Clients&FriendsMemo

# SEC Proposes a New Rule Prohibiting Conflicts of Interest in Securitizations

**October 4, 2011**

On September 19, 2011, the Securities and Exchange Commission (the "**SEC**") issued a release (the "**Release**")[1] proposing new rule 127B (the "**Proposed Rule**") under the Securities Act, which would prohibit "material conflicts of interest" in securitizations. The Proposed Rule is intended to implement Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"),[2] codified as Section 27B ("**Section 27B**")[3] of the Securities Act of 1933, as amended (the "**Securities Act**"). Subject to certain exceptions, Section 27B prohibits certain participants in asset-backed securities ("**ABS**")[4] transactions from engaging in transactions within a designated time period that would involve or result in any material conflict of interest. Disclosure of such material conflicts of interest would not otherwise permit such prohibited transactions.

In the Release, the SEC provides its preliminary clarifying interpretations of Section 27B and the Proposed Rule. These views are based, in part, on evidence of Congressional intent and initial comments from the public received by the SEC regarding the implementation of Section 27B. However, the Proposed Rule itself largely repeats the statutory language of Section 27B and does not incorporate any of these interpretive views.

Specifically, the Proposed Rule prohibits—

- an underwriter, placement agent, initial purchaser, or sponsor of an ABS, or any affiliate or subsidiary of such entity (collectively, "**securitization participants**")

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1 See *Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Release No. 34-65355; File No. s7-38-11; Proposed Rule (September 19, 2011), 76 Fed. Reg. 60320 (September 28, 2011), available at http://www.sec.gov/rules/proposed/2011/34-65355fr.pdf.

2 Pub. L. 111-203, 124 Stat. 1376 (2010).

3 15 U.S.C. 77a et seq.

4 "**ABS**" refers to an asset-backed security as defined in Section 3(a)(77) of the Securities and Exchange Act of 1934 (the "**Exchange Act**"), added by Section 941(a) of the Dodd-Frank Act, and includes for purposes of Section 27B and the Proposed Rule a synthetic asset-backed security. See *infra* note 12.

- at any time prior to the date that is one year after the date of the first closing of the sale of ABS
- from engaging in any transaction
- that would involve or result in an material conflict of interest with respect to any investor in a transaction arising out of such activity.

The following three categories of activities would be exempted from the Proposed Rule:

- Risk-mitigating hedging transactions designed to reduce specific risks to an underwriter, placement agent, initial purchaser, or sponsor arising out of participation in the securitization;
- Purchases or sales made pursuant to commitments of securitization participants to provide liquidity for the ABS; and
- Purchases or sales made pursuant to bona fide market-making in the ABS.

The SEC is seeking comments on all aspects of the Proposed Rule and the SEC's approach to the Proposed Rule and implementation of Section 27B. Comments are due by December 19, 2011.

This memorandum summarizes the SEC's interpretations of Section 27B and the Proposed Rule and the issues on which the SEC is seeking comment.

**BACKGROUND**

Section 27B was enacted by Section 621 of the Dodd-Frank Act to prohibit underwriters, sponsors and others who assemble ABS from packaging and selling those securities and profiting from the securities' failure.[5] Comments from the public offered in response to the SEC's initial solicitation of views on how to implement Section 27B emphasized the extent to which a broad reading of Section 27B could threaten ordinary and essential securitization practices. In crafting the Proposed Rule and the related preliminary interpretive guidance in the Release, the SEC sought to strike an appropriate balance between prohibiting the specific type of conduct at which Section 27B is aimed without restricting other securitization activities. In the Release, the SEC preliminarily agrees that many activities undertaken in connection with the securitization process or activities unrelated to a particular securitization (such as underwriting another ABS transaction for another issuer) would not be prohibited by the Proposed Rule. The SEC notes that these activities generally could be undertaken absent additional facts indicating otherwise, such as facts indicating a securitization participant engaged in a proprietary trade that would profit from a directionally

[5] Congressional Record, S5899 (July 15, 2010) (statement of Sen. Carl Levin).

opposite view of the ABS. Likewise, other activities unrelated to the securitization, such as market research, could also be undertaken by a securitization participant.

> ***Note***: *Although the SEC notes that comment letters identified the financing of investors to purchase ABS as being a traditional securitization-related activity, the SEC did not specifically identify that activity as one not subject to the Proposal Rule.*[6]

As stated above, the Proposed Rule essentially repeats the text of Section 27B. In particular, the Proposed Rule itself provides neither definitions of any key terms, such as "engaging in transactions" or "material conflict of interest," nor instructions as to the application of the Proposed Rule. Moreover, the SEC does not add any exemptions from application of the Proposed Rule beyond those set forth in Section 27B. Instead, the SEC provides preliminary interpretations in the text of the Release and seeks comment on the Proposed Rule and such preliminary interpretations. In particular, the SEC requests that commenters analyze securitization activities, including the use of swaps, caps, credit default swaps and derivatives and the activities of servicers and collateral managers, based on the proposed framework described in the Release.

> ***Note***: *Since the text of the Proposed Rule itself does not incorporate definitions of key terms, interpretive guidance or instructions, securitization participants are potentially subject to greater uncertainty as to whether their activities relating to an ABS transaction could be viewed as violating the Proposed Rule. Although the SEC's interpretive guidance in the Release is helpful, it would not have the force of law.*

## TEXT OF THE PROPOSED RULE

The Proposed Rule states:

(a) An 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, 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

[6] The SEC preliminarily agrees that the following activities would not be prohibited by the Proposed Rule: 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.

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.

(b) The following activities shall not be prohibited by paragraph (a):

(1) Risk-mitigating hedging activities. 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

(2) Liquidity commitment. 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

(3) Bona fide market-making. Purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security.

**CONDITIONS FOR APPLICATION OF THE PROPOSED RULE**

There are five conditions that must be present for the Proposed Rule to apply. Specifically, the relevant transaction must involve (1) covered persons, (2) covered products, (3) covered timeframe, (4) covered conflicts, and (5) a "material conflict of interest".

**1. Covered Persons**

The Proposed Rule would apply to an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an ABS, each of which typically has a substantial role in the structuring and sale of the ABS. None of these terms is defined in the Securities Act or the Proposed Rule, except for "underwriter," which is defined in Section 2(a)(11)[7] of the Securities Act.

The SEC is seeking comment on whether "underwriter," "placement agent," "initial purchaser" and "sponsor" should have the same meaning as defined by Regulation AB or, if undefined, as

[7] See 15 U.S.C. § 77b(a)(11) ("The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission".).

understood in Regulation AB (*e.g.*, the underwriter or initial purchaser) and whether these terms need to be defined differently, particularly in connection with synthetic ABS.[8] Specifically, the SEC is seeking comment on:

- Underwriter: Whether the term "underwriter" in the context of Section 27B should have the same meaning as the definition in Section 2(a)(11) of the Securities Act or in Rule 100 of Regulation M[9] under the Exchange Act.
- Placement Agent and Initial Purchaser: Whether the term "initial purchaser" should be clarified to refer to a broker-dealer functioning in a role equivalent to that of an underwriter or placement agent in a Rule 144A transaction.
- Sponsor: Whether "sponsor" should include the collateral manager or others who for a fee, or some other benefit, play a substantial role in the creation of an ABS, or manage or service the assets underlying an ABS.
- Affiliate: Whether the Proposed Rule should provide that an "affiliate" of, or a person "affiliated" with, a specified person is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified[10] and whether a servicer would typically be an affiliate of an underwriter, placement agent, initial purchaser or sponsor, under such a definition.
- Subsidiary: Whether the definition of the term "subsidiary" should be the same as the definition of subsidiary found in Exchange Act Rule 12b-2.[11]

**2. Covered Products**

The Proposed Rule would apply with respect to any asset-backed security (as defined in Section 3(a)(77) of the Exchange Act),[12] including a synthetic asset-backed security.

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[8] In a synthetic ABS transaction, investors in securities issued by a special purpose entity ("**SPE**") acquire credit exposure to a portfolio of fixed income assets without the SPE owning these assets. Rather, the exposure is created because the SPE has entered into derivatives transactions, such as credit default swaps ("**CDS**") that reference particular assets.

[9] See 17 CFR 242.100 ("Underwriter means a person who has agreed with an issuer or selling security holder: (1) to purchase securities for distribution; or (2) to distribute securities for or on behalf of such issuer or selling security holder; or (3) to manage or supervise a distribution of securities for or on behalf of such issuer or selling security holder".).

[10] The term "affiliate" is defined similarly in Section 16 of the Securities Act, Rule 405 under the Securities Act, and Rule 12b-2 under the Exchange Act.

[11] See 17 CFR 240.12b-2 ("A 'subsidiary' of a specified person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries".).

[12] Section 941(a) of the Dodd-Frank Act added Section 3(a)(77) to the Exchange Act to provide that the term "asset-backed security":

The term "synthetic asset-backed security" is not defined for purposes of the Proposed Rule as the SEC believes that this term is commonly used and understood by market participants. The SEC is seeking comment on whether and how the term "synthetic asset-backed securities" should be defined or interpreted in the Proposed Rule.

> ***Note**: It would appear that insurance-linked securities ("**ILS**") may not be ABS or synthetic ABS and therefore may not be covered products under the Proposed Rule. Investors in ILS receive their periodic interest from premium payments on the applicable risk transfer contract (e.g., reinsurance contract) and investment earnings on the permitted investments (e.g., money market funds) purchased with the sale proceeds of the ILS. The principal of the ILS is not paid from self-liquidating assets, but rather is due at maturity of the ILS and is sourced from redemption of the permitted investments. Investors in the ILS could be negatively impacted (and not receive their full principal or interest) if a covered risk event (e.g., hurricane, earthquake) occurs. Unlike a synthetic ABS CDO, for ILS there is no underlying self-liquidating asset pool.*

In addition, the SEC is requesting comment on whether the Proposed Rule should apply to municipal securities, any other ABS issued by state or local governments or a municipal tax lien securitization.

### 3. Covered Timeframe

The Proposed Rule would apply to transactions engaged in any time prior to the date that is one year after the date of the first closing of the sale of the ABS. However, the Proposed Rule,

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(A) means a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a security or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flows from the asset, including –

  (i) a collateralized mortgage obligation;

  (ii) a collateralized debt obligation;

  (iii) a collateralized bond obligation;

  (iv) a collateralized debt obligation of asset-backed securities;

  (v) a collateralized debt obligation of collateralized debt obligations; and

  (vi) a security that the SEC, by rule, determines to be an asset-backed security for purposes of that section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company. The Proposed Rule incorporates this definition and specifically includes synthetic ABS in describing the scope of the prohibition on certain material conflicts of interests.

consistent with Section 27B, does not specify the commencement point for the covered timeframe. As a result, the Proposed Rule would cover transactions effected prior to the date of the first closing of the sale of the ABS.

The SEC is requesting comment on whether the Proposed Rule should specify the commencement point for the covered timeframe and if so, what that should be (*e.g.*, the date of the first closing of the sale of the ABS, the point at which a person becomes a securitization participant, or some other reference point prior to the first closing of the sale of the ABS to the public).

**4. Covered Conflicts of Interest**

The Proposed Rule does not specifically set forth the types of conflicts it covers. In the Release, however, the SEC proposes that the scope of the conflicts of interest covered by the Proposed Rule would be limited to:

- Conflicts of interest between an entity that is a securitization participant with respect to an ABS and an investor in such ABS.[13]
- Conflicts of interest between a securitization participant and an investor that arise as a result of or in connection with the ABS transaction.[14]
- Conflicts of interest that arise as a result of or in connection with "engag[ing] in any transaction".[15]

> ***Note***: *It is unclear how the Proposed Rule intends to treat the "conflicts" arising out of interest rate or currency swaps between a*

[13] Therefore, according to the SEC, conflicts of interest that arise exclusively between securitization participants or exclusively between investors would not be prohibited under the Proposed Rule. For example, the SEC proposes that the Proposed Rule would not cover conflicts of interest among securitization participants (*e.g.*, conflicts of interests between a sponsor and a collateral manager of an ABS) or conflicts of interest arising solely among investors in the ABS offering using multi-tranche structures (where investors could include securitization participants, provided these conflicts arise only from their interests as an investor).

[14] The SEC provides an example in which the underwriter of an ABS may also be the underwriter in an unrelated common stock offering. One investor may purchase securities in both the ABS offering and the common stock offering. If the underwriter engaged in transactions that undermined the market value of the common stock offering, that activity (while potentially addressed by other provisions of the federal securities laws and rules thereunder, depending on the facts and circumstances) would not fall within the scope of the Proposed Rule even though one of the investors in the common stock offering is also an investor in the ABS offering.

[15] According to the SEC, certain activities (such as the issuance of investment research) undertaken by a securitization participant would not be "engag[ing] in any transaction" for purposes of the Proposed Rule. Engaging in any transaction would include, but not be limited to, effecting a short sale of, or purchasing CDS protection on, securities offered in the ABS transaction or its underlying assets, or selecting assets, directly or indirectly, for the underlying asset pool and selling those assets to the SPE.

> *securitization participant and the SPE. While such swaps do not create conflicts between the securitization participant and the SPE with regard to the performance of the securitized assets, there are "conflicts" in that the securitization participant and the SPE have divergent interests as to whether interest rates rise or fall or as to how currency exchange rates move. These would not appear to be the types of conflicts intended to be addressed by the Proposed Rule, but there is a lack of clarity on this point. Because interest rate and currency swaps with an SPE are often bespoke and hard to hedge, subjecting these swaps to the Proposed Rule would likely impair their use in securitizations.*

The SEC is requesting comment on whether an alternative approach should be used to delineate the scope of the conflicts of interest. Specifically, the SEC is asking:

- Whether the phrase "engaging in any transaction" for these purposes should be interpreted more broadly or narrowly, including the asset-backed offering itself and whether there are other types of activities in which securitization participants may engage that should be specifically excluded from the scope of the phrase "engag[ing] in any transaction"; and
- Whether any conflicts of interest that might arise between securitization participants impact ABS investors and therefore should be addressed under Section 27B.

**5. Material Conflicts of Interest**

The Proposed Rule would apply only to "material conflicts of interest". However, the SEC does not define the term "material conflict of interest". In the Release, the SEC explains that it is reluctant to attempt to incorporate an explicit definition into the Proposed Rule because any such attempt might be both over- and under-inclusive. Certain conflicts of interest, the SEC notes, are inherent in the securitization process, and the SEC does not intend to alter or curtail the legitimate functioning of the securitization markets. According to the SEC, any attempt to define the term "material conflict of interest" in the Proposed Rule might result in unintended consequences. Accordingly, the SEC proposes to clarify the scope of material conflicts of interest through interpretive guidance rather than through a detailed definition in the Proposed Rule.

The SEC's preliminary interpretation is that engaging in a transaction will involve or result in a material conflict of interest between a securitization participant and investors if:

(1) either (A) a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (x) adverse performance of the asset pool

supporting or referenced by the relevant ABS, (y) loss of principal, monetary default or early amortization event on the ABS, or (z) decline in the market value of the relevant ABS; or (B) a securitization participant, who directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS, 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 ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described in clause (A) 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).

*Item 1(A) of "Material Conflict of Interest" Test*

Engaging in a transaction would "involve or result in [a] material conflict of interest" if as a result of such transaction the securitization participant would benefit from the actual, anticipated or potential poor performance of the ABS or the underlying assets. It would not be necessary for a securitization participant to intentionally design an ABS to fail or default in order to trigger the Proposed Rule's prohibition. Thus, under the Proposed Rule a securitization participant would be prohibited from profiting from the decline of an ABS it helped to structure, offer and sell to investors (assuming that the conflict would be important to a reasonable investor), even if that securitization participant did not intentionally cause, or increase the likelihood of, such decline.

The SEC acknowledges that this interpretation might limit certain investment activities that might otherwise be made for bona fide purposes.[16] However, the SEC believes there is a benefit to prohibiting securitization participants from structuring and offering ABS to investors on the premise that the ABS will be a good investment when the securitization participant structures the transaction in a manner designed to fail or takes other actions (*e.g.*, entering into a short transaction) through which it will profit from a failure of such investment.[17]

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[16] The SEC recognizes that it is possible for a securitization participant and investors in an ABS who have complete access to information regarding the underlying assets simply to have different views regarding the future prospects for those assets, based on their independent analysis of market and commercial trends or other factors and that restricting or prohibiting the securitization transaction would limit the ability of both the investor and the securitization participant to transact freely based on their respective views of the underlying assets (even though they might make the same investment choice if they were not involved in the securitization).

[17] The SEC also points out that as a practical matter investors in the ABS may not have as much information regarding the underlying assets as the securitization participant, and may be drawing inferences regarding the quality of the assets based

The SEC is seeking comment on any potential negative impact of this proposed interpretation.

*Item 1(B) of "Material Conflict of Interest" Test*

Alternatively, engaging in a transaction would involve or result in a material conflict of interest if a securitization participant who "directly or indirectly controls the structure of the relevant ABS or the selection of assets underlying the ABS"[18] would benefit directly or indirectly – from "fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration"[19] – "as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS"[20] in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction as described above.

In certain circumstances, a third party might directly or indirectly select assets underlying an ABS or structure an ABS transaction and enter into a short transaction of the type that would be prohibited for a securitization participant under Item 1(A) above. Item 1(B) prohibits securitization participants from receiving any benefits for allowing a third party to select assets in the hopes of profiting from a short transaction. The SEC recognizes that securitization participants might face practical difficulties in determining whether such a third party might engage in a prohibited short transaction, but it believes that appropriate contractual covenants could ensure compliance and seeks comment on the potential use of such covenants.

*Item 2 of "Material Conflict of Interest" Test*

Item 2 above of the proposed interpretation is intended to require that the potential implications of the relevant conflict be sufficiently important to warrant the prohibition imposed under the Proposed Rule. It uses the standard materiality formulation of substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision. The use of that formulation is not, however, intended to suggest that disclosure can render a prohibited transaction permissible. Relevant factors in applying this context-sensitive test include the probability that the securitization participant might benefit, and the magnitude of the benefit.

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on the involvement and marketing efforts of the securitization participant in the transaction as well as any other information provided by the securitization participant.

[18] The SEC is seeking comment on whether this phrase should be defined or whether the term "control" should be replaced with alternative language such as the phrase "exercises control over," "has substantial control over" or "influences".

[19] The SEC is seeking comment on whether the phrase "fees or other forms of remuneration, or the promise of future business, fees or other forms of remuneration" is too narrow or too broad.

[20] The SEC is seeking comment on whether the phrase "structure the relevant ABS or select assets underlying the ABS" should be replaced with the phrase "influence" or "substantially influence" the structure of the relevant ABS or the selection of assets underlying the ABS.

The SEC is requesting comment on the proposed interpretation of a material conflict of interest, including whether and to what extent adequate disclosure of a material conflict of interest should affect the treatment under the Proposed Rule of an otherwise prohibited transaction and what would be the potential consequences of not defining the term "material conflict of interest" in the Proposed Rule text.

The SEC is also requesting comment on possible modifications to the prohibition of Section 27B, including whether the prohibited conduct should be limited to creating and selling an ABS that is "intentionally designed to fail or default" or creating and selling an "intentionally flawed" ABS; or whether the test for prohibited conduct should focus on whether (i) such transaction or activity represents an overall alignment of the risk to the ABS or underlying assets similar to that borne by investors of the ABS, (ii) such transaction or activity is unrelated to the securitization participant's role in the specific ABS, (iii) disclosure of the transaction or activity of the securitization participant adequately mitigates the risk posed by the potential or actual conflict with respect to any investors in the ABS or (iv) another regulatory regime applies with respect to the potential or actual conflict of interest.

## EXCEPTIONS TO THE PROPOSED RULE

The Proposed Rule would provide exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making. Each of these exceptions largely tracks the statutory language set forth in Section 27B. In addition to comments specific to each exception described below, the SEC is also asking whether each exception should be conditioned on disclosure or the maintenance, by some or all of the securitization participants, of the books and records that would demonstrate that the activity in question fell within the exception.

### 1. Risk-Mitigating Hedging Activities

The first exception is for risk-mitigating hedging activities in connection with "positions or holdings"[21] 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. The term "risk-mitigating hedging activities" is not defined in the Proposed Rule.

The SEC's stated goal of this proposed exception is to allow hedging activities that are designed to reduce or mitigate risk for the underwriter, placement agent, initial purchaser, or sponsor, where risk mitigation refers to the practice of limiting the consequences of a risk, without necessarily reducing

[21] The SEC is seeking comment on whether there are any differences between "positions or holdings" and "actual risks created by actual positions" and "actual exposures" and how the Proposed Rule would be applied in light of such difference.

the probability of the risk occurring.[22] While the statutory language and the language in the Proposed Rule do not refer to affiliates and subsidiaries, the SEC preliminarily believes that the exemption should be also available for affiliates and subsidiaries of securitization participants.[23] This proposed exception is not intended to permit speculative trading masked as risk-mitigating hedging activities. Risk-mitigating hedging also does not include trading to establish new positions designed to earn a profit. Over-hedged exposure or failure to unwind a hedge as exposure is reduced may be indicative of a proprietary position rather than a risk-mitigating hedge.

The SEC is requesting comment on whether the term "risk-mitigating hedging activities" should be defined and how the proposed interpretation should be modified. In particular, the SEC is seeking comments on the transparency of risk-mitigating hedging activities and the impact of the proposed exception on principal trading (other than market-making) and warehouse hedging instruments.

**2. Liquidity Commitments**

The second exception is for purchases or sales of ABS made pursuant to and consistent with commitments of a securitization participant to provide liquidity for the ABS. Although Section 27B specifically refers to "purchases or sales of asset-backed securities," the SEC understands that commitments to provide liquidity may be viewed by some market participants as encompassing a variety of activities.[24]

The SEC is seeking comment on whether modifications to this exception are necessary.

**3. Bona Fide Market-Making Exception**

The final exception is for purchases or sales of ABS made pursuant to and consistent with bona fide market-making in the ABS. The term "bona fide market-making" is not defined in the Proposed Rule. In the Release, however, the SEC sets forth the following principles that it preliminarily believes are characteristics of bona fide market-making in ABS:

- Purchasing and selling the ABS from or to investors in the secondary market.

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[22] See *infra* note 28. Similar concepts are used in connection with risk-mitigating hedging with respect to Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule.

[23] See Release at 60334.

[24] For example, a liquidity commitment may be viewed as a way to promote full and timely interest payments to ABS investors. In addition, securitization participants may provide financing to accommodate for differences in the maturity dates between asset-backed commercial paper and the underlying assets. A liquidity commitment could be an agreement by a securitization participant, such as an underwriter, to purchase an ABS from its customer in a repo transaction consistent with applicable limitations on such transactions.

- 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).
- It is driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market-makers.
- It generally is initiated by a counterparty and if a customer initiated a customized transaction, it may include hedging if there is no matching offset.
- It 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 ABS.
- Absent a change in a pattern of customer driven transactions, it typically does not result in a number of open positions that far exceed the open positions in the historical normal course of business.
- It generally does not include actively accumulating a long or short position other than to facilitate customer trading interest.
- It 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.

In addition, the SEC notes that the fact trading is carried out in a market-making account or on a market-making desk would not be determinative of whether such trading is bona fide market-making in ABS.

The SEC is seeking comment on whether the SEC's understanding of the term "bona fide market-making" described above accurately identifies the characteristics of the ABS market-making activities and whether such term should be defined for purposes of the Proposed Rule.

> ***Note***: *Interestingly, some of the activities subject to the above exceptions would not necessarily constitute material conflicts of interest under the SEC's interpretive analysis described above. That may heighten the concern that other activities conducted by a securitization participant that do not appear to be material conflicts of interest under the SEC's interpretation guidance in the Release may nevertheless be viewed as violating the Proposed Rule because those activities are not specifically excluded from the scope of the Proposed Rule.*

**APPLICATION OF MATERIAL CONFLICT OF INTEREST TEST TO EXAMPLES OF TRANSACTIONS**

For illustrative purposes, the SEC sets forth examples of transactions that may be prohibited or not prohibited under the Proposed Rule. Unless otherwise discussed in these examples, it is assumed that Item 2 of the "Material Conflict of Interest" test (*i.e.*, there is a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision) is satisfied and the exceptions described above do not apply.

**Example 1 (Securitization Participant Effecting a Short Transaction in an ABS, or Any of the Assets Underlying an ABS)**: This example features an ABS underwriter purchasing CDS protection on the securities it offered in the relevant ABS three months after the first closing. This CDS purchase constitutes a prohibited short transaction involving a material conflict of interest, because the underwriter would profit from the adverse performance of the ABS.[25]

**Example 2 (Securitization Participant Hedges Retained Investment in an ABS)**: This example features an ABS underwriter purchasing ABS it distributed and simultaneously purchasing CDS protection on such purchased ABS. This transaction is permissible under the proposed risk-mitigating hedging activities exception, assuming that the potential gains on the hedged position are not appreciably larger than the potential losses on that portion of the ABS investment that is being hedged. If the potential gains were larger, this example would resemble Example 1 above and be prohibited because the underwriter would have a risk-taking position directionally opposed to the ABS.

**Example 3 (Synthetic ABS Transaction)**: This example features several variations on the role of a sponsor of a synthetic ABS. In each case, the sponsor is a party to the CDS contract with the SPE and thus is short the credit exposure of the reference portfolio underlying the ABS transaction.

Example 3A: The sponsor has no other exposure to the ABS other than its CDS transaction. This transaction produces a net short exposure, creating a material conflict of interest with the ABS investors, and is therefore prohibited.

Example 3B: The CDS transaction with the SPE offsets the sponsor's existing long exposure to the assets underlying the ABS. The result may be a net neutral position to the sponsor, but the CDS transaction would still be prohibited because the hedging of its existing long investment position is being done through the offering of a synthetic ABS transaction in which the sponsor would benefit and investors would suffer if the performance of the underlying assets is adverse.

[25] The SEC notes that if the short transaction was executed in the context of market-making by the securitization participant (*e.g.*, the securitization participant purchases CDS protection from one customer to offset its sale of CDS protection to another customer), the bona fide market-making exception to the Proposed Rule would apply.

Thus the risk-mitigating hedging exception would not be available. The SEC's conclusion that this transaction is prohibited is preliminary and the SEC requests comment as to whether that result is appropriate in all circumstances.

Example 3C: The sponsor has accumulated a long cash or derivatives position in the underlying assets solely in anticipation of the ABS transaction, and not with a view to taking an investment position in the underlying assets. In this case, the SEC's preliminary view is that a short CDS transaction would fall within the exception for risk-mitigating hedging activities, provided that the CDS exposure merely offset, and did not exceed, the long exposure. The SEC seeks comments on whether this result is appropriate, and whether it is possible to distinguish cases in which the sponsor's long position was acquired for investment purposes, as in Example 3B, from those in which it was acquired only for the purposes of the ABS.

Example 3D: The sponsor that has entered into the short CDS transaction with the SPE simultaneously enters into offsetting CDS transactions with other market participants who did not play a role in selecting the reference assets underlying, or have any influence on any aspect of, the ABS transaction. Provided that the ABS assets were not selected to allow these other market participants to profit from short transactions, and that the offsetting CDS transactions had no significant net basis risk, the SEC preliminarily believes that these transactions would fall under the risk-mitigating hedging exception in much the same way as Example 3C does. If, however, the CDS transactions with market participants pre-existed the ABS transaction and were entered into for unrelated purposes, then the CDS with the SPE would be prohibited for the same reasons as in Example 3B. Again, the SEC requests comment on whether it is possible to distinguish cases in which the short transaction with the SPE is designed to hedge an existing position (and prohibited) from those in which it is designed to facilitate the ABS transaction (and permitted).

**Example 4 (Facilitation of Third Party Activities)**: This example involves variations on situations in which a placement agent benefits by allowing an unaffiliated third party to select the assets underlying an ABS. In each case, the third party purchases CDS protection on the ABS prior to one year before the first closing.

Example 4A: The placement agent receives a fee for facilitating the third party's purchasing CDS protection from a party who is not a securitization participant. The placement agent has given the third party the opportunity to select risky assets, increasing the likelihood of a profitable short transaction, and has been compensated for doing so. This involves a material conflict of interest with the ABS investors and is prohibited.

Example 4B: The third party again enters into a CDS transaction with a party who is not a securitization participant, but the placement agent does not facilitate the transaction or receive direct compensation. Nonetheless, the placement agent has created an opportunity for the

third party to profit by selecting risky assets. The SEC preliminarily believes that this too would be prohibited under the Proposed Rule, on the grounds that it is appropriate to impute a benefit to the placement agent for its creation of the profit opportunity available to the third party. The SEC requests comment on whether this is appropriate, or whether the lack of direct compensation to the placement agent should produce a different result.

Example 4C: The third party who has selected the assets also purchases securities offered in the ABS transaction, and its CDS protection offsets that exposure. The SEC preliminarily believes that this transaction would qualify for the risk-mitigating hedging exception just as in Example 2.

Example 4D: The third party who has selected the assets purchases securities offered in the ABS transaction, but its CDS protection more than offsets the risk of the purchased securities. In this example, the third party has a net position contrary to the ABS investors and the CDS purchase no longer qualifies for the risk-mitigating hedging exception.

> ***Note***: *The above examples illustrate the difficulty a dealer will likely encounter when entering into a CDS with a sponsored SPE. The dealer seemingly cannot enter into a CDS as part of its overall dealer book nor can it enter into a CDS with an SPE based on client demand for the opposite position. Rather the only clear way to comply with the Proposed Rule is for the dealer to enter into the CDS with an SPE and then hedge its position with third parties who have not previously expressed an interest in taking an offsetting position. This would seem to make it quite difficult to execute a synthetic collateralized debt obligation in the customary form where the sponsor or an affiliate is the counterparty under the CDS with the SPE and the conflicts issue is addressed by disclosure.*

The SEC is requesting comment on whether these examples are correctly analyzed and how frequently they occur, as well as examples of other conflicts of interest that should be prohibited. Particularly, it requests identification of activity that would constitute selecting assets and description of circumstances in which complete offset of CDS exposure via third-party transaction (as in Example 3D) is not possible.

**INFORMATION BARRIERS AND DISCLOSURE**

While Section 27B prohibits securitization participants from engaging in transactions that involve or result in material conflicts of interest, Section 28 of the Securities Act provides the SEC with

authority to adopt conditional or unconditional exemptive rules or regulations. The SEC is seeking comment on whether and to what extent the SEC should consider exemptive rules or regulations for certain transactions or activities otherwise covered by Section 27B, including conditional exemptions based on information barriers or disclosure described below.

**Information Barriers**

Information barriers have been recognized in other areas of the federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities.[26]

The SEC's preliminary view is that it may be appropriate to consider the issue of independent units within a multi-service firm in the context of the Proposed Rule, as certain firms involved in securitization may undertake a wide range of activities in connection with multiple and different business lines, underwriting and trading ABS among them.

The SEC is seeking comment on whether the use of information barriers should be applied in connection with the Proposed Rule to address conflicts of interest, in particular, with respect to certain affiliates and subsidiaries of securitization participants that may operate separately and independently.[27] Specifically, the SEC is asking what conditions would be appropriate to maintain the integrity of the independence between the separate units within a multi-service firm to permit transactions in one unit that are truly independent from the creation and distribution of an ABS in another unit (*e.g.*, (1) a written plan of organization to identify each unit, support its objective, and support its independent identity; (2) individual employees assigned to only one unit at any time; (3) compliance and internal audit routines; (4) written records; (5) separate management structure, location, business purpose and profit and loss treatment; and (6) other conditions).

**Disclosure**

Securitization participants typically provide various disclosures to investors in ABS, which generally should include appropriate disclosure as to conflicts of interest between investors and the securitization participants that would be material to investors. While Section 27B does not contain a disclosure alternative to outright prohibition, the SEC is seeking comment on the types of conflicts or transactions that could be managed through disclosure, the level of detail, the format or structure of disclosure and the timeliness, effectiveness and feasibility of disclosure, and the benefits and costs of a disclosure-based exemption.

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[26] For example, Section 15(g) of the Exchange Act recognizes that information barriers may be used to effectively manage the potential misuse of material, non-public information.

[27] In particular, the SEC is seeking comment on the application of the Proposed Rule to an affiliate of a securitization participant that manages a fund, which purchases a CDS referencing securities issued in the ABS transaction.

## RELATIONSHIP OF THE PROPOSED RULE WITH VOLCKER RULE

Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule, amends the Bank Holding Company Act to add new Section 13, Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds. The Volcker Rule includes (1) general prohibitions and restrictions on certain financial entities – including certain broker-dealers – engaging in proprietary trading or sponsoring or investing in a hedge fund or private equity fund, (2) certain exceptions to these prohibitions and restrictions (referred to as "permitted activities"), and (3) limitations on permitted activities.

Given the similarities between Section 619 and Section 621 of the Dodd-Frank Act,[28] the SEC is seeking comments on any potential interplay of the Volcker Rule with the Proposed Rule, in particular, with respect to the treatment of risk-mitigating hedging activities and bona fide market-making exceptions.[29]

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.


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[28] For example, the Volcker Rule is concerned with conflicts of interest that stem from proprietary trading at banking and non-bank financial firms. In addition, the Volcker Rule, like Section 621 of the Dodd-Frank Act, includes the concepts of certain permitted activities concerning market-making related activities and risk-mitigating hedging activities.

[29] The SEC is expected to issue a notice of proposed rulemaking relating to the Volcker Rules in the near future.