CFA Consumer Federation of America

November 16, 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: **File Number S7-26-10**
Issuer Review of Assets in Offerings of Asset-Backed Securities

Dear Secretary Murphy:

I am writing on behalf of the Consumer Federation of America (CFA)[1] in response to the Commission's request for comments regarding "Issuer Review of Assets in Offerings of Asset-Backed Securities." While there are aspects of the Commission proposal that CFA supports, the proposal stops well short of the steps needed to bring about the reforms Congress sought to achieve when it included the asset review requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act. If it is to fulfill this congressional mandate, the rule must set a minimum standard for the asset reviews and it must apply to both public and private offerings. Without these strengthening amendments, this proposal is likely simply to perpetuate a system in which issuers rush asset-backed securities to market without conducting a meaningful review of the assets underlying those securities. That is bad for investors, bad for the credit markets, and bad for the safety and stability of our financial system.

Background

Section 945 of the Dodd-Frank Act directs the Commission to issue rules "that require any issuer of an asset-backed security to perform a due diligence analysis of the assets underlying the asset-backed security and to disclose the nature of this analysis."[2] The purpose of the provision, as described in the Senate Report, is to "re-introduce due diligence into the securities offering process." In crafting that provision, Senate sponsors relied heavily on the

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[1] CFA is a nonprofit association of approximately 280 pro-consumer organizations established in 1968 to represent the consumer interest through research, education, and advocacy.
[2] Senate Report 111-176, "The Restoring American Financial Stability Act of 2010," citing testimony by Professor John C. Coffee, Jr..

testimony of Columbia Law School Professor John C. Coffee, Jr., which described "a rapid decline in due diligence" over the past decade by issuers of mortgage-backed securities.[3]

Citing industry leaders, Professor Coffee noted that in the past firms were typically asked to review 25 to 40 percent of the loans going into asset-backed securities. Moreover, loan buyers who kept the mortgages as investments would typically have 50 to 100 percent of the loans examined. But at the peak of the mortgage-backed securities market, that percentage had dropped to ten percent. In short, as he told the Committee, "Over the last several years, due diligence practices long followed in the industry seemed to have been relaxed, ignored, or treated as a largely optional formality." The concerns raised by Professor Coffee in his testimony have since been reinforced and expanded upon elsewhere, including in recent testimony before the Financial Crisis Inquiry Commission (FCIC). At an FCIC hearing in Sacramento, for example, a senior vice president of due diligence firm Clayton Holdings said that "during the frenzied last months of the boom, when lenders and securitizers were trying to sell off as much as they could before the market collapsed," the percentage of loans Clayton was asked to examine had fallen to "as low as 5 percent."[4]

Perhaps even more disturbing is what happened when those asset reviews turned up loans that didn't meet the lender's stated underwriting standards. When a sampling of assets uncovers problems, best practices demand that examiners go back and review a larger sample until they are confident that they have uncovered the extent of the problem. But that didn't happen, according to Clayton Holdings executives.[5] Moreover, when problems were flagged, issuers should have either forced the lenders to take back the problem loans and replace them with loans that met the stated underwriting standards or, at a minimum, disclosed to investors the extent of problem loans included in the asset pool. Instead, according to the FCIC testimony, nearly 40 percent of the loans red-flagged by Clayton found their way into the mortgage-backed securities, and disclosures to investors were cursory at best.[6]

In his Senate testimony, Professor Coffee attributed the decline in due diligence to a variety of factors, including the limited time available to conduct adequate asset reviews for securities sold "off the shelf." This need for speed is exacerbated by the role investment banks play in these offerings, a role that differs greatly from the gatekeeper role they play in traditional offerings. As Professor Coffee explained it:

> "In these offerings, there is no corporate issuer, but only a 'special purpose vehicle' (or 'SPV') typically established by the investment bank. The product – residential home mortgages – is purchased by the investment bank from loan originators and may be held in inventory by the investment bank for some period until the offering can be effected. In part for this reason, ***the investment bank will logically want to expedite the offering in order to minimize the period that it***

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[3] Testimony of Professor John C. Coffee, Jr. Adolf A. Berle Professor of Law, Columbia University Law School, before the Senate Committee on Banking, Housing and Urban Affairs, "Enhancing Investor Protection and the Regulation of Securities Markets," March 10, 2009.
[4] Shahien Nasiripour, "New Proof Wall Street Knew Its Mortgage Securities Were Subpar: Clayton Execs Testify," *Huffington Post*, September 25, 2010.
[5] Nasiripour, "New Proof."
[6] Ibid. See also, Gretchen Morgenson, "Seeing vs. Doing," *The New York Times*, July 24, 2010.

> ***must hold the purchased mortgages in its own inventory and at its own risk.*** (Emphasis added.)

As a result, investment banks underwriting the deals had strong motives for resisting a careful review of assets that could delay or even derail the offering. As one industry observer told the FCIC, "If issuers had been scrutinizing all the collateral in a security and only putting in loans that met actual underwriting and documentation requirements, a lot of these deals wouldn't have gotten done."[7] And investment banks' profits depended on the deals getting done.

The securitization process also empowered lenders to push back against demands for appropriate due diligence and buy backs of problem loans. Chapman University School of Law Professor Kurt Eggert explained it this way in his recent testimony before the FCIC:

> "During the boom years, subprime loan securities were in such high demand and subprime loans hence so valued that subprime originators could demand that investment houses engage in less due diligence and could resist having to buy back all of the shoddy loans that the diminished due diligence uncovered ... Large subprime originators had so much leverage that they could bargain down this due diligence, insisting that Wall Street firms engage in far less due diligence for loans that would be securitized than financial firms would conduct for loans they intended to hold in portfolio."[8]

Professor Coffee made a similar point, "In a market where the demand seemed inexhaustible, the real issue was obtaining supply, and investment banks spent little time worrying about due diligence or rejecting a supply that was already too scarce for their anticipated needs." As a result of lender's bargaining power, even had investment banks been willing to try to force the lenders to replace problem loans with good loans, they would have found it difficult to do so.

But investment banks had little if any incentive to resist lender pressure, particularly when they could hide problem assets from investors. And disclosures were often minimal at best. According to research cited in Professor Eggert's testimony:

> "the prospectuses and accompanying supplement often made claims about the underwriting used for loan pools, but did not disclose how many of the loans included in the pools were made as exceptions to the underwriting standards. Instead, the offering materials reported mere boilerplate language that exceptions might make up 'substantial' or 'significant' portions of the pool."[9]

Instead of disclosing defective loans to investors, investment banks that were already making outsized profits underwriting mortgage-backed securities were able to boost those profits by

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[7] Nasiripour, "New Proof," quoting Guy Cecala, publisher of *Inside Mortgage Finance*.
[8] Professor Kurt Eggert, Chapman University School of Law, "Beyond 'Skin in the Game' -- The Structural Flaws in Private-Label Mortgage Securitization That Caused the Mortgage Meltdown," prepared for the Financial Crisis Inquiry Commission for its hearing entitled, "The Impact of the Financial Crisis at the Ground Level – Greater Sacramento, California," September 23, 2010 (citations omitted).
[9] Ibid, citations omitted.

negotiating a lower price for the defective loans without passing along those savings to investors, or even clearly disclosing the risks.[10] As Professor Eggert commented, "Such behavior, if proven, stands due diligence on its head, and turns it from a mechanism to protect investors from problem loans to a mechanism for investment houses to benefit from problem loans at the expense of investors who unknowingly end up with the bad loans."

The challenge for the Commission is to develop a rule that addresses these twin problems: 1) that the asset reviews that were conducted were inadequate to reveal the extent of problems with assets underlying the securities; and 2) that, where problems were uncovered by the reviews, they were neither rectified nor clearly disclosed to investors. To solve these problems, the Commission must counteract the strong incentives investment banks and others in the securitization supply chain have to under-invest in due diligence and to hide potential problems from investors. Unfortunately, the Commission proposal is too weak to meet this test.

The SEC Proposal

Proposed Rule 193 would require issuers to perform a review of the assets underlying an asset-backed security. However, the proposed rule does not specify the level or type of review the issuer is required to perform, and it would apply only to transactions registered under the Securities Act, not those sold through private offerings. The proposal would permit the use of third-party due diligence firms to perform the review of pool assets so long as the party performing the review is named in the registration statement and consents to be named as an "expert" in accordance with Section 7 of the Securities Act and Rule 436 under the Securities Act. The proposal also includes revisions to Item 1111 of Regulation AB that would require issuers to disclose both the nature of the review of the assets conducted under proposed Rule 193 and the findings and conclusions of that review.

The Proposed Rule Includes Well Crafted Disclosure Requirements

There are aspects of this proposed rule that CFA strongly supports. In particular, we applaud the Commission proposal to require disclosure of the findings of asset reviews conducted under Rule 193, regardless of whether they are conducted internally or by outside parties. The Commission gets it exactly right when it states that failure to impose the requirement in an even-handed fashion "could create an incentive for issuers to conduct the review themselves to avoid making publicly available the findings and conclusions of any review of the assets underlying the ABS." Moreover, the disclosures the Commission proposes to require would provide useful information to investors about how assets in the pool deviate from the disclosed underwriting criteria, the number and characteristics of assets that do not meet the disclosed standards, and the entity responsible for determining that such assets should nonetheless be included in the asset pool. We agree with the statement in the proposing release that these disclosure requirements will "help elicit important information in areas that became problematic in the recent financial crisis" and will "provide investors with a fuller understanding of the quality and extent of the issuer's review of the assets."

[10] Morgenson, "Seeing vs. Doing." See also, Eggert testimony.

If other flaws in the proposed rule are fixed, this provision could, by improving the quality of information provided to investors, force issuers to price securities commensurate with their risks. It is even possible that requiring issuers to disclose the findings of asset reviews would provide the incentive needed to force buy backs of problem assets, which could in turn promote better underwriting practices on the front-end. That is consistent with Congress's goal of ameliorating the harmful effects of the "originate to distribute" lending model. But these benefits of improved disclosure will only follow if the asset reviews themselves are sufficient to reveal the existence and extent of problem assets.

<u>The Proposed Approach to Reliance on Third-Party Due Diligence Reviews Is Appropriate</u>

We also support the approach outlined in the proposal for reliance on third-party due diligence firms to conduct asset reviews. In its rule proposal, the Commission correctly notes the conflicts of interest that can exist when third parties are paid by issuers to conduct these reviews. However, these conflicts are no greater than those that the issuers themselves face. Therefore, we see no reason to prohibit reliance on third-party reviews. By conditioning reliance on the third-party reviewer's consent to being named as an expert in accordance with Section 7 of the Securities Act and Rule 436 under the Securities Act, the proposal should ensure that these firms are subject to appropriate legal accountability. This should in turn provide sufficient incentive to ensure that the reviews are of high quality and should help to counter-balance the conflicts associated with the issuer paid business model. Moreover, it is consistent with the approach Congress took to counteract conflicts in the issuer-paid business model for credit ratings by increasing rating agencies' legal accountability.

<u>Fatal Flaws Threaten the Proposed Rule's Likely Effectiveness</u>

On the other hand, the failure to set a minimum standard for the asset reviews and the proposed rule's application only to registered offerings fatally undermine its effectiveness. Under the best possible scenario, registered offerings might see a slight improvement in due diligence practices under the proposed rule (though this outcome is far from guaranteed) along with a significant improvement in the disclosures provided to investors. Unless the rule is extended to cover private offerings, however, even under this best possible outcome abusive practices are likely simply to migrate into the market for private offerings. Under the worst scenario, the rule's strongest provision – its requirement that issuers disclose the findings of asset reviews – could actually create a perverse incentive to decrease due diligence reviews even further in order to decrease the likelihood that they turn up problems that would have to be reported to investors. Without a minimum standard for asset reviews, there is nothing to prevent this outcome. It is essential, therefore, that these flaws be fixed in the final rule.

A. The Rule Must Set a Minimum Standard for Asset Reviews

We concur with the conclusion reached by Professor Coffee in his testimony that, "The first lesson to be learned is that underwriters cannot be trusted to perform serious due diligence when they are in effect selling their own inventory and are under severe time pressure." We feel confident, moreover, that Congress had that view in mind when it directed the Commission to adopt rules with regard to asset reviews. Unfortunately, that most basic lesson is not reflected in the Commission proposal perpetuates a failed system in which underwriters are solely responsible for ensuring the quality of due diligence.

The Commission proposal relies primarily on two factors – disclosure to investors of the nature and extent of those reviews and the issuer's responsibility to ensure that disclosures are accurate – to improve the quality of asset reviews. In light of the strong incentives that all members of the securitization supply chain have to skimp on due diligence, however, there is little if any reason to believe these factors alone are adequate to the task. Indeed, if issuers' and underwriters' responsibility to ensure accurate disclosures were adequate to discipline this process, it should have worked in the past. The fact that it did not should serve as sufficient reason not to rely on it to do so now. Similarly, investors' inability to force more extensive or more timely disclosures with regard to asset-backed securities strongly suggests that they will be similarly unable to exert sufficient market power to improve the quality of asset reviews absent a Commission requirement that those reviews meet some minimum standard.

In justifying its decision not to specify the level or type of review an issuer would be required to perform, the Commission correctly notes that asset-backed securities do not lend themselves to a one-size-fits-all approach to asset reviews. Indeed, the nature and extent of reviews *should* vary depending, among other things, on the nature of assets being securitized. As just one example, mortgage-backed securities based on traditional, conforming loans from a reputable lender would arguably require less extensive reviews than a mortgage-backed security based on subprime and Alt-A loans from a lender with a reputation for shoddy underwriting practices. We therefore agree that, in light of the great variety of asset-backed securities potentially covered by such a standard, it would be difficult if not impossible to write a detailed, prescriptive rule outlining exactly how asset reviews should be conducted in each circumstance.

What is needed instead is a principles-based standard that could be adapted to the variety of securities covered by that standard. Given the clear intent on the part of Congress to "re-introduce due diligence" into the securitization process for asset-backed securities, the existing standards with regard to due diligence provide an appropriate model for the Commission to adopt in this context. Toward that end, we support the alternative approach discussed in the Release of requiring that the asset review be sufficient to provide reasonable assurance that the disclosures regarding assets are accurate in all material respects. In this regard, we believe the standard should specify that, where initial reviews uncover discrepancies, further reviews sufficient to uncover the extent of the problem should be conducted. Such an approach could easily be adapted to accommodate the variety of asset-backed securities. If it were not just adopted but also were effectively enforced, it would have the potential to bring about the significant improvements in the quality of asset reviews sought by Congress when it included this provision in the Dodd-Frank Act.

The most likely argument to be lodged against such an approach is that it would impose undue costs or burdens on issuers. But, as Professor Coffee noted in his testimony, slowing down the underwriting process for asset-backed securities to allow for adequate due diligence should be viewed as a goal of reform, not a flaw in the proposal. Moreover, those same issuers and underwriters who are most likely to complain about costs imposed by a minimum standard face daunting, potentially catastrophic, costs today precisely because of their failure to ensure that mortgages in the mortgage-backed securities they sold matched the stated underwriting standards. The cost of up-front compliance with a flexible, principles-based standard pales in comparison to the costs those same issuers could be forced to pay if investors succeed in forcing them to buy back significant numbers of problem mortgages. Even if investor suits are unsuccessful, the legal costs of defending those suits are likely to be substantial.

It would be a far better use of industry resources, and far better for the safety and stability of the market, to invest in sound up-front due diligence practices. Unless they are forced to do so by the Commission, however, we see little indication that issuers or underwriters are likely to be willing to make that investment. Even if practices improve in the short-term, experience has shown that restraints will once again be abandoned when the next bubble begins to inflate. The Commission must therefore seize the opportunity presented by the recent financial crisis and by the passage of the Dodd-Frank Act to impose a minimum standard for asset reviews.

B. The Rule Should Be Extended to Private Offerings

If there is one thing the recent financial crisis should have taught us it is the risks that arise when similar or identical functions are carried out in both the regulated and the unregulated marketplace. Yet the SEC rule proposal perpetuates this potential for regulatory arbitrage by imposing different asset-review requirements on public and private offerings of otherwise identical asset-backed securities. While we recognize that the legislative language is ambiguous on this point, the public interest is not. Failure to extend the asset review requirement to private offerings would create an incentive for issuers to avoid public offerings in order to evade the rule requirements. Moreover, underwriters would have an additional incentive to avoid third-party due diligence reviews of private offerings, since those would have to be disclosed. As a result, any reforms achieved in the market for public offerings would be directly undercut by the ability to evade those requirements in the private market. Nothing in the congressional record suggests that this is consistent with congressional intent.[11]

Moreover, the Commission proposal lays out a perfectly workable approach to extending the asset review requirement to private offerings. Just as it has proposed to do with regard to other issues addressed in the 2010 ABS Proposing Release, the Commission could condition safe harbors for an exemption from registration under Regulation D and Rule 144A on a requirement that the underlying transaction agreement for the asset-backed security include a representation that the issuer performed an asset review that complies with Rule 193. We strongly urge the Commission to adopt this approach. Moreover, if the Commission adopts a minimum standard for such reviews, the reviews for private offerings should be subject to the same minimum standard as those for public offerings, and issuers should be required to provide the same information about the reviews to potential investors in the securities.

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[11] While the legislation uses a definition of asset-backed securities that includes securities typically sold in private transactions, it directs the Commission to adopt rules relating to registration statements, which would appear to relate solely to public offerings. It is at least as likely that this reflects sloppy drafting rather than an intent to distinguish between public and private offerings. To the degree that the Senate Report language offers any guidance, it supports a broader approach. Certainly, it shows no clear intention that the asset review requirement apply exclusively to public offerings.

Conclusion

In his testimony before the FCIC, Professor Eggert called on regulators to be bold in crafting their reform proposals.

> "Some in the financial industry are advocating for minimizing the changes to the system, as if adding a dash of disclosure and risk retention were all that was needed for a safe and vibrant system of private-label securitization. However, the structural problems of private-label mortgage securitization go far beyond mere 'skin in the game' and transparency. Those who would seek to prevent another crash need to make bold, rather than merely cosmetic, changes. By addressing all of the problems of mortgage securitization, we can maximize our chances to avoid another mortgage crisis caused in large part by securitization."

We urge the Commission to heed Professor Eggert's call. Congress has provided the Commission with the opportunity to do so. Unfortunately, the proposal as currently drafted falls far short of the mark. Only by incorporating a minimum standard for asset reviews and applying rules to both public and private offerings can the Commission hope to bring about the bold reform that is needed not only to protect investors but also to restore the flow of credit to businesses and individuals on sound and sustainable terms.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

cc: Chairman Mary Schapiro
Commissioner Luis Aguilar
Commissioner Kathleen Casey
Commissioner Troy Paredes
Commissioner Elisse Walter