March 27, 2023

VIA ELECTRONIC MAIL (rule-comments@sec.gov)

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Request for Public Comment Regarding Proposed Rule 192
"Conflicts of Interest Relating to Certain Securitizations"
File Number S7-01-23

Dear Ms. Countryman:

The Securities Industry and Financial Markets Association ("SIFMA"),[1] the Asset Management Group of SIFMA ("SIFMA AMG")[2] and the Bank Policy Institute ("BPI")[3] (collectively, the "Associations") appreciate the opportunity to comment on proposed Rule 192 (the "Proposed Rule") under the Securities Act of 1933 (the "Securities Act"). When adopted in its final form by the Securities and Exchange Commission (the "Commission"), Rule 192 will implement Section 27B of the Securities Act ("Section 27B"),[4] which prohibits certain material conflicts of interest in securitizations, subject to the exceptions set forth therein.

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

[3] The Bank Policy Institute is a nonpartisan public policy, research, and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks, and the major foreign banks doing business in the U.S. Collectively, they employ almost two million Americans, make nearly half of the nation's bank-originated small business loans, and are an engine for financial innovation and economic growth.

[4] Section 27B was added to the Securities Act by Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

In the proposing release for the Proposed Rule (the "Proposing Release"),[5] the Commission made frequent reference to SIFMA's comment letter of February 13, 2012 (the "2012 SIFMA Letter")[6], on proposed Rule 127B ("Proposed Rule 127B"), the Commission's previously proposed rule under Section 27B. The Associations appreciate the Commission's consideration of the 2012 SIFMA Letter and are grateful that the Commission adopted that letter's recommendation to expand the text of the rule to include the detail and definitional support that Proposed Rule 127B omitted and left to be covered by interpretive guidance from the Commission.

More than ten years have passed since Congress enacted Section 27B under the Dodd-Frank Act. This passage of time should inform, not rush, the final rule. Since the Dodd-Frank Act was passed, the securitization market, with the help of a vast array of generally well-considered rulemaking by the Commission (and other regulatory agencies), together with changes in market practice initiated by the industry itself, has recovered dramatically, helped the U.S. financial system persevere through the COVID-19 economic shock and resumed its central role in the efficient operation of our capital markets.

Accordingly, this letter contains a detailed set of comments and suggestions on the Proposed Rule. The Associations urge the Commission to take these (and other) comments it receives into account and propose a revised version of a rule to implement Section 27B. If the Commission nevertheless decides to issue a final version of the Proposed Rule, the Commission should make the changes to the Proposed Rule described in this letter in order to mitigate the adverse consequences of the rule.

[5] Prohibition Against Conflicts of Interest in Certain Securitizations, 88 Fed. Reg. 9678 (Feb. 14, 2023) (to be codified at 17 C.F.R. pt. 192).

[6] Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule Implementing Rule to Prohibit Conflicts of Interest in Certain Securitizations (Feb. 13, 2012), https://www.sec.gov/comments/s7-38-11/s73811-26.pdf.

EXECUTIVE SUMMARY

In preparing this letter, the Associations have carefully studied the concerns raised by the Commission in the Proposing Release, as well as its specific requests for comment. We hope the Commission will find this letter responsive to both. The Associations appreciate the inherent difficulty of agency rulemaking in the area of conflicts of interest, especially under the pressure of a Congressional mandate. We are grateful that the Commission remains open to comments and suggestions.

The Proposed Rule should not be adopted. The Commission should propose a revised, more tailored, rule under Section 27B.

- The Proposed Rule is significantly flawed – it is both excessively broad and vague. It goes far beyond the scope of the mandate of Section 27B to address certain conflicts of interest between securitization participants and institutional investors.

- The Dodd-Frank Act became law more than twelve years ago. Since that time, the securitization market, with the help of a vast array of generally well-considered rulemaking by the Commission (and other regulatory agencies), has recovered dramatically, helped the U.S. financial system persevere through the COVID-19 economic shock, and resumed its central role in the efficient operation of our capital markets. Indeed, our well-functioning securitization market has helped to mitigate the effects of rising interest rates by acting as a source of cost-efficient financing for auto loans, mortgage loans, unsecured consumer loans, business loans and many other forms of commercial and consumer credit.

- There are no pervasive regulatory issues in the securitization market that warrant the breadth of the Proposed Rule, nor are there any such issues that prevent the Commission from taking whatever additional time is needed to develop an appropriate rule to implement Section 27B.

The Associations stand ready to assist the Commission in its rulemaking effort. This letter contains many suggestions and specific comments, including those summarized below.

- Our comments seek to narrow the scope of a "catchall" provision that is so broad that it would capture basic and commonplace transactions of, and activities within, the securitization market. Even transactions that are an intrinsic component of a securitization transaction could be prohibited under the Proposed Rule.

    - Our comments do not simply seek to reduce the scope of the rule by limiting the types of transactions that are scrutinized under the rule. Rather, our comments intend to cause the scope of the "conflicted transaction" definition to match its purpose – that is, to scope in only those transactions that could lead a securitization participant to breach a securities law duty that it has in connection with a securitization transaction (*i.e.*, a conflict of interest).

- Our detailed and specific comments provide suggested approaches as to how the Proposed Rule can be tailored to scope in transactions that are bets against the performance of the ABS or the functional trading equivalent thereof and how to avoid scoping in important, but innocuous, transactions.

- Our comments seek to narrow the scope of a "securitization participant" definition that is so broad that it applies not only to underwriters, placement agents, initial purchasers and sponsors, but also to all of their affiliates and subsidiaries everywhere in the world regardless of whether they are involved in any way with the securitization. The Proposed Rule provides no exception based on information barriers or any other indicia of separateness. Indeed, the Proposed Rule's definition is so broad that it can capture investors. Many of our comments relate to this topic.

    - Our comments do not simply seek to reduce the scope of the rule by limiting the number of entities whose transactions are scrutinized under the rule. Rather, our comments are intended to cause the "securitization participant" definition to match its purpose – that is, to scope in only those entities whose transactions pose a risk that they could lead a securitization participant to breach a securities law duty that it has in connection with a securitization transaction (*i.e.*, a conflict of interest).

    - Our detailed and specific comments show how the Proposed Rule can be tailored to include a standard by which an underwriter, placement agent, initial purchaser or sponsor, as applicable, can establish and demonstrate various indicia of separateness from its business units, groups, affiliates and subsidiaries who have no substantive role in the securitization.

- We also urge the Commission to permit disclosure as a means of addressing conflicts of interest. Our comments refer to the Investment Advisers Act, under which conflicts of interest may be mitigated by disclosure (noting that disclosure, rather than prohibition, works in that context even though the fiduciary duty applies). We also point to the Volcker Rule's conflict of interest provision, under which disclosure is a permitted solution, as well as various other specific and general securities law disclosure provisions.

The Proposed Rule will have significant adverse economic consequences if adopted without significant modification.

- The Commission has ample room under Section 27B, as well as under its general exemptive authority, to craft a rule that prohibits transactions that create material conflicts of interests between securitization participants and investors without creating significant turmoil whose economic costs threaten to outweigh any foreseeable benefit.

- If implemented in its current form, the Proposed Rule will cause significant unintended economic consequences, not only for the asset-backed securities market, but also for consumers, home buyers and small business owners. The Commission's economic analysis of the Proposed Rule does not adequately consider the consequences of the Proposed Rule.

- Among other things, the Proposed Rule, when read together with the Commission's commentary in the Proposing Release:

    - creates uncertainty about the ability of banks to manage their risks through the well-established mechanism of credit risk transfers conducted by special-purpose entities;

    - threatens (whether intentionally or not) to disrupt very basic and commonplace components of, and activities within, the securitization market and broader corporate capital markets;

    - is likely to cause major shifts in the composition of market participants as the inability of many institutions to comply with the rule may drive them to significantly curtail or discontinue their securitization activities; and

    - will drive up the cost of funding for innumerable banks and other institutions that rely on securitization, and when such costs inevitably flow to consumers, will exacerbate the adverse economic effects of already rising interest rates.

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INTRODUCTION

As the Proposing Release highlights, "[t]here were several ABS deals exhibiting conflicts of interest targeted by the re-proposed rule that were generally originated in the pre-financial crisis years, 2005-2007."[7] These are the types of conflicts of interest that motivated the passage of Section 27B. The Senate Financial Crisis Report[8] (as defined in the footnote) refers specifically to that intent[9] and provides the Commission with a clear guiding objective for its rulemaking:

> Section 27B "if well implemented, will protect market participants from the self-dealing that contributed to the financial crisis."[10]

The Proposed Rule does not satisfy that clear guiding objective. While the Associations support a prohibition of the types of transactions that motivated Section 27B (*i.e.*, those structured to fail), the breadth of the Proposed Rule threatens to disrupt securitization in the United States and, by extension, the capital markets and the economy as a whole. To be sure, in the past, there were some rulemaking initiatives for which significant risks, costs and disruption may have been justified in order to fully root out and eradicate persistent forms of egregious conduct observed in the securities markets. The Associations respectfully suggest that the present rulemaking initiative does not fall into that category. The Commission has ample room under Section 27B itself, as well as under the Commission's general exemptive authority under Section 28 of the Securities Act, to craft a final rule that is better tailored to the legislative purpose of Section 27B and that is informed by the experience of the twelve years that have passed since that section was adopted.

Among other things, the Proposed Rule, when read together with the Commission's commentary in the Proposing Release:

- threatens bank and GSE credit risk transfers that utilize special purpose entities – it is unimaginable that Congress intended any implementing rule under Section 27B

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[7] *See* Prohibition Against Conflicts of Interest in Certain Securitizations, 88 Fed. Reg. 9678, 9713 (Feb. 14, 2023) (to be codified at 230 C.F.R. pt. 192) (the "Proposing Release"). *See infra* notes 11, 112 (demonstrating that the Commission addressed these cases by bringing actions under the disclosure and anti-fraud provisions of Section 17(a) of the Securities Act). *See, e.g.*, Proposing Release, at 9713 n.216 (noting consents and final judgements).

[8] PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFAIRS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (Comm. Print 2011) (the ''Senate Financial Crisis Report'').

[9] The Senate Financial Crisis Reports makes clear that in implementing the conflict of interest prohibition in Section 621of the Dodd-Frank Act, the Commission should consider the types of conflicts of interest described in the case study contained in that report. *Id.* at 639. The types of conflicts of interest in that study are highly particular to that case, a fact made dramatically apparent by the case study's consumption of 260 of the Senate Financial Crisis Report's 639 total pages. To the extent legislative history is relevant in construing the meaning of Section 27B, the pre-enactment statements set forth in Congressional committee reports (such as the Senate Financial Crisis Report) and in the Congressional Record are most instructive. *See* NORMAN J. SINGER & J.D. SHAMBIE SINGER, SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION, § 48:4 (8th ed. 2018). The views of individual members of Congress, when expressed outside of the foregoing sources and after the date of enactment, should carry little weight in construing the intent of the Congress with respect to any legislation, particularly legislation as complex and heavily debated as the Dodd-Frank Act.

[10] *See* Senate Financial Crisis Report, at 638.

to hinder the ability of banks, the GSEs or other financial institutions to manage their credit risks;

- goes beyond the plain meaning of the text of Section 27B to an extent that it threatens (whether intentionally or not) to severely disrupt very basic and commonplace components of, and activities within, the securitization market;

- is likely to cause major shifts in the composition of market participants as the inability of many institutions to comply with the rule may drive them to significantly curtail or discontinue their securitization activities; and

- will drive up the cost of funding for innumerable banks and other institutions that rely on securitization, which will exacerbate the adverse economic effects of already rising interest rates.

The Associations urge the Commission not to adopt the Proposed Rule. Instead, the Commission should consider the comments set forth in this letter and propose another, better tailored, rule under Section 27B.

The regulatory environment in which securitization operates has changed considerably since Section 27B became law. In part III.B.3 of the Proposing Release, the Commission reviews some of these changes, including risk retention (Regulation RR) and the asset-level reporting requirements that the Commission added to Regulation AB.[11] The Commission could have gone further by mentioning:

- the many changes to the securities laws pertaining to asset-backed securities adopted by the Commission in 2014 as part of "Reg AB II";[12]

- Rule 193 under the Securities Act (requiring that the issuer conduct a review of the securitized assets), a new Item 1111(a)(7) of Regulation AB (requiring prospectus disclosure of the nature, findings and conclusions of the review) and a new Item 1111(a)(8) of Regulation AB (requiring prospectus disclosure of the securitized assets that deviate from the underwriting and other criteria disclosed in the prospectus);

- Rule 15Ga-1 under the Securities Exchange Act of 1934 (the "Exchange Act") (requiring detailed disclosure of demands for repurchase of assets that breach representations and warranties); and

[11] As the Commission notes, these changes supplement already applicable securities laws. "[T]he general anti-fraud and anti-manipulation provisions of the Federal securities laws, including Section 17(a) of the Securities Act, Section 10(b) and Rule 10b-5 under the Exchange Act, apply to ABS transactions." *See* Proposing Release, at 9712–13. Indeed, as the Commission notes, "[f]ailure to disclose a person's substantial role in selecting assets underlying an ABS and that person engaging in conflicted transactions would make a securitization participant potentially subject to enforcement actions under the anti-fraud provisions of the securities laws." *Id.* at 9713.

[12] *See* Asset-Backed Securities Disclosure and Registration, 79 Fed. Reg. 57184 (September 24, 2014).

- the surge of private litigation and the emergence of a plaintiffs' bar that is particularly attuned to the actions of securitization participants.[13]

The Associations concur with the Commission's judgment that "current market practices may be generally consistent with the re-proposed rule requirements as a result of compliance with the existing rules described above"[14] and that "the current market equilibrium" is characterized by securitization participants who are incentivized to avoid conflicts due to existing rules and reputational concerns.[15] Indeed, having had the benefit of observing the securitization markets during the twelve years since Section 27B was added to the Securities Act, it is apparent that the current market equilibrium is vastly different, and better, than it was in the years leading up to the financial crisis.[16]

The Commission states that "it is possible that such [conflicted] transactions continue to occur," noting that it has no data on their presence or absence.[17] However, the Associations respectfully submit that the Proposed Rule is significantly out of balance when compared to that mere possibility, given the significant evolution of the securitization market over the last twelve years. Among other things:

- The Proposed Rule's definition of "material conflict of interest" is overly expansive and does not correspond to its ordinary meaning.

- Unlike the Volcker Rule, the Investment Advisers Act of 1940, FINRA Rule 5121 and any number of consumer protection statutes, the Proposed Rule does not allow conflicts of interest to be addressed through adequate disclosure.

- The Proposed Rule applies to all of a securitization participant's affiliates and subsidiaries anywhere in the world regardless of their involvement in or knowledge of the securitization transaction or the presence of information barriers or other indicia of separateness.

- The Proposed Rule's definition of the term "sponsor" goes far beyond the definition of that same term as used in many other rules under the Securities Act and the Exchange Act.

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[13] *See* Richard E. Gottlieb et al., *Two Trials and Other Developments as RMBS Litigation Continues Unabated*, 73 BUS. LAW. 497 (2018); *see also Blackrock Allocation Target Shares: Series S Portfolio v. Wells Fargo Bank*, 247 F. Supp. 3d 377, 382 (S.D.N.Y. 2017) ("In the near-decade since the collapse of the United States real-estate market, this District has been inundated with [RMBS] lawsuits."); Joseph Heller & Gene Phillips, *An Examination of Post-Crisis Financial Markets Litigation*, 23 J. STRUCTURED FIN. 7 (2017).

[14] *See* Proposing Release, at 9713.

[15] *Id.*

[16] We respectfully urge the Commission to recognize the dramatic evolution that inevitably occurs in *any* securities market over a 15-year period, and to give due regard to the particular transformation of the U.S. securitization market over the past 15 years.

[17] Proposing Release, at 9713.

- The Proposed Rule contains an anti-circumvention provision that applies to the entire rule, rather than a more typical anti-evasion rule that applies to the exceptions thereto, thus leaving open the question of what may not be circumvented.

The types of conflicted transactions that are so severe and pervasive as to justify a rulemaking of such breadth would almost certainly be of a type that existing securities laws (such as Section 17(a) and Rule 10b-5) would already reach. But the breadth of the Proposed Rule contrasts sharply with the Commission's acknowledgement that "current market practices may be generally consistent with the re-proposed rule requirements as a result of compliance with the existing rules."[18]

[18] *See id.*

I. MOST OF THE ASSOCIATIONS' COMMENTS RELATE TO FOUR GENERAL ARGUMENTS.

Most of the Associations' specific comments relating to the Proposed Rule arise from four general arguments. Those arguments are:

- ***First*, in the absence of a statutory definition, a statutory term is generally construed "in accordance with its ordinary or natural meaning."[19] The terms "sponsor" and "conflict of interest" are not defined in Section 27B. Therefore, any definition of those terms in the rule that implements Section 27B must reflect their ordinary or natural meanings.**

  The definitions of "sponsor" and "conflict of interest" in the Proposed Rule are far broader than their ordinary or natural meanings.

- ***Second*, in order for any transaction by an underwriter, placement agent, initial purchaser or sponsor to involve or result in a material conflict of interest between that securitization participant and an investor, that transaction must create a material conflict between (a) an *existing* duty that such securitization participant has under the securities laws and (b) that securitization participant's own self-interest.**

  The Proposed Rule's definition of "material conflict of interest" conflates the specific term "conflict of interest" (the term that is used without definition in Section 27B and must therefore be given its ordinary and natural meaning) with the general expression "conflicting interests" **(**which simply describes the differing interests that parties have in any commercial transaction, trade or investment). By conflating "conflict of interest" with "conflicting interests," the Commission proposes a definition of "material conflict of interest" that does not comport with its ordinary or natural meaning.

- ***Third*, the existing securities law duties that are relevant to this rulemaking are the securities law duties that an underwriter, placement agent, initial purchaser, or sponsor, as applicable, already has with respect to its participation in securitization activities (namely, structuring, creating, marketing, or selling an asset-backed security, or selecting the assets backing the asset-backed security).**

  Section 27B does not create any new securities law duties, nor does it empower the Commission to create any new securities law duties, other than the duty to avoid certain transactions that pose a material conflict between a securitization participant's existing securities laws duties and that securitization participant's own self-interest. In seeking to prohibit certain transactions with respect to which a securitization participant merely has "conflicting interests" with investors, the Proposed Rule effectively creates new securities law duties. Those new securities

[19] *Loan Syndications and Trading Ass'n v. Sec. and Exch. Comm'n*, 882 F.3d 220, 223 (D.C. Cir. 2018) (citing *FDIC v. Meyer*, 510 U.S. 471, 476 (1994)).

law duties extend far beyond the duty that Section 27B authorizes the Commission to implement in its final rule – the duty to avoid certain transactions that would involve or result in any material conflict of interests with respect to any investor.

- ***Fourth*, a transaction cannot give rise to a conflict of interest between an underwriter, placement agent, initial purchaser, or sponsor unless such underwriter, placement agent, initial purchaser or sponsor either:**

  - **directly engages in that transaction, or**

  - **indirectly engages in that transaction through, and in coordination with, a related "non-participating entity" (*i.e.*, one of its business units, groups, affiliates and subsidiaries that is not substantively involved in the securitization activities described in clause *Third* above).**

    Under the ordinary and natural meaning of the term "conflict of interest," a transaction must pose a risk that it will induce a securitization participant in that transaction to breach an existing duty that such securitization participant has under the securities laws. The Proposed Rule's expansive definition of "securitization participant" extends the reach of the rule to transactions engaged in by business units, groups, affiliates and subsidiaries that have no participating role in the securitization. Absent facts and circumstances demonstrating that the underwriter, placement agent, initial purchaser or sponsor, as applicable, is engaging in a transaction by, through or in coordination with a related non-participating entity, such a transaction does not create a material conflict of interest between the underwriter, placement agent, initial purchaser or sponsor, as applicable, and any investor.

As a corollary to these four basic arguments, the Associations respectfully submit that any rule adopted by the Commission under Section 621 of the Dodd-Frank Act should bear some appropriate resemblance to the Volcker Rule (the rule that the Commission and other regulatory agencies adopted under Section 619 of the Dodd-Frank Act). As noted in a letter to the Commission regarding the implementation of Section 619, Senators Merkley and Levin noted that "[t]he final rule would . . . be strengthened if it explicitly acknowledged the additional provisions in Section 621 of the Dodd-Frank Act . . . . Sections 619 and 621 *were intended to work in tandem*, and each should cross-reference the other."[20]

Those two sections of the Dodd-Frank Act have been the subject of considerable academic interest. Academics commonly recognize Sections 619 and 621 of the Dodd-Frank Act as companion provisions. Indeed, in one academic paper, the author referred to Sections 619 and 621 collectively as the "Volcker Rule."[21] Another author predicted that the Commission's

[20] Senators Jeff Merkley & Carl Levin, Comment Letter on Proposed Rule to Implement Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Feb. 13, 2012) (emphasis added), https://www.sec.gov/comments/s7-41-11/s74111-362.pdf.

[21] *See, e.g.*, S. Burcu Avci et al., *Eliminating Conflicts of Interests in Banks: The Significance of the Volcker Rule*, 35 YALE J. REG. 343, 364 (2018) ("Sections 619 and 621 . . . are collectively referred to as the Volcker Rule."). *See also* Joshua R. Rosenthal, Note, *Burning Down the House or Simply Rolling the Dice: A Comment on Section 621 of*

interpretation of Section 621 would closely follow its interpretation of Section 619 because the two sections are "worded similarly."[22]

As this letter will highlight, the Proposed Rule is at significant variance with the Volcker Rule in precisely those areas where one would expect similarities. For example, the Volcker Rule contemplates disclosure as a means of addressing conflicts of interest, whereas the Proposed Rule does not. The Volcker Rule also contemplates information barriers as a means of addressing obvious scoping concerns, whereas the Proposed Rule does not.

Section 619 expressly contemplates a broad anti-circumvention provision (with various due process features described therein), and the Volcker Rule contains such a provision. On the other hand, Section 621 does not contemplate any anti-circumvention provision at all, yet the Proposed Rule's anti-circumvention provision is much broader than that contained in the Volcker Rule.[23]

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the Dodd-Frank Act and Recommendation for its Implementation, 17 FORDHAM J. CORP. & FIN. L. 1263, 1278 (describing Sections 619–21 as "the Merkley-Levin Provisions").

[22] *See* Nathan R. Schuur, Note, *Fraud is Already Illegal: Section 621 of the Dodd-Frank Act in the Context of the Securities Laws*, 48 U. MICH. J.L. REFORM 565, 583 (2015).

[23] *See* Part IX of this letter (addressing the Proposed Rule's anti-circumvention provision).

II. THE PROPOSED RULE'S DEFINITION OF "SPONSOR" SHOULD BE SIGNIFICANTLY REVISED BECAUSE IT DOES NOT CORRESPOND TO THE ORDINARY AND NATURAL MEANING OF THAT TERM.

> The definition of sponsor in the context of asset-backed securitization has an ordinary and natural meaning. It is a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.
>
> The following entities should be excluded from the definition of "sponsor":
>
> - investors in a long position in asset-backed securities;
> - credit rating agencies;
> - states and their political subdivisions; and
> - third-party servicers.

A. The Proposed Rule's definition of "sponsor" far exceeds that term's ordinary and natural meaning.

As noted in Part I, in the absence of a statutory definition, a statutory term is generally construed in accordance with its ordinary and natural meaning. The term "sponsor" is not defined in Section 27B. Therefore, any definition of "sponsor" in the rule that implements Section 27B must reflect its ordinary or natural meaning. The definition of "sponsor" in the Proposed Rule is far broader than the ordinary or natural meaning of that term.[24]

> 1. The definition of sponsor in the context of asset-backed securitization has an ordinary and natural meaning. It is a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.

In the context of asset-backed securitization, the meaning of the term "sponsor" as used in Section 27B has an ordinary and natural meaning. Years before the financial crisis and the Dodd-Frank Act, the Commission itself identified and recognized the ordinary and natural meaning of the term "sponsor" in the context of asset-backed securitization. In describing what a sponsor *was already well understood to be* in connection with proposing a formal definition of "sponsor" to be included in proposed Regulation AB, the Commission stated:

[24] We agree with the Commission that it is appropriate for this rulemaking to exclude certain entities from the Proposed Rule that would otherwise fall within the ordinary and natural meaning of the term "sponsor." For example, it is appropriate to exclude the United States and any agency of the United States, as well as the GSEs. As noted below, the definition of "sponsor" should be narrowed further to exclude certain other entities (e.g., states and their political subdivisions) from this rule.

> "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."[25] … The term "sponsor" "is a commonly used term for the entity that *initiates* the asset-backed securities transaction."[26]

In January 2005, that meaning was codified by the Commission in its definition of "sponsor" as set forth in the adopting release of Regulation AB,[27] a regulation predating the Dodd-Frank Act and all of the legislative history pertaining thereto. Following the financial crisis and in connection with its risk retention rulemaking effort under the Dodd-Frank Act, the Commission adopted the identical definition of "sponsor" in Regulation RR.[28] The ordinary and natural meaning of "sponsor" is:

> a person who *organizes and initiates* a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.[29]

This ordinary and natural meaning of the term "sponsor" predates any definition thereof in prior regulations. Thus, the definitions of "sponsor" in the two cornerstone regulations that the Commission promulgated to govern asset-backed securities are consistent with the common and ordinary meaning of that term. That definition of "sponsor" has been used ever since.

Now, the Commission has proposed a "new definition of 'sponsor' for purposes of the re-proposed rule that has not been used before."[30] However, because the term "sponsor" is used in Section 27B and is not separately defined therein, and because the term "sponsor" already has an ordinary and natural meaning as described above, the term "sponsor" in the Proposed Rule must have the same meaning, not a new one.[31]

2. <u>The definition of "sponsor" in the Proposed Rule extends far beyond its ordinary and natural meaning</u>.

The Proposing Release asserts that the Proposed Rule's definition of "sponsor" is a "functional definition[] based on a person's activities in connection with a securitization, *which would generally be based on existing definitions of such terms under the Federal securities laws*

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[25] *See* Asset-Backed Securities, 69 Fed. Reg. 26650, 26654 (May 13, 2004) (emphasis supplied).

[26] *Id*. at 26654 n.43 (emphasis added).

[27] Asset-Backed Securities, 70 Fed. Reg. 1506 (Jan. 7, 2005). Under Item 1101(l) of Regulation AB, "*Sponsor* means the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." 17 C.F.R. § 229.1101(l) (2023).

[28] Under Regulation RR, "*Sponsor* means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." *See* 17 C.F.R. § 246.2 (2023).

[29] *See* footnotes 27–28.

[30] *See* Proposing Release, at 9612.

[31] Leading dictionaries define "sponsor" in the securities context along similar lines. *See, e.g., Sponsor,* MERRIAM-WEBSTER'S DICTIONARY OF LAW (2016) ("one that securitizes assets [or] one that promotes, advocates, or favors a business venture (as investment in a security or limited partnership)").

and the rules thereunder to ease compliance with the re-proposed rule."[32] The Associations agree that clause (i) of the Proposed Rule's definition of "sponsor" corresponds with its ordinary and natural meaning as described above – indeed, it is a direct match.[33] However, clause (ii) of the Proposed Rule's definition of "sponsor" extends the reach of "sponsor" far beyond its ordinary and natural meaning.[34]

The Proposed Rule attempts to mitigate the expansive reach of clause (ii) by carving out "person[s] that perform[] only administrative, legal, due diligence, custodial, or ministerial acts."[35] While the Associations appreciate the Commission's recognition that these persons should not be subject to the Proposed Rule, the necessity of such a carve-out demonstrates the overbreadth of the Commission's definition. The Commission states that "the exclusion should … mitigate concerns about the [definition's] potential overinclusiveness"[36] but the exclusion in fact serves to exacerbate them.

The Proposing Release states that "The proposed definition of 'sponsor' is a functional definition that would apply regardless of the title bestowed upon such person. Accordingly, a person would be a sponsor for purposes of the re-proposed rule if such person organized and initiated the ABS transaction[.]"[37] Here, the Commission is referring to clause (i) of its proposed definition of "sponsor," which (as noted above) does correspond to its ordinary and natural meaning.

However, the Proposing Release goes on to state that a person is a "sponsor" if it has otherwise:

> "directed or had the contractual right to direct the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS, regardless of whether the person is referred to as the sponsor of the ABS or by some other title (e.g., issuer, depositor, originator, or collateral manager), and even if the person does not have a named role in the ABS transaction and is not a party to any of the transaction agreements."[38]

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[32] *See* Proposing Release, at 9680 (emphasis supplied).

[33] Clause (i) of the definition of "sponsor" in the Proposed Rule captures "Any person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the entity that issues the asset-backed security." *Id.* at 9727.

[34] Clause (ii) of the definition of "sponsor" in the Proposed Rule captures "Any person: (A) with a contractual right to direct or cause 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; or (B) 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." *Id.* Recognizing the broad sweep of the foregoing, clause (ii) provides that "Notwithstanding paragraphs (ii)(A) and (ii)(B) of this definition, a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security will not be a sponsor for purposes of this rule." *Id.*

[35] *See id.* (clause (ii)(C) of the definition of "sponsor" in the Proposed Rule).

[36] *Id.* at 9686.

[37] *Id.*

[38] *Id.*

Here, the Commission is referring to clause (ii) of its proposed definition of "sponsor." The Proposing Release explains that clause (ii) is "consistent with a commenter's suggestion in response to the 2011 proposed rule *to define the term ''sponsor'' broadly for purposes of Section 27B in order to ensure that the prohibition would apply to a broad range of securitization participants, including collateral managers and other parties with significant influence in the structure, composition, and management of an ABS*."[39] However, clause (ii) is inconsistent with the ordinary and natural meaning of the term "sponsor."

The foregoing excerpt from the Proposing Release demonstrates how clause (ii) of the definition of "sponsor" causes that definition to exceed its ordinary and natural meaning. The Proposing Release:

- starts with "a broad range of securitization participants, including collateral managers and other parties with significant influence in the structure, composition, and management of an ABS" (collectively "influencers");

- subtracts the influencers that perform only administrative, legal, due diligence, custodial, or ministerial acts;

- subtracts the influencers who are underwriters, initial purchasers and placement agents; and

- characterizes any remaining influencers as "sponsors."

What separates a "sponsor," (when given its ordinary and natural meaning) from a mere "influencer" is the central role that the sponsor plays in organizing and initiating the securitization transaction. As the Commission and the other regulatory agencies noted in the adopting release for Regulation RR, "[t]he agencies believe that the organization and initiation criteria in both definitions [the definition of "securitizer" in Section 15G of the Exchange Act and the definition of "sponsor" in Regulation RR] are critical to determining whether a person is a securitizer or sponsor."[40]

The Associations agree with the Commission's previous identification of the essential "organize and initiate" element that distinguishes sponsors from mere influencers. While clause (i) includes the well-established definition of sponsor that has served the industry well for over a decade (a definition that highlights the role the sponsor has in organizing and initiating the securitization transaction), clause (ii) of that definition (together with the Commission's commentary in the Proposing Release) does not refer at all to the central organization and initiation functions that characterize securitization sponsors. Instead, clause (ii) reimagines "sponsors" as "influencers" that are distinguished from lawyers, custodians, due diligence providers and performers of ministerial acts only by force of an express exception for those particular sub-classes of influencers.

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[39] *Id*. (emphasis supplied).

[40] Credit Risk Retention, 79 Fed. Reg. 77602, 77609 (Dec. 14, 2014).

The Proposed Rule's definition of "sponsor" is a major departure from the ordinary and natural meaning of that term. The new definition is so wide-ranging that it threatens to capture *investors* (the persons for whom the securitization is being organized and initiated). Noting that some ABS investors have preferences regarding asset pools in ABS products, the Commission was compelled by the expansiveness of clause (ii) to assure investors they will not fall under the Proposed Rule's prohibitions if they "have stipulations regarding *general characteristics* of the composition of the underlying pool of an ABS."[41] The Commission, however, did not describe the level of acceptable generality for investors' stipulations or level of engagement, or whether investors would be subject to the Proposed Rule if their stipulations are considered too specific. Again, the Commission's recognition that clause (ii) of its proposed definition of "sponsor" is broad enough to potentially include ABS investors demonstrates how far the Proposed Rule's definition of 'sponsor" strays from the ordinary and natural meaning of that term.

The Proposing Release explains its expansive definition of "sponsor" by noting that "the structure of the ABS and the composition of the underlying asset pool are the factors that will most impact the performance of the ABS."[42] While the structure of the ABS and the composition of the asset pool may be the most important factors in the future performance of a securitization transaction, Section 27B itself has already made the determination as to which transaction parties (underwriters, placement agents, initial purchasers or sponsors) and which transactions (those that would involve or result in any material conflict of interest) are relevant to the purpose of Section 27B.

Indeed the Proposing Release goes so far as to say that it "is appropriate for the proposed definition of 'sponsor' to capture contractual rights sponsors *without requiring a factual determination of whether a contractual rights sponsor has exercised its contractual right to direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS*."[43] An entity that has not actually done those things could not be considered a sponsor of an asset-backed securities transaction under any definition that resembles the ordinary and natural meaning of that term.

3. <u>The Dodd-Frank Act's only references to a securitization "sponsor" are in Section 621 and Section 939F thereof. The term "sponsor" should be construed consistently in those two sections.</u>

Other than Section 621 of the Dodd-Frank Act (the section at issue here), the only other reference to a securitization "sponsor" within the Dodd-Frank Act is in Section 939F thereof. Section 939F deals with the study and potential adoption of a rule with respect to structured finance products (which include asset-backed securities) that:

[41] Proposing Release, at 9686.

[42] *Id.* at 9685.

[43] *Id.* at 9686 (emphasis added).

"prevents the issuer, *sponsor*, or underwriter of the structured finance product from selecting the nationally recognized statistical rating organization that will determine the initial credit ratings and monitor such credit ratings."[44]

In an asset-backed securities transaction, the only entities that select a credit ratings agency in the first place are an issuer, an underwriter, and/or the entity that organizes and initiates a securitization transaction – *i.e.*, the "sponsor." Indeed, selecting the rating agency is one of the key preliminary activities involved in organizing and initiating a securitization transaction. A party that merely "influences" the structure and design of the ABS, or the selection of the underlying or referenced assets, without actually organizing and initiating the transaction, would not be the party selecting the rating agency.

Thus, the word "sponsor" presumptively carries the same meaning – its ordinary and natural meaning – in Section 621. The Proposed Rule's expansive "any party who influences"-based definition of "sponsor" would necessarily require that the meaning of "sponsor" in Section 621 be construed far differently than the meaning of "sponsor" in Section 939F.

Both Section 621 and Section 939F relate to securitization sponsors. The term "sponsor" in both of those sections should be construed as having the same meaning.

B. Investors in a long position in asset-backed securities should be excluded from the definition of "sponsor."

As noted in Part II.A.2. above, due to its expansiveness, the Proposed Rule's definition of "sponsor" is so expansive that it can capture investors. Such a result is contrary to the ordinary and natural meaning of the term "sponsor" as set forth in Section 27B.[45] An investor or prospective investor in a long position in the asset-backed security, regardless of whether that investor specifies preferences or requirements regarding the composition of the underlying assets or the structure, features and design of the asset-backed security, should not be considered a sponsor.

C. Credit rating agencies should be excluded from the definition of "sponsor."

The Proposing Release states 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 fall within the exclusion from the definition of the proposed definition of the term 'sponsor'."[46] That exclusion should be contained in the final rule.

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[44] *See* 15 U.S.C. § 78o-9 (emphasis supplied).

[45] *See* the discussion in Part II.A.2. of this letter ("The Proposed Rule's definition of 'sponsor' is a major departure from the ordinary and natural meaning of that term. The new definition is so wide-ranging that it threatens to capture investors (the persons from whom the securitization is being organized and initiated).").

[46] Proposing Release, at 9686.

D. States and their political subdivisions should be excluded from the definition of "sponsor."[47]

In keeping with the treatment of state and local governmental issuers and their respective agencies, authorities and instrumentalities and their securities in the Investment Company Act of 1940, as amended, the Volcker Rule[48] and Regulation RR,[49] no State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, should be included in the definition of "sponsor." These governmental issuers engage in transactions consistent with enabling legislation that is designed specifically to aid in the accomplishment and furtherance of important government functions and other public purposes, none of which implicate the concerns behind the Proposed Rule.

Application of the Proposed Rule to these entities and activities (including their securitizations) would only serve to burden them, impede the achievement of their goals and needlessly subject government officials and members of such agencies to costs and concerns inconsistent with their missions. Moreover, we believe there is no evidence that Congress intended a rule proposed under Section 27B to apply to, or be otherwise concerned with, the financing activities of state and local governmental units. Apart from this, application of the rule to state and local governmental units would appear as a breach of the principles of federalism and intergovernmental comity, and in circumstances in which none of the purposes that underlie the rule can be expected to be advanced.[50]

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[47] Separately, SIFMA has signed onto, on behalf of its members, a joint municipal securities industry letter of this same date requesting exclusion from the definition of asset-backed securities for securitizations that comprise municipal securities that would otherwise be subject to the Proposed Rule, and that such issuers should be excluded from this proposal's definition of "securitization participants" and "sponsors." Additionally, we note, in support of the exclusion for municipal securities that are asset-backed securities, that in addition to potential liability under Securities Act, underwriters and placement agents of municipal securities are subject to the general fairness obligation in MSRB Rule G-17 and, in connection therewith are required to provide issuers of municipal securities (including municipal issuers of asset backed securities that would be subject to the Proposed Rule) with a G-17 letter at the time of engagement where, among other things, they are required to disclose their actual and potential actual material conflicts of interest, including those related to the trading of credit default swaps, if relevant.

[48] Section 255.6(a)(3) of the Volcker Rule provides, in pertinent part: "(a) The prohibition contained in Section 255.3(a) [the proprietary trading prohibition] does not apply to the purchase or sale by a banking entity of a financial instrument that is: . . . (3) An obligation of any State or any political subdivision thereof, including any municipal security." 17 C.F.R. § 255.6(a)(3) (2023).

[49] Section 246.19(b)(3) of Regulation RR states that the rule shall not apply to "Any asset-backed security that is a security issued or guaranteed by any State, or by any political subdivision of a State, or by any public instrumentality of a State that is exempt from the registration requirements of the Securities Act of 1933 by reason of section 3(a)(2) of that Act (15 U.S.C. 77c(a)(2))." 17 C.F.R. § 246.19(b)(3) (2023).

[50] Section 2(b) of the Investment Company Act of 1940, as amended, states: "No provision in this subchapter shall apply to, or be deemed to include, the United States, a State or any political subdivision of a State or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty, unless such provision makes specific reference thereto." 15 U.S.C. § 80a-2(b).

E. Third-party servicers should be excluded from the definition of "sponsor."

Third-party servicers should be excluded from the definition of "sponsor." In addition to their not being sponsors in the ordinary and natural sense of that term, their role is analogous to that of entities that are already carved out under the Proposed Rule (*e.g.*, entities performing administrative and custodial tasks). Moreover, third-party servicers' duties in connection with securitization transactions are contractual duties (including the implied covenant of good faith and fair dealing), not securities law duties.

III. THE BEGINNING OF THE COMPLIANCE PERIOD SHOULD BE CLARIFIED AND MORE CLOSELY LINKED TO THE DATE OF FIRST SALE.

> The compliance period cannot begin with respect to an entity until it becomes an entity that is described in Section 27B; namely, an underwriter, placement agent, initial purchaser or sponsor.
>
> The compliance period should not begin more than 30 days prior to the date of the first closing of the sale of the related asset-backed securities.
>
> The Proposed Rule's "substantial steps" standard is so vague that it fails to put market participants on notice that they are within the Proposed Rule's scope.

A. The compliance period cannot begin with respect to an entity until that entity becomes an underwriter, placement agent, initial purchaser, or sponsor.

Section 27B calls for a rule that prohibits an underwriter, placement agent, initial purchaser, or sponsor from entering into a transaction that would involve or result in a material conflict of interest between it and an investor. The terms "underwriter," "placement agent," "initial purchaser" and "sponsor" as used in Section 27B each have their own respective ordinary and natural meanings. None of those terms are ambiguous. No entity becomes an underwriter, placement agent, initial purchaser or sponsor simply by taking substantial steps to become one. An entity that has taken "substantial steps" to become the type of entity whose actions are regulated by Section 27B is not yet the type of entity whose actions are regulated by Section 27B.

As noted by the Proposed Rule's own definitions, what makes an entity an underwriter, placement agent or initial purchaser is that it has "agreed with an issuer" to become one. What makes an entity a "sponsor" is the act of organizing and initiating a securitization transaction.

There is no ambiguity with respect to when an entity becomes an underwriter, placement agent, initial purchaser or sponsor. The Proposed Rule creates ambiguity where none exists by stating that an entity becomes subject to the rule because it has taken ambiguous "substantial steps" toward becoming an entity that is described in Section 27B (which, as described above, is an otherwise unambiguous thing). The "substantial steps" standard does not resolve any such ambiguity. The "substantial steps" standard is unreasonable because it exacerbates, rather than ameliorates, any ambiguity and, in so doing, extends the scope of the rule far beyond the limits set forth in Section 27B.

B. The compliance period should not begin more than 30 days prior to the date of the first closing of the sale of the related asset-backed securities.

The compliance period should not begin, with respect to any entity, more than 30 days prior to the date of the first closing of the sale of the related asset-backed securities, even if that entity became an underwriter, placement agent, initial purchaser or sponsor prior to that time.[51]

[51] We note that 30 days is the safe harbor period prescribed under Rule 152 for purposes of determining whether two or more offerings are to be treated as one for the purpose of registration or qualifying for an exemption from

Given how expansively "conflicted transaction" is defined in the Proposed Rule, market participants will have difficulty assessing whether a transaction entered into while the ABS actually exists is a conflicted transaction. This difficulty grows dramatically the further in time that the transaction is from the time that the ABS and the investors therein actually exist.

C. The Proposed Rule's compliance period fails to put market participants on notice that they are within the Proposed Rule's scope.

As drafted, the Proposed Rule's compliance period that begins when an underwriter, placement agent, initial purchaser or sponsor "has reached, or taken substantial steps to reach, an agreement that such person will become a securitization participant" is a particularly vague facts and circumstances determination.

For example:

- It is unclear what constitutes a "step" toward reaching an agreement to become a securitization participant. Similarly, it is unclear what distinguishes a substantial step from an insubstantial one.

- The Proposed Rule does not specify what "substantial steps to reach an agreement" that an entity could take toward becoming a sponsor, or with whom that entity must be trying to reach agreement.

- With respect to an entity that has taken substantial steps to reach an agreement to become a securitization participant but ultimately never reaches an agreement to become a securitization participant, it is unclear whether or how the Proposed Rule applies to any transaction that such entity might enter into.[52]

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registration under the Securities Act. *See* 17 C.F.R. § 230.152(b)(1). Similarly, 30 days is the safe harbor period prescribed under time Rule 163A for purposes of determining whether registration statement "gun jumping" has occurred with respect to certain communications made prior to the filing of the registration statement. *See* 17 C.F.R. § 230.163A(a). Both of these standards are useful in the context of the compliance period under the Proposed Rule because they specify a period of time beyond which a certain prior activity (a previous offering, in the case of Rule 152, and a previous communication, in the case of Rule 163A) can be deemed not to implicate a concern with respect to a present activity (a current offering, in the case of Rule 152, or the filing of a registration statement, in the case of Rule 163A).

[52] The Proposing Release states that "under the re-proposed rule, the prohibition on material conflicts of interest would not apply to a person that never reaches an agreement to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS, even if such person were to take substantial steps to reach such an agreement." *See Proposing Release*, at 9693. While the Associations appreciate this clarification, it remains unclear at what point in time a person will be deemed never to have reached an agreement. We think that determination should be made no later than the date of the first sale the relevant asset-backed securities. Even with that further clarification, the Proposing Release's "substantial steps" test remains unclear because it suggests that a transaction could be subject to challenge if it occurs after "substantial steps" are taken but before it is determined that an agreement to act as a securitization participant has never been reached. These difficulties serve to highlight the underlying problem with the "substantial steps" test discussed above; namely, that parties who have taken substantial steps to become the type of entity whose transactions are subject to scrutiny under Section 27B are not yet parties whose transactions are subject to scrutiny under Section 27B.

Given these many uncertainties, the Proposed Rule's compliance period is so vague that it fails to put market participants on notice that they are within the Proposed Rule's scope. Thus, as stated above:

- the compliance period should not begin until the entity has actually become an underwriter, placement agent, initial purchaser or sponsor; and

- the compliance period should not begin more than 30 days prior to the date of the first closing of the sale of the related asset-backed securities.

IV. THE PROPOSED RULE'S DEFINITIONS OF "SECURITIZATION PARTICIPANT" AND "CONFLICTED TRANSACTION" ARE NOT CONCEPTUALLY ALIGNED WITH THE ORDINARY AND NATURAL MEANING OF "CONFLICT OF INTEREST."

The Proposed Rule's definitions of "securitization participant" and "conflicted transaction" are not conceptually aligned with what a conflict of interest actually is, and therefore they cause the Proposed Rule to exceed the scope of Section 27B.

As explained in this Part IV, the fundamental flaw of the Proposed Rule is that it fails to link its proposed definitions for "securitization participant" and "conflicted transaction" to transactions that conflict with the securities law duties of underwriters, placement agents, initial purchasers and sponsors.

Part V provides related specific comments on the definition of "securitization participant" and proposes changes with respect to that definition.

Part VI provides related specific comments on the definition of "conflicted transaction" and proposes changes with respect to that definition.

In order to be conceptually aligned with what a conflict of interest actually is, the definitions of "securitization participant" and "conflicted transaction" must:

- relate to the duties that underwriters, placement agents, initial purchasers and sponsors have under the securities laws,[53] and
- define the types of transactions that should be prohibited because they pose a material risk that the transaction will induce an underwriter, placement agent, initial purchaser or sponsor to breach its securities law duties.

Section 17(a) of the Securities Act provides a recitation of the existing securities law duties that are relevant to Section 27B:[54]

- The duty not to "employ any device, scheme, or artifice to defraud."[55]

[53] The nature of any duties that a securitization participant has under the securities laws is necessarily dependent on the role that such securitization participant plays in the securitization transaction.

[54] Indeed, these were precisely the legal duties that the Commission alleged were violated in the enforcement actions described in footnote 216 of the Proposing Release. These same securities law duties are also found in Rule 10b-5 under the Exchange Act. Similarly, Section 10(b) of the Exchange Act prohibits any manipulative or deceptive deviance or contrivance in contravention of rules established by the Commission in connection with the purchase or sale of any security.

[55] *See* 15 U.S.C. § 77q(a)(1).

- The duty not to make "any untrue statement of a material fact or [omit] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[56]

- The duty not to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person."[57]

Crucially, Section 27B does not itself create any new underlying securities law duties, nor does it empower the Commission to create any new underlying duties, that securitization participants have under the securities laws. Rather, by using the term "conflict of interest," Section 27B should be read as prohibiting transactions that materially conflict with the already existing securities law duties of underwriters, placement agents, initial purchasers and sponsors.

Rulemaking in the area of "conflicts of interest" necessarily requires a clear identification of the parties that have duties under the securities laws, what those underlying duties are, how certain transactions entered into by one of those parties conflict with its underlying securities law duties, and when those duties arise. The Proposing Release does not satisfy those tests because it:

- proposes an overly-broad definition of "securitization participant,"

- proposes an overly-broad definition of "conflicted transaction,"

- deems any such conflicted transaction by any such securitization participant to constitute a transaction that involves or results in a "material conflict of interest" between that securitization participant and investors, but

- fails to link its proposed "securitization participant" and "conflicted transaction" definitions to transactions that conflict with the existing securities law duties of securitization participants, and fails to recognize when those duties arise.

The foregoing is the fundamental flaw of the Proposed Rule, as well as its predecessor, Proposed Rule 127B. The words "duty" or "duties" do not appear anywhere in the proposing release for Proposed Rule 127B. Those words appear only twice in the current Proposing Release. One is a stray reference to contractual rights that certain parties have a "duty to exercise."[58] The only other reference to "duty" appears in Footnote 220:

> Further, an adviser to a hedge fund, as part of the adviser's fiduciary duty to the hedge fund, has a duty of loyalty that requires it to "make full and fair disclosure to its clients of all material facts relating to the advisory relationship" and "eliminate, or at least expose, through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[59]

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[56] *See* 15 U.S.C. § 77q(a)(2).

[57] *See* 17 C.F.R. § 240.10b-5(c) (2023).

[58] Proposing Release, at 9686.

[59] *Id*. at 9713.

Footnote 220 clearly identifies the party that owes a duty (the investment adviser), clearly describes the underlying duty (the fiduciary duty and the related duty of loyalty) that the investment adviser owes to its advisory clients, and explains how certain classes of transactions entered into by an investment adviser could conflict with that underlying duty. The Proposing Release is not similarly clear in specifying those same elements under the Proposed Rule.

Notably, conflicts of interest between investment advisers and their advisory clients belong to the most troubling category of conflicts of interest under the law because the fiduciary duty standard is the highest standard of duty implied by law. Nevertheless, as the Commission notes in Footnote 220, exposure of the conflict through "full and fair disclosure" can be used to address them. It is troubling that the Commission did not include a disclosure alternative in the Proposed Rule, even after the Commission recognized in the Proposing Release that disclosure is a means of addressing the more troubling conflicts of interest described in Footnote 220.

V. THE PROPOSED RULE'S DEFINITION OF "SECURITIZATION PARTICIPANT" SHOULD BE NARROWED AND CLARIFIED.

A large number of the legal entities that act as underwriter, placement agent, initial purchaser, or sponsor have entities within them (business units or groups), or related to them (affiliates and subsidiaries), that have no substantive role in structuring, creating, marketing, or selling the asset-backed security, or in selecting the assets backing the asset-backed securities. We refer to such business units, groups, affiliates and subsidiaries as "non-participating entities."

A transaction entered into by a non-participating entity on its own, and without coordination with the underwriter, placement agent, initial purchaser or sponsor, does not give rise to a material conflict of interest with investors.

Whether an underwriter, placement agent, initial purchaser or sponsor is engaging in a transaction indirectly through, and in coordination with, a non-participating entity is a facts and circumstances determination.

Information barriers should be one of a number of methods that may be used to establish and demonstrate the separateness of non-participating entities and securitization participants.

Investment advisers and their advisory clients should not be considered securitization participants due to their affiliation with an underwriter, placement agent, initial purchaser or sponsor.

The definitions of "underwriter," "placement agent" and "initial purchaser" should be limited to those persons that are directly involved with structuring the relevant asset-backed securities or selecting the assets underlying the asset-backed securities.

The Proposed Rule applies to conflicted transactions engaged in by securitization participants. The Proposed Rule defines "securitization participant" as:

> "(i) An underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security;[60] or
>
> (ii) Any affiliate (as defined in 17 CFR 230.405) or subsidiary (as defined in 17 CFR 230.405) of a person described in paragraph (i) of this definition."[61]

By this definition, the Proposed Rule characterizes all affiliates and subsidiaries of an underwriter, placement agent, initial purchaser, or sponsor (and all of its separate business units and groups) as "securitization participants" regardless of whether they are in fact participants in

[60] Part II of this letter separately addresses the Proposed Rule's definition of "sponsor." Part III of this letter separately addresses the Proposed Rule's compliance period, a period that begins prior to an entity actually becoming an underwriter, placement agent, initial purchaser, or sponsor.

[61] *See* Proposing Release, at 9727 (clause (c) of the definition of "securitization participant").

the securitization. This characterization has caused the Proposed Rule to lose connection with what a "conflict of interest" actually is, and has led to a rule that would be nearly impossible for large institutions to comply with.

A. A transaction entered into by a non-participating entity on its own, and without coordination with the underwriter, placement agent, initial purchaser or sponsor, does not give rise to a material conflict of interest with investors.

A large number of the legal entities that act as underwriter, placement agent, initial purchaser, or sponsor have entities within, or related to, them that have no substantive role in structuring, creating, marketing, or selling the asset-backed security, or in selecting the assets backing the asset-backed securities. These **"non-participating entities"** are:

- business units or groups within the legal entity *other than* the business unit or group that acts as the underwriter, placement agent, initial purchaser, or sponsor (*i.e.*, the business unit or group that is substantively involved in structuring, creating, marketing, or selling an asset-backed security, or selecting the assets backing the asset-backed security); and

- affiliates or subsidiaries of the legal entity that is the underwriter, placement agent, initial purchaser, or sponsor that are not substantively involved in structuring, creating, marketing, or selling an asset-backed security, or selecting the assets backing the asset-backed security.

1. A transaction cannot create a material conflict between an existing duty that an underwriter, placement agent, initial purchaser or sponsor has under the securities laws and that securitization participant's own self-interest unless that securitization participant (a) engages in the transaction directly or (b) engages in the transaction indirectly through, and in coordination with, a non-participating entity.

As noted in Part IV of this letter, Section 17(a) of the Securities Act provides a recitation of the existing securities law duties that are implicated by Section 27B. For a transaction to induce an underwriter, placement agent, initial purchaser or sponsor to breach one of the foregoing duties, that entity must engage in that transaction either directly or indirectly through a non-participating entity with which it is coordinating. Otherwise, there is no causal link between the transaction and the manner in which the underwriter, placement agent, initial purchaser or sponsor observes its securities law duties.

2. A transaction entered into by a non-participating entity on its own, and without coordination with the underwriter, placement agent, initial purchaser or sponsor, does not pose a material conflict of interest risk because it is not a transaction that poses a material risk of inducing the underwriter, placement agent, initial purchaser or sponsor to disregard a duty that it has under the securities laws.

By definition, a non-participating entity is a business unit, group, affiliate or subsidiary of a securitization participant that is not substantively involved in structuring, creating, marketing, or selling an asset-backed security, or selecting the assets backing the asset-backed security. Thus, transactions that a non-participating entity enters into on its own, and without coordination with its related securitization participant, do not implicate any securities law duties relating to structuring, creating, marketing, or selling an asset-backed security, or selecting the assets backing the asset-backed security.

Of course, it is possible that a non-participating entity could enter into a transaction or scheme on its own, and without any coordination with its related securitization participant, that is itself a direct violation of the securities laws (*e.g.*, a fraudulent transaction or scheme). But such a transaction would not constitute a "conflict of interest." Rather, it would constitute a direct violation of an underlying duty that the non-participating entity has under the securities laws. The transactions covered by Section 27B are those transactions by securitization participants that have a material tendency to induce that securitization participant to breach a securities law duty (*e.g.*, provide false or misleading disclosure to investors), not transactions by a non-participating entity that are themselves a direct breach of the securities laws by that non-participating entity.

A non-participating entity that shorts an ABS, or assets underlying the ABS, on its own, without any coordination with its related securitization participant, is not itself breaching any securities law duty. Even if it is (as part of a plan or scheme to defraud or manipulate market prices, for example), that breach is a separate violation and not the subject of Section 27B, as explained above. However, an underwriter, placement agent, initial purchaser or sponsor (*i.e.*, an entity that is actually participating in the securitization) that shorts an ABS indirectly through, and in coordination with, a non-participating entity *is* engaging in a transaction that could give rise to a conflict of interest between such underwriter, placement agent, initial purchaser or sponsor, on the one hand, and investors, on the other hand.

B. Whether an underwriter, placement agent, initial purchaser or sponsor is engaging in a transaction indirectly through, and in coordination with, a non-participating entity is a facts and circumstances determination.

Whether an underwriter, placement agent, initial purchaser or sponsor is engaging in a transaction indirectly through, and in coordination with, a non-participating entity is a facts and circumstances determination. Although the Proposing Release cites Regulation M for purposes of the "affiliated purchaser" concept as used in Rule 101 and Rule 102 thereunder[62] (rules pertaining to bids and purchases during the restricted period prior to an offering), the "separate accounts"

[62] *Id.* at 9690.

exception used in Rule 105 (dealing with short sales during the restricted period prior to an offering) is a much more relevant paradigm for this rulemaking.[63] Rule 105 states:

> "Separate accounts. Paragraph (a) of this section shall not prohibit the purchase of the offered security in an account of a person where such person sold short during the Rule 105 restricted period in a separate account, *if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between the accounts.*"[64]

Whether such coordination or cooperation exists is itself a factual determination. The Commission has provided guidance in making that determination:

> *"What are indications of separate accounts?*
>
> - *The accounts have separate and distinct investment and trading strategies and objectives;*
> - *Personnel for each account do not coordinate trading among or between the accounts;*
> - *Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;*
> - *Each account maintains a separate profit and loss statement;*
> - *There is no allocation of securities between or among accounts; and*
> - *Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trading in individual securities in the accounts and in fact, do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and in fact, do not pre-approve trading decision for the accounts.*
>
> *Depending on the facts and circumstances, accounts not satisfying each of these conditions may nonetheless fall within the exception."*[65]

The Commission explained that the "separate accounts" exception was appropriate "if decisions regarding securities transactions for each account are made separately and without coordination . . . even though the accounts may be affiliated or otherwise related, [because] the

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[63] *See* 17 C.F.R. § 242.105 (2023).

[64] *Id.* § 242.105(b)(2).

[65] *See Short Selling in Connection with a Public Offering: Amendments to Rule 105 of Regulation M*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/divisionsmarketregtmcomplianceregmrule105-secg.htm#foot1 (last modified May 21, 2008) (emphasis added). The foregoing re-states the indicia of separate accounts as set forth in Short Selling in Connection with a Public Offering, 72 Fed. Reg. 45094, 45098 (Aug. 10, 2007) (to be codified at 17 C.F.R. pt. 242).

incentive that motivates the Rule 105 violation is not present."[66] The Commission further noted that the exception was a "carefully honed response to the comments" it received on the subject and that structures and entities with safeguards that are not in line with the indicia may still fall within the exception as determined by the Commission on a case-by-case basis.[67]

The final rule under Section 27B should use a facts and circumstances framework such as that described above in order to properly scope in, and scope out, the business units, groups, affiliates and subsidiaries that are subject to the rule. As is the case with separate accounts under Rule 105 of Regulation M, information barriers can play a key role in establishing that the requisite facts and circumstances exist to treat transactions by non-participating entities as separate from transactions by securitization participants.

C. The Commission should re-propose a rule under which information barriers are one of a number of methods that may be used to establish and demonstrate the separateness of non-participating entities and securitization participants.

Any final rule under Section 27B should recognize the use of information barriers as an indicia of the separateness of an underwriter, placement agent, initial purchaser or sponsor, on the one hand, and its related non-participating entities, on the other hand. As is the case with separate accounts under Rule 105 above, any rule under Section 27B should not affirmatively require information barriers nor should it impose rigid requirements as to the particular features an information barrier must have. The presence or absence of information barriers, and the robustness thereof, should be part of a multi-factor analysis.

1. The Proposing Release's skepticism about the effectiveness of information barriers is unwarranted given their prevalent use under existing securities laws.

As the Proposing Release notes, information barriers:

> "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."[68]

Unlike the conflicted transactions that are the subject of Section 27B, the potential misuse of material non-public information ("MNPI") is among the most significant of all securities law concerns. It is a concern that has existed for as long as securities markets have existed, and will continue to exist for as long as securities markets continue to exist. That information barriers are used to manage the potential misuse of MNPI is a testament to the value that the Commission has previously recognized in them.

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[66] 72 Fed. Reg. at 45098.

[67] *Id.* at 45100.

[68] *See* Proposing Release, at 9690.

Notwithstanding this longstanding recognition of the value of information barriers, the Commission takes the position in the Proposing Release that information barriers are insufficient to prevent conflicted transactions. This position stands in sharp contrast to the Commission's previous positions on information barriers, as well as the long-standing codification of information barriers under various securities laws as a means of addressing or mitigating potential conflicts of interest. [69]

The Commission has studied information barriers and the effectiveness thereof as part of its general oversight of the markets. In March 1990, the Commission, through the Division of Market Regulation, published its detailed study of broker-dealer policies and procedures to prevent the misuse of MNPI, including by means of information barriers.[70] In 2012, the Commission, through the Office of Compliance Inspections and Examinations, provided examples of effective information barrier practices for MNPI.[71] The Commission's summary described restrictions of electronic information between public- and private-side employees, formal written processes and documentation of sharing MNPI, physical barriers, and technology barriers as effective practices.[72] It is notable that the comments opposing the use of information barriers cited in the Proposing Release were made prior to the release of the above-referenced 2012 report and its examples of effective information barrier practices.

To the extent that the Commission has concerns about the use and effectiveness of information barriers generally, the Associations respectfully suggest that this rulemaking is not the appropriate forum to announce the abandonment, or general ineffectiveness, of them. Such a major and profound policy shift would benefit from deep study by the Commission and its staff, independent of this rulemaking.

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[69] In the Proposing Release, one of the Commission's few statements against the use of information barriers is that "[t]he re-proposed rule does not include the use of information barriers as an exception for affiliates and subsidiaries because we are concerned about the potential to use an affiliate or subsidiary to evade the re-proposed rule's prohibition." *Id.* While the Proposing Release included descriptions of past commenters who opposed information barriers as an exception because of "perceived permeability, limited utility, and difficulties" with enforcement, the Commission spoke little of its own views of information barriers. *Id.* In contrast, the Commission provides several statements supporting the use and effectiveness of information barriers. Specifically, as noted above, the Commission noted that "[i]nformation 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 hereunder." *Id.*

[70] *See* DIV. MKT. REGUL., U.S. SEC. AND EXCH. COMM'N, BROKER-DEALER POLICIES AND PROCEDURES DESIGNED TO SEGMENT THE FLOW AND PREVENT THE MISUSE OF MATERIAL NONPUBLIC INFORMATION (1990), https://www.sec.gov/divisions/marketreg/brokerdealerpolicies.pdf.

[71] OFF. OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, U.S. SEC. AND EXCH. COMM'N, STAFF SUMMARY REPORT ON EXAMINATIONS OF INFORMATION BARRIERS: BROKER-DEALER PRACTICES UNDER SECTION 15(G) OF THE SECURITIES EXCHANGE ACT OF 1934, app. B (2012), https://www.sec.gov/about/offices/ocie/informationbarriers.pdf.

[72] *Id.*

2. Information barriers were endorsed by the Commission and the other regulatory agencies in the Volcker Rule.

Implemented as the Volcker Rule, Section 619 of the Dodd-Frank Act, with which the Proposed Rule was intended to work "in tandem,"[73] also includes information barrier exceptions.[74] In the Volcker Rule's Adopting Release, the regulatory agencies (including the Commission) explain that "information barriers have been recognized in Federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities."[75] The regulatory agencies (including the Commission) also noted that:

> "Under the final rule, a banking entity may address a conflict by establishing, maintaining, and enforcing information barriers reasonably designed to avoid a conflict's materially adverse effect . . . The Agencies believe that, to the extent, the materially adverse effect of a conflict has been substantially mitigated, negated, or avoided, it is appropriate to allow the transaction, class of transaction, or activity under the final rule. Continuing to view the conflict as a material conflict of interest under these circumstances would not appear to benefit the banking entity's client, customer, or counterparty."[76]

The Volcker Rule's Adopting Release also discusses various factors set forth by the Commission in the current Proposing Release. The regulatory agencies (including the Commission) recognized that several forms of information barriers such as restrictions on information sharing, trading, and common officers or employees could address or mitigate potential conflicts of interest.[77]

3. The Proposing Release's five conditions for the use of information barriers are unnecessary in a multi-factor analysis of the separateness of a non-participating entity from its related securitization participant.

In the Proposing Release, the Commission provided five conditions for information barriers that it would consider when drafting the final rule. Those five conditions are:

(1) An information barriers exception could require establishing, implementing, maintaining, enforcing, and documenting written policies and procedures to prevent the flow of information to and from the securitization participants with policies including, but not limited to:

a. Physical separation of personnel; and

[73] Senators Merkley & Levin, *supra* note 20.

[74] *See* 17 C.F.R. §§ 255.7(b)(2)(ii), 255.15(b)(2)(ii) (2023).

[75] 79 Fed. Reg. 5536, 5560 (Jan. 31, 2014).

[76] *Id.* at 5662.

[77] *Id.* at 5564.

b. Restriction of a securitization participant's activities to only those activities necessary for it to act in its capacity as a securitization participant;

(2) An information barriers exception could require establishing, implementing, maintaining, enforcing, and documenting a written internal control structure governing the implementation and adherence to the securitization participant's written policies and procedures;

(3) An information barriers exception could require an annual, independent assessment of the policies and procedures' operation and internal control structure;

(4) An information barriers exception could require that the affiliate or subsidiary has no officers or persons performing similar functions in common with the securitization participant;

(5) An information barriers exception could be inapplicable if any securitization participant knows or reasonably should know that a specific securitization would result in a material conflict of interest.[78]

These conditions are substantially similar to those found in the definition of "affiliated purchaser" under Rule 100 of Regulation M.[79] However, as noted above, the affiliated purchaser concept is used under Rule 101 and Rule 102 of Regulation M, each of which addresses bids or purchases during the restricted period.

As discussed in Part V.B. above, we believe the "separate accounts" paradigm under Rule 105 of Regulation M, together with its multi-factor indicia of separateness, is more appropriate here. That is because, in the context of this conflicts of interest rulemaking, the purpose of an information barrier is not to prevent the flow of information to parties that should not possess it -- we have separate rules, such as Section 15(g) of the Exchange Act, for that purpose. What any rule under Section 27B should do is create a set of standards to demonstrate and ensure that an underwriter, placement agent, initial purchaser or sponsor, on the one hand, and its related non-participating entities, on the other hand, are in fact acting separately and that such securitization participant is not indirectly engaging in a prohibited transaction through, and in coordination with, a related non-participating entity.

Finally, many entities that act as securitization participants utilize information barriers, "need to know" policies and similar mechanisms to restrict the flow of information and ensure compliance with applicable law. Requiring large institutions to establish custom-made information barriers in order for them to be recognized under this rule would be needlessly prescriptive and burdensome, and would compromise rather than facilitate compliance due to the confusion inherent in maintaining different sets of inconsistent, intersecting and conflicting information barriers.

[78] Proposing Release, at 9691.

[79] *See* 17 C.F.R. § 242.100 (2023) (defining "affiliated purchaser").

To the extent the Commission will require a standard for an information barrier to be recognized as an indicia of separateness under the Proposed Rule, it should utilize one based on the Volcker Rule's standard for information barriers:[80]

> The underwriter, placement agent, initial purchaser or sponsor, as applicable, has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on the types of activity, that are reasonably designed, taking into account the nature of the related entity's business, to prevent the flow of information to and from the underwriter, the placement agent, the initial purchaser, or the sponsor, as applicable, and the non-participating entity.

D. Investment advisers and their advisory clients should not be considered securitization participants due to their affiliation with an underwriter, placement agent, initial purchaser or sponsor.

One worrying consequence of the Proposed Rule's overly-broad definition of "securitization participant" is that it captures investment advisers and even the advisory clients that they control, because it characterizes those clients as affiliates or subsidiaries of the advisers and, accordingly, as "securitization participants" whose transactions would be subject to the prohibitions in the Proposed Rule. This result significantly conflicts with the already-existing, and very comprehensive, regulatory regime that governs investment advisers under federal and state laws.

Indeed, under the Proposed Rule, the following scenario is entirely possible:

- an underwriter in an ABS transaction has an investment adviser affiliate,
- by virtue of that affiliation, that investment adviser is deemed to be a securitization participant under the Proposed Rule,
- that affiliated investment adviser, acting in a fiduciary capacity, causes an advisory client to enter into a transaction that is technically a conflicted transaction under the Proposed Rule,
- that same transaction either does not raise any conflicts of interest between that investment adviser, acting as such, and its advisory client, or if it does, then
- under the Investment Advisers Act of 1940 (the "Advisers Act") or applicable state law, the investment adviser may address the conflict with its advisory client through full and fair disclosure and informed client consent, but the adviser could not similarly resolve the conflict under the Proposed Rule.

In this scenario, under the Proposed Rule, the investment adviser would be prohibited from causing the client to (or otherwise recommending that the client) engage in the transaction.

[80] *See* 17 C.F.R. § 255.7(b)(2)(ii) (2023).

Similarly, the adviser's client itself, if deemed to be a securitization participant, would also be prohibited from engaging in the transaction. These prohibitions would not arise under the Advisers Act or corresponding state laws. They would, however, arise under the rigid provisions of the Proposed Rule. As a result, the Proposed Rule effectively elevates the interests of the ABS investors (to whom no securitization participant[81] acting as such owes a fiduciary duty) over the interests of the advisory clients themselves.

An investment adviser will also be hampered in its ability to act in accordance with the fiduciary duty it owes to its advisory clients under the Advisers Act and corresponding state laws. If a particular investment is one that the adviser, acting as such, has determined is in the best interests of the advisory client to make (or otherwise recommend to the client), the investment adviser, the advisory client, or both, would be prevented from making that investment under the Proposed Rule.

Scenarios such as these must be avoided. The term "securitization participant" should expressly exclude any entity acting in its capacity as an investment adviser, as well as that entity's advisory clients.

E. The definitions of "underwriter," "placement agent" and "initial purchaser" should be limited to those persons who are directly involved with structuring the relevant asset-backed securities or selecting the assets underlying the asset-backed securities.

The definitions of "underwriter," "placement agent" and "initial purchaser" should be limited to those persons who are directly involved with structuring the relevant asset-backed securities or selecting the assets underlying the asset-backed securities. For example, co-managers typically have very little direct involvement with the foregoing securitization activities and instead rely almost entirely on the lead managers.

As noted in various sections of this letter, the purpose of Section 27B is to prohibit certain conflicts between (a) the securities law duties that a securitization participant has in connection with its securitization activities and (b) that securitization participant's own self-interest. The limitation set forth above is consistent with that purpose and necessary to avoid improperly construing transactions by the aforementioned entities, such as co-managers, as creating material conflicts of interest with investors.

[81] Let alone an investment adviser that is deemed to be a securitization participant simply because of its affiliation with an actual securitization participant, such as the ABS underwriter.

VI. THE PROPOSED RULE'S DEFINITION OF "CONFLICTED TRANSACTION" SHOULD BE NARROWED AND CLARIFIED.

The Proposed Rule's definition of "conflict of interest" does not reflect that term's ordinary and natural meaning.

The Associations agree that a short sale of ABS by a securitization participant may create a conflict of interest between that securitization participant and investors.

The catchall provision of the "conflicted transaction" definition is much too broad and does not describe transactions that create material conflicts of interest.

Pre-securitization transactions should be expressly carved out of the definition of "conflicted transaction."

A short position in an index that references the ABS should be expressly carved out of the definition of "conflicted transaction."

A. The Proposed Rule's definition of "conflict of interest" far exceeds that term's ordinary and natural meaning.

As noted in Part I, in the absence of a statutory definition, a statutory term is generally construed "in accordance with its ordinary and natural meaning." The term "conflict of interest" is not defined in Section 27B. Therefore, any definition of "conflict of interest" in the rule that implements Section 27B must reflect its ordinary or natural meaning. The definition of "conflict of interest" in the Proposed Rule is far broader than the ordinary or natural meaning of that term.

1. The term "conflict of interest" has an ordinary and natural meaning. It means a conflict between one's duty and one's own self-interest.

The ordinary and natural meaning of "conflict of interest" is a conflict between one's duty and one's own self-interest.[82] A fundamental issue with the Proposed Rule arises from the disconnect between:

- the statutory language of Section 27B, which directs the Commission to issue rules prohibiting "any transaction that would involve or result in any material conflict of interest with respect to any investor"[83] and

[82] *See, e.g.*, *Conflict of Interest*, BLACK'S LAW DICTIONARY (11th ed. 2019) ("A real or seeming incompatibility between one's private interests and one's public or fiduciary *duties*.") (emphasis supplied). *See, also*, *Conflict of Interest*, MERRIAM-WEBSTER'S DICTIONARY OF LAW (4th ed. 2019) ("A conflict between the private interests and the official or professional responsibilities of a person in a position of trust."); *Conflict of Interest*, THE AMERICAN HERITAGE DICTIONARY (5th ed. 2018) ("A conflict between a person's private interests and public obligations."); *Conflict of Interest*, DICTIONARY OF BANKING AND FINANCE (4th ed. 2010) ("A situation in which a person or firm may profit personally from decisions taken in an official capacity.").

[83] 15 U.S.C. § 77z-2a(a).

- the language of clause (a)(3) of the Proposed Rule (notably, the catchall provision in sub-clause (iii) thereof), which conflates "conflicting interests" with "conflicts of interest."

This is not a mere semantic point. Given the ordinary and natural meaning of the term "conflict of interest" noted above, the Commission's regulatory authority under Section 27B extends only to any transaction that would involve or result in any material conflict between a duty that a securitization participant has under the securities laws and that securitization participant's own self-interest.

The Proposing Release conflates "conflicting interests" (which Section 27B does not reference) with "conflicts of interest" (which Section 27B does reference). Every party to every contract has conflicting interests (seller and buyer, lender and borrower, issuer and investor, credit protection seller and credit protection buyer, etc.). The essential purpose of contracts is to enable the parties thereto to accomplish a transaction despite, and in light of, their conflicting interests.

Section 27B does not prohibit, and cannot be read as prohibiting, material "conflicting interests" between securitization participants and investors. The term "conflict of interest" has an ordinary and natural meaning, and it means much more than mere "conflicting interests" as noted above.

2. <u>The definition of "conflicted transaction" in the Proposed Rule (upon which the definition of "conflict of interest" relies) causes the definition of "conflict of interest" to extend far beyond its natural and ordinary meaning</u>.

The definition of "conflict of interest" as set forth in the Proposed Rule extends far beyond its natural and ordinary meaning. As explained below, that is because the Proposed Rule's definition of "conflicted transaction" is so broad that it captures transactions that do not conflict with the duties that underwriters, placement agents, initial purchasers, underwriters or sponsors have under the securities laws. Indeed, the definition of conflicted transaction is so broad as to capture the intrinsic features of the asset-backed securities transaction itself.

B. The intrinsic features of an asset-backed securities transaction that shift risk from the sponsor to investors do not constitute a "conflict of interest" between the sponsor and investors.

Every securitization transaction utilizes some mechanism (whether it be a true sale, a swap or some other credit derivative or instrument) to shift the credit risk associated with a pool of financial assets from the sponsor to investors. Although, in some sense, such a mechanism puts the sponsor and investors on opposite sides of a trade, *the fact that two parties are on opposite sides of a trade does not mean that there is a "conflict of interest" between them.*

To be sure, sponsors and investors have conflicting interests. Those conflicting interests are mediated by state law contracts, which confer certain rights on investors (*e.g.*, the right to declare a default if specified events occur), and by the Federal securities laws.

The Proposing Release creates considerable confusion around this point. In explaining why the Commission did not accept previous comments arguing that the intrinsic features of a securitization transaction do not constitute a conflict of interest, the Proposing Release states:

> "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."[84]

This confusion is exacerbated by the Proposing Release's discussion of credit-risk transfer ("CRT") transactions involving special purpose entities. In an extended discussion in the Proposing Release, the Commission suggests that CRT transactions are problematic simply because investors in a CRT security would bear the downside risk of, and the sponsor would receive payments under, the contract by which the SPE provides credit protection to the sponsor with respect to a reference pool of assets.[85] The fact that the investors in, and the sponsor of, a CRT transaction are on the opposite side of a trade with respect to the reference pool is the entire purpose of the transaction.

The threat to CRT transactions posed by the Proposed Rule is significant. Banks use CRT transactions to manage their credit risks. If a bank is prevented from managing its credit risks effectively, the potential consequences extend far beyond that bank, as recent events have clearly demonstrated.[86] The Associations firmly believe that Congress did not intend Section 27B to be construed to allow any implementing rule thereunder to hamper the ability of banks to manage their risks.

Whether in the context of CRT transactions or otherwise, it is unambiguously clear that the use of the term "transaction" in the operative language of Section 27B refers to a transaction *other than the securitization transaction itself* as being a transaction that could give rise to a material conflict of interest between a securitization participant and investors. Section 27B(a) states that:

> A securitization participant "shall not, at any time for a period ending on the date that is one year after the date of first closing of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity."

By declining to clarify in the rule's text that the collection of transactions (*i.e.*, the sale agreements, the servicing agreement, the indenture, and other agreements and instruments

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[84] *See* Proposing Release, at 9695.

[85] *See id.* at 9688. For the Commission to suggest that any class of transactions would be *per se* prohibited under the Proposed Rule is deeply problematic for many reasons, including that the Commission is implicitly substituting its judgment for that of "reasonable investors" in deeming the conflict of interest to be "material."

[86] Impediments to Enterprise CRT transactions pose analogous risks to the financial system as well.

(including swaps or security based swaps)) that comprise a securitization transaction are not themselves potential "conflicted transactions" under the Proposed Rule, the Commission suggests that entire categories of securitization transactions are not permitted under the Proposed Rule. Other than with respect to CRT transactions as discussed above, it is unclear to market participants what categories of securitization transactions the Commission may seek to prohibit under the Proposed Rule.

There is nothing in either the text of Section 27B or the legislative history that suggests that the Commission is empowered to ban entire classes or categories of securitization transactions. The Associations urge the Commission to make clear in any final rule that a conflicted transaction does not include the securitization transaction itself or any of the transactions that comprise the securitization transaction.[87]

It may be the case that the Proposing Release is simply unclear and that the Commission does not, in fact, seek to prohibit certain categories of securitization transactions. Indeed, the economic analysis section of the Proposing Release notes that "current market practices may be generally consistent with the re-proposed rule requirements as a result of compliance with … existing rules."[88] Even if the Commission does not intend to prohibit any category of securitization transactions, the language in any final rule and accompanying adopting release should make that clear.

C. The Associations agree that a short sale of ABS by a securitization participant may create a conflict of interest between that securitization participant and investors.

The Associations agree with the Commission that, subject to the exceptions in the Proposed Rule (as revised as suggested herein), a conflict of interest between a securitization participant (properly defined, as described herein) and investors can arise when a securitization participant engages in either:

- A short sale of the relevant asset-backed security;[89] or
- The purchase of a credit default swap or other credit derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of specified credit events in respect of the relevant asset-backed security.[90]

Although the Proposing Release does not set forth its conflict of interest analysis in terms of the related underlying duties, one can recognize that a short transaction of the type described above could create a material conflict of interest between a securitization participant and investors.

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[87] In clause (a)(3)(iii) of the Proposed Rule, this point could be made clear by the following change: "The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction **(other than the relevant securitization transaction)** . . . ."

[88] *See* Proposing Release, at 9713.

[89] *See id.* at 9726 (clause (a)(3)(i)).

[90] *See id.* (clause (a)(3)(ii)).

That is because such an ABS shorting transaction could pose a material risk that the securitization participant would be induced by that transaction to violate one or more of the duties (*e.g.*, disclosure duties) that the securitization participant has under the securities laws (*i.e.*, creates the potential for a material conflict of interest).[91]

D. The catchall provision of the "conflicted transaction" definition is too broad and does not describe transactions that create a material conflict of interest.

Under clause (a)(3)(iii) of the Proposed Rule, a "conflicted transaction" would include the following to the extent a reasonable investor would consider the transaction "important"[92]:

> "The purchase or sale of any financial instrument (other than the asset-backed security) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated or potential:
>
> (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 catchall provision set forth above is vague and unworkable on its face. The vagueness of the foregoing text is compounded by the Commission's commentary in the Proposing Release.

The Proposing Release justifies the catchall provision on the grounds that it is necessary to capture any transaction that is the equivalent of the short sale of the ABS described in clause (a)(3)(i) of the Proposed Rule or the synthetic short of the ABS described in clause (a)(3)(ii) of the Proposed Rule. The Proposing Release states:

- *First*, the catchall "is intended to address comments to the 2011 proposed rule in support of a definition of the term 'transaction' that would include not only a short sale of the relevant ABS or the purchase of CDS protection on the relevant ABS,

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[91] In that respect, the shorting transaction bears some family resemblance to the parable of the auto mechanic, the brakes and the life insurance policy as told in the legislative history of Section 621. The following re-telling illustrates the lesson of that parable more clearly: Following a highly unusual and well-publicized case, one could imagine the passage of a law (whose legislative history is dominated by discussion of that case) directing the regulatory agency in charge of auto mechanics to implement rules prohibiting any transaction that would involve or result in any material conflict of interest between auto mechanics and car drivers. After reviewing the law and the legislative history, the regulatory agency might very well propose a rule that an auto mechanic's taking out a life insurance policy on the driver is a prohibited transaction. The regulatory agency would explain that taking out such a policy is a prohibited transaction because it creates a conflict between the mechanic's duty of care (a duty which already exists) and the mechanic's own self-interest. Even if the proposing release did not specify which legal duty the regulatory agency had in mind, market participants would nevertheless understand which legal duty is implicated and why the proposed rule is a valid exercise of the agency's rulemaking authority.

[92] As noted in Part VI.D.3. of this letter, the "reasonable investor" standard is not the correct materiality standard for this rule.

but would also include the purchase or sale of products that are linked to, or otherwise create an opportunity to benefit from the actual, anticipated, or potential adverse performance of, the pool of assets underlying the relevant ABS."[93]

- *Second*, "given the potential ability of market participants to craft novel financial structures that can replicate the economic mechanics of the types of transactions described in proposed Rule 192(a)(3)(i) and (ii) without triggering those prongs, proposed Rule 192(a)(3)(iii) should help alleviate the risk of any attempted evasion of the rule that is premised on the form of the transaction rather than its substance."[94]

A securitization participant may very well enter into a transaction that is neither a short sale of the ABS as described in clause (a)(3)(i) of the Proposed Rule nor a synthetic short of the ABS described in clause (a)(3)(ii) of the Proposed Rule. Whether such a transaction should be captured by this rule requires much more precision than is found in clause (a)(3)(iii) of the Proposed Rule or in the Proposing Release's underlying analysis as set forth above.

The Associations do not believe that any catchall provision is necessary, as the prohibition of a short sale of the ABS as described in clause (a)(3)(i) of the Proposed Rule or a synthetic short of the ABS as described in clause (a)(3)(ii) of the Proposed Rule accomplishes the goal of Section 27B. If the Commission decides to include a catchall in the final rule, a more appropriate catchall would:

- provide that such conflicted transactions must be the functional trading equivalent of a short sale, or synthetic short, of the relevant asset-backed security (essentially, a plan or scheme to evade the prohibitions covered by clauses (a)(3)(i) and (a)(3)(ii));

- scope out taking a short position in a portion of the assets underlying or referencing an asset-backed security;

- use a "materially adverse" standard (which is a prohibition standard) rather than a "reasonable investor" standard (which is a disclosure standard);

- clarify that transactions intrinsic to the creation of the asset-backed security are not "conflicted transactions"; and

- contain a knowledge qualifier that the securitization participant knows, or reasonably should have known, that it will achieve a net benefit contingent upon the adverse performance of the relevant asset-backed security.

Moreover, if the Commission decides to retain the catchall concept, we urge the Commission to do so in the form of a re-proposal of the rule, rather than in the form of a final rule. If a catchall is included in the final rule, and even if the Commission reflects some of the principles

[93] *See* Proposing Release, at 9695.

[94] *Id.*

discussed below in the text of the final rule, market participants will need to analyze their operational ability to comply with any such catchall, particularly if the rule applies to a securitization participant's affiliates and subsidiaries that are not involved in the securitization. A re-proposal would afford market participants the opportunity to provide the Commission with further comments to ensure that the rule is in a form that is amenable to operational compliance.

1. The catchall should be limited to those transactions that are the functional trading equivalent of a short sale, or synthetic short, of the ABS.

As discussed in Part IV of this letter, Section 27B directs the Commission to adopt a rule that would prohibit any transaction that would involve or result in any material conflict between a duty that a securitization participant has under the securities laws and that securitization participant's own self-interest (*i.e.*, a material conflict of interest between a securitization participant and an investor). This necessarily requires that the transaction creates a material risk that it will induce the securitization participant to disregard its securities law duties.

If the final rule contains any catchall, it should be limited to those transactions that are the functional trading equivalent of a short sale of the ABS as described in clause (a)(3)(i) or a synthetic short of the ABS as described in clause (a)(3)(ii). That is, the transaction must be the equivalent of a bet against the ABS itself such that the net payments to a securitization participant under that transaction are contingent on the adverse performance of the ABS (*i.e.*, it must operate as a plan or scheme to evade the prohibitions covered by clauses (a)(3)(i) and (a)(3)(ii)). Any transaction that is not the equivalent of a bet against the ABS itself falls far outside the scope of Section 27B because it does not create a material conflict of interest between a securitization participant and investors.

2. A short position in a portion of the assets underlying or referencing an asset-backed security is not equivalent to shorting that asset-backed security or otherwise "betting against" the ABS.

The Proposed Rule lists three events that can render a transaction a "conflicted transaction" if a securitization participant benefits from them:

> "(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."[95]

Clause (A) should be eliminated because a short position in the assets underlying or referencing an asset-backed security does not raise the same conflict of interest concerns as are raised by shorting the related asset-backed security. Thus, a short transaction referencing the assets

[95] *See* clause (a)(3)(iii) of the Proposed Rule.

is not a transaction that is included within the scope of Section 27B and therefore should not be included in any rule that implements that section.

A securitization participant may wish to securitize a pool of financial assets (*e.g.*, mortgage loans or auto loans) because it has a legitimate business reason to do so (*e.g.*, to raise liquidity and/or to remove risk from its balance sheet). A securitization participant may also wish to short some portion of the pool of financial assets because it has a legitimate business reason to do so (*e.g.*, as part of a risk-management objective). However, the securitization transaction and the short transaction are independent of each other. No securitization transaction is necessary in order to enable a person to short financial assets.

The performance of a short position in financial assets that happen to be included in a securitization is *not* contingent on the success or failure of the related ABS backed or referenced by those financial assets. Indeed, no securitization is necessary to the trade.

To be sure, if there is a securitization transaction, then a securitization participant's taking a short position in securitized assets may require disclosure thereof to prospective ABS investors. Under Rule 10b-5, disclosure of the short position to investors would be required if the failure to disclose that short position constitutes an omission to "state a material fact necessary in order to make the statements made [in the prospectus or other offering document], in light of the circumstances under which they were made, not misleading."[96] However, nothing under existing securities laws prohibits a securitization participant from taking an otherwise legitimate and lawful short position in assets simply because they are also included in an otherwise legitimate and lawful securitization.

A short position in the ABS is distinctly different. In that case, the securitization transaction is necessary in order to make the short position possible. Unlike a short position in assets (that happens for one business reason) and a securitization of the assets (that happens for another business reason), a short of the ABS by a securitization participant does create the potential for a conflict of interest because the business reason for creating the ABS may be simply to short it.

The distinct difference between a short position in the assets and a short position in the ABS creates a distinct difference in how they should be analyzed with respect to the question of whether they create a material conflict of interest with investors. As noted above, the performance of a short position in assets that are included in a securitization is *not* contingent on the performance of the ABS. Therefore:

- the performance of the short position in the assets that happen to be included in a securitization is *not* contingent on whether or not (or the extent to which) an underwriter, placement agent, initial purchaser or sponsor, as applicable, observes its securities law duties;

[96] *See* Rule 10b-5(b).

- as a result, the short position in the assets does not create a conflict between the duties that a securitization participant has under the securities laws and that securitization participant's own self-interest; and

- thus, a securitization participant's short position in the assets does not give rise to a material conflict of interest between it and any investors in the related ABS.

Even if any re-proposed or final rule does not fully reflect the foregoing distinction between a short position in underlying or referenced assets and a short position in the related ABS, any re-proposed or final rule should *not* prohibit any shorting transaction with respect to the underlying or referenced assets *unless* that shorting transaction is part of a trading strategy specifically designed by the securitization participant to achieve indirectly what it is prevented from doing directly – engaging in an ABS shorting transaction described in clause (a)(3)(i) or clause (a)(3)(ii) of the Proposed Rule. Any asset shorting transaction that is not part of such a specifically-designed trading strategy should not be prohibited under the rule.

3. The "reasonable investor" standard is the wrong materiality standard for this rule.

Section 27B's prohibition of certain conflicts of interest between securitization participants and investors is limited to *material* conflicts of interest. The Commission proposes to define materiality by reference to the securities law disclosure standard. Under the Proposed Rule, materiality means that, with respect to any transaction being scrutinized thereunder:

> "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."[97]

There are three main issues with the Commission's use of the "reasonable investor" standard here:

First, the Commission replaces Section 27B's reference to "material conflict of interest" (*i.e.*, a conflict of interest that is material) with "material transaction" (*i.e.*, a transaction that is material). Clearly, a reasonable investor could consider a transaction to be "important" even if that investor ascribes absolutely no importance to any purported conflict of interest arising from that transaction.

Second, the phrase "including a decision whether to retain the asset-backed security" is not part of any existing materiality standard under the securities laws, at least insofar as the Associations are aware. To consider what an investor might find important at the time of its investment decision necessarily requires a consideration of the facts and circumstances existing at that time. To consider what an investor might find important in deciding whether to retain a security necessarily requires a consideration of the facts and circumstances existing at all times

[97] *See* clause (a)(3) of the Proposed Rule.

while the investor holds the security. Market participants are familiar with the former standard. The latter standard is impossible to apply and utterly unknown to market participants.

Third, the Proposed Rule uses the securities law disclosure standard in a rule that is not a disclosure rule. The Proposing Release cites *Basic v. Levinson* in support of its proposal to use the "reasonable investor" disclosure standard[98] in the context of this rule. In *Basic v. Levinson*, the Court explains that "As we clarify today, materiality depends on the significance that the reasonable investor would place on the withheld or misrepresented information."[99] On the other hand, in the Proposing Release, the Commission explains that "The use of [the *Basic v. Levinson*] standard would not in this context imply that a transaction otherwise prohibited under the re-proposed rule would be permitted if there were adequate disclosure made by the securitization participant to the relevant investors."[100] The Associations respectfully suggest that the only way the *Basic v. Levinson* standard would not imply something about disclosure is because it is being used out of context.

The *Basic v. Levinson* standard is a standard for what must be disclosed, not a standard for what should be prohibited.[101] Section 27B directs the Commission to adopt rules as to what types of transactions should be prohibited.

The correct standard of materiality for the Proposed Rule is the standard of materiality used by the Commission and the other agencies in the Volcker Rule's conflict of interest provision; that is, the "materially adverse" standard.[102]

4. The catchall should make clear that transactions that are intrinsic to the securitization transaction are not "conflicted transactions."

A component part of a securitization transaction is not the functional trading equivalent of a short sale, or a synthetic short, of the related ABS. A securitization transaction cannot bet against itself. As acknowledged previously in this letter, the Commission has explicitly declined to make clear that transactions that are intrinsic to the securitization transaction itself are not "conflicted transactions."[103] The Proposing Release exacerbates the concern by its discussion of CRT transactions involving SPEs, suggesting that their intrinsic characteristics render them problematic under the rule. This should be clarified in any re-proposed or final rule.

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[98] *See id.* at 9696 (citing *Basic v. Levinson*, 485 U.S. 224 (1988) ("*Basic v. Levinson*")).

[99] *Basic*, 485 U.S. at 240.

[100] *See* Proposing Release, at 9696.

[101] By analogy, the FDA requires that packages of food offered for sale to consumers provide accurate disclosure of the ingredients contained therein. However, in determining whether to prohibit a certain ingredient altogether, the FDA would not utilize its packaging disclosure rules but would instead consider whether that ingredient is materially bad for (adverse to) consumers.

[102] Under the Volcker Rule, "a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being ***materially adverse*** to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section." 17 C.F.R. § 255.7(b) (2023) (emphasis added).

[103] *See* Part VI.B. of this letter.

5. The catchall should contain a knowledge qualifier and clarify that the securitization participant must receive a net benefit contingent upon the adverse performance of the asset-backed security.

The phrase "through which the securitization would benefit from the actual, anticipated or potential…" in the Proposed Rule should be changed to reflect that the securitization participant knows, or reasonably should know, that it will achieve a net benefit *contingent upon* the adverse performance of the relevant asset-backed security. The knowledge qualifier makes clear that in order for any transaction under the catchall to create a material conflict between a duty that a securitization participant has under the securities laws and the securitization participant's own self-interest, the securitization participant has to know, or reasonably should know, that the transaction will result in net payments to it upon the occurrence of adverse events with respect to the ABS.

Specifying that the securitization participant must anticipate a net benefit *contingent upon* the adverse performance of the ABS would clarify the ambiguity about whether a securitization participant could be said to "benefit" from the actual, anticipated or potential adverse performance of the underlying or referenced pool simply because it avoids suffering from the future actual, anticipated or potential adverse performance of that pool simply by the act of securitizing it. Although we recognize, and disagree with, the Commission's intent for a very broad catchall provision, we are hopeful that the Commission does not intend the above interpretation of the catchall. The use of "net benefit" helps to alleviate that ambiguity.

Also, the use of the phrase "contingent upon" is a crucially important clarification because the existing language suggests that a transaction that confers benefits upon events that are merely correlated with the adverse performance of the ABS could be picked up by the catchall. A transaction does not pose a material risk that it will induce a securitization participation to disregard its securities law duties (and does not constitute a material conflict of interest) unless the benefits or payments under the transaction are contingent on the adverse performance of the ABS.

Finally, the Proposed Rule's reference to "actual, anticipated or potential" adverse events with respect to the ABS should be removed. Any transaction that a securitization participant might enter into will not make payments to a securitization participant simply because an adverse event with respect to the ABS is "anticipated" or "potential."

E. Pre-securitization transactions should be expressly carved out of the definition of "conflicted transaction."

It is very typical that a variety of "pipeline management" activities happen with respect to financial assets prior to their securitization. These pipeline management activities include hedging, financing, transfers and other transactions that conclude before the assets are included in the securitized pool.

For securitizations in which all of the underlying or referenced assets are included in the pool on the closing date thereof, the final rule should make clear that pipeline management activities that conclude on or prior to that date should not be considered "conflicted transactions" under the rule.

Similarly, for securitizations in which underlying or referenced assets may be included in the pool after the closing date (*e.g.*, securitizations featuring a ramp-up or pre-funding period), the final rule should make clear that pipeline management activities that conclude on or prior to the date that such assets are included in the pool should not be considered "conflicted transactions" under the rule.

We refer to the date on which assets are added to the securitized pool (either on the closing date or after the closing date, as noted above) as the "inclusion date."

Although the compliance period may begin prior to the date of first sale, the investors and a transaction involving securitized assets have to exist simultaneously for some period of time during the compliance period in order for that transaction to be plausibly subject to the scrutiny of any conflict of interest rule under Section 27B.[104] Thus, the following transactions should be expressly excluded from the definition of "conflicted transaction" under the rule:

- *Pre-securitization hedging transactions*. Any interest rate hedge, credit hedge, index hedge, TBA market hedge or other hedge with respect to all or any portion of the pool of assets underlying an asset-backed security entered into prior to the related inclusion date for such assets and terminating with respect to the pool of assets or portion thereof on or prior to the related inclusion date for such assets;

- *Pre-securitization financing transactions*. Any financing (including warehouse financing, repo financing or other form of financing) of all or any portion of the pool of assets underlying the asset-backed security entered into prior to the related inclusion date for such assets and terminating with respect to the pool of assets or portion thereof on or prior to the related inclusion date for such assets;

- *Pre-securitization transfers*. Any purchase, sale, assignment, contribution or other transfer of all or any portion of the pool of assets underlying the asset-backed security prior to the related inclusion date for such assets; and

- *Other pre-securitization transactions*. Any other transaction relating to all or a portion of the pool of assets underlying the asset-backed security that concludes on or prior to the related inclusion date for such assets.

F. A short position in an index that references the ABS should be expressly carved out of the definition of "conflicted transaction."

If an ABS is referenced in an index, a short position in that index should be expressly carved out of the conflicted transaction definition so long as the ABS represents less than a threshold percentage of that index. Under such circumstances, a securitization participant's shorting such an index would not pose a material risk that its interest in the transaction would induce it to disregard its securities law duties.

[104] As noted in Part VI.C.2., even after assets are included in the securitized pool, a short position in such assets is not equivalent to shorting the related ABS or otherwise "betting against" the ABS.

The Associations propose the following exclusion which is based on the "permitted hedging activities" provision in Regulation RR:[105]

> Purchasing or selling a security or other financial instrument or entering into an agreement, derivative, or other position with any third party where payments on the security or other financial instrument or under the agreement, derivative, or position are based, directly or indirectly, on an index of instruments that includes the relevant asset-backed securities will not constitute a conflicted transaction under this rule if any class of asset-backed securities that were issued in connection with the securitization transaction and that are included in the index represents no more than 10 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the asset-backed securities are issued, as applicable) of all instruments included in the index.

[105] *See* 17 C.F.R. § 246.12(d)(2) (2023).

VII. THE PROPOSED RULE SHOULD PERMIT DISCLOSURE AS A MEANS OF ADDRESSING MATERIAL CONFLICTS OF INTEREST.

Under the securities laws, disclosure is the fundamental approach for addressing the risks faced by investors. The Proposed Rule should follow that fundamental approach and permit disclosure as a means of addressing conflicts of interest. The Commission has statutory authority to prescribe a disclosure alternative. Even if the Commission does not provide a general disclosure alternative, the Commission should provide a disclosure alternative with respect to any "catchall" category of conflicted transactions.

Like many other industry participants, SIFMA advocated for a disclosure alternative to the outright prohibition of material conflicts of interest in Proposed Rule 127B.[106] The Proposed Rule does not contain any disclosure-based exception, although the Proposing Release provides a discussion of the Commission's concerns about such an exception. We seek to address those concerns below.

A. Under the securities laws, disclosure is the fundamental approach for addressing the risks faced by investors. The Proposed Rule should follow that fundamental approach and permit disclosure as a means of addressing conflicts of interest.

In its Request for Comment No. 53, the Commission calls into question the fundamental efficacy of disclosure in asset-backed securities transactions:

- "If you believe that the re-proposed rule should allow securitization participants to manage potential conflicts of interest using disclosure or through obtaining investor approvals, then please explain how disclosure or investor approval of such potential conflicts of interest would adequately protect investors against the risks associated with such conflicts of interest, particularly in light of the concerns expressed in this re-proposal."[107]

- "How could a disclosure exception be structured so that the resulting disclosure would not contain vague boilerplate language?"[108]

As to the first point, our securities laws prescribe disclosure as the means of protecting investors against nearly every risk they face. More precisely, the purpose of disclosure is not to protect investors from the risks associated with their investments, but to protect investors from the risks associated with a "buyer beware" market for securities. As the court in *Basic v. Levinson*

[106] *See* the 2012 SIFMA Letter, *supra* note 6, at 35–38.

[107] *See* Proposing Release, at 9698.

[108] *Id.*

observed: "We have recognized time and again, a 'fundamental purpose' of the various Securities Acts, 'was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.'"[109] One need only to examine the "risk factors" in any given prospectus or offering memorandum to find disclosure of the many consequential and numerous risks that investors face. The disclosure-based approach of the securities laws is buttressed by the anti-fraud provisions as set forth in Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act. Any rule adopted under Section 27B need not diverge from the disclosure-based approach of the Securities Act and the Exchange Act.

As to the Commission's question about "vague boilerplate language," the Volcker Rule provides a suitable template to address that concern. Unlike the Proposed Rule, the Volcker Rule specifically contemplates disclosure as a means of addressing conflicts of interest:

> "(2) Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity: (i) Timely and effective disclosure. (A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and (B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest."[110]

A well-designed disclosure regime can adequately protect investors in asset-backed securities from the risks posed by conflicted transactions. Indeed, it already does. For example, there is certainly the potential for a material conflict of interest between a securitization participant and an investor where the sponsor, depositor or issuing entity is an affiliate of the trustee[111] or a significant obligor under the securitized assets. Rather than prohibiting transactions involving these troubling affiliations and resulting potential conflicts of interest, Item 1119 of Regulation AB prescribes a disclosure approach. Regulation AB establishes the disclosure standard for registered public offerings, in which retail investors may freely participate.[112]

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[109] *See Basic v. Levinson*, 485 U.S. 224, 234 (1988).

[110] *See* 17 C.F.R. § 255.7(b)(2)(i) (2023). In the context of a securities offering, clause (B) of this standard would not be necessary to include because the investor can negate or mitigate the risk by not investing in the ABS, or by investing less than it otherwise would in the ABS. With respect to the Commission's question in Request for Comment No. 53 as to suitability of disclosure in the context of a transaction entered into after closing, we note that disclosure provided to the investors prior to the time of sale (*e.g.*, the prospectus or offering memorandum) could contain disclosure of future transactions that will or may occur, subject of course to the specificity described in the Volcker Rule standard for disclosure.

[111] Although Rule 3a-7 under the Investment Company Act of 1940 imposes an independent trustee requirement, that requirement applies only with respect to securitization transactions that rely on the exemption from Investment Company Act regulation provided in that rule.

[112] Like any disclosure rule the Commission might adopt here, the disclosure rules in Regulation AB do not stand alone in protecting investors – they are buttressed by the general anti-fraud and anti-manipulation provisions of the Federal securities laws, including Section 17(a) of the Securities Act, Section 10(b) and Rule 10b-5 under the Exchange Act.

As noted above, the Volcker Rule prescribes disclosure as a means of addressing conflicts between banks and their counterparties. FINRA Rule 5121 also prescribes disclosure as a means of addressing (significant) conflicts of interest in certain public offerings.[113] Any number of consumer protection laws also prescribe disclosure as a means of addressing conflicts of interest.

The Advisers Act provides perhaps the most compelling example under current federal securities laws of the distinction between the approach taken by the Proposed Rule, which flatly prohibits certain conflicts of interest, and the approach largely taken by the Advisers Act, which provides more flexibility regarding conflicts of interest, namely full and fair disclosure and informed consent. Investment advisers have a fiduciary duty to their advisory clients. A conflict of interest between them belongs to the most troubling category of conflicts of interest under the law because the fiduciary duty standard is the highest standard of duty implied by law.

Yet, with respect to conflicts of interest, the Advisers Act generally focuses on appropriate disclosure to the advisory client and informed client consent. Other approaches to conflicts under the Advisers Act include mitigation and of course avoidance or elimination. The Commission staff's recent bulletin on this topic provides extensive guidance to help investment advisers identify and address conflicts of interest.[114]

If such a disclosure approach works to protect advisory clients from conflicts of interest with their investment advisers, then surely the approach advocated by the Associations above can work to protect investors in asset-backed securities.[115] No entity acting in its capacity as a securitization participant has a fiduciary duty to investors, yet the Proposed Rule does not recognize the same types of distinctions in addressing conflicts of interest that are recognized under the Advisers Act.

B. The Commission has statutory authority to prescribe a disclosure alternative.

In request for comment No. 53, the Commission asks "Please also explain how disclosure or investor approval would be consistent with Section 27B."[116] The Associations note that the general language of Section 27B refers to a prohibition on transactions that would involve or result

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[113] *See* FIN. INDUS. REGUL. AUTH. R 5121(a)(1).

[114] *See Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Conflicts of Interest*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/tm/iabd-staff-bulletin-conflicts-interest#_ftnref1 (last modified Aug. 3, 2022).

[115] We note that the Commission has recently allowed the use of disclosures to resolve perceived and actual conflicts in more broadly applicable regulations. The Commission's recently-implemented Investment Adviser Marketing Rule prohibits investment advisers from directly or indirectly distributing an advertisement that contains false statements of material fact or discusses potential benefits without a fair and balanced consideration of material risks or limitations. 17 C.F.R. § 275.206(4)-1(a) (2023). Within this new rule, the Commission also requires, in any advertisement with a testimonial or endorsement, that "[t]he investment adviser discloses, or reasonably believes that the person giving the testimonial or endorsement [clearly and prominently] discloses . . . That the testimonial was given by a current client or investor . . . That cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and [a] brief statement of any material conflicts of interest." *Id.* § 275.206(4)-1(b)(1). In its Adopting Release, the Commission noted that these "disclosures are needed to inform and protect investors effectively when they are presented with testimonials and endorsements." *See* Investment Adviser Marketing, 86 Fed. Reg. 13024, 13047 (Mar. 5, 2021) (to be codified at 17 C.F.R. pt. 275).

[116] *See* Proposing Release, at 9698.

in a material conflict of interest. However, that language does not preclude the Commission from providing that full and fair disclosure renders an otherwise material conflict of interest immaterial because of the informed investor's ability to either eliminate the adverse consequences by not investing or reduce the adverse consequences by investing less.

In addition to the foregoing, the Commission also has general exemptive authority under Section 28 the Securities Act. Like many other securities laws, including the Advisers Act, the use of disclosure as a means of addressing conflicts of interest is fully "consistent with the protection of investors."[117]

C. Even if the Commission does not provide a general disclosure alternative, the Commission should provide a disclosure alternative with respect to any "catchall" category of conflicted transactions.

Even if the Commission does not provide a general disclosure alternative, the Associations urge the Commission to provide a disclosure alternative with respect to any "catchall" category of conflicted transactions that the Commission might adopt. Any transaction that fits only within a catchall category will necessarily be a less significant conflict of interest than shorting the ABS itself.

[117] *See* Section 28 of the Securities Act.

VIII. THE TERM "SYNTHETIC ASSET-BACKED SECURITY" SHOULD BE DEFINED.

Although the Proposed Rule defines *non-synthetic* asset-backed securities by incorporating by reference the definition of "asset-backed security" in Section 3(a)(79) of the Exchange Act, the Proposed Rule contains no definition of "synthetic asset-backed securities." The Proposing Release states:

> "The re-proposed rule does not define 'synthetic ABS.' We have previously described synthetic securitizations, in general, as securitizations that are designed to create exposure to an asset that is not transferred to or otherwise part of the asset pool. [Citing its description in Regulation AB]. These 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. We believe that our previous descriptions of synthetic securitizations are well understood by market participants and adequately address the key issues raised by commenters, and that market participants have been able to readily distinguish synthetic ABS from other types of transactions."[118]

Although the Commission has previously described synthetic securitizations, in general, in the context of their being ineligible for registered public offerings governed by Regulation AB, that description does not suffice as a definition of the term for the purpose of this rule, because this rule expressly covers synthetic asset-backed securities. The Associations do not agree that market participants understand the Commission's previous Regulation AB commentary about synthetic asset-backed securities nearly well enough to have any certainty at all about what is included and what is excluded from the coverage of the Proposed Rule.

The Associations agree with the Commission's decision to define cash securitizations by incorporating the Exchange Act definition of "asset-backed security" as noted above. If it is appropriate to define the asset-backed securities issued in cash securitizations, surely it is appropriate to define the asset-backed securities issued in synthetic securitizations. Indeed, the term "synthetic asset-backed security" calls out for definition even more than does its cash counterpart, particularly given the nature of the Regulation AB adopting release's previous very general and ambiguous narrative description of synthetic securitizations.

The Associations propose the following definition of "synthetic asset-backed security." This definition comports with the market's understanding of that term and provides the requisite certainty as to the scope of the rule.

> *Synthetic asset-backed security* means a fixed-income or other security (a) issued by a special purpose entity, (b) collateralized by one or more credit derivatives that reference self-liquidating financial assets (including a loan, a lease, a mortgage, a secured or unsecured receivable, or an asset-backed security) that allows the holder of the security to receive payments that depend primarily on the terms of such credit derivatives, (c) under which the credit risk of such referenced financial assets has been separated into at least two tranches reflecting different levels of seniority and all or a portion of the credit risk of such

[118] *See* Proposing Release, at 9681.

tranches is transferred to the holders of such security, and (d) performance of the security depends upon the performance of the financial assets. The term "synthetic asset-backed security" shall not include any corporate debt or insurance policy or contract, whether or not payments thereunder are contingent on the performance of referenced financial assets. The term "synthetic asset-backed security" and "self-liquidating financial asset" (as used in this definition) shall not include any corporate debt, security-based swap or single name CDS under market standard terms.

Further, the Commission should ensure the definition is appropriately limited to cover only synthetic ABS within its jurisdictional scope. For example, synthetic CDS which include non-security derivatives that are primarily regulated by the U.S. Commodity Futures Trading Commission should not fall within the scope of the definition.

IX. THE ANTI-CIRCUMVENTION PROVISION SHOULD BE REMOVED AND REPLACED WITH AN ANTI-EVASION PROVISION THAT APPLIES TO THE EXCEPTIONS AND SAFE HARBORS.

The Proposed Rule's anti-circumvention provision provides that "[i]f a securitization participant engages in a transaction that circumvents the prohibition in paragraph (a)(1) of this section, the transaction will be deemed to violate paragraph (a)(1) of this section."[119] By this provision, the Commission seeks to extend the scope of the rule to pick up transactions that it considers "economically equivalent" to the conflicted transactions as defined in the rule.[120]

Referring back to the corollary set forth in Part I of this letter, it is useful to compare the Volcker Rule with the Proposed Rule on this point. The most important point of comparison exists at the underlying statute level. The Volcker Rule contains a broad anti-evasion provision because its underlying statute does. Section 619 provides:

> "(e) ANTI-EVASION.—
>
> (1) RULEMAKING.—The appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall issue regulations, as part of the rulemaking provided for in subsection (b)(2), regarding internal controls and recordkeeping, in order to insure compliance with this section.
>
> (2) TERMINATION OF ACTIVITIES OR INVESTMENT.—Notwithstanding any other provision of law, whenever an appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, has ***reasonable cause*** to believe that a banking entity or nonbank financial company supervised by the Board under the respective agency's jurisdiction has made an investment or engaged in an activity in a manner that functions as an evasion of the requirements of this section (including through an abuse of any permitted activity) or otherwise violates the restrictions under this section, the appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, shall order, ***after due notice and opportunity for hearing***, the banking entity or nonbank financial company supervised by the Board to terminate the activity and, as relevant, dispose of the investment. Nothing in this paragraph shall be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law."[121]

This statutory anti-evasion provision is the basis for the anti-evasion provision found in the Volcker Rule itself.[122] Because the anti-evasion provision in Section 619 is so extraordinary, the statutory language necessarily embeds the due process protections highlighted in the language above.

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[119] *See* clause (d) of the Proposed Rule.

[120] *See* Proposing Release, at 9699.

[121] *See* 12 U.S.C. § 1851 (emphasis added).

[122] 17 C.F.R. § 255.21 (2023).

In sharp contrast, Section 621 of the Dodd-Frank Act does not contain any anti-evasion or anti-circumvention provision at all. Yet, the Proposed Rule contains an anti-circumvention provision that is much broader than the anti-evasion provision found in Section 619 or in the Volcker Rule itself. Moreover, the Proposed Rule's formulation does not contemplate any basic due process limitations.

To be sure, the Associations recognize that it is quite common for the Commission's rules to provide that exceptions or safe harbors to a rule cannot be used as a mechanism for evading the general prohibition contained in the rule. For example, Regulation RR's safe harbor for foreign-related transactions contains an anti-evasion provision.[123] The provision states that:

> "[i]n view of the objective of these rules and the policies underlying Section 15G of the Exchange Act, the safe harbor . . . is not available with respect to any transaction or series of transactions that, although in technical compliance with paragraphs (a) and (b) of this section, is part of a plan or scheme to evade the requirements of section 15G and this Part."[124]

In 2019, the Commission initially proposed a broad anti-evasion provision in Rule 163B regarding the Solicitations of Interest Prior to a Registered Public Offering but later removed the provision after reviewing submitted comments. The broad anti-evasion provision under the proposed rule provided that parties in technical compliance with the rule but acting as part of a plan or scheme to evade it would be in violation of the rule.[125] In its Adopting Release, the Commission noted that "[t]hree commenters recommended eliminating the 'anti-evasion' language from paragraph (a)(2) of the proposed rule." Of these three, two commenters noted that the provision "could give rise to confusion or uncertainty, and thereby limit the utility of the proposed rule."[126] Additionally, the Commission observed that "[o]ne of these commenters asserted that such language is not necessary since it is 'typically included in exemptions that are intended to serve as safe harbors.'"[127] In removing the anti-evasion provision from Rule 163B, the Commission announced that it had been

> persuaded by the commenters who expressed concerns that such language may raise uncertainty and would risk limiting the utility of the rule. Communications made under the rule will be deemed offers under Section 2(a)(10) and will still be subject to the anti-fraud and other applicable provisions of the federal securities laws, and an issuer that proceeds with the contemplated public offering after testing-the-waters will be required to file a registration statement. *We therefore believe eliminating the anti-evasion language will avoid any confusion or chilling effect such language may introduce without introducing significant risk to investors.*[128]

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[123] *Id.* § 255.20(c).

[124] Credit Risk Retention, 79 Fed. Reg. 77602, 77763 (Dec. 14, 2014) (codified at 17 C.F.R. pt. 246).

[125] Solicitations of Interest Prior to a Registered Public Offering, 84 Fed. Reg. 6713, 6732 (Feb. 28, 2019).

[126] Solicitations of Interest Prior to a Registered Public Offering, 84 Fed. Reg. 53011, 53015 (Oct. 4, 2019) (codified at 17 C.F.R. pt. 230).

[127] *Id.* at 53014.

[128] *Id.* at 53015.

In omitting the anti-evasion provision of Rule 163B, the Commission cited SIFMA's proposed letter as one of the three persuasive commenters. In its comment, SIFMA noted that it did not believe an anti-evasion provision was necessary because "this type of language is typically included in exemptions that are intended to serve as safe harbors" for the Securities Act.[129] The Associations stand by that view and ask the Commission to stand by that view as well.

We urge the Commission to adhere to the approach that it has taken in its other rulemakings: specifying that an exception or safe harbor is not available with respect to any transaction or series of transactions that, although in technical compliance with that exception or safe harbor, is part of a plan or scheme to evade the general prohibition contained in the rule. The final rule should not contain an anti-evasion or anti-circumvention provision that applies to the entire rule.

In Request for Comment #64 in the Proposing Release, the Commission asks:

> [s]hould proposed Rule 192(d) be modified such that a transaction circumventing the re-proposed rule's prohibition will only be deemed to violate proposed Rule 192(a)(1) if the securitization participant *knows or has reason to know* that the transaction is undertaken for the purpose of circumventing the re-proposed rule's prohibition?[130]

As noted above, if the rule contains an anti-evasion provision at all, it should apply only with respect to the use of exceptions and safe harbors as part of a plan or scheme to evade the rule. Under that formulation, it would not be necessary to explicitly state a "knows or has reason to know" standard. Regardless of its form, basic due process principles dictate that no anti-circumvention or anti-evasion provision with respect any rule under Section 27B can impose a strict liability standard on market participants who are otherwise in compliance with the terms of that rule.

In Request for Comment #66 in the Proposing Release, the Commission also asks whether:

> proposed Rule 192(d) [would] be overinclusive or otherwise result in potential uncertainty as to the coverage of the re-proposed rule's prohibition, and if so, how should proposed Rule 192(d) be modified to address such concerns? Are there examples of transactions that proposed Rule 192(d) would prohibit but should not? Please explain how any such modifications to proposed Rule 192(d) would be consistent with Section 27B.[131]

As noted above, the strict-liability anti-circumvention provision found in the Proposed Rule has the potential to be both overinclusive and vague, not only by operation of its own overly-broad terms, but particularly in conjunction with the overly broad language in the general

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[129] Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule for Solicitations of Interest Prior to a Registered Public Offering (Apr. 29, 2019), https://www.sifma.org/wp-content/uploads/2019/04/SIFMA-Comment-Letter-re-Testing-the-Waters-4.29.19.pdf.

[130] Proposing Release, at 9699 (emphasis added).

[131] *Id.*

prohibition itself (*e.g.*, "directly or indirectly," "substantial steps," what a reasonable investor would deem to be "important," clause (ii) of the definition of "sponsor," "benefit from the actual, anticipated, or potential" adverse performance of the securitization, etc.) and its application to all affiliates and subsidiaries of any securitization participant. The fundamental problem is that no market participant can determine with requisite certainty which transactions the Proposed Rule would prohibit.

X. THE EXCEPTIONS TO THE PROHIBITION SHOULD BE MODIFIED AND EXPANDED.

The risk mitigating hedging activities and bona fide market making activities exceptions should be clarified and simplified.

The risk mitigating hedging activities exception should include permitted risk transfer transactions.

The risk mitigating hedging activities exception should include interest rate, currency and other non-credit related trading and hedging activities.

The risk mitigating hedging activities exception should include an exception for hedging activities in connection with tender option bonds ("TOBs").

The Proposed Rule should exclude Section 4(a)(2) direct private placements to investors.

The Proposed Rule should not apply to corporate debt.

The Proposed Rule should not apply to insurance policies or contracts.

As discussed below, the Associations believe the exceptions should be clarified, simplified and expanded in various respects. With regard to our comments that seek to clarify, simplify and expand the exceptions for risk-mitigating hedging activities and bona fide market-making activities in the Proposed Rule, we seek a better and more operationally practical rendering of the statutory exceptions in the final rule. For example, although we do not believe that interest rate, currency or other non-credit related trading and hedging activities should be construed as "conflicted transactions" under any final rule, we seek the specific exclusion of such activities in our proposal in order to provide legal and operational clarity to the market. Moreover, we seek expansion of the exceptions in part because the manner in which the Proposed Rule defines a "material conflict of interest" goes well beyond what is contemplated by Section 27B, as described in this letter. The Associations seek to ensure that the scope of the exceptions is appropriately congruous with the scope of the prohibition that is ultimately set forth under the final rule.

Similarly, with respect to our proposed exceptions for Section 4(a)(2) direct private placements, corporate debt and insurance policies or contracts, we seek to ensure legal and operational clarification. We do not believe that any such transactions are within the scope of Section 27B *(i.e.*, they do not give rise to any "material conflict of interest" (properly construed) and/or are not themselves asset-backed securities transaction). Thus, any final rule should make clear that such transactions are specifically excluded from the scope of rule.

A. Risk-Mitigating Hedging Activities.

1. The risk-mitigating hedging activities exception should be clarified and simplified.

The Proposed Rule's current exception for risk-mitigating hedging activities should be clarified and simplified in several respects. Clause (b)(1)(i) of the Proposed Rule should be modified as follows in order to align it more closely with its counterpart in the Volcker Rule and to clarify its scope and meaning.

> *Permitted risk-mitigating hedging activities*. Risk-mitigating hedging activities of a securitization participant conducted in accordance with this paragraph (b)(1) in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization participant ~~arising out of its securitization activities~~, including the origination or acquisition of assets that it securitizes, ~~except that the initial distribution of an asset-backed security is not risk-mitigating hedging activity for purposes of paragraph (b)(1) of this section~~.

The phrase "arising out of its securitization activities," for example, could be read as prohibiting risk mitigating hedging activity on an auto finance company's entire origination portfolio. The phrase that excludes the initial distribution of an asset-backed security is unclear in that the initial distribution of an asset-backed security is not prohibited by the Proposed Rule in the first instance.

In addition, clause (b)(1)(ii)(B) of the Proposed Rule should be revised to specify that the ongoing recalibration should be "reasonably designed" to ensure continued compliance with the exception. Foot faults or temporary periods of imbalance under an otherwise reasonably designed recalibration mechanism should not invalidate the exception. In addition, the final rule should clarify that recalibration should be required only with respect to the aggregated holdings of the securitization participant, not individual positions.

Finally, clause (b)(1)(ii)(C) of the Proposed Rule should be deleted. The requirement of a compliance program with respect to risk mitigating hedging activities is unduly burdensome. Moreover, a rule that denies Section 27B's statutory exception to a securitization participant who is engaged in permissible risk mitigating hedging activities is not consistent with the unambiguous text of Section 27B.

2. The risk-mitigating hedging activities exception should include permitted risk transfer transactions.

The risk-mitigating hedging activities exception should include the following types of risk transfer transactions:

- A synthetic securitization or credit risk mitigant entered into or benefiting a financial institution or its affiliate intended to satisfy the regulatory requirements applicable to such institution or its affiliate; and

- Any synthetic securitization or credit risk mitigant entered into by any other person or entity in which such person or entity manages risk in a manner intended to be similar to that specified under the regulations applicable to a regulated financial institution.

The types of transactions described above are squarely within the statutory exception for risk-mitigating hedging activities. Banks and other financial institutions use these transactions to manage their credit risks. As discussed in detail in Part VI.A.1., the Associations do not believe that Congress intended Section 27B to be construed to allow any implementing rule thereunder to hamper the ability of banks to manage their risks.

We have reviewed the comment letter submitted by the International Association of Credit Portfolio Managers ("IACPM"), dated March 27, 2023. We share the concerns raised by the IACPM in its letter and urge the Commission to expressly permit risk transfer transactions in any re-proposed or final rule it may issue.

3. The risk-mitigating hedging activities exception should include interest rate, currency and other non-credit related trading and hedging activities.

The risk-mitigating hedging activities exception should include interest rate, currency and other trading and hedging activities that are not materially related to the credit risk of the relevant asset-backed security or the asset pool supporting or referenced by the relevant asset-backed security. Such hedging activity is completely unrelated to the concerns that motivated Section 27B. These are not the types of transaction that give rise to a material conflict of interest because they are not the types of transactions that would induce a securitization participant to disregard its securities law duties. Moreover, as recent events highlight, no rule under Section 27B should make it more difficult for banks and other financial institutions to mitigate their interest-rate, currency and other non-credit related risks.

4. The risk-mitigating hedging activities exception should include an exception for hedging activities in connection with tender option bonds ("TOBs").

There are securitization transactions, such as tender option bonds, in which the sponsor is executing the transaction to obtain financing to carry the investment in the underlying security or securities for a period short of maturity of such security.

For further discussion of the impact of the proposal on TOBs, we direct your attention to a SIFMA letter of this same date requesting that the risk mitigating hedging activities exception should clearly state that hedges with respect to the underlying assets are permissible to the extent the sponsor either provides credit enhancement on the asset or the ABS issued or where the sponsor assigns, subordinates its right of payment on the hedge to or otherwise provides the benefit of the hedge to the ABS investors ahead of its benefitting therefrom. [132]

[132] *See* Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule Implementing Rule to Prohibit Conflicts of Interest in Certain Securitizations (Mar. 27, 2023).

5. The risk-mitigating hedging activities exception should include transactions (i) that hedge risk where a Sponsor serves as an intermediary to facilitate a customer's exposure to an asset-backed security or an asset underlying an asset backed security and (ii) where a Sponsor provides financing to investors for the ABS or assets underlying the ABS acquired by such investors, in the form of repurchase transactions or total return swaps.

The Volcker Rule permits a banking entity to acquire an ownership interest in a covered fund if it is designed to "reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with . . . a position taken by the banking entity when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund."[133]

Likewise, the Proposed Rule's risk mitigating hedging activities exception should include an exception for transactions which hedge risks to a bank or other financial institution when that bank or financial institution is acting in its capacity as an intermediary on behalf of a customer to facilitate the customer's exposure to ABS (or assets underlying an ABS) with respect to which that bank or financial institution is a sponsor. For example, a customer may seek synthetic exposure to an ABS (or assets underlying an ABS) for which a bank is a sponsor. The bank, acting in its capacity as its customer's intermediary, purchases the ABS (or underlying asset) and executes one or more total return swaps (under which the customer is ultimately long and the bank is short) to provide the exposure to the customer and hedge the bank's exposure to the ABS (or underlying assets). This market function for the benefit of investors and corresponding risk hedge for the facilitating bank or financial institution is directly analogous to the Volcker Rule provision summarized above and should be permitted.

In addition, investors often seek financing in connection with the acquisition of ABS or assets underlying the ABS. The execution of a repurchase transaction or total return swap transaction at the request of an investor to provide such financing similarly provides a market function for the benefit of the investors and should be permitted.

B. Bona Fide Market Making Activities.

The Proposed Rule's current exception for bona fide market-making activities should be clarified and simplified in several respects. Clause (b)(3)(i) of the Proposed Rule should be modified as follows in order to align it more closely with its counterpart in the Volcker Rule and to clarify its scope and meaning.

> *Permitted bona fide market-making activities*. Bona fide market-making activities, including market-making related hedging, of the securitization participant conducted in accordance with this paragraph (b)(3) in connection with and related to asset-backed securities with respect to which the prohibition in paragraph (a)(1) of this section applies, the assets underlying such asset-backed securities, or financial instruments that reference such asset-backed securities or underlying assets, ~~except that the initial distribution of an~~

[133] 12 C.F.R. § 248.13(a)(ii) (2023).

~~asset-backed security is not bona fide market-making activity for purposes of paragraph (b)(3) of this section~~.

Similar to the exception for risk-mitigating hedging activities, the phrase that excludes the initial distribution of an asset-backed security is confusing and unclear in that the initial distribution of an asset-backed security is not prohibited by the Proposed Rule in the first instance.

Finally, clause (b)(3)(ii)(E) of the Proposed Rule should be deleted. The requirement of a compliance program with respect to bona fide market-making activities is unduly burdensome and unnecessary. Moreover, a rule that denies Section 27B's statutory exception to a securitization participant who is engaged in bona fide market-making activities is not consistent with the unambiguous text of Section 27B.

C. The Proposed Rule should exclude Section 4(a)(2) direct private placements to investors.

The Proposed Rule should exclude transactions by a securitization participant in connection with the issuance of asset-backed securities directly by the issuer to one or more investors pursuant to a transaction that is exempt from registration pursuant to Section 4(a)(2) of the Securities Act. Section 4(a)(2) direct private placements are almost completely unlike registered public offerings or private offerings under Rule 144A. In direct private placement transactions, sophisticated investors typically participate directly in nearly all phases of the structuring and creation of the asset-backed security, as well as the selection of the assets backing the asset-backed security. Investors in such transactions typically perform extensive due diligence on the assets, as well as the originator and servicer, and execute very detailed investor representation letters as to their level of sophistication and experience. The investors are represented by counsel and negotiate directly with the sponsor, the issuer and other transaction parties.

In the context of a Section 4(a)(2) direct private placement, the transaction between the investor and the issuer is much more like the transaction between a lender and a borrower. Although the investor in this circumstance is not the underwriter, initial purchaser, placement agent or sponsor,[134] the investor is very much on equal footing with those entities. Given the investor's close involvement with all phases of the securitization transaction, the risk that a separate transaction by a securitization participant could lead it to disregard its securities law duties is negligible. The rule should therefore exclude:

> Transactions by a securitization participant in connection with the issuance of asset-backed securities directly by the issuer to one or more investors pursuant to a transaction in which all classes of asset-backed securities issued thereunder are exempt from registration pursuant to Section 4(a)(2) of the Securities Act.

[134] *See* Part II (discussing the definition of "sponsor").

D. The Proposed Rule should not apply to corporate debt.

The rule should expressly exclude corporate debt securities. Corporate debt securities represent the payment obligation of the corporate issuer and thus are neither an asset-backed security nor a transaction that conflicts in any way with the interests of investors in asset-backed securities. The rule should therefore exclude:

> Corporate debt securities issued by companies that are not special purpose entities, whether or not payments on such securities are contingent on the performance of specified or referenced financial obligations owned by the issuer or its affiliates.

E. The Proposed Rule should not apply to insurance policies or contracts.

The rule should expressly exclude insurance policies and contracts. This exclusion is consistent with the definition of "asset-backed security" in the Exchange Act (which is incorporated by reference in this rule) and the definition of "synthetic asset-backed security" proposed by the Associations in this letter,[135] as both are limited to financial assets and exposures. The rule should therefore exclude:

> Any insurance policy or other risk protection issued by an insurance company or reinsurance company, or any contract that protects against risks typically covered by insurance companies.

[135] *See* Part VIII.

XI. THE PROPOSED RULE SHOULD INCLUDE A SAFE HARBOR FOR FOREIGN TRANSACTIONS.

In order to provide clarity to the market, the final rule should contain a safe harbor for certain foreign transactions.[136] The Associations urge the Commission to include a safe harbor for foreign transactions which parallels the safe harbor for certain foreign transactions in Regulation RR (except that the definition of "U.S. person" in Regulation RR should conform to the definition of "U.S. person" in Regulation S[137]). The reference to "underlying assets" in the Regulation RR safe harbor as carried over to the Proposed Rule should be expanded to "underlying or referenced assets" in order to conform the safe harbor to the scope of asset-backed securities covered by the Proposed Rule, which includes synthetic asset-backed securities.

The Associations also urge the Commission to include safe harbors for synthetic and hybrid cash and synthetic ABS transactions which similarly clarify that any rule under Section 27B does not apply to securitization participants outside the United States.

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[136] The extent to which Section 27B or any rule adopted thereunder applies outside the territorial jurisdiction of the United States is subject to existing law on the matter. The proposed safe harbor is intended to provide clarity as to the extent of the rule's extraterritorial reach in order to facilitate compliance.

We note that in *Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247 (2010), the Court observed that "[i]t is a longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States." *Id*. at 255. Section 621 of the Dodd-Frank Act gives no clear indication of an extraterritorial application of the provisions thereof. On the other hand, Section 722 of the Dodd-Frank Act does provide a clear indication of the extraterritorial application of that title. Specifically, Section 722(d)(i) of the Dodd-Frank Act states that the provisions of the Commodity Exchange Act relating to swaps that were enacted by Title VII "shall not apply to activities outside the United States" unless certain conditions are met. The distinction between Sections 621 and 722 of the Dodd-Frank Act is particularly relevant give the recent holding in *Garvey v. Admin. Rev. Bd., United States Dep't of Lab*., 56 F.4th 110 (D.C. Cir. 2022). In that case, the court held that Section 806 of the Sarbanes-Oxley Act does not apply extraterritorially because, among other things, "other SOX enactments . . . expressly provide for extraterritorial enforcement," while "Section 806 is silent as to its territorial reach." *Id*. at 123.

[137] Specifically, the definition of "U.S. person" in Regulation RR does not include the partnerships or corporations described in clause (viii) of the definition of "U.S. person" in Regulation S. Under Regulation S, a U.S. person includes "[a]ny partnership or corporation if: (A) Organized or incorporated under the laws of any foreign jurisdiction; and (B) Formed by a U.S. person principally for the purpose of investing in securities not registered under the Act, unless it is organized or incorporated, or owned by accredited investors … who are not natural persons, estates or trusts." *See* 17 C.F.R. § 230.902(k)(1)(viii) (2023). This difference in the "U.S. person" definition under Regulation RR and Regulation S, if carried over to the final rule under Section 27B, would create considerable compliance difficulties because securitization participants would to form a reasonable belief about whether an investor is a U.S. person under two different standards. Moreover, in the context of a rule under Section 27B, there is no policy reason why the much more familiar Regulation S definition of "U.S. persons" should not be used.

XII. THE FINAL RULE SHOULD INCLUDE A COMPLIANCE DATE THAT INCLUDES A TRANSITION PERIOD.

Given the duration and complexity of this rulemaking, it is clear that securitization participants will have a significant number of questions about any final rule and will need adequate time to understand its terms and design policies and procedures to comply with it.

The Associations believe that any final rule should provide that the prohibition therein applies only to those transactions engaged in by a securitization participant, and asset-backed securities for which the date of the first closing of the sale thereof occur, on or after date that is at least twelve months following the date that the final rule is published in the Federal Register.

XIII. THE FINAL RULE SHOULD CONTAIN A PROVISON FOR EXEMPTIVE RELIEF.

Like Regulation RR, this rule should contain a provision for exemptive relief. Given the scope of this rule and the very significant uncertainties surrounding it, such exemptive relief will be necessary to ensure a functioning market. The rule should therefore contain the following exemptive relief provisions:

- *Exempted transactions*. The Commission may provide a total or partial exemption of any transaction as the Commission determines may be appropriate in the public interest and for the protection of investors.

- *Exceptions, exemptions, and adjustments*. The Commission may adopt or issue exemptions, exceptions or adjustments to the requirements of this rule, including exemptions, exceptions or adjustments for the types of entities that constitute securitization participants, the types of transactions that constitute conflicted transactions, the requirements of the rule pertaining to exceptions from the rule, and other matters as the Commission determines may be appropriate in the public interest and for the protection of investors.

XIV. THE COMMISSION'S ECONOMIC ANALYSIS IS INCOMPLETE AND INSUFFICIENT.

The quantified data points provided by the Commission are incomplete and insufficient.
The Commission does not present empirical data to support the Proposed Rule.
The Commission's analysis of the effects of the Proposed Rule on efficiency, competition, and capital formation is inadequate.

Section 706 of the APA provides that "reviewing court[s] shall hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[138] Under APA Section 706, courts must "assure [them]selves the agency has 'examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choices made."[139]

In addition to an agency's usual requirement that its decision be based on a consideration of relevant factors, the Commission "has a unique obligation to consider the effect of a new rule upon 'efficiency, competition, and capital formation.'"[140] While *Business Roundtable* found this requirement under the Exchange Act, identical language is found in the Securities Act (of which Section 27B is a part). Under Section 2(b) of the Securities Act, "[w]henever the Commission is engaged in rulemaking . . . the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." The SEC has failed to fully consider the economic consequences of the Proposed Rule and, to the extent it has considered such consequences, its analysis is deficient, vague, and unreasonable.

A. The quantified data points provided by the Commission are incomplete and insufficient.

In the Proposing Release, the Commission identifies three different topics with identifiable data: (1) the annual number and value of non-municipal and municipal ABS issuance deals;[141] (2) the number of non-municipal and municipal ABS issuance participants; and (3) the estimated compliance costs for securitization participants to establish policies, procedures, and informational barriers to implement the Proposed Rule.[142] These figures, however, do not represent anything

[138] 5 U.S.C. § 706(2)(A).

[139] *Business Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (citing *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co*., 463 U.S. 29, 43 (1983)).

[140] *Id*.

[141] We believe that the number and value of municipal ABS issuance deals and participants stated in the proposal may conflate ABS issued by municipalities, which are municipal securities, and municipal securitizations issued by SPVs, which are not municipal securities. We believe the latter item may thus scope in tender option bond transactions, but this is unclear from the Proposing Release. In addition, it is unclear why the Commission chose to focus so heavily on transactions relating to municipalities, particularly as we are unaware of any assertion that any such past transactions involved conflicted transactions of the type that Section 27B seeks to prohibit.

[142] *See* Proposing Release, at 9712–16.

close to the full data set upon which the Commission should implement a rule with such a significant impact on the U.S. securitization market.

First, while the annual number and value of ABS issuance deals helps educate the public of the size of the securitization market, the Proposing Release does not provide any concrete figures that display the potential reduction or increase in the volume of ABS issuance deals as a result of the Proposed Rule. Instead, the Proposing Release makes un-quantified statements that indicate the securitization market could see a reduction in issuance volume from the implementation of the Proposed Rule. In discussing the rule's possible effects on market participant relationships, the Commission noted "[t]aken together, conflicting out certain relationships can reduce market liquidity and investor choice through a decline in the available set of investment opportunities. This decline could be more acute in the short-term when securitization participants and clients . . . realign their business practices to comply with the rule, but it could persist even in the long run."[143] The SEC, therefore, has relied upon a set of theoretical impacts on the securitization market to consider the economic effect of the Proposed Rule, rather than verifiable data.

Second, the Commission sets forth data on the annual number of securitization participants. While the Commission mentions that the Proposed Rule may have an effect on the number of securitization participants as larger entities may have unavoidable conflicts and be forced out of the securitization market, the Commission again fails to provide any estimate of the number or proportion of entities that may enter or leave the securitization market as a result of the Proposed Rule.

Third, the Commission detailed the estimated annual compliance costs for securitization participants at $27,324,000.00. This figure represents an estimated 45,540 burden hours at a cost of $600.00 per hour. Unlike its other data points, this annual compliance figure represents a calculated cost of the Proposed Rule that market participants can use to compare to their own estimations and provide a benchmark for the rule's impact on the securitization market. Although the Associations do not purport to speak for all market participants, we believe the Commission's estimate very significantly understates the compliance costs.[144] It also does not consider the economic costs that will be borne by American consumers, home buyers and small business owners caused by the accelerating effect that the Proposed Rule will have on the already-rising cost of borrowing.

B. The Commission does not present empirical data to support the Proposed Rule.

While the Commission provided a few data points as described above, the majority of the Commission's consideration of the costs and benefits of the Proposed Rule centers on theoretical or reasoned arguments of the rule's potential effects. The Commission noted in the introduction of

[143] *Id.* at 9717.

[144] Note that the Commission's cost estimates are based on its estimate that there are 1,380 securitization participants currently in the market. *See id.* at 9722, Table 1. As the Proposed Rule defines securitization participants as including not only the securitization participants of the type listed in Table 1, but all of their affiliates and subsidiaries, the number of securitization participants (as defined in the Proposed Rule) is far larger than that set forth Table 1. Thus, the Commission's estimate of the annual compliance cost captures only a fraction of the true compliance costs associated with the Proposed Rule if it is implemented in its current form.

its Economic Analysis discussion that it has attempted to "quantify the benefits, costs, and effects on efficiency, competition, and capital formation, . . . [but] we are unable to reliably quantify many of the economic effects due to limitations on available data."[145] Further, the Commission stated that "quantification of these effects is particularly challenging due to the number of assumptions that we need to make to forecast how the ABS issuance practice would change."[146]

The Commission identified numerous potential costs as to which it is unable to quantify the economic effects of the Proposed Rule. For instance, the Commission notes that it lacked even an estimated number of securitization participants under the proposed rule's definition of "securitization participant."[147] Next, the Commission concludes that it did "not have data on the extent of securitization participants' participation in ABS transactions that are tainted by material conflicts of interest following the financial crisis."[148] Finally, the Commission states that the loss of clientele due to potential conflicts of interest "could have an adverse impact on securitization participant revenues as well as costs, due to the nature of the business."[149]

Through its Division of Economic and Risk Analysis ("DERA"), the Commission is very well equipped to undertake significant and complex economic research and analysis. Despite its extensive research expertise and analytical capabilities, throughout its economic analysis in the Proposing Release, the Commission relies heavily on its assertions that data on key issues is either unavailable or inestimable. While further illustrations of unquantified benefits, costs and economic effects have been omitted for brevity, they make up the great majority of all potential benefits, costs, and economic effects of the Proposed Rule.

The *Business Roundtable* case cited above (as well as other cases) held the Commission must present empirical data to support its actions and rulemaking. As the Commission has largely put forth theoretical arguments to support the Proposed Rule and has not developed the requisite data and economic analysis, the Commission has failed to support the Proposed Rule under the APA and Section 2(b) of the Securities Act.

C. The Commission's analysis of the effects of the Proposed Rule on efficiency, competition, and capital formation is inadequate.

The Proposing Release asserts that the Proposed Rule would increase efficiency as it would "generally lead to lower adverse selection costs, higher expected liquidity, and lower expected volatility in the ABS markets."[150] However, the Proposing Release does not discuss the current state of the securitization market's liquidity, adverse selection costs, and volatility.

The Commission's competition analysis of the Proposed Rule suffers from the same defect as the Commission's analysis of proposed Rule 151A as discussed in *Am. Equity Inv. Life Ins. Co.*

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[145] *Id.* at 9711.

[146] *Id.*

[147] *Id.* at 9712.

[148] *Id.* at 9713.

[149] *Id.* at 9717.

[150] *See id.* at 9718.

v. SEC.[151] In that case, the court noted that "[t]he SEC's reasoning with respect to competition supports at most the conclusion that any SEC action in this area could promote competition, but does not establish Rule 151A's effect on competition. Section 2(b) requires more than this."[152] Further, the court found that the Commission's competition analysis failed because it lacked evidence of the existing level of marketplace competition prior to the Commission's rulemaking. Specifically, the Commission "asserted competition would increase based upon its expectation that Rule 151A would require fuller public disclosure of the terms of FIAs and thereby increase price transparency."[153] Without an assessment of the pre-Rule 151A level of price transparency, however, the court found the Commission could not accurately assess a resulting effect on competition.

Similarly, the Proposing Release discusses the Proposed Rule's promotion of competition through reducing the number of large entities in the securitization market: "larger entities with multiple business lines could have, as a result of their structure, unavoidable material conflicts of interest and such entities might avoid their participation in securitizations to avoid violating the re-proposed rule."[154] While the Proposing Release does make reference to the current state of competition in the securitization when it states that "the re-proposed rule could increase competition amongst covered parties and relatively smaller entities might gain market share at the expense of relatively larger entities,"[155] it simply notes that "large entities" make up a significant portion of the securitization market. Furthermore, unless the Commission believes that larger entities are dominating the securitization market such that they are having an anti-competitive effect (a matter entirely outside the scope of this rulemaking), the Commission's rationale is itself anti-competitive because it amounts to the Commission, rather than the market, picking winners and losers in the market.

[151] 613 F.3d 166 (D.C. Cir. 2009).

[152] *Id.* at 178.

[153] *Id.*

[154] *Id.*

[155] *Id.*

XV. THE 60-DAY COMMENT PERIOD WAS INSUFFICIENT.

The Associations believe that the Commission's 60-day comment period was insufficient to permit the public to fully participate in the rulemaking process. The APA provides that "[a]fter notice . . . , the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments."[156] Courts have noted that "[t]he important purposes of this notice and comment procedure cannot be overstated. The agency benefits from the experience and input of comments by the public, which help 'ensure informed agency decisionmaking.'"[157] Without an adequate period during which the public can examine the Proposed Rule and its effects, the Commission cannot fulfill its obligation to make informed decisions in promulgating a final rule.

We remind the Commission that it released Proposed Rule 127B on September 18, 2011, and set a comment period of 90 days.[158] Recognizing that the initial period was too short to permit a full analysis of the rule, the Commission extended the comment period by 30 days.[159] Before the end of the first extension, the Commission again extended the comment period by a further 30 days to "provide the public with a better opportunity to consider any potential interplay between the ABS Conflicts and Volcker Rule Proposals."[160] The Commission therefore provided the public with 150 days to submit comments and analyze Proposed Rule 127B.

The proposing release for Proposed Rule 127B had 120 requests for comment. In contrast, the Proposing Release has 112 requests for comment. By including nearly the same number of requests for comment in the Proposing Release as it did before, the Commission clearly signaled that it had an acute need for input from market participants.

Moreover, the 112 requests for comment contained in the Proposing Release actually embed more than twice as many questions. Those questions are not of a trivial or "fine tuning" nature. This is most clearly demonstrated in Part XIV of this letter, where the Proposing Release improperly shifts the burden to the commenting public to make an assessment of the economic impacts of the Proposed Rule.

Although this letter contains many comments and suggestions, the Associations were compelled by the short deadline to submit this letter rather than a longer and more detailed letter. In addition, a 60-day comment period is inadequate for market participants to conduct the economic research necessary to address the Commission's very broad requests for comments in the "Economic Analysis" portion of the Proposing Release.

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[156] 5 U.S.C. § 553(c).

[157] *N.C. Growers Ass'n v. UFW*, 702 F.3d 755, 763 (4th Cir. 2012) (citing *Spartan Radiocasting Co. v. FCC*, 619 F.2d 314, 321 (4th Cir. 1980)) (emphasis supplied).

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

[159] Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 78181 (Dec. 16, 2011).

[160] Prohibition Against Conflicts of Interest in Certain Securitizations, 77 Fed. Reg. 24 (Jan. 3, 2012).

XVI. SECTION 27B DOES NOT AUTHORIZE AN IMPLEMENTING RULE AS SWEEPING AS THE PROPOSED RULE.

Because of its breadth, the Proposed Rule, if implemented, threatens to have vast economic consequences as explained in the Executive Summary and elsewhere in this letter. In addition, the Dodd-Frank Act, of which Section 621 is a part, reflects the political mandate that arose after the financial crisis triggered calls for comprehensive reform. The Dodd-Frank Act was the subject of much political debate prior to its passage, and the adequacy of the Dodd-Frank Act continues to be the subject of much political debate today.

The Proposed Rule attempts to resolve matters of current political, and not merely regulatory, significance. These matters include:

- the fundamental nature of the relationship that the issuers of securities (and related participants, such as underwriters) have with investors,
- the general efficacy of our disclosure-based securities law regime,
- the ability of institutions with large numbers of domestic and foreign affiliates and subsidiaries to participate in the securities market, and
- the method and manner by which banks manage their credit risks.

The Associations do not believe that Congress intended to grant the Commission the power to implement a rule with these economic and political effects, nor do we believe that Section 27B confers such power. Moreover, we note that because the Proposing Release does not clearly state what underlying duties are implicated by the expansive "conflicted transactions" definition, it is unclear whether the Proposed Rule purports to address matters that are solely the domain of state law, such as the implied covenant of good faith and fair dealing (which is read into contracts under the laws of most states) and the other state law contractual duties that securitization participants have.

The Associations believe that Section 27B is ancillary to already-existing securities laws (such as Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act) that have been used to address the kinds of transactions that motivated the inclusion of Section 621 in the Dodd-Frank Act. Moreover, we believe that Section 621 of the Dodd-Frank Act, which added Section 27B to the Securities Act, is a provision that is ancillary to the more fundamental securitization market reforms enacted by the Dodd-Frank Act generally, including credit risk retention. The Associations respectfully suggest that Section 621 was never intended to be the source of the fundamental changes and significant adverse consequences that the Proposed Rule portends.[161]

[161] *See Gonzales v. Oregon*, 546 U.S. 243, 267 (2006) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes." (quoting *Whitman v. American Trucking Ass'ns, Inc.*, 531 U.S. 457, 468 (2001)). *See also West Virginia v. EPA*, 142 S. Ct. 2587 (2022).

CONCLUSION

The Associations greatly appreciate your consideration of the views set forth in this letter. We stand ready to assist the Commission in this important rulemaking effort and we would be pleased to have the opportunity to discuss these matters with the Commission and its staff.

If you have any comments or questions, please feel free to contact Christopher B. Killian at (212) 313-1126 (ckillian@sifma.org) , Lindsey Keljo at (202) 962-7312 (lkeljo@sifma.org) or Jack Stump at (202) 589-1932 (jack.stump@bpi.com), or our outside counsel, Mayer Brown LLP, attention: Stuart M. Litwin at (312) 701-7373 (slitwin@mayerbrown.com), Christopher B. Horn at (212) 506-2706 (cbhorn@mayerbrown.com) or Michelle M. Stasny at (202) 263-3341 (mstasny@mayerbrown.com).

Sincerely,

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