American SECURITIZATION FORUM®

February 13, 2012

By E-Mail: rule-comments@sec.gov

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

Re: Release No. 34-65355 (File No. S7-38-11)

Ladies and Gentlemen:

The American Securitization Forum ("ASF")[1] appreciates the opportunity to submit this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comments regarding Release No. 34-65355; File No. S7-38-11, dated September 19, 2011 (the "Proposing Release"),[2] relating to the proposal of a new rule under the Securities Act of 1933 (the "Securities Act") that 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.

ASF commends the Commission for having solicited public comment prior to proposing rules on this critically important subject. ASF was among those providing advance comment and strongly supports the intent of Section 621 to eliminate incentives for market participants to intentionally design asset-backed securities ("ABS") to fail or default.[3] At the same time, we urged the Commission to apply the statutory prohibition in a manner so as to prohibit only the specific types of conduct at which Section 621 was aimed without restricting legitimate securitization activities. We value the Commission's interest in proposing regulations designed to improve investor protection and we applaud the Commission's efforts to develop a proposal that takes account of the concerns expressed by commenters.

Over the past decade, ASF has become the preeminent forum for securitization market participants to express their views and ideas. ASF was founded as a means to provide industry

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[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory and market practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education and training on a range of securitization market issues and topics through industry conferences, seminars and similar initiatives. For more information about ASF, its members and activities, please go to www.americansecuritization.com.

[2] "Prohibition Against Conflicts of Interest in Certain Securitizations," 76 Fed. Reg. 60320 (Sept. 28, 2011).

[3] For a copy of ASF's advance comment letter relating to implementation of Section 621 of Dodd-Frank, see http://www.americansecuritization.com/uploadedFiles/ASFCommentLetterreConflictsofInterest10.21.10.pdf.

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consensus on market and regulatory issues, and we have established an extensive track record of providing meaningful comment to the Commission and other agencies on issues affecting our market. Our views as expressed in this letter are based on feedback received from our broad membership, including our issuer, investor and financial intermediary members.

COMMENTS REGARDING THE PROPOSED RULE

I. OVERVIEW OF THE PROPOSAL

Section 621 of Dodd-Frank adds new Section 27B to the Securities Act. Section 27B prohibits certain persons who create and distribute an 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. Section 27B provides exceptions from the prohibition described above for certain risk-mitigating hedging activities, liquidity commitments and bona fide market-making.[4]

In crafting the implementing rule – proposed Rule 127B – the Commission has primarily incorporated the text of Section 27B and, in doing so, has left a number of important aspects of the proposed rule, including the standards by which to identify a "material conflict of interest," to be determined through interpretation of the rule. The Commission proposes, therefore, to establish an interpretive framework regarding application of the proposed rule that, in most cases, favors a review of facts and circumstances over bright-line tests to determine the existence of a material conflict of interest. Under this interpretive framework, the Commission proposes five conditions that define the circumstances under which a conflict of interest would be prohibited under the proposed rule. The Commission would interpret the proposed rule to prohibit:

- **Securitization participants** – an underwriter, placement agent, initial purchaser or sponsor, or any of their affiliates or subsidiaries … ***Covered Persons***

[4] Section 27B of the Securities Act provides, in pertinent part:

(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 transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

* * * * *

(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.

➢ … **of an ABS**, including a synthetic ABS …	***Covered Products***
➢ … **for a designated time period** – ending on the date that is one year after the date of the first closing of the sale of the ABS …	***Covered Timeframe***
➢ … **from engaging in certain transactions** …	***Covered Conflicts***
➢ … **that would involve or result in a material conflict of interest**.	***Material Conflicts of Interest***

Using these standards, the Commission also provides several examples (Examples 1 through 4 in the Proposing Release) of hypothetical arrangements entered into in connection with, or relating to, securitization transactions and describes how it would interpret the proposed rule to apply to those arrangements and transactions. Illustrations of the Commission's examples are included as Exhibit A to this letter.

II. Application of the Proposed Rule to Traditional Securitization Activities and to Activities Unrelated to Securitization

As noted above, in our advance comment letter we urged the Commission to apply the statutory prohibition in a manner so as to prohibit only the specific types of conduct at which Section 621 was aimed, to avoid restricting routine and other legitimate securitization activities. We cautioned that an overly-broad application of the proposed rule would not only be contrary to the intent of Congress but would cause unnecessary adverse impacts on the markets for ABS – restricting access to critical sources of credit and liquidity, impeding customary servicing activities (including the exercise of loss mitigation activities), prohibiting the issuance of classes of securities whose claims on cash flows are of different priorities or that may receive distributions at different times and be subject to different risks, and constricting access to interest rate and currency swaps that are designed to meet investor needs by reducing or altering market-based risks on the underlying assets.

As noted by the Commission, we and others providing advance comment identified many activities that should be outside the scope of the rule, including: (1) activities that are routinely part of the securitization process that may be effected in connection with structuring an ABS and (2) activities undertaken by securitization participants that are unrelated to the securitization.

1. Activities Related to the Securitization Process

In the Proposing Release, the Commission indicates that activities associated with the typical structuring of a non-synthetic ABS would not be prohibited by the proposed rule. These activities include the basic transfer of risk in a non-synthetic ABS where a securitization participant sells assets to an SPE, the creation of a multi-tranche structure commonly used in securitization transactions and the ownership by a securitization participant of the ABS. The Commission also indicates that most activities that are inherent to the securitization process would not be prohibited by the proposed rule. These activities include, but are not limited to:

providing financing to a securitization participant,[5] deciding not to provide financing, conducting servicing activities, conducting collateral management activities, conducting underwriting activities, employing a rating agency, receiving payments for performing a role in the securitization, receiving payments for performing a role in the securitization ahead of investors, exercising remedies in the event of a loan default, exercising the contractual right to remove a servicer or appoint a special servicer, providing credit enhancement through a letter of credit, and structuring the right to receive excess spreads or equity cash flows.

We applaud the Commission's efforts to develop a proposal that takes account of the concerns expressed by commenters through the advance comment process and strongly agree with the Commission's view that activities associated with the typical structuring of an ABS, or that are inherent to the securitization process, should not be prohibited by the proposed rule. We also agree that such activities would include, but not be limited to, each of the activities identified by the Commission in the Proposing Release. We take this opportunity to identify certain additional activities that are routinely part of the structuring or securitization process and that should not fall within the scope of the final rule.

Additions to, and removals from, revolving asset master trusts: The Commission indicates that the basic transfer of risk in a non-synthetic ABS, in which a securitization participant that is long the underlying assets sells them to an SPE, is typical of most ABS structures and would not constitute a prohibited transaction, because after such sale the securitization participant would not benefit from the subsequent decline in the value of the ABS or the underlying assets.

As the Commission is aware, in a revolving asset master trust (such as a credit or charge card master trust or an automobile dealer floorplan master trust), a single pool of revolving assets supports all outstanding ABS issued by the master trust from time to time. The sponsor initially designates revolving accounts within its managed portfolio and conveys the current and future receivables and proceeds relating to those accounts to the master trust. From time to time, the originator may designate additional revolving accounts and convey the existing and future receivables and proceeds relating to those additional accounts to the master trust, typically in contemplation of future issuances of ABS or to maintain minimum pool balances as required by the governing program documents.[6] In some cases, accounts designated to the master trust may subsequently be re-designated as removed accounts and the receivables and proceeds relating to those removed accounts may be reconveyed to the depositor, which could arise in connection with charge-offs and account terminations or for other business reasons. These are typical and essential features of a revolving asset master trust that have existed since the advent of the master trust structure and are disclosed and well known to investors.

[5] As noted in our advance comment letter, many financial intermediaries – underwriters, placement agents and initial purchasers of asset-backed securities – or their affiliates provide transaction sponsors with short-term funding facilities such as "warehouse" lines, variable funding notes and asset-backed commercial paper, whereby the intermediary or its affiliate provides financing to the sponsor to fund asset originations or purchases of assets. These facilities provide essential liquidity until the assets can be packaged through a term securitization and sold into the debt capital markets. We believe that such activities would, therefore, not be prohibited by the proposed rule but request that the Commission confirm that such financing activities do not fall within the scope of the final rule.

[6] All accounts designated to the master trust must satisfy the eligibility criteria specified in the governing program documents.

The transfer of risk that occurs in a revolving asset master trust when a securitization participant (i) designates initial accounts and conveys current and future receivables relating to those accounts to the master trust, (ii) designates additional accounts and conveys current and future receivables relating to those accounts to the master trust, and (iii) re-designates any such accounts as removed accounts and reconveys receivables relating to those accounts back to the depositor, should not constitute prohibited transactions under the rule because, as the Commission observes in the context of an amortizing trust, after such transactions the securitization participant would not benefit from subsequent declines in the value of the ABS or the underlying assets supporting those ABS. We request that the Commission confirm that such activities do not fall within the scope of the final rule.

Transactions in swaps, caps, CDS and other derivatives: The Commission solicits comment on how certain swaps, caps, CDS and other derivatives should be analyzed under its proposed interpretive framework.[7] As a general matter, swaps, caps and other similar derivatives – such as an interest rate or currency swap covering either or both of the principal or interest payments on the underlying assets supporting the ABS – are designed to meet investor needs by reducing or altering market-based risks resulting from those underlying assets. A credit derivative, on the other hand, could be used to provide credit enhancement for the ABS. For example, a CDS may be used to reference assets actually in the asset pool, which would be analogous to buying protection against losses on those pool assets.

In these circumstances, the counterparty on such derivative instruments does not take a position that is directionally opposite to that taken by the ABS investors. To the contrary, in the case of the interest rate or currency swap, if the referenced interest rate or currency exchange rate moves in a direction adverse to investors (typically, above a specified benchmark), the counterparty would be required to make settlement payments to the issuing entity. Similarly, in the case of the CDS, if a credit event occurred with respect to a referenced pool asset, the counterparty would be required to make settlement payments regarding the pool asset or purchase the asset to provide recovery against losses.

There are, however, circumstances where the counterparty could be viewed as benefitting at a time when the market value of the ABS declines (but not as a direct or indirect result of such decline). For example, assume that an issuing entity holds a pool of fixed-rate loans and issues floating rate ABS indexed to one-month LIBOR. To manage the interest rate risk resulting from the mismatch between the fixed rate pool assets and the floating rate ABS, a counterparty enters into an interest rate swap with the SPE such that, at times when LIBOR equals or exceeds 5%, the counterparty is required to make a settlement payment to the SPE and, at times when LIBOR is below 5%, the SPE is required to make a settlement payment to the counterparty. A decline in LIBOR accrues to the benefit of the swap counterparty (since, at times when LIBOR exceeds 5%, the decline in LIBOR results in a reduction in the amount of the counterparty's settlement payments to the SPE and, at times when LIBOR is below 5%, the decline in LIBOR results in an increase in the amount of the SPE's settlement payments to the counterparty) at the same time that such decline in LIBOR decreases the market value of the floating rate ABS. The counterparty could, therefore, be viewed as benefitting at a time when the market value of the

[7] The ensuing discussions assume that the counterparty on any such investment would be a covered person under the rule.

ABS declines. However, we submit that, while the benefit accruing to the counterparty arises *at a time when* the market value of the ABS also declines, the benefit to the counterparty is not as a direct or indirect result of such decline in the market value of the ABS (*i.e.*, the counterparty does not benefit *from* the decline in the market value of the ABS, but rather from a decline in the same external interest rate index that caused the decline in the market value of the ABS).

We submit, therefore, that transactions in swaps, caps, CDS and other derivatives in the nature of those described above should not fall within the scope of the final rule and request that the Commission confirm our view in the adopting release for the final rule.

2. Activities Unrelated to the Securitization Process

The Commission indicates that many activities undertaken by securitization participants that are unrelated to the securitization would not be prohibited by the proposed rule, so long as the facts surrounding any such activity do not indicate otherwise, such as facts indicating that a securitization participant engaged in a proprietary trade that would profit from a directionally opposite view of the ABS. The Commission offers very little beyond this in the nature of examples of such activities, except to confirm that underwriting an ABS for a different issuer would not be prohibited.

We strongly endorse the view that activities undertaken by securitization participants that are unrelated to the securitization should not be prohibited by the proposed rule, but believe that further guidance on this subject would be appropriate and useful. A securitization participant should not, for example, be prohibited or restricted from offering new or additional financing products or other products and services (or discontinuing the offer of existing products and services) to customers and obligors generally, including obligors on assets supporting outstanding ABS, even if those new or additional products and services (or discontinued products and services) could alter an obligor's payment patterns or, in the case of revolving assets, credit line usage.

By way of further illustration, a securitization participant may from time to time offer new or additional financing products to obligors generally, including obligors on securitized loans, that could increase or decrease the payment rate on outstanding loans (including securitized loans), that could increase obligors' aggregate outstanding debt, or that could increase or decrease obligors' credit line usage (*e.g.*, in the case of revolving assets). Similarly, an automotive manufacturer affiliated with a captive auto finance company securitizer may develop, market and sell a new model of car or truck (or discontinue a brand or model of car or truck) or offer marketing programs for the purchase or lease of new cars and trucks that could impair the residual or recovery value of the cars and trucks currently supporting or collateralizing an automobile lease or loan ABS transaction or could encourage automobile lessees and obligors to prepay their securitized leases or loans early. In each of these cases, the securitization participant is not undertaking activities as a result of or in connection with a securitization transaction but rather for independent purposes associated with a core business unrelated to the structuring or securitization process.

We request, therefore, that the Commission provide further guidance on this subject and, in particular, that the Commission make clear that, in cases where a securitization participant or one of its affiliates is conducting activities unrelated to a securitization that it performs in the normal course of its business or affairs, including the offer of new or additional financing products or other products and services to customers and obligors generally (including obligors on securitized loans), those activities do not fall within the scope of the final rule and would not, therefore, be prohibited. We think that further guidance is all-the-more important because the proposed interpretive framework focuses on direct *and indirect* benefits, making determinations about the ultimate scope of the rule more difficult.

In addition, while the Commission indicates that most activities that are inherent to the securitization process (including conducting servicing activities) would not be prohibited by the proposed rule, operating a profitable business that services automobile loans and leases entails activities that are broader than the phrase "conducting servicing activities." It would be helpful if the Commission could guard against a narrow interpretation of "conducting servicing activities" as applying to servicing securitized loans and the inherent conflicts that may exist in servicing securitized loans or leases by clarifying that servicing business activities, such as adjusting staffing due to changes in serviced portfolio or macroeconomic changes, consolidating servicing business activities or personnel, changing collection business strategies or procedures, decisions about capital investments, and launching new systems, are included in "conducting servicing activities" and would not, therefore, be prohibited by the proposed rule. These types of decisions impact all loans or leases in the servicer's portfolio, not just loans or leases that may be included in a securitization transaction.

III. CONDITIONS REQUIRED FOR APPLICATION OF THE PROPOSED RULE

As noted above, under its proposed interpretive framework, the Commission proposes five conditions that define the circumstances under which a conflict of interest would be prohibited under the proposed rule. To be covered by the prohibition, a transaction must involve: (1) covered persons, (2) covered products, (3) a covered timeframe, (4) covered conflicts, and (5) a "material conflict of interest." Conditions 4 and 5 – the standards by which to identify a covered conflict and a "material conflict of interest" – are perhaps the most fundamental elements of the proposed interpretive framework, and so we address these elements of the framework first. Discussion of the other three conditions is set forth in Section III.C below.

A. Covered Conflicts

The Commission proposes to delineate the scope of "conflicts of interest" that would potentially be covered by the proposed rule. Specifically, there would not be a covered conflict of interest if the conflict in question: (1) arose exclusively between securitization participants or exclusively between investors; (2) did not arise as a result of or in connection with the related ABS transaction; or (3) did not arise as a result of or in connection with "engaging in a transaction." We strongly support these standards, which we believe better align the Commission's proposal with the intent of Section 621, and we once again commend the Commission's efforts to develop a proposal that takes account of concerns expressed by commenters.

One area that we believe warrants further attention and guidance by the Commission, however, is the interplay between these covered conflicts provisions and the covered persons provisions. As noted above, the prohibition under the proposed rule would apply only to those conflicts of interest between a securitization participant and an investor that arise "as a result of or in connection with the related ABS transaction." As noted by the Commission, the proposed rule would not, therefore, address other conflicts of interest that happen to arise between these same parties but are unrelated to their status as a securitization participant and investor, respectively.[8]

At the same time, the proposed rule would apply not only to an underwriter, placement agent, initial purchaser or sponsor of an ABS, but also to any affiliate or subsidiary of any such entity.[9] Insofar as the proposed rule and interpretive framework treat those individuals within a financial institution that structure ABS and control the securitization process as covered persons, we acknowledge and agree that the focus of the rule is appropriate. On the other hand, insofar as the rule treats individuals in independent business units of the institution (including affiliates and subsidiaries) as covered persons, we have significant concerns and believe that the Commission should revise its proposal to ensure that the rule does not extend to persons and transactions within the institution that are unrelated to the relevant ABS transaction.

Financial institutions operate on a global platform in multiple locations around the world. Each location may be comprised of various business units, offices, trading desks and funds. Business units themselves often straddle more than one legal entity within the institution's organizational structure. These institutions employ thousands of employees across their various units that perform tens of thousands of transactions each day in the ordinary course of their respective businesses that are wholly unrelated to betting against any particular ABS transaction sponsored or underwritten by that institution or its affiliates. Within the institution, those individuals involved in sponsoring or underwriting an ABS transaction that seek to comply with the rule will likely never even know that personnel in another business unit have engaged in a transaction that might, absent clarification, inadvertently violate the rule. In many cases, there are no formal information barriers to "wall off" one or more business units from other units of the institution, but the transactions of one unit are, in fact, undertaken wholly independent of the transactions of another unit. In other cases, the institution may be required by law or otherwise elect to wall off one or more business units from other units of the institution, making it all-the-more apparent that transactions in a unit on one side of the wall are undertaken independent of transactions in a unit on the other side of the wall.

The following illustrations serve as simple examples of the kinds of transactions that can happen at any time within the same institution that are unrelated to one another:

- An investor indicates to XYZ Investment Bank that it would like to buy a bond of ABC Auto Company but wants the exposure denominated in Euro. ABC Auto Company only has outstanding debt issued in U.S. dollars. XYZ Investment Bank buys an ABC Auto Company dollar-denominated bond, deposits it in a trust, executes

[8] In footnote 61 to the Proposing Release, the Commission provides one example of a conflict of interest that happens to arise between these same parties but that is unrelated to the ABS transaction. We urge the Commission to provide further examples to better illustrate this principle.
[9] As noted by the Commission, these are the persons specified in Securities Act Section 27B(a).

a Euro/Dollar currency exchange swap with the trust and issues a trust certificate to the investor giving them exposure to an ABC Auto Company bond but denominated in Euros. At or about the same time, commercial bank affiliate of XYZ Investment Bank – XYZ Bank – participates in a syndicated loan to ABC Auto Company and shortly thereafter buys CDS protection referencing ABC Auto Company to manage its ABC Auto Company loan exposure.

XYZ Investment Bank is an underwriter, placement agent or sponsor of a corporate debt repackaging transaction and XYZ Bank is its affiliate, making each a **covered person**. The deposit of the ABC Auto Company bond into the trust and the issuance of the trust certificate appears to meet the definition of an "asset-backed security" as set forth in Section 3(a)(77) of the Securities Exchange Act of 1934 (the "Exchange Act") and, in that case, would be a **covered product**. The purchase of the CDS protection occurs within 1 year of the sale of the trust certificates and so occurs within the **covered timeframe**. The purchase of the CDS protection could be viewed as a short transaction since, with a decline in the value of the asset supporting the ABS (the ABC Auto Company bond) the value of the CDS would increase and, if the conflict were determined to be material,[10] it would appear to be a **material conflict of interest**. In this example, however, the purchase of the CDS protection occurred for purposes wholly unrelated to betting against the ABS transaction. We believe, therefore, that the transaction did not arise as a result of or in connection with the ABS transaction, and so **would not be a covered conflict**.

- In a modest variation of the fact pattern, assume all facts to be the same, except that, instead of an affiliate participating in a syndicated loan and buying CDS protection to manage its exposure, the trading desk that trades ABC Auto Company debt buys protection on ABC Auto Company in connection with market-making in ABC Auto Company debt.[11] Here again, the purchase of the protection occurred for purposes wholly unrelated to betting against the ABS transaction. We believe once again that the transaction did not arise as a result of or in connection with the ABS transaction, and so **would not be a covered conflict**.

- The same issues arise if, instead of the corporate debt repackaging transaction described above, XYZ Investment Bank helped to organize a CLO and one of the loans included in the CLO was an ABC Auto Company loan.

We ask that the Commission clarify that transactions such as those described above, that are undertaken for reasons unrelated to and independent of an ABS transaction, would not "arise as a result of or in connection with the related ABS transaction" and, therefore, would not be covered conflicts of interest under the proposed rule. We believe that if further clarification is not provided, the attendant uncertainty may cause institutions to choose between engaging in

[10] In this illustration, we do not believe the purchase of the CDS protection would be material to an investor in the corporate debt repackaging transaction. However, we are concerned that, inasmuch as materiality is not a bright-line standard, financial institutions will not be willing to engage in transactions where the standard is uncertain and would be judged only in hindsight.

[11] It is our understanding that a statutory exception would be available for bona fide market-making in the ABS but we do not believe that the exception expressly extends to market-making in the underlying assets.

securitizations and engaging in other traditional financial activities (*e.g.*, commercial lending, providing liquidity), which is clearly not the intent of Section 621.

We believe the Commission appreciated these considerations when it solicited comment on how the concept of independent units within multi-service firms might be employed as tools to manage conflicts of interest that would otherwise be prohibited by the proposed rule. Taking these considerations into account, we believe the Commission should revise its proposal to make clear that the rule does not extend to any transaction undertaken in the ordinary course by a business unit of the institution (including any affiliate or subsidiary) that is not involved in the relevant ABS transaction. We believe this approach also aligns closely with the covered conflicts provisions of the proposed interpretive framework, which once again contemplate that a covered conflict must "arise as a result of or in connection with the related ABS transaction." Under this approach, the Commission could adopt as another principle under its covered conflicts provisions that there would not be a covered conflict of interest if the conflict in question arose as a result of a transaction by a unit within a multi-service firm that functions separately and independently from the unit or units that structure ABS and control the securitization process, so long as that separate unit is not involved in the ABS transaction.

The Commission also solicits comment on the role that information barriers can play as a tool to manage conflicts of interest that would otherwise be prohibited under the proposed rule. As noted by the Commission, information barriers previously have been recognized in the federal securities laws as a means to address or mitigate potential conflicts of interest or other inappropriate activities. For example, information barriers have been used in the Commission's broker-dealer regulations, which require that registered brokers and dealers establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by such broker or dealer and any persons associated with such broker or dealer. As the Commission is aware, information barriers are also a central component of the conflict of interest provisions included in the proposed regulations to implement Section 619 of Dodd-Frank (the "Volcker Rule"). In that context, the joint regulators recognize that information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by "limiting knowledge and coordination of specific business activities among units of the entity."[12]

In cases where the lines of separation between business units are not as clear, we believe that information barriers can be highly effective to manage and mitigate a wide array of conflicts of interest that may potentially arise in ABS transactions, including conflicts that would otherwise be covered by the proposed rule. An effective regime to mitigate conflicts of interest through the use of information barriers could include the following:

- A requirement that the securitization participant establish, maintain and enforce information barriers that are memorialized in written policies and procedures that are reasonably designed, taking into consideration the nature of the entity's business to prevent the flow of information related to any particular ABS transaction from any

[12] *See* "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds," 76 Fed. Reg. 68846 (Nov. 7, 2011) (the "Volcker Proposing Release") at p. 68894.

business unit involved in the creation or distribution of the relevant ABS to any business unit of the institution that is not involved in the creation or distribution of the relevant ABS.

- As part of maintaining and enforcing information barriers, the securitization participant should have processes to review, test and modify information barriers on a continuing basis. As part of those processes, the entity should have an ongoing monitoring process that includes periodic assessment of the effectiveness of the barriers and a periodic review of the written policies and procedures. Where a breach of the barrier is identified, the entity should have a process to remediate such breach and to update the barriers and related policies and procedures to prevent further breaches, as necessary.

- A requirement that the securitization participant develop (or expand existing) training programs for its trading personnel and managers that are directly involved in the creation or distribution of the related ABS to effectively implement and enforce the securitization participant's compliance program.

- A requirement that the securitization participant develop and maintain records sufficient to demonstrate the securitization participant's compliance with its compliance program, which the securitization participant would be required to retain for a period of no less than five years and provide to the Commission upon request.

B. Material Conflicts of Interest

The Commission proposes a two-prong test to determine if a conflict of interest is prohibited under the proposed rule. One prong addresses materiality and would treat a conflict of interest as material if there is a substantial likelihood that a reasonable investor would consider the conflict important to its investment decision. The other prong would establish what constitutes a conflict of interest for purposes of Section 27B and proposed Rule 127B. Under this prong, engaging in a transaction would involve or result in a conflict of interest if a securitization participant would benefit, directly or indirectly, in either one of two ways:

- first, from the actual, anticipated or potential (i) adverse performance of the asset pool supporting or referenced by the relevant ABS, (ii) loss of principal, monetary default, or early amortization event on the ABS, or (iii) decline in market value of the relevant ABS (any such transaction, a "short transaction"); or

- second, as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction.

As noted above, ASF strongly supports the intent of Section 621 to eliminate incentives for market participants to intentionally design ABS to fail or default. An ABS that is created for the purpose of entering into another, more lucrative transaction that will provide a material financial reward upon the failure or default of the same ABS creates a clear material conflict of interest.

As proposed, however, we believe that the rule's prohibition is overly broad, extending beyond the intent of Section 621 to prohibit legitimate securitization transactions and structures. In some of these cases, transactions should be permitted so long as the securitization participant has appropriately managed and mitigated the conflict of interest through clear and meaningful disclosure. In other cases, transactions should be outside the scope of the rule altogether.

1. Disclosure

We commend the Commission for soliciting comment on the role that disclosure can play as a tool to manage conflicts of interest that would otherwise be prohibited under the proposed rule. As the Commission is aware, disclosure is a critical component of the conflict of interest provisions included in the proposed Volcker Rule. In that context, the joint regulators indicate:

> "[t]he proposed disclosure standard reflects the fact that some types of conflicts may be appropriately resolved through the disclosure of clear and meaningful information to the client, customer, or counterparty that provides such party with an informed opportunity to consider and negate or substantially mitigate the conflict."[13]

We believe that disclosure can be a highly effective tool to manage and mitigate the vast majority of conflicts of interest that may potentially arise in ABS transactions. Like the joint regulators for the Volcker Rule, we believe that clear and meaningful disclosure relating to conflicts of interest provides investors with an informed opportunity to consider and evaluate the conflict. Indeed, disclosure is a cornerstone of the federal securities laws, whereby investors are allowed to make informed investment decisions on the basis of the information provided to them.

The Congressional record relating to Section 621 supports our view. We note that Senator Levin believes that disclosure alone may not cure material conflicts of interest in all cases, such as in situations where "disclosures cannot be made to the appropriate party or because the disclosure is not sufficiently meaningful."[14] It stands to reason then that effective disclosure can be a powerful antidote for conflicts of interest in many cases, including in situations that are clearly not instances of an ABS being designed to fail.

An effective disclosure regime should include a requirement that conflicts of interest that exist or are contemplated at the time of an ABS transaction be disclosed in the related offering materials, perhaps under a dedicated caption (*e.g.*, a "Rule 127B Disclosure Statement"). Disclosure should be clear and meaningful and should describe the nature of the conflict of interest, including sufficient information about the transaction potentially giving rise to the conflict such that a reasonable investor is able to understand the conflict of interest. Disclosure should also be provided a sufficient period of time in advance of the investor's investment decision so as to give the investor an opportunity to meaningfully consider and evaluate the conflict. Once again, we believe that disclosure can be a highly effective tool to manage and mitigate the vast majority of

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[13] *Id.* at p. 68893.
[14] *See* 156 *Cong. Rec.* S5899 and S5901 (July 15, 2010).

conflicts of interest that may potentially arise in ABS transactions, and we apply this principle in the context of particular transactions in the sections of the letter that follow.

2. The Proposed Rule Should Permit Short Transactions Where a Securitization Participant is Managing an Existing Risk Exposure and Has Managed the Conflict of Interest Through Meaningful Disclosure

United States Senators Jeffrey Merkley and Carl Levin introduced what is now Section 621 on May 10, 2010 as an amendment to Dodd-Frank (the "<u>Merkley-Levin Provisions</u>"). Section 621 evolved as a result of the findings of the Senate Permanent Subcommittee on Investigations, chaired by Senator Levin, after it conducted four hearings relating to the financial crisis.[15] The Merkley-Levin Provisions were intended to stop what Senator Levin called "one of the most dramatic findings of [their] subcommittee hearings, that of firms betting against financial instruments they are assembling and selling."[16] Senator Levin later noted that "sponsors and underwriters of the asset-backed securities are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail" and stated that 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*." [Emphasis added.][17]

Senators Levin and Merkley further clarified the intent of Section 621 in a letter to various heads of governmental agencies charged with implementing Dodd-Frank, including the Chairman of the Commission.[18] The Senators state in their letter that the objective of Section 621 is to "end the conflicts of interest that arise when a financial firm designs an asset-backed security, sells it to customers, *and then bets on its failure*." [Emphasis added.][19]

More recently, Senators Levin and Merkley provided comment on the Commission's proposed rule and interpretive framework in a letter to the Secretary of the Commission. The Senators state in their letter that the proposed rule would "take a needed comprehensive approach in prohibiting the myriad ways in which securitization participants could *profit from taking undue advantage of their role in the securitization process*." [Emphasis added.][20]

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[15] *See* 156 *Cong. Rec.* S4058 (May 20, 2010) (statement of Sen. Levin).

[16] 156 *Cong. Rec*. S3470 (May 10, 2010) (statement of Sen. Levin). *Also see* 156 *Cong. Rec*. S4058 (May 20, 2010) (statement of Sen. Levin) where Levin further reiterated this point that the Senate needed to act to put an end to the conflict of interest that exists when firms sell asset-backed securities to investors and bet against them and considered such action one of the most "dramatic findings" of their subcommittee.

[17] 156 *Cong. Rec*. S5899 (July 15, 2010) (statement of Sen. Levin). Both Senators Merkley and Levin have focused on designing an instrument to fail, likening the practice to someone who sells cars without brakes (or a mechanic servicing a car designed to fail) and then takes out life insurance on the owners. *See* 156 *Cong. Rec*. S3469 (May 10, 2010) (statement of Sen. Merkley), 156 Cong. Rec. S4057 (May 20, 2010) (statement of Sen. Levin) and 156 *Cong. Rec*. S5899 (July 15, 2010) (statement of Sen. Levin).

[18] *See* Letter from Senator Merkley and Senator Levin, dated August 3, 2010 (the "<u>Merkley-Levin Advance Comment Letter</u>"), addressed to, *inter alia*, the Honorable Mary Schapiro, Chairman of the Securities and Exchange Commission, regarding the Implementation of the Merkley-Levin Provisions.

[19] *Id*. at page 2.

[20] *See* Letter from Senator Merkley and Senator Levin, dated January 12, 2012 (the "<u>Merkley-Levin Comment Letter</u>"), addressed to Ms. Elizabeth M. Murphy, Secretary for the Securities and Exchange Commission, regarding the Commission's proposed rule to prohibit conflicts of interest in asset-backed securitizations, File No. S7-38-11.

We believe that the remarks of Senators Levin and Merkley in the Congressional Record and in their subsequent letters make clear that Section 621 is intended to prohibit only those conflicts of interest that provide opportunities for securitization participants to profit from the adverse performance of the ABS they create or distribute. And, while the Senators observe that such profits can take various forms,[21] it is this opportunity for profit upon the failure or default of an ABS, rather than the ability merely to manage an existing risk exposure, that can create incentives for market participants to design ABS to fail or default.

We strongly believe, therefore, that the Commission's proposed rule and interpretive framework should be revised to distinguish between (i) transactions that afford a securitization participant the opportunity for appreciable profit from the adverse performance of an ABS, which may create incentives to design ABS to fail or default (and should, therefore, be prohibited), and (ii) transactions that merely allow a securitization participant to manage or hedge an existing risk exposure, which create no such incentives (and should, therefore, *not* be prohibited so long as (x) potential gains on the notional amount of the hedged position are not appreciably larger than potential losses associated with the hedged exposure and (y) in cases where no statutory exception is available, the conflict of interest is managed through meaningful disclosure as outlined above). Simply stated, the proposed rule and interpretive framework should focus on the potential for "profit" (in whatever form such profit is produced) rather than on efforts to manage existing risk exposure and should, therefore, prohibit "naked shorts" but not "covered shorts."

Under this approach, and assuming the conflict is managed through meaningful disclosure where required, a short transaction would not be prohibited as long as it was effected to manage an existing risk exposure on a delta-neutral or "net long" basis,[22] regardless of the nature of the offsetting existing exposure. Accordingly, in cases where a securitization participant purchases CDS protection on the ABS, or on the assets supporting the ABS, to offset its existing exposure to those ABS or underlying assets on a delta-neutral or "net long" basis, we believe that the purchase of the CDS protection should not be prohibited because the purchase does not present an opportunity for the securitization participant to profit upon the failure or default of the ABS but instead merely allows the securitization participant to manage its existing risk exposure to those ABS. Moreover, this should be the result regardless of whether the offsetting existing exposure arose out of:

(i) the purchase of the ABS in connection with the underwriting, placement, initial purchase or sponsorship of the ABS (as is the case in Example 2 in the Proposing Release);

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[21] The Senators observe that using the term "benefit" (instead of a narrower term) in the Commission's two-prong test ensures that the rule would apply to transactions that produce not only cash profits, but other advantages such as reduced losses, early financial returns, debt relief or a promise of future business. *See* Merkley-Levin Comment Letter at p. 10.

[22] In the Proposing Release, the Commission refers to an instance where potential gains on the notional amount of a hedged position are not appreciably larger than potential losses associated with the hedged exposure as a "delta-neutral" position. For the sake of consistency, we adopt this term for use in this letter, with the meaning ascribed to it in the preceding sentence. As used in this letter, the term "net long" refers to an instance where potential gains on the notional amount of a hedged position are smaller than potential losses associated with the hedged exposure. For the avoidance of doubt, these assessments focus on the *potential* for gains and losses (*i.e.,* actual results should not have a bearing on the character of the hedge as delta-neutral or net long).

(ii) an existing long investment exposure to the assets supporting or referenced by the ABS that continues after consummation of the securitization transaction (as is the case in Example 3B);[23]

(iii) a long cash or derivative position in the underlying reference assets accumulated in anticipation of creating and selling a synthetic ABS (as is the case in Example 3C); or

(iv) any other circumstance where the short transaction operates to offset an existing risk exposure to the ABS or underlying assets.

On the other hand, in cases where a securitization participant purchases CDS protection on the ABS, or on the assets supporting the ABS, but has no offsetting exposure to those ABS or underlying assets (as is the case in Example 1 in the Proposing Release), we agree with the Commission that the securitization participant would profit through the CDS transaction from the adverse performance of the ABS and, therefore, that the purchase of the CDS protection should, absent other relevant facts, be prohibited under the proposed rule. We also agree with the Commission that in these cases the bona fide market-making exception could nevertheless be available where the securitization participant is, for example, an underwriter and (A) the underwriter's client requested the long CDS exposure or (B) the underwriter purchased CDS protection from one customer to offset its sale of CDS protection to another customer.

3. Synthetic ABS

Synthetic ABS are the subject of considerable attention in the Proposing Release, including four variations on a fact pattern (Examples 3A-D in the Proposing Release) where the Commission applies its interpretive framework to a synthetic ABS. As noted by the Commission, in a typical synthetic ABS, investors in securities issued by an SPE acquire credit exposure to reference assets that the SPE does not own.[24] The investors gain this exposure because the SPE simultaneously enters into a CDS contract that references these same assets. The counterparty on the CDS purchases protection on the reference assets underlying the ABS transaction while the SPE, as seller of protection under the CDS, is in effect long the credit exposure on those assets as if it had purchased them.[25]

In substance, therefore, the conflict of interest that arises in a synthetic ABS between the purchaser and the seller of CDS protection is no different from the conflict that arises in a non-synthetic ABS between the purchaser and the seller of the underlying assets – that is, the inherent conflict that exists when a purchaser seeks to acquire and a seller seeks to dispose of a particular financial exposure in pursuit of their respective investment objectives.[26] Indeed, in some cases

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[23] We also discuss the treatment of synthetic ABS under the proposal separately in <u>Section III.B.3</u> below.
[24] The reference assets may be, for example, a portfolio of assets, a single asset, or an index.
[25] The purchaser of the CDS protection is in many cases a securitization participant (such as the sponsor of the synthetic ABS) and may purchase the CDS protection as a hedge to protect itself against the adverse performance of assets that it owns. In other cases, the purchaser may seek CDS protection even though it does not own the reference assets underlying the CDS.
[26] The Commission makes substantially the same observation in the Proposing Release:

> "[T]he securitization participant [as counterparty to the CDS] would be taking an investment position that is directionally opposite to that taken by the investors in the synthetic ABS, as is generally the case in any transaction

(such as Example 3B), the conflict that arises in a synthetic ABS may be *less* significant than the conflict that arises in a non-synthetic ABS since, in a synthetic ABS, the purchaser of CDS protection is acquiring protection against *credit* risk but may retain ongoing exposure to a variety of other market-based risks.[27] We submit, therefore, that, insofar as the conflict that arises between the purchaser and the seller of the underlying assets in a non-synthetic ABS would not constitute a prohibited transaction for purposes of Section 621, neither should the conflict that arises between the purchaser and seller of CDS protection in a synthetic ABS.

In distinguishing synthetic ABS from non-synthetic ABS, the Commission appears to give weight to the fact that a synthetic transaction inherently involves a party – the counterparty to the CDS – that has purchased CDS protection on the same reference assets and thus has an ongoing short exposure to those assets. Given that the conflict that arises in synthetic ABS is the same as (or even less significant than) the conflict that arises in non-synthetic ABS, we see no reason why an ongoing short exposure to the underlying assets should have a bearing on the analysis. Similarly, the mere fact that the long investment exposure to an underlying reference asset in a synthetic transaction takes the form of newly-issued ABS, rather than a purchase of the underlying assets themselves (which could also be ABS),[28] should not result in a different treatment for purposes of Section 621. A synthetic ABS that references assets, like a purchase and sale of such assets, has an inherent long and short component that is well understood by market participants.

We believe, therefore, that the proposed rule and interpretive framework should operate as follows:

- A synthetic ABS should only be prohibited where (i) a securitization participant takes the short exposure to an ABS that it created or distributed within the prior year and (ii) no statutory exception is available (such as the risk-mitigating hedging activities exception); and

- All other synthetic ABS – whether or not accompanied by an offsetting long exposure (*i.e.*, both covered and naked shorts) – are beyond the scope of the prohibition in Section 621 and should, therefore, be permitted outright or permitted so long as the related conflict is managed through clear and meaningful disclosure, as discussed generally in Section III.B.1 above and as applied in the context of synthetic ABS later in this section of the letter.

We do not believe that the conflict of interest that arises in a synthetic ABS, which is inherent to the structure of the security, is even among the types of conflicts intended to be prohibited under

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through which a buyer is able to acquire and a seller is able to dispose of a particular financial exposure in pursuit of their respective investment objectives." *See* Proposing Release at p. 60322.

[27] Even in cases where the purchaser is acquiring credit risk protection, a synthetic ABS may be structured to provide such protection only for a specified period of time, or within a specified band of credit performance, beyond which the purchaser of protection may continue to have credit exposure to the reference assets. By contrast, in a non-synthetic ABS the sale of the underlying assets typically constitutes an absolute and irrevocable transfer of all risk, title and interest to and in those assets.

[28] We note that the transaction may take the form of a synthetic ABS simply because an investor wanted exposure to particular assets that were not available on the open market or because gaining exposure to a large pool of diversified assets is not otherwise possible.

Section 621. Senator Levin made the following observations about the scope of the prohibition in Section 621:

> "[Section 621 does not] restrict a firm from creating a synthetic asset-backed security, which inherently contains both long and short positions *with respect to securities it previously created*, so long as the firm does not take the short position. But 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." [Emphasis added.][29]

We believe the remarks of Senator Levin in the Congressional Record make clear that a synthetic ABS would be prohibited under Section 621 only insofar as it enables a securitization participant to do synthetically that which it is prohibited from doing directly – namely, to use a synthetic ABS to take a short exposure to an ABS that it created or distributed within the prior year. There is no indication in the Congressional Record that Congress intended to prohibit a firm from creating a synthetic ABS and taking the short position *so long as the long and short positions do not relate to securities that it created or distributed within the prior year*.[30]

We also find support for our view in the statutory text of Section 27B, which provides, in pertinent part:

> (a) IN GENERAL.—A [securitization participant] of an [ABS] …*, which … shall include a synthetic asset-backed security, shall not,* [during the covered timeframe], *engage in any transaction that would involve or result in any material conflict of interest* with respect to any investor in a transaction arising out of such activity. [Emphasis added.]

We believe that a plain reading of this statutory text leads to the clear conclusion that the prohibition on engaging in "any transaction" means a transaction *other than the ABS transaction itself*. Stated another way, the Commission's proposal to prohibit a firm that creates or distributes a synthetic ABS from taking the short position would effectively prohibit synthetic ABS altogether, which is inconsistent with the statutory text in Section 27B(a). Moreover, a synthetic ABS merely enables a securitization participant to accomplish indirectly that which it *is* permitted to accomplish directly – the basic transfer of risk exposure on an underlying reference asset. The intent of Section 621 is *not* to prohibit that basic transfer of risk; instead, the intent of Section 621 is to remove the incentive to design such ABS to fail or default by prohibiting the securitization participant from engaging in *another transaction* that will provide

[29] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).

[30] We note that, in their most recent comment letter, Senator Merkley and Senator Levin have expressed support for the Commission's proposed rule and interpretive framework. However, as discussed later in this letter, we also note that in virtually every transaction examined by the Senate Permanent Subcommittee on Investigations that was cited by the Senators in their most recent comment letter, the Senators' critique centered around an absence of disclosure about some conduct relating to the ABS transaction. As such, we continue to believe that a broad-based prohibition on synthetic ABS as contemplated by the Commission's proposed interpretive framework goes far beyond Congressional intent.

profit or other benefit by betting against such ABS. Thus, where a firm has created or distributed an ABS, and assuming that no statutory exception is available, it would be prohibited during the covered timeframe from taking the short position in a synthetic ABS that references the ABS that it created or distributed; but the statute should not be read to prohibit a firm that creates or distributes a synthetic ABS from taking the short position where the synthetic ABS references any other asset (*e.g.*, a corporate bond, a portfolio of bonds, an index or, for that matter, an ABS that it created or distributed more than a year earlier).[31]

Beyond legislative intent and statutory construction, there are valid and competing considerations and policy goals that stand in opposition to an outright prohibition on creating a synthetic ABS and taking the inherent short position, including important risk management concerns and tax and accounting considerations. An institution may, for example, seek to hedge its exposure to an asset but, for tax or accounting reasons, may wish to do so by transferring the credit exposure without transferring the asset itself. In fashioning its final rule, therefore, we strongly urge the Commission as a matter of sound public policy to avoid the situation where an institution is compelled to choose between the "lesser of evils" – for example, the choice between forgoing a course of risk mitigation or suffering adverse tax or accounting consequences.

As noted by the Commission, the proposed rule and interpretation would also restrict or prohibit bona fide investment activities and, therefore, limit the ability of both the investor and the securitization participant to transact freely based on their respective views of the underlying assets. We agree with the Commission that, in many cases, a securitization participant and investors in a synthetic ABS may have complete access to information regarding the underlying assets and simply have different views regarding the future prospects for those assets based on their independent analysis of market and commercial trends or other factors. This would clearly be the case where a synthetic ABS references an index or a portfolio of bonds or other assets, and could well be the case even where a synthetic ABS references a single asset, such as an ABS that the securitization participant did not create or distribute, or a corporate bond or other asset that the securitization participant did not distribute, that has been outstanding for some period of time or where the obligor is an Exchange Act reporting entity.

But even in the case of a synthetic ABS where information asymmetry may exist, the situation is no different from the information asymmetry that exists between the sponsor of a non-synthetic ABS and investors. The information asymmetry that exists between the sponsor of a non-synthetic ABS and investors does not give rise to a conflict that would be prohibited under Section 621 and so, neither should the information asymmetry that may exist between the sponsor of a synthetic ABS and investors. Indeed, it is the function of the existing federal securities laws to regulate any such information asymmetry through disclosure regulations and related liability provisions, and the Commission's existing disclosure regulations and liability

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[31] Section 621 prohibits material conflicts of interest during the covered timeframe. We believe that the covered timeframe is intended to serve as a proxy of sorts for intent – establishing a prohibition on short transactions for one year as a bright-line test for whether an ABS that performs adversely may have been intentionally designed to do so. If the Commission were to prohibit a firm from taking the short position where a synthetic ABS references an ABS that it created or distributed *more than* a year earlier, the Commission would in effect be extending the prohibition in Section 621 as applied to the underlying ABS beyond the one-year period specified in Section 621.

provisions operate effectively for those purposes. We believe, therefore, that clear and meaningful disclosure, rather than outright prohibition, is the tool to effectively manage and mitigate any continuing conflict of interest concerns. In this regard, we again note that, in virtually every transaction examined by the Senate Permanent Subcommittee on Investigations that was cited by Senator Merkley and Senator Levin in their most recent comment letter, the Senators' critique centered around an absence of clear and meaningful disclosure about some conduct relating to the ABS transaction.[32]

As discussed earlier in this letter, an effective disclosure regime would include a requirement that conflicts of interest that exist or are contemplated at the time of an ABS transaction be disclosed in the related offering materials. Disclosure should be clear and meaningful and should describe the nature of the conflict of interest, including sufficient information about the transaction giving rise to the conflict such that a reasonable investor is able to understand the conflict of interest. This disclosure should also be provided a sufficient period of time in advance of the investor's investment decision so as to give the investor an opportunity to meaningfully consider and evaluate the conflict.

Taking into account our views as set forth in this letter, we turn to Examples 3A-D in the Proposing Release, which involve four variations on a fact pattern where the Commission applies its interpretive framework to a synthetic ABS. In each case, an SPE issues synthetic ABS that reference particular assets (*e.g.*, a portfolio of assets, a single asset or an index) and simultaneously sells CDS protection on the reference assets to a securitization participant (in these cases, the sponsor). The variant facts cover four scenarios:

- Example 3A, where the sponsor does not have any exposure to the synthetic ABS or underlying assets other than its short position through the CDS transaction;

- Example 3B, where the sponsor's short position offsets an existing long investment exposure to the assets underlying the synthetic ABS;

- Example 3C, where the sponsor has accumulated a long cash or derivatives position in the underlying assets solely in anticipation of creating and selling a synthetic ABS; and

- Example 3D, where the sponsor has entered into one or more offsetting CDS transactions with other market participants that did not play a role in selecting the reference assets of the ABS and did not have any influence on any aspect of the ABS transaction.

As discussed earlier in this letter, we believe that each of these scenarios is beyond the intent of Section 621 because the conflict that arises between the sponsor, as purchaser of CDS protection, and the SPE, as seller of that protection, is no different from the conflict that arises in a non-synthetic ABS between the purchaser and the seller of the underlying assets. The only exception would be where the CDS references ABS that the sponsor created or distributed within the prior

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[32] *See* Merkley-Levin Comment Letter.

year (or the assets underlying such ABS) since, consistent with the Congressional Record and the statutory text of Section 27B, a firm that creates or distributes an ABS "would run afoul of [Section 621] if it takes the short position in a synthetic ABS that references the same assets it created."[33]

We also believe that in each of these scenarios, the sponsor is merely accomplishing synthetically that which it is permitted to accomplish directly – the basic transfer of risk exposure on an underlying reference asset. Again, the intent of Section 621 is not to prohibit that basic transfer of risk, but instead to remove the incentive to design ABS to fail or default by prohibiting the securitization participant from engaging in a transaction *beyond the ABS transaction itself* that would provide profit or other benefit by betting against such ABS.

As noted above, there are also valid and competing considerations and policy goals that stand in opposition to an outright prohibition on these transactions, including important risk management concerns and tax and accounting considerations. In Example 3B, for instance, where the sponsor's short position offsets an existing long investment exposure to the assets underlying the synthetic ABS, the sponsor may seek to hedge its long investment exposure but, for tax or accounting reasons, may wish to do so by transferring the credit exposure without transferring the asset itself. We see no reason why an institution should be prohibited from transferring that credit exposure through a synthetic ABS when it would be permitted to do so through a non-synthetic ABS, particularly in cases where the asset transfer associated with a non-synthetic ABS might subject the institution to adverse tax or accounting consequences.

Example 3B also concerns us because the Commission appears to base its views on a presumption of deceptive intent on the part of the sponsor. Specifically, the Commission indicates that the sponsor might be seeking to reduce its long investment exposure to the relevant assets "because it has come to believe that the assets will perform poorly" and that the sponsor might seek to accomplish this by transferring the risk of its long position to ABS investors through a synthetic ABS – while marketing the ABS to investors "as a good investment opportunity." We believe it would be extraordinarily impractical to attempt to draw distinctions in outcome under the proposed interpretive framework based on the perceived motivations and marketing activities of a securitization participant and we strongly urge the Commission to avoid such an approach. Moreover, a sponsor's motivations in this situation are far more likely to be aimed at more generalized risks associated with its long investment exposure to the relevant assets – for example, to preserve realized gains on the investment by putting in place a hedge against future volatility in the performance of the relevant assets – rather than because the sponsor has come to believe that the assets will perform poorly.

Examples 3B and 3C, taken together, also raise the implication that the determination of whether a transaction is prohibited or not could turn on the sponsor's subjective intent, depending on whether the sponsor's short position offsets (i) an existing long investment exposure to the reference assets or (ii) a long cash or derivatives position accumulated in anticipation of creating and selling a synthetic ABS. We see no difference whatsoever in the nature of the conflict of interest presented in these two examples yet the Commission proposes to distinguish them –

[33] 156 *Cong. Rec.* S5899 (July 15, 2010) (statement of Sen. Levin).

prohibiting one and permitting the other – based on the sponsor's reasons for accumulating its exposure to the reference assets. Inasmuch as the nature of the conflict of interest is the same in Examples 3B and 3C, we see no principled basis upon which to distinguish the two examples and believe that both are beyond the intended scope of the prohibition in Section 621. Finally, even if the Commission were to take a different view, we once again believe that it would be extraordinarily impractical to attempt to draw distinctions in outcome under the proposed interpretive framework based on the subjective intent of the securitization participant in accumulating its exposure to the reference assets.

In Example 3A, the sponsor does not have any exposure to the synthetic ABS or underlying assets other than its short position through the CDS transaction. While this transaction is different from the other scenarios because there is no offsetting long exposure, once again, we see no difference in the fundamental nature of the conflict of interest presented. In our view, this transaction serves merely as another example of a bona fide investment activity where the investor seeks to acquire and the sponsor seeks to dispose of a particular financial exposure in pursuit of their respective investment objectives – just as occurs in a non-synthetic ABS transaction. As a result, we believe that the synthetic ABS transaction presented in Example 3A should be permitted, except in cases where the CDS references ABS that the sponsor created within the prior year since the synthetic ABS transaction would enable the sponsor to acquire a short position in the very ABS that it created.

We agree that Example 3D should be permissible but believe that should be the case without the need to rely on a statutory exception, since the resulting conflict of interest is no different from the conflict that arises in each of the other scenarios presented or, for that matter, the conflict that arises in a non-synthetic ABS between the buyer and seller. As discussed above, in many cases, securitization participants and investors have access to the same information regarding the underlying assets and simply have different views regarding the future prospects for those assets. In cases where information asymmetry may exist, it is no different from the information asymmetry that exists between the sponsor and investors in a non-synthetic ABS.[34]

As discussed above, in the event the Commission continues to believe that further regulatory focus in the area of synthetic ABS is warranted, we believe that clear and meaningful disclosure, rather than outright prohibition, is the tool to effectively manage and mitigate any continuing conflict of interest concerns.

Taking all of our views into account, we believe that the Commission's proposed approach is far too over-inclusive, prohibiting a broad array of legitimate investment products involving routine conflicts of interest that should be permitted outright or managed through meaningful disclosure. As discussed above, we believe therefore that the proposed rule and interpretive framework should operate as follows:

- A synthetic ABS should only be prohibited outright where (i) a securitization participant takes the short exposure to an ABS that it created or distributed within the

[34] As noted above, it is the function of the existing federal securities laws to regulate such information asymmetry through disclosure regulations and related liability provisions, and the Commission's existing disclosure regulations and liability provisions operate effectively for those purposes.

prior year and (ii) no statutory exception is available (such as the risk-mitigating hedging activities exception); and

- All other synthetic ABS – whether or not accompanied by an offsetting long exposure (*i.e.*, both covered and naked shorts) – are beyond the scope of the prohibition in Section 621 and should, therefore, be permitted outright or permitted so long as the related conflict is managed through clear and meaningful disclosure as outlined above in this letter.

C. Comments on the Other Proposed Conditions

1. Covered Persons

The proposed rule would apply to an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an ABS. The Commission indicates that these persons are specified in Securities Act Section 27B(a) and typically have substantial roles in the assembly, packaging and sale of ABS.[35]

The Commission notes that the term “underwriter” is defined in Securities Act Section 2(a)(11) but that the other terms – “placement agent,” “initial purchaser,” “sponsor,” “affiliate” and “subsidiary” – are not defined for purposes of Section 27B. The Commission is not proposing to define these other terms for purposes of the proposed rule at this time.

Like the Commission, we agree that terms such as “placement agent” and “initial purchaser” are sufficiently well understood in the context of the market for ABS that no definition is required for purposes of Section 27B. As noted by the Commission, the securitization market in the form we know it today developed more than three decades ago and market participants identify the various participants in the securitization process using these terms (for example, by specifying the placement agent or initial purchaser in offering documents).

The Commission does solicit comment on whether the term “sponsor” should be defined and, if so, whether it should be defined by reference to Regulation AB or if it should specifically include a collateral manager or any other person who, for a fee or some other benefit, plays a substantial role in the creation of an ABS or in managing or servicing the assets underlying an ABS. Senator Merkley and Senator Levin suggest that the Commission create a similarly broad definition.

We strongly believe that, if the term “sponsor” is to be defined, it should be defined by reference to Regulation AB, where the term was extensively vetted through the comment process leading

[35] We have provided comment earlier in this letter relating to the interplay between these covered persons provisions and the covered conflicts provisions. Insofar as the proposed rule and interpretive framework treat those individuals within a financial institution that structure ABS and control the securitization process as covered persons, we acknowledge and agree that the focus of the rule is appropriate. On the other hand, insofar as the rule treats individuals in independent business units of an institution (including affiliates and subsidiaries) as covered persons, we have significant concern and believe the Commission should revise its proposal to ensure that the rule does not extend to persons and transactions within the institution that are unrelated to the relevant ABS transaction. We refer you to <u>Section III.A</u> of this letter for more information relating to our concerns and comments.

up to the adoption of Regulation AB. As noted by the Commission, the term is also defined in the second prong of the definition of "securitizer" in Exchange Act Section 15G, using virtually the same definition as used in Regulation AB. The Regulation AB definition of "sponsor" is also well understood by the market and any attempt to formulate a broader meaning in this context will most certainly lead to market confusion. More fundamentally, we believe that the term "sponsor" appropriately focuses on a person that organizes and initiates an ABS transaction by selling or transferring assets to the issuer and that, if Congress had intended that the rule apply to a broader segment of the marketplace, it would not have used a term with such a commonly-accepted meaning, and instead would have specifically referred to servicers, custodians or collateral managers.[36]

Finally, we urge the Commission to avoid a definition that is overly-broad, such as the definition put forth by Senators Merkley and Levin in their most recent comment letter,[37] because that definition could be interpreted to include law firms, accounting firms, third party due diligence providers and other parties that play no role in the structuring of an ABS.

2. Covered Products

The proposed rule, like Securities Act Section 27B, would apply with respect to any "asset-backed security" as defined in Exchange Act Section 3(a)(77), but also specifically includes any synthetic asset-backed security. The Commission is not proposing to define the term "synthetic asset-backed security" for purposes of the proposed rule based on its understanding that the term is commonly used and understood by market participants.

We agree with the Commission that the term "synthetic asset-backed security" is sufficiently well understood in the context of the market for ABS that no definition is required for purposes of Section 27B. We also note the views of Senator Merkley and Senator Levin, acknowledging that the term may be commonly understood by market participants but that its scope should not be based exclusively on market understandings.[38] We understand the Senators' views but are concerned that a definition – such as the definition put forth in their comment letter – could prove to be overly broad in its application.[39] For example, there are a variety of synthetic securities – such as corporate credit-linked notes and insurance-linked securities[40] – that are not

[36] We do not believe the definition of "sponsor" should cover servicers, custodians or collateral managers, since those who merely service or manage the assets underlying an ABS, by definition, do not play a role in structuring an ABS and are not, therefore, in a position to design the ABS to default or fail.

[37] The definition of "sponsor" proposed in the Merkley-Levin Comment Letter would expand the scope of the rule to include any entity that provides any services, for a fee, in connection with a securitization transaction.

[38] *See* Merkley-Levin Comment Letter at pp. 4-5.

[39] The Senators indicate that a possible definition for "synthetic asset-backed security" would be a "fixed-income or other security that references any type of financial asset (including a loan, a lease, a mortgage, a secured or unsecured receivable, or index) and allows the holder of the security to receive payments that depend primarily on the value or performance of the referenced assets." *Id*.

[40] In a typical insurance-linked security, or ILS, investors in securities issued by an SPE acquire a financial exposure to a remote catastrophic risk event unrelated to the collateral supporting the ILS, such as a hurricane, earthquake, flood or other catastrophic event. The investors gain this exposure because the SPE, which is generally a legally-constituted, licensed reinsurance company, simultaneously enters into a reinsurance agreement or other risk transfer contract with the insurance company, the ILS sponsor, covering the same risk event. ILS are not synthetic ABS. ILS transactions do not involve credit exposure to a portfolio of income-producing assets and the SPE has not entered into a derivatives transaction with regard to any risk of the failure of any asset pool or other financial asset. ILS are a common way for insurance companies to hedge or reinsure their risks and we do not

synthetic ABS and, therefore, are clearly outside the intended scope of Section 621, but that could be viewed as within the scope of the Senators' proposed definition, depending on how that definition is interpreted. We therefore urge the Commission to proceed carefully in order to avoid such an overly-broad result.

3. Covered Timeframe

The proposed rule uses the Securities Act Section 27B language "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 [ABS]." While Section 27B specifies the end of the covered timeframe, it does not specify the starting point, and the Commission is not proposing to do so at this time. As a result, the proposed rule would cover transactions effected prior to "the date of the first closing of the sale of the asset-backed security." In taking this approach, the Commission indicates its concern that using the sale date as a starting point might be under-inclusive, but requests comment on whether its proposed approach might also be over-inclusive, and whether alternative approaches to defining the covered timeframe (such as treating the first sale as the starting point) might be appropriate.

We appreciate the Commission's concern that using a date at the completion of the securitization process as a starting point could be under-inclusive since, as noted by the Commission, prior to the first closing securitization participants involved in structuring and marketing an ABS could engage in transactions that would be prohibited if they occurred after the first closing. We respectfully submit, however, that those concerns should not lead the Commission to conclude that no starting point can or should be specified, particularly when the absence of a starting point would almost certainly be an over-inclusive approach that could lead to inadvertent violations of the rule. The absence of a well-demarcated starting point would also make it difficult to fashion clear policies and procedures intended to avoid violations of the rule.

Insofar as the covered timeframe is intended to eliminate incentives for securitization participants to design ABS to default or fail, we believe that an appropriate and meaningful starting point for the covered timeframe would be the first time that offering or marketing materials are used for the transaction or, perhaps, the point in time at which an issuer engages those involved in structuring and marketing the relevant ABS.[41]

IV. COMMENTS ON THE STATUTORY EXCEPTIONS

The proposed rule, like Section 27B, would provide exceptions to the prohibition on material conflicts of interest for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making. In crafting these exceptions, the Commission has again primarily incorporated the text of Section 27B. ASF strongly endorses these provisions, which are critical to enable securitization participants to support the ABS and to mitigate the consequences of certain

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believe the intent of Section 621 was to prohibit ILS transactions in the form described above. To the contrary, many sections of Dodd-Frank exclude the business of insurance from the scope of the legislation to avoid interfering with the ability of insurance companies to otherwise conduct their business under state law regulations.

[41] This approach is similar to the approach taken by the Commission in defining the so-called "quiet period" for issuers whose securities are in registration. In that context, "in registration" refers to the entire securities offering process, starting at the point an issuer reaches an understanding with underwriters. *See* Release No. 33-5180 (Aug. 16, 1971).

attendant risks. We do, however, request that the Commission clarify the scope of these exceptions as provided below.

Risk-mitigating hedging activities: We understand that this exception is designed to help ensure that securitization participants are able to support the ABS that they have created and distributed and is available only for securitization participants seeking to reduce financial risks created by taking actual positions in those ABS. As a result, the exception covers only those risk-mitigating hedging activities that occur in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS.

As noted by the Commission, risk-mitigating hedging is effected to reduce risk from an existing position or a position about to be taken. The Commission illustrates this principle in Example 2 in the Proposing Release, where an underwriter purchases ABS that it distributed and contemporaneously purchases CDS protection on the ABS to hedge its position on a delta-neutral basis. The Commission indicates that the risk-mitigating hedging activities exception could apply because the underwriter is hedging a position arising out of the underwriting, placement, initial purchase or sponsorship of the ABS. We agree with this conclusion. However, in order to avoid uncertainties on this important subject, we request that the Commission provide further clarity on this subject and additional examples covering different fact scenarios.

First, the hedging activity addressed in Example 2 is limited to a CDS transaction with a counterparty. We request that the Commission clarify that other hedges, including a synthetic ABS securitization, could qualify for the risk-mitigating hedging activities exception under fact patterns that are 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 activities 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 but there does not appear to be any policy reason to prohibit a synthetic ABS from qualifying as a permissible risk-mitigating hedge under the exception. In fact, in Example 3C in the Proposing Release, the Commission acknowledges that a synthetic ABS could be a permissible hedge under the risk-mitigating hedging activities 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 activities exception would have the same impact (economic and otherwise) on the securitization participant. Whether the securitization participant sells the retained ABS directly, enters into a CDS consistent with that 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 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 activities exception if such synthetic ABS transaction were structured as the economic equivalent of such CDS transaction.

Second, 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 activities exception. There is no such requirement stated in Securities Act Section 27B(c)(1) and the rationale and principles underlying the risk-mitigating hedging activities exception, as outlined by the Commission in the Proposing Release, 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 should 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 issuances and regularly retains some of those ABS, the sponsor's hedging policy (for efficiency 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 Proposing Release (*e.g.*, no ability to profit from hedge, hedge should unwind as exposure is reduced, etc.), these regular periodic hedging transactions should qualify for the proposed risk-mitigating hedging activities exception.

Liquidity commitments: This exception would permit securitization participants to provide liquidity pursuant to a commitment. The Commission correctly observes that, while the statutory language specifically refers to "purchases or sales of asset-backed securities," commitments to provide liquidity encompass a variety of activities. For example, a liquidity commitment may operate as a mechanism to promote full and timely interest payments to ABS investors or to provide financing to account for differences in the maturity dates between asset-backed commercial paper and the underlying assets. A liquidity commitment could also take the form of an agreement by a securitization participant to purchase an ABS from its customer in a repo transaction (consistent with applicable limitations on such transactions) or could operate as a mechanism to make the ABS eligible for purchase by money market funds.

We believe that each of these liquidity arrangements and activities operates to support the relevant ABS and, therefore, serves a valid and important market function. We urge the

Commission, therefore, to revise the text of the proposed rule to make clear that these activities are outside the scope of the rule's prohibition.

V. EXTRATERRITORIALITY

On its face, the proposed rule has no territorial, jurisdictional or other limitations on its scope. We believe that the rule should not apply to ABS transactions that occur outside the U.S. absent a substantial effect in the U.S. or on U.S. persons. We believe this result strikes an appropriate balance that advances the Commission's objectives by applying the rule when U.S. interests are at stake, but also takes into account the reasonable expectations and interests of participants in the global markets, who would have no reason to expect that a U.S. law would operate to regulate their conduct abroad where no U.S. interest is at stake.

As a result, we believe that the rule should not apply to ABS that will be offered and sold upon issuance, and that any securitization participant will reoffer and resell during the covered timeframe, only in transactions that occur outside the U.S. An example of a transaction that occurs outside the U.S. would be a transaction that complies with the applicable safe harbor under Rules 903 and 904 of Regulation S. We request that the Commission confirm our views and address this subject in connection with the adoption of the final rule.

VI. TRANSITION; PROSPECTIVE APPLICATION

The proposed rule and interpretive framework represent a major change in the ABS markets. Most securitization participants will have to develop and implement significant new policies, processes and procedures to adjust to changes of this magnitude, including changes in how conflicts of interest are identified and handled, changes in how business units across a global platform are organized and operate, changes in how information relating to the securitization process is managed, and changes in when and how disclosure relating to conflicts of interest is made. Developing and implementing such policies and procedures, and associated training of personnel on a global basis, will initially impose significant burdens on market participants and will take time.

We strongly believe that compliance will be a long and difficult process for many in the ABS industry, particularly at a time when so many other significant new regulations, each with their own significant ramp-up periods, are being implemented. As a result, we believe that a longer transition period is in order and we propose that the effective date be at least 12 months following the date of publication of the related final rule in the Federal Register.

We also strongly believe that the new rule should apply only prospectively – to ABS that are issued after the effective date of the new rule – and, conversely, that ABS issued prior to the effective date should be grandfathered and not be subject to the new rule. In the case of synthetic ABS, and taking into account our views on how the proposed rule and interpretive framework should operate in that context, a synthetic ABS issued after the effective date should only be prohibited outright where (i) a securitization participant takes the short exposure to an ABS that it created or distributed within the prior year (even if that underlying ABS was created or distributed before the effective date) and (ii) no statutory exception is available.

VII. CONCLUSION

Once again, we commend the Commission for having invited public comment prior to proposing rules on this critically important issue and for its efforts in developing its proposal to take account of the concerns expressed by commenters. ASF was among those providing advance comment and we urged the Commission to avoid applying the statutory prohibition in a broad manner that would impair the ABS market to the detriment of both investors and securitization participants. In formulating the proposed rule, it is evident that the Commission sought to prohibit the specific type of conduct at which Section 621 was aimed without restricting traditional securitization practices. As discussed in greater detail in this letter, however, we believe the Commission's proposals nevertheless extend beyond the intent of Section 621 and would have unnecessary adverse impacts on the ABS markets.

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ASF very much appreciates the opportunity to provide the foregoing comments in response to the Commission's Proposing Release. Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact me via telephone at 212.412.7107 or via email at tdeutsch@americansecuritization.com, Evan Siegert, ASF Managing Director, Senior Counsel, via telephone at 212.412.7109 or via email at esiegert@americansecuritization.com, or ASF's outside counsel on these matters, Michael Mitchell of Chapman and Cutler LLP, via telephone at 202.478.6446 or via e-mail at mitchell@chapman.com.

Sincerely,

Tom Deutsch

Tom Deutsch
Executive Director
American Securitization Forum

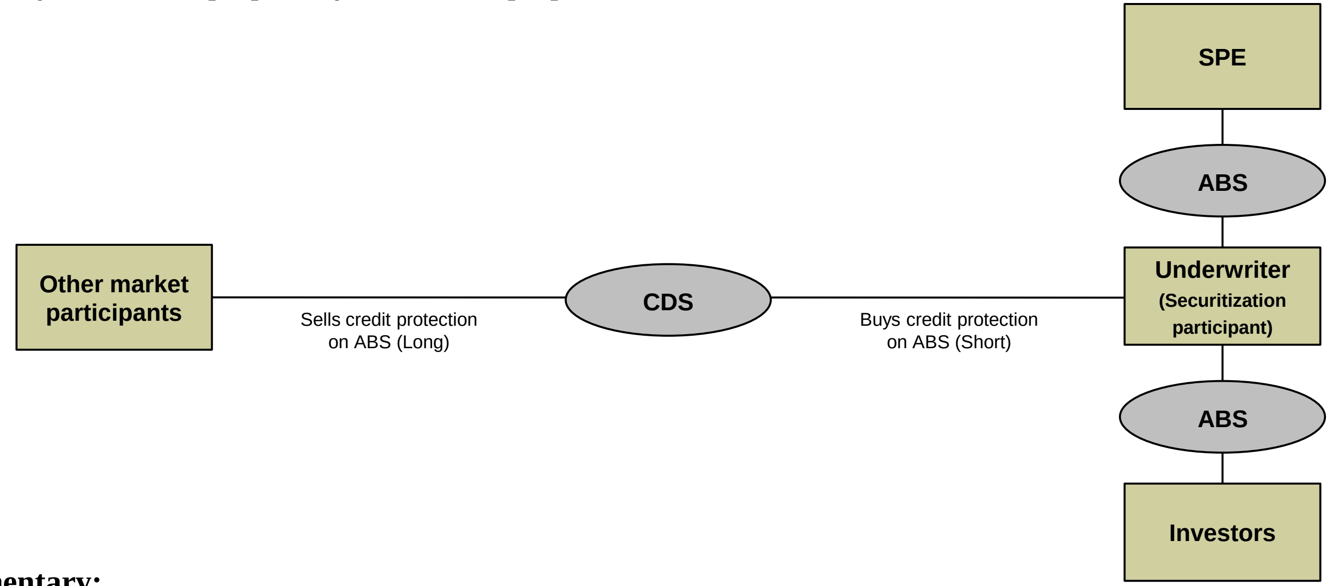
cc: Via Hand Delivery

The Honorable Mary L. Schapiro, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Elizabeth Sandoe, Senior Special Counsel, Office of Trading Practices and Processing
David Bloom, Branch Chief, Office of Trading Practices and Processing
Anthony Kelly, Special Counsel, Office of Trading Practices and Processing
Barry O'Connell, Attorney Advisor, Office of Trading Practices and Processing
Jack I. Habert, Attorney Fellow, Division of Trading and Markets
Meredith B. Cross, Director, Division of Corporation Finance
Paula Dubberly, Deputy Director (Policy and Capital Markets), Division of Corporation Finance
Katherine W. Hsu, Chief, Office of Structured Finance, Division of Corporation Finance
David Beaning, Special Counsel, Office of Structured Finance, Division of Corporation Finance

EXHIBIT A

EXAMPLE 1:
SHORT TRANSACTION IN ABS

A securitization participant, in this case an ABS underwriter, purchases CDS protection on the ABS offered in the relevant transaction three months after the date of the first closing of sale of the ABS. The underwriter's purchase of the CDS protection was made solely for its own proprietary investment purposes.

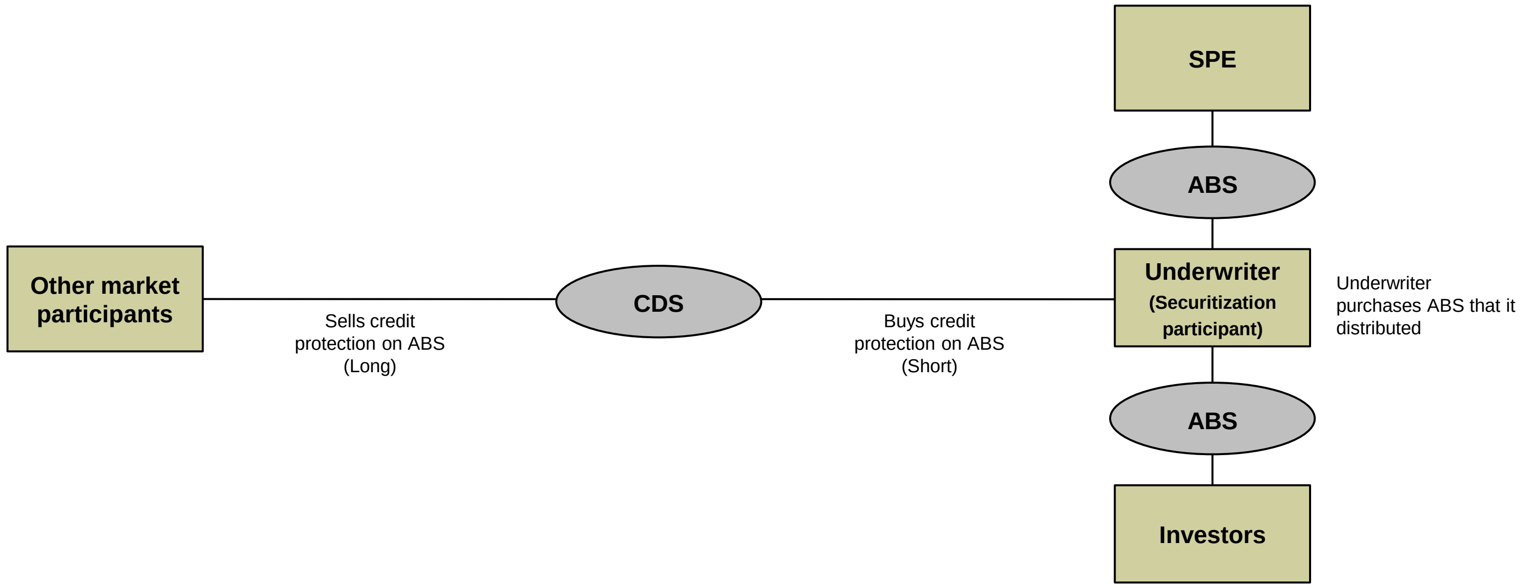


<u>SEC Commentary:</u>

- The underwriter would profit from the adverse performance of the ABS and, therefore, the underwriter's purchase of the CDS protection is prohibited by the proposed rule.
- In this example, the SEC assumes the underwriter's purchase of the CDS protection does not qualify for any exception in the proposed rule.
- The SEC indicates that the bona fide market-making exception may be available where (A) the underwriter's client requested the long CDS exposure or (B) the underwriter purchased CDS protection from one customer to offset its sale of CDS protection to another customer.

EXAMPLE 2:
HEDGE OF RETAINED INVESTMENT IN ABS

An ABS underwriter purchases ABS that it distributed and contemporaneously purchases CDS protection on the ABS. The underwriter's purchase of the CDS protection was made to hedge its ABS position on a delta neutral basis (such that the potential gains on the hedged positions are not appreciably larger than the potential losses on that portion of the ABS investment that is being hedged).



<u>SEC Commentary</u>:

The proposed risk-mitigating hedging activities exception could apply because the securitization participant is hedging a position arising out of the underwriting, placement, initial purchase or sponsorship of the ABS. However, if the CDS transaction is structured on other than a delta neutral basis (such that potential gains on the hedged positions are appreciably larger than the potential losses), the risk-mitigating hedging position would not apply.

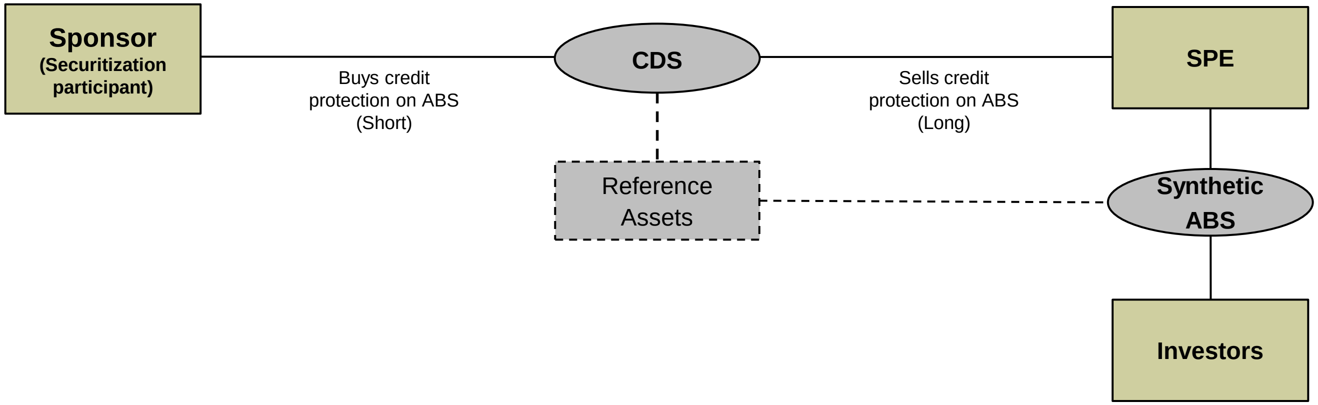
EXAMPLE 3A:
SYNTHETIC ABS TRANSACTION

Common Facts:

Securitization participant, in this case the sponsor, and SPE are parties to a CDS contract that references particular assets (*e.g.*, a single asset, a pool or an index). The sponsor purchases CDS protection on the reference assets underlying the ABS transaction.

Variant Facts:

The sponsor does not have any exposure to the ABS or underlying assets other than its short position through the CDS transaction.



SEC Commentary:

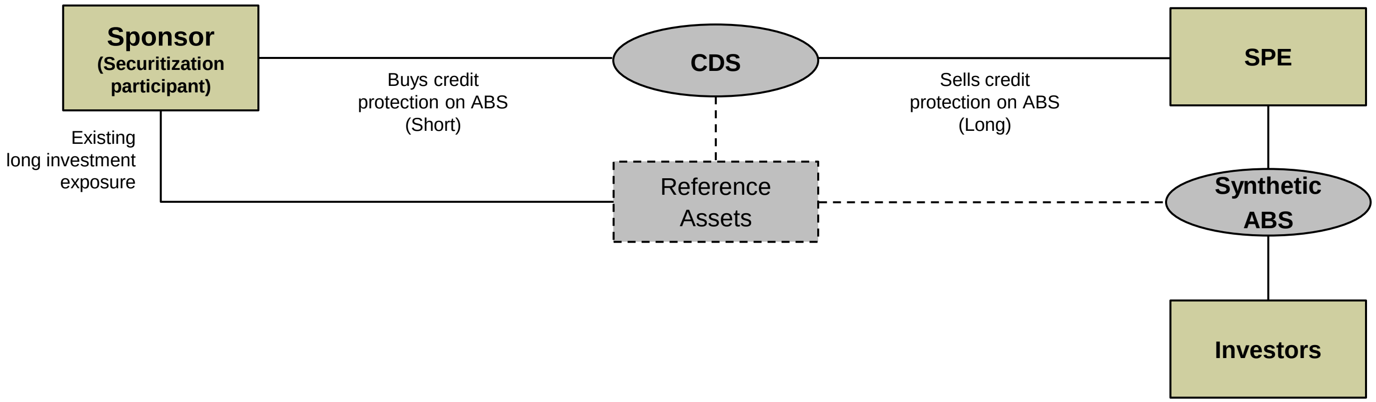
Entering into the CDS with the SPE would, by itself, generally involve or result in a material conflict of interest between the sponsor and the ABS investors because the sponsor would benefit through the CDS transaction from a potential decline in the ABS.

EXAMPLE 3B:
SYNTHETIC ABS TRANSACTION

Common Facts: See Example 3A

Variant Facts:

The sponsor's purchase of the CDS protection offsets its existing long investment exposure to the assets underlying the synthetic ABS. The sponsor transfers risk of its long position to ABS investors through a synthetic ABS because it believes the assets will perform poorly. Simultaneously, the sponsor markets the ABS securities to investors as a good investment opportunity.



SEC Commentary:

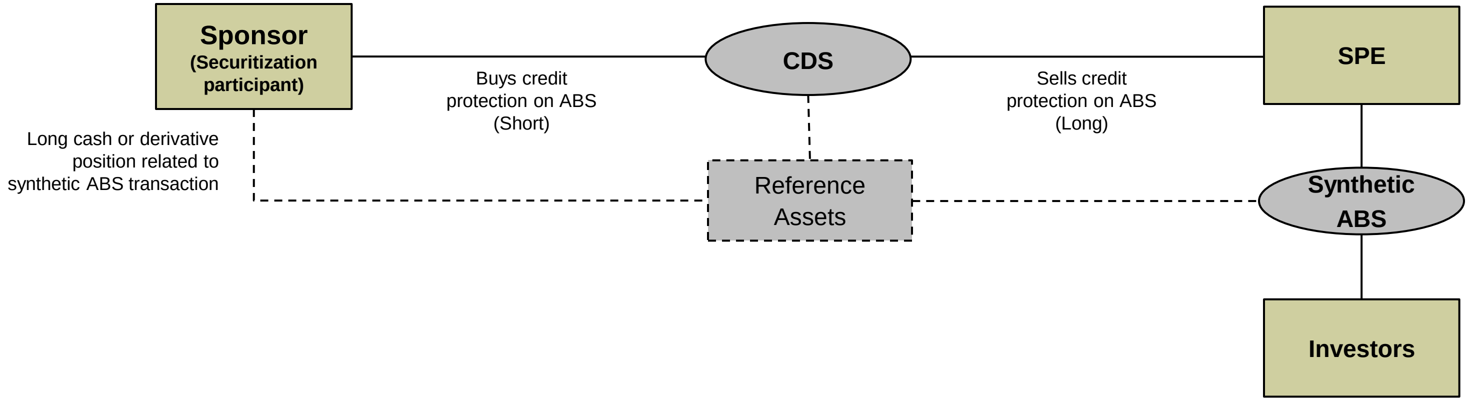
SEC's preliminary belief is that entering into the CDS transaction would result in a material conflict of interest between the sponsor and the ABS investors because the sponsor would benefit through the CDS transaction from a potential decline in the ABS.

EXAMPLE 3C: SYNTHETIC ABS TRANSACTION

Common Facts: See Example 3A

Variant Facts:

The sponsor has accumulated a long cash or derivatives position in the 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.



SEC Commentary:

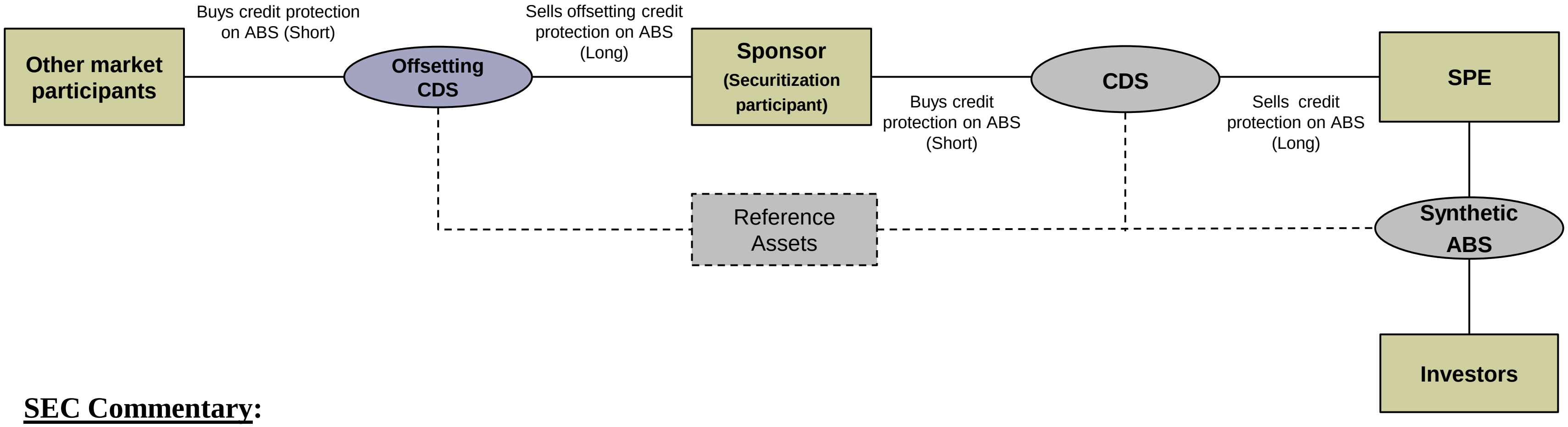
- SEC's preliminary belief is that entering into the short CDS transaction would fall within the exception for risk-mitigating hedging activities, provided that there was no significant net basis risk, and that potential gains (or losses) by the sponsor from the CDS protection it purchased from the SPE would be directly offset by losses (or gains) from the long position accumulated to offset that exposure.
- The SEC acknowledged the practical difficulty of determining the sponsor's intent in accumulating positions and asked for comment on that topic.

EXAMPLE 3D:
SYNTHETIC ABS TRANSACTION

<u>Common Facts</u>: See Example 3A

<u>Variant Facts</u>:

The sponsor has entered into one or more offsetting CDS transactions with other market participants that did not play a role in selecting the reference assets of the ABS, and did not have any influence on any aspect of the ABS transaction.



<u>SEC Commentary</u>:

- SEC's preliminary belief is that, under the risk-mitigating hedging exception, the sponsor would be permitted to enter into this combination of CDS and offsetting CDS transactions, provided that (A) the sponsor did not specifically select assets that were biased to enable the other market participants to profit from short positions, and (B) the sponsor's gains (or losses) from the CDS transaction would be directly offset by those from the offsetting CDS transactions.
- Conversely, if the offsetting CDS transactions were entered into before the ABS transaction, and for unrelated purposes, the risk-mitigating hedging exception would not apply.

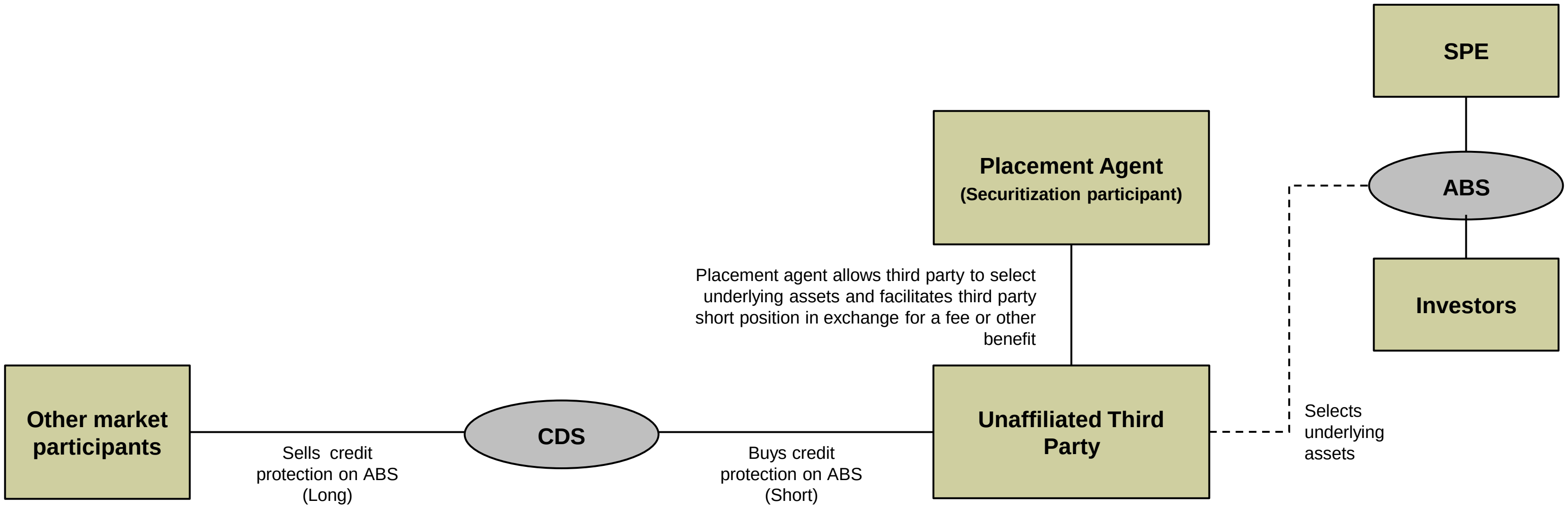
EXAMPLE 4A:
FACILITATION OF THIRD PARTY ACTIVITIES

Common Facts:

The securitization participant, in this case the placement agent, allows an unaffiliated third party to select the composition of the assets that underlie an ABS. Unaffiliated third party purchases CDS protection on the ABS.

Variant Facts:

The placement agent, for a fee, facilitates the unaffiliated third party's purchase of CDS protection on the ABS.



SEC Commentary:

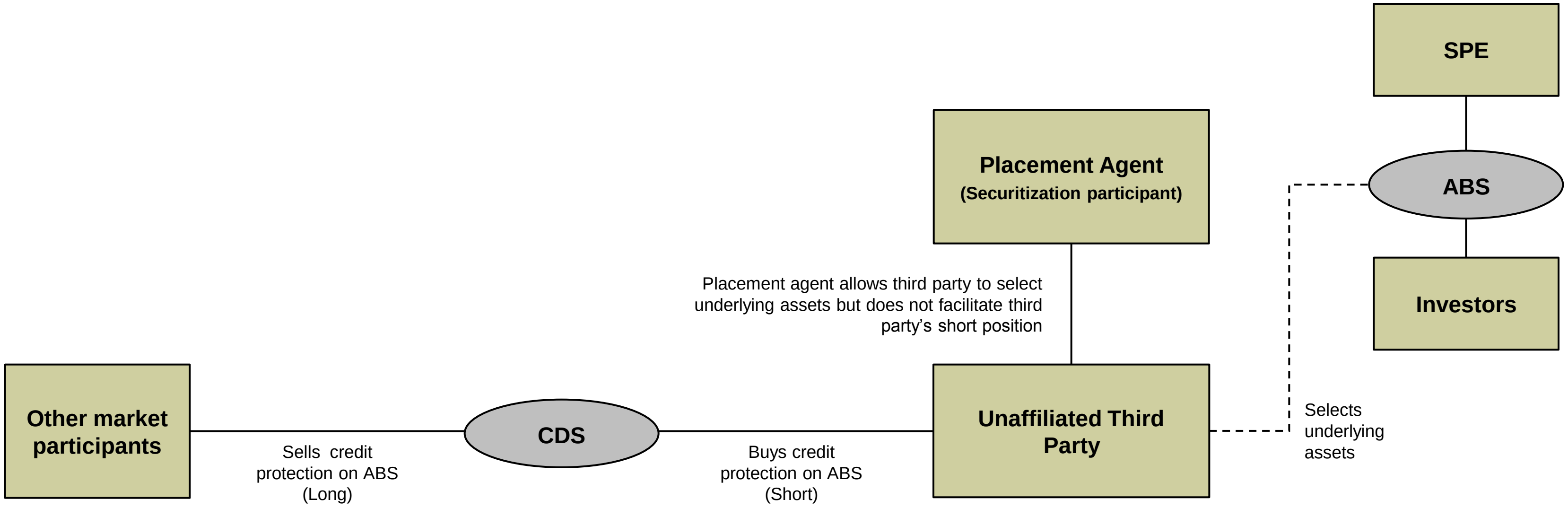
By allowing the third party to select assets underlying the ABS, and then facilitating the third party taking a short position on the ABS or its underlying assets, the placement agent has engaged in a transaction that involves or results in a material conflict of interest between the placement agent and the ABS investors, and such activity would be prohibited under the proposed rule.

EXAMPLE 4B:
FACILITATION OF THIRD PARTY ACTIVITIES

Common Facts: See Example 4A

Variant Facts:

The placement agent does not facilitate unaffiliated third party's CDS transaction or receive a fee for doing so



SEC Commentary:

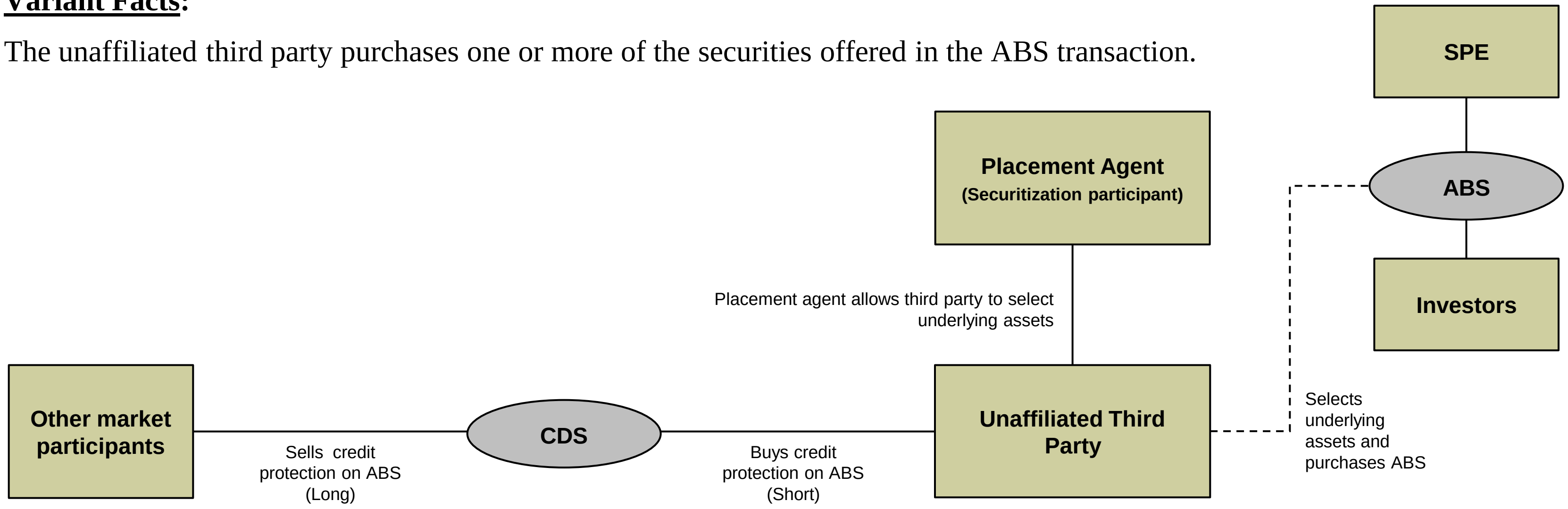
SEC's preliminary belief is that it would be appropriate to impute a benefit to the placement agent for creating the opportunity for the third party to select the underlying assets and to purchase the CDS protection from which it would profit if the underlying assets perform poorly.

EXAMPLE 4C:
FACILITATION OF THIRD PARTY ACTIVITIES

<u>Common Facts</u>: See Example 4A

<u>Variant Facts</u>:

The unaffiliated third party purchases one or more of the securities offered in the ABS transaction.



<u>SEC Commentary</u>:

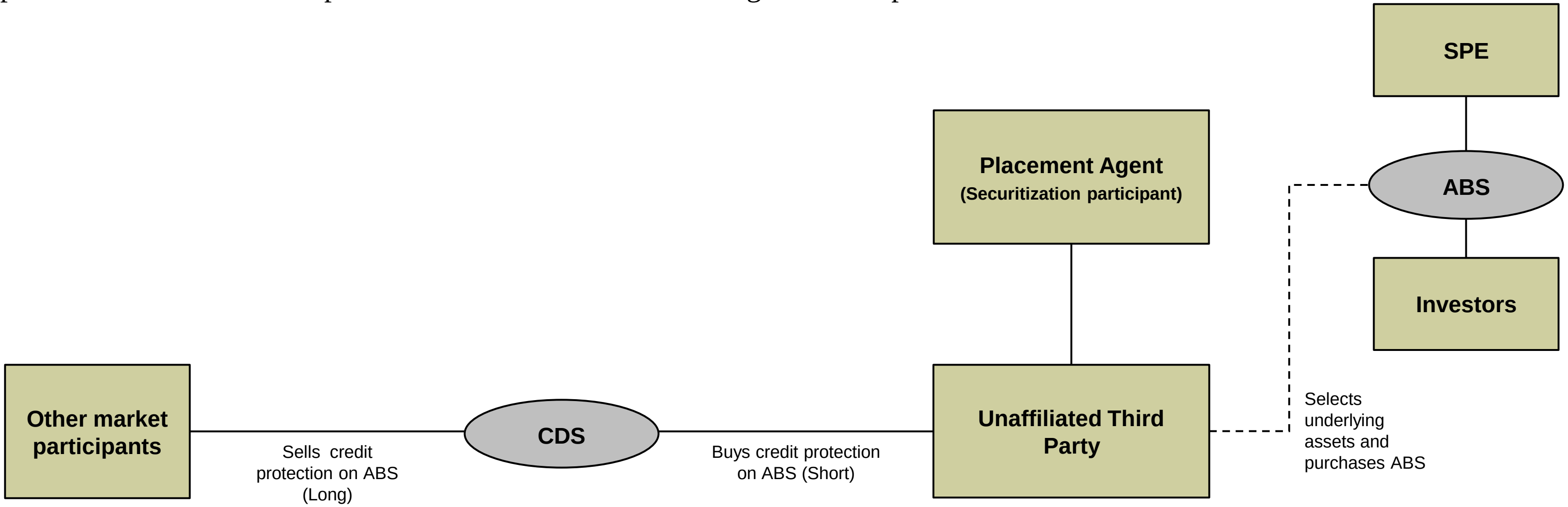
- SEC's preliminary belief is that activities in which investors who purchase one or more securities offered in an ABS transaction decide, at that time or later, to reduce or hedge their exposure to these investments through subsequent short transactions, such as purchasing CDS protection, would qualify for the risk-mitigating hedging exception.
- Further, the unaffiliated third party is in the same position as a securitization participation who selects the assets underlying the ABS, purchases the ABS and then seeks to hedge the ABS by buying CDS protection. Since, in that case, the securitization participant would qualify for the risk mitigating hedging exception, so would the unaffiliated third party. (See Example 2.)

EXAMPLE 4D:
FACILITATION OF THIRD PARTY ACTIVITIES

Common Facts: See Example 4A

Variant Facts:

The unaffiliated third party purchasing one or more securities issued by the ABS also buys CDS protection on those same securities or other securities in the offering (or their underlying assets), in a manner such that the unaffiliated third party will profit more from the short position than it will lose on the long securities position.



SEC Commentary:

This activity would no longer qualify for the risk-mitigating hedging exception. By allowing an unaffiliated third party to select assets underlying an ABS in a way that facilitates that unaffiliated third party's ability to profit from a short position on the ABS or its underlying assets, the placement agent has engaged in a transaction that involves or results in a material conflict of interest between itself and investors in the ABS.