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SEC Proposed Conflicts of Interest Rule: FAQs

Why is the proposed rule problematic?

All securitization market participants agree with the intent of the rule – one should not be able to design a transaction to fail and then bet against it. However, the proposed rule is written so broadly that it would outlaw many ordinary-course market activities. Securitization participants would have to choose between participating in the securitization market and their other lines of business, or they would have to eliminate the use of certain hedging strategies for managing risk. As currently written, the rule would significantly reduce participation in the securitization market, which provides affordable credit for American households and businesses.

What is a practical example of why the proposed rule is problematic?

As written, an asset manager in their role as an investor or a collateral manager who participates in collateral selection for a securitization deal could be scoped into the rule. Additionally, if the asset manager has an affiliate that manages an investment fund, the fund cannot enter a transaction whose performance could be negatively correlated with the securitization even if such fund has no knowledge or connection to the securitization.

Doesn't the proposed rule permit hedging and why isn't that good enough?

There are legitimate reasons why an asset manager or investor could take a directional view on a security that does not involve hedging. We call this activity "investing." The limited hedging exemption in the rule does not solve the problem because investors and asset managers conduct investment activities other than hedging. Furthermore, the rule as proposed only allows for hedging exceptions in very limited circumstances, such as hedging that is related to securitization activities themselves. This is a material change to how investors manage their fiduciary duty to clients.

Does the proposed rule negatively impact securitization participants' ability to manage risk?

Yes, the proposal severely limits a securitization participant's ability to hedge and manage its risks. The proposal only allows a securitization participant to hedge its activities that relate directly to its securitization activities, which excludes most hedging. In addition, the proposal restricts the ability of a securitization participant to engage in synthetic risk transfer transactions, further impeding a securitization participant's ability to manage its balance sheet risk. In relation to banks, that prohibition, when combined with the hedging restrictions described above, seems particularly overbroad, unnecessary, and dangerous considering recent regional bank failures.

Why is compliance with the proposed rule so difficult if securitization participants already comply with the Volcker Rule?

First, most securitization participants (including asset managers, investors, and issuers) are not subject to the Volcker Rule. Second, the Volcker Rule was designed for an entirely different purpose: to stop banks from engaging in short-term speculative trading. Compliance with Volcker is measured at the desk level and not on a trade level basis with one trade being explicitly a hedge for another trade. The proposed rule, however, would require securitization participants to identify trades that might be correlated with other trades and/or whether they were hedging a specific position. Compliance with the proposed rule goes across all affiliates at an enterprise level. The Volcker Rule was never intended – and has never been used – to enforce a rule like the one currently proposed.

If the rule is an investor protection rule, what do investors think?

Investors, in general, agree with the intent of the rule – that one shouldn't be able to design a transaction to fail and then bet against it. However, our investor members also think the rule as currently written is too broad and would restrict their investment activities in a manner that could violate their fiduciary duty to their asset management clients. It is unfortunately ironic that an investor protection rule could make investors more cautious about providing structuring and collateral criteria to avoid getting brought within the scope of the rule.

How can the proposed rule be fixed to accomplish the goals of the legislation but not unnecessarily disrupt the securitization market?

At a minimum, the scope of prong (iii) of the definition of "conflicted transaction" should be substantially narrowed and the rule's reach should only be targeted at securitization desks and should not include all affiliates. Without further action by the SEC, the rule will make it impossible for a market participant to conduct critical business activities – including risk-mitigating hedging, financing, and investing – while not knowing whether they are scoped in by the rule, and if so, whether its conduct could be deemed to be violating the rule.

SFA Staff Contact Listing

Michael Bright CEO Michael.Bright@structuredfinance.org 202.999.0536	Leslie Sack Head of Government Relations Leslie.Sack@structuredfinance.org 202.524.6304
Scott Frame Chief Economist & Head of Policy Scott.Frame@structuredfinance.org	Jeff Gudiel Policy Associate Jeff.Gudiel@structuredfinance.org 202.524.6307