sifma®

Invested in America

September 23, 2011

Submitted via E-mail to ***rule-comments@sec.gov***

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

Re: SIFMA Comments on Release No. 34–64352; File No. S7–15–11; RIN 3235–AL14,
Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934

Dear Ms. Murphy,

The Securities Industry and Financial Markets Association (SIFMA)[1] is pleased to submit these comments regarding the Securities and Exchange Commission's ("Commission") May 6th request for comments ("Request") regarding the removal of references to credit ratings under certain of the Commission's rules. This letter is specific to the portion of the request requesting comments regarding section 939(e) of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[2], which addresses the definition of a mortgage-related security ("MRS"). SIFMA previously submitted comments regarding other portions of the rules, and those comments stand as submitted.[3]

The Dodd-Frank Act removed a reference in section 3(a)41 of the Exchange Act[4] that a security must be *"rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization"* and replaced it with a requirement that the security *"meets standards of credit-worthiness as established by the Commission"* to meet the definition of a MRS. Given this statutory change, the Commission must determine standards of creditworthiness

---

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.
[2] Public Law 111–203 § 939(e)
[3] SIFMA's comments on the sections of the request for comments regarding Rules 101 and 102 of Regulation M, Rule 15c3–1, Rule 15c3–3 and Rule 10b–10 are available here: http://sec.gov/comments/s7-15-11/s71511-6.pdf
[4] 15 U.S.C. 78a(3)(a)(41).

for the purposes of this definition by July 21, 2012 when this revision becomes effective. SIFMA hopes that the comments in this letter are helpful to the Commission in undertaking this task.

The Commission requests comment on a "*new rule under the Exchange Act that would apply the "minimal amount of credit risk" standard the Commission is proposing with respect to the Net Capital Rule, as described above, to persons assessing whether a security is a mortgage related security within the meaning of Section 3(a)(41).*" As regards the Net Capital Rule, the Commission proposed that *"…a broker-dealer would be required to establish, maintain, and enforce written policies and procedures designed to assess the credit and liquidity risks applicable to a security, and based on this process, would have to determine that the investment has only a "minimal amount of credit risk."* Broker-dealers would be able to consider a number of qualitative and quantitative measures to determine whether or not a security represented only a minimal amount of credit risk, including:

- Credit spreads;
- Securities-related research;
- Internal or external credit risk assessments (including by rating agencies, irrespective of NRSRO status);
- Default statistics;
- Inclusion on an index;
- Priorities and enhancements;
- Price, yield and/or volume; and
- Asset class-specific factors (e.g., in the case of structured finance products, the quality of the underlying assets).

While we appreciate the thought put in to this proposal, and the challenge the Commission faces in carrying out the difficult task laid before it, SIFMA believes further consideration of a more refined approach is needed.[5] A principle that should guide the development of replacement criteria is that the replacement criteria must provide certainty to market participants as to exactly what standard they are required to meet, and clear knowledge as to when they have met it, as the original ratings-based approach did. In the context of the definition of an MRS, SIFMA does not believe this minimal credit risk standard, as proposed, satisfies this principle. There are a number of reasons for this, which we discuss below.

It is important to recognize that the concept of a MRS was created under the Secondary Mortgage Market Enhancement Act ("SMMEA") in order to expand the non-Agency securitization markets by making them more competitive with Agency MBS markets. Specifically, many aspects of SMMEA, including the concept of an MRS, relate to preemption of state and other laws relating to investments that treated Agency MBS differently than non-Agency MBS. The idea was to broaden the investor base for non-agency securitizations. Given that preemption of various laws and regulations is at stake, whether or not a security is a MRS must be determinable before the time of issuance or purchase of a security, and with certainty. Therefore bright line, objective standards are essential. Credit ratings did provide such standards, and did allow market participants to purchase MRS with certainty that they would not be second-guessed as to its MRS status. A replacement for credit ratings in the definition of an MRS must do likewise. We do not believe that the minimal amount of credit risk standard creates such bright line, objective measures. If the

[5] As noted we have provided a number of comments regarding the specific application of the minimal amount of credit risk standard to capital charge calculations in our other letter.

definition is amended as proposed, the impact will be to lessen the liquidity of private securitization markets, and disadvantage them relative to Agency markets. This is contrary to the intent of SMMEA, and contrary to the intent of public policy, as Congress, the Administration, and others have recently focused significant energy on ways to reduce the dominance of the government in the funding of mortgage credit.[6]

We note at the outset that the proposal does not place parameters around what is a "minimal" amount of credit risk. Should it be measured by a *de minimis* expected loss, the expectation of no loss at all, default rates on collateral, or by some other measure? It is difficult for a market participant to answer the question of whether or not a security presents minimal credit risk in accordance with a regulatory standard when the regulatory standard is not defined in the first place. As we also noted in our previous letter regarding the Net Capital Rule, the proposed minimal amount of credit risk standard may lead to different participants arriving at different conclusions as to whether a security presents minimal credit risk, and in this case whether or not it is an MRS. In any case, the determination would always be subject to challenge after the fact by regulators or other parties. In the context of the Net Capital Rule, an error would result in a broker-dealer applying an incorrect capital charge to a given security. In the case of an error with respect to MRS status, the result would be a security that a market participant thought was not subject to a state law or other regulation due to SMMEA's preemption actually being subject (and having been subject all along) to those laws or regulations, potentially rendering that party non-compliant with the law or regulation.

Leaving aside the lack of clarity as to what "minimal" means, of all of the factors in the bullet point list above only three relate directly to credit risk *and* provide clear, binary decision points for a holder or issuer – external credit assessments, enhancements (in the form of overcollateralization), and default statistics. In and of themselves, however, they may not be appropriate parameters. External credit assessments created the needed "yes" or "no" answer to the question of whether or not a security presents a minimal amount of credit risk. Default statistics are generally objective and measurable – however, default rates at the time of issuance are generally zero. Enhancement, in terms of credit support provided by overcollateralization, is relatively easily observable. On the other hand, yield spreads are subject to a number of forces beyond credit risk and may not even be the product of internal bond factors, but rather external market forces, such as liquidity, and as such are not reliable indicators of credit risk. Research is generally the expression of an opinion in a non-quantified manner (and we note that securitization research does not generally focus on specific securities on any broad scale, rather focus tends to be on subsets of asset classes, in contrast to equity research where the focus is on specific issuers). CDS spreads, similar to yield spreads, are subject to a number of other factors, and may not be widely available for every security. Price, yield, volume and inclusion in indices are not necessarily determinative of anything, in and of themselves, given the large number of factors that impact those items, such as liquidity, public policy, regulatory actions, rebalancing of indices, and capital charges. In sum, SIFMA does not believe the aforementioned criteria are objectively determinative of credit risk. As stated in our previous letter, we believe policies and procedures reasonably designed for determining whether a security has only a minimal credit risk should base the determination solely on a *small number of objectively determinable factors*. To the extent the Commission moves forward with any of these criteria, it must place clear parameters around what is acceptable, and what is not.

---

[6] E.g., The white paper published jointly in February 2011 by the Departments of the Treasury and Housing and Urban Development, *Reforming America's Housing Finance Market, A Report To Congress*, available here: http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf

The minimal amount of credit risk standard would in essence require a subjective matrix approach to the determination of whether or not a security was an MRS. These determinations, absent definition of what 'material' means, and quantification of how to meet that standard, will create uncertainty. This uncertainty would reduce liquidity, and this reduction in liquidity would limit buyside demand, distribution and secondary trading, thereby further harming the ability of non-Agency securitization to fund mortgage credit.

SIFMA would also like to reiterate a comment from our previous letter, but refine it a bit more specifically to this context. In our previous letter we noted concern that this matrix approach would disadvantage smaller dealers relative to larger ones, because of the resource-intensive and sophisticated review, on a security-by-security basis, that it would entail. Similarly in this context, purchasers of mortgage-backed securities would need to employ a sophisticated, multifactor analysis as to whether or not they were permitted to own the security, much less whether or not they wanted to. While SIFMA agrees strongly that investors should not place sole reliance on credit ratings as measures of credit risk, we are concerned that creating too complicated a regime will dissuade all but the most sophisticated investors from considering investments in high-quality mortgage backed securities. If the privately issued MBS markets are to recover, the recovery must be broadly based and cannot rely only upon a handful of the largest and most sophisticated investors.

SIFMA believes further consideration of more clear, objective and easy to apply standards is needed. To the extent possible, these standards should be applicable universally, not just to a subset of structures or asset classes. This is a challenging task, and for this reason we believe the Commission should consider a variety of objective standards, whereby if a security meets one of the objective tests, it is deemed a mortgage related security. We have not been able to determine a single new standard that would effectively replace credit ratings. We propose the below merely as examples and note that each has shortcomings that prevent it from fully meeting the principle in the preceding sentence. For example, if a security is registered on form SF-3, it meets the high standards of the Commission for shelf registration. While this could lead to a security rated below AA being deemed an MRS, we believe that the proposed new conditions for shelf eligibility, along with other recent regulatory efforts such as risk retention, will serve significantly to enhance the general level of quality of senior classes of securitized products. Alternatively, the Commission could devise a test where the credit support for a security (at issuance and on an ongoing basis, differentiated for different asset classes) was greater than or equal to some number "X". Another alternative would combine that measure with the Qualified Residential Mortgage (QRM) standard; if a securitization were collateralized solely by QRMs, and the credit support of the security at or above some number "Y" (which would be less than X in the example above). We reinforce that the standard should be objective. However, both of these proposals would limit applicability to certain structures or certain asset classes.

We also note that while 939A may compel agencies to remove references to ratings, it does not require them to entirely disallow usage of credit ratings or other third party assessments of credit. Therefore, we would generally support a standard that allowed participants to consult third-party assessments of credit risk, in combination with an internal due diligence process that is specified in internal policies and procedures. Given that Dodd-Frank mandates an inability to refer directly to the parameters of these sources of analysis (due to Dodd-Frank), the standard will be somewhat less clear than objective tests such as those discussed above, but we believe that market familiarity with the use of these sources will alleviate most of the problems that come with other less clear measures of risk. We note, however, that sellers would still face disclosure issues with respect to this approach, as it is not clear how the seller would describe the security given the decrease in objectivity of compliance with the standard.

SIFMA encourages the Commission to consider these issues further. We recognize the very difficult task Section 939(e) presents the Commission. In the end, the market will only perform optimally if participants have certainty as to exactly what standard they are required to meet, and clear knowledge as to when they have met it. SIFMA believes that standard must guide rulemaking in this area.

SIFMA would be pleased to discuss these issues further at the convenience of the Commission. Please do not hesitate to contact Chris Killian (ckillian@sifma.org or 212-313-1126) of our staff with questions or comments.

Sincerely yours,

Richard A. Dorfman
Managing Director
Head of Securitization

Christopher B. Killian
Vice President, Securitization Group