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GLOBAL FINANCE UPDATE

Securities and Exchange Commission issues proposed rules under the Dodd-Frank Act's prohibition on conflicts of interest for certain securitization participants

On September 19, 2011, the SEC approved proposed rules to implement Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] Section 621 of the Dodd-Frank Act amended the Securities Act of 1933 (the "Securities Act") to add Section 27B, which prohibits underwriters, placement agents, initial purchasers and sponsors (and their affiliates and subsidiaries) of asset-backed securities (as defined under the Securities Exchange Act of 1934 (the "Exchange Act")) and synthetic asset-backed securities from engaging in any transaction for a period ending on the date that is one year following the date of the first closing of the sale of such securities that would involve or result in any material conflict of interest with respect to any investor in the transaction.

This prohibition does not apply to:

- risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase or sponsorship of asset-backed securities or synthetic asset-backed securities if such activities are designed to reduce the specific risks to the related entities associated with positions or holdings arising out of such activities; or
- purchases or sales of asset-backed securities or synthetic asset-backed securities made pursuant to and consistent with:
    - commitments of the underwriter, placement agent, initial purchaser or sponsor (or their affiliates or subsidiaries) to provide liquidity for such securities; or
    - bona fide market-making in such securities.

Section 27B will not be effective until the final rules adopted by the SEC to implement the section become effective.

[1] The Dodd-Frank Act, Public Law 111-203 (July 21, 2010). See SEC Release No. 34-65355, "Prohibition against Conflicts of Interest in Certain Securitizations," dated September 19, 2011, available at http://www.sec.gov/rules/proposed/2011/34-65355.pdf.

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Proposed Rule 127B would essentially track Section 27B[2] with the SEC proposing for comment guidance as to the nature and scope of conduct prohibited under the rules – rather than including the provisions in the proposed rule itself. The release describes the conditions that must exist for the rule to apply and the types of activities that are exempt from the rule. It also provides analysis as to whether certain transactions would be subject to the proposed rule and/or fit within one of the proposed exceptions.

Conditions required in order for the proposed rule to apply

In order for the proposed rule to apply, the transaction must involve (i) covered persons, (ii) covered products, (iii) a covered timeframe, (iv) covered conflicts and (v) a material conflict of interest.

Like Section 27B, the proposed rule would apply to underwriters, placement agents, initial purchasers, sponsors and any of their respective affiliates or subsidiaries. With the exception of "underwriter," none of these terms is defined in the Securities Act and neither Section 27B nor the proposed rule defines these entities. The SEC preliminarily believes that no definitions are warranted but requests comment on whether definitions should be included, specifically whether the term "sponsor" should be defined to include collateral managers and other entities who for a fee, or some other benefit, play a substantial role in the creation of the asset-backed securities or the managing or servicing of the underlying assets. The SEC indicates that the definition of sponsor under Regulation AB might be too limited for purposes of proposed Rule 127B because it would not extend to synthetic securitizations and might not extend to collateral managers in CDOs/CLOs (which it believes should be covered persons).

Products covered by proposed Rule 127B include registered, privately-placed and exempt asset-backed securities as defined under the Exchange Act (a broader definition than the one included in Regulation AB) as well as synthetic securitizations. (References to asset-backed securities in this update include synthetic asset-backed securities unless otherwise specified.) Because the SEC believes the term synthetic securitization to be understood in the market, the SEC does not propose to define the term and requests comment on whether a definition should be included.

Section 27B covers transactions during the period ending one year following the date of the first closing of the sale of the securities; it does not specify the date on which the period begins. Because transactions that predate the first closing of the sale of the securities may involve similar conflicts of interest, the SEC indicates transactions predating the first sale of the securities would also be subject to the proposed rule.

With respect to the scope of the conflicts of interest, the SEC states that the covered conflicts would be limited to material conflicts of interest between an entity that is a securitization participant with respect to asset-backed securities and an investor in those asset-backed securities (regardless of whether the investor purchased the securities from the participant). The proposed rule would not extend to conflicts of interest between securitization participants, such as a sponsor and a collateral manager, or to conflicts of interest between investors, such as investors in different tranches of securities. The SEC also states that the proposed rule would extend only to those conflicts of interest that arise out of the securitization transaction and not conflicts of interest that might arise between a participant or investor in other contexts. Finally, the SEC specifies that the conflict of interest must arise as a result of or in connection with the participant engaging in a transaction and distinguishes putting on a short transaction – which would constitute engaging in a transaction – from issuing investment research – which would not constitute engaging in a transaction.

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[2] Proposed Rule 127B provides that

> [A]n underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this rule shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

Exceptions to this prohibition are discussed below.

In proposing the standard by which to measure the materiality of a conflict of interest for purposes of Section 27B, the SEC notes that it does not intend to capture transactions arising in typical securitizations:

> We are not aware of any basis in the legislative history of Section 621 to conclude that this provision was expected to alter or curtail the legitimate functioning of the securitization markets, as opposed to targeting and eliminating specific types of improper conduct. Moreover, as a preliminary matter, we believe that certain conflicts of interest are inherent in the securitization process, and accordingly that Section 27B and our proposed rule should be construed in a manner that does not unnecessarily prohibit or restrict the structuring and offering of an [asset-backed security].

To identify transactions that would involve or result in a material conflict of interest, the SEC proposes a two part test. Under the SEC proposal, a transaction involves or results in material conflict of interest if:

1. Either
   a. a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (i) adverse performance of the asset pool supporting or referenced by the relevant asset-backed securities, (ii) loss of principal, monetary default or early amortization event on the asset-backed securities, or (iii) decline in the market value of the relevant asset-backed securities (referred to as a "short transaction"); or
   b. a securitization participant, who directly or indirectly controls the structure of the relevant asset-backed securities or the selection of assets underlying the asset-backed securities, would benefit directly or indirectly from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration, as a result of allowing a third party, directly or indirectly, to structure the relevant asset-backed securities or select assets underlying the asset-backed securities in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above; and
2. There is a "substantial likelihood" that a "reasonable" investor would consider the conflict important to his or her investment decision (including a decision to retain the security or not).

The SEC notes that, with respect to the first alternative to determine if a material conflict of interest exists, it interprets Section 27B to prohibit a participant from benefiting directly or indirectly from any actual, anticipated or potential decline in the value of the asset-backed securities, regardless of whether the participant intended or designed the asset-backed securities to fail or default. However, nothing in the proposed rule would prevent a participant from taking a position that would be aligned with the interests of investors, such as purchasing asset-backed securities or taking a long position on an asset-backed security. The SEC states in the release that ownership of an entire tranche of securities, such as in the case of risk retention in the form of a horizontal slice, would not constitute a material conflict because the ownership by itself would not cause the participant to benefit from the adverse performance – rather the participant would benefit from the positive performance of the assets.[3]

With respect to the second alternative, in which a participant allows a third party to select assets or structure the asset-backed securities, the SEC takes the position that the receipt of fees or other remuneration (or the promise of future fees, business or remuneration) by a participant alone would constitute "engaging in a transaction" for purposes of Section 27B, without the need for the participant itself to be party to any short transaction, in effect extending the analysis of short positions to positions taken by third parties where this element exists. The burden of determining if a third party might engage in a short transaction would fall on the participant. The SEC states that where reasonable, a participant could rely on contractual representations from a third party or the participant might determine that there was no reasonable basis to determine that the third party would engage in a short transaction.

[3] See p. 79 of the release. However, if the participant took a short position on securities that did not meet the hedging exception, it could constitute a prohibited conflict of interest.

With respect to the materiality element of the condition – whether there is a substantial likelihood that an investor would consider the conflict important to the investment decision – in the SEC's view it is not possible to designate in advance certain facts or occurrences that would be determinative of materiality. Rather the release would require an assessment in each case of the inferences that a reasonable investor would draw from the specific facts and circumstances. The SEC does state that in doing so it would be appropriate to consider both the probability that the securitization participant would receive a benefit and the magnitude of the benefit. The SEC notes that, while this materiality formulation is also used in federal securities law to determine if information must be disclosed to investors, the SEC's current position is that disclosure of the conflict would not permit an otherwise prohibited conflict.

Exceptions to the proposed rule based on statutory exceptions

Proposed Rule 127B essentially tracks Section 27B's statutory exceptions to the prohibition on material conflicts of interest, extending to:

- risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings; or
- purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, to provide liquidity for the asset-backed security; or
- purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security.

The SEC states that the risk-mitigating hedging exception is not intended to permit speculative trading or positions designed to earn a profit but to allow a participant to hedge risk specific in its role as such, including for example hedging by a sponsor to protect against price movements on assets slated for securitization or hedging by an underwriter on securities in which the underwriter is making a market. The SEC indicates that if the predicted performance of a hedge in the event of incrementally poor performance of an asset-backed security would result in appreciably more profits to a participant than losses incurred from its exposure to the asset-backed securities, the hedge would not constitute permissible hedging activity.

To establish the parameters of permitted market-making in the context of asset-backed securities, the SEC focuses on principles aimed at customer trading, customer liquidity needs, customer investment interest and risk management by customers or market-makers. Specifically, the SEC identifies eight principles of permissible market-making, although it notes that market-making that lacks one of these might still constitute permissible market-making and requests comment on the issue. The eight principles of permissible market-making are where the market-making -

- includes purchasing and selling the asset-backed securities from or to investors in the secondary market;
- includes holding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction);
- is driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market-makers;
- is generally initiated by a counterparty and if a customer initiated a customized transaction, it may include hedging if there is no matching offset;

- does not include activity that is related to speculative selling strategies or investment purposes of a dealer, or that is disproportionate to the usual market-making patterns or practices of the dealer with respect to that asset-backed security;
- absent a change in a pattern of customer driven transactions, typically does not result in a number of open positions that far exceed the open positions in the historical normal course of business;
- generally does not include actively accumulating a long or short position other than to facilitate customer trading interest; and
- generally does not include accumulating positions that remain open and exposed to gains or losses for a period of time instead of being closed out promptly. In contrast, an aged open position taken to facilitate customer trading interest would be hedged rather than exposed to gains and losses for a period of time.

Application of the material conflict of interest test

In the release, the SEC provides a number of illustrative examples as to how proposed Rule 127B would apply to various circumstances. For example, an underwriter with a short position for its own proprietary account on asset-backed securities it underwrote would constitute a prohibited transaction. However, a short position by an underwriter in the context of market-making to cover a long position taken at the request of a customer could fall under the permitted exceptions for market-making, and a short position by an underwriter on securities purchased by the underwriter where the potential gains on the hedge were not appreciably larger than the potential losses on the securities held by the underwriter might qualify for the hedging exemption if the hedge were not for speculative purposes.

In the context of synthetic transactions, the SEC states that a sponsor that purchases protection from a special purpose vehicle issuer either to hedge against a long position held as an investment or as a naked short would fall within the proposed rule prohibition. The SEC contrasts a long position held by a sponsor for investment purposes (which, when combined with the short position with the issuer, would be prohibited) from a long position in assets acquired by a sponsor for purposes of the securitization transaction, which would fall within the hedging exception. Similarly, the SEC indicates that a short position entered into with an issuer where the sponsor contemporaneously enters into a matching long position with a third party that was not involved in the selection of the assets, could fall within the permitted hedging exceptions, assuming the offsetting transactions had no significant net basis risk. Entering into a short position with respect to existing long positions would not fall within the exception, as the long position would not have been entered as part of the sponsor's role in structuring the transactions. In each case, the SEC asks if, as a practical matter, it will be possible to distinguish one type of long position from the other.

The SEC also provides examples of transactions where a participant allows a third party to select the underlying assets in a transaction to determine when the proposed Rule 127B prohibition would apply. If the third party selects the underlying assets and enters into a short position on the asset-backed securities regardless of whether the participant received any fee or facilitated the short position, the SEC believes that transaction would fall under the proposed rule due to the imputed benefit to the participant from creating the opportunity. If, however, the third party selected the assets, purchased asset-backed securities in the transaction and entered into an offsetting short position that was not for speculative purposes, the transaction would not fall within the proposed rule due to the hedging exception. The SEC contrasts this with the situation where the third party would profit more from the short position than it will lose on the long position, which it believes would not fall within the hedging exception.

Application of the rule to securitization activities

Certain comment letters on Section 621 asked the SEC to recognize that many activities in securitization transactions have inherent conflicts of interest that should not fall under Section 27B or rules adopted by the SEC under that

section. Although the SEC declined to specifically issue exemptions for these activities, it did state that it preliminarily agreed that most activities identified as being inherent conflicts of interest in the securitization process would fall outside the scope of the rule or would fall within one of the exceptions. The SEC goes on to state that:

> [W]e preliminarily agree that most activities undertaken in connection with the securitization process would not be prohibited by the proposed rule, including but not limited to: providing financing to a securitization participant, deciding not to provide financing, conducting servicing activities, conducting collateral management activities, conducting underwriting activities, employing a rating agency, receiving payments for performing a role in the securitization, receiving payments for performing a role in the securitization ahead of investors, exercising remedies in the event of a loan default, exercising the contractual right to remove a servicer or appoint a special servicer, providing credit enhancement through a letter of credit, and structuring the right to receive excess spreads or equity cashflows.

Additional request for comment

The SEC indicates that is it considering whether to permit informational boundaries to be used to wall off different areas of securitization participants in order to avoid unwarranted restrictions of participants with multiple, independent units. The SEC also seeks comment on the extent to which certain conflicts of interest could be managed through disclosure to investors and whether the SEC should consider exempting certain transactions from the proposed rule where certain conditions where met. Finally, the SEC notes that rulemaking with respect to Section 619 of the Dodd-Frank Act (referred to as the "Volcker Rule"), which deals with conflicts of interest in the banking entity context and is anticipated in the next few months, could result in revisions to the rule proposals in order to bring the conflicts of interest rules into alignment. Comments on the proposed rule are due on or before December 19, 2011.

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