THE COMMONWEALTH OF MASSACHUSETTS
OFFICE OF THE ATTORNEY GENERAL
ONE ASHBURTON PLACE
BOSTON, MASSACHUSETTS 02108

MARTHA COAKLEY
ATTORNEY GENERAL

(617) 727-2200
www.mass.gov/ago

August 2, 2010

Via e-mail: rule-comments@sec.gov
Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Securities and Exchange Commission's Proposed Rule Concerning Asset-Backed Securities, Release Nos. 33-9117; 34-61858; File Number S7-08-10

Dear Ms. Murphy,

Thank you for the opportunity to comment on the Commission's proposed revisions to Regulation AB and other rules concerning the issuance and disclosure obligations for asset-backed securities, as set forth in Release Nos. 33-9117; 34-61858 (the "Proposing Release"). The following are our comments.

1. Introduction

As the Commission prepares to overhaul the regulatory framework for asset-backed securities, we write to share some thoughts, concerns and suggestions our office has gleaned from our investigations into the origination, financing, purchase, and securitization of subprime home mortgage loans. While we commend many of the proposed reforms, we believe there are many issues surrounding the secondary market's role in the subprime crisis that remain to be addressed. This letter broadly sets out our areas of concern, lists a number of issues raised in our industry-wide investigation of the securitization market along with suggestions for regulatory action, and concludes with additional recommendations related to specific items in the Proposing Release. We hope these thoughts and suggestions assist the Commission as it pushes forward with its important tasks. These comments reflect the extensive investigative work of the Insurance and Financial Services Division ("IFSD") of our office. Please feel free to reach out to Glenn Kaplan, IFSD Chief, at 617-727-2200 to discuss the issues raised in this letter.

1.1. The Experience of the Attorney General's Office

Since early 2007, the Massachusetts Attorney General's Office has actively sought accountability at all levels of the subprime lending crisis. Our office was among the first in the nation to pursue foreclosure rescue scammers that took advantage of our residents who had fallen victim to the subprime crisis. We also sued subprime lenders operating in Massachusetts for unfair and deceptive practices, obtaining injunctions against foreclosures. In addition, we promulgated new consumer protection regulations governing mortgage lenders and brokers.

However, the subprime crisis was not caused by wrongdoers at the retail level alone. Rather, Wall Street's appetite for mortgage loans vastly increased the volume of subprime loans and encouraged ever more lax lending standards at the retail level. At the same time, the securitization model passed the risk of poor lending decisions on to investors, removed incentives for real loan underwriting at the retail level, and fueled a boom in thinly-capitalized mortgage originators that were never destined to survive a downturn.

Approximately two years ago, our office launched a series of investigations of major investment banks that had securitized the mortgages of some of the worst loan originators in the country. While we have announced settlements in two such investigations to date,[1] a number of other investigations remain open and are ongoing. Because of securitization's integral role in fueling the subprime crisis, our office reviewed the role played by the middlemen who lent money to and bought loans from originators, on the one hand, and then packaged those loans into highly rated securities for investors, on the other. In our investigations, we have focused on the relationships between the securitizers and originators, and on the flow of information among securitizers, originators, investors, and rating agencies. We have also examined conflicts of interest that arose when the middlemen tried to satisfy the originators and the investors while watching their own bottom lines. In some cases, securitization methodologies were created that permitted the pricing and purchase of loans known to be of poor quality or in violation of guidelines.

Although it is not normally our office's practice to discuss ongoing investigations, the circumstances of the Commission's reform efforts, combined with our office's unique perspective, have led us to submit these comments on the Commission's proposals. Because of the ongoing nature of our investigations, the sensitivity of the information we have reviewed, and the confidentiality required by our state statute, our observations here are necessarily stated in general terms and are not intended to implicate any individual market participant.

---

[1] The settlement with Goldman Sachs can be found at: http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2009_05_11_goldman_settlement&csid=Cago. The settlement with Morgan Stanley can be found at: http://www.mass.gov/?pageID=cagopressrelease&L=1&L0=Home&sid=Cago&b=pressrelease&f=2010_06_24_ms_settlement&csid=Cago.

1.2. Overview of the Attorney General's Comments

We commend the Commission for tackling the substantial task of re-writing the "rules of the road" for asset-backed security issuances. The new rules set forth in the Proposing Release are strong in many respects and go a long way towards addressing many of the concerns we express in this letter. However, as set forth below, there are a number of ways in which the Commission's proposals may be improved as they relate to residential mortgage backed securities ("RMBS"). Our suggestions for improvement will lead to stronger protections for investors, and will both ensure that homeowners are treated more fairly and assist the Commission and state and federal regulators in overseeing this market.

We laud the Commission's strong proposals in the areas of risk retention and asset-level disclosures. While we have suggestions in each of these areas, the general thrust of these reform efforts is positive for the markets, for investors, and for the borrowers whose mortgages are placed into these securitizations.

In order to provide the full necessary solution to the problem, however, the proposals should be extended to require disclosure of additional information in the possession of participants in the securitization process. In particular, the investment banks that sponsor and underwrite RMBS often perform substantial activities both pre- and post-securitization that go undisclosed to investors and that may affect the ultimate performance of the securities. Disclosure of such information, together with the processes that will and will not be undertaken by these entities, and the potential conflicts of interest that may influence the manner in which such processes are implemented, would significantly improve the information available to investors.

Specifically, any revamped regulation of the RMBS market needs to address the process by which the loans subject to a securitization are procured, including detailed disclosure of the results of any due diligence processes used by securitization sponsors to vet the assets deposited into securitizations. This due diligence disclosure should also be supplemented by enhanced disclosure concerning the ongoing relationships between the sponsor and the originators of the mortgage loans.

In addition, once a securitization has been issued, enhanced disclosure is required to inform investors about the mechanisms to monitor and enforce potential claims for loan repurchases, the degree to which the sponsor has committed to participate in such activities, and, where appropriate, any conflicts of interest that could affect the sponsor's decision-making in this regard.

2. Predicate: Originator v. Principal Securitizations

Before discussing our office's concerns about the RMBS market, an introductory note on two different securitization models will provide a context for many of our comments.

In the RMBS market, mortgage loans are typically securitized in one of two ways.[2] The first method is through a process in which underwriters do not buy the loans, but simply securitize them for an originator. Here, a mortgage loan originator (or its affiliate) sells loans directly into a securitization entity, which then issues securities. In such a process, investment banks provide advice and underwrite the securitization. The originator may retain the equity portion of the deal, although this equity may in turn be sold off to other investors. Because the originator is generally the sponsor of such a securitization under Regulation AB, and because the investment bank is not technically involved in the sale of the loans to the securitization, due diligence may be limited. Similarly, the originator, acting as sponsor, has little or no interest in pursuing post-securitization claims against itself for breaches of representations and warranties.[3]

These deficiencies, as well as a lack of confidence in many originators in this market sector, lead many investors to prefer securitizations in which the investment bank actually purchases the loans and securitizes them on its own behalf. For ease of reference we will call this sort of securitization a "principal securitization," referring to the fact that the investment bank is securitizing the loans on its own behalf, and usually acts as sponsor, depositor and underwriter through various affiliates.[4] The expectation is that where the investment bank is buying the loans itself and acts as the "sponsor" for the securitization, it will undertake diligence on the pools it purchases. In addition, many investment banks retain – at least initially – the equity portion of their principal securitizations, although some or all of these interests may be the subject of a sale or re-securitization in a so-called "net interest margin" transaction. Investment bank sponsors may also stay involved in their transactions post-securitization, monitoring the assets for breaches of representations and warranties and assisting the securitization trustee in pursuing claims against the originator based on such breaches.

We note the differences between the originator and principal securitization models because many of the proposed amendments to Regulation AB appear primarily addressed to issues that arise in originator securitizations and therefore focus on requiring disclosures by originators. By contrast, our investigations and comments focus primarily on the principal securitization process, which comprised a substantial portion of the RMBS market during the 2004-2007 period. As will be apparent from the discussion that follows, information obtained by securitizers in the securitization process may be used to both limit the production of problematic loans in the first instance and to better inform investors about the quality of the assets underlying their investments. The Commission

---

[2] This description is necessarily a simplification. We have come across many variants of securitization structures in our investigation. One common such variant not discussed here, the "rent-a-shelf" structure, is a hybrid of the originator securitization model and the principal securitization model.

[3] For investors to be willing to acquire the mortgage-backed securities, "they must be persuaded that the credit quality of the underlying mortgages is high and that the origination-to-distribution process is managed so that originators . . . have an incentive to undertake careful underwriting." Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve Sys., Speech the UC Berkeley/UCLA Symposium: The Future of Mortgage Finance in the United States (October 31, 2008) (transcript available at: http://www.federalreserve.gov/newsevents/speech/bernanke20081031a.htm).

[4] Also referred to as "Whole Loan ABS." See written comments of Barclays, provided to Commissioner Troy A. Paredes on April 27, 2010, available at: http://www.sec.gov/comments/s7-08-10/s70810-24.pdf.

should carefully consider its proposals in light of the various roles that investment banks play in the principal securitization process.

3. Predicate: Information Asymmetry

As the Commission recognizes in its proposal, investors' willingness to invest in residential mortgage backed securities often is dependent on the ability to mathematically model the expected performance of the underlying collateral so that the risks of the transaction can be properly weighed. Rating agencies similarly engage in modeling activity to assess the likelihood of default. In part as a consequence of this fact, within the structure of residential mortgage backed securities easily quantifiable risks (like FICO scores or loan-to-value ratios) were disclosed as data points, and less quantifiable risks (like fraud) were addressed through representations and warranties designed to give investors comfort that such risks were not present in the pool. Our comments will focus on two related information asymmetries that arise from the RMBS structure. First, investment banks, through their diligence process, may discover that loans have poorer quantifiable criteria than are present on the loan tape (for example, if the bank's review calls into question the quality of appraisals underlying the calculation of the loan-to-value ratios). Second, investment banks may discover concentrations of otherwise unquantifiable risks like fraud. The appearance of a concentration of fraudulent loans in a sample could assist investors in quantifying the risk of fraud in the remainder of the pool. In the end, data that meaningfully illuminates risks associated with the loan pools should be disclosed.

4. Disclosure of Key Asset Information to Investors

4.1. Due Diligence

In the typical principal securitization of residential mortgage loans, the sponsor agrees to purchase loans from an originator subject to the sponsor's right to conduct due diligence on those loans and reject loans that the sponsor deems unacceptable. This diligence process is a key part of the principal securitization process. To the extent information is developed in this process that may be material to the expected performance of the underlying securities, our view is that it should be disclosed to investors. For instance, the Commission's proposal in Item 1111(a)(5) of Regulation AB to include disclosure concerning the originator's due diligence process does not appear to address the information uncovered by sponsors performing due diligence in principal securitizations. The Commission should require such disclosure in accordance with the recommendations below.

4.1.1. What is Loan-Level Due Diligence?

Loan-level due diligence is a process whereby the investment bank re-underwrites a sample of loans to determine whether it conforms with the selling originator's

representations and warranties. This includes checking that the loans comply with law, were originated in accordance with the originator's underwriting guidelines, and were accurately described in the loan data file provided by the originator to the sponsor.

Due diligence is an economically efficient step in the loan-buying process because it permits the investment bank to examine the quality of the assets backing its securities and to determine if there are underlying problems in the loans it is buying. Due diligence may be used to identify problems ranging from basic credit issues, such as a misreported credit score or a poor decision to extend credit under an exception to underwriting guidelines, to indications of unfair or predatory lending, such as broker fraud, violations of consumer protection laws, or overstated appraisals.

The type of diligence conducted by a sponsor falls into three general categories: credit, compliance, and valuation due diligence. Credit diligence examines the sampled loans in order to ascertain whether they have been originated in accordance with the originator's underwriting guidelines, whether the loan characteristics reported by the originator are accurate, and whether the credit profile of the loans is acceptable to the sponsor. Compliance diligence focuses on whether the loans have been originated in compliance with federal, state, and local laws, including predatory lending and truth-in-lending statutes. Valuation diligence checks the accuracy of the originator's reported property value for the collateral backing the loans.

4.1.2. Credit & Compliance Diligence; Failure of Loans to Comply with Underwriting Guidelines

The credit and compliance diligence process generally involves a review of a sample of the loans presented for purchase, followed by an analysis of whether those loans differ from the originator's representations about the loans. This process is often conducted for a sponsor by an outside vendor. A vendor is engaged to review each sampled loan file and determine whether each reviewed loan complies with the originator's underwriting guidelines, various predatory lending laws, and other requirements set out by the sponsor. As part of this process, the vendor often recalculates important data points, such as debt-to-income ratios, loan-to-value ratios, points and fees, and other figures important to the underwriting decision. Ultimately, the vendor provides its detailed quantitative and qualitative findings to the sponsor, along with a score for each loan. The score identifies noncompliance or "exceptions" (whether to guidelines, laws, or otherwise) with respect to the relevant loan and whether such exceptions were material.

Sponsors typically purchase both those loans identified by their diligence vendor as having no exceptions, as well as those loans with only non-material exceptions. Sponsors' typical policies required rejection for purchase of loans found to have material exceptions without sufficient compensating factors. In practice, however, sponsors often overrule or "waive" the findings of vendors concerning such exception loans. Such decisions are supposed to be based on an independent determination that the loan does not contain a material exception or that there were sufficient identified compensating

factors. At times, however, a sponsor's decision to overrule its vendor may be made based on other factors such as the ongoing business relationship between the investment bank and the originator. In this relationship, a key factor is the so-called "pull-through rate," or the percentage of loans that are purchased as opposed to rejected. If the pull-through rate is too low, the originator may decide not to continue to do business with the investment bank. In a competitive marketplace, this leads to a dangerous temptation to purchase flawed loans, particularly flaws that are not identifiable on the typical reports provided to investors. Other factors that could lead to the waiver of material exceptions could include capital structure requirements, rating agency models, and other non-credit-related business reasons.

4.1.2.1. Compensating factors

Most subprime originators' underwriting guidelines permitted the origination of loans that were exceptions to such guidelines so long as there were sufficient compensating factors identified.[5] Thus, as part of the credit diligence process, the sponsor's vendor was typically charged with identifying whether sufficient compensating factors existed to warrant the granting of an exception. Where this was the case, the loan was typically scored as having non-material exceptions.

Because the characterization of a loan as an exception, along with the reason for such characterization, is important in determining whether a loan was properly underwritten, a sponsor's due diligence results with respect to exceptions should be provided to investors. The proposed asset-level exception reporting should also include additional fields disclosing the specific underwriting exception, as well as the type of compensating factors relied on.

Because vendors work for sponsors, sponsors have the ability to direct vendors to grade loans as non-material exceptions even where the vendor identifies no compensating factors. Similarly, sponsors can waive or overrule, without reviewing underlying data, vendors' conclusions that insufficient compensating factors exist. Where this is the case, a description suggesting that exceptions are made "where compensating factors exist" would not be accurate.

Moreover, as discussed in further detail below, to the extent a sponsor determines to overrule the decision of its vendor or diligence staff finding that a loan has a material exception without compensating factors, that fact should be disclosed. This disclosure could be provided by including both the grade provided by the due diligence vendor and the final grade as determined by the sponsor. We expect that this disclosure will help ensure that the decision to accept such loans is based on defensible grounds.

---

[5] For example, a borrower who might not otherwise be allowed to take out a loan with a high loan to value ratio may be permitted to do so if the borrower had a credit score significantly above the required threshold for such loan. Such high credit score would be considered a sufficient compensating factor permitting the granting of an exception by the originator.

We note the Commission's proposed Item 1111(a)(3) of Regulation AB that seeks to provide disclosure on exceptions to origination criteria. However, this proposal focuses only on the originator's own determinations as to whether a loan met its own underwriting criteria. To the extent a sponsor discovers flaws in these determinations, such flaws should also be disclosed.

In addition, the Commission's proposal in Schedule L, Item 1(a)(19) to require a "yes" or "no" response as to whether the asset was an exception to defined or standardized underwriting criteria is a useful data point. However, market participants sometimes use the term "exception" to refer to loans that were unacceptable under the underwriting guidelines (i.e., they do not comply with the underwriting guidelines *and* do not meet the "compensating factor" standard set out in the guidelines to otherwise allow the approval of such loans) and at other times use the term "exception" to refer to loans that were acceptable under the underwriting guidelines because they demonstrated sufficient compensating factors. For this reason, Schedule L, Item 1(a)(19) should require disclosure on an asset level basis of exceptions both with and without the presence of sufficient compensating factors.

4.1.2.2. Sample basis – adverse v. random

As noted above, credit and compliance diligence is conducted on a sample basis. For any given pool of loans an investment bank intends to purchase, it may select from 10% to 50% of the pool as a sample to review for credit and compliance problems. As its name suggests, a "sample" typically provides the purchasing investment bank with a picture of what the remainder of its pool will look like. Indeed, a reason why anti-predatory lending legislation often contains sample requirements is the expectation that conclusions can be drawn concerning the quality of the entire pool from the sample review. In the future, investment banks should disclose their sampling methodologies including, on a loan level basis, which loans were sampled and whether the sampling was random or adverse selection. Moreover, the Commission should mandate that every sample include a significant random sampling component.

In many pools, the level of exceptions in the random sample was significant. When the remaining unsampled loans in the pool are purchased, there is an extraordinarily high likelihood that they will demonstrate problems similar to those in the randomly selected loans in the sample.

For even greater clarity, investors should be given aggregate data on the percentage of random and adversely sampled loans and, within each category, the percentage of loans for which exceptions were uncovered in the due diligence process. The exception data should further be broken down into material and non-material exceptions, so that if an investor is concerned about conflicts of interest in connection with the sponsor's decision to grade exceptions non-material, such investor can evaluate the impact of such decisions on the pool. In addition, for both randomly and adversely sampled loans, the data should show the percentages of loans for which exceptions

without sufficient compensating factors were found by the vendor and waived or overruled by the securitizer.

The inclusion of a meaningful random sample is important to the diligence process. If the sample is entirely adverse, it can be too easy for a sponsor to convince itself that negative findings derive from the adversity of the sample rather than the poor quality of the loans. This in turn may cause the sponsor to fail to increase the size of the sample where problems are found. Should originators press sponsors to agree to limited diligence samples and not to increase sample sizes upon poor findings, the entirely adverse sample may provide a rationalization for failing to follow through on diligence findings. It may also cause the sponsor to conclude that poor results need not be disclosed. As a result, investors may be denied access to information that could affect their investment decisions. Random samples necessarily provide sponsors, and investors, with more information about the overall loan pool. Requiring random samples would also remove ambiguity as to the significance of the diligence findings. Incorporating into Regulation AB a requirement that sponsors review a sample of loans containing a significant random component, and that detailed information about the method of sampling and the results of such sampling be disclosed, are critical for the prospective success of investor protection in this arena.

4.1.2.3. Non-reporting of waivers

A sponsor can easily overrule the findings of its diligence vendor as to the materiality of exceptions. Where this happens, the vendor's score of material exception without sufficient compensating factors may be changed by the sponsor to a final score of non-material exception.

Some sponsors provided diligence findings to rating agencies and requested that the rating agencies consider the findings, and in particular the kick outs of exception loans, in their ratings. In some instances, a sponsor gave what appeared to be due diligence scores (often called grades) assigned by a diligence vendor to rating agencies, when in fact, the sponsor had waived a substantial portion of the vendor's findings. This gave the appearance that problem loans identified as exceptions without sufficient compensating factors were excluded from the pool when many such loans had their scores changed by the sponsor, leading to purchase and securitization.

In light of these issues, we think that where a sponsor conducts due diligence and provides those results to investors, rating agencies, or others involved in the securitization process, those results should include both the vendor's final diligence results and the sponsor's final diligence determinations as to the loans. In addition, because of our concerns about conflicts of interest relating to a sponsor's overruling the diligence findings of its vendor, any diligence disclosure should describe the process for approving the purchase of exception loans, including both the sponsor's policies on "waiver" or overruling of the vendor's findings and an identification of where in the sponsor's organization the authority for overruling diligence recommendations lies.

In our Assurance of Discontinuance with Morgan Stanley, we address this issue.[6] To the extent the amendments to Regulation AB or other federal law do not address this issue, Morgan Stanley has nevertheless agreed to provide these disclosures to Massachusetts investors. We believe a nationwide requirement, benefitting all investors and applicable to all issuers, would be the best solution here. The Commission can use our requirement in the Morgan Stanley Assurance of Discontinuance as a model, and incorporate this concept into the new federal standard.

4.1.2.4. Document cures

Another reason for providing investors with vendor diligence results arises from a particular type of exception loan referred to as a "document" exception. Part of the compliance diligence process requires the vendor to check that all documents required for the origination of the loan are present in the loan file. Where the originator's underwriting is sloppy, this can lead to poor document trails and substantial numbers of missing documents, including important truth-in-lending disclosure documents that were required to be provided to borrowers under applicable laws. The absence of key documents is generally uncovered in diligence.

Where missing documents are identified, the sponsor typically informs the originator and allows the originator to cure the document exceptions by providing the missing document. However, to the extent only loans in the sample are reviewed, only loans in the sample will be cured. If there were a substantial number of document deficiencies in the sample, there are likely to be a substantial number of document deficiencies in the unsampled portion of the pool. If only final diligence results are disclosed, it may appear that there are no document deficiencies in the pool despite the sample diligence findings. These deficiencies may not come to light until many years later, if litigation becomes necessary, at which time the originator may no longer be able to cure the underlying defect. As such, diligence results provided to investors or others involved in the securitization process should identify cured document exceptions in the sample and provide detail on such cures on an aggregate basis.

4.1.2.5. Correcting data tapes

The credit and compliance diligence process undertaken by sponsors often results in the discovery that data included in the so-called "loan tape" provided by an originator is incorrect. Where this is the case, the data should be corrected, or the sponsor should be required to disclose the instances and manner in which the data determined to be correct by the vendor differs from the data on the loan tape.

---

[6] In the Assurance of Discontinuance, Morgan Stanley agreed to the following in paragraph 45(g): "If, within the next fourteen (14) months after the date of the AOD, the Federal Government adopts no law or regulation requiring asset-backed securities disclosure of waivers or similar action that resulted in loans found by a due diligence vendor to be material exceptions to the underwriting guidelines without compensating factors being placed in the securitized pool, Morgan Stanley will make such disclosures to investors in Massachusetts." The Assurance of Discontinuance is available at: http://www.mass.gov/Cago/docs/press/2010_06_24_ms_settlement_attachment3.pdf.

4.1.2.6. **Recommendations**

In sum, the Commission should require sponsors to include disclosure concerning their due diligence processes and the results obtained.[7] Because of the importance of the diligence process to the selection of loans for a securitization, a sponsor should disclose whether it undertakes due diligence on the loans it purchases. Where due diligence is undertaken, the sponsor should describe the material aspects of its diligence process, including:

- whether samples are used;
- how samples are selected;
- what the sponsor's policy is regarding increasing sample sizes upon negative findings;
- whether a vendor is used;
- whether the sponsor has an in-house diligence staff;
- where in the sponsor's organization the ultimate authority for accepting or rejecting loans based on diligence recommendations resides; and
- whether the sample of diligenced loans was increased based on the diligence results, along with the reasons why or why not.

In addition, a sponsor should include quantitative information on its diligence results for the loan pools that contributed loans to the securitization, along with comparative diligence data on an aggregated basis for prior pools from the same originator and for prior pools of the same asset class purchased by the sponsor in preceding years. This should include the size of the sample in each instance, the diligence findings, and the percentage of loans in each pool actually purchased. This quantitative disclosure should break down results on an adverse and random basis.

We also note the Commission's proposal to require narrative disclosure regarding compensating factors under Item 1111 of Regulation AB. We agree with this recommendation and only add that, for principal securitizations, the disclosure should either be based on the sponsor's diligence results, or specify whether the sponsor's diligence results agree with the presentation of compensating factors set forth by the originator.

On an asset-level basis for each diligenced loan, the sponsor should include the vendor (if any) and sponsor due diligence scores assigned to such loan, and should identify waivers or overruling of the diligence vendor's findings. In the Assurance of

---

[7] This recommendation, which focuses on the activities of a sponsor in putting together a principal securitization, is distinct from the Commission's proposal to require disclosure of originator review in the loan origination process in the proposed revision to Item 1111(a)(5) of Regulation AB.

Discontinuance filed by our office with respect to its investigation of Morgan Stanley, Morgan Stanley agreed in future securitizations to disclose to investors in Massachusetts waivers or similar action that resulted in loans found by a due diligence vendor to be material exceptions to the underwriting guidelines without compensating factors being placed in the securitized pool.[8] We believe this is a key piece of information and that it should become a universal requirement for sponsors under the amended Regulation AB.

4.1.3. Valuation Due Diligence, LTV and CLTV Ratios

In addition to credit and compliance diligence, sponsors typically undertake valuation diligence, whereby they attempt to ascertain whether the value for the mortgaged property reported by the originator is accurate. Appraisal quality is a large driver in the ultimate loss performance of subprime pools because poor appraisals may overstate the amount of equity a borrower has in the home. Property valuation is the denominator in the loan-to-value ("LTV") and combined loan-to-value ("CLTV") ratios, which are key criteria in assessing the risk of loss.

4.1.3.1. What is Valuation Due Diligence?

Valuation diligence is often orchestrated by a sponsor's in-house diligence staff, which hires outside vendors to provide independent estimates of a property's value. A sponsor will typically try to identify, using automated valuation models ("AVMs") or other procedures, the loans with the greatest overvaluation risk and then order a check on those properties through a so-called "broker price opinion" or BPO. BPOs provide the sponsor with an independent local broker's estimate of the underlying property value.

After receiving a BPO value for a given loan, a sponsor can compare that value against the appraised value and determine if the reported appraisal is accurate. The sponsor typically establishes a tolerance between the BPO value and the appraisal value within which it will purchase the loan for securitization. Much like overruling decisions in credit due diligence, the impact of valuation diligence on pull-through rates can be mitigated by manipulating the tolerance and deciding not to kick out loans where the appraised value is questionable.

4.1.3.2. General Recommendations

An excessive tolerance, will, without disclosure of the BPO value, create an environment in which sponsors may improperly purchase and securitize loans that do not comply with applicable representations relating to value, such as statements about the accuracy of the mortgage loan data or the lack of high-LTV loans within a purchase pool. For borrowers with high reported LTVs, and significant discrepancies between the BPO and appraisal values, the borrowers may already have negative equity at the time of

---

[8] See *supra*, note 6. The Assurance of Discontinuance is available at: http://www.mass.gov/Cago/docs/press/2010_06_24_ms_settlement_attachment3.pdf.

securitization. For example, if 20% variance were permitted, a loan with a reported 100% LTV could have a BPO-based LTV of 125%.

In light of the importance of accurate information about property values in securitization disclosures, sponsors should provide investors with information concerning their valuation diligence process. In particular, sponsors should provide narrative disclosure concerning the steps undertaken in their valuation diligence process, including any opportunity provided to the originator to dispute results, if applicable. To the extent a sponsor has a numerical variance that permits discrepancies between the BPO and appraised values, that should also be disclosed. The disclosures should also include aggregate disclosure of the average BPO-based LTVs and CLTVs for the securitized loans; because the materiality of the BPO-based LTV and CLTV will increase as the original LTV and CLTV increases, such aggregate disclosure may be most useful when provided as a stratification based on the originator's reported LTV and CLTV.

Most importantly, asset-level disclosure of the BPOs or other values obtained in valuation diligence, along with recalculated LTVs and CLTVs based on such values, should be provided to investors. In the Assurance of Discontinuance filed by our office in connection with its investigation of Morgan Stanley, Morgan Stanley agreed going forward to provide to investors in Massachusetts loan level and aggregate data disclosing the BPO values and recalculating all LTV and CLTV fields using the BPO values.[9] This important disclosure should be required of all sponsors under the amended Regulation AB.

4.1.3.3. Comments on Specific Valuation-related Proposals

We have the following additional comments on valuation-related proposals:

4.1.3.3.1. Schedule L, Items 2(b)(8) - (10): Valuations other than original appraisal

The disclosures contemplated by Schedule L, Item 2(b) appear to relate only to valuations obtained by the originator. The Commission should require any sponsor who obtains an alternative property valuation as part of due diligence – whether it is an appraisal or an alternative methodology such as a BPO that produces an indicated value – to disclose that value to the extent it is the most recent property value. In addition, the Commission should consider requiring disclosure of the lowest alternative property value

[9] In the Assurance of Discontinuance, Morgan Stanley agreed to the following in paragraph 45(e): "To the extent that Morgan Stanley obtains BPOs on Subprime Loans that are securitized on a principal basis, it will provide to investors in Massachusetts loan level and aggregate data showing the BPO values and recalculate all LTV and CLTV fields using the BPO values." In addition, Morgan Stanley agreed that, where it "has obtained more than one BPO within six months of the date of a securitization, Morgan Stanley will provide to investors in Massachusetts loan level and aggregate data showing the latest BPO value and the lowest other BPO value, together with recalculated LTV and CLTV fields using both BPO values." The Assurance of Discontinuance is available at: http://www.mass.gov/Cago/docs/press/2010_06_24_ms_settlement_attachment3.pdf.

in the last six months (in addition to the most recent property value) to prevent the sponsor from evading the requirements by getting alternate values only when the then-most recent value is lower than the sponsor would like.

4.1.3.3.2. Schedule L, Items 2(b)(15) and 2(b)(16): Original CLTV and LTV.

In addition to reporting of the Original CLTV and LTV, the Commission should require a recalculated CLTV and LTV based on the Schedule L, Item 2(b)(10) most recent property value. Securitization documents often include representations and warranties providing that LTV or CLTV ratios will not exceed some threshold, usually 100%. Investors should be provided the information necessary (i) to determine if alternative valuations result in LTV or CLTV ratios exceeding 100% and (ii) to evaluate risk due to negative equity and the possibility of appraisal problems that may indicate a representation and warranty breach.

Even where the diligence values result in a broad distribution of recalculated CLTVs both below and above the original reported CLTV, such a result may be material to investors. For example, consider the situation of an investor faced with two identical pools of loans with an average CLTV of 95. 100% of Pool A's loans have a CLTV of 95. 50% of Pool B's loans have a CLTV of 85 and 50% of Pool B's loans have a CLTV of 105. Many investors would find this distinction material.

4.1.3.3.3. Commission's Request for Comment on Schedule L: Efforts to identify additional liens

The Commission also asks whether asset-level disclosure should be required concerning whether an originator or sponsor made any effort to determine whether additional loans secure the same property. Because the failure to account for an additional loan will result in an inaccurately reported CLTV, a failure to include such debt would likely be important to investors, particularly if no such verification effort was made on a substantial portion of the pool. Thus, such disclosure should be required.

4.1.4. Disclosure of DTI Ratios

The debt-to-income ("DTI") ratio is an important metric in investor assessment of the borrowers' ability to repay loans and thus of the quality of the underlying assets. In many cases, DTI ratios for adjustable rate mortgages ("ARMs") were reported based solely on the teaser rate, thus substantially understating the overall riskiness of the loans over time. In order to enable investors to accurately assess the risk of the assets, DTI ratios should be provided that reflect debt payments at the fully indexed rate. Below we address specific points in the Commission's proposals that relate to DTI, followed by our general recommendation.

4.1.4.1. Schedule L, Item 2(a)(18)(iii): Fully Indexed Interest Rate

We strongly support the required disclosure of the fully indexed interest rate under Schedule L, Item 2(a)(18)(iii). However, the Commission should also require the disclosure of the DTI ratio recalculated using the fully indexed rate. This will provide investors with a more accurate picture of the borrower's ability to afford the payments over the life of the loan.

4.1.4.2. Schedule L, Items 2(a)(21)(iv) and 2(a)(21)(v): Updated DTI

Where the Commission mandates DTI disclosure, such disclosure should be accompanied by additional disclosure of a recalculated DTI based on the fully indexed rate where the relevant loan is an ARM.

4.1.4.3. Schedule L, Item 2(c)(16): Originator DTI

The DTI ratio determined by the originator is an important data point for investors. However, additional data points will allow investors to more accurately assess a borrower's true ability to pay. These additional data points include: (i) the monthly income used to calculate the DTI; (ii) where the loan is an ARM, the DTI recalculated using the fully indexed interest rate;[10] (iii) any corrected or recalculated monthly income determined by a sponsor or its vendor in the due diligence process; (iv) any corrected or recalculated monthly debt determined by a sponsor or its vendor in the due diligence process; and (v) recalculated DTI ratios based on any such corrected or recalculated values. In addition, the Commission should require the Originator DTI in Schedule L, Item 2(c)(16) to include both the front DTI and the back DTI.

4.1.4.4. Schedule L-D, Items 2(e)(23) and 2(e)(25): Post modification DTI ratios

As in Schedule L, Item 2(c)(16), the Commission should require disclosure of additional data along with the DTI ratios, including the monthly income and debt upon which they are based (i.e., were they updated in connection with the modification) and, for loans that remain ARMs post-modification, the fully-indexed DTI.

Because it appears that Schedule L-D does not require any updated obligor information, calculations such as the post modification DTI ratio will be based on stale data and may be misleading to investors if represented as a new data point by appearing on a Schedule L-D. While we appreciate that such information may not be easily obtained, where a servicer or other transaction party has obtained such information (such

[10] We note that Schedule L, Item 2(c)(17) ("Qualification Method") would allow an issuer to identify whether the start rate or the fully indexed rate was used to qualify the borrower. This is useful, but not a replacement for providing the recalculated DTI ratio based on the fully indexed interest rate where such rate was not used to qualify an ARM borrower.

as would be presumably done with respect to monthly debt and income in the context of approving a loan modification), that information should be reported on the Schedule L-D.

4.1.4.5. Recommendations

For all ARM loans, the fully indexed DTI ratios should be disclosed. In addition, investors should receive information concerning the fully indexed mortgage payment and the monthly income of the borrower. In the Assurance of Discontinuance filed by our office in connection with its investigation of Morgan Stanley, Morgan Stanley agreed going forward to provide to investors in Massachusetts loan level and aggregate data reporting the fully indexed mortgage payment, the originator-provided monthly income of the borrower, and the resulting DTI ratio.[11] This important information should be required to be disclosed to investors nationwide.

4.1.5. Diligence Certification

In response to the Commission's request for comment on the proposed "Certification of the Depositor's Chief Executive Officer," we offer one final recommendation concerning the diligence process. In the proposed shelf-eligibility requirements, we support the Commission's proposal to require a certification by the depositor as to the pool characteristics and the expected cash flows from the pool assets. In light of the gate-keeping role of the depositor's affiliates, however, this certification should be supplemented with a statement that the certifying officer of the depositor has reviewed the results of any diligence process conducted with respect to those pool assets. The certification should include a statement that nothing has come to the attention of the depositor or any affiliated entity on whose behalf the diligence was conducted that would cause such entities to believe that the representations and warranties of a seller or originator will not be accurate and complete in all material respects for a pool asset as of the date of initial issuance of the securities.

4.2. Potential Conflicts of Interest

Perhaps the most important role of a sponsor is to select appropriate assets for the securitized pool. Where the sponsor has a potential conflict of interest, such as an important ongoing business relationship with an originator, the sponsor may weigh that relationship and choose to purchase and securitize poor quality loans to satisfy the originator.

---

[11] In the Assurance of Discontinuance, Morgan Stanley agreed to the following in paragraph 45(f): "For adjustable rate Subprime Loans securitized by Morgan Stanley on a principal basis, Morgan Stanley will provide to investors in Massachusetts loan level and aggregate data reporting of the Fully Indexed Mortgage Payment, the originator-provided monthly income of the borrower, and the resulting DTI." The Assurance of Discontinuance is available at: http://www.mass.gov/Cago/docs/press/2010_06_24_ms_settlement_attachment3.pdf.

The nature of an investment bank's relationship with an originator is often multi-faceted. Typically, an investment bank deals with an originator in a warehouse financing capacity, whereby the sponsor provides secured financing for the originator's loan origination business in exchange for fees and interest income. An investment bank may also act as advisor and underwriter for an originator's own securitizations, earning underwriting fees and obtaining league-table credit. In addition, an investment bank often maintains an ongoing whole loan purchase relationship with an originator, pursuant to which the investment bank obtains loans for its principal securitizations. In this context investment banks earn revenue from selling the bonds and from proceeds from retained interests. Finally, after securitization, investment banks may engage in surveillance, service loans (generally through affiliates), and participate in efforts to cause originators to repurchase loans, whether on behalf of the investment bank or a securitization. These roles are often intertwined. For example, investment banks may view a warehouse financing relationship as the price of admission for obtaining securitization mandates and opportunities to purchase loans from an originator.

The existence of such a relatively complex relationship between a securitization sponsor and the originator of the securitized loans presents a number of opportunities for conflicts of interest to arise. The following are some potential conflicts that should be addressed.

4.2.1. Conflict of Interest Fact Patterns

4.2.1.1. Overruling Due Diligence Recommendations

As noted above, investment banks may be pressured to purchase loans that they would otherwise reject in order to keep the so-called "pull through rate," or loan acceptance rate, at a level preferred by the originator. The investment bank may do this to preserve its business relationship and avoid the risk of losing future business. Such extra unwarranted purchases can be accomplished through excessive waivers of credit exceptions and tolerance of poor appraisals. This risk is most salient where the bankers responsible for maintaining a business relationship with an originator are the same individuals responsible for deciding which loans ultimately will be purchased and securitized. We have seen bankers overrule the final findings of diligence teams, causing questionable loans to be purchased and securitized. Where diligence professionals expect to be overruled if a threshold level of loans do not pass, it would be difficult for such professionals to focus solely on making correct findings.

4.2.1.2. Enforcement of repurchase claims

Another conflict arises where the sponsor is responsible (or assumes de facto responsibility) for pursuing repurchase claims on securitized loans. If the same entity also has claims for repurchase with respect to loans that it owns, it may choose to prioritize its own claims ahead of those of the securitization, or even leverage investor claims to encourage payment of its own claims. An investment bank could also leverage

its ability to bring claims on behalf of the trusts to obtain concessions in whole loan purchase prices or other transactions with originators.

Similarly, if the investment bank provides representations and warranties itself, it is disincentivized from pursuing remedies for potential breaches on behalf of investors. Without substantially better disclosure, investors may never know that improper loans were placed into the trust.

The same is true of situations in which breaches of representations and warranties, or information demonstrating a risk that such breaches may have occurred, is discovered in diligence. Absent proper disclosure, a sponsor may choose to gamble on allowing breaching loans into the trust to limit its rejection rate and protect its relationship with the originator.

Finally, in some securitizations, second lien loans that go substantially delinquent are written-off and transferred to another entity, often the residual holder. In circumstances where a sponsor is the entity that is entitled to receive such loans and also retains the ability to enforce representations and warranties on loans it holds, the sponsor may be incentivized to permit such loans to go into default with the expectation of windfall profits through repurchases after transfer.

Investment banks often obtain a warranty from originators that the originators will repurchase loans from the owner (who is often a securitization trust) if the loans default within a certain number of months after purchase, a so-called "early payment default" or EPD. Such warranties may be contained in side agreements that are not disclosed to investors, despite the fact that the warranties may technically belong to the securitization. If the EPD rights are not described in the securitization documents, the other parties to the securitization may not know that the rights exist, and therefore the investment bank may essentially control the option to force the originator to buy back a given EPD loan. The decision whether and to what degree to exercise EPD repurchase rights may significantly impact the performance of a securitization, particularly in the early months. For example, an investment bank may delay or otherwise strategically manipulate the timing of EPD repurchases to affect the apparent prepayment speeds or delinquency triggers in a securitization. In some cases, in order to build its relationship with or extract other concessions from an originator, an investment bank may privately agree with an originator that it will not seek repurchase on EPD loans up to a specified percentage of the purchased pools.

The temptation to act on conflicts of interest relating to repurchases increases as an originator approaches bankruptcy. In such a situation, the investment bank is essentially in a competition for repayment with its own securitizations. An investment bank with a warehouse facility and information about its own pending repurchases often has superior information about the credit risk associated with an originator compared to investors in a securitization. Particularly where an investment bank is a primary lender to an originator with deteriorating finances, it may be able to extract consideration that otherwise might be paid to investors. This is even more likely if the bank is in position to ensure that investor claims are not made.

4.2.1.3. Premium Recapture

An additional conflict of interest that may affect the sponsor's selection of assets for the trust arises when a sponsor is entitled to so-called "premium recapture" in the event an originator repurchases breaching loans from a securitization trust. The mechanism of premium recapture (in which the excess of the sponsor's purchase price over the par value of a loan is refunded to the sponsor in the event the loan is repurchased out of a securitization) allows the sponsor to temporarily increase the size of the securitization, earn any gain-on-sale obtained by the deposit of the to-be-repurchased loan into the securitization, and earn interest carry for having held the risky loan prior to the securitization. In such circumstances, the sponsor may have an incentive to deposit loans into a securitization that it knows will be subject to repurchase shortly after securitization. This practice provides the sponsor with additional revenue and a lower rejection rate in diligence, while resulting in a shorter expected maturity for the issued securities than was disclosed to investors.

4.2.2. Recommendations

The Commission should require enhanced disclosure regarding both actual and potential conflicts of interest that may influence the sponsor. This would go beyond the current required disclosure concerning non-arms length relationships between the primary parties to the securitization transaction.[12]

A sponsor should be required to disclose the extent and nature of its relationships with the originator(s) of the mortgage loans included in a securitization, including any warehouse financing relationships, investment banking relationships, loan-purchasing relationships, and any other participation in the business of the originator, such as the establishment of underwriting guidelines or assistance in the servicing operations. This disclosure should include quantitative disclosure of the volume of loans financed and/or purchased on a historical basis, rejection rates on such originator's loans, and a comparison of such originator-specific rates against such rates on an aggregate basis across the sponsor's residential mortgage loan business. In addition, the sponsor should include a description of the potential conflicts of interest that may be material to an investor, including any activities or procedures the sponsor has undertaken to minimize the risks posed by such conflicts of interest. Similar disclosure may be appropriate for other parties to the securitization transaction, such as any independent entity engaged to enforce repurchase claims against an originator.[13]

To the extent a sponsor conducts due diligence on the securitized loans, the sponsor should describe any incentive structures for its professional diligence staff that may tend to affect decisions about whether to accept or reject loans.

---

[12] For example, if a sponsor has reached an agreement with an originator to limit the due diligence rejection rate, such agreements appear to already require disclosure under the existing Regulation AB standards.

[13] See recommendations, infra.

Where a sponsor retains rights to proceeds from loans after such loans have been transferred to the trust (like premium recapture), these should be disclosed, together with a sponsor's practices with respect to enforcing such rights.

The sponsor should also disclose its role, if any, in pursuing repurchase claims on behalf of the securitization. Such disclosure should include all such roles whether set forth in the controlling documents or otherwise. If the sponsor takes on such a role, its potential conflicts and undertakings to manage those conflicts should be disclosed.[14]

5. Disclosures Related to Representations and Warranties and Loan Repurchases

5.1. Enforcement of repurchase rights against originator

The repurchase obligation of the originator is a key mechanism in a principal securitization that guards against the risk that the underlying assets fail to conform to the attributes promised in the prospectus and other securitization documents. As explained above, an originator typically provides representations and warranties with respect to each loan it sells. These include assurances that the loan was underwritten in accordance with the originator's underwriting guidelines, that the loan was not fraudulently made, that it complies with applicable predatory lending laws, etc. Where a securitized loan is in breach of a representation or warranty, the trustee on behalf of the issuer has the right to force the originator to repurchase the loan, thus avoiding a significant potential loss to the trust.

Most principal securitizations that we reviewed charge the trustee with enforcement of the repurchase rights vis-à-vis the originator. However, securitization trustees are not typically charged with, and not really compensated for, undertaking the independent investigation necessary to determine that a breach of a representation or warranty has occurred, giving rise to a repurchase right against the originator. In order to provide the trustee with the information necessary to enforce the issuer's rights, most pooling and servicing agreements[15] also require each party to the agreement to notify the trustee in the event it becomes aware that any securitized loan is in breach of a representation or warranty.

In some cases, as discussed above, a conflict of interest may incentivize sponsors to fail to notify trustees of breaches of representations and warranties. In other cases, the sponsor may have evidence tending to suggest a breach but not definitively demonstrating it, and has little incentive to perform any further investigation that is required (the sponsor may know, e.g., that a borrower's stated income is unreasonable but not take the additional step of seeking income documentation). This lack of information exchange is compounded by the fact that the trustee is not generally economically

---

[14] This recommendation may be rendered moot to the extent an independent entity is engaged to pursue representation and warranty breaches on behalf of the securitization, as discussed below.

[15] The pooling and servicing agreement is, generally, the controlling contractual document of a securitization.

incentivized to investigate or pursue repurchase claims.[16] In practice, the sponsor's superior information, together with the limited practical work of the trustee given typical compensation for trustee service, usually leaves a repurchase claim subject to the sponsor's incentives. If the sponsor retains risk in the securitization and is not particularly close to the relevant originator, it may provide the necessary assistance to the trustee. If the sponsor does not remain meaningfully exposed to the securitization or maintains an important relationship with the originator, the sponsor may not provide the necessary assistance.

Without proper disclosure of a sponsor's role and conflicts of interest with respect to monitoring and curing breaches of representations and warranties, there is a risk that repurchases will not take place and that the factors that affect that risk will remain opaque to investors. A sponsor taking on such a role is performing a servicer-like function, and investors should be given sufficient information to assess that role and to hold the sponsor responsible where appropriate.

5.2. Reports to Investors

Although a repurchased loan has roughly the same immediate economic effect on a securitization as a loan that was prepaid in full, the nature of a given loan's disposition is important to investors because it may be indicative of the expected performance of remaining loans in the pool. For example, early defaults in a pool are generally considered harbingers of poor performance to come, demonstrating poor underwriting quality or the potential for fraud in a pool. Where early payment defaults are repurchased and not reported, it may appear that there were simply an unusual number of early prepayments.[17] Only if the loans are identified as repurchases will it be clear to investors that there were substantial problems with the quality of the loans in the pool and potentially with the quality of the sponsor's diligence.

The Commission should make clear that any repurchase, for any reason, must be disclosed as a repurchase in the periodic distribution reports filed on Form 10-D. In addition, the reasons for the repurchases should be disclosed on an asset-level basis.

5.3. Comments on Specific Repurchase-related Proposals

Below we provide comments on specific items in the Commission's proposal, followed by further general recommendations.

---

[16] It should be noted that some securitizations appoint a separate entity as credit risk manager. However, this entity appears to have had limited access to information, much like the trustee.

[17] An astute investor reviewing a pool with an unusually large percentage of early prepayments may assume that such prepayments are due to undisclosed repurchases. Where a sponsor wishes to mask the appearance of a sharp rise in EPD repurchases from such savvy investors, it may work with an originator to spread undisclosed repurchases over a period of months, thus reducing the apparent "spike" in prepayments.

5.3.1. Schedule L-D, Item 1(i): Repurchase indicator

We agree with the Commission's efforts to require disclosure of the occurrence of repurchases. The Commission should also require ongoing disclosures in Schedule L-D for loans that have been repurchased from the pool.

5.3.2. Schedule L-D, Item 1(i)(4): Repurchase reason

Because repurchases may occur for many reasons, the Commission's inclusion of this data point will assist investors in understanding whether a spike in a pool's prepayment rate is due to EPD repurchases or for other reasons. Depending on the granularity of the disclosure required by this item, it may also allow investors to determine whether there are trends in the pool assets that are causing the repurchases – such as over-stated appraisals – which might indicate potential problems in the pool as a whole. However, the proposed response for this item is "Text," and without more specific direction from the Commission, disclosure will likely be too general. Instead, the Commission should provide choices of coded repurchase reasons, such as early payment default, credit breach, compliance breach, valuation breach, borrower fraud, appraisal fraud, etc., with an additional line for explanatory text if more specific information is material.

5.3.3. Item 1111(e) of Regulation AB: Representations and Warranties

The Commission's proposals regarding disclosure of representation and warranties and the related remedies do not fully address the problems for enforcement of such representations and warranties discussed above, including conflicts of interest, and appropriate flow of information. The Commission should supplement Item 1111(e) of Regulation AB in accordance with the recommendations below.

5.3.4. Commission's Request for Comment on Item 1111 of Regulation AB: Other types of repurchase obligations

The Commission notes that repurchase obligations may be imposed in circumstances other than a breach of representations under the transaction documents, such as an early payment default. Such additional types of repurchase obligations are material to investors. Early payment default warranties may be included in side letters between a sponsor and an originator and, thus, may not show up in an investor's review of the transaction documents. However, the existence of such warranties, along with the sponsor's ability and willingness to enforce them, often has a material effect upon the performance of a securitization. Any mechanism that enables the contents of the pool to be manipulated should be disclosed.

In addition, as indicated in connection with Schedule L-D, Item 1(i)(4), above, the disclosed repurchase reason on Schedule L-D should include with specificity the type of repurchase, including whether it was a result of an early payment default.

5.3.5. Items 1104(f) and 1110(c) of Regulation AB: History of Asset Repurchases

We support the Commission's proposed disclosure requirement concerning a sponsor or originator's past repurchases of securitized assets.

In its requests for comments on this proposal, the Commission asks whether requiring historical repurchase data would unintentionally incentivize sponsors or trustees to demand repurchases more frequently than required. In certain situations, it may have the opposite effect. For instance, in principal securitizations, the threat of such a disclosure requirement relating to an originator could induce a sponsor to be more reticent in pursuing repurchase claims where the originator may be a business partner of the sponsor. A sponsor may also be worried that a large number of successful repurchase claims could indicate that its initial due diligence, or the originator's loan quality, was poor.

5.4. General Recommendations

The Commission should require that, in addition to current disclosure regarding the existence of repurchase rights, issuers describe the process for monitoring and enforcing breaches of representations and warranties. This disclosure should include a description of each entity that is charged with monitoring and/or enforcement, along with:

- any limitations that may be placed on the entity's ability to enforce the repurchase rights of the trust;
- the information to which the entity will have access, such as the loan file, the sponsor's due diligence results and historic servicing data;
- any conflicts of interest the entity may face in pursuing enforcement, including business relationships it may have with the obligor of any repurchase obligation and fees the entity may earn by continued servicing;
- any economic interest the entity may have in the securitization; and
- any incentive structure in place to ensure the entity's proper monitoring and enforcement of the repurchase rights, including fees to be earned, premium recapture, and/or cash flow to a retained tranche.

The Commission should require a sponsor to disclose (on behalf of itself and its affiliates) whether it has provided all information in its possession concerning the loans to the entity charged with enforcement of the securitization's repurchase rights. This could be accomplished by transferring the due diligence results to the trustee or other such entity.

The Commission should consider going a step beyond this recommendation and requiring that, as a condition of shelf eligibility, an additional independent transaction party must be used to monitor and enforce breaches of representations and warranties. Such a requirement could replace the Commission's proposed "Third Party review of Repurchase Obligations" set forth in proposed General Instruction I.B.1(b) of proposed Form SF-3, and would serve as a stronger protection for the quality of the representations and warranties.[18] While we agree with many of the Commission's statements in support of this proposed requirement of Form SF-3, this proposal is triggered only when the trustee for a securitization asserts that a breach of a representation or warranty has occurred, and it does not address the incentive and information issues that inhibit identification of a breach. An independent entity charged with enforcement of the repurchase obligations under the securitization and given access to loan-level data, diligence results, and other information is the most effective way to ensure proper enforcement. The disclosure and use of the sponsor's diligence materials should also assist in protecting the quality of the representations and warranties.

6. Risk Retention

Some securitizers, despite their significant roles in purchasing the loans, performing due diligence, structuring the securitization, and acting as sponsor, depositor and underwriter for the securitization, have no risk exposure to the deal and thus arguably had insufficient incentives to perform their due diligence and other roles adequately. Even where a sponsor's broker-dealer affiliate initially retains the equity piece of a securitization transaction (and assures investors that it is, in fact, doing so), sponsors often resecuritize the cash flow on the residual[19] so that the remaining risk on the investment bank's balance sheet is so small as to eliminate any substantial incentive for the investment bank to act in the interest of the securitization. Moreover, even where an investment bank does retain a portion of the issued securities, there may be instances where such exposure has effectively been hedged with derivatives. In such cases, without a sufficient economic stake in the securitization, the sponsor may have interests that are not directly aligned with the interests of investors.

6.1. General Comments

We applaud the Commission's proposed vertical risk retention requirement. We agree that this should apply at all levels of the capital structure in order to ensure that the attempt to align the sponsor's incentives with those of investors does not unintentionally result in misaligned incentives.

---

[18] The Commission's proposal mandates a provision in the Pooling and Servicing Agreement obligating an originator to obtain an independent opinion relating to any asset for which the trustee has asserted a breach of any representation or warranty and for which the asset was not repurchased or replaced by the obligated party on the basis of an assertion that the asset met the representations and warranties contained in the pooling and servicing or other agreement.

[19] This is referred to as a "net interest margin" securitization.

While the Commission's proposed risk retention requirements will not thwart a sponsor who is intent on finding a way to take advantage of its position as the asset-selector for a securitization, we believe the new requirements will substantially realign incentives. They will go a long way towards ensuring that there is an economic cost to a sponsor that places its own interest above the interests of the investors in its securitizations.

6.2. Specific Recommendations

In addition to the general comments on risk retention offered above, we present below some comments and additional recommendations on specific proposals related to this topic.

6.2.1. Definition of entity retaining risk

The Commission should ensure that the risk retention requirement falls on the correct entity. Risk retention needs to be directed to the entity preceding the depositor in the chain of assignment.

In principal securitizations, the sponsor, or its affiliate, purchases mortgage loans from an originator and is responsible for selecting the assets and vetting them through a due diligence process. For principal transactions, we agree with the Commission's proposed requirement that the sponsor retain transaction risk in order to ensure that appropriate incentives exist during the asset selection and vetting process to ensure that the securitized pool is as strong as it purports to be.

We strongly disagree with the suggestions made by other commenters that, in all instances, the goal of risk retention is more properly placed upon originators because they make the loans and evaluate the borrower's credit in the first instance.[20] A key reason for placing risk retention on the sponsor is that many originators are thinly capitalized, focused on the short term, and essentially unreliable. While it is useful for the originator to face heavy incentives to behave honestly and with the interests of investors in mind, the additional check of incentivized sponsor oversight is critical to this process. Leaving risk retention with originators only will certainly be ineffective. The originator's ability to skew the pool, absent diligent oversight, is too great.

Aligning the investment bank's incentives with those of investors will provide some protection against such unscrupulous originators. Moreover, placing risk retention on sponsors in principal securitizations is not only effective, it also aligns with the market expectations regarding the role of investment banks in the securitization process. Investment banks often seek a premium for their securitizations over originator securitizations because of the implied value of diligence, among other things. As such, it

[20] See e.g., written comments of Barclays, provided to Commissioner Troy A. Paredes on April 27, 2010, available at: http://www.sec.gov/comments/s7-08-10/s70810-24.pdf.

is most appropriate to impose the risk retention requirement on the investment bank in order to ensure that its incentives are properly aligned with those of investors.

6.2.2. Disclosure of the actual risk retained, net of hedging

The prospectus disclosure concerning a sponsor's, servicer's, or originator's continuing interest in the transaction should include any hedge positions taken by such an entity with respect to the continuing interest. The Commission should clarify Items 1104(e), 1108(e), and 1110(b)(3) of Regulation AB to state that such disclosure should be net of hedging.

In addition, a similar clarification is warranted with respect to proposed Item 6.09 of Form 8-K, which requires a description of any material change in a sponsor's interest in the securities.

6.2.3. Hedging

Putting aside the question of whether and the extent to which hedging should be allowed in the context of principal securitizations, we are encouraged by the Commission's inclusion of hedge positions in the proposed risk retention calculation that a sponsor or its affiliate must undertake to meet the proposed shelf eligibility requirements. However, the proposed hedging requirement appears to be limited to the entity required to retain the risk. Because investment banks routinely conduct their hedging through affiliates, the Commission should expand the risk retention requirement to take account of hedges entered into by affiliates of the sponsor or other affiliates required to retain the risk under the Commission's proposed rule.

The Commission's risk retention proposal also limits the netting of hedge positions to those positions "directly related" to the securities at issue. However, in addition to direct hedges, sponsors of RMBS may use more general hedging tools, such as swaps referencing the ABX.HE index, to reduce their exposure to residual positions in their own securitizations.[21] The Commission's proposal may result in an increase in the use of such more general hedging tools. While we appreciate that there may be some practical limitations to a sponsor's ability to tie general hedges to a given risk that is subject to the Commission's risk retention requirement, such hedging practices can be material to investors for many of the same reasons as the existence of retained risk. As such, the best result would be to bar such hedging that negates risk retention by entities that sponsor securitizations. To the extent such hedging is permitted, the Commission should require sponsors to disclose any hedging policies and practices that exist with respect to the asset class that is the subject of the securitization at issue. Such disclosure should include a statement as to whether the sponsor has a policy of using derivatives or

[21] We agree with the Commission's recognition, at note 112 in the proposing release, that an ABX.HE hedge would count towards the risk retention calculation where the security at issue was included in the ABX.HE index. Such inclusion, however, does not go far enough. An ABX.HE hedge should also count towards the risk retention calculation of other securitizations of the types represented in the index.

other instruments to maintain a neutral position, or whether it takes short positions with respect to each such asset class.

We share the Commission's expressed concern that a sponsor may circumvent the proposed risk-retention requirement by selling or hedging the interest required to be retained between the testing intervals. To ensure the effectiveness of the proposal, a sponsor should be required to maintain the required interest on a continuous basis and to provide updated disclosure in the event the interest is disposed of, temporarily or otherwise, including by way of a hedge. The Commission's proposed new Item 6.09 of Form 8-K would appear to cover such an event; however, the Commission should clarify that the sponsor's interest for purposes of this new Item 6.09 should be calculated net of hedging positions.

7. Delinquency Disclosure

We are pleased to see the Commission address delinquency disclosure in the proposed rule. Existing Regulation AB rules allow issuers to use a variety of methods to assess delinquency for purposes of determining an issuer's disclosure obligation with respect to such asset, and provide too much of an opportunity for issuer mischief.

Securitizations of subprime mortgage loans typically use the so-called "OTS method" to calculate delinquency. The use of the OTS method presents a number of problems. First, it can give the impression that certain delinquent loans are current. Second, where the description of the calculation deviates from the definitions in the rating agency glossaries or the use of the phrase OTS, the descriptions may appear to describe the more conservative MBA calculation methodology. When compounded with the fact that a cut-off date can precede a reporting date, loans with significant delinquencies may be reported as current on the disclosures associated with the securitizations. This manipulation of the common understanding of the word "delinquent" carries with it the potential to mislead investors. We have identified this problem during our ongoing investigation, and believe it must be fixed.

In addition, sponsors may from time to time receive updated delinquency reports during the interim period between the cut-off date and the closing date of a securitization. Such reports, depending on the language of the delinquency calculation disclosure, may render that disclosure inaccurate. Generally speaking, cut-off dates tend to be timed to the last possible moment of a reporting period; in such cases, one additional day will render the loans an additional month delinquent. Accordingly, reports received between reporting periods will often show substantially higher levels of delinquency. Where material information about shifting delinquency in a pool under the disclosed calculation methodology becomes available to a sponsor, it should be disclosed. This requirement may also be addressed by adopting a conservative calculation methodology that times calculation as of the first day of the reporting period.

Regarding the timing and definitions for delinquency disclosure, the Commission's proposal significantly improves the rules. However, for the purposes of

reporting asset-level data on Schedule L, the proposal uses a "measurement date" that is "designated by the registrant that is as recent as practicable." The Commission should adopt a more specific requirement with respect to this definition, in light of issuers' tendencies to push such dates as early as possible in order to avoid disclosing the most recent information to investors. In addition, the Commission should reconsider its definition of "cut-off date" in order to ensure that the most recent performance information is captured.

Proposed Schedule L, Item 1(b)(5) continues in the mode of existing Regulation AB rules by requiring disclosure of delinquency status according to the transaction documents. This proposal should require disclosure of the actual delinquency calculation methodology used.

Proposed Schedule L, Item 1(b)(6) requires an objective disclosure of the number of days an asset is past due. This "past due" methodology will make it substantially easier for investors to independently assess the performance of the assets in the securitization.[22] We understand the Commission has a concern regarding the need for flexibility in delinquency calculation methodologies for certain asset classes. However, for standard asset classes such as residential mortgage loans, a unified definition of delinquency based on the Schedule L, Item 1(b)(6) "past due" methodology is practical, will enable investors to avoid the confusion of multiple methodologies, and will reduce the possibility for manipulation based on reporting dates. Thus, such a requirement should be incorporated throughout Regulation AB.

8. Additional Comments on Specific Proposed Amendments to Regulation AB

8.1. Asset-level Disclosures – Schedule L and Schedule L-D

We generally support the new asset-level disclosures under proposed Schedule L and Schedule L-D. What follows are some comments on specific aspects of the proposed data points.

8.1.1. Commission's Request for Comment on Schedules L and L-D: Inclusion of calculated data points

Providing calculated data points, such as the DTI ratio, will assist investors by allowing them to easily assess whether a given loan meets the requirements of the securitization or of the investor. In addition, because calculations such as the DTI ratio and LTV ratios are so central to assessing the likely ability and willingness of a borrower to make payments on a loan, the failure to include them may put less sophisticated

[22] This will also assist investors' ability to monitor other metrics in the deal, such as potential early payment default loans, that can be assessed using the "past due" methodology. Even where a transaction uses the OTS method to define delinquency for purposes of investor reporting, the payment warranties on the underlying loans are often calculated on a more straightforward failure-to-pay basis.

investors (or resource-limited investors), who are not in a position to comprehensively recalculate data, at a disadvantage.

8.1.2. Schedule L, Item 1(a)(2): Unique Asset Number

We agree with the Commission's general goal of increasing the ease and ability of investors to perform asset-level analysis by requiring that a single asset identifier be used consistently through the various documents and reports filed with respect to a given securitization.

However, the Commission should also require that such an asset identifier be permanently tied to a given asset. In some instances, loans may be repurchased out of one securitization (e.g., because of a breach of an early payment default warranty) and deposited into another securitization. Having a unique asset number that is permanently tied to each asset will allow investors to discover whether such asset has been previously securitized and, if so, to review that asset's history. A single identifier will also make it easier for regulators to follow an asset through its life cycle. The Commission should add an instruction to Schedule L, Item 1(a)(2) stating that if an asset has previously had an asset number assigned to it and filed with EDGAR, that number must be used.

8.1.3. Blank Data Fields

The Commission proposes including ten "blank" data tags in the XML schema. Given the past history of the rapidly developing asset-backed market, and the speed with which new data was created that investors might have found material, limiting the number of additional fields to ten may be insufficient. The Commission should significantly increase this number, so as to allow flexibility for future developments in both the types of data available and emerging standards of materiality for the market. Indeed, just the data points Morgan Stanley has agreed to begin supplying to Massachusetts investors would use up much of the reserved space.[23] Significant additional space should be set aside for other future disclosure points, so as to minimize disruption and facilitate comparisons of deals over time.

8.2. Transaction Parties – Item 1110 of Regulation AB: Originator

The existing Regulation AB rules set forth percentage thresholds for when originator-specific disclosure is necessary. We support the Commission's proposed changes to these thresholds for "under 10%" originators, but do not believe they go far enough. Especially in situations in which an originator's representations are no longer dependable, due to bankruptcy, excessive credit risk or otherwise, a more rigorous standard is needed. In these circumstances, the trust may not be protected from breaches,

---

[23] See *supra*, notes 6, 9, and 11. The Assurance of Discontinuance with Morgan Stanley is available at: http://www.mass.gov/Cago/docs/press/2010_06_24_ms_settlement_attachment3.pdf.

including fraud, which may increase in likelihood as the originator's financial condition deteriorates. Moreover, the originator may not be able to satisfy representation and warranty breach claims. Due to this risk, the Commission should require disclosure of the identity of originators who contribute smaller numbers of loans to a pool but have since declared bankruptcy or are otherwise unable to satisfy representation and warranty claims.

8.3. Item 6.05 of Form 8-K: Securities Act Updating Disclosure

We agree with the Commission's proposal to reduce the reporting threshold for Securities Act Updating Disclosure from five percent to one percent. As discussed below, small changes in the underlying assets may be material to investors, especially those at the bottom of the capital structure.

However, because many of the relevant numbers for residential mortgage backed securities are expressed in the first instance as percentages, clarity should be provided as to whether the threshold applies to the aggregate number or to the rate of change in that number. For example, where the characteristic is "weighted average coupon" ("WAC"), if the disclosed WAC is 7%, disclosure should be required based on a change to 6.93% (subtracting one percent of the 7% disclosed) rather than a change to 6%. This should be the case unless the numbers involved are extremely small. This change would still be significant to many investors, given the importance of the WAC and the sensitivity investors have to directional changes in this number. The Commission's proposal could be read to allow an issuer to hide such a change until the value in the example we provide had dropped almost 15% (from a WAC of 7% to a WAC of 6%). Indeed, if the WAC were at 2% initially, the Commission proposal could allow concealment of anything less than a 50% drop. Similarly, the Commission should clarify the way in which "materiality" applies to structured securities where a single disclosure document is used to provide information to investors at different levels of a tranched capital structure.

We also support the repeal of the existing carve-out for untimely filing of an Item 6.05 of Form 8-K. Material changes to the asset pool should be made in a timely manner to investors, especially in light of the potential for sponsors to discover (or orchestrate belated discovery of) bad loans or otherwise replace good loans with bad loans at the last moment.

In addition, we support the requirement that an issuer provide an updated Schedule L whenever an Item 6.05 update on Form 8-K is required.

9. Conclusion

We hope that the Commission finds our comments, both general and specific, helpful. The changes we suggest will better protect investors, and should also assist in limiting unfair lending that is otherwise fueled by the securitization process. Moreover, the improved disclosures should be helpful to regulators, both in addressing concerns with securitizations and in assessing underlying lender behavior. Much key information

concerning the underlying assets and the market for assets and securities is in the possession of the investment banks who engage in securitizations. Requiring this information to be made available through securitization reporting documents will increase the transparency of the market and of market transactions and will help regulators respond to market problems before a crisis occurs.

Thank you. Please contact Attorney General Martha Coakley or Glenn Kaplan, the Chief of our Insurance and Financial Services Division, at 617-727-2200 if we can be of further assistance to the Commission.

Respectfully Submitted,

COMMONWEALTH OF MASSACHUSETTS
MARTHA COAKLEY
ATTORNEY GENERAL

Dated: August 2, 2010

By: _____

Glenn Kaplan
Assistant Attorney General
Insurance & Financial Services Division
Public Protection & Advocacy Bureau
One Ashburton Place, 18th Floor
Boston, MA 02108
(617) 727-2200