Association of Institutional INVESTORS™

February 13, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE.,
Washington, D.C. 20549

Re: Prohibition Against Conflicts of Interest in Certain Securitizations (RIN 3235–AL04) (File Number S7-38-11)

Dear Ms. Murphy,

The Association of Institutional INVESTORS (the "Association")[1] appreciates the opportunity to provide comments related to the Securities and Exchange Commission's ("SEC" or "Commission") proposed rule titled, "Prohibition against Conflicts of Interest in Certain Securitizations" (the "Proposed Rule").[2] The Association recognizes the efforts undertaken by the Commission to implement rules required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") with minimal market disruption.[3] Nonetheless, we have concerns with the Proposed Rule related to (1) the risk mitigation hedging exception; (2) the definition of "material conflict of interest;" and (3) the definition of "covered products."

Section 621 of the Dodd-Frank Act created new Section 27B of the Securities Act, which prohibits an underwriter, placement agent, initial purchaser, sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security ("ABS") from engaging in a transaction that would involve or result in certain material conflicts of interest. This provision is intended to end conflicts of interests in securitizations by prohibiting a firm from assembling asset-backed securities, selling those securities to clients, betting against those securities, and then profiting from the ultimate failure of

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[1] The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

[2] *See* Prohibition against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 60,320 (Sept. 28, 2011).

[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

those securities. We believe that this proposed rule overreaches in its definitions of risk-mitigating hedging and conflicts of interests, among others.

I. Risk-Mitigating Hedging

Section 621 of the Dodd-Frank Act requires regulators to include an exemption from the conflicts of interest rulemaking for risk-mitigating hedging activities. We agree that this exemption is critical and appreciate the Commission's efforts to ensure that risk-mitigating hedging activities remain permitted. However, we are concerned that the exemption in the proposed rule is too narrow and may ultimately reduce liquidity in the secondary mortgage market for investors.

The proposed rule defines risk-mitigating hedging activities as positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS, 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. We believe that using the term "specific" is not in harmony with congressional intent in drafting this section of the Dodd-Frank Act.

During the Dodd-Frank Act debate, Congress realized it would be difficult to determine what should be considered a hedge. Senator Jeff Merkley (D-OR), one of the principle drafters of Section 621, stated on the Senate floor that financial firms must be provided with enough interpretative leeway to make "reasonable regulatory judgment calls."[4] By placing the term "specific" in the definition, we are concerned that the Commission may be implementing stringent and non-flexible requirements and taking away the ability of financial firms to make such "reasonable regulatory judgment calls" regarding important financial products and activities that are imperative to the proper functioning of the institutional markets, such as the imperfect hedge. Put another way, disallowing banks from engaging in activities such as imperfect hedging may cause banks to refrain from engaging in transactions with institutional investment advisers out of fear that regulators will not view their activities as risk-mitigating hedging. Banks will often not be able to create a perfect hedge of the specific risk embedded in the securitization transaction. In such situations, banks must have other options that may leave them susceptible to some risk, but ultimately allow such banks to continue providing a market for these securities.

The Association urges the Commission to remove the term "specific" from the risk-mitigating hedging exemption. The Commission's rulemaking should allow the industry to imperfectly hedge. Such activity is inherently beneficial: it allows banks to properly and effectively hedge their risk. Additionally, removing the term "specific" will ensure that banks do not leave the market due to concerns that their legitimate risk-mitigating hedging activities will not be viewed as such by the regulators and ensure that reasonable regulatory judgment calls are left intact.

II. Conflicts of Interest

Under the proposed rule, a material conflict of interest is defined as a conflict arising between a securitization participant and investors in the relevant ABS if the securitization participant would

[4] 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley (D-OR)).

benefit directly from any adverse performance, loss, or decline in market value of the relevant ABS and a reasonable investor would consider this important to an investment decision. Alternatively, the proposed definition of conflict of interest accounts for a situation in which a securitization participant, controlling the ABS structure, benefits as a result of allowing a third party to structure the transaction in a manner that would allow for such third party to potentially benefit from a short transaction, and a reasonable investor would consider the conflict important to an investment decision.[5]

As a threshold matter, the Association disagrees with the premise that simply taking an adverse position, such as shorting mortgage securities, necessarily creates a conflict of interest. In the capital markets, deals occur between counterparties willing to engage in the transaction. Transactions necessarily have "losers" and "winners" because they inherently involve some element of risk. However, it should not be considered an inherent conflict of interest when two parties engage in a transaction and one party determines that the position taken by the other party was not wise, as parties do not always have the same motivators or risk position. For example, in the securitization process, asset originators and ABS sponsors seek to reduce their risk exposure, while the purchasers hope for a return on their investment. Thus, the premise that simply taking an adverse position, such as shorting mortgage securities, necessarily creates a conflict of interest is misguided.

The Commission's overly broad definition of conflict of interest may limit the liquidity and capital available – effectively shrinking the market. In response to the SEC's initial request for comments on Section 621 of the Dodd-Frank Act, entities such as the Securities Industry and Financial Markets Association ("SIFMA") explained in a comment letter that the rule would have to be limited to ensure the ABS market can continue functioning effectively.[6] The Association agrees with SIFMA's comments and believes that the Commission's expansive definition will negatively affect the market. While the Association recognizes that the SEC has attempted to limit the universe by clearly defining "material conflict of interest," we propose that the Commission narrow this definition further.

Accordingly, the Association offers that transparency may resolve many potential conflicts of interest, providing the buyer with full knowledge of what is being purchased and permitting the seller to still take any position. In discussing disclosure on the Senate floor, Congress noted that additional conflicts of interest prohibitions are necessary for synthetic ABS.[7] For traditional ABS,

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[5] In other words, a securitization participant may benefit directly or indirectly from: 1. the actual, anticipated, or potential adverse performance of the asset pool underlying the relevant ABS; 2. the loss of principal, monetary default, or early amortization event on the ABS; or 3. the decline in market value of the relevant ABS. A securitization participant may also control the structure of the relevant ABS or the selection of assets underlying the ABS and benefit from fees, other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party to structure the relevant ABS, or select assets underlying the ABS, in a way that allows for the third party to potentially benefit from a short transaction. Under either scenario, there must be a substantial likelihood that a reasonable investor would consider these conflicts important to the investment decision. Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. at 60,329.

[6] Letter from Mr. Richard A. Dorfman, SIFMA, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (December 10, 2010), *available at* http://www.sec.gov/comments/df-title-vi/conflicts-of-interest/conflictsofinterest-10.pdf.

[7] 156 CONG. REC. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin (D-MI)) ("But a firm that underwrites an asset-backed security would run afoul of [Sec. 621] if it also takes the short position in a synthetic asset backed security

however, transparency through disclosure seems to be a viable alternative. The Association agrees that disclosure itself may not cure conflicts of interest associated with synthetic ABS, but concerns regarding conflicts of interest in traditional ABS transactions would be adequately addressed by disclosure. The Commission could address Congress' goal in this rulemaking by requiring disclosure for traditional ABS, and limiting this rulemaking to the areas where it is necessary, namely collateralized debt obligations ("CDOs") stemming from synthetic ABS.

Furthermore, we believe the Commission should consider independent pricing of ABS as a way to limit conflicts of interest without harming this market. Currently, the firms that package securities also price them, and the Association believes that such a dual role lacks adequate checks and balances. Independent pricing would allow firms to meet end-of-day compliance accounting requirements more easily, as well as help firms comply with other recordkeeping and reporting requirements under the Dodd-Frank Act. It will also allow firms to conduct transactions over an easier platform, less susceptible to error. Although including a third party entity to price ABS may increase some costs, it will also provide some investor protections to ordinary investors while allowing the market to remain liquid.

III. Covered Products

Finally, the Association also believes the definition for covered products, similar to the other definitions, is over-inclusive. The proposed rule defines covered products as any ABS, including fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a security or unsecured receivable), that allows the holder of the security to receive payments that depend primarily on cash flows from the asset including: (1) a collateralized mortgage obligation, (2) a collateralized debt obligation, (3) a collateralized bond obligation, (4) a collateralized debt obligation of ABS, (5) a collateralized debt obligation of collateralized debt obligations, and (6) a security that the SEC determines to be an ABS, including a synthetic ABS.

By including all of these products in the rule, we believe the regulators are overcorrecting for a problem that occurred solely in the mortgage market. In the process, we believe this definition has the potential to destroy the broader ABS market and adversely affect the real economy.

The Association believes the majority of the risk arises out of synthetic ABS and CDOs, rather than with the traditional ABS market. Therefore, we argue that including traditional ABS and other cash purchases in the proposed rule may go beyond what is necessary to address the most problematic products. In traditional ABS transactions, asset managers hire dealers to help turn loans into securities as an inexpensive funding source for the market. These situations allow dealers to earn a small fee, but include less risk because there are no synthetic transactions at any step in the process. The amount of risk that can be taken and leveraged is limited in such a situation, as opposed to synthetic ABS, where limitless amounts of risk can be taken by banks because the securitization is not tied to specific assets. The definition of covered products should be revised to include synthetic

that references the same assets it created. In such an instance, even a disclosure to the purchaser of the underlying asset-backed security that the underwriter has or might in the future bet against the security will not cure the material conflict of interest.").

ABS, and exclude traditional ABS, thereby addressing the problem without causing any additional and unnecessary harm to the market.

At a minimum, we urge the Commission to limit the definition to focus on synthetic ABS, while allowing for traditional ABS to continue playing its important role in the secondary market with enhanced disclosure requirements.

V. CONCLUSION

The Association recognizes the challenges the SEC faces in implementing these new requirements and appreciates the Commission's consideration of our concerns. We thank the Commission for the opportunity to comment on the Proposed Rule. Please feel free to contact me with any questions you may have on our comments at jgidman@loomissayles.com or (617) 748-1748.

On behalf of the Association of Institutional INVESTORS,

John R. Gidman

cc: **Honorable Mary Schapiro, Chairman**
Honorable Elisse Walter, Commissioner
Honorable Luis Aguilar, Commissioner
Honorable Troy Paredes, Commissioner
Honorable Daniel Gallagher, Commissioner