

**MEMO# 25548**

October 10, 2011

# **SEC Proposes Rule Prohibiting ABS Conflicts of Interest; Call Scheduled for October 20**

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TO: SEC RULES COMMITTEE No. 85-11  
FIXED-INCOME ADVISORY COMMITTEE No. 73-11  
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 46-11  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 51-11 RE: SEC PROPOSES RULE  
PROHIBITING ABS CONFLICTS OF INTEREST; CALL SCHEDULED FOR OCTOBER 20

The Securities and Exchange Commission (the “SEC” or “Commission”) recently proposed Rule 127B under the Securities Act of 1933 (“Securities Act”) to implement the prohibition under Section 621 of the Dodd-Frank Act on material conflicts of interest in connection with certain securitizations (“Proposed Rule”). [\[1\]](#) The Proposed Rule is summarized below.

Comments on the Proposed Rule are due to the SEC no later than December 19, 2011. We will hold a conference call on October 20, 2011, at 2 p.m. Eastern time, to discuss the Institute’s comments relating to the SEC’s Proposed Rule. The dial-in number is 888-324-9361 and the passcode is 32660. Please let Jennifer Odom ([jodom@ici.org](mailto:jodom@ici.org) or 202-326-5833) know if you will participate on the call.

## **Background**

Section 621 of the Dodd-Frank Act added Section 27B to the Securities Act, which prohibits an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity of an asset-backed security (“ABS”), as defined in Section 3 of the Securities Exchange Act of 1934 (“Exchange Act”), [\[2\]](#) but also including a synthetic ABS, from engaging in a transaction that would involve or result in certain material conflicts of interest. [\[3\]](#) The prohibition applies both to registered and unregistered offerings of ABS, and applies during the period ending on the date that is one year after the date of the first closing of the sale of the ABS. Section 27B provides exceptions from the prohibition for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making, and directs the SEC to engage in rulemaking to implement the section’s prohibition.

# Proposed Rule

## A. Conditions of Proposed Rule

The Commission's Proposed Rule closely mirrors the text of Section 27B. The Commission states that there are five key conditions that are required in order for the Proposed Rule to apply. A relevant transaction must involve: (1) covered persons; (2) covered products; (3) a covered timeframe; (4) covered conflicts; and (5) a "material conflict of interest." These elements are described below.

**Covered Persons** – The Proposed Rule would apply to an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an ABS. The term "underwriter" is defined in the Securities Act. The Commission notes that the other terms are not defined, for purposes of Section 27B, and does not propose to define them at this time. The Commission states that it preliminarily believes that terms such as placement agent and initial purchaser are sufficiently well understood in the context of the market for ABS. It requests comment on whether it should provide definitions for any or all of these terms.

**Covered Products** – The Proposed Rule, like Section 27B, would apply with respect to an ABS as defined in Section 3 of the Exchange Act, but also including a synthetic ABS. The Commission does not propose to define the term "synthetic asset-backed security," but requests comment on whether it should do so. Like Section 27B, the Proposed Rule would apply both registered and exempt ABS offerings.

**Covered Timeframe** – If a transaction occurs in the period prior to one year after the date of the first closing of the sale of the ABS, it would be covered by the Proposed Rule. The Commission requests comment on whether the Proposed Rule should specify the beginning point in time at which the rule would apply; for example, the point at which a person becomes a securitization participant, the first closing, or some other point in time.

**Covered Conflicts of Interest** – The Commission explains that there would not be a covered conflict of interest involved if the conflict in question (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." Specifically, the Commission states that "conflicts of interest arising solely among investors in the ABS offering (where investors could include securitization participants) provided these conflicts arise only from their interests as an investor) would also not be covered by the Proposed Rule." [\[4\]](#)

**"Material Conflict of Interest"** – Section 27B and the Proposed Rule would not apply if a conflict of interest is not a "material conflict of interest." The Proposed Rule does not define the term "material conflict of interest," but the Commission proposes an interpretation that, for purposes of the Proposed Rule, engaging in any transaction [\[5\]](#) would involve or result in a material conflict of interest between a securitization participant and investors in the relevant ABS if:

(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 (each of these, a "short

transaction”); or

(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 conflict important to his or her investment decision (including a decision to retain the security or not).

Notably, under this test, the analysis does not turn on whether the securitization participant intentionally designed the ABS to fail, but whether the securitization participant would benefit, through the actual, anticipated or potential decline in the market value of the ABS.

## **B. Exceptions**

Consistent with Section 27B, the Proposed Rule would provide exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making. The language of these exceptions is closely modeled on Section 27B; however, the Commission has provided commentary in the proposing release regarding its intent. The Commission states that it preliminarily believes that all of the exceptions would apply to affiliates and subsidiaries of securitization participants.

**Risk-Mitigating Hedging Activities** – This exception uses the same language as Section 27B. [6] The Commission states that the proposed exception is designed to reduce the specific risk to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings, and is not intended to permit speculative trading masked as hedging activities.

**Liquidity Commitments** – This exception, which also tracks the language of Section 27B, [7] would permit securitization participants and their affiliates to provide liquidity pursuant to a commitment. The Commission notes that liquidity commitments may include a variety of activities, including asset-backed commercial paper liquidity facilities.

**Bona Fide Market-Making Exception** – This exception, which closely tracks the language of Section 27B, [8] would permit purchases or sales of ABS to be made pursuant to and consistent with bona fide market-making in the ABS. The Commission enumerates eight principles it preliminarily believes are characteristics of bona fide market-making in ABS, and notes that the fact that trading is carried out in a market-making account or on a market-making desk would not be determinative of whether the trading is bona fide market-making.

## **C. Other Matters**

The Commission discusses, and requests comment on, application of the Proposed Rule to activities undertaken by securitization participants that are unrelated to the securitization. The Commission notes that the Proposed Rule neither would prohibit the multi-tranche structure typically used in ABS transactions, nor would mere ownership by a securitization participant of the ABS constitute a material conflict of interest under the Proposed Rule.

The Commission discusses the similarities between Section 621 of the Dodd-Frank Act and Section 619 of the Dodd-Frank Act (the “Volker Rule”). Both address conflicts of interest, and include concepts of permitted activities concerning market-making related activities and risk-mitigating hedging activities. The Commission states that it may consider whether aspects of the rules adopted to implement the Volker Rule should be applied to the Proposed Rule in the future. The Commission states that its preliminary belief is that the exceptions for risk-mitigating hedging activities and bona fide market-making activities for purposes of the Proposed Rule should be viewed no less narrowly than the comparable exceptions for such activities under the Volker Rule.

Commenters suggested that the Commission consider whether information barriers could serve as a means to reduce potential burdens triggered by Section 27B on a securitization participant’s affiliates that engage in ordinary course activity. The Commission states that it preliminarily believes it may be appropriate to consider the issue of independent units within a multi-service firm in the context of the Proposed Rule, and requests comment. The Commission also requests comment regarding the extent to which disclosure might mitigate conflicts in the context of Section 27B and the Proposed Rule.

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#### **endnotes**

[1] Prohibition against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65255 (September 19, 2011), available at <http://www.sec.gov/rules/proposed/2011/34-65355.pdf>.

[2] The definition of an ABS under the Exchange Act is much broader than the definition of an ABS under Regulation AB under the Securities Act.

[3] See Section 27B of the Securities Act.

[4] The Commission notes, in this regard, that the Proposed Rule is not intended to prohibit the multi-tranche structures commonly used in ABS offerings, even though those structures may inherently involve conflicts of interest between the various classes of investors.

[5] A transaction would include effecting a short sale of securities offered in the ABS transaction or its underlying assets, or buying CDS protection on the relevant ABS or its underlying assets.

[6] The Proposed Rule states that the following would not be prohibited: Risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with such positions or holdings.

[7] The Proposed Rule states that the following would not be prohibited: Purchases or sales of asset-backed securities made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, to provide liquidity for the asset-backed security.

[\[8\]](#) The Proposed Rule states that the following would not be prohibited: Purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security.

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