Morgan Stanley

February 10, 2012

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

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

Re: Comments on Proposed Rule 127B under the Securities Act implementing Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (File No. S7-38-11)

Ladies and Gentlemen:

We are submitting this letter in response to the request of the Securities and Exchange Commission (the "Commission") for comments regarding the Commission's proposed rules (the "Proposed Rule") regarding conflicts of interest in asset-backed securities ("ABS") contained in Securities Exchange Act Release No. 34-65355, 76 Fed. Reg. 60320 (September 28, 2011) (the "Proposing Release"). We appreciate the opportunity to provide comments on the Proposed Rule which implements Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").

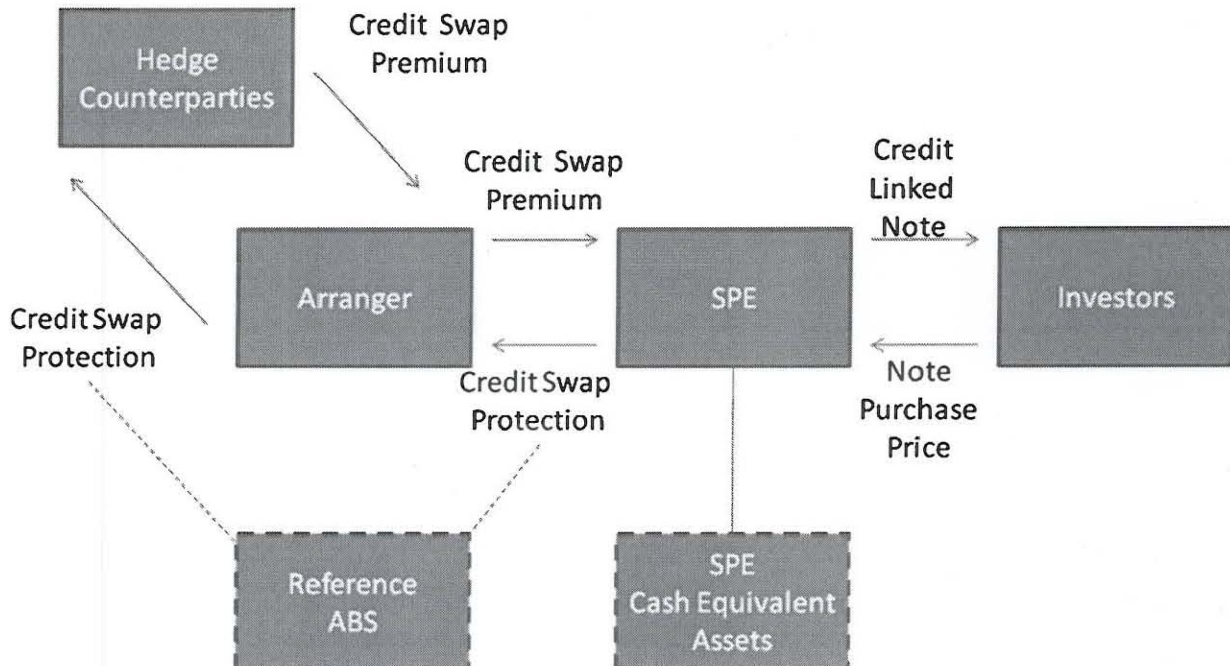
We concur with the comments on the Proposed Rules that have been submitted by the Securities Industry and Financial Markets Association and the American Securitization Forum. However, we wish to highlight several specific additional comments on the Proposed Rules.

1. The Commission should clarify certain exclusions from the definition of "synthetic asset backed security."

The Proposing Release notes that the Commission is "not proposing to define the term 'synthetic asset backed security' because we understand the term is commonly used and understood by market participants." Proposing Release at 76 Fed. Reg. 60326. While there are

certain financial products that would clearly be understood to be "synthetic asset backed securities," however, the term does not have a sufficiently fixed meaning to be left undefined. Section 941 of Dodd-Frank sets out an expansive definition of "asset backed security," to include any "security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." And "synthetic" is not defined by Dodd-Frank in any way. Thus it is likely for there to be substantial degree of confusion as to what products might or might not be included in the notion of a "synthetic" "asset backed security." It may not be possible for the Commission to define "synthetic asset backed security" in a manner that adequately includes all variations of such transactions that Section 621 aims to reach. Nevertheless, at a minimum, the Commission should clarify that certain types transactions are expressly _not_ "synthetic asset backed securities." We describe three important examples in this respect below.

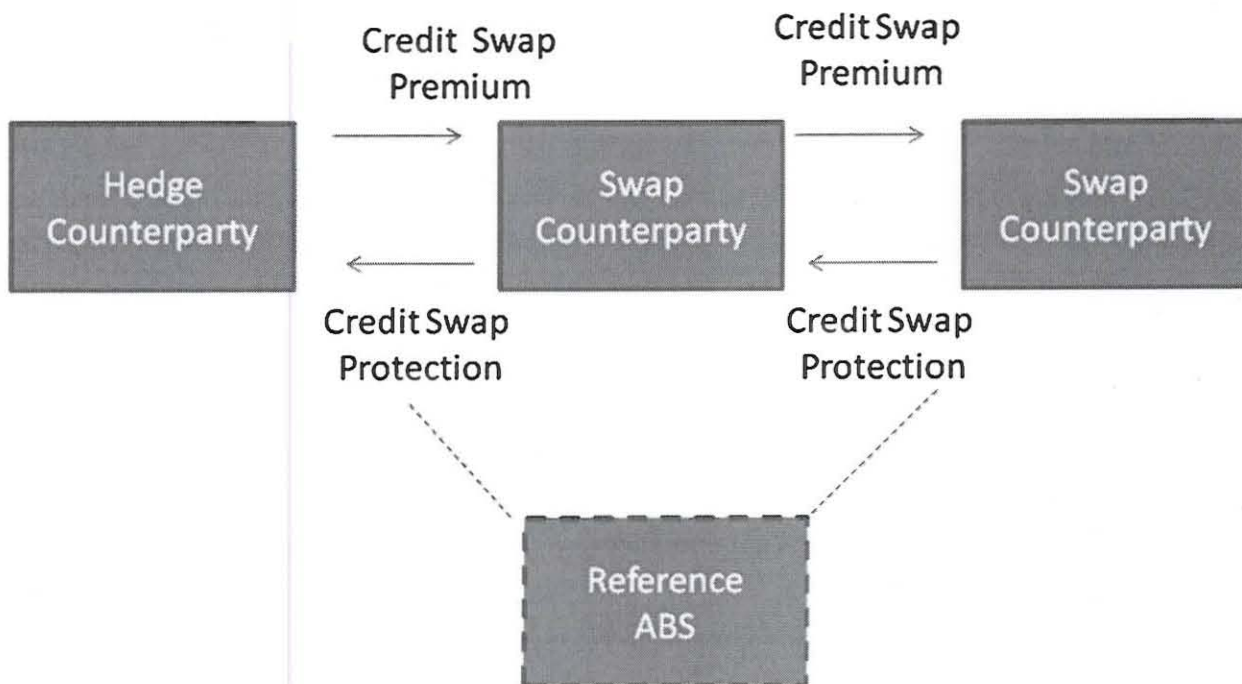
a. "Synthetic asset backed securities" should exclude swaps. Market participants readily distinguish swaps – whether falling into the legal category of "swaps" or "security-based swaps" -- from "asset backed securities." A typical synthetic asset backed security, illustrated below, involves an SPE issuing a credit linked note or similar security, and the SPE and the arranger entering into a credit swap that references an asset backed security:



SYNTHETIC ASSET BACKED SECURITY

The SPE security here is a "synthetic asset backed security" because the risks and returns for the investor in the credit linked note are primarily linked to a synthetic asset as well as to the other assets owned by the SPE. The SPE will typically invest the proceeds of the credit linked note in high quality assets (such as cash equivalents), in order to ensure its ability to perform its obligations under the credit swap. The performance of the credit linked note, however, is primarily tied to the credit exposures in the referenced synthetic asset.

A "synthetic asset backed security" always involves a credit linked note or similar security issued by an SPE. The same credit swap referencing an ABS, if executed between two swap counterparties without issuance of a credit linked note or similar security, should not be considered a "synthetic asset backed security," but simply a security based swap:



SECURITY BASED SWAP

The distinction between a synthetic asset backed security and a security based swap is driven not only by differences in economic features of the transaction, but also by the different expectations of the parties. Swaps are traded, not underwritten: they are bilateral contracts generally negotiated between eligible contract participants, and are not marketed for resale or distribution to third parties. In the context of a security based swap transaction, the concerns of Section 621 that investors be protected against underwriters who bring securities to market that are "designed to fail" are misplaced. But because "synthetic" is not defined in Dodd-Frank, a high degree of

confusion and uncertainty may result if the Commission does not clarify that a "synthetic" asset backed security should still mean a "security" as commonly understood: a note, certificate or similar instrument. Swaps, whether legally defined as "swaps" or "security based swaps," should be specified not to constitute "asset backed securities" or "synthetic asset backed securities."

Under the Securities Act and Exchange Act as amended by Dodd-Frank, the definition of "security" now encompasses a "security based swap". But there is no indication in Section 621 of Dodd-Frank that Congress intended "synthetic asset backed securities" to include any of the "security based swaps" that were being newly brought into the Commission's general jurisdiction under Title VII.[1] Instead, conflicts of interest and similar concerns with respect to transactions in the swaps market were separately addressed under Title VII. For example, Section 764 of Dodd-Frank, addressing business conduct standards in Section 15F(h) of the Exchange Act, gave the Commission general authority to prevent "abusive practices" by security-based swap dealers and major security-based swap participants, and to promulgate requirements to disclose "material incentives or conflicts of interest that the security-based swap dealer or major security-based swap participant may have in connection with the security-based swap." Rather than subject security based swaps to an overlapping regulatory provision intended for the securities markets, the Commission should implement any necessary conflict of interest regulations for security based swaps separately under Title VII.

Security based swaps entered into by an issuer of "asset-backed securities" may still be relevant under Section 621, but only where the security based swap is a "short transaction" relating to the ABS or its underlying assets. For instance, as described in Example 3 of the interpretive examples in the Proposing Release, if a synthetic ABS is issued by an SPE, the SPE may write a security based swap to the arranger of the ABS, and the arranger may then hedge that security based swap with a third party. Depending on the manner in which the hedging transaction is effected, the security based swap may involve a material conflict interest as described in the Commission's examples. But it is in this manner, not through regulation of the security based swap *itself* as a "synthetic asset backed security," that such a security based swap should be addressed by Section 621. If the same security based swap is executed between two counterparties in the absence of any real "asset backed security" being marketed to investors, Section 621 should not apply. Anti-evasion principles can be applied to transactions where counterparties enter into security based swaps solely to avoid application of Section 621. But ordinary course security based swaps should be expressly excluded from "synthetic asset backed securities."

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[1] One indicator of this intent is that Section 621 applies its prohibition during a restricted time period from "the first closing of the sale of the asset-backed security." Swaps do not have "closings" or "sales": if Congress had intended the prohibition to reach to swaps, it would have used different language.

It is extremely important to certainty in the market that the distinction between a "security based swap" and a "synthetic asset backed security" be this clearly drawn. Otherwise, across a broad range of security based swaps, no clear, reliable, consistent rule will be available to distinguish such swaps from "synthetic asset backed securities."

Indeed, the types of fixed income derivatives that might be swept up by too broad a construction of "synthetic asset backed security" would even include "security based swap agreements" and other "swaps" that are outside the Commission's general jurisdiction under Title VII of Dodd-Frank. It would be especially incongruous to conclude that Congress would commit "security based swap agreements" and other "swaps" to CFTC jurisdiction under Section 721 and related provisions of Dodd-Frank (other than with respect to antifraud provisions of the securities laws), and yet contemplate that a rule regarding conflicts of interest on "asset-backed securities" might indirectly bring such security based swap agreements within SEC jurisdiction. The Commission should clarify that "synthetic asset backed securities" include neither "security based swaps" nor "swaps".

b. "Synthetic asset backed securities" should expressly exclude corporate debt securities with derivative features. In addition to potential confusion as to products which are *not* securities, Section 621 raises the prospect of certain products which *are* securities being incorrectly classified as "synthetic" asset backed securities merely because they incorporate derivative features. A wide variety of corporate debt securities incorporate some elements of derivatives in their interest or principal entitlements, but are nevertheless direct corporate obligations of an operating company or parent holding company and not an SPE. Examples include convertible debt securities, as well as corporate index-linked or other hybrid notes which have principal or interest payments that are determined by one or more interest rate, currency, credit, equity or commodity indices. When sold to the public, convertible debt securities and hybrid notes have typically been registered on Form S-3 for Securities Act purposes without reference to Regulation AB; but they do involve linkage to underlying assets or derivatives to define payment rights. Similarly, "exchange traded notes" or "ETNs", may reference a particular set of or class of "self-liquidating financial assets" in a manner that indirectly – synthetically – creates an investment comparable to debt issued in an asset-backed security transaction.

As noted earlier, Dodd-Frank does not define "synthetic," and the term is easily misunderstood. The Commission should avoid uncertainty among issuers of such debt securities that could result from a too-broad understanding of "synthetic asset backed security." A corporate debt security that (i) is issued by an operating company or holding company that has market capitalization of at least $75 million that is a reporting company under the Exchange Act, (ii) is included as a liability on the issuer's balance sheet (even if it may also have an embedded derivative contract) and (iii) if registered, is registered on Form S-3 under the Securities Act and

not as an asset-backed security under Regulation AB, should be expressly excluded from the definition of asset backed security under Section 621.

c. Structured securities that package broad-based interest rate, commodity and currency derivatives should either be excluded from "asset backed securities" or recognized not to create material conflicts of interest. In addition to corporate debt securities, there is a significant class of structured products that should be expressly excluded from the scope of the Proposed Rule. These involve securities issued by SPEs for which the primary asset is an interest rate derivative, commodity derivative, equity derivative, currency derivative or foreign exchange contract ("Risk-Linked Notes"). In the case of such products, the SPE generally holds no assets that provide for simple, one-way payments, but is party to an interest rate, commodity or currency derivative or foreign exchange contract that requires bilateral payments, or entitles the SPE to a contingent payment depending on the value of the relevant currency, commodity or interest rate index. Risk-Linked Notes essentially represent a transferable participation in the relevant derivative contract. They involve exposure to very general rates, indices, commodity prices or foreign exchange values, rather than the credit exposure that is typical of asset backed securities, and should not be considered ABS or synthetic ABS.

A security issued by an SPE that owned an interest, commodity, equity or currency derivative contract and nothing more would not have been classified as an "asset-backed security" prior to Dodd-Frank. For example, in adopting Regulation AB in 2005, the Commission permitted "an interest rate or currency swap covering either or both of the principal or interest payments on assets in the pool held by the issuer" but only where "[t]he return on the ABS is still based primarily on the performance of the financial assets in the pool." 70 Fed. Reg. 1506, 1514 (January 7, 2005). While the definition of "asset backed security" under Dodd-Frank is broader than that under Regulation AB, "self-liquidating" assets ought to exclude bilateral derivative contracts and/or foreign exchange contracts that make net payments based on changes in market rates or values. Such contracts may produce a net cash payment, but they are not "self-liquidating" in the usual sense associated with underlying assets in a securitization. Accordingly, structured securities that merely pass through the payments under a broad-based interest rate, commodity or currency derivative or foreign exchange contract should be excluded from "asset backed securities".

Alternatively, if Risk-Linked Notes are not excluded from "asset backed securities," the Commission should recognize that transactions in the "underlying assets" for such securities do not raise material conflicts of interest. Risk-Linked Notes simply do not raise the concerns at which Section 621 aimed. A conflict of interest may arise from a "short" position in ABS or the payment obligations underlying an ABS arranged by a securitization participant, but a "short" position in a general index or market indicator – the level of LIBOR, the value of

the euro, levels of inflation, and so on – is very different in this respect. Purchasers of structured products linked to these rates and indices are no doubt aware that their counterparties trade continually – in billions of notional amounts -- on both sides on the very deep and liquid international markets in these exposures, and participants arranging such securities do not have special access to information in this respect. A reasonable investor in a Risk-Linked Note that passes through exposure to general indicators of interest rates, currency, equity, commodity or foreign exchange values would not regard as material the fact that the securitization participant arranging the issuance of such Risk-Linked Note might have – somewhere within its institution – an opposite exposure. At the same time, for institutions to have to evaluate their overall risk position with respect to broad based interest rates, commodity prices, currency values, equity indices or foreign exchange contracts to evaluate "materiality" of a conflict of interest vis a vis a particular Risk-Linked Note would not further the goals of the Proposed Rule. If Risk-Linked Notes are considered "asset backed securities," the Commission should specify an interpretive example permitting short transactions in the interest rates, currency, commodity or foreign exchange values or indexes underlying the Risk-Linked Note.

2. **The Commission should provide guidance protecting market making and other secondary market trading in securities and derivative exposures.**

a. Secondary market trading does not give rise to material conflicts of interest. The process of structuring and distributing an asset-backed security most typically involves a direct connection between the participants in the ABS transaction and the originator of the "loan . . . lease . . . mortgage . . . secured or unsecured receivable" or other "self-liquidating financial asset" that is securitized. As is evident from the focus in regulatory reform on the failures of the "originate to distribute" model for ABS, a key aim of the securitization provisions in Dodd-Frank has been to improve underwriting practices and incentives in the steps that link credit formation and securitization. The concern in the Proposed Rule that participants not "structur[e] and offe[r] the ABS to investors on the premise that it will be a good investment" when the securitization participant has "structured the transaction in a manner that is designed to fail" (Proposing Release, 76 Fed. Reg. at 60330), shows this same focus. As the Commission notes, an important premise of the Proposed Rule is that "as a practical matter investors in the ABS may not have as much information regarding the underlying assets as the securitization participant". (Id.)

Nevertheless, ABS are often formed where no such asymmetry of information exists. Many types of ABS, synthetic ABS and other synthetic securities consist entirely of underlying assets or derivative exposures which are acquired in the secondary market, such that the link between these assets and credit origination activity is no longer present. The sale of the security is simply an indirect means of structuring a transaction with a purchaser in a secondary

market asset or exposure that could have been traded without creating a new security. We discuss two examples below.

1. ***Repackagings of secondary market assets***. In a repackaging transaction, the securitized assets are acquired in the secondary market and the securitization participants rely entirely on publicly available information regarding the credit characteristics of the assets. In this context, the expectations of investors with respect to the securitization participants are different. Investors might well still depend on the underwriter or other securitization participants to properly design and disclose characteristics of the ABS structure. But it is understood that the securitization participants have no special access to information regarding the originator of the assets or exposures which are included in the ABS. Securitization participants are simply not in a position to incorporate secondary market exposures on "the "premise that it will be a good investment".[2]

2. ***Secondary synthetic securities.*** As discussed in Section 1 above, "synthetic asset backed securities" should be limited to securities that reference an ABS. However, if the Commission adopts a broader – and in our view, unjustified – definition of "synthetic asset backed securities," to include securities that reference other assets, the definition of "synthetic asset backed securities" could potentially reach a very large category of synthetic securities that incorporate only secondary market exposures. In this category of transactions, payments on the synthetic security depend on a derivative which is linked to already existing reference assets. The derivative may reference an existing ABS or other security trading in the secondary market. It may also reference a tranche of credit risk on the widely traded debt of one or more corporate or sovereign reference entities. In either case, the relevant assets or exposures are not originated by the derivative counterparty or its affiliates, and the sponsor of the synthetic security transaction has no agreement or arrangement with any obligor or originator. Such synthetic security transactions are thus economically equivalent to a secondary transaction: either a secondary sale of specific underlying securities, or a derivative referencing a tranche of credit

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[2] Proposing Release, 76 Fed. Reg. at 60330. The Commission has recognized this concept in Rule 190 under the Securities Act. Under Rule 190, a sponsor registering asset-backed securities that are backed by securities of another underlying issuer need not obtain that underlying issuer's participation in the underwriting and registration of the asset-backed securities, so long as (i) "neither the issuer of the underlying securities nor any of its affiliates has a direct or indirect agreement, arrangement, relationship or understanding, written or otherwise, relating to the underlying securities and the asset-backed securities transaction"; and (ii) "the offering of the asset-backed security does not constitute part of a distribution of the underlying securities"; and (iii) certain public information requirements are met. In such a repackaging, investors are referred to public sources for information regarding the credit characteristics of the underlying assets. They do not rely on securitization participants for this information.

risk on a pool of secondary corporate or sovereign reference entity exposures. In this context, again, the securitization participants have no better access to information regarding the underlying assets or corporate or sovereign exposures than does the buyer of the synthetic security. Investors do not have an expectation that the credit quality of these underlying exposures – as opposed to the terms of the security itself – are better understood by the securitization participants than by the investors.

ABS, synthetic ABS and other synthetic securities which incorporate secondary market exposures play an important role in market making activity and the overall structure of the derivatives market. Dealers in the credit derivative market assemble inventories of long and short credit risk positions as part of their market making activity, and arranging for issuance of synthetic asset backed securities is an important means by which dealers may hedge or accumulate inventories over time. Some synthetic security transactions begin with investors who seek exposure to corporate or sovereign credit risks and look to a market maker to structure a synthetic CDO security that is linked to that specific pool of names, without requiring the negotiation of a derivative master agreement or similar derivative documentation. Other synthetic securities are marketed to investors in connection with sale or creation of credit derivative inventory by dealers in the form of single name credit derivatives or tranched exposures to pools of credit risk. In each case the ability to issue synthetic securities is an important means through which market participants can pool and diversify exposures, and hedge and accumulate inventory in a manner that is essential to market making and market liquidity. Again, participants in these markets look to the securitization participants to structure the synthetic securities, but not for disclosure regarding the underlying corporate credits, most of which are actively traded in the single name credit default swap market or a bond market.

These considerations dictate different expectations regarding conflicts of interest. In the case of securities or derivative exposures that are the subject of an active secondary market, investors reasonably understand that market participants – especially large financial institutions with different trading desks and other business units – may frequently be a seller on one day and a buyer on another. An investor would not expect that an institution would cease its secondary market trading activity in such securities or exposures merely because one or more amounts of such exposures are being included in an ABS, synthetic ABS or other synthetic security. While in some sense such trading could involve divergent exposures, there is no material conflict of interest.

b. Market making is not a conflict of interest. Independently of the nature of the traded securities or exposures, a wide range of the activity whereby dealers accumulate and hedge securities and derivative exposures should come within an exemption for market making. In Section 621, Congress expressly protected "purchases or sales of asset-backed securities made

pursuant to and consistent with . . . bona fide market-making in the asset backed security." If Section 621 is to be applied to restrict not only transactions in the asset backed security but transactions in the underlying assets or derivative exposures, the market making exception should be applied in a similar manner. For example, where a dealer structures a synthetic CDO, the motivation for the dealer's issuance of the synthetic CDO notes is often to meet customer demand for the credit risks created by the notes. Conversely, the dealer may structure the synthetic CDO to provide for expected future demands of customers for the purchase of credit *protection* from the dealer. The dealer is not 'betting against' the security, but structuring the security in a manner that will enable the dealer to make a market in the underlying credit risk. The importance of synthetic securities to this market making function should be recognized in an exception that gives full scope to the market making exemption Congress intended.

c. ***Proposed interpretive examples***

1. ***Exception for secondary market exposures***. The existing interpretive examples in the Proposed Rule should be supplemented to take account of the context of secondary market trading. The Commission should recognize a class of assets or exposures for which widespread public information exists and which are the subject of secondary market trading. Example 1 and Example 3 should specify that a "short transaction" on such assets or on a tranche of such credit exposures does not raise a material conflict of interest. To define the qualifying assets or exposures, we would suggest looking to the characteristics identified by the Commission in the joint proposed rules defining the "narrow-based security index" component of the "security based swap" definition under Dodd-Frank. In this context, the Commission has proposed that in order not to be treated as a "narrow-based security index", an index must predominantly incorporate only securities or reference entities for which adequate public information is available. The Commission notes that such a standard "reduce[s] the likelihood that broad-based debt security indices or the component securities or issuers or securities in that index would be readily susceptible to manipulation" (Product Definitions Proposing Release, 76 Fed. Reg. 29818, 29848 (May 23, 2011)). A qualifying security or exposure in this context includes reference entities having (directly or by means of a guarantee from a guarantor having) one of the following characteristics:

> (A) The reference entity is required to file reports pursuant to section 13 or section 15(d) of the Act (15 U.S.C. 78m or 78o(d));
>
> (B) The reference entity is eligible to rely on the exemption provided in [Rule 12g3-2(b) under the Exchange Act];
>
> (C) The reference entity has a worldwide market value of its outstanding common equity held by non-affiliates of $700 million or more;
>
> (D) The reference entity (other than an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) has outstanding

securities that are notes, bonds, debentures, or evidences of indebtedness having a total remaining principal amount of at least $1 billion;

(E) The reference entity is the issuer of an exempted security as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)) (other than any municipal security as defined in section 3(a)(29) of the Act (15 U.S.C. 78c(a)(29)));

(F) The reference entity is a government of a foreign country or a political subdivision of a foreign country;

(G) If the reference entity is an issuer of asset-backed securities as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), such asset-based securities were issued in a transaction registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.) and have available distribution reports; and

(H) For a credit default swap entered into solely between eligible contract participants as defined in section 3(a)(65) of the Act (15 U.S.C. 78c(a)(65)):

(1) The reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) provides to the public or to such eligible contract participant information about the reference entity pursuant to [Rule 144A(d)(4)) under the Securities Act];

(2) Financial information about the reference entity (other than a reference entity that is an issuing entity of an asset-backed security as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77))) is otherwise publicly available; or

(3) In the case of a reference entity that is an issuing entity of asset-backed securities as defined in section 3(a)(77) of the Act (15 U.S.C. 78c(a)(77)), information of the type and level included in public distribution reports for similar asset-backed securities is available about both the reference entity and such asset-backed securities.

Product Definitions Proposing Release, 76 Fed. Reg. 29894.

Proposed Rule 3a68-1a(a)(1)(iv) should be employed to define a "qualified secondary market exposure" which could be the subject of a short position even where the exposure is included in an ABS transaction. A "qualified secondary market exposure" would include an exposure to a reference entity of any of the types set out in subparagraphs (A) through (G) for all ABS issuances, and include a reference entity of any of the type set out in subparagraph (H) only where issuance and secondary transfer of the ABS was limited to eligible contract participants as described in the rule.

The list set out in Proposed Rule 3a68-1a(a)(1)(iv) should also be supplemented by two additional types of exposures. First, the Commission should add corporate reference entities which are the subject of liquid single name credit default swaps. Single name CDS are actively traded only on corporate names for which a substantial degree of public information is available. In some cases these corporate reference entities are not Exchange Act reporting

companies – they may for example be bank subsidiaries of public bank holding companies – but public information is nevertheless widely available. The best measure of liquidity in this respect, however, would be whether the single name credit default swap is also "issued" by a clearing agency in its function as a central counterparty in accordance with the clearing requirements of Dodd-Frank.[3] Contracts of this type should be accompanied by adequate market liquidity and available public information to be treated as secondary market exposures. Second, the list should also include U.S. federal, state and local governmental entities, given the securities law exemptions generally applicable to obligations of these entities.

Incorporating these standards, an "Example 1A" and "Example 3E" under the Proposed Rule would be revised to permit a short position by a securitization participant where:

> (i) the short position is not a short position on the asset-backed security itself but only on an underlying asset or derivative exposure included in the asset-backed security;
>
> (ii) each issuer (or any relevant guarantor) of the underlying assets for such asset-backed security, or reference entity with respect to credit derivative exposures included in the underlying portfolio for a synthetic asset-backed security (A) would meet the requirements of Proposed Rule 3a68-1a(a)(1)(iv), (B) is a reference entity under a single name credit default swap transaction that would be exempt from Section 12(a) of the Exchange Act pursuant to Rule 12a-10 thereunder or (C) is a U.S. federal, state or local governmental entity.
>
> (iii) no securitization participant has any direct or indirect agreement, arrangement, relationship or understanding, written or otherwise with the originator of the underlying assets regarding the asset-backed security transaction; and
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> (iv) the purchase of the underlying asset or derivative exposure by the securitization participant, or purchase of credit protection through synthetic securitization, does not constitute part of a distribution of the underlying securities and does not provide a hedge to the securitization participant with respect to the unsold allotment from a public or private distribution of securities by the securitization participant.

We believe it would be consistent with the reasonable expectations of investors that secondary market trading in such exposures, whether buying or selling, would continue even where such exposures are being incorporated into an ABS.

2. ***Market making exception***. Second, even outside the context of "qualified

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[3] See 76 Fed. Reg. 34920 (June 15, 2011) (Proposing Rule 12a-10 under the Exchange Act to exempt security based swaps that "Is issued or will be issued by a clearing agency registered as a clearing agency under Section 17A of the Act.")

secondary market exposures," the Commission should recognize an exception from the prohibitions in Example 1 and Example 3, in the case of short transactions on assets or exposures which have been or are being acquired in connection with market making activity of a securitization participant. The existing Example 3C recognizes to some extent the ability of a securitization participant to intermediate between a purchase of credit protection in a synthetic securitization and a related sale of credit protection in an offsetting transaction. But the existing Example 1 and Example 3A would prohibit a purchase of protection through issuance of a synthetic security that might occur as part of ordinary market making in the underlying exposure. At the same time, the interpretive examples exclude any use of a synthetic securitization "to offset pre-existing CDS exposures to third parties that were entered into for purposes unrelated to the ABS transaction" (Proposing Release at 76 Fed. Reg. 60339). This would not permit the ordinary use of synthetic securitizations to hedge exposures previously acquired as part of market making activity not directly related to a specific securitization. Moreover, Example 3C requires that there be "no significant basis risk" between the purchased protection and the hedged exposure. This is not a workable standard, particularly in the context of hedging of exposures previously acquired as part of market making activity. Thus, the existing variations on Example 3 do not address situations where a securitization participant may be using a synthetic securitization to *acquire* credit protection in connection with market making activity, or using a synthetic securitization to hedge an exposure *previously acquired* in connection with market making activity. A broader market making exception is appropriate.

3. **The Commission should provide guidance that a participant's hedging of exposures from an investor selected portfolio is not a conflict of interest.**

As a related point, the Commission should recognize that in some cases investors (owners of a note issued by an SPE) are sufficiently involved with selection of a portfolio included in ABS that the Proposed Rule should not apply. For example, it is not uncommon for an investor to request an investment bank to structure a synthetic ABS or other synthetic security that incorporates certain underlying assets or exposures to which the investor wishes to have exposure, and thereby obtain investment returns, as owner of the security issued by the SPE. In this context, the "selection" of assets by a securitization participant involves a give and take between the investor and the securitization participant regarding which assets or exposures can be hedged by the securitization participant at a cost that, taken together with the costs necessary to source other elements of the synthetic portfolio, will produce a return on the securities that is acceptable to the investor. Here, the investor is not merely an investor, but is itself a securitization participant.

The Proposing Release draws a similar distinction. In Example 3C, the Commission notes that where a "securitization participant's long position was acquired for

purposes of creating the ABS," it should be consistent with the policies of Section 621 to permit a short position between the securitization participant and the ABS issuer that does no more than allow a securitization participant to "offset the exposure to the underlying reference portfolio that it in turn acquired for purposes of effecting the ABS transaction." (Proposing Release, 76 Fed. Reg. at 60338). However, Example 4A goes on to state that if the counterparty to a long position acquired by the securitization participant is in fact a third party who may "profit from its short transaction" by "select[ing] risky assets for the underlying asset pool" (Proposing Release, 76 Fed. Reg. at 60339), it may be impermissible to include the long position of the securitization participant in the ABS pool. Just as the Commission gives importance to selection of assets or exposures by third parties, active selection of assets by the investors themselves should make an important difference. The securitization participant should not have to discontinue its other trading activities in the underlying exposures simply because an investor has selected such exposures for inclusion in a synthetic ABS or other synthetic security that investor wishes to purchase.

4. **The exceptions for risk mitigating hedging activities in Rule 127B should be at least as broad as permitted risk mitigating hedging activities under the proposed Volcker Rule.**

Section 621 of Dodd-Frank sets out an exception for "risk mitigating hedging activities," using the same phrase as is set out in Section 619 of Dodd-Frank (the "Volcker Rule") as an exception to the Volcker Rule's general prohibition that a banking entity shall not "engage in proprietary trading." Unlike the proposed Volcker Rule, however, Section 621 does not contain any general prohibition against a securitization participant's engaging in proprietary trading in ABS. Section 621 is instead aimed at a specific *category* of proprietary trading: that is, the taking of a proprietary position that results in a conflict of interest with investors in an ABS. Accordingly, the standards for activities that are considered as "risk mitigating hedging activities" should be at least as inclusive as those defined under the Volcker Rule as presently proposed.

In particular, the Proposed Rule should incorporate the standards of subparagraphs (2)(ii) and (iii) the proposed § ___.5(b) implementing Section 619, to the effect that a position is part of "risk mitigating hedging activities" where that position "[h]edges or otherwise mitigates one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks" and "is reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate." (Volcker Rule Proposing Release, 76 Fed. Reg. 68846, 68948 (Nov. 7, 2011)). However, the condition in subparagraph (iv) that the hedge not give rise to "significant

exposures that were not already present in the individual or aggregated positions, contracts, or other holdings" should not apply, because Section 621 does not restrict proprietary positions generally. As long as a hedge is consistent with the policies against conflicts of interest, the fact that it may create additional proprietary risk should not be relevant under Section 621. In addition, the more general program and documentation requirements of subparagraphs (1) and (2)(i), (v) and (vi) would be misplaced, because of the more specific focus of Section 621 and its applicability to non-banking entities. Section 621 applies to many securitization participants who would not be expected to have compliance programs and policies of the type described in Section 619, and therefore these more general requirements should not apply.

5. The Commission should provide guidance that certain conflict of interests that have been the subject of disclosure and consent are not material for purposes of the Proposed Rule.

Section 621 prohibits not conflicts of interest, but *material* conflicts of interest. The Commission properly focuses on the investor's perspective to address the standard for materiality, looking to whether "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) (Proposing Release, 76 Fed. Reg. at 60330, citing *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988)). However, as the Commission notes, "the proposed interpretation uses a materiality formulation that is also used under the federal securities laws for determining whether *disclosure* is necessary." Proposing Release, 76 Fed. Reg. at 60332. The source of the *Basic v. Levinson* materiality test is antifraud jurisprudence, which addresses material misstatements and omissions in the context of an investment decision. But in securities fraud cases, an investment decision intrinsically has been made in the *absence* of true disclosure, and the investor has not had the opportunity to decide what weight to give the relevant information.

The test of "materiality" in the Proposed Rule must therefore allow for the impact of disclosure. Where an investor is properly informed of a conflict of interest, the investor can determine *how important* the conflict of interest is to his or her investment decision, and adjust that investment decision in response. Accordingly, many provisions of the securities laws address the issue of conflicts of interest by emphasizing disclosure and consent. For example, Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act") recognizes the conflicts of interest that may be raised by transactions effected by investment advisers with affiliated brokers or other counterparties. The Advisers Act rules recognize – even in the context of a fiduciary advisory relationship – that proper disclosure can be the most appropriate means to address conflicts of interest. See, e.g. SEC Staff Study on Investment Advisers and Dealers of January 2011) at p.23 ("The duty to disclose material facts applies to conflicts of interest—or potential conflicts of interest—that arise during an adviser's relationship with a client. Therefore,

the type of required disclosure will depend on the facts and circumstances. As a general matter, an adviser must disclose all material facts regarding the conflict *so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser*.")

The Commission should similarly recognize the effectiveness of disclosure here. Given the breadth of the Proposed Rule – extending to all transactions within a year of the closing of a sale of asset-backed securities – there should be a substantial area where disclosure rather than prohibition is the proper means to address conflicts of interest. This has been recognized in § __.8(b)(1) of the recently proposed Volcker Rule provisions, which make exemptions from proprietary trading restrictions inapplicable where the relevant banking entity has a conflict of interest with its clients, customers or counterparties, and in § __.17(b)(1) of the proposed Volcker Rule which make exemptions for ownership or other relationships with covered funds inapplicable in the presence of material conflicts of interest. In both situations specific and detailed disclosure is required in a manner that permits the client, customer or counterparty to meaningfully evaluate and react to the conflict. But where such disclosure is made, the relevant conflict is not deemed "material." Especially given the close relationship between Section 621 of Dodd-Frank and Section 619, the Commission should take the same approach for Proposed Rule 127B.

Accordingly, in fashioning a disclosure exemption for Proposed Rule 127B, the Commission should combine several elements. First, the transaction in question should not involve the core concern of Section 621, which is directly "betting against" a security recently distributed to investors, as opposed to short positions or transactions in constituent assets or exposures that may relate less directly. Second, the disclosure should meet the same general standards of specificity described in the proposed Volcker Rule provisions.

Taken together, the following parameters would describe a transaction that would be deemed not to involve or result in any material conflict of interest with respect to any investor in an asset-backed security:

(i) The transaction does not involve a short position in the relevant asset-backed security itself (but may involve a short position in one or more of such underlying assets); and

(ii) The transaction is of a type for which the documentation for the relevant asset backed security makes clear and effective disclosure as to the relevant conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable investor to meaningfully understand the conflict of interest.

Such an exemption would strike a balance that would permit transactions where the relevant conflict of interest is indirect and where such conflicts have been adequately disclosed.

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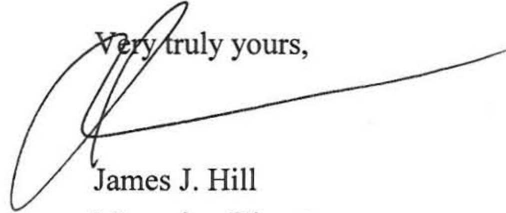
We greatly appreciate your consideration of the views set forth in this letter, and we would be pleased to have the opportunity to discuss these matters further with you or with any member of the Commission staff. Please feel free to contact the undersigned at 212-761-2514.

Very truly yours,



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