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ASSOCIATION

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March 27, 2023

Securities and Exchange Commission
100 F St., N.W.
Washington, DC 20549

Re: File No. S7-01-23 - Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Rel. No. 33-11151, 88 Fed. Reg. 9678 (Feb. 14, 2023)

Ladies and Gentlemen:

The Structured Finance Association (the "SFA") appreciates the opportunity to provide feedback on the recently re-proposed securitization conflicts of interest rules.[1]

The SFA's mission is: "*To help its members and public policy makers grow credit availability and the real economy in a responsible manner*."

The SFA is a consensus-driven trade association with over 370 institutional members representing the entire value chain of the securitization market. By facilitating the responsible issuance and investing of loans and securities, the market provides trillions of dollars of capital to consumers and businesses in communities across the country. SFA members include issuers and investors, broker-dealers, rating agencies, data analytic firms, law firms, servicers, trustees and accounting firms. As such, unlike many other trade associations, before we take any advocacy position our governance requires us to achieve consensus by agreement rather than majority vote, ensuring the perspectives of all our diverse membership are included. This diversity is our strength, as it builds healthy tension in arriving at our consensus position. Because of this, we are methodical and thoughtful as we analyze the pros and cons of regulatory proposals before we reach a mutually acceptable position.

SFA and its membership share the Commission's goal of maintaining investor confidence that market participants involved in the structuring of asset-backed securities ("ABS") will be free from the influence of betting against the ABS. However, **we believe the sweeping approach taken in the re-proposed rule would significantly impede and restrict vital activities across a wide-swath of the investor, bank, broker-dealer, corporate issuer and servicer communities – and all of their affiliates and subsidiaries. We urge the Commission to strike the right balance to protect investors while maintaining the strengths of our financial markets.**

[1] Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Rel. No. 33-11151, 88 Fed. Reg. 9678 (Feb. 14, 2023) [hereinafter Conflicts Rule Re-Proposing Release].

A strength of our membership is its representation across the entire securitization market. This provides us with a full picture of market considerations and encourages a healthy tension in our consensus building process that supports positions focused on maintaining a stable, healthy market. Given the sweeping scope, extensive ambiguities and complex exemption conditions of the re-proposed rule, the short comment period provided by the Commission simply has not given our members enough time to fully evaluate its implications on not only their securitization businesses but also across the entirety of their institutions and all their affiliates and subsidiaries. Even more time is needed to consider how the rule could be revised to achieve the stated goals without impeding a healthy functioning market, and to respond to the extensive requests for comment in the proposal.

We are working diligently to assess the full scope of the impact of the re-proposal, and to build industry consensus on how to draw the line between prohibiting material conflicts of interest and assuring the continued functioning of the ABS markets. Therefore, this letter contains only our preliminary comments on the re-proposal. We intend to submit a follow-up letter within 90 days hereafter, expanding on our initial comments, providing more detailed suggestions on how to revise the re-proposed rule, providing a cost benefit analysis, and responding more directly to the Commission's thorough requests for comment.

While we continue to consider the specifics of how the rule should be revised, even at this early stage, **all our members, including our investor members, agree that the re-proposed rule is critically flawed, conflicts with the goals of numerous prudential regulators, relies too heavily on the Volcker Rule as a precedent, and would impose significant impediments to the continued healthy functioning of the ABS and broader finance markets, which is not what Congress intended.**

We acknowledge and sympathize with the current Commission's desire to wrap up this outstanding piece of the Dodd-Frank rule-making. But we do not believe the re-proposed rule reflects the intent of Congress, and, if adopted in its current form, would create an almost insurmountable impediment to the functioning of the securitization markets, with associated negative effects on the broader financial markets and, in particular, risk management functions. In many cases, compliance with the rule would not so much be burdensome as it would be impossible. The result will be a lesser availability of credit, greater risk, and greater instability to our financial markets.

Background

In the aftermath of the financial crisis, Congress became concerned about practices involving financial institutions betting against—or "shorting"—asset-backed securities ("ABS") that they had assembled or underwritten. Late in the legislative process for the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"),[2] Congress amended the proposed legislation to prohibit such transactions by defining them as an unlawful conflict of interest between those designing or distributing ABS and those investing in them.

The legislative history of this provision is short but instructive. The late Sen. Carl Levin, who was one of the driving forces behind the amendment that added this provision, was very clear in describing the underlying intent to Congress before it was enacted:

> The intent of section 621 is to prohibit underwriters, sponsors, and others who assemble [ABS], from packaging and selling those securities and profiting from the securities' failures. [T]he sponsors and underwriters of the [ABS] are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail. They . . . would know if the vehicle has been designed to fail. And so they must be prevented from securing handsome reward for designing and selling malfunctioning vehicles that undermine the [ABS] markets.[3]
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> The conflicts of interest provision under Section 621 arises directly from . . . how some firms were creating financial products, selling those products to customers, and betting against those same products. . . . In the [ABS] context, the sponsors and underwriters of the [ABS] are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail. . . . [T]hey must be prevented from securing handsome rewards for designing and selling malfunctioning vehicles that undermine the [ABS] markets.[4]

Congress foresaw that a broad, bright line prohibition would not work. According to Sen. Levin, Section 621 gave "the Commission sufficient authority to define the contours of the rule in such a way as to remove the vast majority of conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets."[5] The SFA appreciates the difficulty of this balancing act; and the Commission appears to acknowledge it too, stating that the re-proposal is intended to:

> provide strong investor protection . . . , while also providing an explicit standard for determining which types of transactions would be prohibited by the re-proposed rule *[without] unnecessarily*

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[2] Section 27B of the Securities Act of 1933, as amended (the "Securities Act"), 15 U.S.C. § 77z-2a. For convenience and consistency, we refer to this provision throughout this letter by its Dodd-Frank Act identifier, "Section 621."
[3] 56 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).
[4] 56 Cong. Rec. S5901 (daily ed. July 15, 2010) (statement of Sen. Levin).
[5] 56 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).

> *prohibiting or restricting activities routinely undertaken in connection with the securitization process, as well as routine transactions in the types of financial assets underlying covered securitizations*.[6]

An effective securitization conflicts of interest rule must prohibit the "bets" that were the focus of Congress. It also must ensure that routine, expected – and vital – market activities are not impeded. It is also crucial that the rule not sweep in market or commercial activities that do not have anything to do with the securitization process, or the ABS markets more broadly. In the end, though, because the ultimate mandate of Section 621 is to improve the fair functioning of the ABS markets, the Commission's rulemaking cannot result in a prohibition so extensive that it could grind those markets to a halt.

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[6] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9679 (emphasis added).

STRUCTURED FINANCE ASSOCIATION

Section I: Executive Summary

The re-proposed rule combines an extremely broad prohibition that applies to a wide swath of institutions, including many who may have limited or no connection to the relevant securitization, with a limited set of highly circumscribed exemptions. The combined, layered effect would prohibit a universe of transactions that are necessary for the healthy functioning of our capital markets.

- As re-proposed, the rule would encompass a number of extremely broad definitions and operative provisions, including the definitions of "sponsor" and "conflicted transaction."
  - The proposed "*sponsor*" definition could scope in parties beyond the ABS bond issuers including insurance providers, servicers, and even the very investors the rule is intended to protect.
  - The proposed rule also scopes in all the affiliates and subsidiaries of every such "*sponsor*", *and of every underwriter, placement agent, and initial purchaser* – regardless of their role or involvement in the securitization activity.
  - Therefore, across all parties, and their affiliates and subsidiaries, the re-proposed rule would scope in a broad range of institutions across a wide-range of industries, including insurance companies, manufacturers, mortgage companies, commercial real estate lenders, broker-dealers, collateralized loan obligation ("CLO") managers, investors, asset management firms, insurance companies, banks, bank holding companies, and others that are not themselves necessarily involved in securitization activities.
- The "conflicted transaction" definition is unworkably broad and could prevent institutions subject to the rule from performing routine, critical market activities because it encompasses any transaction where a scoped-in institution has the mere potential to benefit from some adverse performance of the ABS or the underlying asset pool, without regard to any actual impact to an investor and without regard as to whether an actual conflict of interest exists. We have concerns about the scope of these provisions individually. But they cannot be considered only individually – they also must be viewed in light of their overall effect. When layered together, their scope is broad and blunt.
- While the re-proposed rule includes exemptions, they contain unduly restrictive conditions including extensive compliance program requirements – all modeled primarily after certain Volcker Rule exemptions as they apply to the largest regulated banking entities – which, based upon our members' initial analysis, do not seem appropriate for other types of entities, or consistent with the purpose of the re-proposed rules.[7]

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[7] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9703 (hedging activities), 9705 (market-making activities).

- Compliance with these conditions would be difficult or even impossible for a multitude of securitization participants – including non-bank broker-dealers, asset managers, institutional investors, corporate issuers, and servicers – and all their affiliates and subsidiaries. Most concerning, the conditions the re-proposed rule places on the risk mitigating activities in which any securitization participant, its clients and affiliates may engage in would be limited to those narrowly permitted by the Volcker Rule, which is intended for the wholly different purpose of preventing the largest banking entities from engaging in proprietary trading.

- This would make it almost impossible for a market participant to conduct critical business activities – including risk mitigating hedging, financing, investing and potentially, transactions contemplated under the securitization documents themselves – amid uncertainty as to whether such activity is covered by the rule, and if so, whether the participant could be deemed to have violated the rule.

- **We do not believe that Congress meant to give the Commission the power to substantively regulate the vast business activities of the broad cross-section of business entities included within the definition of "sponsor".**

- Additionally, the re-proposed rule could perversely discourage ABS investors from negotiating the terms and collateral of ABS or any action that could be interpreted as "substantial involvement" in the design, structure or assembly of the ABS or selection of the assets underlying an ABS, in an effort to avoid being tagged as a "sponsor" under the rule.

- The significant costs and regulatory uncertainty related to this rule may result in some market participants – including some investors, as well as broker-dealers, originators and banks - exiting all or a portion of their securitization business, and would serve as a considerable hurdle for new entrants to the market.

- As a result, the re-proposed rule could inadvertently impact the size and liquidity of the $12.5 trillion market for ABS,[8] which is an essential source of funding for American consumers, small business owners and home buyers.

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[8] Figure includes outstanding CLOs, residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS"). Source: Market Compilation; as of December 31, 2022

Section II: The Scope of the Re-Proposed Rule is Unprecedented and Overreaching

The sheer reach of the re-proposed rule is overwhelming – and, as such, the implications cannot be overstated. As we detail below, the rule would unduly restrict a wide range of risk management, financing, investing, lending and servicing activities that are crucial to the ABS and broader finance markets. These markets are an essential source of funding for American corporations, consumers, small business owners and home buyers, and – as we describe in more detail below – to the broader capital markets.

A. Several Aspects of the Re-Proposed Rule Contribute to its Overreach

There are several main aspects of the re-proposed rule that contribute to the problems with its overall scope. Taken in concert, the layering of these provisions would make it almost impossible for a market participant to conduct certain critical business activities amid uncertainty as to whether or not such activity is covered by the rule, and if so, whether its conduct could be deemed to have violated the rule.

We discuss these specific issues in more detail below, but a big-picture overview is needed. In order to address the concerns we have identified, the Commission must step back and address the issues with its proposal as a whole, not simply as a list of loosely connected individual parts. Otherwise, the Commission risks creating a problem significantly worse than the transactions that were the target of Section 621.

Expansive definition of "conflicted transaction" captures a boundless range of activities

Clauses (i) and (ii) of the proposed definition of "conflicted transaction" in the re-proposed rule would prohibit any short sale of the relevant ABS, or the purchase of a CDS or other credit derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of a specified adverse event with respect to the ABS. **We agree with the Commission that if a party designed a deal to fail these types of transactions would "constitute direct bets against the relevant ABS itself,"[9] and are the types of transactions that were squarely in the sights of Congress when it enacted Section 621. Whether or not an ABS issuance has been "designed to fail," these types of transactions reflect direct bets against the success of the related ABS.**

In addition to including short sales of ABS and purchase of CDS against ABS, the Commission proposes to add the following provision into the definition of "conflicted transaction":

> (iii) The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated or potential:

[9] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9694.

(A) Adverse performance of the asset pool supporting or referenced by the relevant asset-backed security;

(B) Loss of principal, monetary default, or early amortization event on the relevant asset-backed security; or

(C) Decline in the market value of the relevant asset-backed security.

Clause (iii) is unworkably broad, and would include countless types of transactions, even those only tangentially related to the ABS, such as:

- Transactions on behalf of a client, customer or counterparty pursuant to a fiduciary duty;
- Transactions unrelated to the credit risk of the ABS, including interest rate and currency hedges and swaps, and transactions in commercially available, widely recognized indices;
- The release of the ABS collateral from a warehouse facility;
- Activities in connection with financing provided to holders of the ABS;
- Routine servicing activities;
- Risk management transactions, like credit risk transfer transactions; and
- Sale of assets to initiate the securitization.[10]

Clause (iii) could even arguably include normal-course transactions that are part of the normal rights and obligations under securitization transaction documents.

Because the type of prohibited activity or transaction is identified by a potential result rather than specifying the type of activity or transaction, we do not know how any institution could be expected to create and implement policies to assure its compliance with this rule. The issues inherent in this provision are compounded because the re-proposed rule prohibits securitization participants, which includes all of their affiliates and subsidiaries, from "directly or indirectly" engaging in these transactions, and are even further compounded by a provision that makes a circumvention of the prohibition a violation of the rule. This framework creates a violation of law even when there is no impact on the investor, no intent to violate or circumvent the law, and no certainty as to whether a transaction is a prohibited transaction for that entity at the time it was executed.

We provide specific detailed examples in subsection II.C below.

While the Commission proposes exemptions, they are narrow in scope and have significantly restrictive conditions to their applicability, as described further below in subsection II.D.

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[10] We provide more detailed examples below.

Unworkable definition of "material" provides little certainty.

The materiality qualifier in Section 621 is supposed to provide a reasonable limit to the types of conflicted transactions that would violate the rule. The Commission uses a formulation that looks to whether "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision whether to retain the asset-backed security." According to the Commission, this standard was derived from Rule 10b-5 jurisprudence, but there are a number of differences that make it far from an "explicit standard."[11]

First, when the Commission refers to a "reasonable investor," what type of investor does it mean? Presumably, it means a direct, long investor in the ABS in question – not a short investor, or an indirect long investor through a fund or an index – but the proposed standard is not clear.

Second, there is no market precedent for determining materiality in connection with anything other than the purchase or sale of a security, because neither Section 10(b) of the Exchange Act nor Rule 10b-5 (including the materiality standard from which the Commission draws) applies at any other point in time.[12] Nonetheless, the Commission asks market participants to divine what a hypothetical reasonable investor might consider important in deciding whether to retain bonds, a determination as to which there is no authority or market experience. For example, assume that an asset manager that is a securitization participant develops a more negative view on the pool assets significantly after issuance but within the one-year prohibition of the rule, and as a result it wants to short some of those positions in one of its managed funds. This short position has nothing to do with the original design of the ABS, it is based solely on changed market circumstances. Would a hypothetical reasonable investor consider the fact of the short itself important in a decision not to sell its ABS? There is no clear answer.

Third, the materiality standard proposed by the Commission was crafted by the courts specifically to identify when disclosures are inadequate, so it is very difficult to divorce from the context of the disclosures that have been made. It is entirely possible that a "reasonable investor" might fairly conclude that a "conflicted transaction" is immaterial to it if all of the risks of the ABS it is buying are fully and fairly disclosed, at least so long as the transaction was not "designed to fail." In other words, a conflicted transaction generally would have no measurable impact on the performance of the ABS unless the ABS was "designed to fail." Because the materiality test proposed by the Commission was developed to take disclosure into account but the Commission does not propose to do so, it does not provide a workable mechanism for evaluating the materiality of the broad array of activities that could fall within the definition of "conflicted transaction." It is wholly unclear how market participants are expected to thread this needle.

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[11] See Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9679.

[12] See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 732-33, 755 (1975) (noting that Section 10(b) was limited by Congress to purchases and sales of securities, and holding that private rights of action under Rule 10b-5 are also so limited).

Enormous numbers of covered securitization participants are scoped into the regulatory regime.
Clause (i) of the definition of "securitization participant" includes underwriters, placement agents and initial purchasers of the ABS in question, as well as "sponsors," and clause (ii) includes all of their affiliates and subsidiaries.

We have significant concerns surrounding the proposed definition of "sponsor."[13] Clause (i) of the definition" is consistent with the definition of "sponsor" in Item 1101(l) of Regulation AB, clause (ii) of the definition of "securitizer" in Section 941(b) of the Dodd-Frank Act,[14] and the correlative definition of "sponsor" in the credit risk retention rules adopted by the Commission and the other applicable agencies:[15] A person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.[16]

Clause (ii), however, would add a broad universe of other securitization participants to the definition including any person that "directs" or causes the "direction" of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security (referred to by the Commission as a "directing sponsor"), and any person with a contractual right to do so (referred to by the Commission as a "contractual rights sponsor"). Further, the Commission appears to believe that clause (ii) covers parties "participating in asset selection,"[17] or "with a significant role in asset selection,"[18] or with "a significant role in determining the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS."[19]

This could scope in almost anyone with any role in the structuring of a securitization. This could include non-bank broker-dealers, asset managers, insurance companies, third-party servicers, banks of all sizes, and issuers of and investors in all types of ABS, RMBS, CMBS and CLOs.[20] The Commission goes on to include all these affiliates and subsidiaries of any entity that falls within the definition of "securitization participant," which further exacerbates the breadth of the definition.

The combination of the breadth of the definitions of "conflicted transaction" and "sponsor," together with the shortcomings in the proposed materiality exception, means that it would be almost impossible for a securitization participant to know whether it is in compliance with the rule at any given point in time. For example, the re-proposed rule is so broad it may capture trades that could be correlated to the

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[13] We discuss our concerns regarding the incorporation of affiliates and subsidiaries below.
[14] As codified at 15 U.S.C. § 78o-11.
[15] The Department of the Treasury, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Department of Housing and Urban Development. *See*, *e.g.*, 12 C.F.R. § 246.2 (Commission version of risk retention rules). We cite to the Commission version of these rules in this letter for convenience.
[16] Reg. AB Item 1101(l) uses the term "issuing entity" and the credit risk retention definition uses the term "issuer," but these differences are immaterial.
[17] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9686.
[18] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9685.
[19] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9694.
[20] We provide more detailed examples below.

performance of an asset pool or an ABS only in the very loosest sense, but the proposed materiality standard would be of little help in evaluating whether such a trade is a material conflict of interest. This lack of clarity would also make it virtually impossible for a securitization participant to set up an effective compliance program designed to identify these transactions – much less prevent them. That cannot be what Congress intended.

The following are some examples of the real-world transactions that could be scoped into the currently-proposed broad definition of "conflicted transaction," even though they have little or no meaningful connection to the ABS in the examples.

1. A broker-dealer, on its fixed income side, purchases a portfolio of consumer loans that it intends to securitize. It wishes to hedge the credit risk of the portfolio while it accumulates enough receivables to securitize economically in then-current market conditions. Because there is not a more direct means of hedging the consumer loan portfolio, the broker-dealer buys equity puts and CDS protection on a variety of consumer-sensitive companies.. This strategy, while not perfectly correlated, is designed to rise in value if the value of the consumer loan portfolio declines. The broker dealer then executes the securitization. If the hedge occurs after the broker-dealer becomes a securitization participant, this could be deemed to be a conflicted transaction.

2. Three months after the closing of the securitization referred to in Example 1, the equity division of the broker dealer buys a series of equity puts on consumer companies, since its view is that consumer resilience is becoming weaker as the risk of recession increases. Again, while not perfectly correlated, these puts should rise in value if the value of the consumer loan portfolio declines. However, the equity personnel involved have no knowledge of or involvement in the securitization. Because there is no requirement of intent or design, this independent, and only loosely-correlated, transaction could be deemed to be a conflicted transaction.

3. An asset manager manages a CLO, and also manages both a fund and various accounts that trade and invest in loans. The CLO has loans to Company XYZ in its portfolio, and the fund also owns Company XYZ loans. Six months after the CLO closing, Company XYZ's credit deteriorates, so the fund sells its loan position in Company XYZ. The fund could be deemed to be an affiliate of the asset manager, and the sale might help the fund avoid a loss. Therefore, it could be deemed to be a conflicted transaction, even though the failure to sell Company XYZ's loans could be considered a breach of the asset manager's fiduciary duty.

4. A broker-dealer acts as the initial purchaser on a CLO that has loans from Company XYZ in its portfolio. In a wholly separate division, its bank affiliate, acts as agent for the Company XYZ loan. Six months after the closing of the CLO, the bank affiliate acting as agent agrees to a restructuring of the Company XYZ loan that reduces the interest rate. This reduction in

interest rate could be deemed to be a conflicted transaction because it benefits the bank in its role of agent, at the cost of a reduction in cash flow for CLO investors.

5. A broker-dealer's bank affiliate makes a loan to Company XYZ, and that loan is managed by the bank's loan portfolio management group. The broker-dealer acts as initial purchaser on a CLO that includes a Company XYZ loan. Six months after the CLO closes, the loan portfolio management group hedges its exposure to the Company XYZ loan by purchasing a CDS that references Company XYZ. This could be deemed to be a conflicted transaction because the loan portfolio group could benefit under that CDS from adverse events surrounding Company XYZ, which could adversely impact the performance of the CLO.

Narrow set of exemptions with significantly restrictive conditions.
The Commission proposes narrow transactional exceptions, including liquidity commitments, market-making activities, and risk-mitigating hedging activities. As described further below in subsection II.B., the conditions imposed by the re-proposed rule would include compliance requirements modeled primarily after the analogous Volcker Rule proprietary trading exemptions as they apply to the largest prudentially-regulated banking entities.

Taken as a whole, we do not believe that Congress intended to give the Commission the power to substantively regulate the vast business activities of the broad cross-section of business entities (many of whom are regulated by prudential authorities) that are within the scope of the re-proposed rule.

B. Volcker-Level Restrictions Including Compliance Programs Would Be Required for All Entities to Engage in Crucial Business Activities

As described above, the proposed rule sweeps broadly, both in terms of the parties it covers and the types of transactions that would be prohibited, including various vital business activities. The Commission has proposed only three narrow exceptions,[21] which include risk mitigating hedging activities, bona fide market making, and liquidity commitments. Additionally, two of the exemptions impose restrictive conditions, including extensive Volcker-level compliance requirements.

Permitted risk mitigating hedging activities are significantly restricted by stringent conditions.
Financial institutions, corporations and investors utilize hedging as a protective strategy to manage risk. As demonstrated by recent events in the banking sector, the failure to hedge against interest rate exposure amid an unpredictable and fluctuating market can have disastrous consequences. Overall, SFA members are concerned about the potential restrictions these conditions place on their ability to hedge their credit, interest rate, and other risks for themselves and their clients. The threat of overly broad

[21] While the Volcker Rule serves a different, more restrictive purpose than the re-proposed rule, it also has numerous exceptions in addition to those for market-making and risk mitigating hedging activity, including transactions where a banking entity is acting as an agent, broker or custodian, and the Volcker Rule definition of "financial instrument" carves out many types of instruments, including loans.

definitions of prohibited activities, coupled with stringent requirements for the exception, make the rule effectively unworkable.

While there is an exception for risk mitigating hedging activities, it is only available to the extent that market participants comply with three specified conditions.

The first condition is that "the activity must be designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, contracts, or other holdings of the securitization participant arising out of its securitization activities." The narrow scope of this exception, when contrasted with the breadth of the definition of "conflicted transaction," could unduly limit the hedging activities that may not "[arise] in connection with securitization activities" or are not "related to identified positions, contracts, or other holdings of the securitization participant."

It is unclear if hedging transactions that use an index will be able to avail themselves of this narrow exception. For instance, an asset manager may be deemed a "sponsor" in a securitization of commercial real estate loans by virtue of its involvement in the collateral selection process. Meanwhile, an insurance company affiliate of that asset manager has a portfolio of commercial real estate loans, and it wishes to enter into a short position to mitigate its downside risk on these loans. Would the entry into a CMBX hedge to mitigate the insurance company's commercial real estate exposure be considered to "arise in connection with securitization activities" related to the CMBS in question? **SFA members believe that a short position on an index that is independently administered and commercially available or an index that does not reference a significant a portion of the assets underlying the ABS and is not composed to a significant degree of the ABS in question is fundamentally different than "betting against" that ABS.**

To reiterate, transactions that merely hedge risks (including, but not limited to interest rate risk, foreign exchange risk, and other risks apart from the credit risk of an ABS), do not appear to pose the problems that Section 621 was intended to address. Neither do transactions that hedge against an index that is not composed to a significant degree of the ABS in question. It is not clear why these uncontroversial activities should be scoped into the re-proposed rules, or alternatively, why they should be burdened by the extensive requirements for the proposed risk-mitigating hedging activities exception.[22]

The second condition for risk mitigating hedging activity indicates that all hedging activity would be subject to "ongoing recalibration to ensure that the hedging activity satisfies the requirements" and "does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk-reduction." This provision further places restrictions on how a market participant can manage hedges for itself and its clients, seeming to imply that market participants may need to reduce their hedges over time and across all entities even when the hedges are unrelated securitization activities. For example, in the CMBX example detailed above would the insurance company need to reduce its hedges on the

[22] The Commission recognizes these types of transactions are acceptable in the risk retention rule and do not misalign a risk retention holder's obligation to maintain skin-in-the-game by using them as hedges. The Commission reached a similar conclusion in excepting these types of transactions from the prohibition on hedging ABS interests required to be retained under the credit risk retention rules.[22] *See* 17 CFR § 246.12(d)(2).

commercial real estate loan portfolio based upon amortization of CMBS owned by its asset manager affiliate?

The third and final condition requires the securitization participant to implement a compliance program to ensure it is abiding by the standards of permitted risk mitigating hedging activities. The requirement is primarily modeled after the Volcker Rule proprietary trading exemptions which apply to the largest prudentially regulated banking entities.[23] This too is acknowledged by the Commission in the proposal: "certain of the proposed conditions to the proposed risk-mitigating hedging activities exception are similar to those that are applicable to the equivalent exception to the Volcker Rule's proprietary trading prohibition." [24] Both the design and recalibration requirements are similar to requirements that apply to all banking entities under the Volcker Rule,[25] while only banking entities with "significant trading assets and liabilities" are subject to the compliance program requirement.[26] However, under the re-proposed, rule, all securitization participants, banking entities or not, and regardless of their size, including investors as well as entities such as affiliates and subsidiaries that have no connection to securitizations, will need to institute similar internal compliance programs, even though they might not easily be able to identify the conflicted transactions that are supposed to be the subject of these compliance programs.
We note the conceptual difficulty of applying Volcker Rule concepts to non-banks. The analogous exceptions from the Volcker Rule apply to its prohibition on proprietary trading, as it was Congress' goal to limit banking entities' involvement in trading activity. **However, limiting the ability to make routine trades for all of the types of entities that the Commission proposes to scope into the conflicts of interest rule was not with Congress' intent in adopting Section 621.** To the contrary, trading in ABS is the primary focus of the business of asset managers and other investors who may be subject to the rule. Requiring them to comply with a set of conditions that is designed to limit their trading activities as a condition to allowing them to participate in a significant manner in ABS offerings is a non-sequitur and is not supportable under Section 621. Ultimately, this burdensome condition has the potential to create unintended consequences for the market at large.

SFA is still working with its members to assess the potential impact and quantify the cost of developing these types of compliance programs. According to one member bank, it cost $80 million to develop just the technology and infrastructure program needed to implement a Volcker Rule compliance program for the applicable banking entity. While SFA and our members are still carefully assessing the Economic Analysis section of the re-proposed rule at Section III.D.2, our initial assessment is the analysis significantly understates the costs and the economic feasibility for all securitization participants. **SFA and its members are concerned about what this means for future market participation.** For instance, if an asset manager needs to invest significant resources to fund a new compliance program that impacts its entire business in order to participate in the ABS market, it may choose to reduce its activity in or leave the ABS market entirely. Even if it chooses to stay in the ABS business, it likely will seek to be compensated for the increased costs which could trickle down to clients. From our perspective, the re-

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[23] *See* 17 C.F.R. § 255.5(b).
[24] *See* Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9703.
[25] *See* 17 C.F.R. §§ 255.5(b)(1)(ii)(B) and (D)(3) (banking entities with significant trading assets and liabilities), 255.5(b)(2)(i) and (ii) (banking entities without significant trading assets and liabilities).
[26] *See* 17 C.F.R. §§ 255.5(b)(1)(i).

proposed rule overestimates the benefits of these requirements, while implicitly underestimating the costs of a compliance program necessary for a securitization participant to utilize exemptions, including how those costs would be borne by the very parties the rule is seeking to protect.

We have reviewed the letter submitted by the International Association of Credit Portfolio Managers (the "IACPM"), dated March 27, 2023. We share the concerns raised by the IACPM in how the narrow risk mitigating exceptions will impact bank credit portfolio managers.

Conditions to permitted market-making activities would substantially increase costs for broker-dealers and other market-makers

The second exception provided in the re-proposed rule is for market-making, which is important not only to the issuers of and investors in ABS and the broker-dealers who facilitate those markets, but also to those who make markets in certain types of receivables that are routinely bought and sold. In proposing an exception to allow this important business activity, the Commission has also imposed restrictive conditions. The Commission "draw[s] from the concept of market-making in . . . the Volcker Rule.[27]" The "routinely stands ready," "designed not to exceed" and compensation requirements are similar to requirements that apply to all banking entities under the Volcker Rule,[28] while only banking entities with "significant trading assets and liabilities" are subject to an analogous compliance program requirement. [29]

Some securitization participants, including larger broker-dealers that make markets in ABS, are banking entities. For them, the proposed requirements will be familiar. We see the superficial appeal of applying a Volcker Rule-like framework to these entities, though the variations in the rules mean that existing Volcker Rule compliance programs will have to create parallel, and slightly different, compliance programs, and banking entities without significant trading assets and liabilities that are not subject to Volcker Rule would be required to create and implement compliance programs.[30]

In summary, there is a broad universe of securitization participants that are not banking entities, including non-bank broker-dealers, investors, asset managers, insurance companies, reinsurance companies, and many types of operating companies. Some of these entities are prudentially regulated by one or more state or federal regulators. Congress' straightforward prohibition in Section 621 was generated by objections to a small number of trades more than a decade ago, which, to the best of our knowledge, no longer occur. But as a result of this re-proposed rule, a vast number of entities would be subject to intrusive internal regulation by the Commission as a condition to being able to effectively manage the risks on their balance sheets, or to engage in routine market-making activities. This result is directly contrary to the goals of the related prudential regulators. **While our members are still carefully completing their assessment of the viability and costs of these exemption conditions, it is questionable whether the scope of the exceptions and the conditions proposed by the Commission are appropriate, workable or cost-effective.**

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[27] *See* Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9703.
[28] 17 C.F.R. §§ 255.4 (b)(2)(i), (ii) and (v).
[29] 17 C.F.R. § 255.4(b)(2)(iii). Those larger banking entities also are subject to other requirements.
[30] This assumes that "conflicted transactions" can actually be tracked, which as discussed above would pose its own problems.

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C. Examples of the Broad Scope of the Re-Proposed Rule

Our members agree that the re-proposed rule could extend to cover a wide-ranging group of market participants and an almost endless list of vital risk-mitigating, financing and liquidity tools, as well as investment functions. Below are just a few examples of critical participants and transactions that would be scoped into the re-proposed rule.

The following market participants could be scoped into the rule:

ABS Investors
The Commission implies that "long" investors[31] in the ABS could be considered sponsors under clause (iii) in some circumstances. Investors are intimately involved in the creation and issuance of ABS. Such investors are frequently involved in structuring the ABS and in reviewing the underlying asset pool. Investors frequently receive loan files, loan data, diligence results, and ABS informational and computational materials. Investors may specify a certain rating, yield or maturity, or require subordination, collateral enhancement, or a specific structure. Some securities are created and structured specifically in accordance with investor direction, for example, targeted amortization class bonds. Securitizations are often structured through an iterative negotiation process between deal participants and investors. And yet, if their participation would result in being scoped into the prohibitions of the rule and being identified as a "sponsor" of the ABS for purposes of the re-proposed rule, investors would be forced into implementing Volcker Rule-level compliance programs designed to prevent proprietary trading, in order to execute normal risk mitigation and trading functions (for which they may not even be eligible).

The re-proposed rule could perversely discourage long investors from actively participating in discussions regarding the deal structure and asset pools underlying an ABS, and consequently to be less involved and less informed about the transaction, in order to avoid being scoped into the definition of "sponsor" and encountering all the impediments to regular business activities that come with it.

Section 621 was intended to protect investors from the nefarious activities of others, not to subject them to a restrictive regulatory regime. Even if Congress meant for a "sponsor" under Section 621 to mean more than the traditional Reg. AB/risk retention sponsor, characterizing a long investor a "sponsor" is counterintuitive at best – they are discrete and separate roles, and are otherwise generally recognized as such.

Servicers
Many servicers' roles are ministerial in the same manner as the lawyers, accountants, rating agencies, trustees, custodians, paying agents and calculation agents that the re-proposed rule excludes. For example, a primary servicer is typically only responsible for billing and collections services, so our

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[31] Meaning investors acting with the intention to buy long-positions.

membership does not believe they should be scoped into the prohibitions of the rule, with all that entails. This is especially important as primary servicers play a critical role in the mortgage, consumer loan and small business loan sector. As such, unnecessarily raising their regulatory risk and the associated costs should be carefully considered.

Underwriting syndicate members who are not involved in asset selection or structural design
With respect to the definitions of "underwriter," "initial purchaser" and "placement agent," not every participant in these roles is involved in the selection of assets or structuring the ABS. For example, co-managers rely to a great extent on the lead managers in connection with the offering, including structuring the ABS to meet the needs of investors and assisting the sponsor in selection of the asset pool. Typical co-managers have very limited involvement in those types of activities –*i.e.*, they are not "assembling" or "packaging" ABS.

Affiliates and Subsidiaries
The re-proposed rule would classify all affiliates and subsidiaries of a sponsor, an underwriter, a placement agent, or an initial purchaser as securitization participants, and therefore primary obligors under the prohibition.

Many underwriters, placement agents, initial purchasers and sponsors of securitizations are parts of some of the largest banking, corporate and investment management organizations in the world. Imposing the requirements of the rule directly on all of those affiliates and subsidiaries would create an immense regulatory compliance challenge under the rule as re-proposed. In our view, this would create a prohibition that is far more sweeping than is necessary to achieve the objectives of Section 621, a prototypical example of the type of "hid[ing] elephants in mouseholes"[32] that is prohibited by Supreme Court precedent.

We acknowledge that the statute mandates coverage of affiliates and subsidiaries of an underwriter, placement agent, initial purchaser or sponsor, but that does not mean they need to be regulated in the same manner as securitization participants. We agree with the Commission that a securitization participant should not be able to "[direct], either directly or through one or more intermediaries, an affiliate or subsidiary to enter into such a bet against the relevant ABS."[33] But as acknowledged by the Commission, this is to "help to prevent affiliates and subsidiaries from being used to evade the rule's prohibitions" by underwriters, placement agents, initial purchasers and sponsors. Affiliates and subsidiaries are called out in the statute because Congress did not wish for underwriters, placement agents, initial purchasers and sponsors to be able to do indirectly, by means of affiliates and subsidiaries, what they are prohibited from doing directly.

Affiliates and subsidiaries are not "securitization participants," and should be deleted from that definition. Of course, a blunt instrument of a rule would be easier to enforce, because it sweeps in more entities and more conduct. We believe a better approach to addressing this type of conduct would be to treat it as an evasion of the prohibition of Section 621. The very real and justifiable

[32] *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001).
[33] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9690.

concerns regarding potential evasion of the rule through the indirect use of affiliates and subsidiaries should properly be dealt with through the anti-circumvention provision, which is expressly intended to deal with this kind of evasion.

For reasons highlighted by recent events, we believe the Commission should not limit tools that allow institutions including investors, insurance companies and banks to manage their interest rate and credit risk in the most efficient manner. This is particularly important during periods of market volatility. Preserving risk mitigation activities[34] should take precedence over the remote risk that a bad actor can find a means to circumvent an otherwise tightly structured regulatory regime. Importantly, nefarious actions will be captured by the anti-evasion rule and other enforcement tools the Commission has available to it; the Commission does not have to impede or effectively prohibit legitimate, commercial activities.

The following activities could be scoped into the rule*:*

Interest rate, foreign exchange and other non-credit related hedging
The value of fixed-rate financial assets including ABS and the underlying asset pool decrease when interest rates rise. Therefore, any interest rate hedge entered into by a securitization participant, or its affiliates could be scoped into the definition of "conflicted transactions." For example, an auto manufacturer may seek to hedge its interest rate risk or exposure to consumer credit risk. The re-proposed rule should not consider these hedges "conflicted transactions" if their auto finance subsidiary issues an ABS, even though these hedges can increase in value when the ABS decreases in value. These transactions are integral to basic, crucial risk management practices as demonstrated by the recent bank failures.

Transactions for clients, including those under a fiduciary relationship
Many securitization participants, including asset managers and investment advisers, may have fiduciary duties to their clients and customers. A transaction that is considered a "conflicted transaction" with respect to an ABS, could be beneficial to a client or customer to whom a securitization participant has fiduciary duty. Not allowing such a securitization participant to execute such a transaction could cause it to violate its fiduciary duties imposed by law.

For example, in the context of an asset manager, the definition of "securitization participant" is so broad that it could include the very investors the re-proposed rule is intended to protect, thereby leading to the potential to impede or prohibit the asset manager's fiduciary responsibilities across its various clients/funds. Take, for instance, an asset manager that may be considered a "securitization participant" in its role as a long investor to ABS sponsored by a monoline, as to which it provides input into the selection of the collateral. If within one year thereafter, a separate portfolio manager at the same asset management firm desires to short the monoline finance company's stock on behalf of a long-short equity fund it manages, that short could be considered a "conflicted transaction." This

[34] We acknowledge that sponsors subject to the risk retention rules are already subject to prohibitions on credit-risk hedging. However, as drafted, the re-proposed rule's prohibition goes beyond the scope of the prohibition in the risk retention rules.

appears true even if each trade were executed by a separate portfolio manager and for a separate client to whom the manager owes a separate fiduciary duty.[35]

“Warehouse” financing of pool assets and sales of pool assets into a securitization
Receivables, whether they are originated by the sponsor or acquired from third parties, usually must be temporarily financed in a “warehouse” financing until they can be sold, or more permanently financed in a securitization. The payoff of the warehouse facility from the proceeds of the securitization, and the release of the receivables from the facility, could each be considered a conflicted transaction, because to the extent the receivables decrease in value post-payoff the warehouse lender may have benefitted from the securitization take-out. Similarly, the pool assets need to be sold or otherwise transferred into the securitization vehicle for a securitization to occur. There may be multiple steps in these transfers that involve securitization participants – for example, from the warehouse lender to the sponsor to the depositor to the issuing entity. Each such transaction could be considered as a conflict of interest because the lender or prior owner may be considered to have avoided a loss to the extent the receivables do not perform as expected. These are routine but vital securitization activities that do not address the concerns behind Section 621, and as to which the legislative history mandates non-interference. Moreover, this is consistent with the position the Commission expressed in the 2011 proposing release with regard to these types of transactions:

We believe that activities associated with the typical structuring of a non-synthetic ABS would not be prohibited by the proposed rule. For example, the basic transfer of risk in a non-synthetic ABS in which a securitization participant who is long the underlying assets sells them to an SPV 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.[36]

Financing of ABS
Investors often finance the ABS they acquire. In many instances, institutions involved in the securitization are best suited to provide that financing, because of their detailed understanding of the structure and the pool assets. Such transactions usually are structured as repurchase transactions, though they may also take other forms such as secured loans or total return swaps. Numerous routine activities that may take place in such a financing could be considered conflicted transactions. For example, in a repurchase transaction, the repurchase buyer (lender) has the right to protect its

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[35] In this example, it is important to note that the two portfolio managers’ fiduciary responsibilities would prevent them from colluding to avoid the rule (*i.e.*, they could not force one fund to absorb losses on the long positions so that a second fund could benefit from short positions on the same ABS. *See*, *e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248, 84 Fed. Reg. 33669, 33676 (July 12, 2019) (discussing an investment adviser’s fiduciary duty of loyalty, including for addressing conflicts between clients and associated obligation to disclose “how the adviser will manage conflicts between clients if and when they arise”).
[36] Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Release No. Release No. 34–65355, 76 Fed. Reg. 60320, 60340 (Sept. 28, 2011).

level of collateralization through the "borrowing base" mechanics by marking the ABS to market. When it does so in a declining market, it often will make a "margin call" on the repurchase seller (borrower) for additional cash or collateral. This activity clearly is related to the decline in the value of the ABS and is intended for the lender to avoid a loss. Nevertheless, this type of activity is both expected and inherent in routine securities financing activity, and does not serve as any kind of incentive for the lender or repurchase buyer to design the transaction to fail.

Mortgage Insurance-Linked Notes ("MILNs")
Private mortgage insurance protects lenders from a portion of default related losses on a covered mortgage and plays a central role in providing credit risk mitigation to the Fannie Mae and Freddie Mac (the "Enterprises") and the housing market. The statutory charters of the Enterprises require low down payment mortgages, which carry a higher risk of loss, to include credit enhancements such as mortgage insurance from a qualified insurer. Overall, mortgage insurance benefits the Enterprises – and therefore taxpayers – because private mortgage insurance absorbs potential losses before the Enterprises.

Reinsurance enables mortgage insurers to remain financially strong counterparties to the Enterprises in stressed economic environments.[37] Most mortgage insurance companies purchase reinsurance from a combination of "traditional reinsurers" (i.e., in direct counterparty transactions with rated reinsurers) and through capital markets structures (such as MILNs) as a way to manage concentrated risk aggregations, provide protection against elevated losses, and to enhance their capital position. In a typical MILN structure, investors purchase securities issued by a licensed special purpose insurer that simultaneously enters into a reinsurance agreement with the mortgage insurance company. MILN structures mitigate adverse selection risk by reinsuring all or virtually all of the ceding insurer's mortgage insurance policies originated during a specified coverage period that satisfy stated eligibility criteria. Mortgage insurance companies are subject to regulation by state insurance laws, as well as oversight by the Enterprises, and have to comply with capital requirements and other metrics.

An insurer buys reinsurance to protect itself against losses under the original insurance policy. MILNs are structured so that the insurer is only entitled to recover its actual loss above a pre-defined point, similar to a deductible in an insurance policy. Because of the significant retained risk exposure and the requirement to maintain an insurable interest, the mortgage insurer maintains a strong alignment of interest with MILN investors to underwrite insurance on high quality loans and mitigate losses through a robust claims process. The mortgage insurer never benefits from the adverse performance of a mortgage insurance pool. Rather, the MILN is a prudent risk management tool that helps to mitigate losses under more extreme actuarial loss scenarios affecting the insurer's policies. We are concerned that the broad, ambiguous re-proposed rule, together with statements in the proposing release, suggest that a reinsurance agreement within a MILN may be impacted.

Portfolio/whole loan sales

[37] Reinsurance arrangements have been viewed by the SEC as distinguishable from derivatives subject to regulation under the Commodity Exchange Act by identifying certain insurance contracts (including reinsurance with respect to certain products) as a specific exclusion from the definition of "swap."

In order to form an ABS, the underlying financial assets must come from somewhere. When the sponsor of an ABS transaction is also the originator, the assets usually are sold to a depositor and then by that depositor into the issuing entity. However, pool assets may also be purchased from a third-party originator or owner before they are sold into the securitization structure. Under the proposed definition of "conflicted transaction," the sale of pool assets by a third-party seller (e.g., sellers/originators that are unaffiliated with the sponsor/depositor), or by the sponsor or depositor, into the securitization structure could be considered to cause the seller to benefit from the "actual, anticipated or potential adverse performance of the asset pool." These are routine, necessary capital markets functions, which logically cannot be prohibited by the rule, because the intent of Section 621 was not to prohibit securitization altogether. It is also critical to corporations seeking to divest assets to raise capital or exit businesses because their purchasers can use securitization to finance their acquisition of the assets. It is also consistent with the position taken by the Commission in the 2011 proposing release and referenced above.

Securitization transaction parties exercising contractual rights or performing contractual duties
Securitization transaction documents allocate rights and obligations to various participants in a securitization transaction. A broad reading of clause (iii) of the definition of "conflicted transaction," the uncertainty regarding the materiality standard, and the refusal to carve out integral transactions to the securitization[38] all call into question the exercise of rights under the transaction documents themselves, such as the right to amend the securitization documents by the transaction parties, the right to terminate the servicer or the right to purchase defaulted assets. Similarly, the performance of certain contractual obligations could also be called into question. The purpose of the transaction documents is to define the rights and remedies of the transaction parties and investors. Yet, the text of the proposing release and the re-proposed rule are so broad they could render certain rights and remedies, which form the very basis of the investors' investment, non-operational. Section 621 in no way requires the SEC to fundamentally upend the securitization process, and legislative history does not support such an interpretation. Moreover, the proposing release includes no economic analysis that addresses the potential wholesale analysis that could be required of market participants (including investors) if the re-proposed rules were adopted. The layering that results from blurring the lines that distinguish "sponsors" from investors, coupled with the breadth of "conflicted transaction," may undercut investors' rights in ABS transactions.

Offshore activities and transactions
At present, the re-proposed rule gives no indication of the Commission's views as to its extraterritorial application. The financial markets are global. Many participants in the U.S. ABS markets are parts of large institutions with affiliates and subsidiaries worldwide. In order for them to

[38] "We received comment to the 2011 proposed rule that the scope of prohibited transactions should be limited to transactions other than those that are an integral part of the creation and sale of the relevant ABS. We are not including such a standard in the re-proposed rule … [A]ny transaction that the securitization participant enters into with respect to the creation or sale of such ABS (*e.g.*, a transaction whereby a securitization participant takes the short position in connection with the creation of a synthetic ABS) would need to be analyzed to determine if it would be a ''conflicted transaction'' under the re-proposed rule." *See* Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, at 9695.

be able to comply effectively with the rule, there needs to be a clear safe harbor for activities and transactions that do not fall within the jurisdictional limit of the United States – or at least, as noted by the Commission and the other agencies that adopted the risk retention rules, "to provide clarity that the agencies will not apply the requirements of the final rule to transactions that meet all of the conditions of the safe harbor."[39]

Synthetic securitizations

A definition of synthetic securitization needs to be added. What constitutes a synthetic securitization is unclear, and there is no commonly-understood meaning of the term among market participants. While the proposed rule includes both cash securitizations as well as synthetic securitizations in the definition of asset backed security, the term "synthetic securitization" is not defined. However, the Commission described a "synthetic securitization" as "securitizations that are designed to create exposure to an asset that is not transferred to or otherwise part the asset pool."[40] The Commission believes that no definition is necessary since the Commission's "descriptions of synthetic securitizations are well understood by market participants . . . that market participants have been able to readily distinguish synthetic ABS from other types of transactions."[41] The Commission also states that it is "concerned that any particular definition of 'synthetic ABS' that we might propose would be susceptible to potential over-inclusiveness or under-inclusiveness" and "that a securitization participant might attempt to evade the re-proposed rule's prohibition by structuring such transactions around any particular definition. . . , which would weaken the re-proposed rule's conflict of interest protection for investors."[42]

The Commission rejects the idea of a "a catch-all provision to cover any product that functions as the economic equivalent of a cash ABS, synthetic ABS, or hybrid ABS" since "[a] security that functions as the economic equivalent of a cash ABS, synthetic ABS, or hybrid ABS, as contemplated by these comments, should already meet the re-proposed rule's definition of ABS".[43]

According to the Commission, "synthetic transactions are generally effectuated through the use of derivatives such as a CDS or a total return swap, or an ABS structure that replicates the terms of such a swap," [44] and describes a synthetic securitization as a lender "purchasing a CDS contract from the special purpose entity that issues a synthetic ABS."[45]

Based on these statements, we believe that the Commission intended to scope into the definition of synthetic securitizations only those transactions involving traditional ABS features such as asset remoteness and special purpose vehicles issuing securities backed by credit derivatives, not other forms of credit risk transfers ("CRT") involving insurance-, corporate-, or bank-issued securities or

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[39] Risk Retention Adopting Release, 79 Fed. Reg. 77601, 77668 n. 215.
[40] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9681.
[41] *Id*.
[42] *Id.*
[43] *Id.*
[44] *Id*.
[45] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9682.

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instruments (i.e., bank-issued credit-linked notes ("CLNs"), insurance contracts, security based swaps, and guarantees, or unsecured and unguaranteed debt obligations issued by the Enterprises. But without an explicit definition of "synthetic," the re-proposed rule itself is unclear.

Risk mitigating synthetic securitizations

We do not believe that balance sheet synthetic securitizations used for risk mitigation purposes should be per se prohibited as a conflicted transaction or excluded from the risk mitigating hedging exemption. However, the re-proposed rule "prohibits a securitization participant from creating and/or selling a new synthetic ABS to hedge a position or holding."[46] We do not understand why the Commission would prohibit synthetic securitizations that are used for mitigating balance sheet risk. Synthetic securitizations are one form of CRT that banks, insurance companies, and corporations use to manage risk. Economically, synthetic securitizations used for risk mitigating purposes are the same as the other forms of CRT, but have the added benefit of not subjecting investor principal repayment to the credit risk of a sponsor. Therefore, we believe a synthetic securitization that bases payments to investors on the performance of a reference pool to cash assets held on a securitization participant's balance sheet should be included as a valid risk mitigating hedge and not per se prohibited as a conflicted transaction.[47]

Drawing the proper boundaries is an achievable exercise that provides significant benefit to market participants, and the Commission should not shy away from it. A sensible definition for such transactions could be created and does not appear to us to create any particular loopholes, especially with appropriate anti-evasion provisions. These transactions typically involve only very sophisticated investors, and the investors in these transactions may have significant involvement in the selection of the reference assets.

As noted above, maintaining the ability to conduct risk mitigation activities should take precedence over the very remote risk that a bad actor can find a means to circumvent a tightly structured regulatory regime. If the Commission intends to limit or eliminate synthetic securitizations, then its rulemaking needs to address this directly, including the costs and impact on capital formation and on the goals of prudential regulators. A cursory statement, solely in connection with the Enterprises, that the rule "may increase frictions in . . . the Enterprise ABS or CRT processes, perhaps increasing costs for U.S. mortgage borrowers or limiting the transfer of credit risk to investors," is wholly insufficient to justify such a sweeping change. A proper risk/reward analysis needs to be made.

Enterprise credit risk transfer transactions

The above arguments apply equally to what the Commission refers to as the "Enterprises' security - based credit risk transfer (CRT) transactions." It is hard to emphasize enough the importance of Enterprise CRT to the stability of the housing market and the ability for the Enterprises to manage their risk. According to their regulator, Federal Housing Finance Agency, "the credit risk transfer (CRT) programs . . . were established to reduce taxpayer exposure" and that "[it has] become a core part of

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[46] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9700.
[47] *Id*., at n. 133

the Enterprises' single-family guarantee business."[48] Since 2013, Fannie Mae and Freddie Mac have transferred a combined $197 billion in single-family risk to private market participants.[49]

As proposed, the Enterprises would be exempted from the definition of "sponsor" with respect to the guaranteed mortgage-backed securities for so long as they remain in conservatorship. The Commission also appears to believe that perhaps there should be an exemption from the definition of "asset-backed security" (as opposed to an exclusion from the definition of "sponsor") for ABS that are fully insured or fully guaranteed as to the timely payment of principal and interest by the Enterprises while in conservatorship. However, the broad wording of the rule leaves ambiguity as to whether a risk transfer transaction entered into by an issuer special purpose vehicle ("SPV") in connection with the issuance of Enterprise CRT would be permitted. Enterprise CRT in its current form may not be able to continue without clarification.

For these reasons, there should not be a per se prohibition on Enterprise CRT, whether or not the Enterprises are in conservatorship.

D. The Re-Proposed Rule Would Impede or Prohibit Critical Activities that Congress Mandated the Commission to Protect

In light of our preliminary analysis of the vast impact the re-proposed rule would have on a wide swath of entities, we revisit the exhortation of Sen. Levin for the Commission "to define the contours of the rule in such a way as to remove the vast majority of conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets."[50] The Commission asserts that the re-proposal "targets transactions that effectively represent a bet against a securitization"[51] by "provid[ing] an explicit standard for determining which types of transactions would be prohibited, . . . while not unnecessarily hindering routine securitization activities that do not give rise to the risks that Section [621] was intended to address."[52] Unfortunately, the Commission has missed that target by a wide margin.

As a condition to participation in the securitization process, the re-proposal would arguably impose an expansive, overly burdensome regulatory regime that would impede the participant's ability to appropriately hedge risks, including uncontroversial interest rate and currency hedging. More crucially, it could threaten the returns, capital, liquidity and even solvency of the vast universe of operating companies and financial institutions that would be scoped in as "securitization participants," as well as the clients of those securitization participants. Moreover, the far-reaching effects of the re-proposed rule are not fully addressed in the economic analysis, which seems to only address a rule that would prohibit shorting and credit default swaps on ABS. The rule should be clear about what it requires, and should not impede routine securitization, capital markets or operating activities.

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[48] FHFA, Credit Risk Transfer Policy, *available at* https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Credit-Risk-Transfer.aspx.
[49] Compilation of Fannie Mae and Freddie Mac.
[50] 56 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).
[51] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9679.
[52] *Id*.

Section III. The Commission Has the Regulatory Authority to Strike the Balance Mandated by Congress

Although the Commission "must give effect to the unambiguously expressed intent of Congress,"[53] there are many instances where "Congress has not directly addressed the precise question at issue, [and] the statute is silent or ambiguous with respect to the specific issue, the question,"[54] and it is acceptable, and at times necessary, for the Commission to exercise its regulatory flexibility to craft a workable rule. We believe that the Commission should use its discretion to craft a workable conflicts of interest rule that is tailored to follow the unambiguous language of Section 621 but avoids prohibiting or significantly impeding broad swaths of routine and vital market activities.

An effective securitization conflicts of interest rule must prohibit the "bets" that were the focus of Congress. But, as acknowledged by the Commission, it must avoid "unnecessarily prohibiting or restricting activities routinely undertaken in connection with the securitization process, as well as routine transactions in the types of financial assets underlying covered securitizations.[55] In that regard, it must ensure that routine, expected – and vital – securitization activities, including the issuance of ABS, are not unduly restricted. It also must not sweep in market or commercial activities that do not have anything to do with the securitization process, or even the ABS markets more broadly.

A securitization participant must be able to know whether a compliance program, once established, complies with the rule. A targeted prohibition such as Section 621 cannot be interpreted so broadly as to become the organizing principle for risk management, market-making and financing activities for a wide swath of market participants, many of whom already are subject to prudential regulation by other agencies (such as federal or state banking regulators or state insurance commissions), and some of whom are not subject to prudential regulation at all. Congress clearly did not hide those enormous regulatory "elephants" anywhere in the tiny "mousehole" of Section 621 – the overall impact of the rule as a whole is neither permissible nor reasonable.

In some respects, the Commission asserts that its authority as to specific matters is limited by the text of Section 621 in ways that are not "unambiguously expressed" by Congress in Section 621. The most important example lies in the Commission's definition of "conflicted transaction." Section 621 simply uses the term "material conflict of interest," but clause (iii) of the definition of "conflicted transaction" includes:

> (iii) The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated or potential:

[53] *See Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc.,* 467 U.S. 837, 842-43 (1984) (footnoted omitted).
[54] *Id*.
[55] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9694.

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(A) Adverse performance of the asset pool supporting or referenced by the relevant asset-backed security;

(B) Loss of principal, monetary default, or early amortization event on the relevant asset-backed security; or

(C) Decline in the market value of the relevant asset-backed security.

The only limitation on clause (iii) is the Commission's proposed materiality test - if "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision." The Commission believes that this is an "explicit standard,"[56] but it is not. It is entirely possible that a "reasonable investor" might fairly conclude that a "conflicted transaction" under clause (iii) is immaterial if all of the material risks of the ABS it is buying are fully and fairly disclosed, even without specific disclosure of that conflicted transaction. In other words, a clause (iii) "conflicted transaction" generally would have no impact on the measurable performance of the relevant ABS unless the ABS was "designed to fail." On the other hand, clause (iii) of the re-proposed rule is written to describe various characteristics of potentially conflicted transactions but doesn't provide any mechanism for evaluating their impact on investors or ABS performance. It is unclear how market participants are expected to thread this needle.[57]

If the Commission added an element of intent in clause (iii), which it has the authority to do, that addition would help to narrow its application to the types of transactions that Congress intended to prohibit.[58] But the Commission states that would be outside its scope of authority:

> We believe that the proposed definition of "material conflict of interest" in the re- proposed rule is consistent with Section [621], which is not limited only to ABS that are intentionally designed to fail.[59]

In other words, the Commission feels constrained by the text of Section 621 to adopt a broad, per se prohibition that does not take the intent of a securitization participant into account in any way, despite multiple statements in the legislative history making it clear that the focus was on prohibiting the sales of ABS that were "designed to fail," a formulation that clearly would take intent into account.[60]

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[56] *See* Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9679.
[57] *See* Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9697 (Request for Comment 44).
[58] As with the rest of the problems we have identified with the re-proposed rule, we intend to address this further in our follow-up letter.
[59] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9698.
[60] "The intent of section 621 is to prohibit underwriters, sponsors, and others who assemble [ABS], from packaging and selling those securities and profiting from the securities' failures. [T]he sponsors and underwriters of the [ABS] are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail. They . . . would know if the vehicle has been designed to fail. And so they must be prevented from

In another example, a nuanced, targeted disclosure exemption for certain types of uncontroversial conflicts could help to narrow the application of clause (iii) to the types of transactions that Congress intended to prohibit. But the Commission also believes that even such a narrow disclosure exemption is not in its power:

> [A] disclosure-based exception to the re-proposed rule would fail to align with Section [621] given that the proposed prohibition would apply for one year after the date of the first closing of the sale of the relevant ABS.[61]

The Commission "believe[s] that . . . disclosure would be insufficient . . . as the . . . rule is designed to prevent the sale of ABS that are tainted by material conflicts of interest by prohibiting a securitization participant from entering into a conflicted transaction with respect to ABS that it creates or sells to investors.[62] This rationale is circular. The question is, what is a "material" conflict of interest in this circumstance, and should disclosure have any impact on that characterization?

Congress did not specifically mention either intent or disclosure in the statute. The phrase "any transaction that would involve or result in any material conflict of interest" is not unambiguous in prohibiting the consideration of intent or disclosure in what constitutes a material conflict of interest – it is silent on those matters. Congress' failure to explicitly mention intent and disclosure does not prohibit the Commission from taking them into account in defining what constitutes a material conflict of interest, particularly in light of multiple statements in the legislative history indicating the contrary. The Commission should properly consider the roles of both intent and disclosure in promulgating a final rule and should not dismiss them entirely because it misconstrues its authority. Furthermore, the approach we recommend is consistent with the general thrust of the securities laws in a way that the Commission's interpretation is not.

Furthermore, we believe it is important that the scope of securitization participants encompassed by the rule include only those parties whose nefarious activities could pose the types of problems envisioned by Congress when it enacted the rule, who bet against securities they designed to fail and sold to investors. There is no unambiguous language in Section 621 that prohibits the Commission from adopting a final rule with such a scope. But as described above, clause (iii) of the definition of "sponsor" appears much wider than that, including directing sponsors and contractual rights sponsors. Even more broadly, the

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securing handsome reward for designing and selling malfunctioning vehicles that undermine the [ABS] markets." "The conflicts of interest provision under Section 621 arises directly from . . . how some firms were creating financial products, selling those products to customers, and betting against those same products. . . . In the [ABS] context, the sponsors and underwriters of the [ABS] are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail. . . . [T]hey must be prevented from securing handsome rewards for designing and selling malfunctioning vehicles that undermine the [ABS] markets. 56 Cong. Rec. S5899, S5901 (daily ed. July 15, 2010) (statements of Sen. Levin).

[61] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9697.

[62] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9695.

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Commission appears to equate the term "directs" to include parties "participating in asset selection,"[63] or "with a significant role in asset selection"[64] or with "a significant role in determining the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS."[65]

The question, of course, is what Congress meant when it used the term "sponsor" in Section 621. According to the Commission, its expansion of the term "sponsor" is not limited by the definition in Regulation AB:

> [T] he Regulation AB definition of "sponsor was adopted for the limited purpose and scope applicable only to those ABS eligible for registration under Regulation AB, and would not be appropriate to cover the full range of ABS that would be covered by the re-proposed rule, including those that are unregistered.[66]

This is a mischaracterization. The definition of "sponsor" in Reg. AB was not crafted by the Commission for some limited purpose. Rather, the Commission adopted the commonly understood definition as used in the markets prior to the rule,[67] which also is consistent with Section 941 of the Dodd-Frank Act, the basis for the definition of "sponsor" in the credit risk retention rules.[68] Congress would have had that in mind when applying Section 621 to "sponsors."[69]

SFA does not intend to take the position that the Commission should be strictly limited to the commonly understood industry and prior regulatory usage of the term "sponsor." As noted above, we believe the

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[63] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9686.
[64] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9685.
[65] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9694.
[66] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9685.
[67] The term "sponsor" had a commonly-accepted meaning in the securitization industry long before Reg. AB, which was acknowledged by the Commission in the original rule proposal: "A sponsor typically initiates a securitization transaction by selling or pledging to a specially created issuing entity a group of financial assets that the sponsor either has originated itself or has purchased in the secondary market. . . . . While "sponsor" is a commonly used term for the entity that initiates the asset-backed securities transaction, the terms 'seller' or 'originator' also are often used in the market. However, as noted in the text, in some instances the sponsor is not the originator of the financial assets but has purchased them in the secondary market. Hence, we use the term 'sponsor.'" Asset-Backed Securities, Securities Act Release No. 33-8419, 69 Fed. Reg. 26,560 (May 13, 2004).
[68] "The . . . second prong of this definition is substantially identical to the definition of a ''sponsor'' of a securitization transaction in the Commission's Regulation AB . . . . [T]he agencies believe that applying the risk retention requirement to the sponsor of the ABS interests—as provided by section [941]—is appropriate in light of the active and direct role that a sponsor typically has in arranging a securitization transaction and selecting the assets to be securitized. This role best situates the sponsor to monitor and control the credit quality of the securitized assets." Credit Risk Retention, SEC Release No. 34-73407, 79 Fed. Reg. 77601, 77608 [hereinafter Risk Retention Adopting Release].
[69] *Cf. Sullivan v. Stroop*, 496 U.S. 478, 484 (1990) (applying the "normal rule of statutory construction that identical words used in different parts of the same act are intended to have the same meaning"); *Smith v. City of Jackson*, 544 U.S. 228, 233 (2005) (plurality) ("when Congress uses the same language in two statutes having similar purposes, particularly when one is enacted shortly after the other, it is appropriate to presume that Congress intended that text to have the same meaning in both statutes" (emphasis added))

final rule should include certain entities other than traditional securitization sponsors. Reasonableness must be determined in light of both the statutory language and its purposes, and the interpretation of a statutory term cannot be counterintuitive.[70] **In our view, the Commission's proposal goes too far, sweeping in numerous market participants whose influence on securitization structure or pool composition either does not give the opportunity or incentive (or both) to design the ABS to fail, as detailed in subsection II.A. This *redefined usage of "sponsor" goes beyond any "permissible construction of the statute*."** [71]

<u>Section IV. Summary of SFA Member Preliminary Considerations</u>

As a whole, the re-proposed rule is overly broad. It takes a narrow statutory prohibition that was originally aimed at a clearly-defined type of egregious conflict and turns it into an extensive regulatory scheme that would directly conflict with the goals of many prudential regulators and prohibit broad swaths of routine market activities. The rule would then impose on every entity that touches the structuring of a securitization, and all of their affiliates and subsidiaries, the kinds of compliance procedures required of the largest prudentially-regulated banking entities under the Volcker Rule. That is not what Congress intended and is not a permissible interpretation of the statue.

Given the complexity and scope of the re-proposed rule and the interconnectedness of its provisions, the short comment period has not given our members time to evaluate fully the myriad of implications and unintended consequences of the re-proposed rule and develop member consensus on detailed, concrete market-wide recommendations. We will address these matters in our follow-up letter. However, we would like to preview some of the specific measures we are evaluating:

- ** Membership Still Evaluating*:* ***<u>Narrow clause (iii) of "conflicted transactions" definition.</u>***
  SFA members agree that one of the most troublesome provisions in the re-proposed rule is the almost limitless and ambiguous clause (iii) of the "conflicted transactions" definition. **SFA members are considering what modification(s) could strike the right balance between investor protection and a viable regulatory regime.** For example, including a limitation on the prohibition on material conflicts of interest to transactions in which a conflicted transaction requires some element of design, or intent,[72] such as when a securitization participant enters into a transaction that is part of a strategy specifically designed for the securitization participant to benefit from actual, anticipated or potential problems with the ABS or the asset pool. This could help to make

[70] *See Goldstein v. SEC*, 451 F. 3d 873, 881 (D.C. Cir. 2006) (characterizing investors in a hedge fund as "clients" of the adviser to the fund was not reasonable, because it came close to violating the plain language of the statute and was at best counterintuitive).
[71] *See Chevron,* 467 U.S. at 843.
[72] The Commission characterizes such an approach as where a "securitization participant structure[d] the ABS transaction or select[ed] the underlying assets with the intent or expectation that the ABS securities will default or decline in value." Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9697 n. 125.

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the Commission's proposed materiality standard more workable. Alternatively, SFA members are also considering limiting clause (iii) to apply to transactions that are the substantive equivalent of clause (i) and (ii) but due to a difference in form are not captured by clause (i) or (ii).

- ***Exclude transactions not related to ABS credit risk (i.e., interest rate hedges, foreign exchange hedges, and the like).***
  SFA members agree that merely hedging interest rate risk, foreign exchange risk, and other risks apart from the credit risk of an ABS, do not pose the problems that Section 621 was intended to address. These transactions that are integral to basic risk management practices should have a flat, explicit exception that is not burdened by any of the requirements for risk-mitigating hedging activities.

  The Commission reached a similar conclusion in excepting these trades from the prohibition on hedging ABS interests required to be retained under the credit risk retention rules that also were adopted under Congressional mandate in the Dodd-Frank Act.[73] As described by the Commission and the other agencies that adopted those rules:

  > The statutory hedging prohibition is focused on the credit risk associated with the interest or assets that a sponsor is required to retain, which itself is dependent on the credit risk of the particular securitized assets that underlie the ABS interests. Therefore, hedge positions that are not materially related to the credit risk of the particular ABS interests or exposures required to be retained by the sponsor or its affiliate would not be prohibited under the proposal. Such positions would include hedges related to overall market movements, such as movements of market interest rates . . . [and] currency exchange rates.[74]

  Section 621 and the re-proposed rules are similarly focused on the credit risk of ABS.[75] A hedge that could otherwise be a "conflicted transaction," but does not implicate the credit risk of the ABS, simply does not bring an incentive or opportunity to design a transaction to fail. Securitization participants should not need to comply with the complex requirements proposed by the Commission for risk-mitigating hedging activities to engage in these types of trades, as such hedges are basic components of risk management.

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[73] 17 C.F.R. § 246.12(d)(1).
[74]Credit Risk Retention, SEC Release No. 34–64148, 76 Fed. Reg. 24090, 24116 (April 29, 2011).
[75] Where there is no credit risk to investors, the protection of the rule is not needed. As noted by the Commission in the proposed exclusion of the Enterprises from the definition of "sponsor," "with respect to the types of fully insured or fully guaranteed securities of which the United States, an agency of the United States, or the Enterprises might otherwise be a sponsor absent these proposed exclusions, it is the United States that is exposed to the credit risk of the underlying assets. Therefore, if these entities were to enter into the types of conflicted transactions that this rule is intended to address, investors would ultimately not be exposed to credit risks stemming from such transactions." Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9687.

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- ** Membership Still Evaluating*: **Exempt certain vital activities.***
  In conjunction with our member discussions regarding the narrowing of clause (iii) of the definition of "conflicted transactions", our members are analyzing its interplay with critical market activities and the potential need for strict exemption or conditional exemption on these activities. Due to the short comment period, this does not purport to be a complete list; we expect to have more in our follow-up letter:
  - Repurchase agreements and total return swaps used to finance the ABS
  - Warehouse financing prior to the issuance of the ABS
  - Transactions on behalf of clients
  - Transaction using independently administered, widely available indices
  - Traditional market making and providing of liquidity in the underlying assets

- **Membership Still Evaluating*: **Tailor conditions to risk management hedging and market-making exemptions.***

- ***Whether the main prohibition should apply to indirect violations, including violations through the use of affiliates and subsidiaries.*** There is already an anti-circumvention provision that covers this ground.

- ** Membership Still Evaluating*: **Clarify/Narrow the types of securitization participant and securitizations that are scoped into the rule.***
  Our members are carefully considering under what circumstances a market participant should or should not be scoped into the rule. Due to the short comment period, this does not purport to be a complete list; we expect to have more in our follow-up letter:
  - "Long" investors
  - Co-managers in an underwriting syndicate
  - Servicers performing certain roles
  - Portfolio/whole loan sellers who sold assets in arms-length transaction separate from securitization
  - Insurance providers[, including issuers of funding-agreement backed notes[76]]
  - Safe harbor for offshore activities and transactions
  - Warehouse lenders
  - Municipalities

- ** Membership Still Evaluating*: **Role disclosure can play, especially if a broad "conflicted transactions" clause (iii) is retained.***

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[76] *See* Regulation AB Compliance & Disclosure Interpretation 301.03.

One crucial issue raised by both the originally proposed rule and the re-proposed rule is the extent to which adequate disclosure should be able to cure an otherwise prohibited conflict of interest. SFA members believe there is a need for an exception for disclosures for a targeted list of transactions, especially if clause (iii) is not eliminated or substantially amended. Specifically, where that line should be drawn is an important area of ongoing discussion with our membership. Regardless our membership agrees that the exception should only apply where clear, timely and effective written disclosure has been made to investors, in a manner sufficient to permit them to meaningfully understand the conflict. The Commission, along with other prudential regulators adopted a similar disclosure standard for addressing conflicts of interest under the Volcker Rule. This modification would limit the scope of the rule to those transactions that motivated the inclusion of Section 621 in the Dodd-Frank Act.

- ** Membership Still Evaluating*:* ***The role information barriers could play in a rule that protects investors while providing workable inclusion of subsidiaries and affiliates.***
  The Commission did not propose an exception for transactions that take place on the other side of an information barrier, on the grounds that it might lead to evasion of the rule. We find this surprising – especially as many of the regulated entities that are scoped into the re-proposed rule rely on information barriers for other sensitive potential conflicts of interest, and the Commission has endorsed the use of information barriers in similar contexts. As noted by the Commission:

  > Information barriers, in the form of written, reasonably designed policies and procedures, have been recognized in other areas of the Federal securities laws and the rules thereunder. For example, brokers and dealers have used information barriers to manage the potential misuse of material non-public information to adhere to Section 15(g) of the Exchange Act. Also, Regulation M contains an exception for affiliated purchasers if, among other requirements, the affiliate maintains and enforces written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate that might result in a violation of Regulation M.[77]

  Given the scope of "conflicted transactions" under the re-proposed rule, SFA members are carefully considering in what circumstances, if any, a properly designed and implemented

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[77] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9690 (footnotes omitted), *citing* 7 U.S.C. § 78o(g) (Section 15(g)), 17 CFR 242.100–105 (Regulation M). There are yet other accepted uses of information barriers under the federal securities laws. For example, the Commission staff has taken the position that a firm's advisory division would not be deemed acting as investment adviser in margin call liquidation transactions where any decision to effect such a transaction is on the other side of an information barrier. Goldman, Sachs & Co., SEC No-Action Letter (February 22, 1999). The definition of "investment adviser" under the Investment Advisers Act of 1940 deems a "separately identifiable department or division" of a bank as an investment adviser – and "not the bank itself" – so long as the there is an information barrier meeting certain criteria. *See* 15 U.S.C. §§ 80b–2(a)(11) (definition of "investment adviser"), –2(a)(26) (definition of "separately identifiable department or division"). The Commission and the banking regulators also allow information barriers with certain caveats to be used to address conflicts of interest under the Volcker Rule. 12 CFR § 44.7(b)(2)(ii).

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information barrier in combination with the anti-circumvention provision could serve to mitigate appropriately certain conflicts of interest under the rule.

- ** Membership Still Evaluating*:* ***Use of anti-circumvention provisions.***
  As stated by the Commission, an anti-circumvention is needed in order to avoid "an attempt to evade the prohibition on material conflicts of interest."[78] "Attempt" and "evade" both include an element of intent, because the entire purpose of an anti-circumvention provision is to make it illegal for a person to do indirectly what it cannot do directly. A straightforward anti-circumvention provision that makes it clear that a securitization participant cannot engage in a transaction or a series of related transactions as part of a plan or scheme to evade the prohibition of the rule, whether directly or indirectly, including through the use of affiliates and subsidiaries, should go a long way in satisfying the Commission's anti-evasion concerns. SFA members are considering how some of the other provisions of the rule could be limited to the types of transactions and securitization participants that were clearly in Congress' sights when it enacted Section 621.

  The SFA is also considering alternatives to information barriers in combination with the anti-circumvention provision that could serve to appropriately mitigate certain conflicts of interest under the rule.

- ***Removal of qualifier on exclusion for administrative, legal and ministerial service providers.***
  The Commission has proposed an exclusion for a person that performs "only" administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS. However, the use of "only" undercuts this exemption because the typical "administrative, legal, due diligence, custodial, or ministerial acts" of these parties can also be viewed as causing the "direction of the structure, design or assembly of an ABS or the composition of the pool of assets underlying the ABS." For example, trustees, custodians, paying agents, calculation agents, administrators, accountants, lawyers, rating agencies and other contractual service providers also have key input into the creation of an ABS. These entities may be involved in (i) the drafting and negotiation of the operating and disclosure documents, (ii) setting fees, (iii) reviewing the asset pool, (iv) in some cases, negotiating the priority of payments within an ABS transaction, and (v) potentially advising on how to structure an ABS to meet the objectives of the deal parties, including investors. None of these entities should be scoped into the prohibitions of the rule by performing their routine securitization functions, even if those roles cause them to "participate substantially" in the structuring of an ABS or selection of the pool assets.

- ***Clarify that NRSROs are not considered "sponsors."***
  The Commission has noted that the "activities customarily performed by … credit rating agencies with respect to the creation and sale of an ABS … are the sorts of activities that would typically

[78] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9699 (emphasis added).

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fall within the exclusion from the definition of the proposed definition of the term 'sponsor'."[79] SFA members agree and believe the Commission should specifically exclude nationally recognized statistical ratings organizations in the final rule to eliminate any potential ambiguity.

- ***Timeframe of the prohibition.***
  To be able to comply with the sweeping requirements of the re-proposed rule, securitization participants need a definitive starting point for the application of the rule. We are concerned that the "substantial steps" formulation is not clear enough to properly allow securitization participants to conform their activities to the rule. The vagueness of the proposed starting point could also create enforcement problems for the Commission. To the extent that evasion remains a concern, that could be dealt with through the anti-circumvention provision.

- ***Time for compliance.***
  The Commission has proposed a sweeping rule that would affect a large number of market participants and all of their affiliates and subsidiaries, and apply to many types of transactions, with only limited and complex exceptions. Once the final rule is adopted, market participants will need to take the time to "get it right" internally. The Commission will need to provide an extended effective date, a long compliance period, or both, when adopting the final rule.

- ***Provision for exemptive relief.***
  The rule is like a giant Venn diagram – in order to determine if an activity or transaction is permissible, a market participant must carefully examine numerous different aspects of the rule to ensure that it is in one of the areas of the diagram that does not prohibit either the transaction or its participation in the transaction. It is likely that even a more narrowly-focused formulation of the rule would leave a number of unanswered questions and "grey areas." As a result, the rule's application would be enhanced by the inclusion of provision expressly authorizing exemptive relief.

Section VI. Conclusion

We look forward to working with the Commission to finalize the re-proposed conflicts of interest rule in a manner that addresses' Congress concerns, but is not so far-reaching that it has severe unintended consequences for the capital markets, the participants in those markets (including investors) and the consumers and businesses whose financing needs are provided for by those markets. As noted, due to the short comment period this letter contains only our preliminary comments on the re-proposal. We intend to submit a follow-up letter within 90 days hereafter, expanding on our initial comments, providing more detailed suggestions on how to revise the re-proposed rule, providing a cost benefit analysis, and responding more directly to

[79] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9686

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the Commission's thorough requests for comment. In the meantime, should you have any questions, please do not hesitate to call.

Regards,

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