MEMORANDUM

TO:	File
FROM:	Division of Trading and Markets
RE:	Meeting with members of SIFMA, Skadden, Bank of America, JP Morgan, Citi and Morgan Stanley
DATE:	April 17, 2012

On April 17, 2012, staff from the Division of Trading and Markets, Division of Corporation Finance, Office of the General Counsel, and the Division of Risk, Strategy and Financial Innovation met with the following individuals: Andrew Faulkner (Skadden), Chris Haas (Bank of America), Bianca Russo (JP Morgan), Myongsu Kong (Citi), James Lee (Morgan Stanley), Richard Dorfman (SIMFA), Chris Killian (SIFMA), and Bradley Edgell (SIFMA).

The purpose of the meeting was to discuss the proposed implementation of the prohibition against conflicts of interest in certain securitizations.

Attachment

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CONFLICTS OF INTEREST IN SECURITIZATION

APRIL 17, 2012

Agenda

1. Introductions
2. Key Issues Raised
3. Impact
4. Suggested Amendments
5. Conclusion

Key Issues with the Proposed Rule

- The Proposed Rule creates a regulatory regime whereby all units of a financial institution must be aware of the activities of other units at a transaction-specific level. Compliance with the proposed rule would therefore be very challenging and impractical in some instances.
- Firms involved in securitization activities tend to be large global firms with many lines of business, and many business units, that function independently. Information regarding specific transactions or activities of one unit generally is not known by other units within the financial institution.
  - Certain of these business lines or units may be separated intentionally by information barriers required to be implemented under various regulations.
  - While other business lines may not have a regulatory mandate to be separated, they function independently and the financial institution may have put in place information barriers or "need to know" limitations on the flow of information as a best practice measure.
- SIFMA believes it is critical that the scope of the rule be narrowed and clarified so that only the units involved in the structuring or sale of the securitization who act with a prohibited intent are covered by the Rule's prohibitions.
- If this is not done, there will be a significant detrimental impact to the securitization markets, banking activities, or both. The scope of the Proposed Rule would constrain risk management and other traditional banking activities, and force banks to choose between participating in securitization versus other traditional banking activities.
  - Additionally, it appears that certain transaction structures are prohibited by the examples in Proposed Rules.

Impact of the Proposed Rules on Risk Management and Traditional Banking Activities & Broader Implications for Securitization

- Risk management and other traditional banking activities (e.g., brokering and dealing, lending) may be significantly impacted by the proposed rule. Examples:
  - Investment bank sponsors CLOs, affiliated commercial bank makes corporate loans and needs to hedge its risk.
  - Investment bank sponsors MBS, affiliated asset management unit takes various positions in MBS, and affiliated originator needs to hedge pipeline or servicing risk.
  - US broker-dealer co-manages an ABS, affiliated broker-dealer unit in Japan facilitates local customer long and short positions in such ABS.

- More broadly, the unclear contours of the prohibited activities, identity of covered persons, and types of transactions subject to the prohibitions will cause financial institutions to not enter into transactions that are not clearly permitted (as opposed to not engaging in transactions that are prohibited), and will unduly restrict securitization activity.

- Additionally, certain types of transactions that have not traditionally been considered "securitization transactions" could be subject to the prohibitions of the rule given the breadth of the Exchange Act definition of "asset-backed security" and the undefined term "synthetic asset-backed security".
  - E.g., covered bonds, EETCs, insurance-linked securities.

Suggested Change: Narrow the Scope of Covered Persons

- The proposed definition would require each of a securitization participant's separate business units, affiliates and subsidiaries to be aware of the securitization participant's activities.
  - In some cases, regulations mandate information barriers and compliance policies that prevent the flow of this information; e.g. between a broker-dealer and an affiliated asset management unit.
  - In other cases, business units, affiliates, and subsidiaries operate independently, and do not typically share information on specific transactions.

- It is unclear why business units that were not involved in the structuring or sale of a securitization should be restricted from investing in or hedging an ABS, or engaging in customary banking business.

- The rule should apply to those business units within a financial institution that are directly involved in the structuring and sale of an ABS transaction, and should not apply to business units that are not involved in the securitization process
  - The final rule should include a safe harbor that permits each financial institution to design its own policies and procedures to restrict the spread of information regarding securitization transactions from the business unit or units structuring the ABS to other parts of the institution

Suggested Change: Incorporate Intent

- The goal of Congress was not to prevent investors from suffering losses because of declines in market value or poor performance of investment choices
- The goal of Congress was to prevent "designed to fail" transactions where investors were taken advantage of, or otherwise deceived by a securitization participant assembling a transaction that *by design* would be profitable for the securitization participant at the expense of the investor.
  - *Intent* is a necessary element of *design*
- The goal of Congress is best achieved by precluding securitization participants from designing and intending to profit from the decline in market or other value of a security
- All transaction participants have an obligation to understand what it is they are buying or selling. Risk transfer is inherent in securitization

Suggested Change: Do Not Prohibit All Synthetic ABS Where A Securitization Participant Takes A Short Position

- The Proposed Rule might prohibit certain types of synthetic ABS, particularly where a securitization participant holds a short position
- Synthetic ABS is often substantially equivalent to an investor entering into a derivative contract with a third party, but may offer greater liquidity than a portfolio of derivative contracts
- Prohibiting an SPE from entering into a derivative transaction, like CDS, with a securitization participant is equivalent to prohibiting synthetic ABS

Suggested Change: Disclosure Should Play a Role In Mitigating Potential Conflicts

- Disclosure is contemplated in the proposed Volcker Rule; it should also be a consideration here. Disclosure is also contemplated by Senators Merkley and Levin in their January 11 comment letter.
  - Disclosure should be meaningful, detailed, and specific.

- Disclosure is at the foundation of our securities laws. It would be much more consistent with the history and design of the Securities Act and regulations thereunder to provide for enhanced disclosure requirements.

Suggested Change: Incorporate Commentary into the Final Rule

- The most descriptive and instructive elements regarding the Proposed Rule are found in the Commentary rather than in the text of the rule itself.
- The guidance in the Commentary should be incorporated into the text of the final rule to prevent misinterpretation of the rule that could significantly curtail the use of securitization in the capital markets.
- Guidance that would prove especially helpful in providing clarity to market participants would include the entire five-factor analysis laid out by the Commission (Covered Persons, Covered Products, Covered Timeframe, Covered Conflicts and Material Conflicts of Interest).