Conflicts of Interest in Securitizations

SEC Proposes Rule under Section 621 of the Dodd-Frank Act to Prohibit Securitization Participants from Engaging in Transactions Involving Material Conflicts of Interest with ABS Investors

SUMMARY

On September 19, 2011, the Securities and Exchange Commission proposed for public comment Rule 127B to implement the prohibition in Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act against securitization participants engaging in any transaction that would involve or result in any material conflict of interest with respect to any investor in a securitization transaction. Although the text of the proposed rule repeats the statutory language almost verbatim, the SEC is also proposing an interpretation of the term “material conflict of interest” for purposes of the prohibition. The proposing release also presents four examples to illustrate transactions that would or would not be prohibited under the proposed rule. Rule 127B as proposed would not provide exemptions based on information barriers or disclosure of actual or potential conflicts of interest, but the SEC is soliciting comment on whether either of these approaches should be the basis for exceptions from the rule’s prohibitions. Comments are due on or before December 19, 2011.

I. BACKGROUND

Section 27B of the Securities Act, added by Section 621 of the Dodd-Frank Act, provides that “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], which for the purposes of this section 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.”
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Excepted from this prohibition are: “(1) 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 positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or (2) purchases or sales of asset-backed securities made pursuant to and consistent with (A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or (B) bona fide market-making in the asset-backed security.”

Section 621 directed the SEC to issue implementing rules within 270 days of the enactment of the Dodd-Frank Act, and the statutory provision will take effect on the effective date of those rules. Having received initial comment letters from the U.S. Senators who sponsored Section 621 and various industry associations and representatives of market participants, on September 19, 2011 the SEC proposed for public comment a rule that essentially restates the statutory language verbatim, although it did propose an interpretation of “material conflict of interest” for purposes of the prohibition and offer several examples of how the rule would apply to particular fact patterns.

II. SCOPE OF RULE 127B

According to the proposing release, for the prohibition under proposed Rule 127B to apply the relevant transaction must involve (1) covered persons, (2) covered products, (3) a covered timeframe, (4) covered conflicts and (5) a “material conflict of interest.”

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. The SEC notes that of these terms, only “underwriter” is defined in the Securities Act, but it is not proposing to define any of the other terms at this time. While the term “sponsor” is defined in Regulation AB, the SEC observes that the Regulation AB definition may not identify all persons involved in the structuring and sale of synthetic ABS transactions, which would be covered by Rule 127B but are not covered by Regulation AB. On the other hand, the SEC believes the terms “placement agent” and “initial purchaser” are sufficiently well understood in the ABS market not to require definition for purposes of the rule. The SEC is seeking comment on whether the term “sponsor” should specifically include a collateral manager or any other person, such as a servicer or custodian, who for a fee or some other benefit has a substantial role in the creation of the ABS, or managing or servicing the assets underlying the ABS. The release also solicits input on the extent to which definitions of these terms in other federal securities laws and rules should be incorporated into proposed Rule 127B.

Covered Products. As noted above, both the statute and the proposed rule incorporate the Exchange Act definition of “asset-backed security,” while also specifically including synthetic ABS, which are not
within the ambit of that definition. The SEC is not proposing to define synthetic ABS for purposes of the rule since it understands that the term is commonly used and understood by market participants. The release also states that both the statutory provision and the proposed rule would apply both to ABS that are sold in registered offerings and those that are sold in exempt transactions.

**Covered Timeframe.** Although the statute and proposed rule specify the end of the covered timeframe as one year following the first closing of the sale of the ABS to the public, neither the statute nor the rule specifies a starting point for the covered timeframe. The proposing release states that securitization participants may engage in transactions prior to the first closing that involve or result in material conflicts of interest that in form or effect are difficult to distinguish from similar transactions occurring after the first closing. The SEC is soliciting comment on whether the rule should specify the time a person becomes a securitization participant, the first closing or some other point in time as the beginning of the covered timeframe.

**Covered Conflicts.** The SEC indicates that there would not be a covered conflict under Rule 127B if the conflict in question: (1) arose exclusively between securitization participants or exclusively between investors; (2) did not arise as a result of or in connection with the ABS transaction; or (3) did not arise as a result of or in connection with “engag[ing] in any transaction.” For example, conflicts of interest between a sponsor and a collateral manager would not be prohibited by the rule. Nor would the rule cover conflicts among investors (including investors who are also securitization participants) in different tranches by virtue of the different risks and rewards associated with such tranches. The rule also would not cover conflicts that happen to arise between the same parties that are unrelated to their respective status as a securitization participant and investor, such as a securitization participant also acting as an underwriter for a common stock offering in which the investor is a purchaser. The release cites effecting a short sale of, or purchasing CDS protection on, securities offered in an ABS transaction as examples of “engag[ing] in any transaction,” and issuing investment research as an example of an activity that does not constitute “engag[ing] in any transaction” for purposes of the rule.

**Material Conflicts of Interest.** Citing the risk that a precise definition of “material conflict of interest” might be both over- and under-inclusive in light of the complex and evolving nature of the securitization markets, the range of participants involved and the various activities that they perform, the SEC is proposing to clarify the scope of conflicts that are material through interpretative guidance rather than by incorporating a detailed definition into the proposed rule. Acknowledging initial comments that multiple conflicts of interest often arise between securitization participants and investors as an inherent part of the securitization, the SEC states that it is not aware of any basis in the legislative history of Section 621 to conclude that it was expected to alter or curtail the legitimate functioning of the securitization markets as opposed to eliminating specific types of improper conduct.
The contemplated interpretative guidance would provide that engaging in a transaction would involve or result in a material conflict of interest between a securitization participant in the relevant ABS if:

“(1) Either:

(A) a securitization participant would benefit directly or indirectly from the actual, anticipated or potential (1) adverse performance of the asset pool supporting or referenced by the relevant ABS, (2) loss of principal, monetary default or early amortization event on the ABS, or (3) decline in the market value of the relevant ABS (where these are discussed below, any such transaction will be referred to as a ‘short transaction’); 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 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).”

According to the release, it would not be necessary for a securitization participant to intentionally design an ABS to fail or default in order to trigger the rule’s prohibition. Further, if the securitization participant effected a short transaction in the ABS, it would not be necessary for the market value actually to decline for a “material conflict of interest” subject to the rule’s prohibition to arise. The SEC acknowledges that a securitization participant and an investor, based on their independent analysis of market and commercial trends and other factors, may simply have different views on the future prospects of the securitized assets. The SEC is concerned, however, that as a practical matter an investor may not have as much information about the underlying assets as the securitization participant and may be drawing inferences based on the involvement and marketing efforts of the securitization participant in the transaction.4

Item (1)(B) of the contemplated test interprets the statutory reference to “engag[ing] in a transaction” to include circumstances where the securitization participant indirectly benefits from facilitating or creating an opportunity for a third party to benefit from a short transaction when the securitization participant allows the third party to structure the transaction or select the underlying assets. The SEC notes that in both Item (1)(A) and Item (1)(B) of the test, either the securitization participant or the third party, as applicable, would have to engage in the short transaction. The SEC would impose the burden of compliance with Rule 127B on securitization participants, indicating that they could rely on appropriate contractual covenants and representations, either between themselves or with the relevant third parties, where reasonable to do so.

With respect to Item (2) of the materiality test, for guidance the SEC points to leading cases addressing materiality in the Section 10(b) context, noting in particular that it would be appropriate to consider both the probability that the securitization participant would receive a benefit from the short transaction and the
magnitude of the benefit. The SEC points out, however, that although the contemplated standard is
drawn from the disclosure context, its use is not intended to suggest that a transaction otherwise
prohibited under the proposed rule would be permitted if there was adequate disclosure.

The SEC is asking commenters to discuss whether interpreting rather than defining the term “material
conflict of interest” may lead to uncertainty that creates an unintended chilling effect on securitizations,
and it is inviting commenters who believe that the rule should define “material conflict of interest” to
suggest a definition. Further, the SEC is inviting comment on whether the phrase “allowing a third party,
directly or indirectly, to structure the relevant ABS or select assets underlying the ABS” is over- or under-
inclusive and whether a more appropriate standard would be “exercises control over,” “has substantial
control over” or “influences the structure” of the relevant ABS or the selection of the underlying assets.

III. EXCEPTIONS
As noted above, the proposed rule includes exceptions taken from the text of the statute. The first
exception covers risk-mitigating hedging activities. The SEC cites hedging of price declines in assets
while the asset pool for the ABS is being formed as an example of a type of activity covered by this
exception. The SEC believes that hedging activities by affiliates and subsidiaries of securitization
participants as well as hedging activities of securitization participants themselves should be covered by
this exception. On the other hand, it cautions that risk-mitigating hedging does not include trading to
establish new positions designed to earn a profit, and indicates that risk-mitigating hedging may include a
series of transactions based on the price movements of underlying assets, while intermittent activity,
activity inconsistent with a hedging policy or over-hedging may be indicative of a proprietary position.
Further, if incrementally poor performance of an ABS or its underlying assets would result in the
securitization participant earning appreciably more profits on the purported hedge than the losses
incurred from its ABS exposure, the SEC believes that the hedging activity would not qualify as a risk-
mitigating hedge for purposes of this exception. The proposing release notes that the Volcker Rule raises
similar questions concerning how to distinguish between risk-mitigating hedging and proprietary trading
and states that the SEC may consider whether aspects of the rules adopted to implement the Volcker
Rule should be applied to proposed Rule 127B.5

The second exception would permit securitization participants and their affiliates and subsidiaries to
provide liquidity for an ABS by purchasing and selling the ABS pursuant to and consistent with a
commitment. The SEC notes that providing liquidity may entail activities other than purchases and sales
of ABS and is soliciting comment on whether the exception should be interpreted so as to permit such
activities.
The final exception would permit purchases and sales of ABS by securitization participants, their subsidiaries and affiliates made pursuant to and consistent with bona fide market-making in the ABS. The release identifies the following principles as characteristics of bona fide market-making:

- It includes purchasing and selling the ABS from or to investors in the secondary market.
- It 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).
- 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.

The SEC also notes that because of the potential for disguising proprietary trading as market-making, the fact that trading is carried out in a market-making account or on a market-making desk would not be determinative of whether it is bona fide market-making in an ABS.

### IV. ILLUSTRATIVE EXAMPLES

The proposing release presents four examples to illustrate the application of the rule and interpretative guidance, focusing primarily on whether a transaction implicates either prong of Item (1) of the contemplated “material conflict of interest” test. The examples assume that the materiality requirement of Item (2) of the proposed interpretation would be satisfied.

In Example 1, an ABS underwriter purchases CDS protection for its own proprietary investment purposes on the securities offered in the relevant ABS three months after the first closing of the sale of the ABS. The SEC concludes that this transaction would be a short transaction by a covered person within the covered timeframe that is prohibited by Rule 127B, while noting that nothing in the proposed rule would prohibit the securitization participant from purchasing the ABS or selling protection on the ABS or the assets underlying it.
In Example 2, the ABS underwriter purchases ABS that it distributed and contemporaneously purchases CDS protection on the ABS to hedge its ABS position on a delta-neutral basis. While indicating that the proposed risk-mitigating hedging activities exception could apply since the securitization participant is hedging a position arising out of the underwriting of an ABS, the SEC points out that if the CDS is structured so that in some circumstances the recovery on the CDS might be appreciably greater than the exposure on the ABS, the hedging exception might not apply.

Example 3 addresses various scenarios involving a synthetic ABS transaction where the securitization participant is a party to the CDS contract with the ABS issuer. The sale of the CDS protection by the securitization participant would be a short transaction by a covered person. Where the securitization participant does not have any exposure to the ABS or the underlying assets other than its short position through the CDS transaction, the proposing release indicates that the CDS transaction would generally involve or result in a material conflict of interest prohibited by the rule. Where the CDS offsets an existing long exposure of the securitization participant to the relevant assets, the SEC believes it should be prohibited under the rule because it is providing a hedge for the existing position rather than for assets associated with underwriting activities. Where the securitization participant has accumulated a long cash or derivative position in the underlying assets solely in anticipation of creating and selling a synthetic ABS, however, the SEC believes the short transaction would fall within the exception for risk-mitigating hedging activities, provided that there was no significant net basis risk and that potential gains (or losses) by the securitization participant from the CDS protection would be directly offset by the losses (or gains) from the long position accumulated to offset that exposure. It would appear difficult, however, to offer a principled distinction based on the policy objectives of Section 621 between a synthetic securitization and a cash securitization of a long cash position, which Rule 127B would permit. In the final variant of Example 3, the SEC indicates that Rule 127B would not prohibit a securitization participant from entering into a CDS transaction with the ABS issuer and contemporaneously entering into offsetting CDS transactions with other market participants that did not play a role in selecting the reference assets of the ABS. If, on the other hand, the securitization participant were to enter into the CDS transaction with the ABS issuer to offset preexisting CDS exposures to third parties, the transaction would be prohibited by the proposed rule.

Example 4 contemplates various scenarios in which a placement agent benefits by allowing an unaffiliated party to select the underlying assets for the ABS, and assumes that the third party purchases CDS protection within the covered timeframe. In the first scenario, the SEC indicates that Rule 127B would prohibit the securitization participant from facilitating the third party’s purchase of CDS protection for a fee, on the theory that the securitization participant creates an opportunity for the third party to select riskier assets for the ABS so that the anticipated poor performance would increase the likelihood of a profitable short transaction. In the second scenario, the SEC indicates that Rule 127B would also prohibit a transaction in which the third party selecting the assets purchases CDS protection but the securitization...
participant does not receive a fee. The SEC believes that it would be appropriate to impute a benefit to the securitization participant for creating an opportunity for the third party to profit from its short transaction because the securitization participant may receive compensation from its role in connection with the ABS or compensation for future business that the third party promises to direct to it. In the third scenario, the SEC indicates that Rule 127B would not prohibit a transaction in which the third party selecting the assets purchases ABS and also purchases CDS protection to offset its exposure on the ABS, because the third party is in the same position as a securitization participant who has selected the underlying assets, purchases the ABS and then seeks to hedge its exposure by buying CDS protection, as in Example 2. In the final variant of Example 4, the SEC indicates that Rule 127B would prohibit a transaction in which the third party would profit more from its short position than it would lose on its long ABS position. The SEC believes that such transactions would encourage the selection of riskier assets, citing as an example a hedge fund’s strategy of purchasing the equity in a CDO and at the same time purchasing short positions on other tranches of the same CDO when it might gain more on the short positions than it could lose on the equity.

The SEC is seeking input, among other things, on whether there are other situations that occur frequently on which guidance is needed, whether the activities it contemplates prohibiting occur frequently and the potential market impacts of prohibiting them.

V. MISCELLANEOUS

The proposing release requests comment on whether information barriers and disclosure may be appropriate tools to manage conflicts of interest in securitization transactions, citing various examples under the federal securities laws and rules where information barriers may be used to address or mitigate potential conflicts of interest or improper activities.

The SEC also calls attention to its authority under Section 28 of the Securities Act to adopt conditional or unconditional exemptive rules and regulations and invites comment on whether it 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.

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ENDNOTES

Section 3(a)(77) of the Securities Exchange Act provides that the term “asset-backed security”:

“(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 secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow 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 Commission, by rule, determines to be an asset-backed security for purposes of this 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 SEC has to date not proposed or adopted any rule expanding the scope of the term “asset-backed security” pursuant to the statutory definition.

Shortly after the passage of the Dodd-Frank Act, the SEC provided the public with the opportunity to express views on the various Dodd-Frank Act provisions that the SEC is required to implement, including Section 621.

Item 1101(l) of Regulation AB defines “sponsor” as “the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” Essentially the same wording is used in the second prong of the definition of “securitizer” in Section 15G of the Securities Exchange Act.

The SEC also notes that its proposed interpretation would not prevent a securitization participant’s transactions in the securities of a lender whose mortgage pools are included or referenced in an ABS because the proposal is focused solely on the ABS and its underlying portfolio.

Section 619 of the Dodd-Frank Act. The SEC states in the proposing release that it believes that the exceptions for risk-mitigating hedging activities and bona fide market-making activities for purposes of Rule 127B should be viewed no less narrowly than the comparable exceptions for such activities under the Volcker Rule.

The SEC observes that the general prohibition on structuring balance sheet CDOs might have a negative effect on efficiency and capital formation because it would limit the hedging options available to a lender who originated assets without the intent to securitize them.

The SEC is seeking comment on whether in practice it would be possible to distinguish between cases involving an existing long exposure and cases involving accumulation in anticipation of an ABS offering.
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