



February 13, 2012

Submitted via E-mail to rule-comments@sec.gov

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

Re: Joint Association Comments on the Proposed Rule 127B Under the Securities Act of 1933 (File Number S7-38-11)

Dear Ms. Murphy,

The Association for Financial Markets in Europe ("AFME"), the Asia Securities Industry & Financial Markets Association ("ASIFMA") and the International Capital Market Association ("ICMA") described in the Annex are pleased to respond to the request for comment by the Securities and Exchange Commission (the "**Commission**") on Release No. 34-65355 (the "**Release**")¹ proposing new Rule 127B (the "**Proposed Rule**"). The Proposed Rule seeks to implement the prohibition under Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") on material conflicts of interest in certain securitizations.

Our members appreciate the Commission's continuing efforts to restore confidence in the asset-backed markets. We therefore support the Proposed Rule's objective of prohibiting an entity that participated in the creation of a securitization transaction from betting against and improperly profiting from the failure of that transaction. We also strongly encourage Chairman Shapiro's over-arching aim to implement the Proposed Rule without interfering with traditional securitization practices.

Background

We endorse both the general spirit and detail of the comments made by the members of our sister organization, the Securities Industry and

¹ Prohibition Against Conflicts of Interest in Certain Securitizations, Proposed Rule, Release No. 34-65355 (September 19, 2011), 76 Fed. Reg. 60320, 60340 (September 28, 2011).

Financial Market Association ("**SIFMA**"), in its letter to the Commission in response to the Proposed Rule (the "**SIFMA Letter**").

The aim of our response is therefore to emphasize the key points and themes raised in the SIFMA Letter and reiterate the need for clarity surrounding the distinction between the specific types of misconduct to be prohibited by the Proposed Rule and other legitimate activities undertaken in connection with the securitization process.

Comments

Our comments with respect to the Proposed Rule are set out below:

1. Construct of the Proposed Rule

The guidance provided in the Commentary attempts to establish a framework with respect to the scope of activities that would be prohibited under the final rule. However, our members share SIFMA's fundamental concern that the framework set forth in the Commentary is not part of the Proposed Rule itself and would therefore not have the force of law. We therefore strongly urge the Commission to include the list of activities "undertaken in connection with the securitization process"² that are not intended to fall within the scope of the Proposed Rule (for example conducting servicing, collateral management or underwriting activities) in the text of the final rule itself.

We would also highlight that, given that the text of the Proposed Rule does not incorporate definitions of key terms (for example, in relation to covered persons, covered products and the standard of materiality), guidance or instructions, there is clearly room for interpretation. This would inevitably lead to uncertainty as to whether various activities relating to a securitization transaction could be viewed as violating the Proposed Rule and, at a minimum, would require industry participants to closely monitor market practice (in so far as it can be ascertained at any time) and Commission staff interpretations in order to determine the limits of permissible behavior. Many market participants will likely be deterred from engaging in lawful and useful transactions because of the potential regulatory risks involved.

For these reasons we request that the Commission adopt a precise rule incorporating a specific set of defined terms in place of the existing Commentary.

² *Ibid*

2. *Covered Persons – Jurisdictional Nexus*

We agree with SIFMA's assertion that the final rule should specify definitions for each of the applicable securitization participants³. This is particularly important not only because these terms have different meanings under various US securities laws but also because some of these terms are potentially subject to a different interpretation by non-US market participants.

Our members would also like to highlight that the wording of the Proposed Rule currently includes (directly or indirectly) transactions that lack a clear US connection. SIFMA's specific concern that the inclusion of affiliates and subsidiaries (of securitization participants) in the scope of the Proposed Rule might result in the rule having a global reach⁴ is particularly pertinent from a non-US perspective. Moreover, we strongly believe that the regulatory needs in relation to conflict of interest issues in non-US securitization transactions are best assessed and addressed by local regulators. We therefore wholeheartedly agree with SIFMA's request that the Proposed Rule should explicitly exclude the conduct of securitization participants in relation to non-US offerings absent a substantial effect in the US or on a US person *even if* the issuer is an affiliate or subsidiary of a US person⁵.

3. *Covered Products*

(a) *Scope of the Definition "Asset-Backed Security"*

We support SIFMA's concern that the definition of "asset-backed security"⁶ is too wide and consequently market participants will find it difficult to identify those transactions that are caught by the Proposed Rule.

Moreover we encourage the Commission to acknowledge the differences between asset-backed securities (and other structured finance products) on the one hand and covered bonds on the other. Covered bonds are full recourse debt instruments typically issued by a credit institution that are fully secured or "covered" by a pool of high-quality on balance sheet

³ SIFMA Letter, Section III.A.1

⁴ SIFMA Letter, Section IV.A.2

⁵ *Ibid.*

⁶ As such term is defined in section 3 of the Securities Exchange Act of 1934 (as amended).

collateral (e.g. residential or commercial loans or public sector loans) and represent a significant funding source in Europe. Because these securities also benefit from a full recourse, direct claim against the issuing credit institution, payments on them do not depend solely on the underlying financial assets and are therefore fundamentally different in nature to traditional asset-backed securities.

We therefore agree with SIFMA that a safe harbor should be introduced for covered bond transactions⁷ broadly defined to include structures that provide recourse both to the originator and to a collateral pool whether owned by the originator or a special purpose entity.

In addition, we propose that all corporate-credit based secured financings along with those transactions that are structured to provide the investor with the dual protection described above should not fall within the scope of the Proposed Rule. These transactions are clearly not of the type that the Proposed Rule is intended to address.

(b) Synthetic Asset-Backed Securities

(i) Proposed definition

We support SIFMA's view that the term "synthetic asset-backed security" should be defined in the final rule to avoid speculation as to what types of transactions are intended to fall within the scope of the Proposed Rule and agree with their thoughts as to the category of transaction that should not fall within this definition⁸.

By way of example, we concur with SIFMA that the Commission should provide a safe harbor with respect to insurance-linked securities⁹. Investors in insurance-linked securities receive periodic interest payments from premium payments on the underlying risk transfer contract (e.g. the insurance contract) and investment earnings on the permitted investments (e.g. money market funds). The principal of the insurance-linked securities is not paid from self-liquidating assets but is rather due at maturity of the insurance-linked securities and is sourced from the redemption of the permitted investments. Investors would not receive their full principal or interest if a certain risk event (e.g. a natural disaster) occurred.

⁷ SIFMA Letter, Section IV.B.2

⁸ SIFMA Letter, Section IV.B.4

⁹ SIFMA Letter, Section IV.B.2

In addition, we request that the Commission should also except synthetic balance sheet Collateralized Loan Obligations ("CLO") from the Proposed Rule on the basis that they are typically structured to mitigate any conflict of interest between the issuing bank and the investor, for example, the bank does not normally commit the full exposure to any borrower to the CLO and the selection of assets is done on an automated (or semi-automated) basis.

(ii) The SEC's illustrative examples

The Release sets out four examples of transactions in order to illustrate where material conflicts of interest might arise in certain synthetic ABS structures.

We are particularly concerned with Example 3B¹⁰, where a sponsor purchases credit protection from an SPE issuer pursuant to a credit default swap under which its short exposure offsets its existing long exposure to the underlying ABS. The Commission's preliminary belief is that this scenario would result in a material conflict of interest between the sponsor and the investors because the sponsor would benefit from a potential decline in the ABS.

This type of synthetic securitization provides a legitimate risk transfer from the sponsor to the investors; rather than conflicting with the interests of the investors in the transaction, this risk transfer is the basis of the bargain between sponsor and investors. Further, it would be contradictory for the Commission to prohibit such transactions while permitting traditional securitization transactions that are economically identical. These transactions provide financial institutions with an effective mechanism to hedge balance sheet risk and we strongly believe that they should not be prohibited under the rule provided that they satisfy certain conditions (for example, the sponsor's short position is fully disclosed to investors).

(c) Investors Who Knowingly Take Risk

SIFMA have identified certain transactions and securities that should be exempt from the final rule, for example, where the transaction is established to satisfy investor demand, perhaps with the investor itself selecting the underlying assets or the securitization participants structuring the transaction to meet investor specifications¹¹.

¹⁰ Proposed Rule Release, Section C

¹¹ SIFMA Letter, Section IV.B.4

This is clearly a sensible approach and, as noted above, we would emphasize that the Proposed Rule should allow market participants to differentiate between transactions that have a clear conflict of interest and those that represent the desire of a party to take a position on a trade.

4. *Covered Conflicts Of Interest*

The Commentary states that certain activities associated with the typical structuring of a non-synthetic securitization would not be prohibited by the Proposed Rule and we recognize that the Commission has attempted to clarify the scope of these activities. However, we agree with SIFMA's view that these clarifications should be included in the final rule and that the list of non-prohibited activities should be augmented.

Our members support SIFMA's argument that interest rate swaps and caps, foreign exchange swaps and other similar derivatives should be included in the Commission's list of typical activities undertaken in connection with a securitization transaction that do not fall within the scope of the Proposed Rule¹².

As a case in point, we would highlight that it is currently unclear how the Proposed Rule intends to treat the "conflict" arising out of interest rate or currency swaps between a securitization participant and the relevant SPV issuer. Such swaps do not create conflicts between the securitization participant and the SPV issuer in relation to the performance of the securitized assets. However, there are conflicts in the sense that the securitization participant and the SPV issuer have different interests as to whether interest rates fall or rise or as to how the currency exchange rates move but these conflicts are clearly not of the type that the Proposed Rule intended to address.

5. *Material Conflicts of Interest*

In the Commentary, the Commission specifically states that "it would not be necessary for a securitization participant to intentionally design a securitization to fail or default in order to trigger the rule's prohibition." It would appear, however, that a continuing opportunity to benefit from adverse events would be the critical element in determining whether an activity is of the type that the Proposed Rule was intended to prohibit.

The Proposed Rule thus appears to impose strict liability for engaging in a transaction that results in a conflict of interest. In contrast to Section 17(a)(1) of the Securities Act of 1933 and Rule 10b-5 under the Securities Exchange Act of 1934 Act, there is no requirement of "scienter".

¹² SIFMA Letter, Section II

The Proposed Rule might therefore give rise to the possibility that a participant might be subject to a proceeding by the Commission without having intent or even reckless disregard; this poses a concern given that there is currently a degree of vagueness surrounding what constitutes a conflict of interest and is unduly onerous particularly in a scenario where a properly constructed information barrier has been used to mitigate a potential conflict of interest. We therefore urge the Commission to remove the strict liability requirement.

6. *Use of Information Barriers*

As we observe above, the broad scope of Proposed Rule might have unintended consequences for the affiliates and subsidiaries of securitization participants. We also believe that the Proposed Rule does not satisfactorily accommodate the way in which many large financial institutions are organized; specifically the current language could potentially restrict legitimate business activities that are conducted through various business units, offices and trading desks in different jurisdictions.

SIFMA address this issue by proposing a definition of "business unit" that is based on business function rather than legal entity (or geographic location) and suggest that only those "business units" that are involved in the creation and sale of ABS in its initial distribution should be caught by the Proposed Rule¹³. We wholeheartedly agree with SIFMA's emphasis that the Proposed Rule should focus on such "business units" rather than securitization participants and believe that this approach effectively addresses the way in which large financial institutions are organized.

In the European Union, the corresponding regulation (for example, MiFID¹⁴) addresses this commercial reality by allowing authorized firms to manage potential conflicts through organizational and administrative arrangements (including information barriers and segregation of functions). The use of information barriers is also is also accepted practice for managing certain activities under MAD¹⁵ and we would encourage the Commission to adopt an approach that doesn't

¹³ SIFMA Letter, Section IV.A.2

¹⁴ The Markets in Financial Instruments Directive (2004/39/EC). The main objectives of MiFID were to strengthen investor protection, eliminate barriers to cross-border trading and enhance competition in the securities industry across the EEA, with the ultimate aim of encouraging the integration of capital markets and creating a level playing field for firms providing investment services across the EEA.

¹⁵ The Market Abuse Directive (2003/6/EC). Its aim was to introduce a common EU legal framework for the prevention and detection of insider dealing and market manipulation.

inadvertently create a tension with such existing EU regulation and practice.

Our members therefore strongly support SIFMA's proposal that the final rule should include a safe harbor that permits financial institutions to implement information barriers to prevent the flow of information between business units (in relation to the relevant ABS transaction) that possess certain prescribed characteristics¹⁶.

7. Disclosure of Conflicts

The Proposed Rule (and Commentary) moves away from the use of disclosure as a method of addressing conflicts of interest in securities offerings. This represents a fundamental departure from existing US securities laws which have historically allowed investors to form an independent judgment as to the merits of the proposed securities on the basis of full disclosure by the issuer.

We support SIFMA's position that the effect of disclosure in the context of securitization transactions should not deviate from historic practice (perhaps subject to exceptions for specific transactions), especially given that the concept is consistent with the relevant European regulation in this area. Specifically, in the European Union, we would like to highlight that Article 18 of MiFID permits disclosure as a means of managing certain conflicts of interest.

We also agree that the key provisions of the proposed Volcker rule should be appropriately embodied in the Proposed Rule in this respect.

Conclusion

We concur with SIFMA's caution against an overly broad approach and therefore encourage the Commission to address the points raised in the SIFMA Letter. In this way we very much hope that an appropriate balance will be maintained between prohibiting specific types of misconduct without restricting other activities inherent in the ordinary course of a securitization.

¹⁶ SIFMA Letter, Section IV.A.2

Thank you for soliciting our comments as part of your Proposed Rule. We would be pleased to assist the Commission further if required. In particular, if you have any questions or desire additional information regarding any of the comments set out above please do not hesitate to contact Richard Hopkin on + 44 207 743 9375 or by email at richard.hopkin@afme.eu, Nicholas de Boursac on +852 2537 3895 or by email at nboursac@asifma.org, or Ruari Ewing on +44 20 7213 0316 or by email at ruari.ewing@icmagroup.org.

Yours sincerely,



Richard Hopkin

Managing Director,
Association for Financial
Markets in Europe

Nicholas de Boursac

Chief Executive Officer,
Asia Securities Industry &
Financial Markets Association

Ruari Ewing

Director, Primary Markets
International Capital Market
Association

Annex

The Association for Financial Markets in Europe

The Association for Financial Markets in Europe ("AFME") represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association ("SIFMA"). AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European, and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the U.S. Securities Industry and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). For more information, visit the AFME website, www.afme.eu.

The Asia Securities Industry & Financial Markets Association

The Asia Securities Industry & Financial Markets Association ("ASIFMA") is an independent association that promotes the development of liquid, efficient and transparent capital markets in Asia and facilitates their orderly integration into the global financial system. ASIFMA priorities are driven by over 40 member companies involved in Asian capital markets, including global and regional banks, securities dealers, brokers, asset managers, credit rating agencies, law firms, trading and analytic platforms, and clearance and settlement providers. ASIFMA is located in Hong Kong and works closely with global alliance partners: the Global Financial Markets Association (GFMA), the Securities Industry and Financial Markets Association (SIFMA) and the Association for Financial Markets in Europe (AFME). More information about ASIFMA can be found at: www.asifma.org.

The International Capital Market Association

The International Capital Market Association ("ICMA") represents financial institutions active in the international capital market worldwide and has members located in 50 countries. Its market conventions and standards have been the pillars of the international debt market for over 40 years, providing the framework of rules governing market practice which facilitate the orderly functioning of the market. ICMA actively promotes the efficiency and cost effectiveness of the capital markets by bringing together market participants including regulatory authorities and governments. See: www.icmagroup.org.