In Practice

Authors Alex Martin, Ellen Marks and Kristine Kozicki

Conflicting signals? Potential impacts of the SEC's proposed conflicts of interest rule on UK and EU CLO managers

On 25 January 2023, the US Securities and Exchange Commission (SEC) proposed a far-reaching rule (Rule 192)[1] to prohibit securitisation transactions involving or resulting in a material conflict of interest between certain securitisation participants and investors. The rule is required by s 27B of the Securities Act,[2] as inserted by s 621 of the Dodd-Frank Act.[3] In this In Practice article the authors consider the impact of Rule 192 on UK and EU CLO managers.

Section 621 was introduced in the wake of the 2007-2009 financial crisis to address legislators' concerns about asset-backed securities (ABS) that had been "designed to fail" so that investors holding short positions in the ABS could profit from their failure. The intention behind this was to prevent sponsors, underwriters, and others involved in structuring ABS (including the affiliates of such participants, even if the affiliates were not involved with the ABS), from profiting by "betting against" the ABS. However, Rule 192 is drafted broadly and would affect a wide range of ABS that have not been designed to fail, including collateralised loan obligations (CLOs).

The SEC shelved a similar proposed rule in 2011 following the comment period. While Rule 192 substantially revises the original proposal, it takes little notice of the post-crisis ABS/CLO regulatory environment, which introduced substantial transparency and risk retention requirements, as well as rules limiting proprietary trading by and conflicts of interest for banking entities.[4]

WHY DOES RULE 192 MATTER TO UK/EU CLO MANAGERS?

Importantly, Rule 192 does not include territorial limitations or safe harbours for non-US transactions, which means its scope potentially includes European CLOs, even if they have a limited US nexus. Thus, Rule 192 may apply even to CLO transactions that are structured to rely on the foreign safe harbour of the US risk retention rules[5] and the safe harbour for offers of securities made outside the US to non-US persons.[6]

WHY IS RULE 192 PROBLEMATIC FOR CLO MANAGERS?

Section 621 targeted conflicts of interest in securitisations to reduce the risk of financial institutions profiting from the failure of products that they designed. By contrast, CLO managers have significant economic interests in the success of their transactions, and often have fiduciary duties to their clients, and historically CLO default rates are significantly below those of equivalently rated corporate bonds.

Despite this, Rule 192 expressly captures CLO managers in the definition of "sponsor",[7] itself included in the list of "securitisation participants".[8] Securitisation participants are prohibited from engaging, directly or indirectly, in transactions that would involve material conflicts of interest with investors.

Under Rule 192, a transaction is prohibited if it is a "conflicted transaction". Conflicted transactions comprise the following, where there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision whether to retain the ABS:

- short sales of the ABS;
- credit derivatives (including credit default swaps) under which the securitisation participant receives payments upon the occurrence of a specified adverse event involving the ABS; and
- purchases or sales of financial instruments or entry into transactions through which the securitisation participant (including affiliates) would benefit from actual, anticipated or potential:
  - adverse performance of the underlying assets pool;
  - loss of principal, default or early amortization events on the ABS; or
  - decline in the market value of the ABS. Additionally, a broad anti-circumvention rule captures "economically equivalent" transactions.

Complying with Rule 192 could prove challenging for CLO managers. The third limb of the definition of "conflicted transactions" is broadly drafted and potentially restricts a number of activities CLO managers and their affiliates currently undertake in the normal course of business. These include unrelated investment activities by other (CLO or non-CLO) portfolio managers within the firm's wider business (even if each manager makes investment decisions independently), as well as normal hedging activities, portfolio risk management and market making activities in the corporate assets underlying the CLO. Acting as agent with respect to loan amendments, restructuring, or refinancing of loans held within CLOs may also be affected.

While adequate disclosure, investor consent, and robust information barriers could mitigate the risks that Rule 192 aims to address, in its release proposing Rule 192, the SEC asks whether it should permit securitisation participants to mitigate conflicts through these methods but does not provide for such mitigation.[9]

CLO managers tend to advise not only the CLO issuing entity, but also other clients that may have conflicting interests. CLO managers of open-market transactions are typically subject to fiduciary and/or contractual obligations when advising clients. However, Rule 192 does not take account of the protections provided by such obligations, potentially limiting the ability of CLO managers to manage other asset pools.

Rule 192 may, therefore, result in CLO managers being forced to identify and exit parts of their business that involve a conflicted position being taken by one or more of their portfolio managers, affiliates, or subsidiaries.

CONCLUSION

While the SEC's comment period closed on 27 March 2023, respondents have urged the SEC to extend the period due to a lack of data to assess the potential impacts of Rule 192. It therefore remains to be seen whether the SEC will proceed with implementation or seek further input.

The evolution of CLO market norms and imposition of a robust regulatory environment since the global financial crisis should provide investors with sufficient comfort that the excesses of the pre-crisis environment will not be repeated. Excessive regulation, especially in a cooling market cycle, could chill the CLO markets further, and the resulting reduction in access to capital and the ability to manage risk, could see Rule 192 negatively impact not only the global CLO markets, but also the underlying corporate loan markets and the borrowers that rely upon them. ■

1 As published in the Federal Register, *Prohibitions against Conflicts of Interest in Certain Securitizations*, Release No. 33-11151, 88 Fed. Reg. 9678 (Feb. 14, 2023): https://www.sec.gov/rules/proposed/2023/33-11151.pdf.

2 The Securities Act of 1933.

3 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

4 The "Volcker Rule", s 13 of the Bank Holding Company Act of 1956, as amended.

5 17 CFR s 264.20.

6 There are similar safe harbours in Rule 17g-5 and Rule 15Ga-2 of the Securities Exchange Act of 1934.

7 SEC Release No. 33-11151, p 27. The commentary specifically includes "a collateral manager for a CLO transaction with the contractual right to direct asset purchases or sales on behalf of the CLO".

8 Proposed Rule 192 would use the same definition of "asset-backed securities" to delineate its scope as that used by the SEC and other regulators to define the reach of the US risk retention rules. However, the exemption from those rules for sponsors of open-market CLOs depended on a court interpretation of the definition of "sponsor" in the Dodd-Frank Act that is not relevant here. CLO managers who are not required to comply with the US risk-retention rules should nonetheless expect to be subject to the conflicts of interest rules.

9 SEC Release No. 33-11151, p 53-56, questions 32 to 38.

Biog box

Alex Martin is a partner in the Finance Department of Latham & Watkins' London office and is a member of the Structured Finance Practice.

Ellen Marks is a partner in the Finance Department of Latham & Watkins' Chicago office and is a member of the Structured Finance Practice.

Kristine Kozicki is an associate in the Finance Department of Latham & Watkins' London office and is a member of the Structured Finance Practice. Email: alex.martin@lw.com ; ellen.marks@lw.com and kristine.kozicki@lw.com