STRUCTURED FINANCE ASSOCIATION

# SEC Reproposed Rule on Conflicts of Interest in Securitizations:

## A Blast from the Past

March 2023

# SEC Conflicts of Interest Proposal
## Congressional Mandate

- In January 2023, the SEC reproposed its rule on Conflicts of Interest (Rule 192) to implement section 27B of the Securities Act of 1933
  - Required by Congress pursuant to a provision of the Dodd-Frank Act which prohibits the sale of ABS that would involve or result in any material conflicts of interest with respect to any investor in the transaction.
  - Dodd Frank Act mandated the SEC to implement this provision "[n]ot later than 270 days after the date of enactment" of the Act – which was July 21, 2010
- The Commission has provided a short comment period of only 60 days – due March 27, 2023
- The Proposal will "**prohibit a Securitization Participant in an ABS from directly or indirectly engaging in any Conflicted Transaction during the applicable period.**"

# SEC Conflicts of Interest Proposal

## Congressional Intent + Broad SEC

- We believe the legislative record supports the view that Congress intended this provision of the Dodd-Frank Act to prevent underwriters and sponsors of securitization transactions from intentionally designing securitization transactions to fail
- The SEC asserts the latest proposal was developed to "provide greater clarity regarding the scope of prohibited and permitted conduct"
- However, as outlined in the following pages, the proposal not only scopes in a much broader range of market participants it also prohibits a far-reaching spectrum of vital market activities including many that are not related to securitization at all

**According to the SEC:**

"[t]he re-proposed rule targets transactions that effectively represent a bet against a securitization and focuses on the types of transactions that were the subject of regulatory and Congressional investigations and were among the most widely cited examples of ABS-related misconduct during the lead up to the financial crisis of 2007-2009."

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## Scopes In Broad Range of Market Participants

- The Congressional provision is aimed at underwriters, placement agents, and sponsors.
- However, the Proposal would encompass a very broad range of securitization participants in its definition of "sponsor" – which is much broader than other regulations – such as risk retention
  - Includes any party who has a contractual right to direct the construction or design of an ABS, and additionally anyone with a significant role before or after the initial issuance of the ABS
- Therefore, some other securitization parties that are likely classified as a "sponsor" and subject to the proposed rule and its prohibited activities
  - ABS investors
  - Asset manager
  - Insurance providers
  - Servicers
- The definition of "Sponsor" also scopes in all subsidiaries and affiliates to these parties
  - Includes foreign affiliates

**"Sponsor" is defined as:**

"Any person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including though an affiliate, to the entity that issues the asset-backed security; or

With a contractual right to direct or cause the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security; or

That directs or causes the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security."

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## Prohibits Far-reaching Spectrum of Vital Market Activities

- "Conflicted Transaction" definition includes:

1. Short sale of the ABS
2. CDS or other credit derivative on the ABS
3. **Other transactions in which a securitization participant would benefit from an actual or potential adverse performance in the deal or a decline in market value.**
   - (A) **Adverse performance of the asset pool supporting or reference by the relevant asset-backed security**
   - (B) **Loss of principal, monetary default, or early amortization event on the relevant asset-backed security; or**
   - (C) **Decline in the market value of the relevant asset-backed security**

***This 3rd prong raises significant concerns.**

As written, the rule seems to imply that literally any transaction anywhere in an organization including any affiliates/subsidiaries that in any way goes up in value if a securitization deal goes down in value (even if due to interest rate movements) could be a violation.

** Important: Conflicted transaction **does not require any intention or knowledge** that prohibition is circumvented.

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## Limited Number of Exemptions Provided

- The Proposal provides a limited list of exemptions and would not apply when a securitization participant engages in:
  - Risk-mitigating hedging activities (excludes the initial distribution of the ABS)**;
  - Bona fide market-making activities**;
  - Liquidity commitments.

** Important: There are significant conditions required for a company to avail itself of the risk-mitigating hedging exemption or market-making exemption.

Resulting in significant costs to even use an interest rate hedge.

Summary of conditions to qualify for "risk-mitigating hedging activities":

(A) …the risk-mitigating hedging activity is designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks …;

(B) …is subject, as appropriate, to ongoing recalibration by the securitization participant to ensure that the hedging activity satisfies the requirements set out in paragraph (b)(1) of this section and does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk-reduction; and

(C) … has established, and implements, maintains, and enforces, an internal compliance program that is reasonably designed … including reasonably designed written policies and procedures regarding the risk-mitigating hedging activities that provide for the specific risk and risk-mitigating hedging activity to be identified, documented, and monitored.

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## Initial List of Vital Market Activities Caught in Conflicted Transactions

- Some noted are:
  - Interest rate hedging
  - Credit index hedging
  - Repo or rate swap transactions
  - Balance sheet credit-linked note (CLN) deals
  - GSE and Private CRT transactions
  - Warehouse finance prior to securitization
  - Total return swaps
  - Shorting corporate bonds (i.e., in a separate long-short fund managed by the same XYZ asset manager who acts as a CLO manager for the CLO trust)