by passing through to MBS holders the cash flow provided by the underlying mortgage loans. Generally, the mortgage loans in each MBS are pooled in a pass-through trust relating to each MBS. Fannie Mae is the trustee of the trust.

Fannie Mae also aggregates MBS into pools and issues securities backed by these MBS. These securities may be either a mere aggregation of securities ("Mega Securities") or a strip of

---

[2] See Letter, dated October 21, 2010, from American Securitization Forum to Securities and Exchange Commission re: *Implementing Section 621 (Conflicts of Interest) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*; and Letter, dated December 10, 2010, from Securities Industry Financial Markets Association to Securities and Exchange Commission re: *Request for Public Comments Regarding Implementation of Section 621 (Conflicts of Interest) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.*

these securities into interest-only and principal-only cash flows ("Stripped MBS"). Fannie Mae is the trustee of the trust for the Mega Securities and Stripped MBS.

Fannie Mae also engages in other resecuritization transactions in which MBS back multi-class securities ("REMIC Securities") issued through a trust that qualifies as a real estate mortgage investment conduit for federal income tax purposes. In turn, REMIC Securities can also back other "Re-REMIC Securities." Fannie Mae is the trustee of the trust related to the REMIC Securities.

In addition, Fannie Mae purchases private-label ABS issued by unaffiliated third parties, resecuritizes these ABS and issues new securities backed by these ABS. The residential single-family and multifamily mortgage loans that back the ABS purchased by Fannie Mae may also back ABS that have not been purchased by Fannie Mae. (The same trust typically issues the ABS purchased by Fannie Mae as well as the ABS not purchased by Fannie Mae.) The third-party ABS that are resecuritized by Fannie Mae are placed in a trust of which the trustee typically is Fannie Mae.

Fannie Mae also invests in mortgage loans and mortgage securities, holding approximately $713 billion as of November 30, 2011.[3] In order to limit the interest rate risk on this portfolio, Fannie Mae enters into a variety of debt and derivative instruments. Our principal purpose in using derivatives instruments is to manage our aggregate interest rate risk profile within prescribed risk parameters. We generally use only derivative instruments that are relatively liquid and straightforward to value. Fannie Mae helps manage the prepayment risk embedded in its mortgage portfolio through the use of derivatives and the issuance of callable debt. These transactions help to minimize changes in the sensitivity of the fair value of the portfolio to changes in interest rates as well as to minimize the amount of trading activity needed to rebalance the duration of the portfolio.

The mortgage securities described above (the "Fannie Mae Securities") differ from those in the registered ABS market insofar as Fannie Mae generally guarantees payments of principal and interest thereon. Issuers of non-GSE, private-label securities generally do not guarantee their own ABS. The existence of this guaranty means that Fannie Mae retains the credit risk related to the mortgage loans backing the related security. The retention of this credit risk significantly reduces the circumstances in which conflicts may arise. At the same time, investors in Fannie Mae Securities carry interest rate risk, repurchase risk and refinance risk. This letter examines each of these risks and how the Proposed Rule might apply to them.

*Credit Risk*. Fannie Mae guarantees to its MBS trusts that Fannie Mae will supplement amounts received by the trusts as required to permit the timely payment on the MBS. Thus, if a borrower on a mortgage loan in an MBS defaults, the investor should still receive the required payment on the MBS as a result of Fannie Mae's guaranty.

[3] Fannie Mae has agreed in its senior preferred stock purchase agreement with the U.S. Treasury to reduce its mortgage assets in its portfolio. The agreement restricts the amount of mortgage assets that Fannie Mae could own on December 31, 2010 to $810 billion, and requires Fannie Mae to reduce its portfolio each year thereafter to 90 percent of the maximum allowable amount it was permitted to own as of December 31 of the immediately preceding calendar year until the portfolio reaches $250 billion.

Because Fannie Mae bears this credit risk, Fannie Mae frequently obtains credit enhancement. This credit enhancement may take the form of mortgage insurance, recourse or repurchase obligation by the seller (which obligation may or may not be collateralized) or some other form of credit enhancement. In the case of single-family mortgage loans with loan-to-value ratios in excess of 80 percent, Section 302(b)(2) of Fannie Mae's Charter Act[4] requires Fannie Mae to obtain specific forms of credit enhancement in connection with the purchase. Because of Fannie Mae's guaranty, this credit enhancement does not constitute a conflict of interest with investors, but helps Fannie Mae to reduce its own risk as it performs its guaranty function. Accordingly, we believe that the Commission would not view this credit enhancement as a violation of the Proposed Rule.

*Interest Rate Risk*. Although Fannie Mae bears the credit risk in Fannie Mae Securities, investors do have interest rate risk with these investments. Fannie Mae Securities can fluctuate in value due to changes in prevailing interest rates. Fannie Mae does not enter into "short" transactions whereby it seeks to gain from reductions in value of its mortgage securities occasioned by increases in interest rates. We do, however, enter into debt and derivatives transactions as described above, to protect the value of our portfolio from interest rate fluctuations. These transactions are targeted to our outstanding portfolio and consequently should fit within the exception for hedging activities set forth in the Proposed Rule.

*Repurchase Risk*. The related trust agreements for Fannie Mae's MBS generally provide that Fannie Mae has the right, but not the obligation, to remove a mortgage loan from a trust if the mortgage loan has been delinquent for a certain period of time. Fannie Mae currently follows a policy for most of its MBS to exercise this repurchase right once a mortgage loan is four months delinquent. Fannie Mae clearly discloses its right to do so in its related securities disclosure. A number of factors influence Fannie Mae's decision of when to remove delinquent mortgage loans from an MBS. Fannie Mae also has the discretion in the event of a material breach of a representation and warranty to repurchase the related mortgage loan from a securitization trust. As in the case of a defaulted loan above, Fannie Mae clearly discloses this right in its securities disclosures. In both cases, Fannie Mae exercises this discretion to protect itself from financial loss even if keeping these mortgage loans in an MBS trust would benefit the related investor by not creating early prepayments on the securities.

Fannie Mae believes that the exercise of its discretion in both these cases is entirely appropriate and is an important tool in its efforts to save money and mitigate losses on the mortgage loans it guarantees. Accordingly, we believe that the Commission should view such actions as part of the legitimate functioning of the securitization market and not a violation of the Proposed Rule.

*Refinance Risk*. Because of Fannie Mae's guaranty of its mortgage securities, prepayments of mortgage loans in Fannie Mae securitization trusts, not credit defaults, constitute the single most significant factor affecting the return of investors in these securities. Thus, refinances of mortgage loans, usually as a result of declines in prevailing mortgage interest rates, have a significant impact on an investor's return at a time when the interest rates available on

[4] Title III of the National Housing Act (12 U.S.C. 1716 et seq.)

generally declined. Fannie Mae has long had a policy that it could take these steps, together with mortgage lenders, to streamline the residential mortgage loan refinance process. This policy benefits the nation's homeowners by making refinances of existing mortgage loans easier and less expensive, but just as this policy assists homeowners, it also potentially reduces the return to existing investors.

In addition, Fannie Mae has taken steps as directed by the Obama Administration as part of the Administration's Home Affordable Refinance Program ("HARP") to eliminate obstacles to refinancing of mortgage loans with high loan-to-value ratios. This involves certain waivers by Fannie Mae to previous eligibility rules for deliveries of mortgage loans. The Obama Administration believes that HARP is an important effort to improve the nation's economy by reducing the housing expense of many homeowners and encouraging homeowners to stay current on their mortgage loans. Fannie Mae believes that the Commission does not intend the participation of Fannie Mae in (i) efforts to streamline refinancings generally, (ii) the Obama Administration's Home Affordable Refinance Program or (iii) other similar efforts that may arise in the future as violations of the Proposed Rule, even though initiatives like this, if successful, may reduce the return to investors in the related securities.

Dollar Roll Transactions

One of the ways in which Fannie Mae provides additional liquidity to investors in Fannie Mae MBS is by entering into dollar roll transactions. In a dollar roll transaction, the investor commits to sell its security to Fannie Mae at a specific price and to purchase a similar security back from Fannie Mae at a lower price on a specified date in the future. The difference in the sales and purchase price is the implied cost of financing. Dollar roll transactions differ from repurchase agreements in that dollar roll transactions do not require return of the same collateral, but such collateral need only have the same prefix and coupon as the security that was initially delivered as part of the transaction, thus giving Fannie Mae a certain amount of discretion in selecting the actual MBS for delivery at the end of the dollar roll transaction. Such MBS may perform more or less favorably than another MBS with the same prefix and coupon. If such MBS performs less favorably, Fannie Mae should not be subject to liability under the Proposed Rule for its selection, absent some actual intent to harm the dollar roll counterparty. Consequently, Fannie Mae seeks confirmation from the Commission that such transactions fall within the exception for liquidity commitments, as set forth in the Proposed Rule.

Material Conflict of Interest

The Proposing Release sets forth a test for determining a material conflict of interest that, in relevant part, includes the following elements:

1] Either:

A) a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (i) adverse performance of the asset pool supporting or referenced by the relevant ABS, (ii) loss of principal, monetary default or early amortization event on the ABS, or (iii) decline in the market value of the relevant ABS or default or early amortization event on the ABS, or (iii) decline in the market value of the relevant ABS or

B) a securitization participant, who directly or indirectly controls the structure for the relevant ABS or the selection of assets underlying the ABS, would benefit directly or indirectly from fees or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above . . .

The normal process by which Fannie Mae issues REMIC Securities could fall within this definition. Investment bankers aggregate Fannie Mae MBS or mortgage loans and deliver them to Fannie Mae in a swap transaction for Fannie Mae REMIC Securities, for which transaction Fannie Mae charges a fee. The investment bankers will determine the structure, or "waterfall," by which principal and interest will be distributed to investors. Fannie Mae reverse-engineers the waterfall and then incorporates it into the related REMIC trust and securities offering documents. We are concerned that incorporation of Item 1B of this materiality test into the Proposed Rule will require Fannie Mae to monitor the waterfall requested by the investment banker to determine if it might create a conflict of interest between the investment banker and the investor. This duty will be impossible for Fannie Mae to meet and may ultimately result in fewer REMICs being issued, thus diminishing our ability to provide liquidity in the secondary market for residential mortgage loans. Therefore, Fannie Mae believes that the Commission should revise this material conflict of interest test to exclude third-party issuers who did not actually develop the related REMIC waterfall from Item 1B of such test under the Proposed Rule.

From time to time, Fannie Mae has issued REMIC Securities where certain tranches are unguaranteed, serving as credit support classes for the guaranteed tranches. The volume of these securities has been very limited and none has been issued since 2009. In the future, Fannie Mae may wish to increase its volume of these securities as a means of managing its credit risk. In addition, Fannie Mae may wish to consider alternative methods of managing its credit risk that may involve the issuance of synthetic securities that may carry credit risk related to a reference pool of mortgage loans.

Item 1A of the materiality test, as currently drafted, could be interpreted to make the issuance of these securities a violation of the Proposed Rule because Fannie Mae would benefit directly from defaults on the reference pool of mortgage loans. In this case, however, Fannie Mae would be limited to hedging some of the credit risk that it already bears, either as a result of its guaranty obligations with respect to another fully guaranteed security or as an investor in mortgage loans. Any gain that it would receive from the synthetic security would merely offset the loss that it had suffered as guarantor of or investor in mortgage loans. Accordingly, we ask the Commission to clarify that these issuances, in the absence of intent by Fannie Mae to harm investors, would not violate the Proposed Rule.

Defined Terms

The Proposed Rule subjects "underwriters," "placement agents," "initial purchasers" and "sponsors" to liability for violations of the Proposed Rule. In the Proposing Release, the Commission asks whether it should define these terms in the final rule or should adopt definitions already in place in existing regulations issued by the Commission. For example, in Question 11 the Commission notes the definition of "sponsor" as provided in Regulation AB, where it is defined as "the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." The Commission then inquires if this definition is appropriate in this context. In Fannie Mae guarantor swap transactions, a seller of mortgage loans typically brings us a pool of mortgage loans. We acquire the pool, immediately transfer it to a securitization trust, issue securities backed by the mortgage loans and deliver the securities to the mortgage loan seller in consideration for the mortgage loans. We request that the Commission clarify who it intends in this case to be a "sponsor."

Likewise, the Commission has asked whether the definition of "underwriter" for purposes of the Proposed Rule should have the same meaning as the definition of this term in Section 2(a)(11) of the Securities Act of 1933.[5] Alternatively, the Commission suggests that it adopt the definition of "underwriter" found in Rule 100 of Regulation M under the Exchange Act.[6]

We believe that the term "initial purchaser" should be clarified, at least as it applies to Fannie Mae's securitization model. In the case of a guarantor swap, the party delivering a pool of mortgage loans to Fannie Mae receives an MBS backed by these mortgage loans. Frequently, but not always, that party will sell this MBS to an investor. Will that delivering party be the "initial purchaser" or will the investor to which that MBS is sold be the "initial purchaser?" We request that the Commission clarify who it intends in this case to be an "initial purchaser."

Fannie Mae believes that the Commission should not include within the definition of "sponsor," "underwriter" or "initial purchaser" those lenders that use GSE securitizations to transfer residential mortgage loans into the secondary mortgage market (unless those lenders undertake an intentional effort to harm investors). Many of these lenders are small-to-medium-size lenders that are not accustomed to having "sponsor" or "underwriter" liability under federal securities law for *bona fide* secondary mortgage market transactions involving GSE securities. This potential liability may unduly chill their willingness to engage in these transactions, thus damaging the liquidity of their mortgage loans and limiting the ability of those lenders to compete with larger mortgage lenders. The Commission should consider excluding from liability lenders who deliver loans to GSEs in exchange for related securities, absent some intentional effort by those lenders to harm investors.

[5] 15 U.S.C. 77b(a)(11) states that the term "underwriter" means "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking."

[6] 17 C.F.R. 242.100 states that the term "underwriter" means "a person who has agreed with an issuer or selling security holder: (1) to purchase securities for distribution; or (2) to distribute securities for or on behalf of such issuer or selling security holder; or (3) to manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder."

Conclusion

As discussed above, Fannie Mae believes that the Proposed Rule is too broad and may curtail legitimate securitization activities. To avoid this result, the Commission should adopt a test that limits the scope of the final rule to securitizations that are designed to fail or are intentionally flawed. In the alternative, the Commission should provide guidance that certain activities, as described in this letter, will not constitute violations of the final rule.

Fannie Mae appreciates the opportunity to provide the foregoing comments to the Commission. Should you have any questions or wish to clarify any of the matters addressed in this letter, please contact me at (202) 752-2793 or stephen_h_mcelhennon@fanniemae.com or David E. Kalinski, Associate General Counsel of Fannie Mae, at (202) 752-3417 or david_e_kalinski@fanniemae.com.

Sincerely,

Stephen H. McElhennon
Vice President and Deputy General Counsel