MEMORANDUM

TO: File No. S7-14-11

FROM: Arthur Sandel
Special Counsel
Office of Structured Finance
Division of Corporation Finance
U.S. Securities and Exchange Commission

RE: Conference call with representatives of the Securities Industry and Financial Markets Association

DATE: December 19, 2013

On December 19, 2013, Katherine Hsu, Arthur Sandel and David Beaning of the Division of Corporation Finance and Sean Wilkoff of the Division of Economic and Risk Analysis participated in a conference call with the following representatives of the Securities Industry and Financial Markets Association ("SIFMA"): Chris Killian of SIFMA; Michael Berg of Bank of America Corporation; Stephan Meili of Barclays; Charles Sweet of Bingham McCutchen LLP; Bianca Russo of JPMorgan Chase & Co.; James Lee of Morgan Stanley; and Stephen Hoffman of Wells Fargo.

The participants discussed topics related to the Commission's August 28, 2013 joint proposed rules regarding credit risk retention. Handouts are attached to this memo.

Attachment

CREDIT RISK RETENTION RE-PROPOSAL

DECEMBER 10-11, 2013

Priority Issues

Of the issues identified by SIFMA's sponsor and dealer members, these 6 are the most important:

1. Restrictions on cashflows to EHRI
2. Fair value calculation, timing & disclosure
3. QM = QRM & Blended Pools
4. Legacy assets
5. Representative sample and participations
6. Cross-border issues

1. Restrictions to Cash Flows on EHRI

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Summary of Proposed Restrictions

- As proposed, the sponsor must, as of the closing date and using the same assumptions and discount rate used in its fair value calculation with respect to the horizontal interest:
  - Determine the “closing date projected cash flow rate” by dividing the fair value of all projected cash flows to the horizontal interest on each payment date by the fair value of all projected cash flows to the horizontal interest through maturity;
  - Determine the “closing date projected principal repayment rate” by dividing the amount of all projected principal cash flows to be paid to all ABS interests on each payment date by the aggregate principal amount of all ABS interests issued in the transaction; and
  - Certify to investors that the closing date projected cash flow rate for each payment date does not exceed the closing date projected principal repayment rate for that payment date.
- The Agencies also requested comment on an alternative method of implementing payment restrictions on an eligible horizontal residual interest. Under this alternative, on any payment date, “the cumulative amount paid to an eligible horizontal residual interest [could] not exceed a proportionate share of the cumulative amount paid to all holders of ABS interests in the transaction.”

Problems with Proposed Restrictions

- The Agencies' proposed approach does not work for securitization structures where the investors' entitlements to principal and interest are treated separately.

  - For example, in some cases the holders of the ABS interests sold to investors are entitled to receive no, or limited, principal payments for a period of time. This might include, for example, a pass-through transaction where the asset pool contains primarily interest-only loans, so that investors may not receive principal until the refinancing or final due date of the pool loans.

  - Another example is a transaction that accounts for principal collections differently than a straight pass-through, such as by diverting principal collections during a reinvestment period during which such collections are used to acquire additional pool assets rather than being passed through to investors.

- In these structures, investors would continue to receive their coupon rates of interest, but because the closing date projected cash flow rate effectively could not exceed the closing date projected principal repayment rate for each payment date, the holder of the residual could receive nothing at all, possibly for a very long time. The purpose of this restriction is unclear.

- The cash flow belongs to the residual holder and ultimately will be paid to the residual holder. This provision will merely delay payment for no reason, since the senior classes of ABS interests will have no claim or entitlement to the withheld amounts.

Problems with Proposed Restrictions

- Another unintended result of the proposed payment limitations would be to artificially increase the size of the required horizontal residual interest.
  - If the holder of an eligible horizontal residual interest is not entitled to receive a return commensurate with the risk of the interest, that will decrease the fair value of the interest, requiring that it represent a significantly greater portion of the capital structure of the securitization in order to reach 5 percent of the fair value of all ABS interests issued.

Cashflow Restrictions Should be Eliminated

- For all of these reasons, we urge the Agencies to eliminate the proposed limitations on payments to the holder of an eligible horizontal residual interest.

- We recognize that allowing the holder of the residual to receive unlimited interest cash flows might result in the residual being paid faster than the investors' interests, but the economic and practical impediments generated by Agencies' proposal are almost insurmountable.

- We do not object to requiring the disclosure document to detail the expected cash flows on the residual interest, so investors will be able to make an informed investment decision as to whether to accept it in the context of their individual investment decisions.

If the Restrictions are Not Eliminated, they Should be Revised

- While we continue to believe that implementing the restrictions poses great practical difficulties, if the restrictions are retained in any form, they should be significantly revised.
- First, we suggest that the Agencies permit sponsors to use, at their option, either the proposed projected method of calculating the payment limitations on the eligible horizontal residual interest, or the alternative actual payment method on which the Agencies request comment.
- Second, regardless of whether the sponsor uses the projected or actual payment, it should be permitted to calculate the payment limitation in one of two separate ways.

First Suggested Alternative

- The first optional way we recommend would be based on the Agencies' primary proposal, but instead of requiring a comparison of ***all cash flows*** cumulatively paid or to be paid on the residual as of any payment date to ***all principal cash flows*** cumulatively paid or to be paid on the other ABS interests, we would compare:

  - ***all principal cash flows*** cumulatively paid or to be paid on the residual as of any payment date

    to

  - ***principal cash flows*** paid or to be paid on the other ABS interests.

- This would prohibit the eligible horizontal residual interest from being de-leveraged by means of principal payments proportionately faster than the investors are paid their principal.

- Interest payments to the holder of the eligible horizontal residual interest would not be restricted, consistent with the notion that the more subordinated an interest is, the riskier it is, and the higher the effective interest rate should be to compensate the holder for that risk.

Second Suggested Alternative

- Our second optional way would be consistent with the proposed alternative actual payment method, and would compare:
  - ***all amounts paid*** (or, in the projected method, to be paid) to the holder of the residual as of any payment date

    to

  - ***all amounts paid*** (or, in the projected method, to be paid) to the holders of the other ABS interests.

2. Fair Value Calculation, Timing, & Disclosure

Fair Value Calculation, Timing & Disclosure

- We generally support the use of fair value for the calculation of required retention amounts, at least for the proposed horizontal risk retention option.

- The re-proposal, however, creates several problems related to the timing of the calculation and disclosure of the calculation's inputs, which need to be addressed in final rules.

Fair Value - Timing of Calculation

- As proposed, fair value calculations – as well as the sizing of the retained interest, which depends on the fair value calculations – would be required to be made ***as of the closing date***.
- The interest rates on and purchase prices of all of the ABS interests in the deal, ***which are dependent on pricing***, need to be taken into account in determining fair value.
- Conversely, the timing of determination of fair value and the size of the residual must allow issuers sufficient time for issuers to prepare and make all required ***disclosures to investors***, both as specifically required by the proposed risk retention rules and as may be otherwise required by SEC regulations or anti-fraud concerns. This is especially acute with respect to the SEC's Rule 159 which would require updated documentation to be circulated if there were changes to disclosure.
- This implies that the determination needs to be made much earlier in the offering process.
- As a practical matter, it is not clear to us how these timing conflicts would be managed.

Fair Value - Disclosure

- We do not believe that all of the proposed disclosures should be required to be provided to investors as they are not material to a reasonable investor's decision whether to purchase the ABS being offered.
- Requiring this level of detail in the disclosures -- particularly, the reference data set -- could allow the reverse-engineering of proprietary models. The more detailed the disclosure that is required, the more of a risk to the proprietary nature of the sponsor's models.
- We do not object to disclosure of these items to the sponsor's primary regulatory agency, which we believe is better situated to address any compliance issues in this regard.
- Once the transaction has priced, the fair value calculus may differ substantially from that which would apply before that evidence is available. Therefore, the calculation of fair value performed to size the retained interest may differ substantially from a similar calculation undertaken immediately post-closing. In these circumstances, detailed disclosures surrounding the calculation of fair value not only are immaterial, but they may well be inaccurate.

Disclosure Safe Harbor Needed

- If the Agencies require the proposed disclosures to be made to investors, it is crucial that the final rules provide for a safe harbor from liability with respect to any private action brought in reliance on any forward-looking information contained in those disclosures.

- This would be similar to the safe harbors for certain forward-looking statements provided by Section 27A of the Securities Act and Section 21E of the Exchange Act.

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Fair Value – Vertical Retention

- Mandating a fair value approach for the vertical option (either through retention of multiple classes or a single vertical security) adds needless complexity, because retention of 5% of the par value of each class of ABS interests issued will always equal 5% of the fair value of the same class.

ABS Interest	Par Value	Px	FV	5% of FV	5% Par Retention	FV of 5% of Par Retention
Example 1						
A	80	1.25	100	5	4	5
B	20	.50	10	.5	1	.5
Total	100		110	**5.5**	5	**5.5**
Example 2						
C	80	1.00	80	**4**	4	**4**
D	10	.90	9	**.45**	.5	**.45**
E	10	.40	4	**.20**	.5	**.2**
Total	100		93	**4.65**	5	**4.65**

- Simplified disclosure is the most obvious benefit from dispensing with the fair value calculation where it is not necessary. Also, the sponsor will not have to make difficult and unnecessary determinations about which assumptions and inputs it will use to calculate fair value, such as the methodology and key inputs and assumptions, or the reference data. The sponsor could simply disclose the percentage of the ABS interests it has retained.

3. QRM = QM, Certifications and Blended Pools

QRM = QM

- QM should be adopted as the standard for QRM, rather than QM-plus. QM is meaningful standard for high quality loans.
- The characteristics of QM-plus, particularly the 70 percent LTV ratio, would exclude most borrowers from these loans.
- We believe the adoption of QM-plus would reduce the competitiveness of private mortgage originators and delay the transition of the housing finance system away from the GSEs.

QRM Depositor Certification

- As proposed, it is a strict condition of the exemption that all pool assets actually be QRMs. Any loans that turn out not to be QRMs must be repurchased within 90 days of discovery of noncompliance, so investors already have a built-in remedy for the inclusion of noncompliant assets. The certification adds no additional assurance.

- Rule 193 under the Securities Act appear to be much more aptly targeted, by requiring the issuer to perform a review of the pool assets designed to provide “reasonable assurance” that the disclosure in the prospectus regarding the assets (which would include their QRM status) is accurate in all material respects.

- Therefore, we ask that the proposed certification be required to be provided confidentially to the Commission and any other appropriate agency, but not to investors.

Blended Pools (Generally)

- Blended pool risk retention should be proportional to the inclusion of non-qualified assets. There should be no arbitrary minimum.
- It is unclear why the Agencies believe that allowing sponsors of blended pools to include a risk retention requirement based precisely on the percentage of non-qualified assets in the pool is “inconsistent” with the principle that sponsors should “hold a meaningful exposure to all assets they securitize that are subject to the full risk retention requirement.”
- A fully proportional approach would maintain 5 percent risk retention with respect to each and every non-qualifying asset, which is by definition a meaningful exposure.

Blended Pools (QRM)

- We continue to believe that a blended pool option should be available for QRMs, and that the Agencies have a statutory basis for providing such an option.

- In the Re-Proposing Release, the Agencies requested comment on whether a blended pool option for QRMs could be constructed, *"given the provisions of paragraph (c)(1)(B)(i)(II) and the exemption authority in paragraph (c)(2)(B), (e)(1) and (e)(2) of Section 15G."*

- The Agencies have extremely broad exemptive authority.
  - Pursuant to paragraph (c)(1)(G), the rules *"shall ... provide for ... a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors."*
  - Paragraph (e)(1) allows the Agencies to *"adopt or issue exemptions, exceptions, or adjustments for classes of institutions or assets,"* subject to the requirement of paragraph (e)(2) that such an exemption, exception or adjustment must *"help ensure high quality underwriting standards for securitized assets, encourage appropriate risk management practices, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors."*

- Nothing distinguishes the applicability of these conclusions to QRMs. The blended pool option will be even more important if, despite our serious reservations, the Agencies adopt QM-plus rather than QM as the standard for QRMs.

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4. Legacy Assets and Structures

Legacy Assets

- Imposing mandatory risk retention in securitizations of legacy assets would not further the purposes of Section 941(b) of the Dodd-Frank Act because it would not be possible to influence the credit quality of the legacy assets.

- This issue is especially pressing for asset classes that will rely primarily on the qualified asset exemptions/

- Large pools of non-qualifying assets originated before the effective date of the rules will no longer be able to be securitized economically, in the absence of alternative risk retention methods that work well for those asset classes.

- The proposed resecuritization exemption, for example, would not apply to legacy assets. We believe that the vast majority of these transactions will become uneconomical.
    - That would be quite unfortunate, as resecuritization is an important risk-mitigating tool for investors.

Legacy Structures

- ABCP - We request that the Agencies provide a grandfathering exemption from requirements for legacy pool assets of otherwise eligible and qualifying ABCP conduits, at least until the associated contractual commitments expire or are renewed.

- Master Trusts - The credit risk retention requirements will apply to existing securitization programs on the effective date of the final rules, but none of the proposed risk retention options will work for most master trusts as currently structured. E.g., if the definition of sellers interest is not amended as discussed in our comment letter, then legacy structures will be non-compliant.

5. Representative Sample + Participations

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Participations

- Participation interests should be permitted methods of risk retention.
- It is unclear to us why the Agencies did not include some version of several commenters' proposals for a participation interests approach.
- This option is much simpler than the proposed 'standard' approach, and would perfectly align the incentives of sponsors and investors.

Representative Sample

- We believe retention of a representative sample of assets should be an option.
- The auto ABS industry has a successful track record of using the representative sample methodology to implement risk retention. An appropriate representative sample option for auto ABS also would preserve the ability to receive sale accounting treatment for the transferred assets. We urge the Agencies to adopt a final rule that would include a representative sample risk retention mechanism, at least for auto ABS.
- The FDIC Safe Harbor provides certain protections for securitizations when, among other things, the sponsor retains an economic interest in a material portion of the interests or assets, which retention may be in the form of "a representative sample of the securitized financial assets equal to not less than five (5) percent of the principal amount of the financial assets." The FDIC adopted this change to its "securitization rule" in recognition of the goals of section 941 of the Dodd-Frank Act.
- The Auto ABS industry has effectively and efficiently complied with this Rule for three years.

Our Representative Sample Proposal

- In order to create a valid representative sample, an issuer would start with an initial asset pool of potential Auto ABS assets comprising assets chosen based upon the sponsor's selection criteria (the "Initial Auto ABS Pool").

- Once the Initial Auto ABS Pool has been established, the sponsor would retain assets equal to 5 percent of the aggregate unpaid principal balance of the Initial Auto ABS Pool, determined by taking a random sample in accordance with an established randomizing methodology (the "Retained Auto ABS Pool").

- The assets remaining in the Initial Auto ABS Pool would subsequently be securitized. The sponsor would then hold the Retained Auto ABS Pool to satisfy its risk retention requirement in accordance with other provisions of the rules. The random sample would preclude "cherry picking" of more creditworthy assets for the Retained Auto ABS Pool.

- If the selection of the Retained Auto ABS Pool complies with our suggested random process, requiring the disclosure of a comparison of the material characteristics between the two pools would be unnecessary. At a minimum we believe there should no such disclosure requirement under circumstances where the Initial Auto ABS Pools contains at least 6,000 assets.

- Based on statistical analyses done by some of our members, where the Initial Auto ABS Pool has 6,000 or more assets, a randomly selected Retained Auto ABS Pool will always be within 5 percent or less variance from the material characteristics of the Initial Auto ABS Pool (*i.e.,* a 95% confidence interval, see p.55 of our letter).

- If the Initial Auto ABS Pool is not comprised of at least 6,000 assets, certain additional disclosures that illustrate the randomness of the Retained Auto ABS Pool could be included in the offering documentation, which would enable investors to determine that the Retained Auto ABS Pool is materially similar to the securitized assets.

6. Cross-Border Issues

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Mutual Recognition

- The differences between the EU retention regime and the proposed U.S. rules are significant. We support AFME's comment letter regarding cross-border issues, in particular that a mutual recognition process should be developed.
- Generally, the portions of the regimes that provide the most flexibility (*e.g*., specific risk retention methods and exemptions crafted for particular types of structures and assets) will be unavailable. In some cases, the two regimes may directly conflict (*e.g*., retention by one vs. multiple sponsors).
- EU banks may be prohibited from acquiring ABS that do not comply with the EU risk retention scheme, even if they comply with the U.S. rules. This would effectively prohibit EU banks from providing liquidity and market making activity in the U.S. securitization market.
- Since EU banks issue and trade a large share of U.S. securitizations, the inconsistencies between the EU and U.S. rules would have a large impact on lending and liquidity in the ABS markets and otherwise.
- For the reasons stated in AFME's letter, we support AFME's suggestion to amend the foreign transactions safe harbor condition with the U.S. investor limitation, so that it may be satisfied either by compliance with the U.S. investor limitation or by commitment of the non-U.S. sponsor to retain a net economic interest in compliance with the EU retention regime (or another recognized credit risk retention regime).

Safe Harbor Threshold

- In the proposed safe harbor, the U.S. person limitation on investors should be eliminated in favor of mutual recognition – or substantially raised.
- In the proposal's discussion of the 10% threshold, the Agencies appear to be referring to Rules 801 and 802 under the Securities Act. Rules 801 and 802 address situations where the number of existing U.S. security holders is relevant, whereas in the safe harbor, the proposed 10 percent limit would apply to all potential purchasers in a securities offering.
- It will be extremely difficult for market participants to rely on the safe harbor. Generally, it is not possible to forecast in advance the level of U.S. investor participation, and the relevant placement levels will not be known until pricing or even later.
- If the Agencies adopt any limit, we ask that it be set at 20 percent, rather than 10 percent as proposed. This would reduce the risk of good-faith errors having a significant, negative consequence for securitization sponsors.
- In any case, however, a more efficient solution would be to implement a mutual recognition regime.

Safe Harbor for Foreign Sales Modeled on Reg S

- As proposed, any U.S.-based securitization (either involving a U.S.-based sponsor or issuer, or containing assets exceeding the limit for U.S.-generated assets) would be required to satisfy the credit risk retention requirements or find another exemption – even if none of the securities are offered or sold to U.S. persons by the issuer, and restrictions are adopted to discourage flowback of the securities into the United States.

- In our view, such transactions, which clearly are intended for a foreign investor base, should not be subject to U.S. risk retention requirements.

- We urge the Agencies to adopt an additional safe harbor for transactions in which all securities offered or sold to non-affiliates of the sponsor are offered and sold in accordance with the applicable provisions of Regulation S.

- Making the threshold for compliance with U.S. securities registration requirements co-extensive with the threshold for compliance with U.S. risk retention rules, particularly with respect to foreign offerings by U.S. issuers, would set clear and consistent guidelines for sponsors, would protect investors who have reasonable expectations of reliance on U.S. law, would simplify and ease regulatory burdens, and would reflect important principles of comity.

Contact Information

About SIFMA

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

For Further Information

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