BETTER MARKETS
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February 13, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Prohibition Against Conflicts of Interest in Certain Securitizations, File No. S7-38-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rule ("Proposed Rule") of the Securities and Exchange Commission ("Commission"), which would implement prohibitions against conflicts of interest in certain securitizations as required by Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

INTRODUCTION

Conflicts of interest in the mortgage securitization market played a central role in the financial collapse of 2008. This was the grease on the conveyor belt that embedded time bombs wrapped in Triple A ratings throughout the entire financial system.

Wall Street investment banks assembled securitizations comprised of low-grade mortgages, sold them to unsuspecting investors, and then bet against those investments in the derivatives markets. This egregious conduct was doubly harmful. First, it victimized the investors who lost untold amounts from purchasing ultimately worthless mortgage-backed securities. Second, and even more importantly, it caused the build-up of massive systemic risk.

By creating opportunities for the banks not only to off-load assets destined to fail, but also to profit handsomely by wagering on the failure of those assets, the practice incentivized the banks to continue flooding the market with worthless securities. The accumulation of risk in those mortgaged-backed securities, and in the web of derivatives linked to those investments, was at the epicenter of the financial crisis. The magnitude of the financial crisis, and its enormous costs in terms of financial losses and human suffering, can in large measure be traced to these mortgage-backed securities transactions and the conflicts that pervaded them.

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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Recognizing that the existing provisions in the securities laws, including the antifraud measures, were inadequate to address these conflicts of interest in securitization transactions, Congress enacted Section 621 of the Dodd-Frank Act. That section is broadly framed and it prohibits sponsors and other market participants involved in the issuance of asset-backed securities ("ABS") from engaging in any transaction that would result in any material conflicts of interest with respect to any investor in such transactions, subject to certain conditions and exceptions. The exceptions cover risk-mitigating hedging activity, trading in connection with liquidity commitments, and bona fide market-making activity. Section 621 requires the Commission to promulgate rules implementing the statutory prohibition against conflicts of interest in securitization transactions, and the Commission has issued the Proposed Rule to fulfill that mandate.

In terms of form, the Proposed Rule simply tracks the statutory language in Section 621. The critical interpretive guidance governing the application of the Proposed Rule is found in the proposing release ("Release"). The Release addresses the core elements of the rule, including (1) the persons covered by the prohibition; (2) the products covered; (3) the timeframe for the prohibition; (4) the conflicts covered; and (5) the meaning of "material conflicts of interest. It also provides interpretive guidance for applying the three statutory exceptions for hedging, liquidity trading, and market-making.

SUMMARY OF COMMENTS

To ensure that the language and intent of Section 621 is fully implemented, the Proposed Rule and the accompanying interpretive guidance in the Release must be strengthened, and the Commission must resist calls to weaken the Proposed Rule and the guidance, as follows:

- The universe of covered persons must be expanded to include collateral managers, issuers, and a general catchall provision so that rampant evasion is avoided.
- The products covered must be clarified with a definition of synthetic ABS and a catchall definition, again to prevent the foreseeable evasion that will quickly inundate the market.
- The starting date for the period during which conflicts are prohibited must remain open-ended.
- The types of transactions that create prohibited conflicts of interest have to be expanded.
- The Commission must reject unfounded calls to implement an intent requirement or require an actual downturn in the value of ABS before a conflict of interest is deemed material.
- The Commission must not allow conflicts of interest to persist simply by virtue of disclosure.

- The interpretive guidance used to identify bona-fide risk-mitigating hedging activity must be expanded.

- The universe of acceptable liquidity commitments must be limited and additional factors must be applied to identify bona fide market-making.

COMMENTS

The universe of covered persons must be expanded to include collateral managers, issuers, and a general catchall provision so that rampant evasion is avoided.

The effectiveness of the Proposed Rule will depend largely on the universe of market participants to which it applies. The Release explains that the Proposed Rule incorporates the list of covered persons found in Section 621, which includes "an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity."[2] Although this list mirrors the statutory categories and captures the major participants in the ABS market, it is still too limited and should be expanded in several respects to achieve the statutory mandate.

First, the Proposed Rule should expressly cover collateral managers, who, as noted in the Release, play a significant role in selecting, managing, and servicing the assets underlying an ABS offering.[3] Any market participant that exerts that degree of influence over an ABS transaction with respect to both its design and implementation has to be included within the conflict of interest prohibition or a loophole will be created. In addition, the list of securitization participants subject to the Proposed Rule should include issuers. This change would address the inevitability that the organizers of a securitization would seek to evade the Proposed Rule by arranging for the **issuer** to assemble the assets underlying the ABS and then engage in transactions giving rise to prohibited conflicts of interest.

Even more important, the Proposed Rule must include a general catchall provision to ensure form does not triumph over substance and labels of convenience do not dictate the level of regulation. That provision must encompass any person who, by whatever label, performs the same functions that the enumerated market participants perform, and, in addition, any other person who participates in the design, assembly, sale, or management of an ABS transaction. This type of generic, functional description of the market participants subject to the Proposed Rule is necessary to help prevent evasion of the rule through simple labeling, shifting of duties and responsibilities, or the creation of novel and esoteric categories of securitization participant.

History and the most recent financial crisis teach us that regulated persons and entities will migrate into unregulated roles and arenas whenever possible. Moreover, they also teach us that whenever a loophole is present, market participants quickly adapt and there is typically an explosive increase in those unregulated activities.

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2 Release at 60325.
3 *Id.*

The Proposed Rule must simply not allow that type of ready evasion, which will make the rule far less effective and quickly defeat the statutory goal.

The products covered must be clarified with a definition of synthetic ABS and a catchall definition, again to prevent the foreseeable evasion that will quickly inundate the market.

Successful implementation of Section 621 also hinges on applying the Proposed Rule to a sufficiently large universe of ABS offerings. In accordance with Section 621, the Proposed Rule correctly incorporates the broad, statutory definition of "asset-backed security" found in Section 3 of the Securities and Exchange Act of 1934.[4] That definition in turn encompasses both registered and unregistered ABS offerings, as it must, given the prominent role of unregistered ABS in triggering the financial crisis. The Proposed Rule also correctly and explicitly applies to any "synthetic asset-backed security," as required by Section 621.

However, the Proposed Rule must be expanded in two ways to ensure that the definition of covered products is sufficiently broad and flexible to include not only the ABS in existence today but also those that Wall Street will inevitably and quickly devise in the future, as they design products in response to this very rule. First, the Proposed Rule must define the term "synthetic asset-backed security" in broad, but clear terms. The Release explains its failure to do this in the Proposed Rule on the ground that the term "is commonly used and understood by market participants."[5] However, reliance on industry understanding is an unreliable and transitory foundation on which to base such key regulatory requirements. That "understanding" is vague, shifting, and subject to interpretations by industry that will inevitably limit its scope and quickly become outdated in the marketplace.

The Release includes possible definitions for synthetic ABS that would be useful in this context. The core concept that must be included in the definition is "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."[6] That will provide essential flexibility, scope, and certainty. To do as proposed is to needlessly invite problems that are foreseeable and addressable now.

In addition, the Proposed Rule should include a catchall definition of asset-backed security that covers any financial product, by whatever label, that serves as the functional equivalent of an ABS, synthetic or otherwise. As with the universe of market participants subject to the Proposed Rule, this functional definition of the covered products will prevent evasion of the rule through labeling or the design of novel and complex financial

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4 15 U.S.C. § 78c.
5 Release at 60326.
6 Release at 60327.

instruments that appear to fall outside the purview of the Proposed Rule but are in reality and substance ABS that should be subject to the restrictions in Section 621.

The starting date for the period during which conflicts are prohibited must remain open-ended.

With respect to the duration of the ban on conflicts of interest, the Proposed Rule incorporates the statutory language of Section 621, which provides that conflicts are prohibited "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." As noted in the Release, this provision specifies an end-point for the period during which conflicts are prohibited, but no beginning point. The Release also correctly observes that the Proposed Rule would risk being under-inclusive if it designated any particular point in time, such as the first sale date of the ABS, as the beginning of the period.[7]

Allowing the starting point for the covered time frame to remain undefined is appropriate as a practical matter, because prior to the first closing in an ABS offering, securitization participants have the opportunity to engage in transactions involving the types of conflicts of interest that are the very focus of Section 621. This conclusion also follows as a conceptual matter, since it is difficult to envision any justification for allowing material conflicts of interest to arise at any point during the incipient stages of an ABS transaction, no matter how early.

The types of transactions that create prohibited conflicts of interest have to be expanded.

The Release provides guidance for defining the conflicts of interest prohibited under the Proposed Rule largely by identifying the types of conflicts that would be **excluded** from coverage, including (1) conflicts arising exclusively between securitization participants or exclusively between investors; (2) conflicts that do not arise as a result of or in connection with the related ABS transaction; and (3) conflicts that do not arise as a result of or in connection with certain types of transactions by the securitization participant.[8]

This guidance is generally consistent with the language and intent of Section 621, but it is too narrow with respect to the third category: the types of transactions by a securitization participant that may trigger a prohibited conflict of interest. The Release suggests that only transactions traditionally associated with conflicts of interest in ABS offerings would be prohibited by the Proposed Rule. Examples of those covered transactions cited in the Release include "effecting a short sale of, or purchasing CDS protection on, securities offered in the ABS transaction or its underlying securities."[9]

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7 *Id.*
8 Release at 60328.
9 Release at 60328.

The Release suggests that the Proposed Rule would not cover other transactions falling outside this familiar scenario. For example, the Release explains that the Proposed Rule 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."[10]

This circular, self-referential interpretation of the statutory mandate is much too narrow and it is inconsistent with the statutory language. Section 621 prohibits securitization participants from engaging in—

> **any** transaction that would involve or result in **any** material conflict of interest with respect to **any** investor in [the ABS transaction].[11]

The Proposed Rule incorporates this broad language, yet the interpretive guidance is far more narrow. For example, it is easily foreseeable that taking a short position not as to pool assets but as to other investments that are linked to pool assets would create an opportunity for a securitization participant to benefit from the adverse performance of pool assets. Although such conflicts might be characterized by some as indirect, the statutory ban against conflicts of interest set forth in Section 621 nonetheless requires them to be within the scope of the Proposed Rule.

Given the broad language of Section 621, and its goal of eradicating conflicts of interest in ABS offerings, the transactions that create conflicts of interest within the scope of Section 621 must be broadly interpreted. The final interpretive guidance must dispel the suggestions in the Release that a narrow interpretation of the Proposed Rule will apply.

The Commission must reject unfounded calls to implement an intent requirement or require an actual downturn in the value of ABS before a conflict of interest is deemed material.

The Release explains that the Proposed Rule does not define the term "material conflict of interest" because establishing a precise definition might render the Proposed Rule either over- or under-inclusive, especially given the complex, varied, and evolving nature of the securitization market.[12] Instead, the Release sets forth interpretive guidance for determining whether or not a conflict of interest is "material" within the meaning of Section 621 and the Proposed Rule. The guidance essentially provides that a conflict of interest is material if—

(1) a securitization participant would benefit from the actual or potential adverse performance of the asset pool; **or**

[10] Release at 60331.
[11] Dodd-Frank Act, § 621(a) (emphasis added).
[12] Release at 60329.

(2) a securitization participant who controls the structure of the ABS would benefit by allowing a third party to structure the ABS in a way that gives the third party an opportunity to benefit from short transactions on the ABS; **and**

(3) there is a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision.[13]

The Release also includes two general guidelines for determining whether a conflict of interest is material. It explains that it would **not** be necessary for a securitization participant to intentionally design an ABS to fail to trigger the prohibition in the rule against material conflicts of interest.[14] Rather, the Release notes that the intent of Section 621 is broader, as it flatly—

> prohibits securitization participants from benefiting from the failure of financial instruments that they help structure, offer, and sell to investors.[15]

The Release also explains that it would **not** be necessary for the market value of the ABS to actually decline for a material conflict of interest to arise, and that it would be sufficient if a securitization participant engaged in a transaction that would give the participant the **opportunity** to benefit if the value of the ABS were to decline.[16]

Both of these interpretations are positive and they are consistent with the language of Section 621 and its underlying purposes. That statutory section contains **no** reference to an intent requirement, and the actual phrasing of the provision does nothing to suggest that Congress intended to impose one. Indeed, the statutory language compels the opposite conclusion. It specifically prohibits transactions that would "involve **or result**" in any material conflict of interest,[17] and this construction is **not** consistent with an intent requirement.

In addition, requiring a showing of intent would make violations of the statutory provision and the Proposed Rule vastly more difficult to prove. The intent element in any securities law violation is a hurdle that often frustrates efforts by regulators to hold violators accountable, even where intent is undoubtedly present. This challenge is even more acute when the market participant involved in illegal activity is a massive Wall Street firm with dozens of employees involved in a given transaction and multiple layers of supervision. That is presumably one of the reasons why Congress did not write an intent requirement into the law and why the Proposed Rule must not either.

Finally, requiring an actual market decline in ABS assets as an element of a violation of the ban against conflicts of interest would allow unsuccessful attempts to violate the law

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[13] Release at 60329-33.
[14] Release at 60330.
[15] *Id.*
[16] *Id.*
[17] Dodd-Frank Act, § 621(a). (emphasis added)

to escape punishment, an approach that is widely inconsistent with the securities laws. This requirement would also conflict with the language and intent of Section 621 and must be kept out of the Proposed Rule as well.

Notwithstanding these provisions that are consistent with the statutory mandate and goals, some of the guidance set forth in the Release raises a concern. For example, the second prong of the materiality test above is too narrow. It only applies to securitization participants who directly or indirectly **control the structure of the ABS transaction** or the selection of assets underlying the ABS, and who allow a third party to structure the transaction so as to benefit from a downturn in the ABS assets.[18] There is no basis or need for the Proposed Rule or the interpretive guidance to establish such a precondition that centers on the degree of control that a securitization participant exerts over the transaction.

Such an approach is legally unnecessary, unduly restrictive, and difficult to apply. It would be sufficient and fully consistent with the statutory provision simply to provide that a material conflict of interest arises if a participant, regardless of their degree of control over the structure of the ABS transaction, does in fact allow a third party to structure the transaction in a way that enables it to benefit. The exact nature of the control or authority used to achieve this delegation is irrelevant from a statutory and regulatory perspective.

This simpler and less limiting approach is more consistent with the goal of Section 621, which is to broadly prohibit the types of conflicts of interest that may arise in connection with the issuance of ABS. Lastly, creating such a precondition would only serve to create defenses for securitization participants who have the de facto power to influence the structure of an ABS offering, but could nevertheless disclaim any liability on the ground that they lacked the formal authority to control the structure of the transaction. Again, form simply cannot be allowed to control over substance.

The Commission must not allow conflicts of interest to persist simply by virtue of disclosure.

The Release raises another important concern by soliciting comment on "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."[19] The Release explains that the issue arises because the third prong of the materiality test centers on the importance that a reasonable investor would attach to a conflict of interest. As observed in the Release, this is a well-established test under the securities laws for determining whether disclosure to investors about securities transactions is necessary.[20]

Disclosure, no matter how thorough, must not be permitted to eliminate or mitigate the responsibility under the Proposed Rule to avoid conflicts of interest in securitization

[18] Release at 60331.
[19] Release at 60332; 60343-44.
[20] Release at 60332.

transactions. Nothing in the language or intent of the law supports the creation of a broad exception from the prohibition against conflicts of interest based on mere disclosure.

Allowing disclosure to de facto authorize conflicts of interest is also unjustifiable from a practical standpoint. As noted in the Release, reliance on disclosure to address conflicts of interest is simply not feasible at least as to transactions arising after offering documents have already been disseminated.[21]

Disclosure is also a flawed remedy for conflicts of interest because it is exceedingly difficult to ensure that investors receive accurate, clear, comprehensible, and timely disclosure of the information they would truly need to understand the nature and significance of the conflicts of interest presented. In fact, a disclosure regime can actually facilitate abuse by enabling market participants to invoke the most obscure and meaningless disclosure to investors as a shield against liability for even egregious conflicts of interest, the very conduct the law prohibits.[22]

In short, allowing a disclosure regime to exonerate conflicts of interest would actually cause their proliferation, gut the Proposed Rule, and defeat Congress's core purpose in enacting Section 621 of the law. [23]

The interpretive guidance used to identify bona-fide risk-mitigating hedging activity must be expanded.

In accordance with Section 621, the Proposed Rule would identify three types of activities that would not be deemed to create a conflict of interest within the meaning of

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21 *Id.*

22 If, notwithstanding the unconditional prohibition against conflicts of interest in Section 621, and the many practical considerations discussed above, the Proposed Rule was nevertheless amended to allow conflicts of interest to be mitigated or excused by disclosure, the disclosure requirements would have to be very strong and prescriptive. For example, disclosure to investors would have to be (1) in written form, (2) a minimum time period in advance of investment, (3) in plain language that clearly and comprehensibly detailed the nature and significance of the conflict, and (4) subject to a written acknowledgment of the disclosure from the investor. All of these requirements would be necessary to create any possibility of meaningful disclosure and they would also be necessary to help monitor and enforce compliance with a disclosure regime, both by regulators and in private actions or dispute resolution proceedings. However, none of these comments should be read to suggest that a disclosure regime which allows conflicts of interest to persist would actually be acceptable or consistent with the clear statutory prohibition in Section 621 and its underlying policy goal.

23 In a related vein, the Release solicits comment on whether "information barriers" could be used to permit affiliates of firms, or different units within a firm, to engage in transactions that would otherwise be prohibited under the Proposed Rule. Release at 60341-43. Apart from the fact that Section 621 does not contemplate such exceptions, history has proved time and again that information barriers are not reliable and are difficult for regulators to monitor and enforce; they have no place in the implementation of Section 621. *See, e.g.,* Christopher M. Gorman, Note, *Are Chinese Walls the Best Solution to the Problems of Insider Trading and Conflicts of Interest in Broker-Dealers?* IX FORDHAM J. OF CORP. & FIN. L. 475 (2004) ("Chinese Walls, whether used conceptually to prevent insider trading or structurally to prevent conflicts of interest, are inefficient, largely ineffective, and have more shortcomings than advantages"). A recent SEC enforcement action exemplifies the point: http://www.sec.gov/news/press/2011/2011-144.htm.

the statute: (1) hedging, (2) trading pursuant to liquidity commitments, and (3) market-making. First among those exempted activities is hedging, described as—

> 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.[24]

As with the Proposed Rule generally, this language tracks the statutory wording, and the Release provides important guidance for the interpretation and application of the hedging exception.

The Release makes clear that the purpose of the exception is to support the securitization process by enabling participants to mitigate their risks associated with securitization transactions, and that its purpose is **not** "to permit speculative trading masked as risk-mitigating hedging activities."[25] The Release illustrates the narrow focus of the exception by noting that securitization participants would be permitted to hedge against declines in the price of assets as those assets are being assembled for inclusion in the ABS pool, a scenario that poses a low threat of abuse,[26] assuming that it is in fact, form, and substance properly hedged.

To help prevent abuses of the hedging exception, the Release includes a number of important requirements and guidelines that would assist in identifying bona fide hedging activity covered by the exception. They include the following:

1. The hedging would have to reduce specific risks associated with positions or holdings arising out of the securitization transaction;

2. The hedging could not include trading to establish new positions designed to earn a profit;

3. Material changes in risk should generate a corresponding change in the hedging;

4. The hedging generally should unwind as the exposure is reduced;

5. Intermittent hedging activity (i.e. hedging only when one chooses to act) or activity that is inconsistent with a hedging policy is indicative of proprietary trading rather than hedging;

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[24] Release at 60333-35.
[25] Release at 60333-34.
[26] *Id.*

6. The hedge should not be significantly greater than the actual exposure to the underlying assets;

7. The notional amount of the hedge should be correlated so that losses and gains on the position being hedged are offset by gains and losses on the hedge without appreciable differences; and

8. Activity would not qualify as risk-mitigating hedging if a securitization participant earned appreciably more profits on the hedge than the losses incurred from their ABS exposure.[27]

These are useful guides for identifying the type of activity that could be considered legitimate risk-mitigating hedging under the Proposed Rule, but the list must be strengthened and the following requirements must be added:

1. The guidance should stipulate that there must be exact congruence between risks being hedged and the corresponding hedge positions, rather than merely a rough correspondence between the risk hedged and the hedging position as suggested in item 6 above; if exact congruence is impossible, then a detailed explanation of the market conditions and other reasons must be contemporaneously documented and certified by the Chief Executive Officer and the Chief Compliance Officer;

2. The participant claiming the exception must document the transactions with information showing the precise risk being hedged, the corresponding hedge transaction, the manner in which the position taken addresses the risk identified, and the evolution of the hedge and the correlated risks over time;

3. To be eligible for the exception, all hedges must be made in accordance with written policies and procedures regarding risk-mitigating hedging activities;

4. All hedging activity related to the ABS transaction must be disclosed to investors in a timely fashion and in a readily accessible and comprehensible form;

5. Participants claiming the exception must affirmatively certify that the activity is entered for the sole purpose of hedging a risk arising in connection with the securitization activities, and not for the purpose of generating speculative profits; and

27 Release at 60334.

6. No employee may receive compensation arising from or related in any way to any income generated by any hedging activity because any such income would be incidental and unintended.

The addition of these important elements to the interpretive guidance will not only help reliably distinguish bona fide hedging from speculative trading, it will also help ensure that the Commission has the tools necessary to monitor and enforce compliance with the terms of the hedging exception.

The universe of acceptable liquidity commitments must be limited and additional factors must be applied to identify bona fide market-making.

In accordance with Section 621, the Proposed Rule exempts two additional types of trading activity from the prohibition against conflicts of interest in connection with ABS offerings. The first type relates to transactions that fulfill liquidity commitments:

> 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.[28]

The second type relates to "purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security."[29] These exceptions were intended to allow securitization participants to "support the value of [an ABS] security in the aftermarket by providing liquidity and a ready two-sided market for it."[30]

The guidance in the Release for implementing these exceptions is helpful, but insufficient. It must also include some additional limitations and requirements. With respect to liquidity transactions, the Release suggests that a wide range of activities would fall under that rubric, including, for example, short term loans to ensure that adequate cash flows are maintained for investors.[31] However, this broad interpretation of the exception goes well beyond the plain language of the statute, which limits the exception to "**purchases or sales of asset-backed securities**" pursuant to liquidity commitments.[32] Moreover, applying this exception to an open-ended and unspecified variety of transactions creates uncertainty and invites abuse.

It is quite possible that loan transactions could be structured with terms that would significantly benefit the lending entity upon default or poor performance in the pool assets. Therefore, the interpretive guidance should make clear that the liquidity transactions permitted under this exception must be purchases and sales of ABS, and it must more

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28 Release at 60335.
29 Release at 60336.
30 *See* 156 Cong. Rec. S5899 (July 15, 2010) (statement of Sen. Levin).
31 Release at 60335.
32 Dodd-Frank Act, § 621(a).

specifically identify the types of purchase and sale transactions that would qualify for the exception governing liquidity commitments.

With respect to market-making, the Release enumerates various characteristics of bona fide market-making activity that would not violate the ban on conflicts of interest:

1. It includes purchasing and selling the ABS from or to investors in the secondary market;

2. It includes holding oneself out as willing and available to provide liquidity on both sides of the market;

3. It is driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market-makers;

4. 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;

5. 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 or the dealer with respect to the ABS;

6. 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;

7. It generally does not include actively accumulating a long or short position other than to facilitate customer trading interest;

8. 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; and

9. The fact that the 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, since otherwise such an account or trading desk could be used to disguise proprietary trading as market-making.[33]

These guidelines are helpful and appropriate, but also incomplete. For example, Factor number 2, which involves holding oneself out as willing and available to provide liquidity on both sides of the market, should be expanded to include **actually providing** liquidity on both sides of the market, even under adverse conditions. That is an important

[33] Release at 60336.

characteristic of true market-makers, and it distinguishes them from participants such as high frequency traders who trade both sides of the market only when it serves their proprietary trading purposes.[34]

Furthermore, the list of factors identifying market-making activity eligible for the exception must be expanded to include some of the same factors discussed above in connection with hedging activity and for the same reasons. These additional elements must include the following:

1. All transactions must be documented to reflect the presence of the required indicia and to demonstrate that the activity constitutes bona fide market-making with respect to the ABS offering;

2. All market-making transactions must be made in accordance with written policies and procedures;

3. All market-making activity related must be disclosed to investors in a timely fashion and in a readily accessible and comprehensible form; and

4. All participants claiming the exception must affirmatively certify that the activity is entered for the sole purpose of market-making in connection with the securitization, and not for the purpose of generating speculative profits.

As in the case of the hedging exception, the application of these additional factors will help ensure that the exception for market-making activity is narrowly applied, that abuses are minimal, and that the Commission will be better equipped to monitor and enforce compliance with the terms of the exception.

CONCLUSION

Without the additions and modifications set forth above, the Proposed Rule may not only defeat the clear purpose and language of the statute, but also open the markets, through loopholes and narrow constructions, to the very predatory conduct that the law seeks to prevent.

[34] High volume trading strategies must not be confused with market making. Many firms, including banks, use computer executed algorithms as part of their trading strategies, including a particular form of algorithmic trading called High Frequency Trading ("HFT"). However, a trading strategy is not in itself market making. Algorithmic traders in general and HFTs in particular do not hold themselves ready to buy or sell the financial instruments they trade. On the contrary, they offer to buy or sell only when they believe there are profits to be made by doing so. These traders can and do walk away from markets when it is in their interest. Therefore, HFT and algorithmic traders are not market makers and would not fall within the exception in the Proposed Rule for "bona-fide market-making."

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We hope these comments are helpful.

Sincerely,

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