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February 13, 2012

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

Re: Prohibition Against Conflicts of Interest in Certain Securitizations, Dodd-Frank Section 621
File Number S7-38-11

On behalf of more than 250,000 Public Citizen members and supporters, we are pleased to comment on the Proposed Rule regarding implementation of § 621 of the Dodd-Frank Wall Street Reform Act.

We object to the suggested use of disclosure and information barriers in the regulations to implement Section 621 (Section 27B of the Securities Act) of the Dodd-Frank Act (the "Act"). Section 27B prohibits material conflicts of interest in the sale of an asset-backed security. In particular, it prohibits "An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security" for one year from the closing of the sale of the ABS from engaging "in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity."[1] The proposed regulations for Section 27B inquire about the use of disclosure and information barriers to avoid liability for conflicts of interest. We believe that the use of such measures to avoid liability would result in a rule that fails to carry out the Act and greatly weakens the protections enacted by Congress.

Section 27B was enacted in the aftermath of the 2008 financial market collapse as a mechanism to prevent conflicts of interest by underwriters in asset-backed securities. In enacting this provision, Congress was influenced by a series of transactions by Goldman Sachs in which Goldman allegedly had taken a short position on complex financial instruments that it marketed to investors.[2] A bipartisan Senate Subcommittee concluded that such transactions were unethical

[1] Dodd-Frank Act, Section 621 (codified at 15 U.S.C. 77a et seq.).
[2] *See* United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and

and contributed to the financial crisis,[3] and suggested that regulators "implementing the conflict of interest prohibitions in Sections 619 and 621 should consider the types of conflicts of interest in the Goldman Sachs case study."[4] Viewed in this context, the conflicts limitation in the Volcker Rule serves three principal functions: imposing fiduciary-like obligations on institutions that might otherwise engage in self-dealing transactions with their clients, preventing conflicts of interest to preserve banks' gatekeeper functions, and prohibiting certain types of risky transactions that contributed to the financial crisis in 2008.[5]

1. Disclosure is not an adequate solution

The proposed regulations Section 27B inquire about the use of disclosure to avoid liability for conflicts of interest. The congressional authors of Section 27B have made it absolutely clear that disclosure is not an appropriate way for underwriters to avoid liability for conflicts of interest. As Senator Carl Levin stated in the congressional debates, in cases where a firm that underwrites an asset-backed security "takes the short position in a synthetic asset-backed security that references the same assets it created . . . even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has or might in the future bet against the security will not cure the material conflict of interest."[6] This clear expression of legislative intent should guide the regulators' decision-making.

Further, disclosure is an inappropriate solution because allowing underwriters to maintain conflicts of interest at all undermines their role as information gatekeepers. As Professor Andrew Tuch has argued, the purpose of Section 27B is not to solve a principal-agent problem by imposing duties akin to fiduciary duties, since underwriting an offering is classically an arms-length transaction with sophisticated counterparties.[7] Rather, the purpose of Section 27B is to prevent underwriters from facing perverse incentives to hide relevant information about an

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Government Affairs, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, Majority and Minority Staff Report, April 13, 2011 (available at http://levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf), at 376-636 [hereinafter Wall Street and the Financial Crisis].

[3] *Id.* at 318-20 (discussing the role of conflicts of interest at investment banks in contributing to the mortgage crisis, and noting that: "Investment banks were a major driving force behind the structured finance products that provided a steady stream of funding for lenders to originate high risk, poor quality loans and that magnified risk throughout the U.S. financial system. The investment banks that engineered, sold, traded, and profited from mortgage related structured finance products were a major cause of the financial crisis."); *id.* at 638 (stating that Sections 619 and 621, "if well implemented, will protect market participants from the self-dealing that contributed to the financial crisis").

[4] *Id.* at 639.

[5] For an extended discussion of how Section 27B and the Volcker Rule impose fiduciary-like obligations and preserve the gatekeeping function, see Andrew F. Tuch, Working Paper, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs*, April 2011, *available at* http://ssrn.com/abstract=1809271.

[6] Congressional Record – Senate, S5899, July 15, 2010 (statement of Sen. Carl Levin).

[7] *See* Tuch, *supra* note 6.

instrument. If underwriters are unable to short their own securities or develop other conflicts, then their incentive to preserve their reputations as quality underwriters will provide a seal of approval to potential investors. Allowing conflicts perverts that incentive. As Professor Tuch notes, a disclosure provision would undermine this purpose of Section 27B because while a conflict might be disclosed, the incentives to distort one's gatekeeping function remain. "[T]he underlying conflict of interest provides incentives for gatekeepers to police such disclosures less than adequately. Put differently, while accurate disclosures of conflicts may promote the information cost-economizing role gatekeepers perform, the problem of conflicts risks compromising the accuracy of these disclosures."[8] It should be noted that in the public offering context, disclosure of conflict is insufficient – either the primary underwriter must be conflict-free, or a conflict-free underwriter must participate and the conflict of the primary underwriter must be prominently disclosed.[9]

Further, even full and accurate disclosure of a conflict does not provide the other party with all the information that would be necessary to evaluate the information disclosed or use it as the basis for investment decisions. For example, taking a short position on an instrument could be a strategy for hedging the underwriter's risk, but it might also reflect a judgment on the part of the underwriter that the instrument is going to fail. It is very difficult for the purchaser of the asset-backed security to distinguish these situations. Unless the Rule requires full disclosure of underwriters' trading strategies and the rationales behind them, allowing underwriters to avoid liability by disclosing will indemnify the conflicted party without adequately mitigating the harm from the conflict.

Disclosure is also inappropriate because it can have perverse effects on both the disclosing party and the party that is disclosed to. Empirical research on the behavioral effects of conflict of interest disclosure has demonstrated that, in contexts such as financial transactions, disclosure of conflicts provides moral license to the disclosing party to provide biased advice. [10] That is, it can backfire by alleviating the guilt of the conflicted party. Disclosure can also perversely cause the party receiving the disclosure to actually become more credulous of the disclosing party, since it is then perceived as more trustworthy.[11] Having underwriters disclose their conflicts could thus actually be affirmatively harmful.

Finally, if the regulators do determine that it is appropriate to allow disclosure to limit liability, it is crucial that they spell out precisely what information must be disclosed and ensure that such disclosure is made effective. Burying the disclosure in marketing material or in lengthy

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[8] *Id.*at 37.
[9] Public Offerings of Securities With Conflicts of Interest, FINRA Rule 1521.
[10] Daylian M. Cain, George Lowenstein, & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005); Daylian M. Cain, George Lowenstein, & Don A. Moore, *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. 836 (2011) (presenting the results of four studies that suggest disclosure backfires).
[11] *See id.* at 5-6; Fiona Lee, Christopher Peterson, and Larissa Z. Tiedens, *Mea Culpa: Predicting Stock Prices from Organizational Attributions*, 30 PERSONALITY & SOCIAL PSYCHOLOGY BULLETIN 1636 (2004).

paperwork will fail to fulfill this need. The regulations should require the conflicted entity to obtain affirmative consent from the other party to the specific conflicted transaction including the nature of the conflict and the economic value of the conflict to the covered banking entity, not merely provide them with notice.

2. Information barriers are not adequate or appropriate

The proposed regulations for Section 27B inquire about the use of intrafirm information barriers (aka Chinese walls) to prevent liability. The commentary on the proposed regulations notes that "We preliminarily believe it may be appropriate to consider the issue of independent units within a multi-service firm in the context of the proposed rule."[12] The regulators should not allow firms to use information barriers to avoid liability in the manner suggested.

Information barriers invite abuse on the part of the company that implements them, and thereby present major enforcement problems. There have been several recent high-profile scandals involving the breach of internal information barriers, including an SEC enforcement action against Merrill Lynch and the stock research analyst scandals of the early 2000s.[13] There is also empirical evidence that investment banks make unusually high returns in trading the stock of companies involved in merger and acquisition deals that they have advised, suggesting that they systematically make use of non-public information despite information barriers.[14]

Further, it is difficult to envision how such information barriers could operate in practice. For example, in the series of Goldman Sachs transactions that influenced Congress' consideration of Section 27B, Goldman made $3.7 billion in gains on its net short positions on mortgages, while several of the mortgage-backed CDOs that Goldman underwrote were worth more than $1 billion each.[15] It is hard to imagine that the executives of a company that engages in both of these activities on such a large scale could be unaware of one of them and still competently manage the company. The walled off entities would have to, in effect, become separate companies. This problem is less significant in other contexts. For example in the Rule 10b5-1 context information barriers can effectively be used to prevent insider trading because no single executive at the financial firm needs to know the information on both sides of the barrier in order to do their job effectively. Yet an executive of a financial firm could not feasibly remain

[12] Prohibition against Conflicts of Interest in Certain Securitizations, S.E.C. Release No. 34- 65355, at 43 (proposed Sept. 19, 2001) (to be codified at 17 C.F.R. pt. 230).

[13] See SEC Order Against Merrill Lynch, Pierce, Fenner & Smith Incorporated, 25 March 2011 (available at http://sec.gov/litigation/admin/2011/34-63760.pdf); DAVID CALLAHAN, THE CHEATING CULTURE: WHY MORE AMERICANS ARE DOING WRONG TO GET AHEAD 152 (2004) ("A second [failure] was the fall of the 'Chinese Wall' that was supposed to separate stock research analysts from investment bankers, providing the incentive for star analysts like Henry Blodget and Jack Grubman to mislead investors on a massive scale.").

[14] *See* Andriy Bodnaruk, Massimo Massa & Andrei Simonov, *Investment Banks as Insiders and the Market for Corporate Control*, 22 REV. FIN. STUD. 4989 (2009).

[15] Wall Street and the Financial Crisis, *supra* note 3, at 376, 388-98.

unaware of either its general trading strategy or a major CDO it was offering. Thus even if information barriers might be useful in other contexts, they are not appropriate for Section 27B.

Your consideration is appreciated, and we remain,

Sincerely,

David Arkush
Director, Public Citizen's Congress Watch

Eric Fish,
Fellow, Public Citizen's Litigation Group