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U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: Prohibition against Conflicts of Interest in Certain Securitizations
(Rel. Nos. 34-65355, 34-65942 and 34-66058; File No. S7-38-11)

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee and the Securitization and Structured Finance Committee (together, the "Committees") of the Business Law Section of the American Bar Association (the "ABA") in response to the Proposed Rule 127B under the Securities Act of 1933, as amended (the "1933 Act"), relating to the Prohibition against Conflicts of Interest in Certain Securitizations referenced above (the "Proposal") released by the U.S. Securities and Exchange Commission (the "Commission"). We refer herein to the Commission's commentary on the Proposal as the "Commentary" and to the text of the proposed rule as the "Proposed Rule".

The Proposal seeks to give effect to the Commission's mandate in Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") to issue rules implementing new Section 27B of the 1933 Act.

The comments expressed in this letter represent the views of the Committees only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Business Law Section.

Our Committees are composed of lawyers from private practice, corporate law departments, trade associations and other organizations. Collectively, we have substantial experience in the securitization markets and in virtually all of the many asset classes that have been securitized.

The Committees thank the Commission for this opportunity to comment on the Proposal. The Proposal includes numerous questions for public comment. The issues on which we comment below do not always correspond directly to these questions; however, in order to facilitate review by the Commission, we have noted below the question numbers that most closely relate to our comments.

The Committees previously submitted a comment letter dated October 29, 2010 on Section 621 of the Dodd-Frank Act (the "Prior Comment Letter) in response to the Commission's request for comments prior to the Commission's issuance of the Proposed Rule. We were gratified by the Commission's careful consideration of the views expressed in the Prior Comment Letter and the many references to it in the Commentary. In our view, the Proposed Rule *when read together with the Commentary* is largely correct in principle and, for the most part, provides a workable standard for the securitization industry. In that sense, we believe that the Proposal comes close to striking a proper balance between careful tailoring of the implementing rules to the statute, while facilitating the smooth functioning of the securitization market by making it clear that the Proposal is not intended to prevent the types of conflicts of interest that are inherent in securitization transactions.

Although we have a few comments on the scope of the Proposal, as we discuss below, our primary concern with the Proposed Rule lies with its format. We believe that the Commentary is critical to an application of the Proposed Rule that allows for the continued functioning of the securitization market, and in order for market participants to rely on it, we believe that it must be part of the final rule and not merely included in the adopting release. Without that critical change, in our view, the Proposed Rule is likely to hamper securitization activity at a critical time in our economic cycle. Furthermore, we believe that it is essential that the final rule contain an express recognition and approval of the use of information barriers to prevent inadvertent violations of Section 621. We also fear that changes to the Proposed Rule to expand its coverage beyond what appears to have been intended by Congress could seriously disrupt the already fragile securitization markets.

1. Format of the Proposed Rule[1]

The wording of the Proposed Rule is nearly identical to Section 621 of the Dodd-Frank Act, and the Commission itself has noted that the minor variations in wording are not intended to be substantive (footnote 83 of the Commentary). The very lengthy and helpful interpretation provided by the Commission in its more than 115-page Commentary is not a part of the Proposed Rule. Yet the Commentary contains such key concepts as (i) recognition that certain conflicts are inherent in securitization transactions and would not be prohibited by the Proposed Rule (p. 79-80), (ii) five conditions that must all be present in order for the Proposed Rule to apply, including a test of "material conflict of interest" and (iii) examples of the application of the Proposed Rule in various scenarios, including the use of credit default swaps and synthetic asset-backed securities. These concepts are vital to interpreting the Proposed Rule.

[1] This section responds in part to Question 32 of the Commentary.

In their January 12, 2012 comment letter, Senators Jeffrey A. Merkley and Carl Levin said that "the proposed guidance offers a comprehensive, carefully-delineated, and practical set of rules" for securitization participants and regulators.[2] However, because these provisions are not included in the text of the Proposed Rule, it is not at all clear that the guidance contained in the Commentary constitutes part of the "rules" and what effect it will be given. Interpretations by the Commission which are not part of regulations lack the force of law and do not warrant the same judicial deference as is granted to regulations. (Christensen v. Harris County, 529 U.S. 576 at 587 (2000)). *See also* the discussion in Tinney v. Geneseo Communications, Inc., 457 F. Supp. 2d 495 at 504 (D. Del. 2006) (vacated in part on other grounds) applying the Christensen holding (which related to an administrative agency interpretation contained in an opinion letter) to statements by the Commission in an adopting release for Rule 16b-3 under the Securities and Exchange Act.

Furthermore, it is an axiom of statutory construction that if the court determines that a statute is not ambiguous, there is no reason for the court to look beyond the statute. This principle has been recognized by the U.S. Supreme Court on numerous occasions. In Barnhart v. Sigmon Coal Company, 534 U.S. 438 (2002), involving interpretation of the Coal Industry Retiree Health Benefit Act, the Social Security Commissioner wished to introduce evidence of Congressional intent, but the Court determined that the statute was unambiguous, and Congressional intent was therefore not considered. The Court wrote: "As in all statutory construction cases, we begin with the language of the statute. The first step 'is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case.' The inquiry ceases 'if the statutory language is unambiguous and the statutory scheme is coherent and consistent.'" *Id.* at 450. Similarly, we can foresee that a court, faced with interpreting new Section 27B of the 1933 Act, might well review the Proposed Rule, which essentially repeats Section 27B, determine that there is no ambiguity, and ignore the Commentary entirely.

Most importantly, because neither Section 621 of the Dodd-Frank Act nor the Proposed Rule contains any definition of "material conflict of interest" or guidance as to how such term should be interpreted, and in light of the inherent conflicts that exist in virtually all securitization transactions, we are concerned that courts might interpret "material conflict of interest" much more broadly than the Commission intends or than securitization participants[3] anticipate. The lack of a clearly articulated standard within the Proposed Rule itself will make it difficult both for securitization participants to structure transactions and for their counsel to provide clear advice.

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[2] *See* p. 8 of the Letter, dated January 12, 2012, from Senators Merkley and Levin (the "Merkley-Levin Comment Letter"), regarding the Proposed Rule.

[3] The term "securitization participant" is used in this letter with the same meaning that is attributed to it on page 3 of the Commentary: an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity.

Accordingly, we urge that the Commentary be incorporated in the Proposed Rule. This could be done by including the Commentary in an appendix to the Proposed Rule. Similar commentary and/or examples have been appended to other federal agency rules, such as Appendix A to Final Regulations II (Debit Card Interchange Fees and Routing) issued by the Federal Reserve Board, Appendix B to Part 38 of Regulations issued by the Commodity Futures Trading Commission (17 CFR Part 38), and Appendices A, B and C to the Notice of Proposed Rulemaking issued on October 11, 2011 by the Commission and certain other regulatory agencies (the "Volcker Rule NPR") to implement Section 619 of the Dodd-Frank Act. An additional advantage to including the Commentary as an appendix is that the Commentary will not become separated from the Proposed Rule. Many sources of federal regulation, including the Electronic Code of Federal Regulations, contain the text of regulations promulgated by the federal agencies but do not include the text of the relevant adopting releases. If the text of the adopting release is not readily available, it may well be overlooked by courts (if the rules of statutory construction even allow them to look to the Commentary) or by counsel trying to interpret the Proposed Rule.

2. Definition of "Sponsor"[4]

The Commission asks in the Commentary whether the definition of "sponsor" should have the same meaning as defined in Regulation AB or if it should specifically include a collateral manager or any other person (e.g., servicers, custodians, etc.) who, for a fee or some other benefit, has a "substantial role" in the "creation" of an issuance of ABS. Senators Merkley and Levin suggest that the Commission create an even broader definition by including "any person (including a collateral manager, servicer or custodian), who, for a fee or other remuneration or benefit, participates in the design, composition, assembly, sale or management of the ABS."[5]

We believe that the term "sponsor" should be defined by reference to the definition in Regulation AB.[6] In our view, Congress was fully aware of the commonly accepted meaning of "sponsor" in the securitization market when Congress enacted Section 621. The concept of "sponsor," as defined in Regulation AB, was extensively reviewed and discussed by the industry and the Commission in the regulatory process leading up to the adoption of Regulation AB. Moreover, the definition of "securitizer" contained in the risk retention provisions of Section 941 of the Dodd-Frank Act encompasses both issuers and sponsors, and clause (B) of that definition (the sponsor clause) is virtually identical to the definition of sponsor in Regulation AB. The Merkley-Levin Comment Letter refers to the work of the Permanent Subcommittee on

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[4] This section responds to Questions 11 and 12 of the Commentary.

[5] *See* Merkley-Levin Comment Letter, p. 3.

[6] "Sponsor" is defined in Regulation AB as follows: "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." 17 C.F.R § 229.1101(l).

Investigations, chaired by Senator Levin, in identifying entities that "structured, marketed and sold" ABS to investors and contains numerous examples of "investment banks" (which were sponsors and even underwriters, placement agents and initial purchasers of ABS) that engaged in the activities that Section 621 is designed to address. If Congress had intended for Section 621 to be applicable to *any person involved in the creation, sale and management of ABS*, it would not have chosen to limit Section 621 to underwriters, placement agents, initial purchasers or sponsors and their affiliates or subsidiaries.

The definition of "sponsor" articulated in the Merkley-Levin Comment Letter would so expand the scope of the rule as to include any entity that provides any services, for a fee, in connection with a securitization transaction--including law firms, accounting firms, third-party due diligence providers and even the financial printers that print offering documents. None of the evidence cited in the Merkley-Levin Comment Letter points to the involvement of any of these parties in the structure and sale of ABS that involved material conflicts of the kind that were intended to be addressed by Section 621. The language posited by the Commission would be limited to those who have a "substantial role" in the creation of the ABS, but that standard may be too vague to apply in any practical way and still leaves open the possibility of sweeping in service providers that in reality play no meaningful role in selecting the collateral or determining the economic structure of the transaction. In any event, we simply do not believe that Congress intended the rules implementing Section 621 to cover any person other than an "underwriter, placement agent, initial purchaser, or sponsor" (as those terms are commonly understood in the securitization market) and their respective affiliates or subsidiaries, and, accordingly, we urge the Commission to adopt the definition of "sponsor" set forth in Regulation AB.

3. Interpretation of "Material Conflict of Interest"[7]

The proposed test set forth by the Commission in Section III.A.v. of the Commentary contains many similarities to the recommendation we made in our Prior Comment Letter, and we commend the Commission for its serious and thoughtful consideration of our comments and those submitted by other commenters. One area of difference, however, is the Commission's inclusion of the phrase "or indirectly" in both items 1(A) and 1(B) as a modifier to the benefit accruing to the securitization participant. In view of the many kinds of conflicts which may exist between a securitization participant and an investor (many of which are inherent in the nature of the seller-buyer relationship and are customarily disclosed), and because the Commission's definition of "securitization participant" includes affiliates and subsidiaries, we find it hard to imagine many circumstances in which there are indirect benefits. We note that the Volcker Rule NPR contains a definition of material conflict of interest within the proposed rule itself (and not merely as an interpretation in the proposing release) and such definition does not specify indirect benefits as a trigger. However, to the extent that the Commission believes that it is appropriate to make clear that the rule addresses indirect benefits ─ such as referrals or fees ─ we believe that such benefits should be limited to those that are known or reasonably foreseeable to the

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7 This section responds to Question 35 in the Commentary.

securitization party, so that the word "indirect" does not come to include any possible benefit, no matter how attenuated to the securitization party.

The Commission poses a number of questions about the precise formulation of the phraseology of Item 1B of the Proposed Rule. For example, Question 44 asks whether the word "controls" in the phrase "controls the structure of the relevant ABS or the selection of assets underlying the ABS" should instead refer to "substantial control" or "influence". Similarly, Question 46 asks whether the phrase "as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS" should be changed to refer to "influence" or "substantially influence" the ABS structure or selection of assets. We do not believe that any of these changes should be made. The securities laws and regulations routinely use the concept of "control," and we believe that term has a well-established meaning. It is unclear what is intended by the phrase "substantially control" and, in our view, the word "influence" is so vague that it may well render the test unworkable because its application would result in too much uncertainty to be practically applied. These concerns would be magnified if a very broad definition of sponsor is included in the final rule. Accordingly, we recommend that the original phraseology of Item IB, as it relates to "control" and "structure", not be revised.

4. Disclosure as an Appropriate Remedy[8]

The basic approach of the 1933 Act has long been to require proper disclosure rather than to pursue substantive regulation. That is, a seller of a security has been permitted to offer and sell any security he or she may wish to sell, provided it is done in an appropriate manner (e.g., pursuant to a registration statement or pursuant to an appropriate exemption from registration) and so long as the sale is done with appropriate disclosure. The Proposed Rule, if adopted as proposed, would shift the approach of the 1933 Act to one of substantive regulation of the decision between seller and buyer and prohibit the sale of certain securities notwithstanding full disclosure, because the transaction involves a perceived conflict of interest by virtue of the way the transaction is structured. The Commission itself has acknowledged in the Proposing Release that the differing views of buyer and seller represent an inherent conflict of interest. We do not believe that this is the type of conflict of interest Section 621 was intended to prohibit. Where the conflict of interest is inherent in the very structure of the security and represents essentially the difference in valuation between a buyer and seller, disclosure should be an adequate remedy.[9]

If a seller wishes to sell a share of common stock at a given price, and a buyer wishes to buy at that price, the buyer and seller may well have different views as to the direction in which the value of that share of common stock is likely to move. That difference in view may be fundamental to the transaction but is not, in our view, a conflict of interest that should be

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[8] This section responds to Questions 96 and 97 in the Commentary.

[9] We also note, as discussed more fully in section 7 below, that the Volcker Rule NPR expressly exempts from its definition of "material conflict of interest" transactions in which the applicable entity makes "clear, timely and effective disclosure of the conflict of interest."

prohibited. The same transaction, if conducted by a market maker, may not involve a view by the market maker as to the fundamentals of the security but instead may reflect a willingness to support liquidity in the market for a fee. Swap transactions may similarly reflect different views about the direction in which an exposure is going to move. Swap transactions, however, are inherently principal-to principal trades, and securitization participants, especially underwriters, often intermediate swap transactions while managing the risks of the swap through hedging arrangements, including portfolio hedging. What appears to be a conflict of interest, or a significant financial benefit to the securitization participant from adverse pricing movements, may in fact be net neutral to the securitization participant or involve only the minimal exposure that cannot be offset if a perfect hedge is not available. Similarly, the true positional differences in a credit default swap transaction cannot be discerned solely by the fact of one party selling credit protection, and another buying it, and instead must be looked at in the context of overall portfolio management and hedging strategies.[10] Given the complexities associated with management of a trading book, we believe that even where there is an apparent conflict, such a conflict should generally be curable by disclosure.

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[10] As an example, suppose that Company A has three major customers for its products: Purchasers C, D and E. At any time Company A has actual trade receivables outstanding from them that have a face amount of $50 million each, but Company A also has products in production, with significant investment of inventory and labor, that it would not be able to sell if one of the Purchasers were unable to buy. Company A approaches Swap Dealer B and asks to buy credit default swaps ("CDS") on the three Purchasers that would provide protection of $100 million each, which Company A believes is the realistic (not speculative) measure of its exposure to each of them. Swap Dealer B sells Company A the CDS, but Swap Dealer B does not actually have any interest in taking on the risk of these entities. Because CDS are swaps, and documented through bilateral ISDAs, Swap Dealer B enters into a swap transaction with Company A under which it agrees to pay Company A if there is a credit event and receives an upfront payment from Company A. Swap Dealer B then offsets the risk it has just taken on, which it can do that in a variety of ways. For example, it could short sell $100 million of Purchaser C debt securities; enter into a back-to-back credit default swap with a $100 million notional amount for Purchaser D with Hedge Fund X, and cover the Purchaser E exposure by including it in a synthetic collateralized debt obligation ("CDO") structure. At that point, Swap Dealer B is fully hedged. If we look at the synthetic CDO in isolation, we might say that Swap Dealer B has an inherent conflict with the CDO security holders because they will lose money if Purchaser E defaults and Swap Dealer B will gain an offsetting amount. We could go further and say that Swap Dealer B allowed its client, Company A, to influence the selection of an asset that was included in the synthetic CDO. But, if we follow the money, what we see is a situation in which Company A entered into a hedge of risk associated with its "real economy" business by purchasing a credit default swap from a diversified group of investors, thus spreading the risk of its losses, and all that Swap Dealer B did was intermediate the risk. Swap Dealer B is the counterparty to two swaps, because swaps are principal-to-principal trades, but it does not have a meaningful economic interest in either.

The Commentary appears to advocate the position that, if the structure of the transaction involves the possibility of a payment, after closing, from the entity issuing the asset-backed security ("ABS") based on the adverse performance of assets supporting the ABS, there is a "higher level" of conflict of interest which should be treated differently. We disagree with that conclusion on the basis that the nature of the transaction is fundamentally the same, whether risk is transferred through a transfer of the asset or whether that risk is transferred synthetically. Accordingly, in any circumstance in which the risks and rewards of a transaction are fully defined at the time of closing of the ABS transaction, are inherent to the structure of the transaction and relate to real assets that are, or could be, transferred to the issuing entity (rather than representing speculation on performance of assets that are not held by any party to the transaction), we believe that disclosure is the appropriate remedy for any perceived conflict of interest, inasmuch as the conflict is inherently nothing more than the customary conflict between a buyer and a seller.

5. Application of the Commission's Test to Synthetic Securities[11]

The Commentary devotes considerable attention to synthetic securities, including providing four examples to illustrate the Proposal. The Commentary assumes that the conflict of interest inherent in a credit default swap -- namely, the conflict between a seller of protection and a buyer of protection -- is a conflict of interest of the type Section 621 was intended to prohibit, and therefore focuses on the applicability of the risk mitigation exception, deeming as permissible only those cases in which the credit default swap arises out of the underwriting, placement, initial purchase or sponsorship of the related ABS. We view that analysis as overlooking the fundamental question of whether the conflict of interest itself is of a type designed to be prohibited. Where that conflict is inherent in the structure of the security and represents merely the customary conflict of interest between a buyer and seller, we do not believe the conflict should be viewed as of a type that should be prohibited by the final rule.

Consider the four scenarios presented as part of Example 3 in the Commentary. Example 3C, in which the sponsor acquires ABS solely in anticipation of issuing a synthetic ABS, is viewed as acceptable because it represents permitted risk mitigation. Yet unlike other forms of acceptable risk mitigation, such as hedging against securities during a warehousing period, or hedging against an unsold allotment of ABS as they are being offered, the credit default swaps in Example 3C are not temporary measures. We believe, therefore, that the better view is that the transaction described in Example 3C is acceptable because it represents essentially the same transaction that the sponsor could have done directly. That is, rather than depositing the securities into the ABS transaction, the sponsor elects to acquire and hold those securities and purchase credit protection from the ABS issuing entity. This synthetic securitization nonetheless results in the same economic shifting of risk that would be the case if the sponsor had deposited the reference securities in the ABS issuing entity. As such, the conflict of interest in the transaction is essentially the fundamental conflict of interest between a buyer and seller, and is therefore acceptable, not because it is a permitted risk mitigation activity,

[11] This section responds to Questions 89 and 90 in the Commentary.

but rather because the transaction does not evidence the type of conflict of interest Section 621 was designed to prohibit.

Is Example 3B really any different? In that case, the sponsor holds the reference securities in its portfolio before the process of creating the ABS is initiated. The sponsor could create the ABS by simply depositing those securities into the ABS issuing entity. As was the case in Example 3C, the sponsor instead chooses to transfer the risk synthetically, by entering into a credit default swap with the ABS issuing entity, creating the equivalent investment experience for the investor. As also was the case in Example 3C, the resulting conflict of interest is merely the difference in view of value as between a seller and a buyer. Furthermore, in a rule under which determination of a violation purports to be independent of intent, the sponsor's intent is critical to the conclusion reached by the Commission in Example 3B. Were the underlying securities purchased with intent to transfer their risk into the ABS, or were they acquired in advance of that moment? Suppose the sponsor purchased the ABS with the intention of issuing a synthetic ABS, but then, because of adverse changes in market conditions, held the ABS for a period of time until market conditions improved? Drawing a distinction between Examples 3B and 3C becomes very difficult[12] and is arguably unnecessary, because in our view neither represents more than the conflict inherent in a transaction between a buyer and a seller.

In Example 3D, the Commentary suggests that when the securitization participant enters into an offsetting credit default swap with a third party, the analysis depends on whether the third party is involved in selecting the reference assets. In fact, in most cases there is little purpose to such a transaction unless the third party is involved in the selection, since such transactions are normally designed to provide credit protection, and perhaps accounting or capital relief, to the third party on such party's existing portfolio. As with the other scenarios, although a third party is involved, the transaction essentially involves no more than a typical conflict between a buyer and seller.

In Example 3A, there clearly is no risk mitigation activity, but the situation is not really so different. There are many situations in which a seller of a security may have a different interest in performance of an index or portfolio of assets from that of the buyer of a security, such as for credit-linked notes, or notes that pay on the basis of performance of a given index. No party entering into such transactions is called upon to confirm that the transaction hedges a specific risk of the issuer or sponsor. In each case, the decision is simply one between a buyer and a seller, for which customary rules of adequate disclosure should provide sufficient

[12] In our example in footnote 10, Swap Dealer B vis-à-vis the CDO investors falls within Example 3B or 3C depending on whether Swap Dealer B had the intent to do the CDO when it entered into the CDS with Company A. The question of Company A's "influence" over the CDO is discussed in Example 3D, and whether or not the transaction is prohibited would depend, based on our reading of the Commentary, on a determination of whether Company A actually had a role in selecting the CDO's assets. This is a factual determination that, in our view, could go either way and therefore is a market risk that will likely discourage this type of transaction where there is no real justification for doing so.

protection. That said, we view Example 3A as distinguishable from the other examples. Each other case represents a situation in which the reference assets exist and could have been placed directly into the issuing entity, but doing so synthetically was viewed as preferable, whether due to tax or accounting reasons, transfer restrictions in the securities, complexity of generating voluminous transfer documentation or other reasons.

Prohibiting any of these examples, rather than simply mandating timely and sufficient disclosure, may well result in significant disruption in the way standard securitizations are done. In the case of Example 3A, however, the transaction has as its basis nothing more than speculation as to the future value of the asset-backed security or assets supporting it, a transaction that might best be left to less complex transaction structures, such as a customary credit default or total return swap, rather than utilizing a more involved asset-backed security structure. Although we view disclosure as an adequate remedy because the risks and rewards of the transaction are fully within the four corners of the transaction itself and can be fully disclosed in the offering documents for the security, we also recognize that a pure "naked short" of this type more closely resembles transactions about which Congress may have had greater concern.

As noted in Senator Levin's testimony with respect to Section 621 of the Dodd-Frank Act, "while a meaningful disclosure may alleviate the appearance of a material conflict of interest in some circumstances, in others, such as if the disclosures cannot be made to the appropriate party or because the disclosure is not sufficiently meaningful, disclosures are likely to be insufficient. Our intent is to provide regulators with the authority and strong directive to stop the egregious practices, and not to allow for regulators to enable them to continue behind the fig leaf of vague, technically worded, fine print disclosures."[13] In our view, the case in which it is difficult or even impossible to provide adequate disclosure is the case in which the short transaction is not a fundamental element of the transaction, or is entered into after the sale of the ABS. Consider the case in which the portfolio backing an ABS is not fixed at closing and additional synthetic transactions occur after the buyer's investment decision. In that scenario, if a sponsor or collateral manager is in a position to enter into new credit default swaps that are for its own benefit, the new transaction represents a conflict of interest as to which the ABS buyer was in no position to make a judgment. In fact, it is not significantly different from acquisition of additional assets from the sponsor or collateral manager. In that case, a mere disclosure in connection with the sale of the ABS that future transactions may involve conflicts of interest may be viewed as inadequate, but the inclusion of specific mechanisms in the structure which assure market pricing and thereby eliminate an opportunity for a conflict of interest, could serve as an adequate remedy. For example, if the securities being sold, or the swaps being entered into, are traded on a recognized market so that independent pricing is available, it may be permissible to acquire such assets, or an interest in such credit default swaps, without giving rise to a prohibited conflict of interest. If such assets are selected by a collateral manager whose compensation is unaffected by the selection, other than through superior performance of the acquired asset, and who is not otherwise benefitted by selecting such assets or entering into such credit default swaps, the opportunity to benefit from the conflict of interest is similarly

[13] 156 Cong Rec S 5870, 5901.

sufficiently mitigated. Accordingly, we would suggest an approach under which covered transactions that occur after the sale and closing of the ABS are permitted provided that there are structural mechanisms in place to ensure that such transactions are conducted on fair market terms and there is adequate disclosure both as to the nature of any possible conflict of interest and of the mechanisms employed to mitigate the risk associated with any such conflicts.

6. Information Barriers[14]

We are very concerned that, if the Proposal were implemented as currently drafted, large financial institutions would find it virtually impossible to prevent inadvertent violations of the final rule. This is because large financial institutions operate on a national or global basis in multiple locations, with each location comprised of many business units, offices, trading desks and funds. Moreover, large financial institutions are often required by law to maintain separate business units that are walled off from other parts of the financial institution. Therefore, as a practical matter, it would be impossible for large financial institutions to develop any meaningful policies or procedures to enable them to monitor effectively the daily activities of thousands of employees across various locations and business units. For example, a securitization participant at a large financial institution in New York will never become aware of (and thus will not be able to prevent) trades entered into by traders within the same financial institution in different countries and/or across different business units. Unbeknownst to a securitization participant that may otherwise be diligently complying with the rule, these traders may separately enter into swap transactions with one or more relevant parties, causing the securitization participant to violate the rule inadvertently.

Given these practical considerations, we believe that it is critical that the Commission craft a final rule expressly permitting securitization participants to use information barriers, or firewalls, in order to facilitate securitization participants' full compliance with the final rule and avoid any unintended consequences for securitization participants and their respective affiliates.

We note the Commission's recognition in the Commentary that information barriers have often been used as highly effective tools to manage conflicts of interest in other areas of the federal securities laws and as a means to address or mitigate potential conflicts of interest and other inappropriate activities, including with respect to the use of information barriers in Section 15(g) of the Securities and Exchange Act of 1934, as amended (the "1934 Act"), and Rule 14e–5 and Regulation M under the 1934 Act. We are encouraged that the Commission is open to considering whether the effective use of information barriers might permit the Proposed Rule to achieve its policy objectives without unnecessarily restricting beneficial market activities. Furthermore, as we discuss in section 7 below, the Volcker Rule NPR specifically (and, we believe, appropriately) exempts from its conflict of interest rule transactions that are subject to proper information barriers.

[14] This Section responds to Questions 91 and 95 in the Commentary.

We note as well that Section 28 of the 1933 Act provides the Commission with authority to adopt conditional or unconditional exemptive rules or regulations "to the extent that [any] such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." We therefore urge the Commission to consider conditional exemptive rules and regulations based on information barriers for transactions and activities otherwise covered by the Proposed Rule.

We believe that the separation created between securitization participants and their respective affiliates through the effective implementation and enforcement of information barriers will meaningfully protect against the types of material conflicts of interest that the Proposed Rule is designed to address because such information barriers will effectively eliminate securitization participants' incentive to design ABS intentionally to fail or default or to profit from the adverse credit performance of such ABS. Consequently, investors would benefit because the incentives of securitization participants would be better aligned with those of investors in the ABS.

Accordingly, we propose that the Commission create a safe harbor that permits securitization participants to develop, maintain and enforce a stringent information barrier compliance system designed to ensure full compliance with the final rule. In particular, we propose that any securitization participant seeking to rely on this safe harbor would be required to develop, maintain and enforce an information barrier compliance system with the following characteristics:[15] (1) formal, written policies and procedures reasonably designed to prevent the flow of information from the business unit that is the securitization participant to other business units[16] in the institution; (2) maintenance of records sufficient to analyze and review at a later time actions taken pursuant to the compliance system; (3) ongoing monitoring of compliance with the compliance system and documentation of all investigations into any possible non-compliance; (4) restrictions on communications of, and access to, sensitive information across the barriers, including the restriction of dissemination of information other than on a need-to-know basis; and (5) education and training of employees as to the firm's policies.

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[15] *See* the Commission's 1990 study on information barriers titled "Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-public Information" (available at http://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf), and the NYSE Information Memo No. 91-22 dated June 28, 1991 titled "NASD/NYSE Joint Memo on Chinese Wall Policies and Procedures" (which was reviewed by the Commission).

[16] In this context, we believe that "business unit" should include not only a separate division within a securitization participant but also separate affiliates and subsidiaries of the securitization participant.

7. Comparison With Volcker Rule NPR[17]

The Volcker Rule NPR, which proposes the rules to regulate proprietary trading by banking entities and transactions by such banking entities with certain covered funds mandated by Section 619 of the Dodd-Frank Act, contains two virtually identical provisions dealing with conflicts of interest between the banking entity and its clients, customers or counterparties. These conflicts of interest rules are similar in concept to the Proposed Rule; however, Sections ___.8(b) and ___.17(b) of the Volcker Rule NPR, specifically exclude from the definition of "material conflict of interest" any conflict as to which there has been timely and effective disclosure and an opportunity to negate or substantially mitigate the conflict or for which appropriate information barriers are in place.[18] We applaud the Commission and the other

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[17] The Committees will be submitting a separate comment letter on the Volcker Rule NPR. The views expressed herein are subject to any specific comments we may provide on the portions of the conflicts of interest provisions contained in the Volcker Rule NPR.

[18] Sections ___.8(b) and ___.17(b) of the Volcker Rule NPR each define "material conflict of interest" as follows:

> "(b) Definition of material conflict of interest. For purposes of this section, a material conflict of interest between a covered banking entity and its clients, customers, or counterparties exists if the covered banking entity engages in any transaction, class of transactions, or activity that would involve or result in the covered banking entity's interest being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, unless:
>
> (1) Timely and effective disclosure and opportunity to negate or substantially mitigate. Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict of interest may arise, the covered banking entity:
>
> (i) Makes clear, timely and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer or counterparty to meaningfully understand the conflict of interest; and
>
> (ii) Makes such disclosure explicitly and effectively, and in a manner that provides the client, customer or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or
>
> (2) Information barriers. The covered banking entity has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of

regulators involved in crafting the Volcker Rule NPR for recognizing the value of appropriate disclosure and information barriers in dealing with conflicts of interest, and believe that similar exceptions would be appropriate in the context of the Proposal.

If the activity giving rise to the conflict is inherent in the transaction itself and is completed in connection with the initial closing of the transaction, it is possible to provide full and detailed disclosure of the nature of the conflict and the risks and rewards being assigned to and assumed by the investor, giving the investor an opportunity to assess the risks and rewards and all facts surrounding the securitization party's position of conflict. In this circumstance, comparable to the case in which the Volcker Rule NPR would provide an exception, thorough disclosure should be adequate to satisfy the Proposed Rule. Accordingly, we endorse including an exception to the prohibition on conflicts of interest comparable to that included in Section __.8(b)(1) of the Volcker Rule NPR, but modified in clause (ii) to say "Makes such disclosure explicitly and effectively, and in a manner that <u>(a) provides the investor the opportunity to negate, or substantially mitigate, any materially adverse effect on the investor created by the conflict of interest; or (b) for a conflict that is inherent to the asset-backed security itself and relates to a transaction that is completed in connection with the closing of the initial sale of the asset-backed security, is sufficient to enable the investor to assess adequately the risks and rewards of the transaction and the nature of the conflict of interest</u>."

We also believe that an exception based on information barriers would be appropriate as set out in the first sentence of Sections ___.8(b)(2) and ___.17(b)(2) of the Volcker Rule NPR . As described above, information barriers prevent two different business segments in a large organization from acting in concert to create a conflict of interest transaction, and permit them to act independently as though they were two different organizations. We also recognize that there must be an exception to the extent knowledge of a conflict of interest penetrates the information barrier, which we view as the primary intent of the second sentence of Sections ____.8(b)(2) and ___.17(b)(2) of the Volcker Rule NPR. We are concerned, however, that the sentence is written so broadly that it could negate the value of information barriers based simply on the possibility that an affiliate or another business unit of a party on the other side of the information barrier could take an action that would be adverse to the investor. We believe that the concept of the second sentence should be limited to cases in which the securitization party knew, or had reason to know, of an actual conflict of interest.

> the covered banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A covered banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the covered banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

8. Costs Arising from the Proposed Rule[19]

We believe that the issues discussed in the previous sections of this letter will, if not remedied in the final rule to be issued by the Commission, result in significant increased costs to securitization participants and will negatively impact the financial markets generally. Uncertainty caused by the form and scope of the proposed rule, as discussed above, is likely to result in increased legal costs and longer lead times in order to effect securitization transactions and is also likely to reduce the level of new deal activity until the market gains a better sense of what types of activities are or are not likely to be regarded as material conflicts of interests. In the case of synthetic securities, the difficulty of distinguishing between Examples 3B and 3C in real world practice may well cut off the issuance of synthetic securitizations. If an appropriate exception for information barriers is not included in the final rule, large financial institutions will not be able to act as securitization participants unless they are willing to accept as a cost of doing business occasional inadvertent violations of new Section 27B of the 1933 Act (which could include not only legal expenses and fines, but also reputational damage). Moreover, the costs of compliance with the Proposed Rule will increase significantly should the Commission take an expansive approach to defining the parties that are covered by the conflicts of interest rules.

Another cost associated with uncertainty about the scope and application of the Proposed Rule is the cost of litigation. As discussed above, courts have not given deference to language in adopting releases as opposed to the text of the rule, and securitization participants would, in our view, face a higher risk of litigation based on alleged violations of Section 27B or Rule 127.

A further consequence (and cost) of the Proposed Rule is its impact on opinion letter practice, especially given the format of the Proposal and its application to "indirect benefits." At the closing of securitization transactions, counsel for securitization participants are often requested to give opinion letters to other participants and, in rated transactions, to rating agencies. These opinion letters often cover the validity and enforceability of the transaction documents, the receipt of any required governmental approvals and non-contravention of applicable laws. Because new Section 27B of the 1933 Act and the Proposed Rule state that a securitization participant "shall not . . . engage in any transaction that would involve or result in any material conflict of interest," these provisions must be considered in any proposed non-contravention of law opinion. However, these conflict of interest provisions may be triggered by separate transactions entered into by the securitization participant (including an affiliate) that are not part of the securitization transaction on which outside counsel is being asked to advise and outside counsel may be completely unaware of those unrelated transactions. In addition to the interpretive issues arising out of the format of the Proposed Rule and the uncertain effect of the Commentary, as a practical matter, it will not be possible for outside counsel to identify other transactions which he or she has not worked on and which may implicate the Proposed Rule. It would certainly not be appropriate for outside counsel to rely on an officer's certificate of the securitization participant in this situation, because the officer would have to reach a legal conclusion as to the interpretation and application of the conflict of interest rules. Accordingly,

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[19] This section responds to Question 113 of the Commentary.

we do not believe that it is possible for outside counsel to provide a non-contravention of law opinion with respect to Section 27B and the Proposed Rule in an asset-backed security transaction that is subject to Section 27B.

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The Committees appreciate the opportunity to comment on the Proposal, and we respectfully request that the Commission consider the recommendations set forth above. We are prepared to meet with the Commission and its staff to discuss these matters with them in more detail and to respond to any questions.

Very truly yours,

/s/ Jeffrey W. Rubin

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