SEC's Conflicts of Interest Rule Proposal Preserves Considerable SEC Discretion and Creates Market Uncertainty

The SEC's proposed Conflicts of Interest rule for asset-backed securities is so broad that, if adopted as proposed, it would by itself provide little guidance as to its scope and would leave industry participants dependent on further SEC interpretations and proceedings to determine the types of actions that might violate the rule. Even with the benefit of the commentary in the proposing release, many questions remain unanswered, including the following:

- Will transactions specifically designed to have investors in a securitization knowingly take risk for the benefit of a sponsor or third party (e.g., synthetic securitizations or catastrophe bonds) still be possible?
- How can one design a hedging strategy which adequately protects against risk, and is a portfolio hedging strategy still permitted?
- In what cases might disclosure or information barriers be adequate to prevent a violation of the rule?

This client memorandum provides a quick summary and analysis of the potential impact of the proposed rule.

On Monday, September 19, 2011, the Securities and Exchange Commission (the "**Commission**") issued its Release No. 34-65355 (the "**Proposing Release**") proposing for comment a new Rule 127B (the "**Proposed Rule**") under the Securities Act of 1933, as amended (the "**Securities Act**"). The Proposed Rule is designed to implement the prohibition under Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**") against material conflicts of interest in connection with certain securitizations. The Proposed Rule "would prohibit certain persons who create and distribute an asset-backed security ("**ABS**"), including a synthetic ABS, from engaging in transactions, within one year after the date of the first closing of the sale of the ABS, that would involve or result in a material conflict of interest with respect to any investor in the ABS." Comments are being solicited by the Commission on many aspects of the Proposed Rule, and given the ambiguity and uncertainty in the Proposing Release, such comments are likely to be viewed by many as critical to achieving a reasonable final rule. Comments are due on or before December 19, 2011.

Section 621 of the Dodd-Frank Act states that "[a]n underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security . . . shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity," subject to certain specific exceptions.

The Proposed Rule generally mirrors the statutory provision included in the Dodd-Frank Act, leaving the Commission with considerable discretion. The Proposing Release gives guidance as to the Commission's intent, however, and sets out five conditions that are required for the application of the Proposed Rule. In order for the Proposed Rule to apply, the relevant transaction must involve (1) covered persons, (2) covered products, (3) a covered timeframe, (4) covered conflicts and (5) a "material conflict of interest." The Proposing Release also discusses specific exemptions, the interaction of the Proposed Rule with the anticipated "Volcker Rule" and whether disclosure and/or information barriers are adequate ways to handle conflicts of interest, and presents examples to illustrate the applicability of the Proposed Rule.

It remains largely speculative as to which types of actions might be targeted by the Commission under the Proposed Rule. The Proposing Release states that the intent is to "prohibit securitization participants from benefiting from the failure of financial instruments that they help structure, offer and sell to investors." Clearly, selling securities to investors and simultaneously seeking to profit through short sales of such securities would present such a conflict in the Commission's eyes, as is clear from the Commission's actions against investment banks that have allegedly engaged in such practices. However, the Proposed Rule does not clearly identify prohibited activities. Therefore, it may be difficult to ascertain whether certain other activities will be permissible under the Proposed Rule.

- Will transactions specifically designed to have investors in a securitization knowingly take risk for the benefit of a sponsor or third party be possible? For example, will synthetic securitizations still be possible, given that they involve the sale of credit protection to a sponsor, or to a third party for compensation, whose investment experience will be the exact opposite of investors in the securitization? Will catastrophe bonds be possible?

- Where will the line be drawn between permissible hedging to reduce risk of a long position in the securities, on the one hand, and engaging in the same transactions with a view to making a profit (an action that would be prohibited under the Proposed Rule)? Must hedges either be perfect, or be conservatively less than would be prudent to ensure that one cannot profit more from the hedge than might be realized as a loss on the corresponding security, even in a volatile market? Is a portfolio hedging strategy still permitted, or must hedges now be paired with specific securitizations to ensure that there is little opportunity for profit?

- How do market participants differentiate between transactions that have a clear conflict of interest, and others that represent the desire of a fully knowledgeable party to take a point of view on a trade?

- Given the potential scope of the Proposed Rule, will it have an unnecessary adverse impact on the markets for asset-backed securities and inhibit many activities currently undertaken by market participants?

Unfortunately, the Proposed Rule presents little clarification beyond the language of the statute itself, leaving considerable room for interpretation. It is expected that commentary in the Proposed Release and the release adopting the final rule, as well as Commission staff interpretations, will ultimately play a major role in determining the impact of the Proposed Rule when adopted. Industry participants are likely initially to be left with compliance requirements without detailed guidance, and their attorneys will have to closely monitor Commission staff interpretations to determine the limits of permissible behavior. The problem is exacerbated by a proposed standard of liability that is based on a vague standard of materiality, and without a corresponding requirement of intent to create or benefit from the conflict.

The principal concerns with respect to the Proposed Rule may be focused on three particular aspects of the Commission's presentation in the Proposed Release:

- The proposal requires that the conflict involve a "transaction" but does not distinguish between transactions that are integral to a securitization and those that are separate. The transactions that created a focus on conflicts, namely short sales and other transactions that benefitted an investment bank upon failures of the very securities they were selling, were not fundamental to the securitization itself, continued after the securitization and were done without disclosure. Having the issuer issue credit protection or catastrophe risk protection to the sponsor or a third party, on the other hand, is fundamental to the transaction and subject to full disclosure, and therefore appears less ripe for abuse. Sales of securities are often made on the basis that the seller and buyer have different views as to the prospects of such securities. Why prohibit such transactions in the context of ABS under the guise that they present conflicts of interest?

- The Proposing Release questions whether disclosure alone is an adequate method to deal with conflicts of interest. The philosophy of the securities laws has focused on requiring full and adequate disclosure, but then letting investors make their own judgments as to the merits of the offered securities. Why should a different approach be used for ABS? Unfortunately, the Proposed Rule would represent a fundamental change in the approach to offerings of securities by substantively altering the types of transactions that may be done, taking the judgment about the merits of securities away from potential investors who may wish to make their own judgment with full disclosure, and doing so exclusively with ABS transactions, apparently under the presumption that the complexity of ABS makes an investor more dependent on the recommendation of the selling investment banker (and therefore more sensitive to whether that recommendation is being made by someone with a conflict of interest) than is the case with other securities.

- The language of the statute and the rule impose strict liability for engaging in a transaction that results in a conflict of interest. In its release, the Commission underscored that intent is not an element of the violation. In contrast to Rule 10b-5 under the 1934 Act, there is no requirement of "scienter." Therefore, the Proposed Rule would present the possibility of being subject to a proceeding by the Commission without having intent, or even reckless disregard, in an environment where the guidelines of what constitutes a conflict of interest are undefined and hence extremely vague.

The following sets out a summary of the Proposed Rule as presented in the Proposing Release, as well as the impact the various provisions may have.

The Five Conditions of the Rule

The Commission has indicated in the Proposing Release that each of the following conditions must be present in order for the prohibition under the Proposed Rule to apply (such that the absence of any one condition would make the prohibition inapplicable), even though the Proposed Rule as written does not define any of these criteria:

- *Covered Persons*. The Proposed Rule covers only the actions of an ABS underwriter, placement agent, initial purchaser or sponsor, or any affiliate or subsidiary of such entity (collectively, "**Securitization Participants**"). The term "underwriter" is currently defined in the securities laws and regulations. The Commission has indicated it does not intend to define "placement agent" or "initial purchaser," viewing those terms as unambiguous, and apparently intended "initial purchaser" to refer to the investment bank in the sales process and not to an ultimate investor purchasing directly from the issuer. The Commission has indicated that it may broaden the term "sponsor" relative to how that term is used in Regulation AB, particularly to pick up synthetic transactions. The Commission has also indicated that a collateral manager should likely come within the scope of the Proposed Rule based on such entity's role in structuring the ABS transaction and selecting the related assets, and may include other key participants in the creation of a securitization within that term.

- *Covered Products*. The Securitization Participant must be involved in a transaction involving "asset-backed securities" as defined under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), broadened to include "synthetic securitizations," a term that the Commission proposes not to define. The Exchange Act definition of "asset-backed security" is much broader than the definition as used under the Securities Act, and specifically includes exempt securities such as Fannie Mae and Freddie Mac certificates and municipal securities, and securities sold in exempt transactions such as private placements, as well as securities not backed by a discrete pool of assets.

- *Covered Time Frame*. The action giving rise to the conflict must occur within a specified time ending one year after the date of the first closing of the sale of the related ABS. The Commission has indicated that the Proposed Rule would apply before the closing date of an ABS transaction. However, it is currently unclear at what point <u>prior</u> to such closing the Proposed Rule would begin to apply, and the Commission does not propose to clarify the start date.

- *Covered Conflicts*. The Proposed Rule would cover only conflicts between Securitization Participants, on the one hand, and investors, on the other, and therefore would not relate to conflicts exclusively between Securitization Participants or exclusively between investors. Further, the Proposed Rule would only apply to those conflicts that arise as a result of or in connection with the related ABS transaction, therefore explicitly not covering conflicts of interest that happen to arise between the same parties but that are unrelated to their status as a Securitization Participant and investor, respectively. Finally, the conflict of interest must arise as a result of, or in connection with, "engaging in any transaction."

  The Commission provides examples of "engaging in any transaction," including, but not limited to, effecting a short sale of, or purchasing a credit default swap on, securities offered in the ABS transaction or its underlying assets and the Securitization Participant selecting assets, directly or indirectly, for the underlying asset pool. Note that "engaging in a transaction" can be part of the securitization itself, such as entering into a credit default swap with the securitization issuer in a typical synthetic securitization, a transaction which could violate the Proposed Rule if it does not fit within the risk mitigation exception described below.

- *Materiality*. Finally, the conflict must be "material." The Commission declined to define the term "material conflict of interest." Rather, in determining whether the conflict would be material, the Commission suggests the use of the following two-prong test (both prongs of which must be satisfied for there to be a violation under the Proposed Rule):

  - Either: (a) the Securitization Participant must benefit directly or indirectly from the actual, anticipated or potential (1) adverse performance of the asset pool supporting or referenced by the relevant ABS, (2) loss of principal, monetary default or early amortization event on the ABS or (3) decline in the market value of the relevant ABS (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

- There must be 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).

The first prong of the test is a measure of whether the conflict presents an opportunity for the covered person to benefit from the poor performance of the ABS through a "short transaction." The first prong of the test also includes an anti-evasion provision, which prevents a covered person from creating an opportunity for a third party to benefit from such poor performance and to be compensated for so doing. The second prong of the test is a traditional materiality test, grounded in whether it would affect the investment decision of a "reasonable" investor.

The Commission specifically stated that "[i]t would not be necessary for a securitization participant to intentionally design an ABS to fail or default in order to trigger the rule's prohibition." It would appear, however, that some continuing ability to benefit from the adverse events to the securitization described above would be a critical element. In the examples in the Proposed Release, for example, the Commission makes clear that the mere disposition of risk on sold assets by selling such assets is not the type of conflict that the rule was designed to prevent.

The Commission's proposed materiality test is intended to directly address those types of activities that the Proposed Rule was intended to prohibit — situations in which a Securitization Participant engages in a transaction through which it benefits when the related ABS fails or performs adversely or has the potential to fail or perform adversely and there is a substantial likelihood that a reasonable investor would consider the fact of such benefit important to his or her investment decision. The identification by the Commission of a credit default swap counterparty in a synthetic securitization as being in a conflict of interests situation would indicate that the opportunity to benefit need not be outside the context of the securitization itself and may be simply having hedged the risk on reference assets on which credit protection was acquired.

The Commission has solicited comment regarding any potential consequences of not defining the term "material conflict of interest" in the Proposed Rule. In particular, the Commission is concerned with whether or not there may be an unintended chilling effect on securitization transactions resulting from potential uncertainty associated with not defining the term "material conflict of interest."

Exceptions

The Proposed Rule provides exceptions for risk-mitigating hedging activities, liquidity commitments and bona fide market-making.

- *Risk-Mitigating Activities*. The Proposed Rule provides an exception for risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS, provided that such activities are designed to reduce the specific risks to the Securitization Participant associated with such positions or holdings. Risk-mitigating hedging would specifically not include trading to establish new positions or other hedging activities designed to earn a profit. In addition, over-hedged exposure may be indicative of a proprietary position rather than a risk-mitigating hedge and would therefore not qualify as a risk-mitigating hedge for purposes of the Proposed Rule.

An example in the Proposing Release indicates that the purchase by a sponsor from the issuer of credit protection (a typical synthetic securitization element) would not qualify for the risk-mitigation exception if it hedges risk on assets held as a long position that were not acquired in connection with underwriting activities. Similarly, a credit default swap entered into with the issuer and back-to-back with another credit default swap with a third party that did not select the reference assets would be permissible risk mitigation, but a credit default swap created to hedge against pre-existing credit default swaps with third parties would not.

- *Liquidity Commitments*. The Proposed Rule provides an exception for Securitization Participants (including affiliates and subsidiaries) providing liquidity for the ABS pursuant to a commitment.

- *Bona-Fide Market-Making*. The Proposed Rule provides an exception for purchases or sales of ABS made pursuant to and consistent with bona fide market-making by Securitization Participants (including their affiliates and subsidiaries) in an ABS. In determining if activities qualify as bona fide market-making for purposes of the Proposed Rule, the Commission has identified certain principles as characteristics of bona fide market-making in ABS, including that it involve secondary market trading in which the Securitization Participant hold itself out as both willing buyer and willing seller in customer-initiated transactions, and accordingly does not involve the taking of speculative positions or open positions far in excess of those in the normal course of business.

  Depending on the facts and circumstances, bona fide market-making that does not meet each of the stated criteria may still be bona fide market-making for purposes of eligibility under the proposed exception. The Commission's primary objective is to ensure that Securitization Participants do not attempt to disguise proprietary trading as bona fide market-making.

Relationship to the Volcker Rule

The Commission has expressed its view that the Proposed Rule is similar to the Volcker Rule in that it is concerned with conflicts of interest. For example, the Volcker Rule is concerned with conflicts of interest that stem from proprietary trading at banking and non-bank financial firms. In addition, the Volcker Rule, like the Proposed Rule, includes the concepts of certain permitted activities concerning market-making related activities and risk-mitigating hedging activities. Given the similarities between these two rules, the Commission has requested comment on whether the exceptions for risk-mitigating hedging activities and bona fide market-making activities for purposes of the Proposed Rule should apply to such activities under the Volcker Rule.

Potential Methods for Avoiding Liability Under the Proposed Rules

The Commission recognizes that information barriers and disclosure are often used as tools to manage conflicts of interest in other areas of the federal securities laws. The Commission is therefore open to considering whether these tools might permit the Proposed Rule to better achieve its policy objectives without unnecessarily restricting beneficial market activities.

Section 28 of the Securities Act provides the Commission with authority to adopt conditional or unconditional exemptive rules or regulations "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." The Commission therefore seeks comment on whether and to what extent it should consider exemptive rules or regulations for certain transactions or activities otherwise covered by the Proposed Rule, including conditional exemptions based on information barriers or disclosure.

Please feel free to contact any of the following Kaye Scholer attorneys if you have any questions about this Client Memorandum.

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