SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 230

[Release No. 34-65355; File No. S7-38-11]

RIN - [3235-AL04]

Prohibition against Conflicts of Interest in Certain Securitizations

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission ("Commission") is proposing for comment a new rule under the Securities Act of 1933 ("Securities Act") to implement the prohibition under Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") on material conflicts of interest in connection with certain securitizations. Proposed Rule 127B under the Securities Act would prohibit certain persons who create and distribute an asset-backed security, including a synthetic asset-backed security, from engaging in transactions, within one year after the date of the first closing of the sale of the asset-backed security, that would involve or result in a material conflict of interest with respect to any investor in the asset-backed security. The proposed rule also would provide exceptions from this prohibition for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making.

DATES: Comments should be received on or before December 19, 2011.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form

(http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-38-11 on the subject line; or

- Use the Federal eRulemaking Portal (http://www.regulations.gov). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

All submissions should refer to File Number S7-38-11. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Elizabeth Sandoe, Senior Special Counsel, David Bloom, Branch Chief, Anthony Kelly, Special Counsel, Barry O'Connell, Attorney Advisor, Office of Trading Practices and Processing and Jack I. Habert, Attorney Fellow, Division of Trading and Markets, at (202) 551-5720, and David Beaning, Special Counsel and Katherine Hsu, Chief, Office of Structured Finance, Division of Corporation Finance, at (202) 551-3850, at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission is requesting public comment on proposed Rule 127B under the Securities Act.

I. Introduction

Section 621 of the Dodd-Frank Act adds new Section 27B to the Securities Act.[1] This new Section of the Securities Act prohibits an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity (collectively "securitization participants"), of an asset-backed security ("ABS"), including a synthetic ABS, from engaging in a transaction that would involve or result in certain material conflicts of interest.[2] The prohibition under Securities Act Section 27B applies to both registered and unregistered offerings of ABS.[3] This prohibition applies during the period ending on the date that is one year after the date of the first closing of the sale of the ABS. Section 27B provides exceptions from the prohibition described above for certain risk-mitigating hedging activities, liquidity commitments and bona fide market-making.[4]

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 621, 124 Stat. 1376, 1632 (2010).

[2] Section 27B(a) of the Securities Act states that an "underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity." 15 U.S.C. 77z-2a(a).

[3] See infra Section IIIA(ii).

[4] Section 27B(c) of the Securities Act excepts the following activity from the prohibition under Section 27B(a) of the Securities Act: "(1) risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or (2) purchases or sales of asset-backed securities made pursuant to and consistent with- (A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or (B) bona fide market-making in the asset-backed security."

15 U.S.C. 77z-2a(c).

Section 27B of the Securities Act further requires the Commission to issue rules for the purpose of implementing the new Section's prohibition.[5] To meet this statutory requirement, we are proposing new Rule 127B under the Securities Act to make it unlawful for a securitization participant to engage in any transaction that would involve or result in any material conflict of interest between the securitization participant and any investor in an ABS that the securitization participant created or sold at any time for a period ending on the date that is one year after the date of the first closing of the sale of the ABS.[6] Consistent with Securities Act Section 27B(c), the proposed rule excepts from the prohibition certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making. We discuss proposed Rule 127B in more detail below and offer a number of examples of how the proposed rule would apply to particular fact patterns. We also seek commenter input regarding whether information barriers or disclosure would be relevant and appropriate in managing and mitigating conflicts of interest or permitting certain transactions that might otherwise be prohibited by the proposed rule.

In crafting our proposed rule, we have primarily incorporated the text of Section 27B of the Securities Act. This release also sets forth below certain proposed clarifying interpretations of that text and a number of questions for public comment, all of which take into account

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[5] Section 27B(b) of the Securities Act. 15 U.S.C. 77z-2a(b).

[6] We note that Section 27B(a) is not effective until the adoption of final rules issued by the Commission. Section 621(b) of the Dodd-Frank Act states that "Section 27B of the Securities Act of 1933 . . . shall take effect on the effective date of final rules issued by the Commission under section (b) of such section 27B . . .." The proposed interpretations and related examples discussed in this proposing release therefore will have no force or effect except to the extent they are incorporated into any final Commission release adopting rules under Section 27B.

comments we have received to date regarding the implementation of Section 621 of the Dodd-Frank Act.[7]

II. Background

A. Securitization

Securitization is a mechanism for pooling certain financial assets that have payment streams and credit exposures associated with them and effectively converting the pool into a new financial instrument – an ABS – that is "backed" by the pool of assets and offered and sold to investors. More specifically, a financial institution or other entity, commonly known as a sponsor, first originates or acquires a pool of financial assets, such as mortgage loans, credit card receivables, auto loans or student loans. The sponsor then sells the financial assets, directly or through an affiliate, to a special purpose entity ("SPE"). The SPE issues the securities supported or "backed" by the financial assets. These securities are sold to investors in either a public offering subject to an effective registration statement filed with the Commission or an offering exempt from registration. As described by the Commission:

> Securitization generally is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as securities. This financing technique makes it easier for lenders to exchange payment streams coming from the loans [or other pooled assets] for cash so that they can make additional loans or credit available to a wide range of borrowers and companies seeking financing. Some of the types of assets that are financed today through securitization include residential and commercial mortgages, agricultural equipment leases, automobile loans and leases, student loans and credit card receivables.[8]

[7] As of August 24, 2011, the Commission had received eight comment letters addressing new Section 27B of the Securities Act. All the comment letters regarding new Section 27B of the Securities Act are available on the Commission's website at http://www.sec.gov/comments/df-title-vi/conflicts-of-interest/conflicts-of-interest.shtml.

[8] Asset-Backed Securities, Release No. 33-9117 (Apr. 7, 2010), 75 FR 23328, 23329 (May 3, 2010) ("Release 33-9117").

As a result of the securitization, the credit and other risks associated with the pooled assets is transferred away from the sponsor's balance sheet to investors in the ABS.[9]

ABS investors are generally interested in the experience of the collateral manager and the "quality of the underlying assets, the standards for their servicing, the timing and receipt of cash flows from those assets and the structure for distribution of those cash flows."[10] With respect to the structure for cash flow distributions, some ABS transactions are structured to provide cash flow distribution through "pass-through certificates representing a pro rata share of the cash flows from the underlying asset pool".[11] Other ABS transactions offer a range of risk exposures and yields to investors. This is accomplished through the SPE issuing different classes of securities, commonly referred to as tranches.[12] Transaction agreements typically specify the structure of an ABS transaction and detail how cash flows generated by the asset pool will be divided among tranches. This division of cash flows is often referred to as the "flow of funds" or "waterfall."[13]

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[9] One type of ABS is a collateralized debt obligation ("CDO"). In a CDO structure, a sponsor may sell to an SPE an asset pool that holds fixed income products, such as loans, mortgage-backed securities or corporate bonds. The SPE then issues debt securities collateralized or "backed" by this asset pool.

[10] Asset-Backed Securities, Release No. 33-8518 (Dec. 22, 2004), 70 FR 1506, 1511 (Jan. 7, 2005) ("Release 33-8518").

[11] Id.

[12] Id. ("ABS transactions often involve multiple classes of securities, or tranches, with complex formulas for the calculation and distribution of the cash flows. In addition to creating internal credit enhancement or support for more senior classes, these structures allow the cash flows from the asset pool to be packaged into securities designed to provide returns with specific risk and timing characteristics.").

[13] Id. ("The flow of funds specifies the allocation and order of cash flows, including interest, principal and other payments on the various classes of securities, as well as any fees and expenses, such as servicing fees, trustee fees or amounts to maintain credit enhancement or other support.").

The securitization process developed in the 1970s and subsequently has experienced significant growth and evolved dramatically.[14] With this evolution, the investor base has broadened and the ABS themselves have become more complex. There are, for example, now synthetic ABS in which investors in securities issued by SPEs acquire credit exposure to a portfolio of fixed income assets without the SPE owning these assets. Rather, the investors gain this exposure because the SPE has entered into derivatives transactions, such as credit default swaps ("CDS") that reference particular assets.[15] The counterparty to the CDS may be the sponsor who originated or selected the underlying portfolio. The SPE, as seller of protection under the CDS, is in effect long the credit exposure on those assets as if it had purchased them.

For example, a bank that maintains fixed income assets on its balance sheet may protect itself against default of those assets by purchasing a CDS from the SPE that references the same or similar types of assets. In other cases, a person may desire to purchase CDS protection even though such person does not own the reference assets underlying the CDS sold by the SPE. In both of the above cases, the SPE, as seller of the CDS protection, takes on the risk of default on the reference assets underlying the CDS (and the consequent obligation to make a payment to the CDS counterparty as a result of such default) in exchange for ongoing payments from the purchaser of the CDS protection. In addition, in both scenarios any payments the SPE is required to make under the CDS will be funded from amounts received by the SPE from the investors in the ABS issued by the SPE. Thus, the proceeds of the SPE's issuance of securities

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[14] See, e.g., SYLVAIN RAYNES & ANN RUTLEDGE, THE ANALYSIS OF STRUCTURED SECURITIES: PRECISE RISK MEASUREMENT AND CAPITAL ALLOCATION 3 (2003); see also Release No. 33-9117, 75 FR at 23330, ("[a]t the end of 2007, there were . . . nearly $2.5 trillion of asset-backed securities outstanding"). Securities Industry and Financial Markets Association, Global CDO Issuance – Quarterly Data from 2000 to Q1 2011 (updated 4/1/11), available at http://www.sifma.org/research/statistics.aspx (reporting a doubling in the volume of synthetic CDO issuances between 2005 and 2007). In recent years, the market for securitization has declined. See, e.g., David Adler, A Flat Dow for 10 Years? Why it Could Happen, BARRONS (Dec. 28, 2009).

[15] The protection sold by the SPE under a CDS may reference a portfolio of assets, a single asset, or an index.

typically are not used to purchase loans, receivables or other investment assets, but instead are typically used to purchase highly creditworthy collateral[16] to support (i) the SPE's contingent obligation to pay the purchaser of the CDS in the event of one or more defaults with respect to the reference assets underlying the CDS (the synthetic reference pool of assets), and (ii) to the extent not used for payments to the CDS purchaser, the SPE's obligations to investors in the SPE's issued securities.[17] The SPE makes payments to investors based on cash flows and proceeds from the CDS and the collateral pool.

Therefore, in both the non-synthetic ABS and the synthetic ABS, the SPE and the investors in the SPE have an ongoing long exposure to each instrument in a reference pool of assets – i.e., assets held directly by the SPE, in the case of a non-synthetic transaction, or assets referenced in a CDS under which the SPE has sold protection to a counterparty, in the case of a synthetic transaction. The transactions differ, however, in that the synthetic transaction inherently involves a party – the counterparty to the CDS – that has purchased CDS protection on the same reference pool of assets and thus has an ongoing short exposure to those assets. This purchaser of CDS protection may be a securitization participant (such as the bank sponsoring the synthetic ABS). In these cases – and considering the CDS in isolation – the securitization participant would be taking an investment position that is directionally opposite to that taken by the investors in the synthetic ABS, as is generally the case in any transaction

[16] The term "collateral," when used in connection with a synthetic ABS, has a different meaning than the term "collateral" in a non-synthetic ABS. In a non-synthetic ABS the collateral is the pool of underlying assets (e.g., a pool of student loans). In a synthetic ABS, the collateral is often U.S. Treasury securities or other securities used as credit support for the SPE's potential payment obligations under a CDS that references an underlying asset pool.

[17] The assets or types of assets on which the SPE will sell protection would typically be disclosed to investors upfront and they would invest in the SPE's securities based on the anticipated risk of default on those assets and income received by the SPE from selling protection via CDS that reference those assets. The SPE would in effect have a synthetic reference pool of assets created by the SPE's long exposure to the assets underlying the CDS that it sold.

through which a buyer is able to acquire and a seller is able to dispose of a particular financial exposure in pursuit of their respective investment objectives. If the referenced assets default, the securitization participant receives a payment from the SPE pursuant to the CDS and the investors in the SPE ultimately suffer a loss on their investment.[18] If the referenced assets do not default, the investors would have benefited from payments from the CDS counterparty while the SPE would not have any payment obligations to the CDS counterparty.

Request for Comments Regarding the Description of the Securitization Process

1. Are there any other key features of the securitization process that need to be highlighted in considering the scope of Securities Act Section 27B? If so, which features, and why?
2. We seek commenter input regarding the reasons why market participants enter into synthetic ABS transactions instead of non-synthetic ABS transactions. What relative economic or other benefits do synthetic ABS transactions offer to investors and securitization participants? Under what circumstances are such transactions more or less beneficial for each type of market participant? What economic, market or other considerations affect the determination by investors and securitization participants to enter into such transactions?
3. We ask that commenters estimate the volume of synthetic ABS transactions on an annual basis in terms of size and dollar value over the last ten years and to supplement those estimates with data where possible. We would also appreciate comparative estimates of synthetic and non-synthetic ABS transaction volume during this same period.

[18] As further discussed below, the securitization participant's short exposure may itself be hedged – by entering into an offsetting CDS transaction, or otherwise – such that in terms of its overall risk profile the securitization participant does not retain exposures directionally opposite to those taken by investors in the synthetic ABS.

4. We ask that commenters describe the impact on the market, and in particular on investors, if securitization participants refrained from structuring and selling any particular types of synthetic ABS. Please include a discussion of all advantages and disadvantages as well as any effects on investor protection, liquidity, capital formation, the maintenance of fair, orderly and efficient markets and the availability of credit to borrowers.
5. Do synthetic ABS transactions involving other synthetic ABS, CDOs of CDOs or other transactions involving multiple layers of ABS exposures raise additional or heightened conflict of interest concerns? If so, why and how should these factors be reflected in our proposed rule?
6. What are the key features of the securitization process that bear on the existence or significance of conflicts of interest between participants in that process and investors in the ABS? How has the securitization process changed in recent years, and how have those changes exacerbated or mitigated any potential conflicts of interest? Are the potential conflicts of interest in this process different in kind, degree or with respect to transparency than the conflicts that may arise in connection with creating and offering other credit products, such as corporate debt?
7. Are certain types of ABS more susceptible to conflicts of interest? Are certain parties in the securitization process more likely to have a conflict of interest with investors than others? Are there transactions inherent in the structure of a synthetic ABS that raise special or heightened conflict of interest concerns relative to other ABS transactions or otherwise?

8. Are the conflicts of interest that may arise during the securitization process different in kind or degree than those that may arise after the securitization process? How should the Commission interpret issues related to pre- and post-offering conflicts of interest for purposes of Securities Act Section 27B?

9. We request commenters' views concerning conflicts that may arise from the multi-tranche structure, including where securitization participants retain part or all of a particular tranche.[19]

B. Initial Comments Received Regarding the Implementation of Section 27B

Shortly after the passage of the Dodd-Frank Act, the Commission provided the public with the opportunity to express views on the various Dodd-Frank Act provisions that the Commission is required to implement, including Section 27B of the Securities Act, as added by Section 621 of the Dodd-Frank Act.[20] As noted above, we received eight initial comment letters regarding our implementation of Section 27B. One letter was written by the sponsors of Section 621 of the Dodd-Frank Act, who urged the Commission and other federal financial regulators, among other things, to "fully and faithfully" implement the Dodd-Frank Act, including Section 27B of the Securities Act.[21] This letter noted that a central purpose of Securities Act Section

[19] We note that other provisions of the Dodd-Frank Act seek to align the interests of ABS investors with securitizers. See, e.g., Section 941 of the Dodd-Frank Act. The proposed rule is not intended to prohibit risk retention as required by Section 941. See Credit Risk Retention, Release No. 34-64148 (March 30, 2011), 76 FR 24090 (April 29, 2011) (Commission proposing rules jointly with the Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency and the Department of Housing and Urban Development to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934 (15. U.S.C. § 78o-11), as added by Section 941 of the Dodd-Frank Act) ("Release 34-64148").

[20] Public Comments on SEC Regulatory Initiatives under the Dodd-Frank Act, available at http://sec.gov/spotlight/regreformcomments.shtml.

[21] Letter from Senators Jeffrey Merkley and Carl Levin to Commission Chairman Mary Schapiro, et al. (Aug. 3, 2010) ("Merkley-Levin Letter") at p. 1, available at http://www.sec.gov/comments/df-title-vi/conflicts-of-interest/conflictsofinterest-2.pdf.

27B is to prohibit "firms from packaging and selling asset-backed securities to their clients and then engaging in transactions that create conflicts of interest between them and their clients."[22] Further, it noted that a Permanent Subcommittee on Investigations hearing that addressed issues related to The Goldman Sachs Group, Inc. "highlighted a blatant example of this practice: the firm assembled asset-backed securities, sold those securities to clients, bet against them, and then profited from the failures."[23] These commenters included in their letter excerpts from the Congressional Record providing further background as to the purpose of Section 621, including the following statement: "[t]he intent of section 621 is to prohibit underwriters, sponsors and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures."[24]

Other commenters were industry associations and representatives of market participants who expressed their views on the implementation of Section 27B both in general and in the context of specific situations, and who highlighted their concerns about an overly broad application of Securities Act Section 27B. For example, one comment letter supported the prohibition on material conflicts of interest but also urged that certain activities should not be prohibited regardless of whether they result in potential or actual conflicts of interest.[25] Two other commenters cautioned against a broad interpretation of the term "material conflicts of

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[22] Id. at p. 5.

[23] Id.

[24] Id. (citing 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Carl Levin)).

[25] Letter from the Securities Industry and Financial Markets Association (Dec. 10, 2010) ("SIFMA Letter") at pp. 4 and 12 (SIFMA "generally support[s] the prohibition of material conflicts of interest" but "enumerates certain natural and expected conflicts which may arise in ABS transactions but do not constitute the type of 'material conflicts' intended to be regulated by Section 621").

interest" for purposes of Section 27B of the Securities Act.[26] These commenters noted, for example, that the relationship between securitization participants, on the one hand, and investors, on the other hand, can in certain respects be viewed as fundamentally conflicted in the simple sense that a buyer and seller of assets always have opposing interests, as to price, asset quality and other terms and conditions.[27] These commenters asserted that Section 27B was not intended to eliminate this type of conflict.

Commenters suggested different tests for assessing whether a transaction involves or results in a material conflict of interest prohibited by Section 27B. One commenter suggested that a transaction or activity should not be prohibited under Section 27B if "(i) such transaction or activity represents an overall alignment of risk to the ABS or underlying assets similar to that borne by investors of the ABS, (ii) such transaction or activity is unrelated to the [securitization participant's] role in the specific ABS, (iii) disclosure of the transaction or activity of the [securitization participant] adequately mitigates the risk posed by the potential or actual conflict with respect to any investors in the ABS or (iv) another regulatory regime applies with respect to the potential or actual conflict of interest."[28]

Another commenter asserted the proposal should prohibit: "(a) ABS transactions in which the adverse performance of the pool assets would directly benefit an identified party or sponsor (or any affiliate of any such entity) of the applicable ABS transaction; (b) ABS

[26] Letters from the American Securitization Forum (Oct. 21, 2010) ("ASF Letter") at p. 3 and the Committee on Federal Regulation of Securities and the Committee on Securitization and Structured Finance of the Section of Business Law of the American Bar Association (Oct. 29, 2010) ("ABA Letter") at p. 2.

[27] ABA Letter at p. 3 ("The relationship between an ABS sponsor and ABS investors is inherently conflicted, in that the ABS sponsor is seeking funding and the ABS investors are providing that funding on negotiated terms. Pool selection may also involve conflicts . . . We believe that conflicts of this type, relating to the terms and nature of the security, exist in any ABS transaction and cannot be eliminated.").

[28] SIFMA Letter at p. 3.

transactions in which a loss of principal, monetary default or early amortization event on the ABS would directly benefit an identified party or sponsor (or any affiliate); and (c) ABS transactions in which an insolvency event related to the issuing entity of the ABS would directly benefit an identified party or sponsor (or any affiliate)."[29] This commenter believed that most ordinary course business transactions concerning securitization participants do not have these characteristics and should be permitted.[30]

A third commenter suggested that the proposal should "prohibit transactions that create a material incentive to intentionally design asset-backed securities to fail or default."[31] The commenter further proposed that a material conflict of interest would exist if "(i) a [securitization participant] participates in the issuance of an asset-backed security that is created primarily to enable such [securitization participant] to profit from a related or subsequent transaction as a direct consequence of the adverse credit performance of such asset-backed security and (ii) within one year following the issuance of such asset-backed security, the [securitization participant] enters into such related or subsequent transaction."[32]

Commenters provided examples of a number of conflicts of interest that they view as inherent in, and indeed essential to, the securitization process and that in their opinion should not be prohibited by Section 27B.[33] In fact, one commenter listed more than twenty categories of

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[29] ABA Letter at p. 3.

[30] Id.

[31] ASF Letter at p. 4.

[32] ASF Letter at p. 5.

[33] See, e.g., ABA Letter at p. 2 ("We believe rules implementing this provision should give appropriate weight to Congressional intent while permitting a broad range of common activities that are essential to the functioning of the securitization market."); see also SIFMA Letter at pp. 2 and 5 ("The goal of the letter is to provide the Commission with some representative examples of potential conflicts of interest that may arise as part of an ABS transaction but that should not be expressly prohibited under Section 621"; "conflicts of interest are inherent in securitization . . . These conflicts should be disclosed to investors and other transaction parties to the extent they are material, but

potential conflicts of interest that, in its view, are inherent in the ordinary course of securitization but should not be prohibited by Section 27B: (1) the basic risk transfer that occurs in structuring a securitization; (2) the tranching of debt; (3) holding differing classes of securities in an asset-backed transaction; (4) risk retention; (5) retaining the right to receive excess spread or cash flows; (6) failure to provide funding under a liquidity facility; (7) failure to provide a credit enhancement; (8) control rights (e.g., "the contractual right to remove the servicer, appoint a special servicer, exercise a clean-up call or instruct a trustee or servicer to take certain actions with respect to the collateral underlying the ABS or against an issuer or other transaction party" and "voting rights as a security holder or in another capacity in a transaction"); (9) hedging activities unrelated to a securitization; (10) providing financing (e.g., a warehouse line or financing investors to purchase an ABS); (11) servicer conduct (e.g., servicer interactions with obligors including loan modifications and adjustments to loan terms); (12) collateral manager conduct (e.g., the collateral manager acquiring assets for itself or others but not making the assets available to the asset-backed issuer, engaging "in 'agency cross' transactions in which the collateral manager or an affiliate thereof acts as a broker for compensation for both the issuer and the other party to the transaction" and "'client cross' transactions in which the collateral manager or an affiliate thereof causes a transaction between a securitization issuer and another client of the collateral manager without the collateral manager or its affiliates receiving compensation"); (13) conduct in connection with a trustee (e.g., a sponsor "may want to acquire a trustee or the trust business from the trustee"); (14) transactions in swaps and caps; (15) transactions in CDS and other derivatives; (16) receipt of payments for performing a role in a securitization prior to payments made to investors; (17) paying an entity for a rating or to provide

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should otherwise be permitted . . . conflicts created in the normal course of a securitization are sufficiently known by, or disclosed to, investors and do not fall under the intended scope of Section 621.").

due diligence; (18) market research; (19) entering into a merger, acquisition, or restructuring that could be adverse to the securitization activities; (20) a bank affiliate of an underwriter making a loan to the sponsor; (21) an underwriter acting as underwriter or placement agent in connection with securities issued by a competitor of a sponsor; and (22) an underwriter hedging market-making activity.[34] Other commenters echoed the view that there are many activities that involve or result in potential conflicts of interest in connection with a securitization that should not be prohibited by Section 27B.[35]

Three other commenters offered their views on topics including the elimination of conflicts of interest, costs associated with regulation, and disclosure requirements.[36] A sponsor of tax lien-backed securities suggested that "municipally-sponsored [sic] tax lien securitization

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[34] SIFMA Letter at p. 5 through 11.

[35] See, e.g., ABA Letter at pp. 2-4. The ABA Letter sets forth a more limited list of activities that occur in the ordinary course of a securitization, some of which overlap with the SIFMA Letter, that mainly occur either as part of structuring the ABS or in connection with a securitization, and which the ABA believes should not be prohibited by the proposed rule. With respect to conduct that is related to structuring the ABS, the ABA identifies: (1) a securitization participant seeking funding that is provided by the investor in the securitization; (2) pool selection; (3) risk retention; and (4) subordinated tranches. The ABA Letter also highlights the following conduct customarily effected in connection with securitization: (1) "dealing with delinquent assets (e.g., whether and to what extent to modify an obligation or to foreclose on underlying collateral)"; (2) originating or acquiring second lien loans on mortgaged properties; (3) providing a warehouse loan or other loan to be repaid from the proceeds of ABS issuance; (4) loans to servicers or credit enhancers; (5) loans to an investor secured by ABS (e.g., an investor margin account or repo facility); (6) "sales by an identified party of ABS which it originally placed or sales of other debt or equity securities of an ABS issuer or of debt of an entity included in a CDO or CLO;" and (7) the exercise of remedies upon a loan default.

Similarly, the ASF Letter identifies activities that are routinely undertaken in connection with securitization, which in its view should not be prohibited by the proposed rule, including (1) "short-term funding facilities such as 'warehouse' lines, variable funding notes and asset-backed commercial paper, whereby the underwriter or its affiliate provides financing to the sponsor to fund asset originations or purchases," (2) the pursuit of customary servicing activities such as loan modifications, short sales and short refinances; (3) tranche structure; (4) risk retention; and (5) providing best execution in interest rate and currency swaps to obtain interest rates or currencies that differ from the underlying assets. ASF Letter at p. 3.

[36] See Letters from Robin McLeish (July 28, 2010) ("People should not be allowed [to engage in] any conflict of interest."), Timothy Hogan (Sept. 15, 2010) ("Underwriters . . . should disclose whether they are advocating for the Issuer or the Investor or both . . . This requirement should apply regardless of whether the securities are registered or exempt from registration."), and Robert O.L. Lynn (Oct. 6, 2010) ("Redistributing compliance risk toward the individual-employee level could yield cost-efficient enforcement by increasing the downside risk to anyone attempting to disguise conflicts of interest – without requiring additional taxpayer resources.").

programs should be exempt from the rules promulgated pursuant to Section 621 of the [Dodd-Frank] Act."[37]

III. Discussion of Proposed Rule

Pursuant to Section 27B(b) of the Securities Act, the Commission proposes Rule 127B under the Securities Act to address material conflicts of interest that arise in connection with a securitization. As the securitization process has grown more complex, securitization participants may in some circumstances engage in a range of different activities and transactions that give rise to potential conflicts of interest, and the existence and potential effects of conflicts of interest in that process have received increased attention.[38]

The proposed rule is designed to implement Section 27B of the Securities Act. As noted above, the text of proposed Rule 127B is based substantially on the text of Section 27B. As described below, the Commission is proposing for comment guidance to market participants as to the nature and scope of conduct that would be prohibited under the proposed rule. The Commission has received a number of initial comments regarding the breadth of any proposed definition of material conflict of interest, and we have sought to strike an appropriate balance

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[37] See Letter from Mark Page, Director of Management and Budget, The City of New York (Nov. 12, 2010) at p. 5 ("City of New York Letter").

[38] See, e.g., STAFF OF S. COMM. ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, SUB. COMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (Comm. Print 2011), available at http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf (hereinafter "Senate Subcommittee Report: Anatomy of a Financial Collapse"). See also, STAFF OF S. COMM. ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, SUB. COMM. ON INVESTIGATIONS, 111TH CONG., WALL STREET AND THE FINANCIAL CRISIS: THE ROLE OF INVESTMENT BANKS (Comm. Print 2010) (Exhibit 1a), available at http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf (hereinafter "Senate Subcommittee Report: The Role of Investment Banks"); The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, available at http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_full.pdf (hereinafter, "The Financial Crisis Inquiry Report"); Consent and Final Judgment as to the Defendant J.P. Morgan Securities LLC in SEC v. J.P. Morgan Securities LLC (f/k/a/J.P. Morgan Securities Inc.), 11 CV 4206 (S.D.N.Y 2011); Litigation Release No. 22008 (June 21, 2011); and Consent and Final Judgment as to Defendant Goldman, Sachs & Co. in SEC v. Goldman, Sachs & Co. and Fabrice Tourre, 10 CV 3229 (S.D.N.Y. 2010); Litigation Release No. 21592 (July 15, 2010), 2010 WL 2799362 (July 15, 2010).

between prohibiting the specific type of conduct at which Section 27B is aimed without restricting other securitization activities.[39] We preliminarily believe that the proposed rule strikes that balance, but we seek comment on all aspects of proposed Rule 127B and of our proposed interpretations of its scope and requirements. It is important to note that although the proposed rule would prohibit certain transactions that would involve or result in certain material conflicts of interest, it would in no way limit or restrict the applicability of the general antifraud provisions of the federal securities laws to conduct arising before or after the proposed rule becomes effective. Thus, all conduct in connection with a securitization, whether or not effected in compliance with Section 27B and proposed Rule 127B, would remain subject to these and other relevant provisions of the securities laws.

The discussion of the proposed rule set forth below is divided into three parts. First, we describe certain conditions that, under Section 27B, must be present for the proposed rule to apply. In particular, we discuss the persons, products, timeframes and conflicts that potentially fall within the scope of the proposed rule, and we propose a standard for determining whether a "material conflict of interest" exists for purposes of the proposed rule. Second, we discuss three categories of activities - risk-mitigating hedging activities, liquidity commitments, and bona fide market-making - that are excepted from the scope of the proposed rule, as provided in Section 27B. Third, we provide examples of selected securitization transactions and describe how our proposed test for determining whether or not a transaction involves or results in a "material conflict of interest" prohibited by proposed Rule 127B would apply to such examples. Though in a number of examples particular reference is made to synthetic ABS for the purpose of

[39] See Section IIID of the Release.

furthering the discussion or providing clarification, we are seeking to apply the same general principles and guidance to both synthetic ABS and non-synthetic ABS.

We note that in analyzing whether a particular activity is prohibited by the proposed rule, market participants would be permitted to consider each of the conditions and exceptions discussed below independently. Thus, they could conclude that the activity is not prohibited by the proposed rule if: (1) the activity is outside the scope of the proposed rule (because, for example, it does not involve a covered person or product, or does not entail a material conflict of interest), or (2) the activity falls within a permitted exception to the rule. We seek comment on all aspects of proposed Rule 127B and of our proposed interpretations of its scope and requirements.

A. Conditions Required for Application of the Proposed Rule

There are five key conditions, each of which is discussed below, that define the circumstances in which the proposed rule might prohibit material conflicts of interest in the securitization process. In particular, in order for the proposed rule to apply, the relevant transaction must involve (1) covered persons, (2) covered products, (3) a covered timeframe, (4) covered conflicts and (5) a "material conflict of interest". Each of these conditions must be present in order for the prohibition under the proposed rule to apply.

i. Covered Persons

The proposed rule would apply to an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an ABS. These persons are specified in Section 27B(a) of the Securities Act and typically have substantial roles in the assembly, packaging and sale of ABS. They structure the product and control the securitization process,

and thus they may have the opportunity to engage in activities that the proposed rule and Section 27B of the Securities Act are intended to prevent.

The term "underwriter" is defined in Section 2(a)(11) of the Securities Act. The Securities Act, however, does not define for purposes of Section 27B of the Securities Act the terms "placement agent," "initial purchaser," "sponsor," "affiliate" or "subsidiary." We do not propose to define these terms for purposes of the proposed rule at this time. Although the term "sponsor" is defined in connection with Regulation AB's disclosure regime and the second prong of the definition of the term "securitizer" in Section 15G of the Securities Exchange Act of 1934 ("Exchange Act") is substantially identical to the Regulation AB definition of sponsor, the Regulation AB definition might not identify all persons involved in the structure and sale of, for example, a synthetic ABS transaction, who may have the opportunity to engage in activities that the proposed rule is intended to prevent.[40] We note that synthetic ABS are not included within the scope of Regulation AB.[41] Neither the Commission nor our staff has interpreted the Regulation AB definition in the context of synthetic ABS transactions. We preliminarily believe that the Regulation AB definition of sponsor might be under-inclusive or confusing in the context of the proposed rule. Furthermore, we preliminarily believe that a collateral manager should be subject to the proposed rule, based on such entity's role in structuring the transaction and selecting assets.

We preliminarily believe that terms such as placement agent and initial purchaser are sufficiently well understood in the context of the market for ABS, given that securitization

[40] The Regulation AB definition of sponsor is found at 17 CFR 229.1101(l); see also Release No. 34-64148.

[41] Synthetic ABS do not fit within the more narrow definition of ABS included in Regulation AB because payments on synthetic ABS are based primarily on the performance of reference assets and not the performance of a discrete pool of financial assets that by their terms covert into cash and are transferred to a separate entity. See generally Release 33-8518.

developed in the 1970s and market participants frequently identify the various participants in the securitization process using these terms (for example, by specifying the placement agent, initial purchaser, and sponsor in offering documents). [42] We also recognize that many of these terms, however, are defined or used in other provisions of the federal securities laws and rules adopted thereunder.[43] While certain specific definitions used in other areas of the federal securities laws and rules may be workable in this context, others may be over- or under-inclusive. For example, we seek commenter input concerning whether the term "sponsor" in this context should include the collateral manager or others who for a fee, or some other benefit, play a substantial role in the creation of an ABS, or managing or servicing the assets underlying an ABS. Although as noted above we do not preliminarily believe definitions are warranted in the proposed rule text, we seek commenters' views on this issue.

Request for Comments regarding Covered Persons

10. Should we provide definitions for the terms "placement agent," "initial purchaser," "sponsor," "affiliate" or "subsidiary"? One commenter suggested that we adopt definitions for the terms "initial purchaser" and "sponsor" but not for other covered persons.[44] Should we adopt this commenter's approach? We seek comment concerning whether certain terms should or should not be

[42] ABA Letter at page 6 ("Section 27B also uses the term 'sponsor', which is not currently defined in the Securities Act of 1933. However, the term sponsor has been defined in Regulation AB, and the definition there is virtually identical to clause (B) of the definition of "securitizer" that is added to the Securities Exchange Act of 1934 by virtue of Section 941 of the Dodd-Frank Act. We recommend that the Commission utilize the definition of 'sponsor' in Regulation AB for purposes of Section 27B"). While the ABA Letter suggested using the Regulation AB definition of the term sponsor, others did not make such a suggestion.

[43] See, e.g., infra notes 44 through 51.

[44] See ABA Letter at p. 6 (suggesting "the Commission clarify that the term 'initial purchaser' as used in Section 27B refers to a broker-dealer functioning in a role equivalent to that of an underwriter or placement agent in a Rule 144A transaction" and "that the Commission utilize the definition of 'sponsor' in Regulation AB for purposes of Section 27B.").

defined, and the rationale supporting such distinctions. Specifically, we seek comment as to whether definitions of these terms in other provisions of the federal securities laws and rules would be necessary and workable in this area, whether existing definitions should be tailored specifically for this rule proposal, or whether new definitions would be necessary to achieve the purpose of the proposal.

11. Should the term "sponsor" have the same meaning as defined in Regulation AB?[45] Please explain why or why not. Would such definition be workable or would it be over- or under-inclusive in this context?

12. For purposes of proposed Rule 127B, should the term "sponsor" be defined to specifically include a collateral manager or any other person (e.g., servicers, custodians, etc.) who, for a fee or some other benefit, has a substantial role in the creation of the ABS? We seek commenter input regarding whether such definition would be appropriate or over- or under-inclusive. If you believe such a definition would be over- or under-inclusive, please provide examples of how such definition would be over- or under-inclusive. Would clarification or more specificity be needed if we were to use such a definition of "sponsor"? If so, please explain what would be needed and why. Alternatively, should the term "sponsor" be defined to specifically include a collateral manager or any other person (e.g., servicer, custodian, etc.) who, for a fee or some other benefit, participates in the creation of the ABS? We seek commenter input regarding

[45] 17 CFR 229.1101(*l*) ("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.").

whether or not this alternative definition would be more appropriate. If commenters believe that definitions of a particular covered person are necessary but that existing definitions from other areas of the federal securities laws and rules or other sources are not workable in this context, please suggest an alternative definition(s). Commenters should explain why their suggested definition(s) better identifies persons intended to be covered by Section 27B.

13. Should proposed Rule 127B provide that an "affiliate" of, or a person "affiliated" with, a specified person is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified? Such terms are defined similarly in Section 16 of the Securities Act, Rule 405 under the Securities Act, and Rule 12b-2 under the Exchange Act.[46] Would such a definition be workable or would it be over or under-inclusive in this context? Please discuss whether or not a servicer would typically be an affiliate of an underwriter, placement agent, initial purchaser or sponsor, under such a definition.

14. Should the definition of the term "subsidiary" be the same as the definition of subsidiary found in Exchange Act Rule 12b-2?[47] Please explain why or why not. Would such definition be workable or would it be over or under-inclusive in this context?

[46] See 15 U.S.C. 77p(f)(1); 17 CFR 230.405; and 17 CFR 240.12b-2, respectively.

[47] See 17 CFR 240.12b-2 ("A 'subsidiary' of a specified person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries.").

15. Should the term "underwriter" in the context of Securities Act Section 27B have the same meaning as the definition in Section 2(a)(11) of the Securities Act?[48] We note that Section 2 of the Securities Act states that terms used in the Securities Act have the meanings assigned to them in that section "unless the context provides otherwise." Is the context in Section 27B of the Securities Act, and proposed Rule 127B thereunder, such that the term "underwriter" should not have the meaning in Section 2(a)(11)? Would that definition be workable or over- or under-inclusive, in this context? Should we define the term "underwriter" instead to have the same meaning as the definition in Rule 100 of Regulation M under the Exchange Act?[49] Please explain why or why not. Would such definition be workable or over- or under-inclusive in this context?

16. Should definitions for each type of covered person be the same as or consistent with Regulation AB? Should "underwriter," "placement agent," "initial purchaser" and "sponsor" have the same meaning as either defined by Regulation AB or, if undefined, as understood in Regulation AB (e.g., underwriter or initial purchaser)? Would these terms need to be defined differently than defined or understood, if undefined, in Regulation AB in order to fulfill the intent of Section 27B of the Securities Act, particularly in connection with synthetic ABS? Please explain. Alternatively, please explain why consistent treatment would be appropriate.

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[48] 15 U.S.C. 77b(a)(11).

[49] 17 CFR 242.100 ("Underwriter means a person who has agreed with an issuer or selling security holder: (1) to purchase securities for distribution; or (2) to distribute securities for or on behalf of such issuer or selling security holder; or (3) to manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder.").

17. For purposes of Rule 127B, should we define "initial purchaser" to mean a broker-dealer functioning in a role equivalent to that of an underwriter or placement agent who purchases the ABS pursuant to an agreement that contemplates the resale of those securities to other purchasers in transactions that are not required to be registered under the Securities Act in reliance upon Rule 144A[50] or that are otherwise not required to be registered because they do not involve any public offering?[51] Would this language adequately describe the types of unregistered transactions in which an initial purchaser might participate (i.e., Rule 144A transactions and private resales made in reliance on the so-called Section "4(1-1/2)" exemption)? Should the definition of "initial purchaser" incorporate different or other concepts? Are there persons that should be subject to this provision in addition to broker-dealers that act as initial purchasers?

ii. Covered Products

Proposed Rule 127B(a), like Section 27B under the Securities Act, applies with respect to any "asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), which for purposes of this rule shall include a synthetic asset-backed security)". Section 941(a) of the Dodd-Frank Act added Section 3(a)(77) to the Exchange Act to provide that the term "asset-backed security":

> (A) means a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a security

[50] 17 CFR 230.144A.

[51] See ABA Letter at p. 6 (suggesting that the Commission "clarify that the term 'initial purchaser' as used in Section 27B refers to a broker-dealer functioning in a role equivalent to that of an underwriter or placement agent in a Rule 144A transaction.").

> or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flows from the asset, including –
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> (i) a collateralized mortgage obligation;
> (ii) a collateralized debt obligation;
> (iii) a collateralized bond obligation;
> (iv) a collateralized debt obligation of asset-backed securities;
> (v) a collateralized debt obligation of collateralized debt obligations; and
> (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and
>
> (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.[52]

The proposed rule, like Securities Act Section 27B, incorporates this definition and specifically includes synthetic ABS in describing the scope of the prohibition on certain material conflicts of interests.

We are not proposing to define the term "synthetic asset-backed security" for purposes of proposed Rule 127B, because we understand that this term is commonly used and understood by market participants.[53] However, we seek comment on whether this understanding is correct and whether we should provide a definition of this term to facilitate implementation of the proposed rule.

We also note that the definition of an ABS in Section 3(a)(77) of the Exchange Act (an "Exchange Act-ABS") is much broader than the definition of an ABS in Securities Act Regulation AB. The definition of an Exchange Act-ABS includes securities that are typically

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[52] Pub. L. 111-203, §941, 124 Stat. 1376, 1890-91.

[53] We note that the definition of ABS in Securities Act Regulation AB does not include a synthetic ABS. See Release 33-8518, 70 FR at 1514 and Item 1101(c) of Regulation AB (17 CFR 229.1101(c)). However, the prohibition in Section 27B of the Securities Act applies both to an ABS as defined in Section 3 of the Exchange Act, and to a synthetic ABS. Synthetic securitizations "create exposure to an asset that is not transferred to or otherwise part of the asset pool. These synthetic transactions are generally effectuated through the use of derivatives such as a credit default swap or total return swap. The assets that are to constitute the actual 'pool' under which the return on the ABS is primarily based are only referenced through the credit derivative." Release 33-8518, 70 FR at 1514.

sold in transactions that are exempt from registration under the Securities Act, such as CDOs, and that are not necessarily backed by a discrete pool of assets.

Neither Section 27B nor proposed Rule 127B distinguishes between ABS that are sold in an offering registered with the Commission or in an offering that is exempt from registration. Accordingly, our proposal would apply to ABS in both such circumstances. We recognize that Section 27B, and our proposed rule, refer to an underwriter, a term that, in the Securities Act, is typically, but not exclusively, used in the context of registered offerings. Section 27B, however, also applies to placement agents and initial purchasers, which are parties that perform functions similar to an underwriter in unregistered offerings. Moreover, as noted above, the definition of Exchange Act-ABS includes ABS typically offered and sold in unregistered transactions.

Request for Comments Regarding Covered Products

18. Should we define or interpret the term "synthetic asset-backed securities" and if so, how? Please explain why or why not. Please provide a suggested definition and the rationale for why the suggested definition is appropriate. Should any such definition or interpretation be limited to ABS for which the credit exposure for the asset pool from which payments are derived consists substantially of swaps, security-based swaps or other derivatives (and the collateral held by the SPE)?
19. Should any such definition or interpretation of "synthetic ABS" include any combination of securities that produces an economic result equivalent to an ABS, whether or not collateralized or having features meeting the specific requirements of the definition of ABS? If we were to define the term, should we define "synthetic ABS" as securitizations designed to create exposure to an

asset that is not transferred to or otherwise part of the asset pool, including transactions effectuated through the use of derivatives such as a CDS or total return swap, and for which the assets that are to constitute the actual "pool" under which the return on the ABS is primarily based are for the most part referenced through the derivative?[54]

20. Please discuss any similarities or differences between security-based swap agreements in general and security-based swap agreements used in synthetic ABS that are relevant for purposes of proposed Rule 127B. Please discuss whether or not such similarities or differences should be addressed in a definition or interpretation of the term "synthetic ABS" for purposes of proposed Rule 127B, and why.

21. We seek comment on the application of proposed Rule 127B to municipal securities that are "asset-backed securities" within the meaning of Section 3(a)(77) of the Exchange Act as amended by the Dodd-Frank Act.[55] Please explain whether you believe there are any differences between the application of this provision to municipal securities that are ABS and its application to other types of ABS. Should there be an exemption under Securities Act Section 28 from proposed Rule 127B for decisions made in the exercise of the governmental function of a state or local government acting as a securitization participant? Please explain why or why not. Would other exceptions

[54] See Section IIIA(2)(a) of Release 33-8518, 70 FR at 1513-1515.

[55] The definition of an ABS within the meaning of Section 3(a)(77) of the Exchange Act as amended by the Dodd-Frank Act includes securities that are typically sold in transactions that are exempt from registration under the Securities Act.

applicable to state and local government issuers or sponsors of ABS be appropriate? Please explain why or why not. If you believe exceptions should be included, please describe what such exceptions should be and why they would be appropriate. We seek specific comment about whether some or all varieties of municipally-sponsored tax lien securities should be exempt from the proposed rule and if so, why such an exemption would be appropriate for such tax-lien securities.[56] For example, we ask commenters to provide their reasoning as to whether or not the proposed rule should apply to a municipal tax lien securitization in which the tax liens arose by operation of law and were sold by a municipality through a tax lien securitization program in which all liens were securitized and the municipality had no role in the lien selection process.[57]

iii. Covered Timeframe

Proposed Rule 127B uses the Securities Act Section 27B language "at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security." It is during this time period, which extends for one year following the first closing of the sale of the security to the public, that no securitization participant could engage in a transaction giving rise to prohibited conduct. Accordingly, if a transaction occurs in the period prior to one year after the date of the first closing of the sale of the ABS, it is covered by the proposed rule.

[56] See City of New York Letter at p. 5 ("Many actions that the City of New York takes in the exercise of its governmental powers pursuant to other statutes or regulations or to serve the public's interest and protect the health and safety of its residents could potentially be viewed as being in conflict with the interest of investors in the tax lien-backed securities. For example, the City could take an action that would adversely impact the value of one of the properties securing a tax lien or the value of other properties in that area, which could adversely impact the value of that property.").

[57] See id.

Securities Act Section 27B specifies the end of the covered timeframe - one year following the first closing of the sale of the security to the public. Section 27B, however, does not specify the commencement point for the covered timeframe and we are not proposing to do so at this time. As a result, the proposed rule would cover transactions effected prior to "the date of the first closing of the sale of the asset-backed security." We preliminarily believe that this result may be appropriate because prior to the first closing securitization participants involved in structuring and marketing an ABS may engage in transactions involving or resulting in material conflicts of interest that in form or effect are, for purposes of the proposed rule, difficult to distinguish from similar transactions occurring after the first closing. Thus, using the sale date as a starting point for the covered timeframe might be under-inclusive. We request comment, however, on whether and how our proposed approach might be over-inclusive, as well as whether alternative approaches to defining the covered timeframe (such as treating the date of first sale as the beginning of the covered timeframe) might be appropriate.

Request for Comments Regarding Covered Timeframe

22. Is there a point in time prior to "one year after the date of the first closing of the sale of the asset-backed security" at which the prohibition in Section 27B was not intended to apply? Please explain why or why not.
23. Should the proposed rule specify the commencement point for the covered timeframe? Please provide an explanation. In particular, please discuss whether or not the commencement point for the covered timeframe should be "the date of the first closing of the sale of the asset-backed security." Please include a discussion of whether or not such commencement point for the covered timeframe would be appropriate, or whether it would be over- or under-

inclusive. In addition, please discuss whether such approach would have any advantages or disadvantages.

24. Should the commencement point for the covered timeframe be tied to the point at which a person becomes a securitization participant? How would such a point in time be defined? Should the commencement point vary depending on which securitization participant role a person performs? Please provide an explanation.

25. Should the commencement point for the covered timeframe be tied to some other reference point prior to the first closing of the sale of the ABS to the public? Please provide an explanation.

iv. Covered Conflicts of Interest

The Commission also proposes to delineate the scope of "conflicts of interest" that would potentially be covered by the proposed rule.[58] Specifically, there would not be a covered conflict of interest involved if the conflict in question: (1) arose exclusively between securitization participants or exclusively between investors; (2) did not arise as a result of or in connection with the related ABS transaction; or (3) did not arise as a result of or in connection with "engag[ing] in any transaction" (as more fully described below).

First, consistent with Securities Act Section 27B, we propose that the scope of the conflicts of interest covered by proposed Rule 127B(a) would be limited to material conflicts of interest between an entity that is a securitization participant with respect to an ABS and an investor in such ABS, whether or not such investor purchased the ABS from the securitization

[58] The proposed interpretations are not intended for broad application concerning the use of the term "material conflicts of interest" and would not apply in other areas of the federal securities laws and rules or SRO rules or in connection with other provisions of the Dodd-Frank Act.

participant. This proposed interpretation is not intended to narrow or broaden the scope of the statutory language. Under this interpretation, however, if conflicts of interest were to arise solely among securitization participants, acting in their capacity as such in connection with the securitization process, they would not be subject to the proposed rule, given the focus of Section 27B on protecting investors (e.g., conflicts of interests between a sponsor and a collateral manager of an ABS are not the focus of the proposal).[59]

Second, conflicts of interest arising solely among investors in the ABS offering (where investors could include securitization participants, provided these conflicts arise only from their interests as an investor) would also not be covered by the proposed rule.[60] Thus, for example, the proposed rule is not intended to prohibit the multi-tranche structures commonly used in ABS offerings, even though those structures may involve conflicts between the interests of various classes of investors in the offering by virtue of the different risks and rewards associated with such tranches.

Third, we propose that the prohibition under Rule 127B(a) would only apply to those conflicts of interest between a securitization participant and an investor that arise as a result of or in connection with the related ABS transaction. Our proposed rule, therefore, would not address other conflicts of interest that happen to arise between these same parties but that are unrelated to their status as a securitization participant and investor, respectively.[61]

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[59] See Merkley-Levin Letter, at attachment (Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Carl Levin)) ("[Securitization participants], like the mechanic servicing a car, would know if the vehicle has been designed to fail. And so they must be prevented from securing handsome rewards for designing and selling malfunctioning vehicles that undermine the asset-backed securities markets. It is for that reason that we prohibit those entities from engaging in transactions that would involve or result in material *conflicts of interest with the purchasers of their products*.") (emphasis added).

[60] See supra note 19.

[61] For example, the underwriter of an ABS may also be the underwriter in an unrelated common stock offering. One investor may purchase securities in both the ABS offering and the common stock offering. If the underwriter

Fourth, we propose that in order for the proposed rule to apply, the conflict of interest must arise as a result of or in connection with "engag[ing] in any transaction." For example, engaging in any transaction would include, but not be limited to, effecting a short sale of, or purchasing CDS protection on, securities offered in the ABS transaction or its underlying assets. "Engag[ing] in any transaction" would also include the securitization participant selecting assets, directly or indirectly, for the underlying asset pool and selling those assets to the SPE.[62]

We recognize that not every activity undertaken by a securitization participant would be "engag[ing] in any transaction" for purposes of Securities Act Section 27B or the proposed rule. For example, the issuance of investment research by a securitization participant would not be "engag[ing] in any transaction" for purposes of the proposed rule. We request comment on whether there are other types of activities in which securitization participants may engage that should be specifically excluded from the scope of the phrase "engag[ing] in any transaction."

Request for Comment Regarding Covered Conflicts of Interest

26. Would the application of the proposed interpretation to conflicts of interest between securitization participants and investors in ABS be appropriate or could

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engaged in transactions that undermined the market value of the common stock offering, that activity (while potentially addressed by other provisions of the federal securities laws and rules thereunder, depending on the facts and circumstances) would not fall within the scope of Proposed Rule 127B even though one of the investors in the common stock offering is also an investor in the ABS offering.

See ABA Letter at p. 5 ("The rules should clarify that the prohibition on material conflicts of interest does not extend to transactions unrelated to the relevant ABS transaction. The language of Section 27B referring to a 'material conflict of interest with respect to any investor in a transaction arising out of such activity', creates some ambiguity as to whether the phrase 'arising out of such activity' is intended to identify the investor, or the context in which the potential conflict may arise. Underwriters, placement agents, initial purchasers and sponsors, or their affiliates, may have a variety of relationships with investors who purchase ABS from or through them. We believe that the better reading of Section 27B is that the conflict of interest shall not arise in the context of the transaction with respect to which the investor acquired the ABS. This construction would help to assure the integrity of ABS offerings, while not imposing unreasonable restrictions on the overall relationships between the identified parties and sponsors, on the one hand, and ABS investors, on the other.").

[62] Merely "engaging in any transaction" does not in and of itself trigger the prohibitions of the proposed rule. For example, the sale of underlying assets to the SPE must also involve or result in a material conflict of interest with ABS investors and all other conditions required for application of the proposed rule must be met.

it be viewed as broadening or narrowing the scope of paragraph (a) of the proposed rule in a way that could prevent it from achieving its intended purpose? Please explain. Please describe any alternative interpretation that would better align the scope of the proposed rule with the conflicts that Section 27B is designed to address.

27. We seek commenter input regarding conflicts of interest that might arise between securitization participants, whether or not such conflicts impact ABS investors, and to what extent, if any, such conflicts are addressed under Securities Act Section 27B.

28. Should the phrase "engaging in any transaction" for these purposes be interpreted more broadly or narrowly? Please provide specific suggestions.

29. Are the examples noted above of activity that constitutes "engaging in any transaction" over-inclusive, under-inclusive or appropriate in the context of the proposed rule? Are there examples of "engaging in any transaction" in addition to effecting a short sale of securities offered in the ABS transaction or its underlying assets, or buying CDS protection on the relevant ABS or its underlying assets, that should be considered in this context? Please explain. Should the phrase "engaging in any transaction" include the asset-backed offering itself?

30. Is the example noted above of an activity that does not constitute "engaging in any transaction" (the issuance of investment research) appropriate in assessing conflicts of interest? Are there other activities that should not be "engaging in any transaction" for these purposes? If so, which activities, and why?

31. Please identify situations, if any, in which a securitization participant has engaged in a transaction that conflicts with the interests of ABS investors as well as engaged in a transaction that is aligned with the interests of ABS investors. Please discuss whether and how you believe such situations should be addressed under the proposed rule.

v. Conflicts of Interest that are Material

Perhaps the most challenging issue in implementing Section 27B is to identify those conflicts of interest involving securitization participants and investors that are "material" and intended to be prohibited under Section 27B and our proposed rule. If a conflict of interest is not a "material conflict of interest", then it would not be covered by Section 27B and our proposed rule.

The proposed rule does not define the term "material conflict of interest." We preliminarily believe that any attempt to precisely define this term in the text of the proposed rule might be both over- and under-inclusive in terms of identifying those types of material conflicts of interest arising as a result of or in connection with a securitization transaction that Section 27B was intended to prohibit, especially given the complex and evolving nature of the securitization markets, the range of participants involved, and the various activities performed by those participants. Accordingly, we propose to clarify the scope of conflicts of interest that are material and intended to be prohibited under Section 27B and our proposed rule through interpretive guidance rather than through a detailed definition in the proposed rule.[63]

In considering how best to interpret the phrase "material conflict of interest" for these purposes, we note that on the one hand, in order to give full effect to Section 27B, this phrase

[63] See supra note 6.

should be interpreted sufficiently broadly so as to capture the full range of transactions by securitization participants that involve or result in a material conflict of interest between securitization participants and investors. If the phrase is construed too narrowly, the proposed rule could potentially permit certain securitization participants to take undue advantage of their role in the securitization process, in which case the proposed rule might fail to enhance the integrity of securitization practices as fully as intended.

On the other hand, however, a number of commenters have argued that multiple conflicts of interest often arise between securitization participants and investors as an inherent part of the securitization process. Thus, they have cautioned, an overly broad interpretation may curtail the willingness of securitization participants to engage in securitization transactions, which ultimately could limit, increase the costs of, or effectively prohibit transactions that might benefit investors, efficiently redistribute risk, and support important segments of the economy.[64]

We are not aware of any basis in the legislative history of Section 621 to conclude that this provision was expected to alter or curtail the legitimate functioning of the securitization markets, as opposed to targeting and eliminating specific types of improper conduct. Moreover, as a preliminary matter, we believe that certain conflicts of interest are inherent in the securitization process, and accordingly that Section 27B and our proposed rule should be construed in a manner that does not unnecessarily prohibit or restrict the structuring and offering of an ABS.

[64] See, e.g., SIFMA Letter at p. 3 ("If not focused on the transactions referenced by Senators Merkley and Levin, rules promulgated under Section 621 could restrict many standard industry practices which are vital to the functioning of the ABS markets and beneficial to investors."). See also ASF Letter at p.3-4 ("Similarly, a broad interpretation of 'material conflicts of interest' could prohibit servicers . . . who are affiliated with the sponsor of a transaction from pursuing customary servicing activities . . . This restriction would effectively prohibit sponsors and their affiliates from servicing the loans that they originate, requiring costly servicing transfers that will decrease efficiency and potentially lead to confusion for consumers and disruptions in the servicing of assets.").

We have considered the various tests suggested by commenters for identifying material conflicts of interest for purposes of Section 27B and our proposed rule. While mindful of these suggestions and of the analysis accompanying them, the Commission preliminarily believes that the appropriate balance would best be struck through an interpretation that, for purposes of the proposed rule, engaging in any transaction[65] would "involve or result in [a] material conflict of interest" between a securitization participant and investors in the relevant ABS if:

1] Either:

A] a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (1) adverse performance of the asset pool supporting or referenced by the relevant ABS, (2) loss of principal, monetary default or early amortization event on the ABS, or (3) decline in the market value of the relevant ABS (where these are discussed below, any such transaction will be referred to as a "short transaction"); or

B] a securitization participant, who directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS, would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above; and

[65] See supra Section IIIA(iv). Such a transaction would include effecting a short sale of securities offered in the ABS transaction or its underlying assets, or buying CDS protection on the relevant ABS or its underlying assets.

2] there is a "substantial likelihood" that a "reasonable" investor would consider the conflict important to his or her investment decision (including a decision to retain the security or not).[66]

We preliminarily believe that this formulation of a conflict of interest that is material would directly address those types of activities that Section 27B was intended to prohibit – e.g., situations in which a securitization participant engages in a transaction through which it benefits when the related ABS fails or performs adversely or has the potential to fail or perform adversely and there is a substantial likelihood that a reasonable investor would consider the fact of such benefit important to his or her investment decision.[67]

a. Item 1(A) of "Material Conflict of Interest" Test

Engaging in a transaction would "involve or result in [a] material conflict of interest" if as a result of such transaction the securitization participant would benefit from the actual, anticipated or potential poor performance of the ABS or the underlying assets. It would not be necessary for a securitization participant to *intentionally* design an ABS to fail or default in order

[66] See Basic v. Levinson, 485 U.S. 224, 231-32 (1988) (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

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

Our proposed approach for identifying when a person engages in transactions that involve or result in material conflicts of interest is, in part, similar to the ABA's suggested focus for the proposed rule. See ABA Letter at p. 2 ("we believe the focus of the rulemaking should be on the following types of conflicts: (a) ABS transactions in which the adverse performance of the pool assets would directly benefit an identified party or sponsor (or any affiliate of any such entity) of the applicable ABS transaction; (b) ABS transactions in which a loss of principal, monetary default or early amortization event on the ABS would directly benefit an identified party or sponsor (or any affiliate); and (c) ABS transactions in which an insolvency event related to the issuing entity of the ABS would directly benefit an identified party or sponsor (or any affiliate)."). In addition, the ABA suggested that the "rules should clarify that the prohibition on material conflicts of interest does not extend to transactions unrelated to the relevant ABS transaction." Id. at p. 5.

to trigger the rule's prohibition.[68] We preliminarily interpret the intent of Section 27B more broadly – to prohibit securitization participants from benefiting from the failure of financial instruments that they help structure, offer and sell to investors. Thus, under the proposed rule a securitization participant would be prohibited from profiting from the decline of an ABS it helped to create (assuming that the conflict would be important to a reasonable investor), even if that securitization participant did not intentionally cause, or increase the likelihood of, such decline. For example, a securitization participant that engaged in a short sale of the relevant ABS four months following the first closing of sale of the ABS would meet item 1(A) of the material conflict of interest test. The securitization participant would be able to benefit from a decline in the market value of the ABS through the short sale even if the securitization participant did not design the ABS to fail. The analysis does not turn on whether the securitization participant intentionally designed the ABS to fail, but rather whether the securitization participant would benefit, through the actual, anticipated or potential decline in the market value of the ABS, in this case in the form of gains from the short sale.

We highlight the reference in our proposed test to the requirement that a securitization participant would benefit directly or indirectly from the actual, anticipated or potential decline in the value of the ABS (or underlying assets). If a securitization participant effected a short transaction in the ABS, it would not be necessary for the market value of the ABS to actually decline in order for a "material conflict of interest" to arise. It would be sufficient that the

[68] See SIFMA Letter at p. 1 ("reforms may be necessary to ensure that securitization transaction parties are not creating and selling asset-backed securities ('ABS') that are intentionally designed to fail or default and profiting from the failure or default of such ABS."). See also, ASF Letter at p. 5 (a material conflict exists if the ABS "is created primarily to enable such [securitization participant] to profit from a related or subsequent transaction as a direct consequence of the adverse credit performance of such asset-backed security.").

securitization participant engaged in a transaction under which it would benefit if the market value of the ABS were to decline.[69]

We recognize that – like other prophylactic conflict of interest rules – the proposed rule and interpretation might limit certain investment activities that might otherwise be made for bona fide purposes. For example, it is possible for a securitization participant and investors in an ABS who have complete access to information regarding the underlying assets simply to have different views regarding the future prospects for those assets, based on their independent analysis of market and commercial trends or other factors. For example, an investor may believe that the assets will perform well, but the securitization participant may believe that the assets will perform poorly. In this case, restricting or prohibiting the securitization transaction would limit the ability of both the investor and the securitization participant to transact freely based on their respective views of the underlying assets (even though they might make the same investment choice if they were not involved in the securitization). We therefore acknowledge the concern that this proposal might have unintended effects, such as potentially limiting investment opportunities for investors if a securitization participant refrains from structuring and selling ABS in reaction to this proposal. We seek commenter input below concerning the extent to which such unintended effects might occur, and any potential impacts, including any impact on investors, investor protection, liquidity, capital formation, the maintenance of fair, orderly and efficient markets and the availability of credit to borrowers (through assets underlying an ABS).

On the other hand, in the context of a securitization transaction, the securitization participant is generally seeking to sell to investors a particular investment view regarding the

[69] We also understand that a securitization participant may engage in a short transaction, for example, in the context of market-making or in the context of hedging assets being pooled to create an ABS. If such activities qualify for the proposed exceptions in the rule discussed below – i.e., the exceptions for bona fide market-making and risk-mitigating hedging – they would be permitted.

underlying assets, in the form of the ABS. In this sense, the proposed rule and interpretation would help prohibit the securitization participant from structuring and offering the ABS to investors on the premise that it will be a good investment when the securitization participant has either structured the transaction in a manner that is designed to fail or takes other actions (i.e., entering into a short transaction) through which it will profit from such failure. Moreover, the proposed prohibition would be all the more important given that as a practical matter investors in the ABS may not have as much information regarding the underlying assets as the securitization participant, and may be drawing inferences regarding the quality of the assets based on the involvement and marketing efforts of the securitization participant in the transaction as well as any other information provided by the securitization participant. We seek commenter input regarding potential benefits, including benefits for investors, investor protection, liquidity, capital formation and the maintenance of fair, orderly and efficient markets that might ensue as a result of the proposed interpretation and how these potential benefits may impact any unintended consequences referenced above.

Nothing in the proposed interpretation would prevent a securitization participant from taking positions in which its economic interests would be aligned with the investors in the ABS it has created and sold – such as by purchasing the ABS.[70] While the proposed interpretation would cover benefiting from the adverse performance of the asset pool supporting the ABS, we note that the proposed interpretation would not prevent a securitization participant's transactions in the securities of a lender whose mortgage pools are included or referenced in an ABS because the proposal is focused solely on the ABS and its underlying portfolio.

[70] See SIFMA Letter at p. 3 (a transaction or activity should not be prohibited under Securities Act Section 27B if "such transaction or activity represents an overall alignment of risk to the ABS or underlying assets similar to that borne by investors of the ABS").

b. Item 1(B) of "Material Conflict of Interest" Test

If a securitization participant would not benefit in the manner set forth in item 1(A) of the material conflict of interest test, one must determine whether the securitization participant would benefit in the manner set forth under item 1(B) of that test. A benefit under either item 1(A) or 1(B) would satisfy item 1 of the test.

Engaging in a transaction would involve or result in a material conflict of interest arising as a result of or in connection with a transaction if a securitization participant who directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS would benefit directly or indirectly – from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration – as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above.[71]

In certain circumstances, a third party might directly or indirectly select assets underlying an ABS or structure the ABS transaction through its relationship with a securitization participant. In these situations, it is possible that the third party, rather than the securitization participant, might enter into a short transaction of a type that would be prohibited for the securitization participant itself under our proposed rule and interpretation. For example, the third party might select assets for the securitization transaction that it anticipates will perform poorly, and then enter into a short transaction on the ABS in order to benefit from the anticipated decline in the market value of the ABS or its underlying assets.

[71] For purposes of item 1(B), we interpret the statutory reference to a securitization participant "engaging in a transaction" to include circumstances where the securitization participant, although not itself a party to a transaction as contemplated by item 1(A), would benefit directly or indirectly as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction.

The securitization participant would not necessarily be a party to the short transaction, and therefore might not directly profit from that short transaction due to any future adverse performance of the ABS or its underlying assets. However, the securitization participant may be incentivized to leverage the role it plays in selecting assets underlying the ABS to seek other benefits. For example, the securitization participant might benefit (e.g., through compensation, the promise of future business, or other forms of remuneration from either the third party or the ABS) by allowing a third party to select the assets in the manner described, and in so doing would effectively benefit by having permitted the third party to potentially profit from a related short transaction. This would result in a material conflict of interest between the securitization participant and investors in the ABS of the type that Section 27B is intended to prohibit. Item 1(B) would apply because the securitization participant would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees or other forms of remuneration. As a result of item 1(B), a securitization participant could not create an opportunity for a third party to engage in any transaction that the securitization participant itself would not be permitted to engage in under item 1(A) of the proposed interpretation.[72]

Given that Section 27B and our proposed rule apply to securitization participants, the burden of compliance with these requirements would fall on the securitization participant that directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS and who then permits or facilitates the involvement of a third party in those aspects of the transaction. We recognize that in certain instances there might be practical challenges for securitization participants seeking to determine whether they are subject to this

[72] We note for clarity that in order for a transaction to be a material conflict of interest under item 1(B), the third party would actually need to effect a short transaction. Thus, with respect to both items 1(A) and 1(B), the material conflict of interest test contemplates the existence of a short transaction by the securitization participant or the third party, as applicable.

restriction, or whether the involvement of third parties in a securitization transaction complied with the proposed rule. For example, in certain cases there might be practical difficulties for a securitization participant in determining whether a third party that was involved in selecting the underlying assets or the structuring of the ABS might also engage in prohibited short transactions. While securitization participants could use different tools to manage these practical difficulties, we preliminarily believe that when reasonable to do so, securitization participants could rely on appropriate contractual covenants or representations, either between themselves or with the relevant third parties, to determine compliance with our proposed rule. For example, if a third party were involved in selecting the underlying assets or structuring the ABS, where reasonable to do so a securitization participant could rely on contractual assurances (from the third party or from another securitization participant who had obtained such assurances from the third party) that the third party would not engage in any short transactions that would be prohibited if engaged in by a securitization participant in the relevant offering.

Of course, it would not be necessary for a securitization participant to obtain such contractual assurances – for example, in circumstances where it did not have any reasonable basis to believe that a third party would engage in a short transaction in a way that would violate our proposed rule.

c. Item 2 of "Material Conflict of Interest" Test

Item 2 of the proposed interpretation, which requires "a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision," is intended to require that the potential implications of the relevant conflict be sufficiently important as to warrant the prohibition imposed under the proposed rule. We preliminarily do not believe it would be appropriate to interpret the proposed rule so broadly as to prohibit all

transactions that give rise to any conflict of interest, even if the potential benefits of such transactions for the securitization participant were so minimal as to be unimportant to a reasonable investor.

We note that in considering whether there is a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision, it is not possible to designate in advance certain facts or occurrences as determinative in every instance. [73] Rather the proposed interpretation would require an assessment of the inferences that a reasonable investor would draw from a given set of facts and circumstances.[74] It would be appropriate, however, to consider both the probability that the securitization participant would receive a benefit and the magnitude of the benefit. [75] Thus, for example, it is possible that a securitization participant might stand to benefit substantially from a decline in the value of the ABS, but the probability of its receiving such benefit under the circumstances might be so small that a reasonable investor would not consider the conflict important to his or her investment decision.

Although the proposed interpretation uses a materiality formulation that is also used under the federal securities laws for determining whether disclosure is necessary – i.e., whether there is a substantial likelihood that a reasonable investor would consider the issue important to his or her investment decision – the use of this phrase in this context is not intended to suggest that a transaction otherwise prohibited under the proposed rule would be permitted if there were adequate disclosure by the securitization participant. We note in this regard that there may be

[73] Basic v. Levinson, 485 U.S. at 236 ("Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.").

[74] Id. (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976)).

[75] Id. at 238 (citing SEC v. Texas Gulf Sulphur, Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, sub nom Coates v. SEC, 394 U.S. 976 (1969)).

practical challenges in relying on disclosure as a means to address all transactions involving a material conflict of interest – including in particular certain transactions arising after the offering documents have been disseminated but before the one-year timeframe covered by the proposed rule has elapsed.[76] Nevertheless, we request comment as to whether and to what extent adequate disclosure of a material conflict of interest should affect the treatment under the proposed rule of an otherwise prohibited transaction.

Request for Comments Regarding Material Conflicts of Interest

32. We seek comment regarding any potential consequences of not defining the term "material conflict of interest" in the proposed rule text and instead proposing an interpretation in the context of the proposed rule. Please discuss whether or not there may be an unintended chilling effect on securitization transactions resulting from potential uncertainty associated with not defining material conflict of interest. If you believe the Commission should define "material conflict of interest," please provide a suggested definition and the rationale as to why such definition identifies the conflicts that the proposed rule is intended to address.[77] Is it likely or unlikely that such a definition would be able to anticipate all future material conflicts of interest? Would such a definition lead to unintended consequences, such as excluding from the proposed prohibition certain activities undertaken by securitization participants

[76] See infra Question 98.

[77] See, e.g., ASF Letter at p. 5 (suggesting that a material conflict of interest "shall exist, if other than for hedging purposes or as permitted by Section 27B(c) of the Securities Act of 1933, (i) a [securitization participant] participates in the issuance of an asset-backed security that is created primarily to enable such [securitization participant] to profit from a related or subsequent transaction as a direct consequence of the adverse credit performance of such asset-backed security and (ii) within one year following the issuance of such asset-backed security, the [securitization participant] enters into such related or subsequent transaction.").

that involve material conflicts of interest? Or would such a definition be over-inclusive and encompass activities undertaken by securitization participants that do not involve material conflicts of interest?

33. Is the distinction suggested by commenters between conflicts that are inherent in the securitization process and those that are not a meaningful one?[78] Is this proposed distinction useful for purposes of defining the scope of Securities Act Section 27B? Are there other ways to distinguish between different conflicts of interest that the Commission should take into account in considering the scope of Section 27B? Would a reasonable investor understand the difference between conflicts of interest that are inherent in the offering process and those that are not?[79] Would the reasonable expectations of an investor in an ABS offering be a useful test for determining which conflicts of interest are material?

34. Is the proposed interpretation regarding what constitutes a material conflict of interest appropriate? Should the interpretation be broader or narrower? Please suggest alternative interpretations for what would constitute material conflicts of interest for purposes of the proposed rule and explain why such interpretations would better identify transactions that involve or result in material conflicts of interest. In addition to the magnitude of a benefit and the probability that it will occur, are there additional (or alternative) factors that should be considered in assessing whether there is a substantial likelihood that a

[78] See supra Section IIB.

[79] Id.

reasonable investor would consider the conflict important to his or her decision to invest?

35. Should the proposed interpretation extend to indirect or unforeseeable benefits to a securitization participant? Please explain why or why not. How would a securitization participant determine that there was no such indirect or unforeseeable benefit?

36. Are there circumstances in which facilitating a third party to benefit from the adverse performance of the ABS or underlying assets would not be a material conflict of interest? Please explain.

37. We seek commenter input regarding the potential use of contractual provisions and covenants by securitization participants to manage their compliance with the proposed rule, as well as a discussion of how a securitization participant would determine that no contractual assurance was necessary.

38. As an alternative, would it be appropriate to prohibit a securitization participant from allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS (absent contractual provisions) if the involvement of the third party in the ABS transaction or the actions of the third party unrelated to the ABS transaction constituted a material conflict of interest with the investors in the ABS transaction (regardless of whether or not the securitization participant benefitted)?

39. Some commenters asserted that the prohibited conduct should be limited to creating and selling an ABS that is "intentionally designed to fail or default"[80]

[80] See SIFMA Letter at p. 2.

or creating and selling an "intentionally flawed" ABS so that a securitization participant can profit from a related or subsequent transaction.[81] As one commenter suggested, should the test focus on whether "(i) such transaction or activity represents an overall alignment of the risk to the ABS or underlying assets similar to that borne by investors of the ABS, (ii) such transaction or activity is unrelated to the [securitization participant's] role in the specific ABS, (iii) disclosure of the transaction or activity of the [securitization participant] adequately mitigates the risk posed by the potential or actual conflict with respect to any investors in the ABS or (iv) another regulatory regime applies with respect to the potential or actual conflict of interest"?[82] Is such a formulation for the proposed rule appropriate? Please explain. Would such a test be over-inclusive and encompass activities that do not involve or result in material conflicts of interest? Would such a test be under-inclusive and fail to cover activities that are intended to be prohibited by Section 27B and the proposed rule? What other approaches would provide a substantially similar or higher level of investor protection as the proposed rule?

40. Are there transactions inherent in the securitization process that would be material conflicts of interest under the proposed interpretation that were not intended to be prohibited by Section 27B? Or, are there transactions inherent in

[81] See ASF Letter at p. 5 ("the definition of 'material conflicts of interest' should prohibit those types of transactions identified by Senators Merkley and Levin that create conflicts of interest by creating intentionally flawed asset-backed securities." Specifically, the commenter suggested that a material conflict of interest exists "if, other than for hedging purposes or as permitted by Section 27B(c) of the Securities Act of 1933, (i) a [securitization participant] participates in the issuance of an asset-backed security that is created primarily to enable such [securitization participant] to profit from a related or subsequent transaction as a direct consequence of the adverse credit performance of such asset-backed security and (ii) within one year following the issuance of such asset-backed security, the [securitization participant] enters into such related or subsequent transaction.").

[82] SIFMA Letter at p. 3.

the securitization process that would not fall within the proposed interpretation and the proposed rule that should be prohibited under Section 27B and application of the proposed rule? Please identify and provide an explanation of these activities as well as an explanation of why they should or should not be prohibited under Section 27B and the proposed rule. We ask that commenters address each of the activities set forth in initial comment letters as described in Section II.B as well as activities not addressed by initial comment letters.

41. Are modifications to the proposed rule or interpretation, consistent with the statute, necessary or advisable to mitigate any such unintended consequences?

42. Is the phrase "fees or other forms of remuneration, or the promise of future business, fees or other forms of remuneration" too narrow or too broad, or is it appropriate? Are there benefits to the securitization participant that would not be captured by this phrase? Should the proposal specifically address the anticipation or expectation of or attempts to induce such benefits? Please explain why or why not.

43. We ask commenters to discuss whether or not the proposal would prohibit any person "engag[ing] in any transaction" that commenters believe should be permitted under Section 27B of the Securities Act? If such activity were prohibited, please discuss any potential impact, including any impact on investors, investor protection, liquidity, capital formation and the maintenance of fair, orderly and efficient markets.

44. We seek commenter input regarding whether the phrase used in item 1(B) "directly or indirectly controls the structure of the relevant ABS or the selection

of assets underlying the ABS" is appropriate, under- or over-inclusive. Please provide examples of persons who would not be identified by this phrase that you believe should be subject to the proposed rule. Please provide examples of persons that would be identified using this phrase that you believe should not be subject to the proposed rule. Would the phrase "exercises control over the structure of the relevant ABS or the selection of assets underlying the ABS" be more appropriate? Please explain why or why not. Would the phrase "has substantial control over the relevant ABS or the selection of assets underlying the ABS" be more appropriate? Please explain why or why not. Would the phrase "influences the structure of the relevant ABS or the selection of assets underlying the ABS" be more appropriate? Please explain why or why not. We seek commenter suggestions on alternative language and an explanation of why it would be more appropriate in this context. Please include in your responses a discussion of whether any alternative option would be over- or under-inclusive and provide examples of persons who would not be identified by the alternatives that you believe should be subject to the proposed rule as well as examples of persons who would be identified by alternatives but that you believe should not be subject to the proposed rule.

45. Is the proposed application of the prohibition under Section 27B to securitization participants if third parties, directly or indirectly, structure the relevant ABS or select assets underlying the ABS appropriate? Should the restrictions be placed on a broader category of activities or a more delineated one? Should we define the phrase "directly or indirectly, to structure the

relevant ABS or select assets underlying the ABS" used in item 1(B)? If yes, please provide a suggested definition and the rationale as to why such definition would be appropriate.

46. We seek commenter input regarding whether the phrase used in item 1(B) "as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS" is appropriate, over- or under-inclusive. Please provide examples of persons who would not be identified by this phrase that you believe should be. Please provide examples of persons that would be identified using this phrase that you believe should not be. Would the phrase "as a result of allowing a third party, directly or indirectly, to influence the structure of the relevant ABS or the selection of assets underlying the ABS" be more appropriate? Please explain. Would the phrase "as a result of allowing a third party, directly or indirectly, to substantially influence the structure of the relevant ABS or the selection of assets underlying the ABS" be more appropriate? Please explain. We seek commenter suggestions on alternative language and an explanation of why it would be more appropriate in this context.

B. Statutory Exceptions

Consistent with Securities Act Section 27B, proposed Rule 127B(b) would provide exceptions to the prohibition in proposed Rule 127B(a) for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making. We have modeled the proposed exceptions on the text of Section 27B of the Securities Act.

i. Risk-mitigating hedging activities

Pursuant to the proposed rule, the following would not be prohibited by paragraph (a) of the proposed rule:

> Risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings.

The proposed exception for risk-mitigating hedging activities uses the language set forth in Section 27B(c)(1).[83] The goal of this proposed exception is to allow certain hedging activities that are designed to reduce or mitigate risk for the underwriter, placement agent, initial purchaser, or sponsor, where risk mitigation refers to the practice of limiting the consequences of a risk, without necessarily reducing the probability of the risk occurring. For example, firms engage in risk-mitigating hedging as they pool assets to create ABS. The assets are assembled over time and firms hedge the specific risk of a price decline of the assets being assembled for the pool while the pool is formed. This type of activity would fall within the proposed exception.

Although the exception in Section 27B(c)(1) by its terms does not address affiliates and subsidiaries, the Commission preliminarily believes that, since affiliates and subsidiaries of securitization participants are included in the list of persons who are prohibited from engaging in the type of activity specified in Section 27B they too should have the benefit of the proposed exception for risk-mitigating hedging activities. Therefore, the Commission would interpret the exception as applying to affiliates and subsidiaries of securitization participants.

[83] We did not incorporate the second use of the phrase "arising out of such underwriting, placement, initial purchase or sponsorship" to streamline the proposed rule text, and intend no substantive change from Section 27B(c)(1).

The proposed exception is not intended to permit speculative trading masked as risk-mitigating hedging activities.[84] Generally, risk-mitigating hedging is effected to reduce risk from an existing position or a position about to be taken.[85] The risk-mitigating hedging activities would be required to occur in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS.[86] In addition, the activities would be required to be designed to reduce the specific risk to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings as mandated by Section 27B. Risk-mitigating hedging may include a series of hedging transactions, based on the price movements of the underlying assets, in order to remain delta-neutral.[87] Risk-mitigating hedging does not include trading to establish new positions designed to earn a profit.[88] That activity might be an indicator of speculation.[89]

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[84] Similar concepts are used in proposed Exchange Act Rule 3a67-4 which defines the term "hedging or mitigating commercial risk." For example, Rule 3a67-4(b)(1) provides that "[s]uch position is: (i) [n]ot held for a purpose that is in the nature of speculation, investing or trading" Release No. 34-63452 (Dec. 7, 2010), 75 FR 80174, 80215 (Dec. 21, 2010).

[85] See infra Section IIIE (discussing the potential interplay with the Volcker Rule). Similar concepts are used in connection with risk-mitigating hedging with respect to the Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule. "Risk-mitigating hedging is defined by two essential characteristics; (i) the hedge is tied to a specific risk exposure, and (ii) there is a documented correlation between the hedging instrument and the exposure it is meant to hedge with a reasonable level of hedge effectiveness at the time the hedge is put in place." FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS (Jan. 2011)("FSOC Study"), at p. 30, available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[86] Risk-mitigating hedging would also be permitted in connection with market-making to the extent it relates to positions taken in connection with the permitted activity.

[87] See, e.g., FSOC Study at p. 30 ("hedging activity should adjust over time").

[88] See, e.g., id. at p. 20 (hedging "presents a potential avenue to evade the proprietary trading prohibition if hedges do not correlate with owned assets or if a banking entity seeks an *independent return through the application of the hedge*") (emphasis added).

[89] See, e.g., William L. Silber, On the Nature of Trading: Do Speculators Leave Footprints?, 29 Journal of Portfolio Management 4, 64 (Summer 2003) ("Silber") (describing speculation as trading in anticipation of future prices and taking on the risk of unanticipated equilibrium price movements in order to earn profits). In addition, we note that

Material changes in risk should generate a corresponding change in risk-mitigating hedging.[90] Moreover, a risk-mitigating hedge generally should unwind as exposure is reduced. Over-hedged exposure may be indicative of a proprietary position rather than a risk-mitigating hedge. Intermittent activity (hedging only when one chooses to act) or activity that is inconsistent with a hedging policy is also indicative of proprietary trading. Typically, the hedge should not be significantly greater than actual exposure to the underlying assets. The hedge (e.g., the notional amount under the hedge) should be correlated so that losses (gains) on the position being hedged are offset by gains (losses) on the hedge without appreciable differences. The Commission preliminarily believes that activity would not qualify as a risk-mitigating hedge for purposes of the proposed rule if the predicted performance of the hedge throughout the length of time that the hedge and the related position were held, resulted in a situation in which incrementally poor performance of an ABS or its underlying assets would result in a securitization participant earning appreciably more profits on the hedge than the losses incurred from their ABS exposure.

We seek comment on the application of the proposed exception to "mitigating" the consequences of a risk as intended by Congress.

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these statements are only intended to describe trading that may not qualify for the proposed exception. These statements are not intended to opine on the permissibility of speculative trading in other contexts.

[90] Risk-mitigating hedging indicia are considered in connection with the Volcker Rule. "Hedging activity should be designed to reduce the key risk factors in the banking entities' existing exposure, and should offset gains or losses that would arise from those exposures. Hedging activity should adjust over time based on changes in a banking entity's underlying exposures. Hedging activity should adjust over time if market conditions alter the effectiveness of the hedge even if the underlying positions remain unchanged. Material changes in risk should generate a corresponding change in hedging activity and should be consistent with the desk's hedging policy." FSOC Study, at p. 30.

Request for Comments regarding Risk-mitigating Hedging Activities

47. It has been argued that firms must hedge actual risks created by actual positions that left them with actual exposures.[91] Please discuss how such exposures arise and how they might be defined. Section 27B uses only the terms "positions or holdings." Please discuss application of Section 27B and the proposed rule to exposures. Is there any difference between "positions or holdings" and "actual risks created by actual positions" and "actual exposures"? If yes, please discuss the application of the proposed rule in light of such difference.

48. Please discuss whether clarifying interpretations concerning the terms "mitigate" and "exposures" would be consistent with prohibiting material conflicts of interest. Please discuss whether such interpretations would narrow or broaden the exception in a manner that is inconsistent with the purpose of Section 27B. Please discuss whether additional interpretations would be needed.

49. We seek comment regarding whether or not there are concerns about the level of transparency for risk-mitigating hedging activities and whether there are ways to assure the transparency of risk-mitigating hedging, such as through the use of standardized instruments.

50. Please describe whether, and if so, how firms engaging in securitization transactions currently distinguish risk-mitigating hedging from other activity.

51. We seek comment concerning the type of activity that would fall within the proposed exception under the proposed rule. Please discuss how firms currently

[91] See, e.g., Jeff Merkley, U.S. Senator and Carl Levin, U.S. Senator, Making the Dodd-Frank Act Restrictions On Proprietary Trading & Conflicts of Interest Work, available at http://www.rooseveltinstitute.org/%5Bmenu-trail-parents-raw%5D/making-dodd-frank-act-restrictions-proprietary-trading-and-conflicts-intere#.

identify risks associated with securitization transactions. Please discuss how firms currently hedge such risks (e.g., currency hedges, interest rate hedges, index hedges, credit derivatives). What policies or procedures are used to control, monitor, or manage those hedges? Should it be a condition to relying on the exception that the hedge was consistent with written, reasonably designed policies and procedures regarding risk-mitigating hedging activities? What types of instruments are used to hedge specific risks? When would securitization participants typically engage in risk-mitigating hedging activities pursuant to the proposed exception? Are these activities continuous? Is there a time when risk-mitigating hedging activities in connection with an underwriting, placement, initial purchase or sponsorship would typically cease? Please discuss whether and why a firm may either fully hedge a risk or partially hedge a risk in connection with activities designed to reduce specific risks arising out of an underwriting, placement, initial purchase or sponsorship. Does risk-mitigating hedging differ among the various securitization participants? If yes, please explain.

52. We seek comment regarding how the proposed exception might affect principal trading (other than market-making) as well as examples of principal trading that you believe could or could not qualify for the exception. Please explain why.

53. We seek commenter input regarding any principal trading that would be prohibited by the proposed rule and that would not qualify for the proposed risk-mitigating hedging activities exception or the proposed bona fide market-

making exception discussed below. Please discuss any positive and negative consequences of any such prohibition of principal trading.

54. Please discuss hedging that occurs during the "warehouse period" as assets are accumulated and held prior to securitization. Please comment upon the types of risk that are hedged during the warehouse period (e.g., credit risk, basis risk, default risk, etc.) as well as the types of instruments used to hedge (e.g., index products, derivatives, etc.) and who undertakes the hedging. Please discuss whether and how the securitization participant conducting the hedging distinguishes such hedging from other trading. Please comment upon whether and how such hedging is separated from other trading (e.g., different accounts, separate profit and loss treatment, etc.). Please discuss how such hedging should be treated under the proposed new rule. Commenters should explain their recommendations.

55. We seek comment concerning the type of activities that should or should not qualify for the proposed exception.

56. We seek comment concerning indicators of speculative or other trading masked as risk-mitigating hedging activity.

57. We seek comment as to whether modifications should be made to the proposed risk-mitigating hedging exception in order to reduce any inappropriate adverse impact on investors.

58. We seek comment as to whether modifications should be made to the proposed risk-mitigating hedging exception in order to clarify its scope for those who may seek to avail themselves of the exception.

59. Should the term "risk-mitigating hedging activities" be defined? If yes, please explain and provide a suggested definition. If no, please explain.

60. We seek comment concerning which department(s) of a securitization participant (e.g., an underwriter) typically effect risk-mitigating hedging.

61. Should the exception be conditioned on the maintenance by the securitization participant of books and records that would demonstrate that the activity in question fell within the exception? If so, what types of records should the securitization participant be required to maintain?

62. Should disclosure be a pre-requisite for relying on the exception? Please explain.

ii. Liquidity Commitments

Pursuant to the proposal, the following shall not be prohibited by paragraph (a) of the proposed new rule:

> Purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, to provide liquidity for the asset-backed security.

The exception would permit securitization participants (including affiliates and subsidiaries of an underwriter, placement agent, initial purchaser, or sponsor of an ABS) to provide liquidity pursuant to a commitment. While the statutory language specifically refers to "purchases or sales of asset-backed securities," generally, we understand that commitments to provide liquidity may be viewed by some market participants as encompassing a variety of activities. For example, we understand that a liquidity commitment may be viewed as a way to promote full and timely interest payments to ABS investors. In addition, we understand that a securitization participant may provide financing to accommodate for differences in the maturity

dates between asset-backed commercial paper and the underlying assets. For example, a sponsor of asset-backed commercial paper may provide a liquidity facility if a tranche of $3 million of the asset-backed commercial paper matures on the 30th day of the month, yet only $2 million of the underlying receivables match that maturity. If there is an inability to repay the $1 million shortfall by issuing new commercial paper, the sponsor may provide a loan secured by the receivables to provide for the $1 million shortfall. By way of another example, a liquidity commitment could be an agreement by a securitization participant, such as an underwriter, to purchase an ABS from its customer in a repo transaction consistent with applicable limitations on such transactions.[92] While we understand that these are some of the ways that liquidity commitments are often understood by market participants, we ask commenters to identify other examples of liquidity commitments and to discuss the application of the exception to such activities as consistent with Securities Act Section 27B.

Request for Comments regarding Liquidity Commitments

63. Are modifications to the proposed Rule 127B(b)(2) exception necessary or are there interpretations that the Commission should provide in order for the exception to work as intended? If yes, please explain why.

64. Are there transactions that involve material conflicts of interest related to a liquidity commitment that should qualify for this exception? Please explain why or why not.

65. Should the proposed exception be interpreted to cover only purchases and sales of the ABS? Please explain why such interpretation would or would not be consistent with the statute.

[92] See, e.g., 15 U.S.C. 78k(d).

66. Is liquidity provided through means other than purchases and sales of the ABS? If yes, please describe all additional means of providing liquidity.

67. Should the proposed exception cover engaging in any transactions involved in warehousing the underlying assets? If yes, please explain, including why this would be consistent with the intent of the exception.

68. We seek comment concerning the current scope of liquidity commitments by each type of securitization participant. How do such entities currently supply liquidity? When does this activity commence and terminate?

69. Please discuss the impact of the proposed exception on liquidity, especially for less liquid securities held by investors.

70. How do firms currently distinguish commitments to provide liquidity from bona fide market-making? Please include a discussion of the use of inventory of the ABS and the underlying securities and the method for setting prices.

71. Please discuss how the various securitization participants provide liquidity commitments. For example, please identify specific ways that a sponsor provides liquidity versus an underwriter.

72. Should the exception be conditioned on the maintenance, by some or all of the securitization participants, of the books and records that would demonstrate that the activity in question fell within the exception? If so, what types of records should the securitization participant be required to maintain?

73. Should disclosure be a pre-requisite for relying on the exception? Please explain.

iii. Bona Fide Market-making Exception

The following activities would not be prohibited by paragraph (a) of proposed Rule 127B under the Securities Act:

> Purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security.

The exception would permit purchases or sales of ABS to be made pursuant to and consistent with bona fide market-making in the ABS. The exception would be available to all securitization participants (including affiliates and subsidiaries of an underwriter, placement agent, initial purchaser, or sponsor of an ABS) that qualify for it if they engaged in bona fide market-making. We understand that the ABS market is typically an over-the-counter market, and ABS are not broadly distributed. We also understand that a few institutions may hold large positions in an ABS.

In determining if activities qualify as bona fide market-making for purposes of proposed Rule 127B, we preliminarily believe that the following principles are characteristics of bona fide market-making in ABS:

- It includes purchasing and selling the ABS from or to investors in the secondary market.
- It includes holding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction).
- It is driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market-makers.
- It generally is initiated by a counterparty and if a customer initiated a customized transaction, it may include hedging if there is no matching offset.

- It does not include activity that is related to speculative selling strategies or investment purposes of a dealer, or that is disproportionate to the usual market-making patterns or practices of the dealer with respect to that ABS.
- Absent a change in a pattern of customer driven transactions, it typically does not result in a number of open positions that far exceed the open positions in the historical normal course of business.
- It generally does not include actively accumulating a long or short position other than to facilitate customer trading interest.
- It generally does not include accumulating positions that remain open and exposed to gains or losses for a period of time instead of being closed out promptly.[93] In contrast, an aged open position taken to facilitate customer trading interest would be hedged rather than exposed to gains and losses for a period of time.[94]

In addition, we note that the fact that trading is carried out in a market-making account or on a market-making desk would not be determinative of whether such trading is bona fide market-making in ABS. The account type or desk would not govern the analysis, since

[93] Silber, supra note 90 (distinguishing market makers from other traders, such as speculators, using the following market-maker characteristics among others: (i) customer-based traders who buy and sell assets to accommodate customer purchase and sale orders, (ii) earn money on the bid/ask spread without speculating on future prices, (iii) tend to close out positions quickly and thus have small losses on positions, (iv) reduce exposure to equilibrium price movements by minimizing the length of time they hold assets, and (v) avoid holding open positions).

[94] Similarly, indicia to be considered in connection with permitted market-making in less liquid markets under the Volcker Rule includes "[p]urchasing or selling the financial instrument from or to investors in the secondary market; [h]olding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction); [t]ransaction volumes and risk proportionate to historical customer liquidity and investment needs; and [g]enerally does not include accumulating positions that remain open and exposed to gains or losses for a period of time instead of being promptly closed out or hedged out to the extent possible. For example, an aged open position taken to facilitate customer trading interest would be hedged rather than exposed to gains and losses for a period of time." See, FSOC Study, p. 29. See infra Section IIIE (discussing the potential interplay with the Volcker Rule).

otherwise a market-making account or desk might be used in an attempt to disguise proprietary trading as bona fide market-making.

We seek comment as to whether the above principles accurately identify the characteristics of bona fide market-making in ABS or whether different or additional characteristics might better identify this activity. We seek comment regarding how utilizing the principles listed above in determining whether activity was bona fide market-making in ABS would affect principal trading and the provision of liquidity by market intermediaries. Please provide examples of principal trading that would qualify for the exception as well as principal trading that would not qualify for the exception.

We note that the applicability of this proposed guidance concerning bona fide market-making is specific to bona fide market-making in ABS and may or may not be applicable in other areas of the federal securities laws and rules, in self-regulatory organization ("SRO") rules or in connection with other provisions of the Dodd-Frank Act.[95]

Depending on the facts and circumstances, bona fide market-making that does not meet each of these principles may still be bona fide market-making for purposes of the proposed exception. However, meeting just one factor might or might not be sufficient to qualify for the exception depending on the facts and circumstances.

We preliminarily believe that these principles would be appropriate as they are aimed at customer trading, customer liquidity needs, customer investment interest, or risk management by customers or market-makers. We also preliminarily believe that these principles would be necessary in order to distinguish bona fide market-making with respect to ABS that qualifies for

[95] Previously, we provided guidance that indicia of "bona-fide market making" for equity securities includes maintaining continuous two-sided quotes, among other things. See Release 34-58775 (Oct. 14, 2008), 73 FR 61690, 61698 (Oct. 17, 2008). However, different factors may apply to ABS, given the differences between the markets in equities and ABS.

the exception from other trading. We recognize, however, that there could be additional principles that would better identify bona fide market-making that is consistent with the intent of the exception. We seek commenters' views on any such principles.

Request for Comments regarding Bona Fide Market-making

74. We seek comment concerning the proposed indicators of bona fide market-making and any additional indicators of bona fide market-making with respect to ABS. We also seek comment concerning additional indicators of speculative or other trading masked as bona fide market-making.
75. Please provide specific, current examples of bona fide market-making in connection with ABS and explain how such activity evidences the proposed characteristics of bona fide market-making. Please discuss activity that does not evidence the proposed characteristics of bona fide market-making but that should qualify for the exception and why.
76. Please discuss whether there are features of ABS market-making that differ from market-making in other types of securities. Please describe the time period for which a market-making position in ABS is generally held and any circumstances which would cause such a position to be held longer.
77. Do firms use derivatives in connection with bona fide market- making with respect to ABS? If yes, how?
78. Please describe whether firms currently identify bona fide market-making in ABS. If so, how?
79. Should we adopt a definition of the term "bona fide market-making" for purposes of proposed Rule 127B? If yes, please provide a suggested definition.

80. Should the exception be conditioned on the maintenance, by some or all of the securitization participants, of books and records that would demonstrate that the activity in question fell within the exception? If so, what types of records should the securitization participant be required to maintain?

81. Should disclosure be a pre-requisite for relying on the exception? Please explain.

Request for Additional Comments concerning the Exceptions

82. Please discuss any activities that you believe would meet the proposed exceptions for risk-mitigating hedging, liquidity commitments and bona fide market-making but that could be viewed as a material conflict of interest. Should the Commission expressly state its view about why such activities would or would not be consistent with the exceptions? Please explain why such activity should or should not be interpreted as consistent with Securities Act Section 27B.

83. Please discuss the ways in which securitization participants might demonstrate compliance with the proposed exceptions for risk-mitigating hedging, liquidity commitments and bona fide market-making.

C. Application of Material Conflict of Interest Test

We set forth below examples of transactions that involve or that do not involve, as the case may be, potential conflicts of interest and describe how our proposed test for identifying material conflicts of interest for purposes of Section 27B and our proposed rule would apply to such transactions. We note that these examples are merely illustrative, and even minor differences in the facts and circumstances could change the analysis of these transactions. We

further note that the examples below are intended only to illustrate the application of the proposed rule, and are not intended to address the application of other laws, rules or regulations to the relevant transactions. The conduct depicted in the examples might or might not violate provisions of the securities laws or rules that are not discussed here.

In the following examples, we focus primarily on items 1(A) and (B) of the interpretation as to whether a transaction involves or results in a material conflict of interest: first, whether under the transaction the securitization participant "would benefit directly or indirectly from the actual, anticipated or potential (1) adverse performance of the asset pool supporting the relevant ABS, (2) loss of principal, monetary default or early amortization event on the ABS, or (3) decline in the market value of the relevant ABS"; or second, whether under the transaction the securitization participant "would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction." We assume for purposes of discussion that, unless otherwise specified, the materiality requirement for our proposed interpretation is satisfied – i.e., there is a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision. In addition, unless otherwise indicated in these examples, we assume that the exceptions under the proposed rule (e.g., bona fide market-making or risk-mitigation hedging activities) would not be available.

Example 1 – Securitization Participant Effecting a Short Transaction in an ABS, or any of the Assets Underlying an ABS

In Example 1, an ABS underwriter purchases CDS protection on the securities offered in the relevant ABS three months after the date of the first closing of the sale of the ABS. For these purposes, assume that the ABS meets the definition of an asset-backed security in Section 3(a)(77) of the Exchange Act and the underwriter's purchase of CDS protection was made solely for its own proprietary investment purposes and does not qualify for any exception in the proposed rule.[96]

The underwriter is a covered person as one of the enumerated securitization participants in the proposed rule. The ABS is a covered product because it meets the Section 3 definition of ABS in the Exchange Act. The purchase of CDS protection is a transaction for purposes of the proposal which occurred prior to one year after the date of the first closing of the sale of the ABS. Therefore, the transaction occurred within the covered timeframe.

In this example, the purchase of the CDS protection by the securitization participant is a short transaction within the covered timeframe that is prohibited by the proposed rule.[97] This short transaction would involve a material conflict of interest between the securitization participant and the ABS investors because the securitization participant would profit from the adverse performance of the ABS.[98]

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[96] For example, the underwriter had no client that requested the long CDS exposure such that the purchased CDS protection could qualify for the bona fide market-making exception.

[97] Nothing in the proposed rule would prohibit the securitization participant from purchasing the ABS or selling protection on the ABS or the assets underlying the ABS.

[98] However, if the short transaction was executed in the context of market-making by the securitization participant (e.g., the securitization participant purchases CDS protection from one customer to offset its sale of CDS protection to another customer), the exception under Rule 127B(b) would permit such market-making.

Example 2 – Securitization Participant Hedges Retained Investment in an ABS

In Example 2, an ABS underwriter purchases ABS that it distributed and contemporaneously purchases CDS protection on the ABS. For these purposes, assume that the ABS meets the definition of asset-backed security in Section 3(a)(77) of the Exchange Act, and the underwriter uses the CDS to hedge its ABS position on a delta neutral basis, such that the potential gains on the hedged positions are not appreciably larger than the potential losses on that portion of the ABS investment that is being hedged at any point in the future.

The underwriter is a covered person as one of the enumerated securitization participants in the proposed rule. The ABS is a covered product because it meets the Section 3 definition of ABS in the Exchange Act. The purchase of CDS protection is a transaction, which for purposes of the proposal occurred within the covered timeframe – i.e., prior to one year after the date of the first closing of the sale of the ABS.

In this case, the proposed risk-mitigating hedging activities exception could apply, because the securitization participant is hedging a position arising out of the underwriting, placement, initial purchase or sponsorship of an ABS. However, if, the CDS transaction is structured such that under some circumstances, now or in the future, the recovery on the CDS might be appreciably greater than the exposure on the ABS, the risk-mitigating hedging exception would not apply, because the securitization participant would profit from the adverse performance of the ABS through a short transaction (the CDS). In this case, the securitization participant would not be managing risk, but instead would have a risk-taking position directionally opposed to the ABS (in the amount of the CDS exposure that exceeds what is necessary for a delta neutral hedge).[99]

[99] Labels such as "hedging" would not permit what would otherwise be prohibited conduct under the proposed rule. If a securitization participant engaged in a transaction within one year after the date of the first closing of the sale of

Example 3 – Synthetic ABS Transaction

Example 3 involves several variations on the role of a securitization participant, in this case a sponsor, in a synthetic ABS transaction. In each case, the securitization participant is a party to the CDS contract with the SPE, and thus the securitization participant is short the credit exposure of the reference portfolio underlying the ABS transaction.

In these scenarios, the sponsor is a covered person because it is one of the enumerated securitization participants in the proposed rule, and the ABS is a covered product because the proposal covers synthetic ABS. For purposes of the proposal, the purchase of CDS protection is a short transaction, which occurred prior to one year after the date of the first closing of the sale of the ABS. Therefore, the transaction occurred within the covered timeframe.

In Example 3A, the securitization participant does not have any exposure to the ABS or underlying assets other than its short position through the CDS transaction. In this instance, entering into the CDS with the issuer of the ABS would, by itself, generally involve or result in a material conflict of interest between the securitization participant and the ABS investors that would be prohibited by the proposed rule.

In Example 3B, the securitization participant's short exposure under the CDS with the issuer offsets the securitization participant's existing long exposure to the same assets underlying the ABS. For instance, the securitization participant might be seeking to reduce its long investment exposure to the relevant assets because it has come to believe that the assets will perform poorly. If the firm accomplishes this result by transferring the risk of its long positions to ABS investors through a synthetic ABS – while marketing the ABS securities to investors as a good investment opportunity – it could be viewed as benefiting from a decline in the ABS at the

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the ABS that involved or resulted in a material conflict of interest with respect to investors in the ABS, that would be prohibited by proposed Rule 127B(a), even if it were referred to by the securitization participant as "hedging."

expense of the ABS investors, who now have the exposure to the underlying assets.[100] Although the securitization participant's existing long exposure to those assets and its short exposure under the CDS transaction may offset each other, in this scenario the CDS transaction is providing a hedge for an existing long investment position, rather than a hedge for assets associated with underwriting activities, and thus the risk-mitigating hedging exception would not be available.[101]

We preliminarily believe that in Example 3B and under our proposed interpretation the securitization participant would be prohibited from entering into the CDS transaction with the ABS issuer for the same reason as in Example 3A – the securitization participant would benefit through the CDS transaction from a potential decline in the ABS, and no exception to the prohibition is available – but we request comment on whether this result is appropriate in all circumstances.

In Example 3C, the securitization participant has accumulated a long cash or derivatives position in the underlying assets solely in anticipation of creating and selling a synthetic ABS – and not with a view to taking an investment position in those underlying assets. The securitization participant might choose to use the synthetic securitization structure rather than a traditional cash securitization when that is a more efficient mechanism for providing particular customers with exposure to the underlying assets. In this case the securitization participant therefore enters into a CDS with the SPE as part of a synthetic ABS transaction to offset the

[100] See 156 Cong. Rec. S2599 (daily ed. July 15, 2010) (statement by Sen. Levin) ("But a firm that underwrites an asset-backed security would run afoul of the provision if it also takes the short position in a synthetic asset-backed security that references the same assets it created.").

[101] We note that that risk-mitigating hedging exception in proposed Rule 127B(b)(1) is available only for hedging in connection with positions or holdings *arising out of* underwriting, placement, initial purchase or sponsorship of an ABS. In this scenario, the securitization participant's position in the underlying assets was acquired as an investment, and not for purposes of the initial offering transaction, and therefore the exception would not apply.

exposure to the underlying reference portfolio that it in turn acquired for purposes of effecting the ABS transaction.

We preliminarily believe that in Example 3C the short CDS transaction by the securitization participant would fall within the exception for risk-mitigating hedging activities – provided that there was no significant net basis risk, and that potential gains (or losses) by the securitization participant from the CDS protection it purchased from the issuer would be directly offset by losses (or gains) from the long position accumulated to offset that exposure. We seek comment on whether this interpretation would be appropriate. In addition, we seek comment on whether as a practical matter it will be possible to distinguish circumstances in which the securitization participant's long position in the underlying assets was originally acquired for investment purposes (i.e., Example 3B), from circumstances in which the securitization participant's long position was acquired for purposes of creating the ABS (i.e., Example 3C).

In Example 3D, the securitization participant that has entered into the short CDS transaction with the SPE contemporaneously enters into one or more offsetting CDS transactions with other market participants that did not play a role in selecting the reference assets of the ABS, and did not have any influence on any aspect of the ABS transaction. Provided that the securitization participant did not itself select assets that were biased to facilitate the ability of these market participants to profit from short transactions, and that the offsetting CDS transactions had no significant net basis risk (i.e., potential gains (or losses) by the securitization participant from the CDS protection that it purchased from the issuer would be directly offset by losses (or gains) from the CDS transactions with third parties), we preliminarily believe that under the risk-mitigating hedging exception the securitization participant would be permitted to enter into this combination of the CDS transaction with the issuer of the ABS securities and the

offsetting transactions with third parties.[102] The CDS transaction with the SPE is itself a position or holding arising out of the ABS transaction, and the securitization participant would not profit from excess exposure directionally opposed to the ABS because of the offset.[103] In this sense, Example 3D is comparable to Example 3C. However, if in Example 3D the securitization participant's CDS with the issuer is entered into to offset pre-existing CDS exposures to third parties that were entered into for purposes unrelated to the ABS transaction, the scenario would be comparable to Example 3B and the risk-mitigating hedging exception would not apply. As above, we seek comment on whether as a practical matter it will be possible to distinguish circumstances in which the securitization participant's short transaction with the ABS issuer is entered into to hedge an existing position (and is thus prohibited) or to facilitate the ABS transaction (and thus permitted).

Example 4 – Facilitation of Third Party Activities

Example 4 involves variations on situations in which a securitization participant, in this case a placement agent, benefits by allowing an unaffiliated[104] third party to select the composition of the assets that underlie an ABS as defined in Section 3 of the Exchange Act. In each case, the third party purchases CDS protection on the relevant ABS prior to one year before the date of the first closing of the sale of the ABS.[105]

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[102] See 156 Cong. Rec. S2599 (daily ed. July 15, 2010) (statement of Sen. Levin) ("Nor does it restrict a firm from creating a synthetic asset-backed security, which inherently contains both long and short positions with respect to securities it previously created, so long as the firm does not take the short position.").

[103] Furthermore, since in this example there is no third party that has influenced the asset selection or structure of the ABS, it is unlikely that the ABS would have been structured in anticipation of underperformance of the ABS or its reference portfolio.

[104] "Unaffiliated" is used to describe the third party because Section 27B of the Securities Act applies to (and proposed Rule 127B would apply to) affiliates of a securitization participant.

[105] Note that in order to fall within item 1(B), a third party must both (i) directly or indirectly structure the relevant ABS or select assets underlying the ABS, and (ii) enter into a short transaction. Thus, if in a synthetic ABS transaction a third party purchases CDS protection on the relevant ABS from the SPE, but does not structure the

In each of the examples below, assume that the placement agent is a covered person as one of the enumerated securitization participants in the proposed rule, and that, the ABS is a covered product because it meets the Section 3 definition of ABS in the Exchange Act.

In Example 4A, the securitization participant, for a fee, facilitates the third party's entering into a short transaction, the purchase of CDS protection on the ABS, with a party who is not a securitization participant. Under item 1(B) of the interpretation of material conflicts of interest, and as previously described in Section III A(v)(b), by allowing the third party to select assets underlying the ABS, and then facilitating the third party taking a short position on the ABS or its underlying assets, the securitization participant has engaged in a transaction that involves or results in a material conflict of interest between the securitization participant and the ABS investors, and such activity would be prohibited under the proposed rule. The securitization participant creates the opportunity for the third party to select riskier assets for the underlying asset pool so that the anticipated poor performance of these assets would increase the likelihood of a profitable short transaction. In return for creating this opportunity for the third party, the securitization participant receives compensation for facilitating the third party's short transaction.

In Example 4B, the third party again enters into the CDS transaction but now with a party who is not a securitization participant, so that in this case the securitization participant does not facilitate that CDS transaction or receive a fee for doing so. As in Example 4A, in Example 4B, the securitization participant creates the opportunity for the third party to profit from its short transaction by permitting it to select risky assets for the underlying asset pool. We preliminarily believe that the securitization participant's activities in Example 4B would be prohibited under

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relevant ABS or select assets underlying the ABS, the third party's activities would not fall within the scope of item 1(B).

our proposed test. Although the securitization participant would not receive direct compensation for facilitating the short transaction we believe it would be appropriate to impute a benefit to the securitization participant for creating the opportunity for the third party to profit from its short transaction. For example, the securitization participant may receive compensation from its role in connection with the ABS or compensation from future business that the third party promises to direct to the securitization participant. We request comment on whether it is appropriate to treat the securitization participant in Examples 4A and 4B in the same manner, or whether the lack of direct compensation to the securitization participant in Example 4B would justify a different result.

In Example 4C, the third party who has selected assets in the ABS also purchases one or more of the securities offered in the ABS transaction. In this case, the third party's purchase of CDS protection on the relevant ABS offsets its exposure to the ABS. In general, we preliminarily believe that activities in which investors who purchase one or more securities offered in an ABS transaction decide at that time or later to reduce or hedge their exposure to these investments through subsequent short transactions, such as purchasing CDS protection, would qualify for the risk-mitigating hedging exception, and that these activities do not involve or result in the types of material conflicts of interest proposed Rule 127B is intended to address. In Example 4C, the third party is in the same position as a securitization participant who has selected the assets underlying the ABS, purchases the ABS, and then seeks to hedge that ABS by buying CDS protection (e.g., the securitization participant in Example 2). By allowing the third party to select assets and then hedge a position in ABS purchased in the offering, the securitization participant would not be permitting the third party to do anything that the securitization participant itself could not do under the proposed rule.

In Example 4D, the same third party purchasing one or more securities issued by the ABS also buys CDS protection on those same securities or other securities in the offering (or their underlying assets), but in this case does so in a manner such that the third party will profit more from the short position than it will lose on the long securities position. For example, the third party may have purchased the equity tranche in order to influence the selection of riskier assets and implement an arbitrage strategy in which it would gain more on a CDS transaction on the issuer's securities than it would lose on the equity tranche.[106] This activity would no longer qualify for the risk-mitigating hedging exception. As per item 1(B) of the test, by allowing a third party to select assets underlying an ABS in a way that facilitates that third party's ability to profit from a short position on the ABS or its underlying assets, the securitization participant has engaged in a transaction that involves or results in a material conflict of interest between itself and investors in the ABS.

Request for Comments Regarding the Examples

We request comment on whether these examples demonstrate engaging in transactions that involve or result in material conflicts of interest of a type that proposed Rule 127B should prohibit. We also request that commenters provide descriptions of any other examples of material conflicts of interest that the proposed rule should prohibit, and address whether our proposed materiality test appropriately captures such conflicts of interest.

84. Please identify activity that would constitute selecting assets underlying the asset pool or structuring the ABS transaction as discussed in the examples above. Should such activity include establishing criteria for asset selection, selecting names from a list of potential reference assets provided by a

[106] See e.g., Senate Subcommittee Report: Anatomy of a Financial Collapse, supra n. 38, at 372 (describing a hedge fund's investment strategy as "purchas[ing] the riskiest portion of a CDO – the equity – and, at the same time, to purchase short positions on other tranches of the same CDO").

securitization participant or other activities? Should the number or percentage of assets selected as collateral be a factor in determining whether or not a person played a role in selecting assets? Should there be some level of activity that should not be considered selecting the assets or structuring the ABS? Please explain why or why not.

85. In connection with Example 3D above, please describe any circumstances in which a securitization participant may not be able to offset its CDS exposure, or can only partially offset its CDS exposure by entering into one or more offsetting transactions with other market participants. We seek commenter input regarding any specific consequences of prohibiting the activity described in Example 3D if the securitization participant cannot fully offset its CDS exposure.

86. We seek commenter input regarding the rationale applied in each of the scenarios in Example 4.

87. Are there additional factors that would better identify material conflicts of interest, especially in the context of evaluating the examples above? Please explain. For example, should we consider any factors not discussed in Example 4B when the unaffiliated third party may purchase CDS protection from another entity? How should such factors be considered in determining whether a transaction involves or results in a material conflict of interest?

88. Are there examples not listed above that occur frequently for which further guidance is needed? Please describe.

89. In Examples 1, 2, 3A, 3B, 4A, 4B, 4D, we illustrate activities that would be prohibited under the proposed interpretation discussed in the release. For each of these examples, we seek commenter input regarding how frequently the transactions described in the examples occur in connection with ABS and synthetic ABS as well as the potential positive and negative consequences of prohibiting such transactions. Please also include a discussion regarding any potential impacts, including any positive or negative impact, on investors, investor protection, liquidity, capital formation and the maintenance of fair, orderly and efficient markets if securitization participants refrained from creating and selling certain ABS and synthetic ABS to avoid the activities described in the examples above as a result of the proposed rule.

90. Example 3B describes a securitization participant transferring the risk of its long positions to ABS investors through a synthetic ABS. We seek commenter input regarding how frequently or infrequently this occurs and the consequences that might result from transferring such risk to ABS investors through a synthetic ABS. We also seek commenter input regarding the reasons why a securitization participant might or might not prefer to transfer such risk using a synthetic ABS instead of a non-synthetic ABS.

D. Application of the Proposed Rule to Other Activities

Initial commenters identified many activities that they believed could be implicated by Section 27B and the proposed rule. These activities include: (1) activities that are routinely part

of the securitization process that may be effected in connection with structuring an ABS; and (2) activities undertaken by securitization participants that are unrelated to the securitization.[107]

We believe that activities associated with the typical structuring of a non-synthetic ABS would not be prohibited by the proposed rule. For example, the basic transfer of risk in a non-synthetic ABS in which a securitization participant who is long the underlying assets sells them to an SPE is typical of most ABS structures and would not constitute a prohibited transaction, because after such sale the securitization participant would not benefit from the subsequent decline in the value of the ABS or the underlying assets. Additionally, the proposed rule would not prohibit the multi-tranche structure commonly used in securitization transactions. While investors in different tranches may have interests that conflict with each other, such conflicts would fall outside the scope of the proposed rule, which is focused on conflicts of interest between securitization participants and ABS investors. In addition, mere ownership by a securitization participant of the ABS would not constitute a material conflict of interest under the proposed rule, because such ownership by itself would not cause the securitization participant to benefit from the adverse performance of the asset-pool or the ABS; instead, the securitization participant would benefit from the positive performance of these assets. [108]

Commenters stressed the importance of the "material" aspect of the phrase "material conflict of interest" in Section 27B and suggested that activities inherent in the securitization process evidence "expected conflicts . . . but do not constitute the type of 'material conflicts' intended to be regulated by Section 621."[109] We preliminarily believe that many activities that

[107] See supra Section IIB.

[108] For this reason, we believe the proposed rule would not prohibit risk retention as required by Dodd-Frank Act Section 941. See supra note 19.

[109] SIFMA Letter at p. 4.

these commenters identified as being inherent to the securitization process would not be prohibited by the proposed rule because they would not fall within its scope or would fall within one of the exceptions to the prohibition.[110] Thus, we preliminarily agree that most activities undertaken in connection with the securitization process would not be prohibited by the proposed rule, including but not limited to: providing financing to a securitization participant, deciding not to provide financing, conducting servicing activities, conducting collateral management activities, conducting underwriting activities, employing a rating agency, receiving payments for performing a role in the securitization, receiving payments for performing a role in the securitization ahead of investors, exercising remedies in the event of a loan default, exercising the contractual right to remove a servicer or appoint a special servicer, providing credit enhancement through a letter of credit, and structuring the right to receive excess spreads or equity cashflows.

Commenters also suggested that certain transactions in swaps, caps, CDS and derivatives should fall outside the proposed rule's prohibition. We invite commenters to analyze any such transactions with our proposed framework. In addition, commenters highlighted activities that are unrelated to a particular securitization (such as underwriting another ABS transaction for another issuer) and suggested that they should not be prohibited. We generally agree that many such activities would not be prohibited by the proposed rule, including underwriting an ABS for a different issuer. These activities generally could be undertaken absent additional facts indicating otherwise, such as facts indicating a securitization participant engaged in a proprietary trade that would profit from a directionally opposite view of the ABS.

[110] See, e.g., SIFMA Letter.

Other activities unrelated to the securitization, such as market research, could be undertaken by a securitization participant. As mentioned earlier, the issuance of research would not be engaging in a transaction for purposes of the proposed rule and as such would not be prohibited.

We ask that commenters analyze these and other activities, using the proposed framework set forth above, including the use of the derivatives and the activities of servicers and collateral managers.

E. Relationship to Volcker Rule

Section 619 of the Dodd-Frank Act,[111] commonly referred to as "the Volcker Rule," amends the Bank Holding Company Act to add new Section 13, Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds. The Volcker Rule includes (1) general prohibitions and restrictions on certain financial entities – including certain broker-dealers – engaging in proprietary trading or sponsoring or investing in a hedge fund or private equity fund, (2) certain exceptions to these prohibitions and restrictions (referred to as "permitted activities"), and (3) limitations on permitted activities.

Like Section 621, the Volcker Rule is concerned with conflicts of interest. For example, the Volcker Rule is concerned with conflicts of interest that stem from proprietary trading at banking and non-bank financial firms. In addition, the Volcker Rule, like Section 621, includes the concepts of certain permitted activities concerning market-making related activities and risk-mitigating hedging activities.[112] Given the similarities between these two sections of the Dodd-Frank Act, the Commission may consider whether aspects of the rules adopted to implement

[111] Dodd-Frank Act, Pub. L. 111-203, § 619, 124 Stat. 1376, 1620 (2010).

[112] See Sections 619(d)(1)(B) and (C) of the Dodd-Frank Act, Pub. L. No. 111-203, § 619(d)(1)(B) and (C), 124 Stat. 1376, 1624 (2010).

Section 619 should be applied to this proposed rule in the future.[113] Our preliminary belief is that the exceptions for risk-mitigating hedging activities and bona fide market-making activities for purposes of proposed Rule 127B should be viewed no less narrowly than the comparable exceptions for such activities under the Volcker Rule.

Request for Comments Regarding Relationship to Volcker Rule

94. Please discuss any potential interplay of the "Volcker Rule" of Section 619 of the Dodd-Frank Act with Section 27B and proposed Rule 127B. In particular, we seek commenter input regarding whether or not the treatment of risk-mitigating hedging activities and bona fide market-making exceptions in Proposed Rule 127B(1) and (3) should be consistent with Section 13(d)(1)(B) and (C) of the Bank Holding Company Act concerning permitted market-making related activities and risk-mitigating hedging activities or whether there are reasons that necessitate different treatment. Please explain.

95. We ask that commenters describe any potential consequences if risk-mitigating hedging and market-making were treated differently under Proposed Rule 127B and the Volcker Rule.

96. We seek commenter input regarding any costs that may be incurred by securitizations participants, ABS investors and others if the exceptions in Proposed Rule 127B(b)(1) and (3) are interpreted differently than Sections 13(d)(1)(B) and (C) of the Bank Holding Company Act.

[113] The Commission must adopt rules not later than nine months after completion of the Financial Stability Oversight Council's study on the Volcker provisions. The study, see supra note 85, was issued on January 18, 2011.

IV. Information Barriers, Disclosure, and Exemptions

Information barriers and disclosure are often used as tools to manage conflicts of interest in other areas of the federal securities laws. While Securities Act Section 27B does not explicitly provide for specific exceptions concerning information barriers or disclosure, we believe it would be useful to explore whether these tools might permit the proposed rule to better achieve its policy objectives without unnecessarily restricting beneficial market activities.

A. Information Barriers

Commenters suggested the Commission consider potential burdens triggered by Securities Act Section 27B on securitization participant's affiliates and the use of existing mechanisms to manage conflicts of interests, including in particular information barriers.[114] Commenters stated that securitization participants may have a large number of affiliates that engage in ordinary course activity that is both "walled-off" from other areas of the securitization participant and effected for purposes unrelated to any particular ABS transaction. Commenters asked that the Commission be mindful of potential "unintended effects on everyday operations" of securitization participant affiliates.[115]

Information barriers, in the form of written, reasonably designed policies and procedures, have been recognized in other areas of the federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities. For

[114] See discussion infra at note 126. See, e.g., SIFMA Letter at p. 7 ("Financial institutions engage in hedging activities in many contexts and at many levels throughout an organization comprised of many business units, offices, trading desks and funds, each of which may be engaged in separate transactions that, in some cases, are walled off from other parts of the financial institution and may otherwise be transacted for purposes other than betting against the specific ABS that is sponsored or underwritten by that financial institution or its affiliate. Curtailing such hedging activities – which are unrelated to the actual ABS sponsored or underwritten by financial institutions and their affiliates and are entered into as part of their risk management practices and not as a bet against that ABS – would have adverse and unintended effects on everyday operations and risk management practices of financial institutions and their affiliates.").

[115] SIFMA Letter at p. 8.

example, Section 15(g) of the Exchange Act recognizes that information barriers may be used to effectively manage the potential misuse of material, non-public information.[116] Exchange Act Rule 14e-5 prohibits certain purchases of securities outside of tender offers,[117] but contains an exception for purchases or arrangements to purchase by an affiliate of a dealer-manager.[118] The exception requires, among other things, that the dealer-manager maintains and enforces written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate.[119] It also requires that the dealer-manager be a registered broker-dealer and that the affiliate have no officers (or persons performing similar functions) or employees (other than clerical, ministerial or support personnel) in common with the dealer-manager that direct, effect, or recommend securities transactions.[120] Likewise, Regulation M, the set of anti-manipulation rules concerning securities offerings, contains an exception for certain persons based on information barriers.[121] Affiliated purchasers are excepted if, among other things, the affiliate maintains and enforces written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate that might result in a violation of Regulation M.[122] In order for an affiliate to avail itself of the exception it must also obtain an annual, independent

[116] Formerly Section 15(f) of the Exchange Act but redesignated by the Dodd-Frank Act. 15 U.S.C. 78o(g).

[117] 17 CFR 240.14e-5.

[118] 17 CFR 240.14e-5(b)(8).

[119] 17 CFR 240.14e-5(b)(8)(i).

[120] 17 CFR 240.14e-5(b)(8)(ii and iii).

[121] 17 CFR 242.100-105.

[122] 17 CFR 242.100(b).

assessment of the operation of such policies and procedures.[123] Like Rule 14e-5, it contains a restriction on common officers and employees.[124]

The concept of independent units (including affiliated entities) within multi-service firms has been recognized in discrete areas of the securities laws for those multi-service firms with units that function separately and independently.[125] We preliminarily believe it may be appropriate to consider the issue of independent units within a multi-service firm in the context of the proposed rule. Certain firms involved in securitization may undertake a wide range of activities in connection with multiple and different business lines, underwriting and trading ABS among them. We seek comment below concerning the extent of the restrictions that the proposed rule would place on firm-wide activities. We seek commenter input regarding whether firm-wide restrictions would be necessary to achieve the objectives of the statute or whether firm-wide restrictions would be unwarranted if transactions were independent of the creation and distribution of an ABS.

Request for Comments Regarding Information Barriers

91. We seek comment concerning the operation of information barriers and whether or not the use of information barriers to address conflicts of interest in connection with securitization transactions might be consistent with Securities Act Section 27B. In particular, the Commission seeks comment concerning

[123] Id.

[124] Id.

[125] See e.g., 17 CFR 200(f) (allowing multi-service broker-dealers to aggregate positions within defined trading units if a registered broker-dealer meets the following requirements "(1) The broker or dealer has a written plan of organization that identifies each aggregation unit, specifies its trading objective(s), and supports its independent identity; (2) Each aggregation unit within the firm determines, at the time of each sale, its net position for every security that its trades; (3) All traders in an aggregation unit pursue only the particular trading objective(s) or strategy(s) of that aggregation unit and do not coordinate that strategy with any other aggregation unit; and (4) Individual traders are assigned to only one aggregation unit an any time.").

whether this would be appropriate for certain affiliates and subsidiaries of securitization participants that may operate separately and independently.[126]

92. Should we consider the imposition of information barriers or other means of managing potential conflicts of interest? If so, what specific means should be considered (e.g., physical separation?) How effective are any such alternative methods as currently used? Can such methods be circumvented? If so, in what ways? We seek commenter input regarding any limitations related to the use of information barriers in the context of managing potential material conflicts of interest under Section 27B?

93. We seek comment concerning whether ordinary business functions of affiliates and subsidiaries of underwriters, placement agents, initial purchasers, and sponsors are sufficiently separated from the process of creating and marketing ABS so as not to create material conflicts of interest that the proposed rule is designed to address. For example, consider application of the proposed rule to an affiliate of a securitization participant that manages a fund and such fund purchases a CDS referencing securities issued in the ABS transaction. Should this type of activity be permitted, and if so, under what conditions? Discuss whether this scenario might form the basis of a clarifying interpretation or an

[126] See ABA Letter at p. 5 ("Section 27B applies to all affiliates of underwriters and placement agents, which could include banks, broker-dealers, asset managers and ERISA fiduciaries. Banks and their affiliates are already subject to statutory and regulatory provisions designed to prevent conflicts of interest and prevent the use of material nonpublic information, and these provisions may require the establishment of information walls between affiliated entities or between different departments of a bank. Additionally, entities which are fiduciaries are obligated to act for the benefit of their beneficiaries and must be permitted to sell securities and enforce loans based on the best interests of beneficiaries. Underwriters and placement agents subject to Section 27B may have a large number of affiliates, which may result in significant administrative difficulties in applying the rule to all related entities. We ask the Commission to be mindful, when preparing its rules, of these existing obligations of transaction parties and their affiliates and of the compliance burdens which may result.").

exemptive rule. Please include in the discussion your views about possible forms of, and utility of, disclosure regarding the fund's CDS purchase. Please provide an explanation concerning any current separation between the securitization participant and/or its affiliates and subsidiaries, and whether the separation is mandated by existing rules and regulation. Please describe in detail how such separation is implemented, maintained and enforced by a firm. Please discuss whether information barriers, with respect to affiliates or subsidiaries, could result in a conflict of interest not being material, and/or whether, where consistent with Commission authority, the use of information barriers should be conditioned on certain requirements (e.g., restrictions on common officers and employees, annual assessments of policies and procedures, being regulated by the Commission, entities providing certification to the Commission or other persons that activities have not involved or resulted in material conflicts of interest). We seek comment concerning whether such separation can meaningfully protect against material conflicts of interest in this context.

94. If consistent with Securities Act Section 27B, should one unit of a firm be able to effect (or be restricted from effecting) a transaction that involves a directionally opposed view of the ABS or its reference portfolio if that unit is separated by information barriers from another unit in the same firm that created and distributed the ABS? Is there any reason why information barriers would not be effective in this context? We seek comment on circumstances in which departments within one firm may be sufficiently separated so as not to create a

material conflict of interest that the proposed rule is designed to address. Please identify all such departments and the activities in which they may engage that could result in the application of the prohibition in proposed Rule 127B, but may not raise the concerns designed to be addressed by Securities Act Section 27B. Discuss whether this scenario might form the basis of a clarifying interpretation or an exemptive rule. Please include in the discussion your views about possible forms of, and utility of, disclosure. Please provide an explanation of the separation between departments and whether it is mandated by existing rules and regulations. Please describe how such separation is implemented, maintained and enforced by the firm. We seek comment concerning whether such separation can meaningfully protect against material conflicts of interest in this context.

95. If a separate, independent unit concept were to be applied in connection with the proposed rule, what conditions would be appropriate to maintain the integrity of the independence between the separate units within a multiservice firm to permit transactions in one unit that are truly independent from the creation and distribution of an ABS in another unit (e.g., (1) a written plan of organization to identify each unit, support its objective, and support its independent identity; (2) individual employees assigned to only one unit at any time; (3) compliance and internal audit routines; (4) written records; (5) separate management structure, location, business purpose and profit and loss treatment; and (6) other conditions).

B. Disclosure

While Securities Act Section 27B does not contain a disclosure provision, commenters discussed the extent to which disclosure might mitigate potential conflicts of interest in this context.[127] Commenters stated that while there can be many potential conflicts of interest that arise in connection with securitization, most are not the type of material conflict of interest intended to be prohibited by Securities Act Section 27B.[128] Commenters stated that many conflicts of interest that arise in the normal course of a securitization are often contemplated by investors and indeed may be disclosed to investors.[129]

We seek comment concerning the role of disclosure in the context of Securities Act Section 27B and the proposed rule. Securitization participants typically provide various

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[127] See, e.g., Merkley-Levin Letter ("Further, the utility of disclosures must be carefully examined and not be seen as a cure for the conflicts. We provided the Securities and Exchange Commission with sufficient authority to define the contours of the rule in such a way as to remove conflicts of interest from these transactions, while also protecting the healthy functioning of our capital markets."); see infra note 129.

[128] See, e.g., ABA Letter at p. 4 ("In view of the many potential conflicts of interest that may arise between participants and investors in ABS . . . and in view of the legislative history and the statutory use of the term 'material conflict of interest,' we believe the rules issued by the Commission should focus on prohibiting the type of blatant conflict of interest described in the legislative history, while permitting other types of conflicts to exist subject to appropriate disclosure requirements . . . Potential conflicts of the type described above that either exist, or are contemplated, at the time of an ABS transaction are customarily disclosed in offering materials. Although the legislative history is clear that disclosure is not necessarily a cure for a conflict of interest arising out of profiting from a 'designed to fail' transaction, we believe adequate disclosure should suffice to address these ordinary course conflicts."); see also SIFMA Letter at p. 5 ("In contrast to the material conflicts of interest created in the 'designed to fail' transactions cited by Senators Merkley and Levin, many other potential conflicts of interest are inherent in securitizations. These conflicts should be disclosed to investors and other transaction parties to the extent they are material, but should otherwise be permitted to fall outside the scope of Section 621. While Senators Merkley and Levin assert that disclosure alone may not eliminate the problematic nature of certain conflicts, SIFMA believes that conflicts created in the normal course of a securitization are sufficiently known by, or disclosed to, investors and do not fall under the intended scope of Section 621."); ASF Letter at note 11 ("We note that Senator Levin believes that disclosure alone may not cure material conflicts of interest in all cases, such as in situations where 'disclosures cannot be made to the appropriate party or because the disclosure is not sufficiently meaningful.' We further note that Senator Levin does not believe that disclosing that the underwriter of an ABS 'has or might in the future bet against the security' will cure the conflict of interest arising if the underwriter takes a short position in a synthetic transaction that references the ABS. However, in situations that are clearly not instances of an asset-backed security being designed to fail, ASF believes that effective disclosure would remedy perceived conflicts.").

[129] See, e.g., SIFMA Letter at p. 5 ("SIFMA believes that conflicts created in the normal course of a securitization are sufficiently known by, or disclosed to, investors and do not fall under the intended scope of Section 621.").

disclosures to investors in ABS, which generally should include appropriate disclosure as to conflicts of interest between investors and the securitization participant that would be material to investors.[130] While we have not identified all circumstances in which a transaction potentially could be characterized as involving or resulting in material conflicts of interest within the meaning of the proposed rule and Securities Act Section 27B, we seek comment on whether certain types of conflicts relating to an investor could be managed through disclosure. We seek comment about the value of disclosure as a means to manage conflicts of interest, while keeping in mind the limits of disclosure.[131] Various provisions of the federal securities rules and laws address actual and potential conflicts of interest in a variety of ways, including through the use of disclosure. We ask that commenters consider the use of the disclosure in the federal securities laws and rules or other areas, such as SRO rules, and reference those laws or rules and their experiences with those laws or rules in their responses to the questions below where applicable.

As discussed in further detail below, Section 28 of the Securities Act provides the Commission with authority to adopt conditional or unconditional exemptive rules or regulations "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[132] We solicit comment as to whether, in some circumstances, material conflicts of interest that would be prohibited under Section 27B and the proposed rule could be addressed sufficiently through a conditional exemption. Specifically, provided the Commission were able to make the findings required by Securities Act Section 28, the Commission could require disclosure, as a condition to an exemption, to allow securitization

[130] We are not addressing the quality or adequacy of typical disclosures in ABS offerings, but are simply noting that such disclosure typically does occur in connection with such offerings.

[131] 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin). In addition, we note that disclosure that is made subsequent to an ABS transaction would not be appropriate in managing conflicts of interests because an investor would have already made an investment decision regarding whether or not to purchase the ABS.

[132] 15 U.S.C. 77z-3. See infra note 135.

participants to engage in what otherwise would be prohibited behavior under Section 27B and the proposed rule.

Request for Comments regarding Disclosure

96. We seek commenter input regarding whether or not disclosure would be useful in this context and why. We seek commenter input regarding whether or not disclosure would adequately improve the alignment of the interests of securitization participants and investors and whether utilizing disclosure in this manner would adequately protect the public interest and the interests of investors. Please provide specific examples (e.g., disclosure that a particular entity, whether or not a securitization participant, directly or indirectly selected the pool of assets or disclosure of other types of information). If you believe that specific disclosure would be appropriate, please explain under what circumstances and what level of detail should be required.

97. Are there conflicts of interest associated with specific types of transactions or activities that should be or could be managed through disclosure?[133] How would such an approach be incorporated in the context of the proposed rule? Should the use of disclosure in lieu of a complete prohibition apply to specific conflicts and not others? Which? What level of detail should any such

[133] See, e.g., SIFMA Letter at p. 4 through 11 (suggesting (i) "To the extent the risk transfer dynamic between ABS sponsors and asset originators and investors constitutes a conflict of interest, this potential conflict is best addressed through disclosure," (ii) "Potential conflicts arising in connection with these types of liquidity facilities should be disclosed to investors and otherwise permitted," (iii) "Disclosure of the existence of control rights and transaction parties entitled to exercise such rights should be sufficient to inform investors of the possibility of such conflicts," (iv) "Potential conflicts of interest arising in a transaction with an affiliated servicer should be disclosed to investors and otherwise permitted under the scope of Section 621," (v) "Potential conflicts arising in a transaction with an affiliated trustee (to the extent permitted by existing law) should be disclosed to investors and otherwise permitted under the scope of Section 621," and (vi) "Each securitization waterfall should clearly set forth the priority of payments for investors, including which payments are made prior to payments to investors, which disclosure should be adequate to permit the continuance of these arrangements.").

disclosures include? Should any such disclosures include details about specific transactions or activities that the securitization participant plans to engage in, or has engaged in, relating to the ABS? Is a substantial level of detail effective or useful?

98. Are there circumstances in which any such disclosure might be impracticable or ineffective? For example, if a securitization participant desired to effect a transaction several months after the closing, how might it be feasible for the securitization participant to send disclosures at that time? Would the securitization participant be able to identify all ABS investors to whom disclosures should be, or would be required to be, sent? Would disclosure of transactions that occurred long after the closing be useful, effective or appropriate?

99. Should the use of disclosures in lieu of a complete prohibition be limited to offerings involving certain types of ABS investors? If yes, please specify which ABS investors and why. Why might disclosure be adequate for some ABS investors but not others? What characteristics should a securitization participant use in determining whether an ABS investor needs particular disclosure? Are there some types of ABS investors for which disclosure should never be sufficient in this context? Should disclosures include risk disclosure statements for certain types of ABS investors? If so, which ones? If not, why not?

100. If disclosure were used in the context of proposed Rule 127B, in what format or structure should such disclosure be made? What information should be disclosed? Are there existing documents that could be used to make

disclosures to ABS investors? Please specify which documents and explain why they would be appropriate. Conversely, please identify existing documents that would not be appropriate sources for disclosure. Please explain why.

101. We seek commenter input regarding the manner in which disclosure could be made so that it is timely, effective, and provides a meaningful opportunity for ABS investors to evaluate the conflict of interest. Please provide examples of disclosure that would be timely, effective, and provide a meaningful opportunity for ABS investors to evaluate a conflict of interest. Please provide examples of disclosures that would not be timely, effective, or provide a meaningful opportunity for ABS investors to mitigate the conflict of interest.

102. In order for disclosure to be timely, is there a specific time period prior to an ABS transaction in which disclosure should be made? Please explain. Alternatively, should disclosure be made within a reasonable time prior to an ABS transaction in order to permit an ABS investor an opportunity to evaluate the conflict of interest? Conversely, please discuss when disclosure might be made so far in advance of an ABS transaction that it would not be useful.

103. In order for disclosure to be effective, please discuss the level of detail that would permit a reasonable ABS investor to understand the conflict of interest. Please provide examples of disclosure that would be effective as well as examples of generic disclosures that would not be useful to ABS investors.

104. We seek commenter input regarding what explicit disclosures might be appropriate so that an ABS investor could meaningfully understand a conflict of interest. We seek commenter input regarding whether specific or enhanced

disclosures should be made in connection with more complex ABS. Please identify the type of ABS and discuss the additional disclosures.

105. If disclosure were used in the context of proposed Rule 127B, should some or all of the securitization participants be required to make and maintain records to document disclosure, or to document that disclosure was made, to qualified customers? If so, what types of records should the securitization participant be required to make and maintain? We ask that commenters include in their response a description of the manner in which they would demonstrate compliance that disclosure was made to ABS investors.

106. Are there additional steps that securitization participants that seek to manage conflicts of interest through the use of disclosure should be required to take with regard to disclosure, such as notifying a regulator (e.g., a designated examining authority or other relevant regulatory agency) of any failures to disclose, or ABS investor complaints?

107. Are there specific types of transactions or activities that should or could be managed through consent? Should the use of consent only apply to specific conflicts and not others? Which? Are there circumstances in which obtaining consent might be impracticable or ineffective? Should consent be limited to certain types of customers? Would consent prior to the first sale in the offering (or a reasonable time prior to first sale) provide adequate investor protection? Should consents, if permitted, require customers to acknowledge receipt, or acknowledge understanding of the matters to which they are consenting? Should a securitization participant be required to obtain new consents for each

new transaction, or should securitization participants be permitted to rely on consents indicating that the securitization participant may also enter into transactions in the future that may result from potential conflicts of interest? Would consents indicating potential future transactions be useful or effective?

108. Please discuss the benefits and costs if a disclosure-based exemption were or were not adopted. In addition, please discuss any positive or negative impact on investors of providing or not providing a disclosure-based exemption. For example, would a disclosure-based exemption avoid potential prohibitions or restrictions (or potential chilling effects) on transactions that might otherwise arise under the proposed rule and that might have the unintended consequence of limiting investment opportunities that – if all the risks were fully disclosed – investors would want to have? Would a disclosure-based exemption adversely impact investor protection? If so, how? Similarly, would a disclosure-based exemption alleviate or exacerbate any unintended consequences of the proposed rule related to investors, investor protection, liquidity, capital formation, the maintenance of fair, orderly and efficient markets, and the availability of credit to borrowers (through the assets underlying an ABS)?

C. Exemptive Authority

While Section 27B of the Securities Act prohibits securitization participants from engaging in transactions that involve or result in material conflicts of interest, Section 28 of the Securities Act provides the Commission with authority to adopt conditional or unconditional exemptive rules or regulations.[134] We seek comment on whether and to what extent we should

[134] Section 28 of the Securities Act provides that "the Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or

consider exemptive rules or regulations for certain transactions or activities otherwise covered by Section 27B, including conditional exemptions based on information barriers or disclosure.

109. We ask for comment about any benefits or disadvantages of using the general exemptive authority in Section 28 of the Securities Act to address circumstances where commenters believe the application of the prohibition under Section 27B would not be consistent with prohibiting material conflicts of interest. Are there any special considerations relating to offshore sales of ABS that we should take into account in the proposed rule?

110. Are there other considerations related to cross-border sales of ABS that should be contemplated in connection with the proposed rule (e.g., securitizations by offshore affiliates of U.S. entities, offshore securitizations sold to U.S. investors both in and outside of the U.S.)? Please provide comments.

111. Please discuss the ways in which the proposal, if adopted, would affect the ABS market, ABS investors, underwriters, placement agents, initial purchasers, or sponsors and the affiliates or subsidiaries of such entities.

V. General Request for Comment

The Commission seeks comment generally on all aspects of proposed Rule 127B, including on our approach to the proposed rule and implementation of Securities Act Section 27B as enacted by Section 621 of the Dodd-Frank Act. Are there other approaches that we should consider? We seek commenter input regarding whether and how the proposal might positively or negatively impact investor protection, the maintenance of fair, orderly, and efficient

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transactions, from any provision or provisions of this title or of any rule or regulation issued under this title, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." 15 U.S.C. 77z-3.

markets (including, e.g., investment opportunities or liquidity), and capital formation. Commenters are requested to provide empirical data or economic studies to support their views and arguments related to the proposed rule. In addition to the questions above, commenters are welcome to offer their views on any other matter raised by the proposed rule. We note that comments are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and if accompanied by alternative suggestions to our proposal where appropriate.

VI. Paperwork Reduction Act

Certain provisions of the proposed rule would impose new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[135] The Commission is submitting the proposed collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. OMB has not yet assigned a control number to the proposed collections of information.

A. Summary of Collections of Information

Proposed Rule 127B might cause securitization participants to rely on appropriate contractual covenants or representations – either between other securitization participants or with relevant third parties – to determine compliance with the rule. For example, if a third party was directly or indirectly involved in structuring the ABS or selecting assets underlying the ABS, a securitization participant might rely on contractual assurances (from the third party or from another securitization participant who had obtained such assurances from the third party) that the

[135] 44 U.S.C. 3501 et seq.

third party would not engage in certain short transactions. We expect that, to facilitate compliance with the proposed rule, securitization participants might enter into new contractual covenants.

B. Proposed Uses of Information

Although proposed Rule 127B does not require that a securitization participant enter into contractual covenants when it allows a third party, directly or indirectly, to structure the ABS or select assets underlying the ABS, the burden of compliance would fall on the securitization participant. Accordingly, entering into such contractual covenants might assist securitization participants in managing compliance with the proposed rule. To the extent that a securitization participant were a regulated entity, we anticipate that this collection of information would be used by the Commission staff in its examination and oversight program. Further, to the extent that a securitization participant were a member of an SRO, we anticipate that this collection of information would be used by the SRO staff in its examination and oversight program.

C. Respondents

According to issuance data from Asset-Backed Alert, supplemented with data from Securities Data Corporation ("SDC"), from 2005 through 2010, there were approximately 751 registered asset-backed transactions yearly. Therefore, the Commission preliminarily estimates that there are approximately 751 securitization participant respondents that might enter into contractual covenants concerning the involvement of a third party in the transaction.[136]

The Commission seeks comment as to the accuracy of the above estimates and all other estimates in this section. The Commission also seeks data regarding the yearly estimated number of unregistered asset-backed transactions.

[136] We note that the actual number of respondents could be less than 751 as some respondents may be involved in more than one asset-backed transaction.

D. Total Annual Reporting and Recordkeeping Burdens

Proposed Rule 127B might cause securitization participants to rely on appropriate contractual covenants or representations to determine compliance with the rule. While the Commission does not have details concerning the nature of the contractual relationships that exist among and between securitization participants and third parties involved in an asset-backed transaction, we expect that these parties typically enter into contractual relationships to protect their interests. For example, we believe that securitization participants likely enter into confidentiality agreements with other parties concerning the structuring of the transaction. We also understand that most asset-backed transactions are conducted as private placements and that in connection with each of these private placements there is a purchase and sale agreement for the equity piece of the transaction. To the extent that third parties and other securitization participants are parties to these confidentiality agreements and purchase and sale agreements, we believe the proposed rule would impose minimal additional burdens on the securitization participants as it would require only an additional covenant to existing contracts.

Because the Commission expects that most securitization participants already enter into some form of a contractual relationship with other securitization participants and third parties involved in the transaction, from discussions with industry experts we estimate that, on average, it would take approximately 2 to 10 internal and 2 to 10 external hours to draft and negotiate a contractual covenant assuring compliance with proposed Rule 127B into an existing contract. For PRA purposes, we conservatively use the upper end of this range and estimate 10 internal hours from a compliance attorney, and also 10 external hours for outside legal services that

would cost $4,000 per contract.[137] Further, we preliminarily estimate that only about half of all securitization participants already have some type of existing contractual arrangements. Accordingly, we estimate that the total annual burden of those securitization participants who already have contractual arrangements would be approximately 3,760 internal burden hours (10 hours x 376 contracts) and approximately $1.5 million ($4,000 per contract x 376 contracts) in external costs.

To the extent there are not existing contracts in place between the securitization participants and third parties, we believe the proposed rule would impose more significant burdens and estimate that it would take approximately 20 internal hours and 20 external hours at a cost of $8,000 (using the estimated $400 per hour cost for outside legal services noted above) per contract to draft and negotiate the contractual covenant. In this instance, we estimate that the total annual burden would be approximately 7,500 internal burden hours (20 hours x 375 contracts) and approximately $3.0 million ($8,000 per contract x 375 contracts) in external costs.

In summary, we estimate that the collection of information would require an annual burden of 11,260 internal hours and $4.5 million in external costs.[138]

E. Collection of Information is Mandatory

The collection of information is not mandatory, however, we recognize that securitization participants may be likely to engage in the collection of information to manage their compliance with the proposed rule.

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[137] This is based on an estimated $400 per hour cost for outside legal services. This is the same estimate used by the Commission for these services in the proposed consolidated audit trail rule: Exchange Act Release No. 62174 (May 26, 2010); 75 FR 32556 (June 8, 2010).

[138] These costs are all monetized in the cost-benefit analysis section of this release. The estimated dollar costs for the internal hours are $3.6 million ($320 per hour x 11,260 hours), where the $320 per hour figure for a compliance attorney is from SIFMA's *Management and Professional Earnings in the Securities Industry 2010*, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits and overhead. The total annual monetized PRA cost for the cost-benefit analysis is therefore $8.1 million ($3.6 million in monetized internal costs + $4.5 million in external costs).

F. Confidentiality

The collection of information is not required to be filed with the Commission or otherwise made publicly available. However, as discussed above, if a securitization participant were a regulated entity, we anticipate that this collection of information would be used by the Commission staff in its examination and oversight program. Further, as discussed above, if a securitization participant were an SRO member, we anticipate that this collection of information would be used by the SRO staff in its examination and oversight program.

G. Request for Comment

We invite comment on these estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to:

- evaluate whether the proposed collection of information is necessary for the performance of our functions, including whether the information will have practical utility;
- evaluate the accuracy of our estimates of the burdens of the proposed collections of information;
- determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and
- evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements of the proposed rules should direct them to (1) the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503; and (2) Elizabeth M. Murphy, Secretary, Securities and

Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with reference to File No. S7-XX-XX. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File No. S7-XX-XX, and be submitted to the Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

VII. Economic Analysis

A. Introduction

We are proposing Securities Act Rule 127B to implement the requirements of new Section 27B of the Securities Act,[139] as mandated under the Dodd-Frank Act. The proposed rule would prohibit securitization participants from engaging in transactions that would involve or result in a material conflict of interest with respect to an investor in such ABS. The proposed rule includes exceptions, as established by Congress, from this prohibition for certain risk-mitigating hedging activities, bona fide market-making, and liquidity commitments.

We are sensitive to the benefits and costs of our rules. Some of those costs and benefits stem from statutory mandates, while others are affected by the discretion we exercise in implementing those mandates. We have endeavored to focus our economic analysis of the proposed rule on the policy choices under the Commission's discretion, recognizing that it may often be difficult to separate the discretionary aspects of the rule from those elements required by statute. We request comment on all aspects of the costs and benefits of the proposal, particularly

[139] 15 U.S.C. 77z-2a.

any effect our proposed rules may have on efficiency, competition, and capital formation. We particularly appreciate comments that distinguish between costs and benefits that are attributed to the statute itself and costs and benefits that are a result of policy choices made by the Commission in implementing the statutory requirements.

B. Benefits

Consistent with the statute, the proposed rule is intended to benefit investors by better aligning incentives of securitization participants with those of investors in the ABS. For example, the proposed rule would apply to an underwriter or sponsor effecting a short transaction in an ABS within the prohibited time period. Although the possibility of short selling the securities during any period of time may create conflicting incentives for securitization participants, the proposed rule is intended to prevent such conflicting incentives during the prohibited time period as required under the statute.

We believe that our decision not to define "material conflict of interest" in the proposed rule would provide the benefit of better investor protection. An inadvertently narrow definition of that term could have the unintended consequence of excluding from the proposed prohibition certain activities undertaken by securitization participants that involve material conflicts of interest. Furthermore, by not limiting the definition to a specific list of material conflicts of interest, the proposed rule may help prevent behavior involving material conflicts of interest that have not come to the attention of investors or the Commission, or that may develop in the future. The broad investor protection provided by the proposed rule could alleviate investor concerns that the securities they purchase might be tainted by conflicts of interest. This would reduce adverse selection costs in the ABS market and encourage investment in ABS to the extent that investors consider material conflicts of interest important in their investment decisions.

As discussed above, one way in which securitization participants might manage their compliance with the proposed rule given the practical difficulties for a securitization participant in determining third-party involvement in the securitization, is through contractual assurances.[140] Similarly, if a securitization participant were a regulated entity, such assurance would be useful information for Commission staff (and, in appropriate circumstances, SRO staff) in its compliance and oversight program. We believe that the use of such assurances would help to prevent transactions that result in a misalignment of interests between securitization participants and ABS investors. Similar or different benefits may or may not ensue if different tools were used to manage compliance. We seek comment regarding the benefits to investors, securitization participants, and the marketplace stemming from the Commission's proposed rule.

C. Costs

We recognize that the proposed rule could impact the scope of some current activities undertaken by underwriters, sponsors, and other securitization participants, such as curtailment or cessation of otherwise common activities which, in turn, could lead to potential costs for such participants and the broader securitization market. As will be described below, material conflicts of interest might only arise between an investor and a particular securitization participant, which might lead the investor to seek a relationship with another securitization participant. However, as illustrated in some of the examples in Section IIIC above, other material conflicts of interest arise as a result of the nature or structure of the transaction as a whole (without regard to the identity of the securitization participants involved), such that these types of transactions might be effectively prohibited. In such cases, there might be costs to the marketplace as a whole as investors and securitization participants seek alternative and potentially less efficient transaction structures to effect a similar investment strategy in a way that would not result in a material

[140] See supra Section IIIA(v)(b).

conflict of interest, or if investors and securitization participants were unable to effect their investment strategies at all. For example, a type of synthetic collateralized debt obligations (CDOs) – balance sheet CDOs - would generally be prohibited under the proposed rule (see Example 3B). Though securitization participants might be able to effect similar types of transactions in the form of non-synthetic ABS (which generally would not be prohibited by the above interpretation of material conflict of interest), there may be reasons why a synthetic form of a balance sheet CDO is a more efficient form of the transaction from the standpoint of the issuer or investors. In addition, this aspect of the proposed rule would limit the hedging options available to a lender who originated assets without the intent to securitize them.[141] Such a lender would be able to sell or securitize assets on its balance sheet, but not synthetically, even if doing so is economically optimal. Thus, a prohibition on structuring balance sheet CDOs might have a negative effect on efficiency and capital formation.

We recognize that by not defining the phrase "material conflict of interest" for purposes of this particular proposal, the proposed rule could create some regulatory uncertainty, which could lead to costs in the asset-backed securitization process. Securitization participants could avoid undertaking certain activities out of concern that the proposed rule would apply to such activities, despite the securitization participant's view that such activities did not create or result in a material conflict of interest. In particular, larger entities with multiple business lines could potentially have, as a dynamic of their structure and relationships with customers (and others), conflicts that – without sufficiently specific guidance – would be perceived as material and unavoidable. Thus, we acknowledge that many of the potential conflicts and costs discussed could disproportionately impact larger, multi-faceted, and diversified firms that offer a variety of

[141] See supra note 100.

services. Below, we identify a number of these potential costs and seek comment on whether there are ways to mitigate them..

Generally, we recognize that securitization participants would incur costs in updating or creating new procedures to monitor for potential material conflicts of interest that would be prohibited under the proposed rule. The magnitude of these potential costs could be more pronounced because we have not proposed definitions of terms, including a definition as to what is material or a conflict of interest. The proposed rule may result in creating an environment in which even the potential for relationships or transaction structures that would result in a material conflict of interest would be reduced. For example, there often may be several independent, unaffiliated parties under the definition of a securitization participant (e.g., underwriters and placement agents) for a given asset-backed securitization. If each such participant in an asset-backed securitization were effectively conflicted out of the process, the asset-backed securitization market could in some situations cease to function efficiently. We recognize that such a restriction on potential participants to an asset-backed securitization could have costs, as well as potential unintended consequences on the ability of market participants to structure asset-backed products. We seek comment as to how the proposed rule might be applied or modified to address such situations.

Because we are not proposing to define the term "material conflict of interest", the effect could amplify the potential costs from the statutory prohibition on a securitization participant's existing and/or potential future client relations. For example, if an existing or potential client approached a firm to request that it undertake a certain conflicted transaction, the firm might determine not to do so because of the concern that the transaction could be viewed as a material conflict of interest between the securitization participant and investors in the ABS if one of the

exceptions to the proposed rule were not available. Under these circumstances, the client might need to approach another financial firm to conduct the desired transaction. In some cases, the financial firm might not be able to determine with a sufficient level of certainty that a conflict of interest did not exist. As described above, in certain circumstances, where the transaction structure itself (without regard to the identity of the parties) involved a conflict of interest, the investor might have to forego the ABS investment entirely and thus might be unable to participate in a particular investment opportunity that it desires. A broad interpretation by market participants of the term "material conflict of interest" in the rule could therefore cause the securitization participant to lose profits or fees that would have resulted from the client's business with respect to the conflicting transaction and, potentially, future profits and fees if the client determines to take some of its future business to other firms, or might cause investors to lose investment opportunities they might otherwise have. We recognize that firms expend considerable time and resources to cultivate relationships with their clients and, thus, if the proposed rule were to diminish (beyond the statutory mandate in Securities Act Section 27B) existing relationships or impede the formulation of new relationships, the impacts of the proposed rule could be significant to firms and the broader marketplace.

In addition, clients also could bear undesirable costs by losing the ability to utilize firms with particular expertise or specialization in certain areas due to real or perceived material conflicts of interest. Clients might also incur costs in searching for a different firm to consummate a transaction, where they have a preexisting relationship that they too have invested resources into developing. In addition, to retain their ability to utilize specific firms for non-ABS related transactions, some potential clients might choose to forego the ABS investment. We recognize that if the proposed rule were to cause an investor to forego an ABS investment

entirely, there could be costs incurred by the investor in terms of seeking out alternative investments as well as the loss of return from the ABS investment. We seek commenter input regarding other costs that might be incurred by investors from foregoing an ABS transaction entirely.

All securitization participants are subject to the proposed rule's prohibition on material conflicts of interest. Thus, although the inability to conduct a transaction that would result in a material conflict of interest between the securitization participant and investors in the ABS might have a negative impact on certain client relations and could require the client to go elsewhere to conduct the requested transaction, presumably all securitization participants and their clients would potentially encounter similar issues. As a result, while a securitization participant could lose the business of one client due to the proposed rule, in some cases it also could gain the business of another securitization participant's client, where that securitization participant could not conduct the transaction due to a material conflict of interest. Collectively, based upon the analysis above related to firm-client relationships, we acknowledge that the potential loss of customers could be more costly to firms than the potential gain of other clients.[142] In turn, clients could incur costs in having to seek out new firms rather than utilizing firms with which they have preexisting, preferred business relationships. In sum, we recognize that both firms and clients could bear costs that may, in turn, impact the broader market, and we seek comment regarding these costs of the Commission's proposed rule.

Further, we recognize that there could be some instances in which the inability of a securitization participant to conduct a transaction that would result in a material conflict of

[142] See, e.g., Myron B. Slovin, Marie E. Sushka & John A. Polonchek, The Value of Bank Durability: Borrowers as Bank Stakeholders, 48 J. FIN. 247 (1993); Mitchell A. Petersen & Raghuram G. Rajan, The Benefits of Firm-Creditor Relationships: Evidence from Small Business Data, 49 J. FIN. 3 (1994); Sreedhar Bharath, Sandeep Dahiya, Anthony Saunders & Anand Srinivasan, So What Do I Get? The Bank's View of Lending Relationships, 85 J. FIN. ECON. 368 (2007).

interest could adversely affect the price of the ABS. Consistent with Section 27B, the proposed rule provides exceptions for risk-mitigating hedging activity, liquidity commitments, and bona fide market-making. A proposed transaction that results in a prohibited material conflict of interest, however, might not fit into one of these exceptions and, thus, would be subject to the general prohibition in the proposed rule. Although the transaction, if executed, could ultimately have a positive impact on the ABS, it would not be permitted to be undertaken under the proposed rule. This could impose costs both on the securitization participant and on investors in the ABS resulting from a decline (or foregone increase) in the value of the ABS. We seek comment on these pricing-related costs of the proposed rule.

The proposed rule could impose certain costs upon departments within a firm not directly involved with the securitization process by impacting their ability to conduct transactions that could result in a material conflict of interest with investors in an ABS for which the firm is a securitization participant. The scope of the proposed rule could require monitoring for potential material conflicts of interest within all or many departments of the firm. If any department's proposed transaction were determined to raise a potential material conflict of interest, that department could have to abandon the proposed transaction or wait until the proposed rule's prohibition period ended. We seek comment concerning any costs that could be incurred with respect to the various activities among different departments within one firm. We also seek comment concerning whether the operation of information barriers within firms might suggest the need for the Commission to provide interpretations to the proposed rule to exclude activity that should not be captured.

As required by Securities Act Section 27B, the scope of securitization participants in the proposed rule includes affiliates and subsidiaries of underwriters, placement agents, initial

purchasers, and sponsors. In some instances, the activities of an affiliate or subsidiary may not be known to the underwriter, placement agent, initial purchaser, or sponsor, and could, inadvertently, involve or result in a material conflict of interest with the investors in the ABS. Monitoring the activities of the affiliate or subsidiary for conflicts could be difficult, especially when there are existing information barriers between the entities, and could impose costs. For this reason, we seek comment concerning any costs that could be incurred by affiliates and subsidiaries.[143]

We recognize the statutory prohibition and thus the proposed rule may have significant costs with respect to how firms and clients establish, maintain, and benefit from relationships. For instance, because larger financial entities tend to form in an effort to achieve synergies and economies of scope in combining and offering multiple services, restrictions on such activities could lead to changes to their business activities that could reduce firm earnings. In part because of the breadth of the statutory provision and, thus, the proposed rule, these potential changes could have some disruptive effect on the firms, their clients, and the broader marketplace, reducing current efficiencies that may exist. Restricting the ability of securitization participants to maintain relationships that service multiple objectives could ultimately impact negatively both financial firms and their clients' ability to conduct economically efficient activities. In addition, firms with particular specialization in given areas that were precluded from providing such expertise due to perceived material conflicts could disadvantage clients.

While not required by the proposed rule, we recognize that one way that securitization participants might seek to facilitate their compliance with the proposed rule is through

[143] See supra Section IV (noting the recognition of information barriers in Section 15(g) of the Exchange Act, Exchange Act Rule 14e-5, and Regulation M under the Exchange Act).

contractual assurances.[144] The costs associated with such assurances could be minimal if contracts are currently utilized and could be easily modified to reflect the assurances (e.g., standardized industry agreements, purchase and sale agreements, and confidentiality agreements). However, in circumstances where there are no agreements in place, there could be more significant costs for parties to negotiate a new agreement in its entirety. Other costs may or may not ensue if a tool other than a contractual assurance were used to manage compliance with the proposed rule. We seek commenter input regarding whether and how behaviors could change as a result of the use of contractual assurances that might increase or decrease costs.

We also note that there are potential costs associated with a clarification we propose to one of the exceptions under the proposed rule.[145] The proposed rule provides exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making, which are consistent with Securities Act Section 27B. We seek comment on the scope of the risk-mitigating hedging exception in the proposed rule in a manner that we believe is consistent with the intent of the legislation, but which could help securitization participants and other industry participants better understand whether an activity qualifies under the exception. In the proposed rule, we seek comment on the application of the proposed exception for risk-mitigating hedging activity to "mitigating" the consequences of a risk. We believe that risk mitigation would permit a securitization participant to limit the consequences of a risk, which could facilitate investor protection. We also seek comment on how "exposures" arise and whether the risk-mitigating hedging exception should apply to exposures as well as positions and holdings. Although we believe that such clarification would allow firms to better reduce and mitigate specific risks that arise out of underwriting, placement, initial purchase, or sponsorship of an ABS, we recognize

[145] See supra Section IIIB(i).

that securitization participants would bear an additional cost in dedicating resources to determine whether their activities fall within this exception as interpreted beyond any cost they already would bear due to the existence of the statutory exception. Similar to the costs that could be incurred for compliance with the proposed rule, securitization participants could also face costs in their assessment of whether their activities qualify for the risk-mitigating hedging exception. We seek comment with respect to all aspects of the proposed risk-mitigating hedging exception.

D. Related Considerations

The coverage of Securities Act Section 27B and, thus the proposed rule which tracks the statute, could negatively impact economic efficiency both from the point of view of the securitizations participants, and sometimes also from the point of view of investors who seek to invest in the pools that back the ABS if certain ABS transactions did not get consummated because of the scope of the proposed rule.

The scope of activities under the proposed rule that could constitute potential conflicts of interest could potentially impact competition among asset-backed securitization market participants. For instance, larger entities with multiple business lines could have, as a result of their structure, unavoidable material conflicts of interest. An investor that utilizes such entities for multiple services could have to switch to competitors, or depending on the structure of ABS, forego the ABS transaction. Under these circumstances, the investor could incur additional search costs and find its business processes less efficient due to the loss of relationships.[146] The securitization participant could also potentially lose any profits or fees that would have resulted from the investor's business with respect to the conflicting transaction and, potentially, future profits and fees if the investor takes future business to another firm. In addition, investors and

[146] See, e.g., Myron B. Slovin, Marie E. Sushka & John A. Polonchek, The Value of Bank Durability: Borrowers as Bank Stakeholders, 48 J. Fin. 247 (1993).

financial firms could both lose the financial benefits gained from established, cultivated relationships with securitization participants. This could be potentially costly to both investors that have established relationships with firms and, ultimately, to investors in the broader marketplace as a contraction in the securitization process could ensue. As firm-investor relationships are costly to develop, but valuable to maintain, firms and such investors might find application of the proposed rule to be disruptive in some circumstances and, thus, the broader marketplace could experience some inefficiency, as well as unintended impacts on capital formation.

In addition, given that the ABS offering process can involve multiple lead underwriters and an underwriting syndicate with several members, the proposed rule could have a multiplicative effect by conflicting out several unaffiliated financial institutions. If an attempt to limit this multiplicative effect through reducing the number of parties involved in a securitization negatively affects the manner in which ABS are structured and underwritten, this might have a negative impact on the efficiency of the securitization process. As previously noted, the scope of the statutory prohibition could amplify the inability of departments within a securitization participant to conduct business as they have in the past, which could increase financial costs, as well as heighten market inefficiency. These inefficiencies could ultimately negatively impact investors in ABS, as well as the consumers whose loans back the ABS.

Request for Comments regarding the Economic Analysis

We seek comments and empirical data on all aspects of this Benefit-Cost Analysis, including identification and quantification of any additional benefits and costs. Specifically, we ask the following:

112. Are there any additional benefits that may arise from the proposed rule? Or, are there benefits described above that would not be likely to result from the proposed rule? If so, please explain these benefits or lack of benefits in detail.

113. Are there any additional costs that may arise from the proposed rule? Or, are there costs described above that would not be likely to result from the proposed rule? If so, please explain these costs or lack of costs in detail.

114. Do the types, or extent, of any benefits or costs from the proposed rule differ between certain securitization participants? For example, do potential benefits or costs differ in their application to underwriters as opposed to placement agents? Please explain.

115. Do the types, or extent, of any benefits or costs from the proposed rule differ between certain kinds of asset-backed securitizations? For example, do any benefits or costs differ between ABS and synthetic ABS? If so, how do the benefits or costs differ?

116. Can you quantify costs that might arise in relation to monitoring for transactions that would result in a material conflict of interest between a securitization participant and investors in the ABS? Do securitization participants have existing procedures that might help mitigate potential costs?

117. With respect to potential costs related to the proposed rule prohibiting transactions by affiliates, subsidiaries, or another department within the firm that would result in a material conflict of interest with investors in the ABS, is it possible to quantify the cost of not being permitted to undertake such transactions?

118. Should the Commission consider interpretations that would be consistent with the goals of Section 27B and the proposed rule, but that would further reduce costs? If so, what areas of interpretation should the Commission explore?

119. What costs would be incurred by securitization participants, investors and others if certain synthetic ABS (e.g., balance sheet CDOs) could no longer be created? We ask commenters to describe any resulting impacts on the ABS market and lending institutions if this were to occur, and provide supporting data if available.

120. We solicit comment on the impact of the proposed rule on efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

IX. Small Business Regulatory Enforcement Fairness Act

Under the Small Business Regulatory Enforcement Fairness Act of 1996,[147] a rule is "major" if it has resulted, or is likely to result, in:

- An annual effect on the U.S. economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposed rule would be a "major" rule for purposes of the Small Business Regulatory Enforcement Fairness Act. In addition, we solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;

[147] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

- Any potential increase in costs or prices for consumer or individual industries; and
- Any potential effect on competition, investment, or innovation.

X. Regulatory Flexibility Act Certification

Pursuant to 5 U.S.C. 605(b), the Commission hereby certifies that the proposed rule, if adopted, would not have a significant economic impact on a substantial number of small entities. The proposed rule prohibits transactions by underwriters, placement agents, initial purchasers, or sponsors of an ABS, or any affiliate or subsidiary of such entities, that would involve or result in a material conflict of interest with investors in the ABS. Based on our current available data, we do not believe that a substantial number of underwriters of ABS would meet the definition of a small broker-dealer for purposes of the Regulatory Flexibility Act.[148] In addition, we are aware of only one sponsor that would meet the definition of a small entity for purposes of the Regulatory Flexibility Act.[149] Thus, the Commission does not believe the proposed rule, if adopted, would have a significant economic impact on a substantial number of small entities.

XI. Statutory Authority and Text of Proposed Rule

The Commission is proposing new rule 127B (17 CFR 230.127B) pursuant to authority set forth in Sections 10, 17(a), 19(a), 27B, and 28 of the Securities Act.

List of Subjects

17 CFR Part 230

Advertising, Brokers, Reporting and recordkeeping requirements, Securities.

[148] This is based on the ABS Database, which captures information on all asset-backed and mortgage-backed securitization issues sold worldwide. The database is compiled by the editors of Asset-Backed Alert. A detailed description of the database is provided at http://www.abalert.com/about_abs.php.

[149] This is based on data from the ABS Database.

Text of the Proposed Rule

For the reasons set out above, Title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 230 – GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for Part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 781, 78m, 78n, 78o, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, 80a-37, and Pub. L. 111-203, §939A, 124 Stat. 1376, (2010) unless otherwise noted.

* * * * *

2. Add § 230.127B to read as follows:

§230.127B Conflicts of interest relating to certain securitizations.

(a) Unlawful activity. An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this rule shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

(b) Excepted activity. The following activities shall not be prohibited by paragraph (a) of this section:

(1) Risk-mitigating hedging activities. Risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings; or

(2) *Liquidity commitment.* Purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, to provide liquidity for the asset-backed security; or

(3) *Bona fide market-making.* Purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security.

By the Commission.

Elizabeth M. Murphy
Secretary

Dated: September 19, 2011