NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

August 2, 2010

Via email: rule-comments@sec.gov

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

Re: Proposed Rule – Asset Backed Securities – File No. S7-08-10

Dear Ms. Murphy:

This comment letter is in response to Release Nos. 33-9117; 34-61858 (the "Proposing Release") in which the Securities and Exchange Commission ("Commission") solicits comments on proposed revisions to Regulation AB and other rules regarding the offering process, disclosure, and reporting for asset-backed securities.

NAREIT, the National Association of Real Estate Investment Trusts, is the worldwide representative voice for real estate investment trusts ("REITs") and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other real estate businesses throughout the world that own, operate and finance commercial and residential real estate. NAREIT's members play an important role in providing liquidity and transparency to real estate. The securitization market is a critical component of real estate finance, and as such is a critical component of our members' businesses. Equity REITs own and operate real estate, and thus are consumers of financing. Mortgage REITs finance real estate, either through whole loans or in the secondary market through securitizations. Together, NAREIT's members represent the perspective of both sides of real estate finance – the borrowers and the investors – that are equally interested in an efficient and stable market.

We first want to commend the Commission for tackling a variety of legal, policy and disclosure issues arising with respect to asset-backed securities in a comprehensive and detailed fashion. In so doing, it is clear that the Commission recognizes that many if not most of the issues raised in the Proposing Release are complex, multi-faceted and not easily resolved. With respect to the issue that is the focus of this letter – risk retention – we appreciate the thorough manner in which risk retention was analyzed, and the variety of risk retention questions for which comment was requested.

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At the outset, we believe it is important to note how profoundly the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") will affect the Commission's proposed revisions. Certain asset classes, most notably "qualified residential mortgages," are exempt from risk retention requirements, and risk retention regulations adopted under the Securities Exchange Act of 1934 ("1934 Act") must specify that a securitizer is not required to retain any part of the credit risk for an asset that is transferred, sold or conveyed through the issuance of an asset-backed security by the securitizer if all of the assets that collateralize the asset-backed security are qualified residential mortgages ("QRM"). Dodd-Frank requires that the regulations defining a QRM take into account underwriting and product features that historical data indicate results in a lower risk of default.[1] NAREIT believes this provision will incentivize underwriters to adhere to higher underwriting standards and lead to a successful securitization market like the one that has grown out of conforming mortgage underwriting standards. In this instance, we believe the QRM will enable Fannie Mae and Freddie Mac to continue to operate in their roles as guarantors of conforming mortgage-backed securities.

For asset classes other than QRMs, Dodd-Frank mandates that the joint regulations require the securitizer to retain not less than 5 percent of the credit risk that is not a QRM that is transferred, sold, or conveyed through the issuance of an asset-backed security by the securitizer. Dodd-Frank further mandates that a securitizer retain less than 5 percent of the credit risk for such non-QRM assets if the originator of the assets meets the underwriting standards required by Dodd-Frank to be established by the Federal banking agencies.

On the fundamental threshold issue of who should be required to retain risk, the Proposing Release makes clear that the Commission believes it is more appropriate to impose risk retention requirements on the sponsor (or affiliate of the sponsor) than the non-affiliated originator, although comment was requested on whether originators should retain risk. While requiring originators to retain risk could serve as an additional layer of protection against recent practices, as discussed below we believe this concern can be addressed by requiring an independent purchaser to acquire and hold the first loss horizontal risk position. We believe that this issue can also be resolved through the development of appropriate underwriting standards as provided for under Dodd-Frank.[2]

Another fundamental question posed in the Proposing Release is whether 5 percent is the appropriate amount of risk for the sponsor to retain. Specifically, the Commission asked "[s]hould it be higher (*e.g.*, ten or 15 percent)? Should it be lower (*e.g.*, one or three percent)? Should the amount of required risk retention be tied to another measure?" As discussed above, Dodd-Frank recognizes that 5 percent is just a starting point and, further, requires that 5 percent

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1 *See* Section 15G(e)(4)(B) of the 1934 Act, as provided in Section 941 of Dodd-Frank.

2 *See* Section 15G(c)(2)(B). With respect to commercial mortgages, Dodd-Frank recognizes that risk retention obligations imposed upon securitizers may be shifted through contractual representations and warranties to originators. *See* Section 15G(c)(1)(E)(iv) and Section 15G(d) of the 1934 Act, as provided for in Section 941(b) of Dodd-Frank. Further, Dodd-Frank explicitly requires the Federal banking agencies and the Commission "in determining how to allocate risk retention obligations between a securitizer and an originator" to reduce the percentage of risk retention obligations required of the securitizer by the percentage of risk retention obligations required of the originator. *See* Section 15G(d).

be adjusted downward if certain underwriting standards are met. Dodd-Frank also requires that the risk retention regulations to be developed reflect the different classes of assets, "including residential mortgages, commercial mortgages, commercial loans, auto loans," as deemed appropriate by the Commission and the Federal banking agencies.[3] Accordingly, given the unambiguous construction of Dodd-Frank on this issue, and the diverse types of assets that have been securitized over the last twenty years, NAREIT urges that the jointly developed risk retention regulations employ a variable approach to risk retention. NAREIT notes that certain commercial asset-backed securities, for example, typically have much larger risk retention amounts than 5 percent, because of what the market dictates. As the markets innovate and develop new structures, NAREIT believes that a variable approach that is flexibly designed is the most likely methodology to balance the varying interests of promoting full disclosure and efficient capital markets while protecting investors.

The Commission's proposed approach to risk retention is to require a sponsor to maintain a minimum of five percent of the amount of each of the tranches sold to investors ("vertical risk") or, in the case of revolving asset master trusts, retention of the originator's interest of a minimum of five percent of the nominal amount of the securitized exposures. Despite the Proposing Release's favoring of vertical risk, it specifically asked "[s]hould sponsors be permitted to satisfy the risk retention condition through a different form of risk retention than what is proposed (*e.g.*, retention of first loss position or retention of first loss position in conjunction with retention of some form of vertical slice of the securitization)?"

We believe the following straightforward example illustrates the basic difference between vertical risk versus horizontal risk retention. If an AB offering raises $100 of capital and the sponsor (or its affiliate) retains 5 percent of the risk of each tranche (no matter how many tranches are created), then a 5 percent vertical risk retention requirement results in the sponsor suffering a complete loss of its $5 investment if and only if the entire offering becomes worthless. If the transaction loses 25 percent of its capital, still a fairly severe loss, the sponsor (or its affiliate) would only lose $1.25 of its invested $5.00.

On the other hand, if the same sponsor (or its affiliate) raises $100 of capital in its AB offering and retains risk through taking the horizontal risk of an appropriately sized first loss position, not only will the first dollar loss in the offering be borne by the sponsor, but a meaningful portion of the sponsor retained investment would be at risk of loss before any of the senior securities incur a monetary loss.

If you refine the example by assuming a subordinate class of 5 percent of the assets, and a loss of 4 percent of the value of the pool of assets, the difference is still dramatic. If the risk retainer had been required to retain vertical risk, it would lose 4 percent of its investment. If it had retained the first loss horizontal risk, the risk retainer would lose 80 percent of its investment.

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3 *See* Section 15G(c)(2)(A), as provided in Section 941 of Dodd-Frank.

Accordingly, while universal solutions may not be perfect, NAREIT believes that first loss horizontal risk is the most effective manner of risk retention and the metric most likely to align the interests of all parties and protect investors.

The Commission has identified two weaknesses it perceives with horizontal risk retention. The Proposing Release states that horizontal risk retention "could lead to skewed incentive structures, because the holder of only the residual interest may have different interests from the holders of other tranches in the securitization." The Proposing Release further notes that, in the past, "sponsors held small portions. These portions were often a small horizontal slice of the securitization and, therefore, would have been unlikely to have driven the sponsor to focus on the quality of the loans or other underlying assets in order to protect that interest." We acknowledge this criticism, but believe that the retention of the horizontal risk position appropriately structured and of meaningful size would respond to the Commission's concerns. If, for example, the Commission were to calibrate horizontal risk retention as a percentage of all subordinated debt raised in an asset-backed offering, that should address the Commission's "small portion" concern. With respect to "skewed incentive" structures, NAREIT believes that the modification of certain securitization structures and terms, through inter-creditor agreements, would adequately address any skewed incentives while maintaining the better risk alignment resulting from first loss horizontal risk retention.

In addition, we believe that conflicts of interest are frequently exacerbated when investors own multiple classes in the capital structure. For example, it is common that investors in subordinate classes receive additional information from borrowers as compared to investors in senior classes. This is particularly true in a public securitization with privately offered subordinate classes. A vertical risk retention approach would require an investor to own both the senior (public) and subordinate (private) classes.[4] This approach potentially allows this investor to make investment decisions with more knowledge than other investors holding senior classes of that securitization. In fact, it is industry practice to prevent investors in subordinate bonds from purchasing the senior bonds. We do not believe that the Commission should adopt rules that exacerbate such conflicts of interests.

We believe that the utility of horizontal risk retention is recognized explicitly by Dodd-Frank. Specifically, Dodd-Frank amends the 1934 Act to permit the Federal banking agencies and the Commission, in jointly prescribing risk retention regulations with respect to commercial mortgages, to rely on a third party purchaser's retention of the first loss position under certain conditions.[5] We believe this provision demonstrates the importance that the horizontal risk position plays in commercial real estate.

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4 The Proposing Release (footnote 117) acknowledged the frequency of this public/private structure in analyzing risk retention.

5 Section 15G(c)(1)(E)(ii) of the 1934 Act, as provided in Section 941 of Dodd-Frank.

We look forward to working with the Commission as it continues to develop its rules and disclosure regulations in this critical area. In the meantime, if you have any questions, please feel free to contact Tony Edwards at 202-739-9408, or Bonnie Gottlieb, NAREIT's Vice President, Industry & Member Affairs, at 202-739-9444.

Sincerely,

Steven A. Wechsler
President and CEO

Tony M. Edwards
Executive Vice President & General Counsel