We are submitting this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comments relating to the proposal of new rule 127B (the "Proposed Rule") under the Securities Act of 1933 (the "Securities Act") as set forth in Release No. 34-65355; File No. S7-38-11, dated September 19, 2011 (the "Release"). We appreciate the opportunity to comment. The Proposed Rule would implement the prohibition under Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") on material conflicts of interest in connection with certain securitizations.

I. Overview

Section 621 of Dodd-Frank added Section 27B to the Securities Act. Section 27B(a) prohibits certain persons who create and distribute an asset-backed security ("ABS"), including a synthetic ABS, from engaging in transactions within one year after the date of the first closing of the sale of the ABS that would involve or result in certain material conflicts of interest.\(^2\)

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\(^2\) Section 27B(a) of the Securities Act provides:

(a) IN GENERAL.—An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities and Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any
Section 27B(c) provides exceptions from the prohibition described in clause (a) for certain risk-mitigating hedging activities, liquidity commitments and bona fide market-making. In crafting the Proposed Rule the Commission primarily incorporated the text of Section 27B and the Release sets forth certain proposed clarifying interpretations of the Proposed Rule. In addition, the Commission sets forth in the Release illustrative examples of transactions that involve or that do not involve, as the case may be, potential conflicts of interest and describes how its proposed test for identifying prohibited conflicts of interest under the Proposed Rule would apply to such transactions.

Because the Commission did not propose any bright-line tests, the analysis required to determine if any particular transaction is prohibited by the Proposed Rule will be heavily dependent on the facts and circumstances of such transaction. The Commission acknowledges this in the Release when introducing its illustrative examples — "We note that these examples are merely illustrative, and even minor differences in the facts and circumstances could change the analysis of these transactions." In order to avoid significant uncertainties for securitization participants concerning whether any specific transaction would be prohibited or would qualify for an exception, it will be important for the Commission to provide in its adopting release greater clarity and additional examples covering differing facts and circumstances.

The focus of this letter is on the risk-mitigating hedging exception under Proposed Rule 127B(b)(1). Specifically, we are requesting that the Commission clarify that:

(i) a synthetic ABS transaction could be utilized as a risk-mitigating hedging activity contemplated by the exception under Proposed Rule 127B(b)(1) where (i) an underwriter, placement agent, initial purchaser, or sponsor retains ABS, which retention

3  (c) EXCEPTION.—The prohibitions of subsection (a) shall not apply to—

(1) risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or

(2) purchases or sales of asset-backed securities made pursuant to and consistent with—

(A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or

(B) bona fide market-making in the asset backed security.

4 Release at p. 60337 (emphasis added).
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arose out of the underwriting, placement, initial purchase, or sponsorship of such ABS,
(ii) such party seeks to hedge its exposure to such retained ABS through the issuance of
a synthetic ABS that references the retained ABS, and (iii) all criteria for utilizing the
risk-mitigating hedging exception as described in the Release are otherwise satisfied;
and

(ii) to qualify for the risk-mitigating hedging exception, the hedge does not need to
be entered into contemporaneously with the securitization participant's acquisition of
the retained ABS it is seeking to hedge.

II. Proposed Risk-Mitigating Hedging Exception in General

Pursuant to the exception in Proposed Rule 127B(b)(1), the following would not be prohibited
by clause (a) of Proposed Rule 127B:

"risk-mitigating hedging activities in connection with positions or holdings arising out
of the underwriting, placement, initial purchase, or sponsorship of an asset-backed
security, provided that such activities are designed to reduce the specific risks to the
underwriter, placement agent, initial purchaser, or sponsor associated with positions or
holdings arising out of such underwriting, placement, initial purchase, or sponsorship."

As discussed above, this proposed exception is modeled on the exception in Section 27B(c)(1)
of the Securities Act.

As indicated by the Commission in the Release, the goal of the proposed risk-mitigating
hedging exception is to allow certain hedging activities that are designed to reduce or mitigate
risk for the underwriter, placement agent, initial purchaser, or sponsor, where risk mitigation
refers to the practice of limiting the consequences of a risk without necessarily reducing the
probability of the risk occurring.\(^5\) In addition, the Commission provides some guidance in the
Release to address what the risk-mitigating hedging exception is intended to capture, as
follows\(^6\):

(i) the proposed exception is not intended to permit speculative trading masked as
risk-mitigating hedging activities. Permissible risk-mitigating hedging is generally
effected to reduce risk from an existing position or a position about to be taken;

\(^5\) Release at p. 60333.
\(^6\) Release at p. 60334.
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(ii) the hedging activities should be designed to reduce the specific risk to the underwriter, placement agent, initial purchaser, or sponsor associated with the ABS positions or holdings that arose out of the underwriting, placement, initial purchase, or sponsorship of such ABS;

(iii) risk-mitigating hedging may include a series of hedging transactions, based on the price movements of the underlying assets in order to remain delta-neutral;

(iv) risk-mitigating hedging does not include trading to establish new positions designed to earn a profit, which might be an indicator of speculation;

(v) risk-mitigating hedging generally should unwind as exposure is reduced because over-hedged exposure may otherwise be indicative of a proprietary position;

(vi) intermittent activity (hedging only when one chooses to act) or activity that is inconsistent with a hedging policy is indicative of proprietary trading; and

(vii) the notional amount under the hedge should be correlated so that losses (gains) on the position being hedged are offset by gains (losses) on the hedge without appreciable differences (e.g., the result should not be a situation in which incrementally poor performance of the hedged ABS or its underlying assets would result in a securitization participant earning appreciably more profits on the hedge than the losses incurred from their ABS exposure).

III. Comments to Risk-Mitigating Hedging Exception

Neither the Proposed Rule nor the Release specifies the list of activities that would qualify for the risk-mitigating exception and the Commission, in its request for comment No. 55, specifically seeks comments concerning the types of activities that should or should not qualify for this exception. In the Release, the Commission does provide some illustrative examples that address the Commission's preliminary views on when the risk-mitigating hedging exception would and would not apply.

In Example 2, a securitization participant (an ABS underwriter) purchases ABS that it distributed and contemporaneously purchases credit default swap (“CDS”) protection, on a delta neutral basis, on such ABS. The Commission indicated that the proposed risk-mitigating hedging exception could apply in this example because the securitization participant is hedging a position arising out of the underwriting, placement, initial purchase or sponsorship of an ABS.
and the recovery on the CDS is not appreciably greater than the exposure of the retained ABS. In order to provide more certainty to securitization participants that will encounter similar, but varying fact patterns, we ask that the Commission, in its adopting release, broaden the facts in Example 2 in at least two respects (or, alternatively, issue additional examples or specific guidance in this regard).

A. Specify Other Hedges (Including Synthetic ABS) That Could Qualify Under the Exception

The hedging activity addressed in Example 2 is limited to a CDS transaction with a counterparty. We request that the Commission provide guidance (or other examples) regarding other hedging activities that could qualify for the risk-mitigating exception under fact patterns otherwise similar to that in Example 2. For example, we believe that if the facts in Example 2 were changed so that the securitization participant, instead of entering into a CDS to hedge its exposure to the retained ABS, entered into a synthetic ABS transaction that is economically equivalent in all respects to the CDS referred to in Example 2, the proposed risk-mitigating hedging exception could apply to such synthetic ABS transaction.

The statutory language of Section 27B(c)(1) of the Securities Act does not specify the types of hedging transactions that would or would not qualify for the exception. There does not appear to be any policy reason to prohibit a synthetic ABS securitization from qualifying as a permissible risk-mitigating hedge under the exception. In fact, in its Example 3C7 in the Release, the Commission acknowledges that a synthetic ABS could be a permissible hedge under the risk-mitigating hedging exception. In that example, the Commission expressed its preliminary view that a securitization participant's entering into a synthetic ABS transaction to offset its exposure to the underlying reference portfolio (that it in turn acquired for purposes of effecting the synthetic ABS transaction) would fall within the proposed risk-mitigating hedging exception, provided there was no significant net basis risk, and the potential gains (or losses) by the securitization participant from the synthetic ABS transaction would be directly offset by losses (or gains) from the long position accumulated.

Also, the use of a synthetic ABS transaction that is economically equivalent to a CDS that would be permissible under the risk-mitigating hedging exception would have the same impact (economic and otherwise) on the securitization participant. Whether the securitization

7 The facts in Example 3C are that the securitization participant has accumulated a long cash or derivatives position in underlying assets solely in anticipation of creating and selling a synthetic ABS and not with a view to taking an investment position in those underlying assets.
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participant sells the retained ABS directly, enters into a CDS consistent with that described in Example 2 or enters into a synthetic ABS with terms economically equivalent to such CDS, the securitization participant would not be in a position to profit from the adverse performance of the assets underlying the retained ABS. Based on the foregoing, we request the Commission to provide guidance that the securitization participant in Example 2, in lieu of the CDS referenced therein, could be permitted to enter into a synthetic ABS transaction pursuant to the risk mitigating hedging exception if such synthetic ABS transaction were structured as the economic equivalent of such CDS transaction.

B. Clarify That Contemporaneous Hedging is Not Required Under the Exception

The facts in Example 2 have the securitization participant purchasing CDS protection contemporaneously with its acquisition of the retained ABS. We do not believe that a hedge must be entered into contemporaneously with the acquisition of the retained ABS being hedged in order to qualify for the risk-mitigating hedging exception. There is no such requirement explicitly stated in Section 27B(c)(1) of the Securities Act. Moreover, the principles outlined by the Commission in the Release and described above in this letter regarding what the risk-mitigating hedging exception is intended to capture do not require such contemporaneous hedging. The Commission indicates that a risk-mitigating hedge should not be an intermittent activity or inconsistent with the hedging policy of the securitization participant. Accordingly, hedges not entered into contemporaneously with the ABS retention could qualify under the proposed exception as long as the hedges are not entered into on an intermittent basis and are consistent with the participant's hedging policy.

For example, where a securitization participant is the sponsor of monthly ABS issuance and such sponsor regularly retains certain of such ABS, such sponsor's hedging policy (for efficiency, accounting, tax or other reasons) may require that it hedge periodically (e.g., quarterly, semi-annually, etc.) its exposure to the ABS it retained during the designated period. In this case, because the sponsor's position in the retained ABS arose out of the underwriting, placement, initial purchase or sponsorship of such ABS, so as long as the hedge satisfies the risk-mitigating hedging principles outlined by the Commission in the Release and described above (e.g., no ability to profit from hedge, hedge should unwind as exposure is reduced, etc.), these regular periodic hedging transactions could qualify for the proposed risk-mitigating hedging exception.
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IV. Conclusion

Again, thank you for the opportunity to comment on the Proposed Rule. In order to avoid significant uncertainties for securitization participants concerning whether any specific hedging activity would be permissible pursuant to the risk-mitigating hedging exception, it will be important for the Commission to provide in its adopting release greater clarity and additional examples covering differing facts and circumstances, including those discussed in this letter. Please feel free to contact me at (212) 504-6820 or frank.polverino@cwt.com if you have any questions regarding the matters addressed in this letter.

Very truly yours,

Frank Polverino