December 2, 2011

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

Re: Prohibition against Conflicts of Interest in Certain Securitizations (File Number S7-38-11)

Dear Ms. Murphy:

This letter is being submitted in response to the Securities and Exchange Commission's ("Commission") request for public comment ("RFC") on its proposed Rule 127B ("Proposed Rule"), implementing Section 621 of the Dodd-Frank Act ("the Act").[1]

As a preliminary matter, it bears noting that securitizations were a central cause of the worst financial crisis since the Great Depression.[2] The asset-backed securities ("ABS") market played a significant, pernicious role in the liquidity crisis of 2008.[3] The ensuing collapse affected global markets, both financial and non-financial, and cost American families and businesses over $13 trillion in wealth and 5.5 million jobs.[4] ABS had the effect of agglomerating risks from trillions of dollars of loans (whether directly-held or in "notional amount"). In many instances, those risks were not well understood or properly priced. Further, credit rating agencies blithely issued stellar ratings to Special Purpose Vehicles ("SPV") issuing securities based on those abstruse risks.

While the Commission is well aware of these facts, any analysis of the effects and implications of Section 621 of the Act must be considered in this historical context. The RFC contains an extensive discussion on the background of the ABS market, the mechanics of synthetic and non-synthetic deals, and the key players in such deals. However, the precarious nature of the ABS

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1 I am an attorney licensed to practice in New York and New Jersey, and am on the roster of FINRA Arbitrators. However, this letter is being submitted in my individual capacity and expresses only my personal opinions.

2 *See* Interview with Matt Taibbi, *Covering Up Wall Street Crimes: Matt Taibbi Exposes How SEC Shredded Thousands of Investigations*, Democracy Now!, *available at* http://www.democracynow.org/2011/8/23/covering_up_wall_street_crimes_matt ("This whole issue of securitization was central to the cause of the financial crisis.").

3 Josh Clark, *How Can Mortgage-backed Securities Bring Down the U.S. Economy?*, howstuffworks, http://money.howstuffworks.com/mortgage-backed-security.htm (last visited Nov. 7, 2011).

4 Phillip Swagel, *The Cost of the Financial Crisis: The Impact of the September 2008 Economic Collapse*, Pew Economic Policy Group, Apr. 28, 2010, http://www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Economic_Mobility/Cost-of-the-Crisis-final.pdf?n=6727 (last visited Nov. 9, 2011).

industry and its danger to global market health receive scant mention. This is a curious and possibly foreboding omission, especially given the fact that the SEC's mission involves maintaining fair, orderly, and efficient markets as a whole.[5]

A. Administrative Law Requires a Strong Implementation of Section 621

In issuing implementing regulations, an administrative agency must give effect to the unambiguously expressed intent of Congress.[6] In this case, the congressional intent is clearly in favor of vigorous enforcement of Section 621:

> We believe this provision will stand the test of time. We hope that our regulators have learned with Congress that tearing down regulatory walls without erecting new ones undermines our financial stability and threatens economic growth. We have legislated to the best of our ability. It is now up to our regulators to fully and faithfully implement these strong provisions.[7]

The unambiguous intent of Congress disfavors deregulatory pressures on the Commission's implementation of Section 621. Consequently, the Commission is required, pursuant to administrative law, to look askance upon any comments to the proposed rule that might have the effect of diluting the impact of that statutory provision.

B. Response to Questions 4 and 119

Despite its obvious risks, the ABS industry is usually justified by its proponents on the basis that it promotes liquidity and capital formation in the market. However, one can hardly argue that capital markets were inefficient or illiquid before the burgeoning of ABS in the last 15 years. After all, the late 1990's saw a burst of real economic growth driven by technological innovation, which was in turn dependent on the ready availability of capital. Indeed, many well-informed people believe that ABS and similar products create no productive value other than as a fee generation mechanism for financial companies. For example, in describing ABS and structured finance derivatives, President Bill Clinton has stated that "[w]e created all these new securities which have no value and create no jobs."[8] In his view, the markets as a whole would be better benefited by longer-term, less complex forms of capitalization.[9] Paul Volcker has expressed a similar sentiment with respect to exotic financial instruments: "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth — one shred of evidence."[10] A similar view has also been espoused by Robert Kuttner, who has stated that:

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5 *See* Sec. & Exch. Comm'n, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, http://www.sec.gov/about/whatwedo.shtml (last visited Nov. 7, 2011).
6 *Chevron U.S.A. Ins. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).
7 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).
8 Robert Lenzner, *Clinton's Cure For Capitalism*, Forbes.com, Sep. 25, 2009, http://www.forbes.com/2009/09/25/clinton-global-initiative-personal-finance-investing-ideas-bill-clinton.html.
9 *See id*.
10 Interview with Satyajit Das, *The Financial Zoo: An Interview with Satyajit Das – Part I*, Naked Capitalism, Sep. 7, 2011, http://www.nakedcapitalism.com/2011/09/the-financial-zoo-an-interview-with-satyajit-das-%E2%80%93-part-i.html ("US financial services increased its share of value added from 2% to 6.5% but is that a reflection of your financial innovation, or just a reflection of what you're paid?") (last visited Nov. 12, 2011).

> [i]t's time to simply abolish credit default swaps and similar exotic, impenetrable, essentially unregulated securities. They add nothing to economic efficiency, they line bankers' pockets, and they add massively to global financial risks. Swaps were only invented in the 1990s. The world got along beautifully -- much better in fact -- without them.[11]

These viewpoints have empirical support. A comprehensive survey of empirical economic data has revealed little evidence for the existence of the financial innovation that is giddily extolled by financial institutions and their proponents.[12]

Even a perfunctory review of other countries reveals strong evidence that ABS, and particularly synthetic ABS, are not necessary for liquidity and growth. For instance, China enjoyed a phenomenal growth rate of 10.3% in year 2010,[13] despite having a rather tepid securitization market.[14] India has enjoyed an even better growth rate of 10.4%[15] and has largely avoided the recent financial meltdown, in no small part due to the Reserve Bank of India's strictures on esoteric derivatives.[16] Not surprisingly, relative to other countries China and India have an extremely low ratio of Debt-to-GDP in their financial sectors.[17] While a more thorough analysis on the merits of the ABS industry is outside the scope of this comment letter, the Commission would be well-advised to consider the possibility that the ABS industry may actually cause more harm than good.

C. Response to Question 6

The securitization industry has grown exponentially over the last two decades. As the market grows and competition increases, participants in the industry are incentivized to seek a competitive edge by structuring riskier products with higher potential yields. At the same time, the financial industry has "seen the leading firms increasing in size and decreasing in number."[18] The result of this consolidation is that securitization participants have access to larger pool of money to play with in structuring their ever-riskier products. These money pools have here-to-fore included depositors' funds as a result of the ultimate dismantling of the Glass-Steagall Act by the Gramm-Leach-Bliley Act.

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11 Robert Kuttner, *Abolish Credit Default Swaps*, Huffington Post, http://www.huffingtonpost.com/mobileweb/2011/10/31/credit-default-swaps_n_1067152.html (last visited Nov. 11, 2011).

12 W. Scott Frame & Lawrence J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action?*, 42 J. Econ. Lit. 1 (2004).

13 Central Intelligence Agency, *The World Factbook*, *available at* https://www.cia.gov/library/publications/the-world-factbook/rankorder/2003rank.html (last visited Nov. 7, 2011).

14 Mimi Hu, *Developing Securitization Laws In China*, 27 Ann. Rev. Banking & Fin. L. 565 (2008).

15 Central Intelligence Agency, *supra* note 13.

16 *See* Debanjali Ghosh, *Indian SF Survives Global Financial Crisis*, Reuters, Oct. 31, 2011, *available at* http://in.reuters.com/article/2011/10/31/idINWLA813220111031 ("Regulations around securitisation in India have been forward-looking, such that many changes implemented in the rest of world in the aftermath of the global financial crisis were already in place in India."). Growth in India and China have been propelled by productive industries (technology in India's case and manufacturing in China's case), and not by financial legerdemain or exotic structurings.

17 Tina Aridas, *Total Debt to GDP (%)*, Global Finance, *available at* http://www.gfmag.com/tools/global-database/economic-data/10403-total-debt-to-gdp.html (last visited Nov. 7, 2011).

18 Mark Kolakowski, *Financial Industry Mergers*, About.com: Impact of Financial Industry Mergers, http://financecareers.about.com/od/overview/a/consolidation.htm (last visited Nov. 7, 2011).

While the securitization industry has grown, transparency as to the true risk profiles of underlying assets has not kept up. Simply put, pricing esoteric derivatives remains difficult. Long Term Capital Management employed world-renowned financial analysts, Nobel Laureates and some of the best minds in quantitative finance. Nevertheless, it collapsed and nearly took the financial industry with it, largely due to an inability to adequately price derivatives.[19]

The combination of market consolidation, risk-seeking incentivization and pricing uncertainties has resulted in a situation where potential conflicts of interest in the ABS industry now have the capacity to do more harm than ever before.

D. Response to Question 7

The potential for such harm is exacerbated in synthetic ABS deals. In such transactions, the Reference Assets form the foundation for the ultimate investor's investment gains. Naturally, pricing and understanding the risks associated with those Reference Assets is essential for the investor to properly analyze exactly what is being bought. However, in synthetic deals, the **Reference Assets do not need to be owned by any participant in the entire securitization process**. Pricing is hard enough when a sponsor owns or has ready access to the underlying asset pool. It can be reduced to mere bookmaking in synthetic ABS deals.

Conflicts of interest that arise in such a risky context have the potential to blindside investors with monumental losses, especially when one considers the outsized notional values of most synthetic ABS deals.[20]

E. Response to Questions 10-17: Definitional Issues; Issuers as "Sponsors"

The Proposed Rule rightly avoids defining terms such as "placement agent," "initial purchaser," "sponsor," "affiliate" and "subsidiary." These are commonplace terms of art in the financial industry, and they are sufficiently well-understood to apprise potentially-covered entities of the possibility that such entities may be required to comply with Rule 127B. If the Commission were to further specify the contours of these terms at this stage, would-be securitization participants could easily parse the definitions of such terms in pursuit of loopholes and exceptions. Moreover, any further delineation of the scope of these terms at this time might not keep up with changes in the securitization industry. This industry is continually devising myriad

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[19] *See* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (2001).

[20] The securitization market is estimated to be around $10 trillion in size. Mary L. Schapiro, Chairman, SEC, Speech by SEC Chairman: Remarks Before the American Securitization Forum 2011 Annual Meeting (June 22, 2011), http://www.sec.gov/news/speech/2011/spch062211mls.htm. By comparison, the entire inflation-adjusted GDP of the United States as of the last quarter was only $13.35 trillion. Timothy R. Homan, *Economy in U.S. Surpasses Pre-Recession Level After 15 Quarters*, Bloomberg Businessweek, Oct. 31, 2011, *available at* http://www.businessweek.com/news/2011-10-31/economy-in-u-s-surpasses-pre-recession-level-after-15-quarters.html. These figures pale in comparison to the larger derivatives market. ISDA found that the total combined notional amount outstanding of interest rate, credit, and equity derivatives at June 30, 2010 was $466.8 trillion. International Swaps and Derivatives Ass'n, *Summary of Recent Survey Results*, http://www.isda.org/statistics/recent.html#2010mid (last visited Nov. 7, 2011).

variations of extant structured products, and an overly specific definition at this stage might allow for easy circumvention.

After the passage of some time, the Commission will be in a better position to assess the impact of Rule 127B, and can then consider the issuance of no-action letters or interpretive guidance to address definitional rules and exceptions. It would be a mistake to attempt to further define terms at this early stage, without the benefit of practical enforcement experience.

The Commission should advise the industry, either through a statement in its Final Rule or through interpretive guidance, that the term "sponsor" might include, in certain circumstances, the issuer of the asset-backed securities. The intent of Section 621 is to prohibit entities that **assemble** asset-backed securities from packaging and selling those securities and profiting from the securities' failures.[21] The ABS industry currently utilizes dummy entities, or Special Purpose Vehicles, to serve as issuers for securities that are backed by assets that are assembled by an investment bank or other financial institution. One possible way to circumvent the restriction of Rule 127B would be for an investment bank to divest itself of a group of key employees or a business unit. Those individuals could then be hired directly by the SPV to conduct conflicted transactions on behalf of the issuer itself, such as the assembly and issuance of ABS contemporaneously with the taking of a direct, short position on those underlying assets.

Senator Levin analogized that a conflicted transaction under Section 621 would be akin to mechanics taking life insurance on their customers.[22] The scenario described above, of an issuer directly assembling conflicted ABS, would be akin to a car manufacturer taking life insurance on its customers. While Section 621 seems geared more towards the secondary ABS market (i.e., sales conducted by underwriters, initial purchasers, etc.), sales in the primary ABS market should also be deemed to be covered in cases where the issuer itself undertakes a significant role in the "assembly" of the ABS.

One might expect the principle of "caveat emptor" to apply in traditional sales between issuer and buyer. In an arms-length security sale, each side of the transaction is inherently conflicted as to the value of the security. However, while the law on the subject is unsettled,[23] one might argue that an underwriter that sells securities to its customers takes on a heightened, quasi-fiduciary duty towards such customers. Section 621 assigns this type of heightened responsibility to parties that assemble ABS because those parties are uniquely privy to information regarding the murky assets that underlie the ABS. Where an issuer takes a significant role in the assembly of the assets underlying its ABS issuances, justice and a fair interpretation of Section 621 demand that that issuer be held to the same standard as third party underwriters or placement agents. Securitization participants should not be able to evade Rule

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[21] 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin) ("The intent of Section 621 is to prohibit underwriters, sponsors, and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures.").

[22] *Id.*

[23] *See* Dechert LLP, *Dechert on Point: The Uncertain Fiduciary Duty of Investment Banks* (2008), *available at* http://www.dechert.com/files/Publication/8f0c95cc-2d16-4d9d-b3af-f06effd02fdd/Presentation/PublicationAttachment/5038ed10-8336-4e89-a5ae-f0d595fa0aec/CF_10_08_SA_Fiduciary_Duty.pdf (last visited Nov. 12, 2011).

127B by indirectly conducting their activities through the ABS issuer itself. Accordingly, an issuer in such a scenario should be considered a "sponsor" within the meaning of Rule 127B.

F. Response to Question 26

The Proposed Rule advances an overly lax interpretation of the phrase "arising out of."[24] Essentially, the Commission proposes to require that both legs of the conflict of interest (i.e., the short sale as well as the ABS underwriting/participation) be a part of the same ABS transaction structure. So, for instance, an underwriter may not seek Credit Default Swap ("CDS") protection on certain reference assets *if* the payment stream from that particular CDS ultimately funds the SPV's waterfall (Example 3B). However, under the Commission's proposed interpretation, that same underwriter *would* be allowed to enter into a separate CDS contract with a third party, seeking protection for the **very same assets** that served as Reference Assets in the underwriter's ABS participation. In other words, the unscrupulous securitization participant in Example 3B could achieve its improper purpose by simply conducting the offending transaction (the short position on the Reference Assets) with a party other than the SPV. This interpretation would eviscerate Section 621, as securitization participants would be free to enter into conflicted short transactions, as long as those transaction did not make up part of the ABS structuring.

The RFC goes so far as to actually advise potential securitization participants on how they can skirt the intent of Section 621:

> While the proposed interpretation would cover benefiting from the adverse performance of the asset pool supporting the ABS, we note that the proposed interpretation would not prevent a securitization participant's transactions in the securities of a lender whose mortgage pools are included or referenced in an ABS because the proposal is focused solely on the ABS and its underlying portfolio.[25]

The car mechanic analogy utilized by Senator Levin in describing the purpose of Section 621 is a useful reference point for this issue.[26] The Commission's interpretation of "arising out of" is akin to punishing an unscrupulous mechanic **only** if he buys an insurance policy on the driver's life from the car maker that sold the car to the driver. The mechanic would be free to buy life insurance on the driver from any third party, through a separate transaction. This interpretation misses the point of Section 621. What matters is the simple fact that the mechanic bought the insurance, one way or another, not the party from which the insurance was bought.

Section 621 bars a securitization participant's conflicted activity with respect to any investor "in a transaction (i.e. ABS sale) arising out of such activity (i.e. the short position)" (parentheticals added). That is, the participant's role in the ABS must **arise out of** the short position. The ABS participation can "arise out of" the offending short sale if both transactions are part of a common scheme. This result can obtain even if the short sale is not an inherent part of the ABS structure.

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24 Prohibition against Conflicts of Interest in Certain Securitizations, Proposed Rule, 76 Fed. Reg. 60320, 60328 (proposed September 28, 2011) ("Our proposed rule, therefore, would not address other conflicts of interest that happen to arise between these same parties but that are unrelated to their status as a securitization participant and investor, respectively.").

25 *Id*. at 60330-31.

26 *See id*.

For instance, assume an investment bank ("Participant") knows that certain receivables are on the verge of default. This knowledge is not available to the public. The Participant takes a short position on the receivables via a CDS protection contract with a third party. Furthermore, knowing that the public is unaware of the assets' impending default, the Participant entices investors to purchase from its SPV certain ABS securities that are undergirded by those risky assets. In this scenario, the ABS participation is a direct consequence of, or **arises out of** the short position taken with the third party. The assets default as expected. As a result, the Participant would enjoy the benefit of a principal gain from the short position, as well as the underwriting fees to be earned from the securitization participation. However, under the Commission's proposed interpretation, there would be no violation of Rule 127B.

A more equitable interpretation would prohibit conflicts of interest as to the assets underlying an ABS issuance, even if the conflict arises as a result of two separate transaction structures, if the conflicted transactions are part of a common scheme.

While this interpretation would add compliance costs to would-be securitization participants, those costs should be minimal. Virtually all of these participants already have robust internal compliance programs to address a panoply of SRO and regulatory restrictions. The incremental increase in compliance responsibility from a vigorous implementation of Rule 127B is likely to be *de minimis*.

Securitization participants with multiples lines of business in different locations can keep track of conflicts of interest using a system similar to that currently used by attorneys at large law firms. Attorneys are required to keep track of conflicts of interest because of the special advisory relationships that they have with clients. Similarly, underwriters and other secondary issuers also have close client relationships that are built on reputation and trust. There is no reason why these parties cannot incorporate a conflicts procedure similar to that employed by attorneys. Indeed, given the gargantuan size of many ABS transactions,[27] the potential for harm from a conflict of interest is no less severe in ABS structuring than in attorney-client relationships.

G. Response to Questions 32-41: Materiality

The Commission correctly declined to further define "material conflict of interest," as the meaning of that term would necessarily depend on the facts of a particular case. Premature definition would only create loopholes and exceptions for creative industry lawyers to exploit.

For a similar reason, indirect and unforeseeable benefits from a conflict of interest should not be excluded from coverage, *per se*. The Commission would not want to enable securitization participants to perform indirectly what they are barred from doing directly.

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[27] As noted above in footnote 20, the notional value of all outstanding derivatives is over 30 times the national GDP of the United States.

At Question 39, the RFC cites a four-part test for materiality that SIFMA has proposed. With the exception of disclosure,[28] the remaining three prongs of SIFMA's materiality test should be considered as mere **factors** in the ultimate materiality inquiry, but none should be considered a *per se* exclusion. Any assessment of materiality must be based on the facts and not broad exemptive categories.

The RFC asks whether the Commission's non-definition of “material conflict of interest” would lead to uncertainty and have a chilling effect on securitization transactions. Even if a securitization participant has to think twice before doing a deal in order to avoid a “material” conflict of interest, investors can only be benefited from this kind of additional circumspection.

Indeed, the very point of regulation is to have a “chilling effect” on covered activity. The usage of an undefined “material conflict of interest” standard would have a chilling effect on ABS transactions that have serious potential to cause losses for investors. An ABS transaction only has utility for the markets if it has a reasonable possibility of being a good investment for investors. ABS proponents claim that profitable ABS investments promote liquidity, grow businesses and grow the nation's economy and GDP. Even if that were true, clearly no-one profits from failed ABS investments, except for the financial institutions that structure them. Failed investments are more likely where a material conflict of interest exists.

At present, the market for ABS does not breed much confidence among investors due to the lack of price transparency involved in these products. Recent SEC investigations against Goldman Sachs[29] and Citigroup[30] have likely exacerbated investor confidence. A pliable and fact-specific interpretation of “material” would motivate participants to only proceed with those deals that are completely free of conflict of interest, and which are, as a consequence, in the best interest of investors. If securitization participants are more deliberative in participating in securitizations, investors are more likely to have confidence in them as advisers. This increased confidence would in turn improve both the reputation and the bottom line of such securitization participants.

Industry commentators have opined that Section 621 might sweep into its purview many trivial and innocuous conflicts of interest.[31] For instance, SIFMA listed around twenty-two conflicts of interest that are structurally inherent to many ABS transactions.[32] However, many of the examples deal with clearly immaterial conflicts of interest relating to ancillary financing deals such as warehouse lines, credit enhancements and liquidity facilities.[33] While Section 621 does not have an explicit intent component, the Congressional Record demonstrates that this statute

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28 The tool of disclosure, while useful in other securities contexts, is inapplicable and irrelevant to Section 621, as discussed in detail below. *See infra* text accompanying notes 50-55.

29 Press Release, *SEC Charges Goldman Sachs With Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages*, SEC (Apr. 16, 2010), http://www.sec.gov/news/press/2010/2010-59.htm.

30 *SEC v. Citigroup Global Markets Inc.*, SEC Litigation Release No. 22134 (Oct. 19, 2011).

31 *See, e.g.*, Letter from the American Securitization Forum (Oct. 21, 2010) (“ASF Letter”), *available at* http://sec.gov/comments/df-title-vi/conflicts-of-interest/conflictsofinterest-6.pdf.

32 Letter from the Securities Industry and Financial Markets Association (Dec. 10, 2010) (“SIFMA Letter”), *available at* http://sec.gov/comments/df-title-vi/conflicts-of-interest/conflictsofinterest-10.pdf.

33 Many of these transactions would also be specifically exempted by the Commission's proposed interpretation of Rule 127(b)(2).

sought to outlaw the conscious assembly of flawed ABS products.[34] In applying the materiality test, the Commission and the courts would likely disregard unconscious, structural conflicts of interest as being immaterial. If in a particular case certain conflicts of interest are truly innocuous, then almost by definition, they would not be considered "material" by the Commission or a court of law. Basically, Section 621 tells securitization participants, "[i]f you intend to have a substantial role in an ABS transaction, be prepared to stand behind it." This is a fair standard.

H. Response to Question 39: Intentionality

While Section 621 does seek to redress conscious assembly of flawed ABS products, it would be a mistake to interpose an intentionality requirement into Rule 127B. A party's motivations can and should play a role as one factor in the total materiality assessment. However, that is the extent to which intentionality should be relevant to Rule 127B. As noted above, the statute does not contain any explicit intentionality requirement or limitation.

An intentionality requirement would be difficult to administer. Proving intentionality is difficult enough when dealing with an individual who may obfuscate his or her intentions. The task is virtually impossible when dealing with large impersonal financial companies with hundred or thousands of employees.

The ASF proposed limiting materiality to situations where an ABS issuance is "created primarily to enable a securitization participant to profit as a direct consequence of the adverse credit performance of another transaction."[35] This test would seriously undermine Rule 127B's effectiveness. It would permit an otherwise barred transaction as long as the intention to profit from flawed ABS products were a secondary intention (i.e. not a "primary" one). Securitization participants can easily invent "primary" intentions for otherwise covered activities. Exploitation of ABS investors should be avoided regardless of whether the motivation to exploit is primary, secondary or tertiary.

Indeed, an unintended conflict of interest could cause as much harm to unsuspecting ABS investors as a willful one. ABS assemblers are in a unique position because they have maximum visibility as to all the parties involved in the transaction as well as a heightened understanding of the underlying assets. Investors rely, often to their detriment, on an ABS assembler's reputation as an information proxy, assuming that the assembler would only stake its reputation on quality structured products.[36] Accordingly, the onus should fall on the ABS assembler to analyze ABS transactions for conflicts of interest, and to voluntarily avoid those conflicted transactions that could reasonably be adjudged as material.

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[34] To elaborate on Senator Levin's example, a mechanic will not normally take out a life insurance policy on a customer. Where such a policy is taken, it is indicative of a willful act. This willfulness component is not explicit, but rather is essentially subsumed into the materiality requirement of Section 621.

[35] Proposed Rule, *supra* note 24 at 60332 n. 81 (citing ASF Letter at p. 5).

[36] Andrew T. Tuch, Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs 57 (Apr. 2011), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Tuch_37.pdf.

I. Response to Question 47: Definition of Risk-mitigating Hedging Activities

The definition of risk-mitigating hedging activities should be amended as stated below, with the bold text representing suggested additions:

> 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 **not for speculative or profitmaking purposes but rather** to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings**, and further provided that such positions or holdings are actually in the assets forming the basis of an asset-backed security**.[37]

As noted by the Commission, "risk-mitigating hedging is effected to reduce risk from an existing position or a position about to be taken."[38] The purpose of a true hedge is to lower risk to specific, identifiable assets and not some vague, inchoate exposure.

> ***"not for speculative or profitmaking purposes but rather"***

The Commission's proposed version of Rule 127(b)(1) only *implies* that speculative or profitmaking purposes are inconsistent with the "risk-mitigating hedging" exception. This should be stated explicitly to provide courts with guidance, through the text of the regulation itself, as to the purposes and limitations of the "risk-mitigating hedging" exception. Speaking in the similar context of Section 619 of the Act, Senator Merkley has stated that risk-mitigating hedging activities are permitted because their sole purpose is to lower risk.[39] Speculative or profitmaking activities are not conducted to lower risk.

> ***" and further provided that such positions or holdings are actually in the assets forming the basis of an asset-backed security"***

The hedging exception must be utilized with respect to readily identifiable assets that are an inherent part of the ABS structure. If a securitization participant's true purpose is to effect a hedge against ABS exposure, that hedge must be tied specifically to the assets underlying the ABS. ABS participation should not be used to hedge exposures outside the ABS structure. Otherwise, "hedging" could be used by unscrupulous securitization participants as a red herring loophole, utilized to justify a whole range of conflicted activities, as long as the securitization participant can unearth some tangentially-related countervailing transaction somewhere in its books. A hedge must reduce risk vis-à-vis the ABS itself, and not some external, amorphously-related exposure.

J. Response to Question 49

Given that many ABS transactions as well as proprietary hedging transactions are conducted in the over-the-counter ("OTC") markets, there would be limited transparency as to securitization

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37 Proposed Rule, *supra* note 24 at 60333.

38 *Id*. at 60334.

39 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley).

participants' actual compliance with Rule 127(b)(1). There is a substantial risk of noncompliance, especially given the limited resources available to the Commission and any applicable SROs. As part of their implementation of Section 619 of the Act, the Commission and banking regulators have proposed a compliance, recordkeeping and monitoring framework that regulates the usage of the risk-mitigating hedging activities exception to the Volcker Rule restrictions.[40] The Commission should extend that framework to also cover the usage of the risk-mitigating hedging activities exception to Section 621. To the extent that securitization participants under Section 621 do not qualify as "banking entities" or "nonbank financial companies" under the Section 619 framework, the Commission should adopt a similar, abbreviated compliance mechanism to monitor compliance with Rule 127(b)(1).

The reality is that written supervisory policies and procedures are routinely ignored and are considered a nuisance in the financial industry, at least among non-compliance professionals. Without external oversight, the risk-neutralizing purpose behind Rule 127(b)(1) would be flaunted routinely.

An external compliance framework may seem burdensome, but as noted above, Congress passed Section 621 with the expectation that the Commission would vigorously enforce it. The Commission can create *de minimis* exceptions and thresholds limits based on the total notional value of reference assets or the size of an ABS collateral pool, as applicable. It can also create a streamlined filing system similar to Form D to gather basic information on parties utilizing the Rule 127(b)(1) exception. Given the expansive regulatory powers accorded to the Commission by Section 2(a)(1) of the Securities Act of 1933, the Commission would be well within its authority to create such a compliance procedure for Rule 127(b)(1).

K. Response to Question 65

The Rule 127(b)(2) exception should only cover purchases and sales of the ABS itself. It is acknowledged that other forms of financing related to the ABS transaction, such as warehouse lines and credit enhancements, could serve the interests of investors by ultimately promoting liquidity in the ABS. However, an explicit exemption for these activities is not required by 127(b)(2) because any conflicts of interest attendant to these forms of financing would likely be considered immaterial. If a loan facility's purpose is simply to provide financing to ABS participants, it is difficult to see how the issuance of that facility could be materially detrimental to ABS investors.

The Rule 127(b)(2) exception should only cover purchases and sales of the ABS because liquidity commitments could be used as a subterfuge to achieve prohibited exposures with respect to an ABS. For example, assume that a synthetic ABS utilizes a CDS, and that the protection buyer is a third party that is not affiliated with any other party. The protection seller is the SPV. Company XYZ serves as the placement agent in the ABS transaction. XYZ could provide a loan to the protection buyer to help it make its "insurance premium" payments to the SPV. The loan could have a stipulation that if the Reference Assets default and the protection

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[40] Matthew Leising, *Volcker Rule Enforcement May Come After the Fact, Bingham Says*, Bloomberg, Oct. 19, 2011, *available at* http://www.bloomberg.com/news/2011-10-19/volcker-rule-enforcement-may-come-after-the-fact-bingham-says.html.

buyer is paid pursuant to the CDS, then the protection buyer's interest payments to XYZ would increase dramatically. Through this mechanism, XYZ would effectively gain a short position on the ABS, while still placing the ABS with unsuspecting investors. Even though this is exactly the kind of transaction that Section 621 intended to prohibit, under the Commission's proposed interpretation of Rule 127(b)(2), XYZ could achieve this result by availing of the exception for liquidity commitments.

L. Response to Question 80

In order to ensure bona fide usage of the market-making exception, the Commission should implement a compliance mechanism. As discussed above in the response above to Question 49, the Commission could piggy-back Section 621 compliance on Section 619 compliance, and also create a short-form filing requirement for securitization participants seeking to utilize Rule 127(b)(3) who fall outside the scope of Section 619 - the Volcker Rule.

For instance, securitization participants seeking to utilize Rule 127(b)(3) could be required to periodically submit records of all market-making activities in a standardized format. Data from those records could be processed by computer programs in search of certain pre-defined indicators of speculative, non-market-making activity.

M. Response to Example 1

In Footnotes 96 and 98, the RFC implies that the underwriter might avail of the market-making exception if it had a client that requested a long exposure on the ABS's underlying CDS. However, this is based on an incorrect reading of Section 621. That statute clearly states that an exception exists for bona fide market-making **in the asset backed security**. The market-making exception is only applicable to purchases or sales of the ABS itself, and not the CDS, which is a separate security altogether. The hypothetical transaction referenced in Footnote 96 could fall short of the materiality requirement, given the underwriter's neutral role with respect to the CDS. Nevertheless, a plain reading of Section 621(c)(2)(B) reveals that the market-making exception must be inapplicable to purchases or sales of a CDS, even if that CDS underlies a covered ABS.

N. Response to Examples 3B and 3C

The RFC creditably distinguishes between Example 3B and a transaction falling under the risk-mitigating hedging exception. This result in appropriate in all circumstances involving the Example 3B fact pattern because the hedge must be “arising out of ” the underwriting of the ABS. That is, in order to utilize the risk-mitigating hedging exception, a securitization participant must be hedging an asset/exposure that it owns pursuant to the ABS structure. In Example 3B, the securitization participant fails to meet that criterion.

This is also a fair interpretation. Given the size and scope of the operations of the major players in the securitization market, an unscrupulous securitization participant could rather easily find some tangentially related long exposure within its worldwide portfolio and claim that the offending ABS short was merely a hedge.

Example 3B can be distinguished from 3C because in the latter case, the securitization participant is taking a short position on reference assets that it owns pursuant to its underwriting of the ABS. In distinguishing between these situations, the Commission can ask, "Was the purchase necessary to effect the ABS transaction?" Various factors would need to be considered to decide this question, including:

- How much time elapsed from the asset purchase to the ABS underwriting?
- Are the assets in the Reference Pool of the synthetic ABS identical to the assets owned by the securitization participant? If not, to what extent is there is a disparity?
- Given that the securitization participant owns the Reference Assets, why did it choose synthetic securitization instead of normal securitization?
- Were there any precipitous drops in the value of the Reference Assets after their purchase and before the ABS underwriting?

O. Response to Questions 85 and 86

In Example 3D, a permissible hedge can only be effected to the extent that the securitization participant can fully offset its CDS exposure. The CDS market, being OTC, is generally quite illiquid and therefore the securitization participant might find it difficult to completely offset its existing exposure. Accordingly, the Commission should advise industry participants to avoid reliance on Example 3D as a practical matter.

The rationale applied with respect to Example 4 is logical and consistent with the statute. Examples 3 and 4 present various scenarios that turn on fine factual distinctions. The Commission would be better able to make these factual distinctions in real-world enforcement cases if it were to implement the data-collection compliance programs described above.

P. Response to Question 92

Information barriers have limited usefulness in ensuring compliance with Rule 127B. The RFC recognizes the fact that numerous information barriers already exist in the financial services industry due to the interplay of various other rules and regulations.[41] The implication is that these information barriers are effective tools in promoting a culture in which the interests of investors is paramount and sensitive information is not exploited for gain. However, the fact is that the existence of these interweaving information barriers did not stop the Commission from bringing actions against Goldman Sachs[42] and Citigroup[43] for conflicts of interest in ABS transactions. Thus, it is unclear what utility an additional information barrier would have, absent heightened reporting requirements and active Commission oversight specific to Rule 127B.

Many commentators have questioned the functionality of information barriers. Whereas financial conglomerates formerly focused on so-called "flow business," the majority of their

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41 Proposed Rule, *supra* note 24 at 60341.

42 Press Release, *supra* note 29.

43 Litigation Release, *supra* note 30.

earnings now derive from proprietary trades that privilege self-interest over client interests.[44] These trades occur in an environment that increasingly rewards risky, short-term bets.[45] These factors create tremendous incentives for information leaks. Not surprisingly, every few months the financial pages are replete with stories of how so-called "rogue traders" were able to circumvent information barriers and other controls to lose billions of dollars in highly risky transactions, at the expense of clients.[46] Academics have also amassed empirical evidence undermining the efficacy of information barriers.[47] Such studies have found that even where information barriers are erected, regulators are routinely unaware of when such barriers have been breached.[48] Information barriers are a regulatory tautology, in that regulated entities are essentially asked to police themselves and to report non-compliance.[49] All of these points undermine the utility of information barriers and further underscore the need for active Commission enforcement and data-collection with respect to ABS transactions.

Q. Response to Questions 96-109: Disclosure

The RFC asks numerous questions from commenters as to whether disclosure would be useful in mitigating conflicts of interest in ABS transactions. However, the entire discussion is largely moot. The legislative intent behind Section 621 demonstrates that the tool of disclosure has a severely limited, if any role in this context:

> [A] firm that underwrites an asset-backed security would run afoul of the provision if it also takes the short position in a synthetic asset-backed security that references the same assets it created. In such an instance, 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.[50]

Congress had an opportunity to include disclosure in the permitted exceptions to Section 621, and it chose not to do so. An administrative agency exceeds its authority when it considers regulatory options that have been purposely dismissed by Congress.[51]

Section 28 of the Securities Act ("Section 28") is an inappropriate mechanism by which to create a disclosure exemption in Rule 127B. Admittedly, the Commission has been granted "general exemptive authority" under Section 28. However, that generalized authority cannot supersede

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44 James A. Fanto, *"Breaking Up is Hard To Do": Should Financial Conglomerates Be Dismantled?*, 79 U. Cin. L. Rev. 553, 568 (2010).

45 *Id.*

46 Jesse Eisinger, Propublica, *In Fight Against Securities Fraud, S.E.C. Sends Wrong Signal*, N.Y. Times Dealbook, Oct. 26, 2011, http://dealbook.nytimes.com/2011/10/26/in-fight-against-securities-fraud-s-e-c-sends-wrong-signal/.

47 *See* Tuch, *supra* note 36 at 32.

48 *Id*.

49 *See* David S. Hilzenrath, *Justice Department, SEC Investigations Often Rely on Companies' Internal Probes*, Washington Post, May 22, 2011, *available at* http://www.washingtonpost.com/business/economy/justice-department-sec-investigations-often-rely-on-companies-internal-probes/2011/04/26/AFO2HP9G_story.html ("As the U.S. government steps up investigations of companies suspected of paying bribes overseas, law enforcement officials are leaving much of the detective work to the very corporations under suspicion.").

50 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).

51 *See Levine v. Apker*, 455 F.3d 71, 80 (2d Cir. 2006) ("[W]e will not defer to an agency's interpretation that contravenes Congress' unambiguously expressed intent.").

the plain words of the statute (which contains no mention of disclosure) or the specific guidance of the Congressional Record (which flatly rejects disclosure's role as a reparative tool for material conflicts of interest in ABS).[52]

Even if the Commission were somehow enabled to utilize Section 28 to craft a disclosure exemption, it should not do so. The Commission has used its exemptive authority under Section 28 only sparingly, and the equities in this case hardly justify the usage of such an extraordinary measure.[53] Moreover, an exemption can only be crafted under Section 28 if the exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. In this specific context, disclosure is inconsistent with protection of investors. Given the havoc caused by ABS and other derivative products on the market, vigorous enforcement of Section 621 is in investors' best interest. The creation of an additional loophole in the form of disclosure is not.

Disclosure is an ineffective remedy where the subject matter of the disclosure is exceedingly obscure, as is the case with ABS. The example of Long Term Capital Management will demonstrate that even sophisticated parties may not be aware of or fully appreciate the risks involved in their activities. Even savvy institutional investors may not have sufficient resources or access to information to verify the contents of disclosed information, especially in synthetic cases where the Reference Assets are not owned by a securitization participant. Many investors simply presume that disclosed information is accurate, relying on the underwriter's reputation. However, disclosure has limited utility where the potential wrong-doer is the party that is disclosing the information to investors.[54] If a securitization participant has designed an ABS to fail, it will not meaningfully disclose that fact to potential investors.

In a recent speech at Fordham Law School, Securities and Exchange Commissioner Troy A. Paredes recognized that disclosure can be of limited practical use in some cases, especially where the sheer volume of the disclosed material militates against actual comprehension of risk.[55] Even if disclosed information is accurate, relevant information may be buried in a sea of paper that would effectively pre-empt meaningful comprehension of risk by investors.

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[52] *See* 5 U.S.C. § 706. ("A reviewing court shall hold unlawful and set aside agency action, findings, and conclusions found to be in excess of statutory jurisdiction, authority, or limitations, or short of statutory right.").

[53] In fact, numerous commentators have even argued that Section 28 may be unconstitutional. *See, e.g.*, Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 Cath. U. L. Rev. 561, 601 (2007) ("It is possible [that] section 28 is an overly broad, unconstitutional delegation of authority to an administrative agency.").

[54] For instance, the SEC recently noted in its action against Citigroup Global Markets that Citigroup had disclosed its role as selector of collateral for a collateralized debt obligation ("CDO") and had further disclosed that it would act as the initial CDS counterparty. However, there was no mention of the extent of its interest in the negative performance of the collateral. *See* Litigation Release, *supra* note 30.

[55] *See* Troy A. Paredes, Address at Twelfth Annual A. A. Sommer, Jr. Lecture on Corporate, Securities and Financial Law, Fordham Law School (Oct. 27, 2011) (speech given in Securities and Exchange Commissioner Paredes's individual capacity).

R. Response to Question 112: Benefits of Rule 127B

The RFC contains three paragraphs of benefits as compared to twelve full paragraphs of anticipated costs associated with its implementation of Section 621.[56] The Commission's overemphasis on the costs of Rule 127B might reflect that (to paraphrase the Rolling Stones) it "has some courtesy, has some sympathy" for financial institutions. Indeed, one might presume from this imbalance that the Commission believes that Rule 127B has more costs than benefits. Such a belief would be wrongheaded. If any group is in need of the Commission's shelter, it is investors. Section 621 is an incremental-yet-vital step towards a salutary overhaul of our financial system.

Many of the costs identified in the RFC would exist within a zero-sum game, wherein an underwriter's cost serves as an investor's benefit. Certain other costs identified in the RFC are actually benefits to both underwriters and investors.

The Commission opines that:

> [a] broad interpretation by market participants of the term 'material conflict of interest' in the rule could therefore cause the securitization participant to lose profits or fees that would have resulted from the client's business with respect to the conflicting transaction.[57]

However, the loss of profits for a securitization participant could also mean the avoidance of investor losses. Such losses are more likely to come to pass in conflicted ABS transactions. Broad enforcement of Rule 127B would require a would-be securitization participant to think twice before assembling a conflicted ABS deal. Admittedly, there is a chance that broad enforcement of Rule 127B could lead participants to bypass ABS transactions involving conflicts of interest that are on the borderline of materiality. While empirical data on the point is non-existent, one might reasonably conclude that a positive correlation exists between investor losses and the level of materiality in conflicted ABS transactions. Assuming such a correlation, the avoidance of even borderline-materially conflicted transactions would be marginally beneficial to investors. Lost profits in such cases are not unintended "costs" or externalities, but rather the crux of Section 621's intended regulatory effect.

A broad interpretation of materiality reduces the risk of investor exploitation because only the most favorable deals (from the perspective of the investor) would make it through the conflict-of-interest gauntlet. This outcome would increase investor confidence in ABS transactions, which in turn would increase liquidity in the ABS market, and as a consequence, the overall market for credit. Increased liquidity could drive down real interest rates, improve consumption and help the global economy rebound from its currently depressed state.

The underwriting industry as a whole has much to gain from a broad interpretation of materiality. That industry is essentially an oligopoly, with only a handful of major players, especially vis-à-vis ABS structuring. If a conflicted underwriter cannot participate in a particular securitization due to Rule 127B, that creates avenues for competition from smaller, more nimble underwriters

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56 Proposed Rule, *supra* note 24 at 60346-49.

57 *Id*. at 60348.

with fewer entrenched interests and conflicts in their books. A broad interpretation of materiality will put pressure on ABS market participants to increase in number and reduce in size. Under classical economic theory, the most efficient markets are typically those having an almost infinite number of competitors, while the most inefficient ones are monopolies and oligopolies.[58] Thus, even if current underwriter-oligopolists are conflicted out of many deals by Rule 127B, the underwriting market at large will nevertheless become more efficient.

A competitive market will put pressure on financial institutions to move away from the pursuit of exotic structured transactions simply for the purpose of reaping profits for themselves, and towards the offering of securities that have bona fide prospects for investor returns. Investors will be protected through "free market regulation," in that their interests will be promoted simply as a consequence of natural market principles. In a competitive market, underwriters will have strong incentives *not* to assemble ABS designed to fail, because doing so could lose them future business. The absence of conflicts of interest can be used as a competitive advantage among competing firms. Exploited investors can "vote with their feet" and move their business to non-conflicted firms. However, when there are only a handful of "reputable" investment banks for ABS investors to choose from, opportunities for exploitation abound. In short, market efficiency is promoted if large scale underwriters are barred from participation in securitization due to conflicts, and ABS underwriting opportunities are routed to smaller competitors as a consequence.

Increasing the number of competitors in the underwriting market would also reduce the likelihood of an ABS investor suffering losses due to a conflict of interest. An investor might incur some transaction costs in having to search for a competing firm, but those costs pale in comparison to the multi-million or multi-billion dollar losses that that investor can expect to suffer from a conflicted ABS transaction.

A larger number of potential ABS underwriters also benefits the global markets outside the ABS niche. At present, many of the premier ABS underwriters are likely considered to be "too big to fail." This creates a moral hazard in that those institutions are incentivized to undertake catastrophic risks because they enjoy an implied promise of impunity that can take the form of government bailouts, unfettered access to the discount window, easy financing via quantitative easing and other Federal Reserve policies.

A broad interpretation of "material conflict of interest" will benefit the American public. Even if such a broad interpretation were to reduce the volume of deals conducted by current ABS participants, that result would be justified because there would be a concomitant reduction in the likelihood of the American public having to bail out those same participants and their affiliates in the future. ABS transactions that are designed to fail present no value to investors, reduce investor confidence, add no real liquidity to the market, create no growth in the productive economy, and enrich only the ABS assemblers. Consequently, the Commission should exercise a heightened level of scrutiny in assessing materiality, in order to ferret out those transactions that are designed to fail.

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[58] *See* K. Jothi Sivagnanam, *Business Economics* 155-56 (2010).

S. Response to Question 116: Benefits of Rule 127B

As discussed above,[59] securitization participants already have robust systems in place to effectively monitor compliance with Commission and SRO rules, and the marginal costs associated with implementing a Rule 127B framework would be minimal. A securitization participant likely has one or more compliance professionals on staff. Even if it takes one full day for a compliance officer to understand the parties and relationships involved in an ABS, that amounts to less than $1000 in salary devoted to Rule 127B compliance. That cost is paltry compared to the fees earned by securitization participants in such deals.

The Commission notes that in certain cases there may not be agreements in place between a securitization participant and a third party collateral manager or investment adviser. However, that scenario seems unlikely; where there is no privity of contract, there is likely to be no direct economic relationship. Where there is no economic relationship, it is hard to imagine how agency-based liability can ensue. Stated differently, if there is enough of a relationship between the securitization participant and the third party to meet the materiality standard imbedded in Rule 127B, there will certainly be privity of contract between those parties. Thus, a securitization participant should be able to rely on contractual provisions to ensure adherence by its agents and deemed-agents to Rule 127B's restrictions.

T. Response to Question 119: Costs to the ABS Market as a Whole

The RFC asks "[w]hat costs would be incurred by securitization participants, investors and others if certain synthetic ABS (e.g., balance sheet CDOs) could no longer be created", and elsewhere raises the possibility that the ABS market could cease to function due to Rule 127B. The Commission overstates the potential fallout from its implementation of Rule 127B.

Indeed, the notion that the Commission **currently** exercises sufficient clout to stifle a multi-trillion dollar industry is slightly Pollyanna. Financial industry participants of the caliber of most ABS participants have little to fear from the Commission's enforcement of Rule 127B, and justifiably so. The Commission has exhibited an anemic response to the "Great Recession," whether due to a lack of resources, poor access to trading data,[60] an ideological solicitude for "liquidity," or simple regulatory capture. The vast majority of recent securities-related actions have taken the form of civil enforcement actions by the Commission, and not criminal actions by the Department of Justice. The Commission's enforcement actions focus on the low-hanging fruit that are so-called "rogue traders," and eschew any meaningful punishment for the excesses that are inherent to the current Wall Street business model.[61] When the Commission has pursued investigatory actions, it has destroyed case files relating to preliminary investigations[62] and relied

59 *See supra* text accompanying notes 27 and 40.

60 *See* Andrew T. Tuch, Regulating Conflicted Financial Conglomerates (Sep. 2011), http://isites.harvard.edu/fs/docs/icb.topic954703.files/Thursday01_Paper02_Tuch_10-6.pdf.

61 Eisinger, *supra* note 46 ("The agency's yardstick seems to be, who wrote the stupidest e-mail?").

62 Matt Taibbi, *Is the SEC Covering Up Wall Street Crimes?*, Rolling Stone, Aug. 17, 2011, *available at* http://www.rollingstone.com/politics/news/is-the-sec-covering-up-wall-street-crimes-20110817.

on documentary evidence selected by the very parties under investigation.[63] Even those cases that become full-scale investigations typically end in paltry settlements devoid of any admission of liability.[64] A significant "concession" obtained by the Commission in many enforcement settlements is the oft-broken promise that wrongdoers will not violate antifraud law in the future, even though the law by its very nature already requires that.[65] The SROs have no better reputation for enforcement. A recent headline regarding the Commission's settlement with FINRA comically described the case as one of "watchdog bites watchdog."[66]

This languid regulatory posture has already sent a strong message to the financial industry that it has little to fear in terms of regulatory limitations. In worrying that Rule 127B might stifle the entire multi-trillion dollar ABS industry, the Commission seems unaware of the level of regulatory noncompliance that pervades the industry, and overestimates its actual role in market enforcement.

U. Response to Question 120: Impact on Capital Formation

Even if the ABS market were somehow debilitated by Rule 127B, there would likely be minimal impact on market efficiency and capital formation. ABS purchases and sales are typically conducted OTC and not on any exchange.[67] Empirical analysis demonstrates that OTC markets are more inefficient and riskier than markets on established exchanges and ECNs.[68] As one commentator noted, "[i]t is surprising that banking authorities have not required banks to move [] derivatives market-making activity to a centralized exchange where transparency is enhanced and bank exposure to counterparty default risk is greatly reduced."[69] OTC markets feature inordinate levels of leverage that lead to non-Pareto optimal levels of default risk.[70]

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63 Hilzenrath, *supra* note 49 ("According to lawyers and accountants involved in internal investigations, current and former government officials, and records of cases in which internal probes have played a role, the practice is widespread.").

64 Eisinger, *supra* note 46. The SEC's recent settlement with Citigroup for $285 million has caused an advocacy group, Better Markets, to file a motion to intervene to block the settlement. Better Markets, *Going to Court to Stop SEC Settlement with Citigroup*, Better Markets Blog, Nov. 6, 2011, http://bettermarkets.com/node/1053. Not surprisingly, the Commission opposed that motion in court. The Southern District of New York rejected the SEC's application to confirm the settlement between the Commission and Citigroup, because such a confirmation would turn the courts into "an agent of oppression." *See SEC v. Citigroup Global Markets Inc.*, Case No. 11 Civ. 7387, slip op. at 15 (S.D.N.Y. filed Nov. 28, 2011).

65 Edward Wyatt, *Promises Made, and Remade, by Firms in S.E.C. Fraud Cases*, N.Y. Times, Nov. 7, 2011, *available at* http://www.nytimes.com/2011/11/08/business/in-sec-fraud-cases-banks-make-and-break-promises.html ("The S.E.C. said in a court filing Monday that it had not brought any contempt charges against [recidivist] financial firms in the last 10 years.").

66 Jean Eaglesham & Andrew Ackerman, *Finra Settles in Battle of Overseers*, Wall St. J., Oct. 28, 2011, *available at* http://online.wsj.com/article/SB10001424052970203554104577001882788203606.html.

67 Proposed Rule, *supra* note 24 at 60336.

68 *See* Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. Chi. L. Rev. 219 (2009) ("many large [financial institutions] act like markets in over-the-counter interest rate, currency and credit default swaps, and other more complex derivatives, being long and short similar contracts. This large degree of derivative exposure by [financial institutions] raises some serious questions and makes it all the more important to have strong board oversight of [their] derivative risk exposure.").

69 *Id*. at n. 104.

70 Viral Acharya & Alberto Bisin, Centralized versus Over-The-Counter Markets, Mar. 16, 2010, http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/acharya_bisin_otc.pdf.

A reduction in the size of the ABS market would siphon investment funds into efficient, transparent and less-risky alternatives. The primary utility of ABS instruments seems to be in generating lucrative fees for securitization participants. The more "exotic" the instrument, the higher the potential for compensation for no reason other than that instrument's opacity. Even if investors have the prospect of earning higher returns through ABS and other OTC instruments, that prospect exists for all the wrong reasons:

- high risk
- inadequate pricing methodologies
- arbitrage opportunities due to imperfect information, and
- heavy leveraging due to massive volumes

These elements are at odds with principles of efficiency, competition and capital formation.

V. Conclusion

In implementing Section 621 and other provisions of the Act, the Commission has been granted a historic opportunity to redress many of the structural wrongs in the financial industry that caused the recent global economic collapse. The Commission should not waste that opportunity.

Thank you for your attention to this matter.

Very truly yours,
/s/
Akshat Tewary, Esq.

Via Internet Submission