United States Senate
WASHINGTON, DC 20510

January 12, 2012

VIA EMAIL (rule-comments@sec.gov)

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

RE: Proposed Rule to Prohibit Conflicts of Interest in Asset-Backed Securitizations, File No. S7-38-11

Dear Ms. Murphy:

The purpose of this letter is to express support for and suggest enhancements to the proposed rule, issued pursuant to Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), implementing the prohibition on conflicts of interest in asset-backed securitizations.[1] Section 621is intended to restore integrity to the securitization markets by providing strong prohibitions against conflicts of interest by underwriters, placement agents, sponsors, and others.

Section 621, which we authored,[2] is intended to prevent the types of abusive securitizations that contributed to the 2008 financial crisis, including securitizations that were collections of unwanted assets, transactions that were designed to fail so that the sponsor could profit by betting against the success of the securities, asset selections that secretly benefited one investor over others, and securitizations that were designed to produce hidden fees or financial advantages for the sponsors at the detriment of the investors. The proposed rule is designed to put an end to this type of self-dealing and ensure asset-backed securities are designed to benefit investors, although the rule would also benefit from changes that would further simplify and strengthen its approach, as indicated below.

Need for Strong Conflict of Interest Protections

Prior to enactment of the Dodd-Frank Act, Congress learned how conflicts of interest in the securitization market contributed significantly to the financial collapse. In an investigation spanning more than two years, the Permanent Subcommittee on Investigations, which Senator

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 sec. 621, § 27B, 124 Stat. at 1631-32 (codified at 15 U.S.C. 77z-2a).

[2] Section 621 arose out of a similar provision in a bill introduced by Senators Merkley and Levin on March 10, 2010. *See* PROP Trading Act, S. 3098, 111th Cong. sec. 3, § 6 (2010). It was then modified in several subsequent Merkley-Levin amendments introduced during the Senate debate over the Dodd-Frank Act. *See, e.g.,* S. Amdt. 4101, 111th Cong. (2010), 156 CONG. REC. S3935-38 (daily ed. May 18, 2010).

Levin chairs, examined the key causes of the financial crisis, holding four hearings,[3] and issuing a 750-page report,[4] including thousands of pages of exhibits.

One of the key issues examined by the Subcommittee was the role of investment banks in contributing to the financial crisis through their role in the mortgage securitization markets.[5] The Subcommittee's investigation showed that those who sponsor, underwrite, or serve as placement agent for asset-backed securities (ABS) typically select the underlying assets, design the securities, market them to investors, and often manage them during the securities' lifetime, and so are exceptionally well-positioned to know and determine whether an ABS product has been intended to succeed or fail. One case history developed by the Subcommittee also demonstrated that, in some cases, investment banks engaged in transactions that created conflicts of interest between them and the investors to whom the ABS securities were sold, and abused their positions by putting their own financial interests before those of their clients.

As part of its work, the Subcommittee developed detailed case histories on how Goldman Sachs and Deutsch Bank structured, marketed, and sold certain high risk, poor quality mortgage products to investors.[6] The Goldman case history also disclosed how that firm engaged in an egregious form of self-dealing: designing ABS products expected to fail, peddling them to unsuspecting clients, and making proprietary trading bets that paid off when the products performed poorly or collapsed,[7] a practice has been analogized to a firm designing a car with faulty brakes and then purchasing a life insurance policy on the driver.[8] The Goldman case history also examined an ABS in which Goldman allowed a favored client who wanted to bet against the mortgage market to help select the assets for the securitization, then sold the securities to unwitting investors, and failed to tell those investors that the cards were stacked against them.[9]

These and other specific securitizations studied by the Subcommittee provide direct evidence of the serious conflicts of interest that Section 621 is intended to stop.[10] Securitization transactions rife with conflicts of interest demonstrate not only the importance of investor safeguards, but also the need to strengthen aspects of the proposed rule.

---

[3] See "Wall Street and the Financial Crisis," hearings before the U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 111-671 to 111-674, Volumes 1-5 (April 2010).

[4] "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," U.S. Senate Permanent Subcommittee on Investigations, S.Hrg. 112-675, Volumes 5, (April 13, 2011)(hereinafter "Subcommittee Report").

[5] "Wall Street and the Financial Crisis: The Role of Investment Banks," S.Hrg. 111-674, Volume 4 (April 27, 2010)(hereinafter "Subcommittee Hearing on Investment Banks").

[6] See Subcommittee Report at 385-764.

[7] See Subcommittee Report at 618-721.

[8] See *First Public Hearing of the Fin. Crisis Inquiry Comm'n* at 29–31 (Jan. 13, 2010) (statement of Phil Angelides, Chairman, Financial Crisis Inquiry Commission) (questioning Goldman Sachs Chief Executive Officer Lloyd Blankfein), *available at* http://fcic.gov/hearings/testimony/first-public-hearing. See also 156 CONG. REC. S4057 (daily ed. May 20, 2010) (statement of Senator Merkley analogizing the self-dealing to hiring an electrician who takes out a fire policy on a client's home).

[9] See Subcommittee Report at 669-86.

[10] 156 CONG. REC. S5899 (daily ed. July 15, 2010) (statement of Senator Levin, "[S]ection 621 … addresses the blatant conflicts of interest in the underwriting of asset-backed securities highlighted in a hearing with Goldman Sachs before the Permanent Subcommittee.").

The Proposed Rule

The proposed rule closely follows the language of Section 621.[11] It establishes five key conditions that define the circumstances in which the proposed rule would apply to prohibit material conflicts of interest in the securitization process. To be covered by the prohibition, transactions must include: (1) covered persons, (2) covered products, (3) a covered timeframe, (4) covered conflicts, and (5) a "material conflict of interest."[12]

Covered Persons. The first element of the rule specifies the persons covered by the proposed rulemaking. The proposed rule would apply to "an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity," of an asset-backed security (ABS)."[13] While recognizing that such parties "typically have substantial roles in the assembly, packaging and sale of ABS,"[14] this language simply repeats the statutory terms without adding needed clarification to ensure key ABS participants are prohibited from engaging in conflicts of interest damaging to the securitization markets.

The rule should define the terms used to describe who is a covered person, and those persons should, in the aggregate, cover any party that has made a material contribution to the economic structure or composition of an ABS, its management, or the sale of interests in the ABS product to investors. The rule should make it clear that the test for whether a person is covered by the rule will depend not just on the person's job title, but the party's economic involvement in the securitization transaction.

For instance, collateral managers typically have significant influence in the structure, composition, and management of an ABS. Collateral managers are typically the main driver behind the selection of assets for an ABS, the structure and the cash flow of the ABS, and the purchase price for assets. To leave collateral managers out of a rule intended to limit conflicts of interest in securitizations would make no sense in the context of industry norms and would unduly restrict the rule's scope and impact.

As currently drafted, the proposed rule could use the term "sponsor" as a type of catchall phrase to encompass a variety of securitization participants. Instead, however, the proposed rule suggests adopting the much narrower definition of "sponsor" used in Regulation AB.[15] Adopting the definition of "sponsor" used in Regulation AB risks using a term that is both under-inclusive and confusing in the context of Section 621.[16] A better approach would be to define "sponsor" broadly for purposes of Section 621 to include "any person (including a collateral manager, servicer, or custodian) who, for a fee or other remuneration or benefit, participates in the design, composition, assembly, sale, or management of the ABS."

The Subcommittee's work demonstrates the need for the rule to cover a broad range of securitization participants. For instance, the Subcommittee examined a 2007 collateralized debt

---

[11] Proposed rule at 17.
[12] Proposed rule at 19.
[13] *Id.*
[14] *Id.*
[15] Proposed rule at 20.
[16] *Id.*

obligation (CDO) that had been assembled by Goldman called Anderson Mezzanine Funding 2007-1 ("Anderson").[17] Goldman served as the placement agent and initial purchaser for the CDO, but also worked closely with a hedge fund, GSC Partners, to organize the transaction. GSC helped structure Anderson and select the assets. GSC also shared warehouse risk with Goldman, and shorted some of the assets in Anderson as a hedge. In addition, GSC played a role in the sale of Anderson securities, working with Goldman traders to help assuage investor fears about the poor quality of the assets selected for the CDO. Despite GSC's significant participation in Anderson, GSC's identity was not disclosed on marketing materials distributed to potential investors. A senior trader at GSC explained that he did not believe that GSC's involvement rose to the level of requiring disclosure to investors.

In the example of Anderson, it is unclear whether GSC would fit within the industry definition of a placement agent, sponsor, or even a collateral manager of the CDO, since it had no ongoing management responsibility for the CDO. At the same time, GSC was a major participant in the CDO's creation and promotion, and was clearly in a position to enter into a material conflict of interest that could disadvantage investors. It is exactly the type of securitization participant who should be covered by the rule. To ensure that parties with significant participation in a securitization are subject to the prohibition on conflicts of interest, we recommend that the rule either define "sponsor" broadly to include parties like GSC, as indicated above, or that the rule be amended to cover "an underwriter, placement agent, initial purchaser, or sponsor of an ABS, any affiliate or subsidiary of such entity, or any other person that makes a material contribution to the design, composition, assembly, sale, or management of the ABS."

Covered Products. The intent of Section 621 is to restore confidence in U.S. securitization markets, so it is crucial that the proposed rule apply broadly to the wide variety of ABS products that exist today, as well as those that will be designed over the coming years. The proposed rule follows the statutory mandate that it cover asset-backed securities, as that term is defined by Section 3(a)(77) of the Securities Exchange Act of 1934, as well as synthetic asset backed securities.[18] In using the newly-created definition under Section 3(a), Congress explicitly rejected the more narrow definition of an ABS used in Regulation AB.

Because the Section 3(a)(77) definition is so new, its contours are still somewhat fluid.[19] The success of the proposed rule will, thus, rely in part on the Commission's interpretation of Section 3(a)(77). Since that definition explicitly applies to "securities," including CDOs, it already encompasses both registered and unregistered ABS products, which is important given that the CDOs at the center of the financial crisis were unregistered securities.

The proposed rule also clearly encompasses synthetic ABS products,[20] a term that currently has no statutory definition. The proposed rule does not offer its own definition of "synthetic asset-backed securities," instead noting that the term is commonly understood by market participants.[21] While that may be true, the rule should not rely exclusively on the

---

[17] See Subcommittee Report at 636-47.
[18] Proposed rule at 25.
[19] The definition is contained in Section 941 of the Dodd-Frank Act, codified at 15 USC 78c(a)(77).
[20] Dodd-Frank Act, §941.
[21] Proposed rule at 26.

understandings of market participants, as those may vary and shift over time. Instead, the rule should provide its own definition, and ensure that it is sufficiently broad to cover any synthetic product that creates an economic exposure equivalent to one or more ABS. A possible definition in line with Section 3(a)(77) would be a "fixed-income or other security that references any type of financial asset (including a loan, a lease, a mortgage, a secured or unsecured receivable, or index) and allows the holder of the security to receive payments that depend primarily on the value or performance of the referenced assets." The rule should also explicitly cover so-called "hybrid" ABS products that contain a mix of cash and synthetic assets, a common occurrence during the financial crisis.

Finally, to ensure that financial innovation does not render the definition under-inclusive, the rule should add a catchall provision to its definition of covered products to ensure the rule will apply to any financial product that is the economic equivalent of a cash, synthetic, or hybrid ABS. Without that added provision, the proposed rule could find itself unable to restrain conflicts of interest affecting products important to the ABS markets.

The Subcommittee's Goldman case study helps to illustrate the need for a broad catchall provision for covered products. In Abacus 2007-AC1, Goldman allowed a favored hedge fund client to participate in the selection of the assets and then short the CDO without telling potential investors of the hedge fund's adverse interest.[22] This transaction is a glaring example of the type of conflicts of interest Section 621 was intended to prohibit. Abacus 2007-AC1 was one of a series of Abacus CDOs that, while synthetic, had complex structures different from a traditional synthetic asset-backed security. Although economically equivalent to a synthetic ABS, the counterparty's investment was not necessarily collateralized by the mortgage-backed securities that were the economic substance of the transaction. Rather, cash was collateralized by one set of low-interest investments owned by the Abacus trust, and the true substance of the transaction was based on premiums or losses accrued to the investor based on the performance of a pool of mortgage-backed securities not owned by the trust. Although it appears the Abacus transactions as they existed before the financial crisis would be covered under the proposed rule, it is also conceivable that a bank could add additional layers of complexity to the structure and potentially avoid classification as an asset-backed security. Therefore, it is important that the rule focus on the economic substance of a transaction, rather than rely solely on technical classifications.

The Subcommittee's work also supports the proposed rule's decision to cover both registered and unregistered securities. Billions of dollars worth of unregistered CDO securities made up a significant portion of the ABS market before the financial crisis. Altogether at its peak, the Securities Industry and Financial Markets Association estimated that the global CDO market between 2005 and 2007 exceeded $1 trillion.[23] If these unregistered securities were not covered by the proposed rule, it would fail to apply to economically significant financial instruments at the center of the financial crisis that were squarely within the intended targets of the section. Because the proposed rule relies on the Section 3(a)(77) definition of asset-backed security, it already covers both registered and unregistered cash ABS products; the same should be true of synthetic and hybrid ABS products. To be effective, the rule must cover all types of

[22] See Subcommittee Report at 669-86.
[23] Press Release, Sec. Indust. and Fin. Mkt. Ass'n, Global CDO Issuance (July 1, 2011).

asset-backed securities, and their economic equivalents, in order to protect markets from conflicts of interest.

Covered Timeframe. To define the timeframe during which material conflicts of interest are prohibited, the proposed rule uses the Securities Act Section 27B language "at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security."[24] While the proposed rule specifies the precise end point of the covered timeframe, it does not specify when the covered timeframe begins, an asymmetry that makes sense in the context of the ABS market.[25]

The proposed rule appropriately covers transactions that occur prior to the closing of the first sale of the asset-backed security, because it is commonplace for ABS transactions to take place before an ABS product is actually put up for sale. In fact, many of the transactions examined by the Subcommittee involved conflicts of interest that originated prior to the first sale of the affected asset-backed security.

For example, one CDO arranged by Goldman, Hudson Mezzanine 2006-1 CDO ("Hudson"), was originated on September 19, 2006, and was designed to offset Goldman's risk related to its subprime ABX index holdings.[26] Goldman acted to reduce its risk by selling interests in Hudson to clients and then betting against the CDO, which meant that it had an interest adverse to the clients to whom it would be marketing Hudson. On October 1, 2006, Goldman obtained a commitment from Morgan Stanley to enter into a $1.2 billion credit default swap in which Morgan Stanley would take the long side of the Hudson CDO and Goldman would take the short side. On October 25, 2006, Goldman obtained commitments from other investors to purchase $400 million in Hudson securities. Both of these transactions took place prior to the first official closing date for the sale of a Hudson security, which was December 5, 2006.

Although the specific conflicts of interest engaged in by Goldman in Hudson would still be prohibited by the language of the proposed rule, this timeline is illustrative of the significant activities that are often undertaken by securitization participants prior to the first closing of a sale of an asset-backed security. That is why, as the proposed rule correctly points out, using the first sale date of an ABS would be under-inclusive.[27]

The proposed rule also correctly refrains from identifying a specific point in time prior to the sale date at which the covered timeframe would begin.[28] Providing a specific time period, such as a specified number of days before the first sale date, would invite securitization participants to time otherwise prohibited transactions to fall just outside of the covered time period. Instead, the better approach is for the rule to remain flexible and encompass all transactions undertaken in connection with a new ABS. If additional specificity is desired, the proposed rule could begin the covered timeframe at the point at which the covered persons could reasonably foresee a conflict of interest with investors of the securitization. This period should

---

[24] Proposed rule at 29.
[25] Proposed rule at 30.
[26] See Subcommittee Report at 619-36.
[27] Proposed rule at 30.
[28] *Id.*

not begin later than the first transaction made in anticipation of the securitization, such as the acquisition and warehousing of assets for later securitization.

The proposed rule also seeks comment regarding whether "the commencement point should vary depending on which securitization participant role a person performs." To prevent unnecessary complexity and retain its flexibility, the rule should refrain from delineating different specific timeframes for different participants. Doing so would invite confusion and gameplaying in which participants could attempt to avoid the restrictions of the proposed rule by assigning different roles to different affiliates or third parties, or even preferred customers.

Covered Conflicts of Interest. There are several actual and potential conflicts of interest inherent in securitization.[29] Section 621 prohibits some of them, but does not restrict the legitimate functioning of the securitization market. It prohibits securitization participants from designing, packaging, and selling asset-backed securities and then profiting from transactions in which the participants' interests materially conflict with those of the persons to whom they are selling or have sold the securities.[30]

When determining the scope of the covered conflicts of interest, Congress elected to focus on the conflicts of interest between those who design, package, sell, and manage a security and, so, are best positioned to structure a security that is intended to succeed or fail, versus the investors solicited to purchase the resulting ABS product. Section 621 and the proposed rule, thus, take a reasonable approach by limiting the scope of the prohibition on material conflicts of interest to those between a covered party on the one hand, and an ABS investor on the other hand, irrespective of whether that ABS investor purchased the ABS product from the covered party.[31]

Further, the proposed rule appropriately limits the scope of covered conflicts of interest to those arising out of transactions related to the ABS, and not unrelated activities.[32]

Another key issue is determining what types of conflicts rise to the level of being a "material conflict of interest." The proposed rule does not precisely define "material conflict of interest," because "any attempt to precisely define this term in the text of the proposed rule might be both over- and under-inclusive in terms of identifying those types of material conflicts of interest arising as a result of or in connection with a securitization transaction that Section 27B was intended to prohibit."[33] Materiality is a concept which is already backed by years of administrative determinations and case law, and in which federal securities regulators already have significant expertise. Capturing that experience in a concise regulatory definition is neither feasible nor wise, since the concept needs to remain flexible and adaptable to ensure its effectiveness. The proposed rule's decision to avoid a precise definition is, thus, a reasonable way to proceed.

---

[29] See Proposed rule at 36.
[30] 156 CONG. REC. S5899 (daily ed. July 15, 2010) (statement of Senator Levin).
[31] Proposed rule at 31-32 (citing 156 CONG. REC. S5899 (daily ed. July 15, 2010) (statement of Senator Levin)).
[32] Proposed rule at 32.
[33] Proposed rule at 35.

In place of a precise definition, the proposed rule instead offers interpretive guidance to determine when a "material conflict of interest" exists.[34] The proposed rule states that a transaction would "involve or result in [a] material conflict of interest" between a securitization participant and investors in the relevant ABS if:

> 1] Either:
>
> > A] a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (1) adverse performance of the asset pool supporting or referenced by the relevant ABS, (2) loss of principal, monetary default or early amortization event on the ABS, or (3) decline in the market value of the relevant ABS(where these are discussed below, any such transaction will be referred to as a "short transaction"); or
> >
> > B] a securitization participant, who directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS, would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above; and
>
> 2] there is a "substantial likelihood" that a "reasonable" investor would consider the conflict important to his or her investment decision (including a decision to retain the security or not).[35]

This guidance, which is similar to that recommended by the American Bar Association,[36] appears to prohibit securitization participants from engaging in a transaction through which it would have the potential to benefit if the related ABS performs poorly, and there is a substantial likelihood that a reasonable investor would consider that fact important.[37] Of the approaches outlined in the proposed rule, as well as those which we separately examined, this approach seems to best capture the intent of Section 621.

The proposed guidance offers a comprehensive, carefully-delineated, and practical set of rules that would cover a wide range of conflicts of interest and provide useful benchmarks for securitization participants and regulators.

Item 1A: Benefiting from Poor Performance. Fundamentally, a securitization participant should not have a material conflict of interest with the investors in an ABS product, such as a situation in which the participant would profit from the failure or adverse performance

---

[34] *Id.*
[35] Proposed rule at 37-38.
[36] Letter from the Committee on Federal Regulation of Securities and the Committee on Securitization and Structured Finance of the Section of Business Law of the American Bar Association to Mary Schapiro (Oct. 29, 2010).
[37] Proposed rule at 38.

of an ABS in which the investors had placed their funds. The best way to ensure securitization participants don't profit from conflicts of interest with their clients is to bar those conflicts completely. As currently drafted, the proposed Item 1A appears designed to do just that.

First, the proposed Item 1A would bar a covered party from profiting from the poor performance of an ABS even if that party did not intentionally seek to do so. The plain text of Section 621 includes no intent element.[38] As the proposed rule correctly notes, given the statutory language, it is unnecessary for a securitization participant (covered party) to intentionally design an ABS to fail or perform poorly in order to give rise to a material conflict of interest.[39] Instead, the proposed rule would correctly prohibit a securitization participant from "profiting from the decline of an ABS it helped create … even if that securitization participant did not intentionally cause, or increase the likelihood of, such decline."[40]

Another question arises with regard to what is "adverse performance." We urge against a narrow interpretation that would restrict it to simply a decline in value of the ABS. Rather, whether performance is "adverse" could also include under-performance, or failure to meet expected characteristics, such as price volatility fluctuations.

Some have proposed narrowing the proposed rule by requiring an "intentionally designed to fail or default" standard to support a determination of a material conflict of interest.[41] Such a standard would be overly cramped, however, and would fail to prevent many of the conflicts of interest the law was intended to prohibit.

For example, the Subcommittee investigated a $1 billion hybrid CDO-squared transaction, known as Timberwolf I ("Timberwolf"), that had been arranged by Goldman and collateral manager Greywolf.[42] Goldman and Greywolf began selecting and warehousing assets for Timberwolf in the summer of 2006, and apparently expected the CDO to be a good investment for clients. By March 2007, however, market conditions had deteriorated, and the warehoused assets had begun losing value rapidly. Goldman decided not to proceed with several other CDOs then under construction, and liquidated the assets in their warehouse accounts. In contrast, Goldman decided to accelerate the completion of Timberwolf and sell securities in the CDO to investors as quickly as possible. The value of Timberwolf bonds began falling as soon as the first securities were sold. In fact, in an effort to make the securities appear more attractive to potential customers, Goldman executives decided not to mark down the price of Timberwolf and instead market the securities at an inflated price. Furthermore, while Goldman's CDO team was actively marketing Timberwolf securities to investors at inflated prices, Goldman's trading desk was "aggressively" shorting the underlying Timberwolf assets.[43] Not only were investors not informed of these "aggressive" shorts, but Goldman may have also benefitted from the decision to market Timberwolf at inflated values, presumably allowing the trading desks to buy shorts at lower prices than would have been available had the Timberwolf securities been marked down to accurate prices. Goldman was clearly conflicted, actively marketing a security it

[38] Dodd-Frank Act, § 621.
[39] Proposed rule at 38.
[40] *Id.*
[41] Proposed rule at 40.
[42] See Subcommittee Report at 647-69.
[43] See Subcommittee Report at 661-62 (quoting email from Ben Case, Goldman employee (June 5, 2007)).

expected to fail at an inflated price while shorting the underlying assets. Although Timberwolf was not intentionally designed to fail, Goldman's actions should be, and appears clearly to be, prohibited by the proposed rule.

Secondly, the statute does not require any loss to be suffered by an investor in order to find the presence of a material conflict of interest. Suppose that a securitization participant engaged in a short sale of a CDO after selling the CDO's securities to multiple investors, and the market value of those securities did not decline for several months.[44] Under the proposed rule, the fact that the securitization participant could potentially gain from the decline in the value of the ABS through the short sale would be sufficient to find a material conflict of interest, even without the victimized investors having experienced an actual loss.[45] The proposed rule instead correctly prohibits any transaction where an "actual, anticipated or potential" benefit could inure to a securitization participant based upon the adverse performance, loss, or decline in value of the ABS. This approach is analogous to prohibiting attempted as well as actual fraud and is critical to preventing securitization participants from attempting as well as succeeding in taking advantage of their clients.

Thirdly, the proposed rule would take a needed comprehensive approach in prohibiting the myriad ways in which securitization participants could profit from taking undue advantage of their role in the securitization process. Using the term "benefit," for example, rather than a more narrow term, ensures that the rule would apply to transactions that produce not only cash profits, but other advantages such as reduced losses, early financial returns, debt relief, discount services, inclusion in other profitable deals, or a promise of future business. The proposed rule would also apply to both direct and indirect benefits, an essential feature given the ability of firms to engineer complex financial products, using derivatives, synthetics, shell structures, and other means to produce indirect and even hidden benefits. Finally, the proposed rule would apply to a wide range of negative events, including financial loss, default, an early payoff, a decline in value, or an adversely performing asset pool. It should also apply to increased volatility. This broad approach is necessary to ensure that the proposed rule would apply to the wide variety of ABS products now on the market as well as future innovations.

The Subcommittee's investigation confirms the need for the proposed rule's comprehensive approach, having identified a wide variety of instances in which, for example, Goldman engaged in material conflicts of interest with the clients to whom it sold ABS products.[46] Many of those conflicts of interest would appear to be barred by Item 1[A], as drafted.

For example, in the fall of 2006, Goldman assembled Hudson Mezzanine 2006-1 ("Hudson"), a $2 billion synthetic CDO referencing subprime residential mortgage-backed securities (RMBS).[47] At the time, senior Goldman executives felt that declines in the ABX index, an index of subprime mortgages securities, were imminent. Rather than trade away its unwanted ABX assets using index swaps, Goldman decided the most efficient method to reduce

---

[44] Proposed rule at 39.
[45] See *id.*
[46] See, e.g., Subcommittee Report at 719 (providing a list of Goldman conflicts of interest analyzed by the Subcommittee).
[47] See Subcommittee Report at 619-36.

its exposure to the ABX index was to assemble the Hudson CDO and sell the CDO securities to investors. The assets Goldman selected for Hudson consisted of $1.2 billion in subprime RMBS that offset its specific ABX exposure and another $800 million in outright shorts of subprime RMBS. Those assets were placed on the balance sheet of an offshore shell corporation via a credit default swap (CDS). Goldman held the entire $2 billion short side of the CDS. Goldman then recommended and marketed the Hudson securities to investors, selling them the long side of the CDS. Goldman also sold a $1.2 billion CDS to an investor, providing that investor with long exposure to the Hudson CDO.

Although Hudson's offering materials included vague and generalized risk factors, it failed to inform investors that the CDO was specifically designed to offset risky assets on Goldman's balance sheet and to produce profits for the firm from shorting the referenced RMBS securities. Worse yet, it affirmatively represented that its interests were "aligned" with potential buyers of the security.[48] When the Hudson assets began losing value, Goldman's CDS gained in value while the holdings of the Hudson investors lost value. Some of the Hudson investors reduced their losses by selling their holdings back to Goldman at a substantial loss. While analysts may differ on whether Goldman benefited directly or indirectly from the poor performance of the asset pool supporting the CDO it created, Goldman ended up with a profit from its Hudson investment of nearly $1.7 billion. Hudson's investors lost nearly the same amount. This activity should be, and appears clearly to be, prohibited by Item 1A of the proposed rule.

Another example involves Anderson, a $305 million synthetic CDO constructed by Goldman using CDS contracts referencing subprime RMBS.[49] The assets were selected over a six month period in 2007, in conjunction with an outside hedge fund. A majority of the referenced assets had been issued by subprime lenders which were known by Goldman for issuing poor quality loans. The largest single issuer was New Century which, during the time Anderson was being assembled, was being scrutinized by Goldman personnel for its poor quality loans. During the entire period in which Goldman recommended and sold the Anderson securities, it had a strongly negative view of the mortgage market in general, and New Century in particular. Goldman was also working intensively to remove mortgage-related assets from its balance sheet and was short 40% of the pooled assets in Anderson. In summary, at the time Goldman was marketing the Anderson securities to investors, it had a negative outlook of the entire mortgage market, a negative view of Anderson's largest issuer, New Century, a negative view of the specific assets in Anderson, and a financial interest in the failure of the CDO. None of those views, risks, or conflicts was disclosed to investors. In fact, when an investor raised concerns about the New Century loans referenced in the CDO, Goldman personnel worked affirmatively to dispel that investor's concerns. Ultimately, even though Anderson may have not been initially designed to fail, Goldman profited from the decline of the CDO assets while Anderson investors lost virtually their entire investments. This activity should be, and appears clearly to be, prohibited by Item 1A of the Commission's proposed rule.

In addition to the Subcommittee's work, other governmental investigations, press reports, and ongoing legal actions demonstrate that other investment banks had material conflicts of

[48] See Subcommittee Report at 627 (quoting a Hudson marketing booklet Goldman sent to clients).
[49] See Subcommittee Report at 636-47.

interest with the investors to whom they recommended and sold ABS products.[50] For instance, Citigroup has agreed to settle a civil complaint by the SEC alleging that the bank used a CDO called Class V Funding III as a vehicle to short unwanted assets, producing a $126 million profit for the bank when the value of the pooled assets fell, although that settlement was recently rejected as inadequate to protect the public interest.[51] While the Subcommittee did not review the facts of these other instances, it appears as though the proposed rule would have captured their conflicted activities as well.

Item 1B: Benefiting from Inappropriate Fees. The proposed rule would also determine that a material conflict of interest exists when certain securitization participants benefit from allowing a third party to structure an ABS in a way that permits that third party to benefit from a short transaction.[52] Put simply, a securitization participant could not get paid for enabling a third party to engage in a conflicts-ridden transaction that the securitization participant itself could not.[53]

Item 1B of the proposed rule would prohibit securitization participants from effectively allowing a third party to load the dice in an ABS transaction in exchange for some "direct or indirect" benefit. As with Item 1A, the proposed rule would define "benefit" broadly to include, not only fees or other types of remuneration, but also the promise of future business, fees, or remuneration.[54] Both "benefit" and its constituent term, "remuneration," should be construed broadly enough to capture all types of advantages that might accrue from a complex ABS securitization or related side deal, including inflated fees, reduced losses, early financial returns, debt relief, discount services, or inclusion in other profitable deals. The proposed rule would also, as in Item 1A, cover both direct and indirect benefits, a feature that is essential given the ability of firms to engineer complex financial products with indirect and even hidden benefits.

The Subcommittee's work supports the proposed focus on prohibiting securitization participants from enabling third parties to engage in conflicts-ridden ABS transactions. Goldman's Abacus 2007-AC1 CDO ("Abacus"), for example, was rife with third party conflicts of interest. Goldman created Abacus in coordination with a favored client, the hedge fund Paulson & Co. ("Paulson"), which Goldman knew held strong negative views of the residential mortgage market. The CDO was structured to enable Paulson to short multiple RMBS securities in leveraged form. As part of the arrangement, Paulson agreed to pay Goldman a higher fee if Goldman provided Paulson with credit default swap (CDS) contracts requiring premium payments below a certain level. Lower premiums paid by Paulson, which held the short side of the CDO, translated into lower cash payments into the CDO's accounts, directly reducing the amount of cash available to the long investors. In marketing and selling Abacus to long investors, Goldman not only failed to disclose the investment objective and key role that the hedge fund played in the asset selection process to the detriment of potential investors, it also failed to disclose how its own economic interest was aligned with Paulson – and against the investors to whom it was selling the securities – through the side arrangement for lower premium

---

[50] See, e.g., Kara Scannell & Justin Baer, *JPMorgan in Talks to Settle SEC Probe Into Mortgage Linked Securities*, FIN. TIMES, April 2, 2011 at 1.
[51] See *SEC v. Citigroup Global Markets Inc.*, Case No. 11 CIV 7387 (S.D.N.Y., Opinion and Order, Nov. 28, 2011).
[52] Proposed rule at 42.
[53] Proposed rule at 43.
[54] Proposed rule at 42.

payments.[55] The Abacus investors ended up losing nearly $1 billion, while Paulson pocketed nearly the same amount in profits.

Other investment banks appear to have engaged in similar efforts to arrange for third party profits at the expense of other ABS investors. JPMorganChase, for example, recently agreed to settle charges alleging that the bank allowed the hedge fund Magnetar to influence the selection of assets in a CDO known as Squared 2007-1 ("Squared") so that Magnetar could take a short position in the underlying assets.[56] Similar charges were filed against an employee of the collateral manager in Squared, alleging, among other things, that the employee allowed Magnetar to select and short assets in Squared at the same time he was seeking a job with Magnetar.[57] The actions of both JP MorganChase and the collateral manager should be, and do appear to be, prohibited by the proposed rule.

These instances, in which a securitization participant allowed a third party to help select the assets in an ABS in exchange for some benefit, fall squarely within the orbit of troubling transactions that Section 621 was designed to prohibit. Each involves a situation in which a favored third party wanted to see an ABS transaction fail or perform poorly, was allowed by a covered party to influence the ABS product to produce that result, and profited at the expense of the investors who purchased the ABS securities. It is these types of transactions that damage investor confidence in U.S. securitization markets, because they suggest that even sophisticated investors can be victimized by rigged ABS products. Each illustrates the material conflicts of interest between the securitization participant and investors in the ABS that the statute is intended to prohibit.[58]

While most aspects of Item 1B are well designed to carry out the intent of Section 621, one part of the provision is overly restrictive and should be broadened. As currently drafted, Item 1B applies only to a securitization participant "who directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS."[59] In the Abacus transaction, however, Goldman had hired an independent collateral selection agent to choose the CDO's assets. Goldman might contend that it did not directly or indirectly "control" the structuring or asset selection process for the CDO; it merely urged the collateral manager to consider including assets recommended by Paulson. Yet without Goldman's actions, Paulson would never have had the opportunity to influence the Abacus asset selections. Goldman also created a material conflict of interest by entering into a side agreement with Paulson to enter into CDS arrangements with lower premium payments to the detriment of the long investors. Again, its role in influencing CDS premium payment rates may not qualify as controlling Abacus' structuring or asset selection process, yet this is clearly the type of conduct Section 621 was intended to prevent. Thus, the proposed rule would be less complex and more effective if it applied to all covered parties and not just those "who directly or indirectly control[ ] the structure of the relevant ABS or the selection of assets underlying the ABS."

---

[55] See Subcommittee Report at 683.
[56] *SEC v. J.P. Morgan Sec., LLC.*, 11 CV 04206 (S.D.N.Y., Filed, June 21, 2011).
[57] *SEC v. J.P. Morgan Sec., LLC.*, 11 CV 04206 (S.D.N.Y., Filed, June 21, 2011).
[58] Proposed rule at 43.
[59] Proposed rule at 42.

Finally, comment is requested on whether the term "as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the," should be replaced with "as a result of allowing a third party, directly or indirectly, to influence the structure of the relevant ABS or the selection of assets underlying the ABS."[60] This change should be made because, as shown in Abacus, it may be more typical for third parties to "influence" rather than "structure" or "select" the assets in an ABS. In Abacus, itself, for example, the assets were selected, not by Paulson, but by an independent collateral selection agent whom Goldman hired because it viewed that company as "flexible" and amenable to selecting poor quality assets recommended by Paulson.[61] Paulson may argue that it did not directly or indirectly select the underlying assets in Abacus, but simply offered guidance to the collateral selection agent who made the final decisions. If the proposed rule were amended as indicated in question 46, then Paulson would have been subject to this portion of the rule—as Paulson should.[62] An alternative that would employ even more effective language to prevent third party conflicts in ABS securitizations would amend the provision to read "as a result of allowing a third party, directly or indirectly, to influence the design, composition, structure, assembly, sale, or management of the relevant ABS."

Item 2: Reasonable Investor Test. Item 2 of the proposed "material conflict of interest" test would incorporate into the proposed rule the well-established standard of "a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision."[63] In other words, the conflict must be big enough for a reasonable investor to want to know about it before investing. While this standard has its advantages, most notably a significant body of court interpretations,[64] the incredibly complex nature of ABS, and the sheer number of roles that may be performed by various securitization participants, may make its application difficult.

To be effective, the proposed rule should make it explicit that the reasonable investor standard should be applied broadly to evaluate, not only obvious conflicts of interest arising from asset selection issues, but also hidden conflicts of interest that may arise from inappropriate fees, ministerial arrangements, or other actions taken by securitization participants. In addition, the rule should make it clear that application of the reasonable investor standard must assume that the investor has all of the relevant facts to perform a fair evaluation the securitization, including facts that may have actually been concealed from the investor at the time of the transaction.

The Subcommittee found a number of instances where significant conflicts of interests occurred, but due to the unique circumstances under which they arose, a "reasonable investor" may not have fully appreciated them without additional information and significant explanation. The Subcommittee investigated, for example, some of the seemingly ministerial functions Goldman performed in servicing the CDOs it issued, and found that Goldman had used its ministerial roles to serve its own interests at the expense of investors—a material conflict of interest that may not have been sufficiently appreciated at the time by a "reasonable investor."

---

[60] Proposed rule at 52.
[61] See Subcommittee Report at 673, quoting email from Fabrice Tourre, Goldman employee (Dec. 18, 2006)).
[62] Proposed rule at 52.
[63] Proposed rule at 44.
[64] See, e.g., *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988).

For example, in Hudson, in addition to holding the entire short position worth $2 billion, Goldman served as the CDO's"Liquidation Agent," responsible for efficiently selling assets in the CDO after they deteriorated to the point of becoming a "credit risk."[65] A "reasonable investor" may not have found the potential conflict involved with Goldman's occupying both roles – short seller and Liquidation Agent -- objectionable, under the assumption that only a small number of assets would become credit risks and require action by Goldman as the Liquidation Agent. As the financial crisis tightened its grip, however, the Hudson assets deteriorated so rapidly that close to 30% required liquidation within one year after the transaction closed. Yet as those assets fell in value, Goldman's short position increased in value. That meant Goldman had a financial conflict, since delaying liquidation of the credit risk assets would result in further losses for the CDO and the long investors, but a corresponding financial gain for Goldman itself. Even after the major long investor in Hudson demanded and pleaded that Goldman sell the credit risk assets to stop the losses to the CDO, Goldman delayed doing so. That sort of material conflict of interest should be barred by the rule, and would be under an interpretation of the rule that assumes a reasonable investor would be fully informed of the facts.

Another instructive instance examined by the Subcommittee involves a rather obscure CDO function involving the purchase and management of default swap collateral. In a synthetic asset-backed CDO, cash payments made by the investors are not used to purchase the referenced assets, as they would be in a cash ABS. Instead, the investor cash payments are typically used to purchase "collateral" for the CDO such as low-risk short-term asset-backed securities or other cash equivalents. The purchase of this collateral is designed to allow investors to earn a small return on their cash payments, yet maintain enough liquidity for the CDO to proceed smoothly. These investments are often referred to as "default swap collateral."

The Subcommittee examined how Goldman handled the default swap collateral purchased in connection with some of its synthetic CDOs.[66] The investigation showed that, in many of the CDOs it arranged, Goldman effectively served as the collateral put provider, agreeing to pay par value for any default swap collateral securities that needed to be sold in order to free up cash to meet the obligations of the CDO. In exchange for providing this put, Goldman obtained certain financial benefits and exercised approval rights over any securities purchased for the default swap collateral. As the mortgage market fell in the summer of 2007, most securities began to lose value, and Goldman began to lose significant amounts of money due to its put obligations.[67] In response, Goldman decided to keep in cash all investor payments and any gains from selling securities, rather than invest in new default swap collateral, by exercising its right to refuse to agree to the purchase of any new collateral.

Goldman's systematic refusal to purchase new default swap collateral placed its own financial interests ahead of the interests of the long CDO investors. That's because investing the cash in securities would have produced a higher return for long investors than keeping the cash in an interest-bearing account. In addition, if the purchased securities lost value, Goldman was obligated to make up the difference under its put obligation. It was that very obligation that Goldman acted to avoid, even though it had obtained a substantial financial benefit for providing

[65] See Subcommittee Report at 687-703.
[66] See Subcommittee Report at 703-18.
[67] According to information obtained by the Subcommittee, Goldman Sachs suffered over $1 billion in losses from collateral securities for six CDOs alone. Subcommittee Report at 718.

the put. While the refusal to buy new default swap collateral resulted in relatively small losses to individual investors who were denied the gains that would have been earned from the investment of cash payments, the losses to the CDO investors in the aggregate were significant. After some larger investors complained, Goldman eventually began to allow purchases of a few low-risk securities. In the meantime, Goldman's self-dealing not only injured the long investors in its CDOs, it also damaged the securities market as a whole, the precise type of damage the Dodd-Frank Act was intended to repair.

The sheer complexity of ABS products and the role securitization participants may play in the ABS lifecycle may overwhelm the "reasonable investor" standard unless the proposed rule makes clear that the standard assumes the reasonable investor is fully informed of relevant facts and capable of understanding hidden, opaque, or disguised, but nevertheless material conflicts of interest. The rule would be strengthened by providing an illustrative list of the types of conflicts of interest, including those arising from fee or ministerial arrangements engaged in by securitization participants.

In addition, to lessen the burden on the reasonable investor, prohibitions should be added on the types of roles that securitization participants might take. For example, a securitization participant or its affiliates should be prohibited from taking any role in which it is compensated, in any form, for taking actions adverse to the interests of the ABS investors. This approach could work in tandem with the "reasonable investor" standard to provide meaningful protections against the largely hidden conflicts of interest that proliferated during the financial crisis.

Statutory Exceptions. To enhance the integrity of the securitization markets, Section 621 includes language allowing securitization participants to engage in (1) risk-mitigating hedging, and (2) market-making activities with respect to the securitizations they sponsor and sell, without violating the section's ban on material conflicts of interest.[68] These activities are intended to be allowed only to the extent necessary to support the ABS and help ensure its success, and only if they do not present a material conflict of interest of the nature that the section seeks to prohibit.

Risk-Mitigating Hedging Activities. The proposed rule essentially repeats the risk-mitigating hedging exception as set forth in the text of Section 621 and then provides extensive interpretive guidance to ensure that the exception is used to restore investor confidence in U.S. securitization markets, and not to undermine the law's prohibition on material conflicts of interest.[69]

The proposed guidance makes clear that the risk-mitigating hedging exception is designed to help ensure that securitization participants are able to support the ABS products they've created. This exception is applicable only for securitization participants seeking to reduce actual financial risks created by taking actual positions in the ABS products they've

---

[68] Similar provisions are included in Section 619 of the Dodd-Frank Act, which, *inter alia*, restricts the proprietary trading of banking entities and non-bank financial companies supervised by the Board of Governors of the Federal Reserve. See Dodd-Frank Act, § 619. The purposes of Section 619 and Section 621 are, however, different, and the terminology for what is "risk-mitigating hedging" or bona fide "market-making" should be treated differently in connection with the two sections of the law.

[69] Proposed rule at 53.

helped create, sell, or manage,[70] while at the same time prohibiting them from profiting from the decline in value or collapse of those same products. In addition, the proposed guidance makes clear that the exception is intended to cover only those risk-mitigating hedging activities that occur in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship[71] of an ABS. Further, the proposed guidance indicates that, to be covered by the exception, activities must be designed to reduce the specific risk to the underwriter, placement agent, initial purchaser, or sponsor associated with the relevant ABS.[72] The proposed guidance also correctly makes clear that the risk-mitigating hedging exception does not allow securitization participants to rely on it to establish new positions designed to earn a profit.[73]

Together, these provisions mean, for example, that a securitization participant can engage only in a hedging transaction that is strongly correlated and proportional in size to the ABS exposure it is seeking to hedge; and that the hedging must be directly related to the risks created by actual positions taken by the securitization participant creating actual exposures.[74] This approach is analogous to ensuring the presence of an "insurable interest"[75] that arises out of the securitization participant's role in the ABS or underlying reference. Generally speaking, the "insurable interest" rule prevents a person from purchasing insurance where the buyer has no risk of loss.[76]

As a general matter, this approach also means that the risk-mitigating hedge should be adjusted over time as the exposure varies, and wound down as the exposure is reduced.[77] To enhance the rule, securitization participants seeking to rely on this exception should be further required to affect the transaction pursuant to a written, detailed hedging policy that requires hedges to be identified as such at the time they are first entered into, tracks those hedges over time to ensure they continue to offset specific, identified ABS risks, and generally does not allow for intermittent hedging activities. Finally, the rule should require the nature and magnitude of such activities to be fully disclosed to ABS investors, including activities before sale of the ABS, as well as other likely hedging activities that may occur following sale.

The Subcommittee's investigation supports the proposed rule's creation of a narrow hedging exception limited to hedging activities that support, rather than undermine, the ABS product developed by the securitization participant. In Hudson, for example, Goldman designed

---

[70] *See, e.g.*, Jeff Merkley, U.S. Senator and Carl Levin, U.S. Senator, "Making the Dodd-Frank Act Restrictions on Proprietary Trading & Conflicts of Interest Work," Roosevelt Institute, available at http://www.rooseveltinstitute.org/sites/all/files/Will_It_Work_Proprietary_Trading.pdf.

[71] See proposed rule at 54. Notably, this approach presumes that "sponsor" is defined broadly to include all relevant securitization participants, including collateral managers, servicers, and custodians.

[72] Proposed rule at 54.

[73] *Id.*

[74] Proposed rule at 56 (citing Jeff Merkley, U.S. Senator and Carl Levin, U.S. Senator, Making the Dodd-Frank Act Restrictions on Proprietary Trading & Conflicts of Interest Work, Roosevelt Institute, available at http://www.rooseveltinstitute.org/sites/all/files/Will_It_Work_Proprietary_Trading.pdf.).

[75] See, e.g., *New England Mut. Ins. v. Caruso,* 73 NY2d 74, 78-81 (1989).

[76] *See generally*, Life Assurance Act 1774.

[77] *See, e.g.*, FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS (Jan. 2011) ("FSOC Study") at 30.

a CDO to offset its existing risk in $1.2 billion worth of ABX positions and included another $800 million in single-name CDS intended to further reduce its subprime mortgage exposure. These activities should not qualify for the risk-mitigating hedging exception. That is because Goldman's short position was not intended to mitigate holdings acquired in connection with the underwriting, placement, initial purchase, or sponsorship of Hudson, but to offset unrelated, massive long positions accumulated by Goldman in the months leading up to the origination of Hudson. Goldman essentially created an ABS product with unwanted assets that it expected to lose value and then shorted the entire $2 billion CDO. Its $2 billion short was not intended to mitigate a financial risk Goldman incurred due to its issuance of the Hudson securities or the securities Hudson referenced, but to produce profits for Goldman when those securities lost value. If Goldman's activities were to be treated as risk-mitigating hedging activities that qualified as an exception to Section 621's prohibition on conflicts of interest, the protections of Section 621 would be undermined. That is why it is essential that the proposed rule limit the hedging exception to a narrow set of activities that enable a securitization participant to structure and support the ABS products it has created, not bet against them, undermine them, or damage the market for them.

Commitments to provide liquidity and bona fide market-making activities. As with the first exception, the proposed rule essentially repeats the market-making exception set forth in the text of Section 621 and then provides extensive interpretive guidance to ensure that the exception is used to restore investor confidence in U.S. securitization markets rather than undermine the law's prohibition on material conflicts of interest.[78] While the proposed guidance generally implements the exception, it needs to be strengthened, as indicated below, to ensure the exception is not misused.

Congress created the market-making exception in Section 621 to allow an underwriter to "support the value of a[n ABS] security in the aftermarket by providing liquidity and a ready two-sided market for it."[79] For the purposes of Section 621, it is unnecessary to draw a clear line between market making and proprietary trading.[80]

The proposed rule correctly indicates that a securitization participant's actions pursuant to a commitment to provide liquidity or bona fide market making must be in support of the success of the ABS investment. The proposed rule also states that liquidity commitments may include a wide array of activities and "other services," including those designed to promote full and timely payments to ABS investors.[81] This approach is overly broad, however, and should be narrowed, since these "other services" could give rise to the conflicts of interest Congress sought to prohibit.

One example of the "other services" that could result in conflicts of interests is Goldman's activities as a collateral put provider for the default swap collateral held in some CDOs. As explained earlier, in many of the CDOs it arranged, Goldman received a substantial

---

[78] Proposed rule at 53.

[79] See 156 CONG. REC. S5899 (daily ed. July 15, 2010) (statement of Senator Levin).

[80] This distinction will be critical, however, when defining market-making in the context of Section 619 of the Dodd-Frank Act, which seeks to restrict banking entities and non-bank financial companies supervised by the Board of Governors of the Federal Reserve from engaging in proprietary trading. Dodd-Frank Act, § 619.

[81] Proposed rule at 59.

financial benefit for effectively serving as the collateral put provider, agreeing to pay par value for any default swap collateral securities that needed to be sold in order to provide liquidity for the CDO. As the mortgage market fell in the summer of 2007, most securities began to lose value, and Goldman began to lose significant amounts of money due to its put obligations. In order to provide liquidity, Goldman was obligated to make up the difference under its put obligation. However, rather than suffer losses associated with this put, Goldman decided to retain in cash all investor payments and gains from the maturation or sale of default swap collateral, rather than invest in new collateral. Goldman's refusal to buy new default swap collateral resulted in significant aggregate losses to the CDO investors. . The Commission should not allow securitization participants to receive fees for providing "other services" to securitizations if those "other services" result in conflicts of interest.

As currently drafted, the proposed rule would allow "[p]urchases or sales of [ABS] made pursuant to and consistent with bona fide market-making in the [ABS]"[82] to be treated as exceptions to Section 621's ban on conflicts of interest. The definition of "bona fide market-making" is, thus, key to the effectiveness of the proposed rule in allowing activities that support the success of an ABS and disallowing activities which would enable a securitization participant to benefit from an ABS' adverse performance, decline in value, or collapse.

Previously, the SEC has interpreted the concept of market-making only in the context of relatively liquid instruments, such as equities.[83] ABS products, in contrast, are often traded over-the-counter, less widely distributed, and less liquid.[84] Thus, the proposed rule may be setting forth a new interpretation of what it means to be a market-maker in a less-liquid financial product. The proposed guidance sets forth eight "principles" defining the characteristics of bona fide market-making by a securitization participant for an ABS which that securitization participant helped to design, assemble, sell and manage:

- It includes purchasing and selling the ABS from or to investors in the secondary market.
- It includes holding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction).
- It is driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market-makers.
- It generally is initiated by a counterparty and if a customer initiated a customized transaction, it may include hedging if there is no matching offset.
- It does not activity that is related to speculative selling strategies or investment purposes of a dealer, or that is disproportionate to the usual market-making patterns or practices of the dealer with respect to that ABS.
- Absent a change in a pattern of customer driven transactions, it typically does not result in a number of open positions that far exceed the open positions in the historical normal course of business.
- It generally does not include actively accumulating a long or short position other than to facilitate customer trading interest.

---

[82] Proposed rule at 62.
[83] See, e.g., Release No. 34-58775 (Oct. 14, 2008), 73 FR 61690, 61698 (Oct. 17, 2008).
[84] Proposed rule at 62.

- 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. In contrast, and aged open position taken to facilitate customer trading interest would be hedged rather than exposed to gains and losses for a period of time.[85]

These principles identify important benchmarks for evaluating transactions claiming status as bona fide market making, but they are also both over-inclusive and under-inclusive. Grounding the market-making exception in the secondary market is a critical first principle, for example, since it means the exception does not apply to a securitization participant's initial recommendations or sales of a new ABS product. On the other hand, with respect to the second principle, a firm should not just "hold itself out as" willing to buy and sell, it must actually stay in the market and demonstrate its willingness to trade, even under adverse conditions, when called upon. When sellers outnumber buyers, it should be willing to buy, and vice versa. This market participation should not depend upon the firm's projections regarding the value of the ABS over time. This principle is critical to ensuring that the securitization participant is attempting to build a market for the ABS product, not simply take a position on one side or the other.

The third and fourth principles would help ensure that the market making activities are client-driven and in response to investor needs, are part of an effort to build a market for the ABS product, and do not provide a cover for an effort by the securitization participant to bet against the ABS product. The fifth principle would help make it clear that the market making exception is not intended to help securitization participants speculate in the underlying value of an ABS product. The sixth, seventh, and eighth principles are also key to preventing securitization participants from accumulating large, speculative ABS positions as opposed to supporting a fluid market.

Further, it would be inappropriate to interpret Section 621's permitted market-making in ABS in the same way as "market-making-related" activities under Section 619,[86] in large part due to the differences in the intent of the provisions. Section 619 intends to restrict proprietary trading by banking entities and other non-bank financial companies supervised by the Federal Reserve Board.[87] In that context, market-making-related activities are permitted, subject to certain limitations and restrictions, only to allow covered firms to serve their clients' interests.[88]

Section 621, in contrast, is intended to restore integrity to the securitization markets, and is unrelated to restrictions on proprietary trading. In this context, market-making under Section 621 is allowed only to the extent that it supports developing a successful market for an ABS.[89] Thus, Section 621's focus on market-making is even more narrowly tailored. Section 621 may allow a firm to take a long or short position in the ABS or an instrument referencing the ABS for

---

[85] Proposed rule 62-63 (internal citations omitted).
[86] Dodd-Frank Act, § 619.
[87] Dodd-Frank Act, § 619.
[88] See 156 CONG. REC. S5895 (daily ed. July 15, 2010) (statement of Senator Merkley).
[89] See 156 CONG. REC. S5899 (daily ed. July 15, 2010) (statement of Senator Levin) ("Section 621 is not intended to limit the ability of an underwriter to support the value of a security in the aftermarket by providing liquidity and a ready two-sided market for it.").

a very limited period of time (such as a "riskless principal" trade). But a firm cannot maintain a position adverse to the ABS it created.

The proposed guidance should be further strengthened by addressing specific concerns related to synthetic ABS products. The guidance should make clear that a securitization participant would not qualify for the market making exception if it takes a short position in a synthetic ABS that references an ABS that it created.[90] In such a case, even disclosure to the purchaser of the synthetic ABS would be inadequate to cure the conflict of interest.[91]

Anti-Abuse Provision. Finally, given the complexities inherent in hedging and market-making activities, the proposed rule should be further strengthened by including in the text of the rule a broad prohibition against the misuse of either exception. To prevent misuse of the hedging and market-making exceptions, the proposed rule should be amended to include an explicit anti-abuse provision, prohibiting use of either exception to circumvent the statutory prohibition on engaging in a covered material conflict of interest.

Thank you for the opportunity to comment on the proposed rule.

Sincerely,

Senator Jeff Merkley

Senator Carl Levin

[90] *Id.*
[91] *Id.*