STRUCTURED
FINANCE
ASSOCIATION

SEC Re-Proposed Rule on Conflicts of Interest in Securitizations

SFA and its membership share the express goals of Congress and the Commission to "[target] transactions that effectively represent a bet against securitization"[1] by "provid[ing] an explicit standard for determining which types of transactions would be prohibited, . . . while not unnecessarily hindering routine securitization activities that do not give rise to the risks that Section 27B was intended to address."[2]

- In the aftermath of the financial crisis, Congress became concerned about several high-profile transactions involving financial institutions betting against—or "shorting"—asset-backed securities ("ABS") that they had assembled or underwritten and that were designed to fail.
- Late in the Dodd-Frank Act legislative process, an amendment was added in an effort to put an end to these types of transactions by defining them as an unlawful conflict of interest between those designing or distributing ABS and those investing in the securities.

While our member firms support the intent of the legislation, there are several reasons why the rule as proposed is completely unworkable for capital markets and will have a materially negative effect on market functioning and risk management. Among the most important of these problems are the following:

(1) "Prong 3" of the rule's list of "conflicted transactions" is enormously broad and pulls in many financial trades and transactions that are only tangentially related to a securitization and are routinely performed by the multitude of parties that would be scoped into the rule.

(2) The entire rule applies to a huge number of securitization participants ranging from non-bank broker-dealers, bond issuers, asset managers, asset servicers, insurance companies (including the long investors that are supposed to be the beneficiaries of the rule), and all their affiliates and subsidiaries.

Congress was clear in the Dodd Frank Act that the SEC must define the contours of the rule in such a way as to prevent material conflicts of interest in these transactions, while also protecting the healthy functioning of our capital markets. The Proposal is a sweeping regulation well beyond Congress' original intent. The SEC has taken an approach of throwing out many good – and economically vital – activities with the bad.

- The Proposal could inadvertently prohibit a broad set of market making, risk management and liquidity activities that are imperative to the funding and liquidity of the $12.5 trillion ABS market[3] which is an essential source of funding for American consumers, small business owners and home buyers.

While the re-proposed rule includes exemptions, they contain unduly restrictive conditions including extensive compliance program requirements – all modeled primarily after certain Volcker Rule proprietary trading exemptions as they apply to the largest regulated banking entities.[4] Even for banking entities that are subject to Volcker, the rule sweeps much broader than the trading desks that must comply with the Volcker Rule hedging restrictions. Because of these broad provisions, the following major problems emerge:

[1] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9679.
[2] *Id*.
[3] Figure includes outstanding CLOs, residential mortgage-backed securities ("RMBS") and commercial mortgage-backed securities ("CMBS"). Source: SFA Market Compilation; as of December 31, 2022.
[4] Conflicts Rule Re-Proposing Release, 88 Fed. Reg. 9678, 9703 (hedging activities), 9705 (market-making activities).

- Normal course transactions that help the market are prohibited.
- Many hedges that are good for managing risk cannot meet the “conditions” the rule requires.

Market participants’ ability to conduct normal course activities may be compromised in the following ways:

- Long investors now are often involved in deals before issuance, and those investors give feedback on the underlying collateral. This is a natural, built-in mechanism to help prevent the issuance of “bad” securities (which, incidentally, is the intent of the rule). Under the rule as proposed, however, long investors that are too heavily involved in collateral selection would be subject to the entire scope of the rule. Many would likely cease giving input on deal collateral, or even exit the market, which would remove one form of natural guardrails from the system.
- The rule appears to rely on Volcker type conditions to allow for hedging. But Volcker reporting is not trade-by-trade, it is a series of metrics that each desk reports. (Such as % of trades done with customers vs. dealers, among other aggregate metrics.) That reporting is not at all meaningful in the context of this rule.
- Macro hedging cannot always be tethered to a specific and quantifiable risk, as required by the “conditions” in the rule. Institutions make big picture decisions about how future changes in benchmark interest rates, credit spreads, and other market conditions could impact their business. Creating material disincentives to macro hedging would materially increase risk for institutions and the financial system more broadly.

On March 27, SFA submitted its first comment letter and stressed that the SEC has the regulatory authority to narrow the scope of the Proposed Rule. On July 13, SFA submitted a second supplemental letter to the Commission detailing market-wide consensus recommendations for how to address the re-proposed Rule’s critical flaws.

- 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, 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.
- The significant costs of the compliance program requirement and regulatory uncertainty created by the rule may cause some market participants exit their securitization business or to stop investing in ABS and would deter new entrants to the market.

Members of Congress echo industry concerns and have urged the SEC to carefully consider all stakeholder input and market implications prior to implementing a final rule.

Members of Congress from both political parties that serve on the House Financial Services and Senate Banking Committees have engaged on the Proposal since its release. This includes raising industry concerns during congressional hearings with regulator witnesses, submitting Questions for the Record following such hearings, writing letters to the SEC, and meeting directly with SEC Chair Gary Gensler and other Commission staff.

Most recently, Rep. Brad Sherman (D-CA) submitted a letter to SEC Chair Gensler expressing concerns about the Proposal’s broad scope. Followed by Rep. Andy Barr (R-KY) and Rep. Ann Wagner (R-MO) who wrote to prudential regulators echoing similar concerns and requested they review the potential unintended consequences that could arise for ABS markets and respond in writing with their findings.

STRUCTURED FINANCE ASSOCIATION

SFA Staff Contact List

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