News Bulletin

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# SEC Proposes Dodd-Frank Conflicts of Interest Rules

On September 19, 2011, the Securities and Exchange Commission ("**SEC**") released a proposed rule ("**Proposed Rule 127B**") implementing the conflicts of interest provisions of section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), which added a new section 27B to the Securities Act of 1933, as amended (the "**Securities Act**"). Proposed Rule 127B was released on September 19, 2011, for a 90-day comment period, which will end on December 19, 2011.

As required by new section 27B of the Securities Act, Proposed Rule 127B would generally prohibit certain persons involved in the structuring, creation and distribution of an asset-backed security ("**ABS**") from engaging in transactions within one year after the date of the first closing of the sale of such ABS that would involve or result in a material conflict of interest with respect to any investor in such ABS.

The addition of section 27B of the Securities Act was one of the changes to the securities laws implemented by the Dodd-Frank Act for which the SEC invited pre-rulemaking comments. Because of the sweeping nature of new section 27B of the Securities Act, several industry participants and trade groups submitted in-depth pre-rulemaking comments. Many commenters were especially concerned that section 27B, as drafted, was broad enough to prohibit a vast range of legitimate and necessary securitization-related transaction types, such as providing credit enhancement, liquidity facilities, warehouse lending and exercising control rights under a securitization. If unchecked, commenters feared, section 27B would have a chilling effect on the securitization markets.

With this as a backdrop, it was perhaps a little surprising to see that Proposed Rule 127B simply repeats the text of new section 27B of the Securities Act more or less verbatim. However, in the release accompanying Proposed Rule 127B, the SEC directly engages the pre-rulemaking comments, and sets forth a proposed framework for identifying and dealing with conflicts of interest. As a preliminary matter, the SEC indicates that it believes that application of the proposed framework would not operate to prohibit inherent securitization activities, such as providing financing to a securitization participant, conducting servicing activities, conducting collateral management activities, conducting underwriting activities, employing a credit rating agency, receiving payments for performing a role in the securitization, exercising remedies in the event of a default, exercising contractual rights to remove servicers or appoint special servicers, providing credit enhancement through a letter of credit and structuring the right to receive excess spreads or equity cashflows.

The proposed framework laid out in the SEC's explanatory release accompanying Proposed Rule 127B sets forth (i) conditions to the application of the rule and (ii) regulatory exceptions to the rule.

## Conditions Required for a Prohibited Conflict of Interest

In order for Proposed Rule 127B to apply to any ABS transaction, it must involve each of the following elements: (i) covered persons; (ii) covered products; (iii) a covered timeframe; (iv) a covered conflict and (v) a "material conflict of interest."

### Covered Persons

Covered persons under Proposed Rule 127B would include **underwriters**, **placement agents**, **initial purchasers**, **sponsors** of an ABS and any **affiliate** or **subsidiary** of any such entity. Of these persons, only the term "underwriter" is defined in the Securities Act. The SEC does not propose defining the other terms for purposes of section 27B, although it does ask in the accompanying release's request for comments whether these terms should be defined, and whether the definition of "underwriter" should be revised. The SEC also appears eager to ensure that collateral managers are "covered persons" for purposes of section 27B.

### Covered Products

Proposed Rule 127B applies to any "asset-backed security" as defined in section 3 of the Securities Exchange Act of 1934. The SEC points out that this definition is intended to cover private as well as registered ABS offerings, and expressly includes synthetic ABS. The SEC does not propose defining the term "synthetic asset-backed security" at this time.

### Covered Timeframe

As a condition to applicability of Proposed Rule 127B, any relevant transaction must have been engaged in prior to the date that is one year after the first closing of the sale of the ABS. The covered timeframe expressly covers the entire period prior to such first closing.

### Covered Conflict

A "covered conflict" under Proposed Rule 127B would be a material conflict of interest between an entity that is a securitization participant with respect to an ABS and an investor in such ABS (whether or not such investor purchased the ABS from the securitization participant) that arises as a result of or in connection with such ABS transaction. The SEC expressly excludes from the scope of "covered conflict" any conflict of interest that (1) arose exclusively **between** securitization participants or exclusively **between** investors; (2) did not arise as a result of or in connection with the related ABS transaction; or (3) did not arise as a result of or in connection with "engag[ing] in any transaction." Examples of activities that would constitute "engag[ing] in any transaction" are selecting assets for the underlying asset pool and selling those assets to the issuing entity, or effecting a short sale of, or purchasing CDS protection on, securities offered in the ABS transaction or its underlying assets. An example of an activity by a securitization participant that would not constitute "engag[ing] in any transaction" for purposes of Proposed Rule 127B is the issuance of investment research by a securitization participant. The SEC requests comments on other activities that should be similarly excluded from the scope of "engag[ing] in any transaction."

### "Material Conflict of Interest"

As described above under "*–Covered Conflict*," a conflict of interest that is a covered conflict must be material to trigger the application of the proposed rule. "Material conflict of interest" is not defined in Proposed Rule 127B. Instead, the SEC proposes a two-pronged materiality test, namely:

(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 ABS, (ii) loss of principal, monetary default or early amortization event on the ABS, or (iii) decline in the market value of the relevant ABS (a "**short transaction**"); or
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> (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 resulting conflict important to his or her investment decision (including a decision to retain the security or not).

In the release that accompanies Proposed Rule 127B, the SEC notes that it is not necessary for a securitization participant to intentionally design an ABS to fail or default in order to trigger the rule's prohibition under prong (1)(A) above. A securitization participant would thus be prohibited from profiting from the decline of an ABS it helped to create, even if such securitization participant did not intentionally cause, or increase the likelihood of, such decline. This seems to go beyond remedying the underlying concern that prior to the financial crisis some securitization participants were allegedly designing ABS to fail, and then betting against them, and profiting from them when they did ultimately fail.

Prong (1)(B) is designed as an anti-evasion measure, to prevent securitization participants from creating opportunities for third parties to engage in transactions that the securitization participant itself would not be permitted to engage in under prong (1)(A) above. While the SEC stresses that it would place the burden of ensuring compliance with prong (1)(B) above on the securitization participant that controls the structure of the relevant ABS or the selection of assets underlying the ABS and who then permits or facilitates the involvement of a third party in those aspects of the transaction, such securitization participant could rely on appropriate contractual covenants or representations to determine third party compliance with Proposed Rule 127B, so long as such reliance is reasonable.

The application of prong (2) above is likely to be heavily interpretation-driven, and will include consideration of such factors as the probability that the securitization participant would receive a benefit and the magnitude of any such benefit. The SEC is also careful to caution that, although the materiality formulation used in the framework is the same as that used under the federal securities laws for determining whether disclosure is necessary, disclosure in the conflicts of interest context is not currently available as a means to redeem activities prohibited under Proposed Rule 127B (*see Information Barriers; Disclosure—Disclosure below*).

## Statutory Exceptions

The framework for Proposed Rule 127B provides exceptions to the conflicts of interest rule for (i) risk-mitigating hedging activities, (ii) liquidity commitments, and (iii) bona fide market-making.

### Risk-Mitigating Hedging Activities

The proposed exception for risk-mitigating hedging activities would allow hedging activities by underwriters, placement agents, initial purchasers, or sponsors designed to reduce risk from existing positions or positions arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS (*e.g.*, hedging of a pool of assets that is being assembled by a sponsor in anticipation of a securitization transaction). Such permitted activities must be designed to reduce the specific risk to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings. The SEC is at pains to point out that the proposed exception is not intended to permit speculative trading disguised as risk-mitigating hedging activities. Indicators that the SEC flags as possibly indicating impermissible speculative trading include: over-hedged exposure, intermittent activity or activity that is inconsistent with a hedging policy. The SEC will be especially suspicious of any hedge that is predicted to produce appreciably more profits for a securitization participant than losses are predicted to be experienced on the underlying ABS.

The SEC also notes that, although the exception by its terms addresses only underwriters, placement agents, initial purchasers, or sponsors' affiliates and subsidiaries, it will interpret the exception as also applying to their affiliates and subsidiaries.

### Liquidity Commitments

This proposed exception would permit securitization participants to make "[p]urchases or sales of asset-backed securities made pursuant to and consistent with commitments ... to provide liquidity for the asset-backed security." In the release accompanying Proposed Rule 127B, the SEC acknowledges that, in normal market parlance, the term "commitments ... to provide liquidity" can encompass a wide variety of activities, including credit enhancement, liquidity facilities for asset-backed commercial paper or repo agreements. The release does not, however, expressly broaden the scope of Proposed Rule 127B to include such other arrangements, and instead asks commenters to opine as to whether the exception should be broadened.

### Bona Fide Market-Making Exception

This proposed exception would permit "[p]urchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security." Taking into account the fact that the ABS market is typically an over-the-counter market and that a small number of institutions may hold large positions in any given ABS, the release enumerates several principles that the SEC believes are characteristic of bona fide market-making in ABS, including purchasing and selling ABS from or to investors in the secondary market, holding oneself out as willing and available to provide liquidity on both sides of the market and purchasing and selling that is driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market-makers. In an interesting example of the possible scope of the bona fide market-making exception, in a footnote the SEC indicates that a securitization participant that purchases credit-default swap protection from one customer against an ABS to cover similar protection that it has sold to another customer could avail itself of the bona fide market-making exception. The SEC also notes in the release that, depending on the facts and circumstances, bona fide market-making that does not meet each of the enumerated principles may still qualify as bona fide market-making for purposes of the proposed exception.

## Information Barriers; Disclosure

### Information Barriers

Noting their usefulness in the context of dealing with material, non-public information and the anti-manipulation rules concerning securities offerings, the release accompanying the proposed rule seeks comment regarding

whether information barriers, or "Chinese walls," could be used to address conflicts of interest in connection with section 27B.

**Disclosure**

The release also states that, although section 27B does not contain a disclosure provision, the SEC welcomes comments as to whether material conflicts of interest that would be prohibited under section 27B and Proposed Rule 127B could be addressed sufficiently through a conditional exemption.

## Relationship to Volcker Rule

The SEC indicates in the release that it may revisit Proposed Rule 127B in the future in order to conform it to certain provisions of its forthcoming rule implementing section 619 of the Dodd-Frank Act (commonly known as the "**Volcker Rule**"). The SEC's current position is that the exceptions for risk-mitigating hedging activities and bona fide market-making activities under Proposed Rule 127B should be no broader than the comparable exceptions for such activities under the Volcker Rule.

## Industry and Public Reaction

The release accompanying Proposed Rule 127B seeks input on 120 questions raised by the SEC. Analysts speculate that there will be plenty of time for industry participants to voice concerns publicly. One of the most interesting aspects of Proposed Rule 127B is the fact that the SEC has attempted to deal with the core of the conflicts of interest framework in narrative text and examples that are outside the text of the rule. While the market is likely to be encouraged by the greater detail provided by the framework, it is not at all clear whether the narrative and examples provided in the release will have the same force as if they were contained in the rule itself. This surely means that the answers to future conflicts of interest questions are going to depend heavily on SEC interpretation, which is likely to develop slowly, on a case-by-case basis. It is likely that commenters will focus on this issue in their comments to Proposed Rule 127B, and we expect many commenters to urge the SEC to expand the text of the rule itself to provide a framework on which market participants can rely with greater legal certainty.

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