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TO: The CRE Finance Council

FROM: Scott A. Sinder
Rhonda M. Bolton

RE: Proposed Securities and Exchange Commission Rule to Prohibit Conflicts of Interest in Certain Securitizations

I. Overview

As required by Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Securities and Exchange Commission (“SEC”) recently issued a proposed rule to prohibit certain conflicts of interest between entities involved in securitizing assets and those that invest in such assets.¹ The proposed new Securities Act Rule 127B may be a disappointment to anyone hoping for very precise delineation of what constitutes prohibited activity. Instead, the rule largely duplicates the text of the statutory provision, and the Proposing Release relies on broad principles, descriptions, and examples to provide market participants with guidance on avoiding the rule’s proscriptions.

A key term in the new framework is only vaguely described – “material” conflict of interest. Indeed, the Proposing Release states that the Commission has consciously avoided offering a precise definition for fear of being under- or over-inclusive, and that the agency expects to define materiality through interpretive guidance rather than regulatory language. The Commission does express, however, the expectation that “most activities undertaken in connection with the securitization process would not be prohibited by the proposed rule,” citing

¹ Proposed Rule, Prohibition against Conflicts of Interest in Certain Securitizations, Release No. 34-65355; File No. S7-38-11 (Sept. 19, 2011) (hereafter, “Proposing Release”), available at www.sec.gov/rules/proposed/2011/34-65355.pdf.

in particular, activities that include exercising the contractual right to remove a special servicer and structuring the right to receive excess spreads.

Importantly, the Proposing Release includes exceptions the securitization industry, including the CRE Finance Council, succeeded in incorporating into the statute, which specify that risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities are permitted under the rule. Like much else in the rule, however, these exceptions are not precisely defined. Ultimately, it may be more advantageous for this new conflict-of-interest framework to be principles-based, as the SEC proposes, rather than having rules that attempt to enumerate every type of prohibited transaction. But it is likely that the industry will desire more clarity even for a principles-based approach, especially with respect to a determinative factor such as materiality. The Commission seeks input on its overall approach, and market participants should consider this issue as part of their evaluation of the proposed rules.

A final notable aspect of the proposed rule are certain “philosophical” observations the Commission makes. These observations are interesting in light of the Commission’s recent castigation by a federal appeals court which, upon review of the new proxy access requirements in SEC Rule 14a-11, overturned those rules because the agency had inappropriately failed to consider that rule’s effect upon efficiency, competition and capital formation.² Examples of these notable observations include the statement in the Proposing Release that “[the Commission] recognize[s] that – like other prophylactic conflict of interest rules – the proposed rule and interpretation might limit certain investment activities that might otherwise be made for bona fide purposes.... We therefore acknowledge the concern that this proposal might have unintended effects, such as potentially limiting investment opportunities for investors if a securitization participant refrains from structuring and selling ABS in reaction to this proposal.”³

As a result, the Commission asks for specific comment on the unintended effects the rule may have that could “impact liquidity, capital formation, the maintenance of fair, orderly and efficient markets and the availability of credit to borrowers (through assets underlying an ABS).” The CRE Finance Council has long encouraged the agency to consider these concerns when adopting rules that affect securitization; thus, to the extent such concerns are created by the proposed conflict-of-interest framework, the industry’s comments should emphasize those concerns. Comments on the proposed rule are due December 19, 2011.

II. Analysis

The Proposing Release defines several conditions that must exist for the rule to apply; describes “conflicts of interest;” discusses the concept of “material” conflicts; and discusses the rule’s exceptions. The Proposing Release then provides some hypothetical examples to illuminate market participants’ analysis of contemplated transactions. Each of these matters is discussed in further detail below.

² *Business Roundtable v. SEC*, No. 10-1305 (D.C. Cir. July 22, 2011).

³ Proposing Release at 40.

A. Conditions for the Rule to Apply

The Proposing Release first specifies the five conditions must occur before the rule will 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”.

All of these conditions must be present in order for the prohibition under the proposed rule to apply.

1. Covered persons

“Covered persons” are defined as an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of such entity, of an ABS (collectively described as “securitization participants”).⁴

Of these terms, only “underwriter” is defined in the proposed rule, by reference to Section 2(a)(11) of the Securities Act. The Commission notes that “sponsor” is a defined term under SEC Regulation AB, but states that it will not employ the Regulation AB definition for purposes of this rule because the Regulation AB definition is not sufficiently broad, for example, it does not identify all entities that could be involved in the structure and sale of a synthetic ABS transaction. Further, the Commission does not propose to define the remaining categories of covered persons, explaining that the terms are well understood in the securitization industry, as evidenced by their use in securitization documents.⁵ The Proposing Release seeks comment on whether further definition of these terms is needed.

2. Covered products

The proposed rule would apply to an “asset-backed security” as the term is defined in the Exchange Act, but includes synthetic ABS for purposes of the proposed rule. An asset-backed security means, therefore:

- (i) a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a security or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flows from the asset, including –

⁴ *Id.* at 19-20.

⁵ *Id.* at 20.

- (a) a collateralized mortgage obligation;
- (b) a collateralized debt obligation;
- (c) a collateralized bond obligation;
- (d) a collateralized debt obligation of asset-backed securities;
- (e) a collateralized debt obligation of collateralized debt obligations; and
- (f) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

(ii) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.⁶

Notably, although synthetic ABS are explicitly covered by the proposed rule, the Commission does not propose to define synthetic ABS, once again because it believes the term is well understood by the industry.⁷ The proposed rule applies to registered as well as unregistered securities.

3. Covered timeframe

The prohibitions in the rule apply “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.”⁸ The Proposing Release explains that this means there is an end date for the prohibitions, such that the prohibitions will no longer apply, but that there is no start date. The Commission states that using a finite start date to apply the prohibitions, such as the date of the first closing of the sale of the ABS, might be under-inclusive: “prior to the first closing, securitization participants involved in structuring and marketing an ABS may engage in transactions involving or resulting in material conflicts of interest that in form or effect are, for purposes of the proposed rule, difficult to distinguish from similar transactions occurring after the first closing.”⁹ For this reason, the Commission concludes that it should not use date of first sale as a starting point, but seeks comment on whether this approach is appropriate.

4. Covered conflicts

The rule will only apply to certain types of “conflict” situations. Most notable in the Commission’s analysis is the recognition that securitization involves some inherent conflict of

⁶ Exchange Act Section 3(a)(77), added by Dodd-Frank Section 941.

⁷ *Id.* at 26.

⁸ Proposing Release at 29.

⁹ *Id.* at 30.

interests, because of characteristics such as the fact that securitization is a risk transfer model.¹⁰ This is a concept the CRE Finance Council has emphasized to the Commission, and it is a positive development to see the Commission acknowledge this reality here. The Commission has accordingly concluded that the prohibitions cannot reasonably apply to every literal conflict that might arise in a securitization, but has identified four situations as “covered conflicts:”

i) the conflict occurs between a securitization participant with respect to an ABS, and an investor in such ABS, whether or not that investor purchased the ABS from the securitization participant;¹¹

ii) conflicts that arise solely between investors in the ABS offering (where investors could include securitization participants, provided these conflicts arise only from their interests as an investor) would not be covered by the proposed rule. The Commission advises that this means that the prohibitions would not address other conflicts of interest that happen to arise between these same parties but that are unrelated to their status as a securitization participant and investor, respectively. Thus, for example, the Commission goes on to advise that “the proposed rule is not intended to prohibit the multi-tranche structures commonly used in ABS offerings, even though those structures may involve conflicts between the interests of various classes of investors in the offering by virtue of the different risks and rewards associated with such tranches.”¹²

iii) the prohibition will only apply to those conflicts of interest between a securitization participant and an investor that arise as a result of or in connection with the related ABS transaction. The Commission advises that the rule accordingly does not address other conflicts that could arise between the same parties but that are unrelated to their status as a securitization participant and investor, respectively;¹³ and

(iv) the conflict must arise as a result of or in connection with “engaging in any transaction.”¹⁴ “Engaging in any transaction” would include, but not be limited to, effecting a short sale of, or purchasing CDS protection on, securities offered in the ABS transaction or its underlying assets.¹⁵ “Engag[ing] in any transaction” would also include the securitization participant selecting assets, directly or indirectly, for the underlying asset pool and selling those assets to the special purpose entity (“SPE”).¹⁶ The Commission recognizes that not every

¹⁰ *See id.* at 36, 40.

¹¹ *Id.* at 31-32.

¹² *Id.* at 32.

¹³ *Id.*

¹⁴ *Id.* at 33.

¹⁵ *Id.*

¹⁶ *Id.*

activity undertaken by a securitization participant should be considered “engaging in any transaction,” and advises that the issuance of investment research, for example, would not be considered “engaging in a[] transaction.”¹⁷

5. Description of a “material conflict of interest”

Once it is determined that covered persons, products, time period and conflicts are involved, the crux of the analysis becomes whether the conflict is material. Here the vagueness of the Proposing Release reaches perhaps its highest point, because the Commission offers only some broad principles, and then a few examples, to explain its concept of materiality. The scope of a “material” conflict is described as occurring where:

i) Either

A) a securitization participant would benefit directly or indirectly from the actual, *anticipated or potential*¹⁸ (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 (referred to in the Proposing Release 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

ii) 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).¹⁹

The purpose of the rule and the Commission’s interpretation is summarized as seeking to “help prohibit the securitization participant from structuring and offering the ABS to investors on

¹⁷ *Id.*

¹⁸ Note the inclusion of even “anticipated or potential” benefit. The Proposing Release advises that this means if a securitization participant effected a short transaction in the ABS, it would not be necessary for the market value of the ABS to actually decline in order for a “material conflict of interest” to arise. It would be sufficient that the securitization participant engaged in a transaction under which it would benefit if the market value of the ABS were to decline. *Id.* at 38-39. Note further, that it is not necessary for a participant to intentionally design an ABS to default in order to run afoul of the rule. *Id.*

¹⁹ *Id.* at 37-38 (emphasis in original).

the premise that it will be a good investment when the securitization participant has either structured the transaction in a manner that is designed to fail or takes other actions (i.e. entering into a short transaction) through which it will profit from such failure.”²⁰ The Proposing Release goes on to say that nothing in the Commission’s interpretation would prevent a securitization participant from taking positions in which its economic interests would be aligned with the investors in the ABS it has created and sold – such as by purchasing the ABS, and for this reason, the Proposed Rule’s requirements will not be inconsistent with, or interfere, with the requirements imposed by the risk retention framework currently being developed by federal regulators.²¹

The Proposing Release goes on to describe a number of examples of situations that would or would not be material conflicts. The examples provide the most concrete guidance of where to draw the “materiality” line, and are probably helpful in “bright-line” situations, but may not offer sufficient guidance where there are gray areas. One example advises, for instance, that where a securitization participant purchases credit default swap (“CDS”) protection on the securities offered in the relevant ABS three months after the date of the first closing of the sale of the ABS, such a transaction would be a short transaction that is prohibited by the new rule as there will be material conflict of interest between the securitization participant and the ABS investors because the securitization participant would profit from the adverse performance of the ABS (unless, as discussed below, the market-making exception applies).²²

The Proposing Release seeks comment on its interpretation of materiality and on whether the examples accurately describe activity that should or should not be prohibited. Comment is sought as well on whether other examples should be included to provide more accurate or practical guidance.

Note that the Proposed Rule does not presently allow for use of information barriers (also referred to as “walling off” certain affiliates or disclosures for the purpose of mitigating conflicts of interest. The Proposing Release acknowledges that such measures may be useful in limited contexts, and seeks comment on whether there is a role for these types of measures in the new rule.²³

B. Exceptions

As discussed, the Proposed Rule includes exceptions the securitization industry, including the CRE Finance Council, succeeded in incorporating into the statute. Even if a transaction meets all of the foregoing criteria for being prohibited, the rule would not proscribe

²⁰ *Id.* at 41.

²¹ *See id.* at 79.

²² *See id.* at 68 (“Example 1).

²³ *Id.* at 83-91.

the transaction if it is undertaken in the context of risk-mitigating hedging, liquidity commitments, and bona fide market-making activities. Like much else in the rule, these exceptions are described through the use of examples rather than being precisely defined.

These exceptions should be examined by CMBS industry participants with a view toward determining whether they are sufficiently and appropriately defined from the CMBS perspective.

1. Exception for Risk-mitigating hedging activities

The exception for risk-mitigating hedging activities mirrors the text of the statute:

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.²⁴

The Proposing Release advises that the goal of the exception is “to allow certain hedging activities that are designed to reduce or mitigate risk for the underwriter, placement agent, initial purchaser, or sponsor, where risk mitigation refers to the practice of limiting the consequences of a risk, without necessarily reducing the probability of the risk occurring.”²⁵ Affiliates and subsidiaries of securitization participants will be allowed to have the benefit of the risk-mitigating hedging exception.²⁶

Because, the Commission observes, risk-mitigating hedging activities are generally effected to reduce risk from an existing position or a position about to be taken, the Commission advises that the risk-mitigating hedging activities would be required to occur in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS, and that the activities would be required to be designed to reduce the specific risk to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings.²⁷

To distinguish between legitimate hedges and speculative activity, the Proposing Release warns that permissible hedging will not include trading to establish new positions designed to earn a profit, and that a permissible hedge generally should unwind as exposure is reduced. Moreover, activity would not qualify as a risk-mitigating hedge for purposes of the proposed rule if the predicted performance of the hedge throughout the length of time that the hedge and the

²⁴ *Id.* at 53 (citing Securities Act Section 27B(c)(1)).

²⁵ *Id.*

²⁶ *Id.*

²⁷ *See id.* at 54.

related position were held, resulted in a situation in which incrementally poor performance of an ABS or its underlying assets would result in a securitization participant earning appreciably more profits on the hedge than the losses incurred from their ABS exposure.²⁸

The Proposing Release provides several examples to illuminate the concept of permissible hedging. For instance, in a situation in which an underwriter purchases ABS that it distributed and contemporaneously purchases CDS protection on the ABS, the Commission concludes that the risk-mitigation hedging exception could apply because the securitization participant is hedging a position arising out of the underwriting, placement, initial purchase or sponsorship of an ABS.²⁹ But the benefit of the exception would be lost, the Proposing Release warns, if the CDS transaction is structured such that under some circumstances, now or in the future, the recovery on the CDS might be “appreciably greater” than the exposure on the ABS; in such case, the securitization participant would profit from the adverse performance of the ABS through a short transaction (i.e., the CDS), and the securitization participant would not be managing risk, but instead would have a risk-taking position directionally opposed to the ABS (in the amount of the CDS exposure that exceeds what is necessary for a delta neutral hedge), according to the Commission.³⁰

Other examples describe the use of synthetic ABS to engage in permissible and non-permissible transactions. For instance, where the underwriter in the above hypothetical is a party to a CDS contract with the issuing SPE, and is, thereby, short the credit exposure of the reference portfolio underlying the ABS transaction, and does not have any exposure to the ABS or underlying assets other than its short position through the CDS transaction, the Proposing Release states that entering into the CDS with the issuer of the ABS would, by itself, generally give rise to a prohibited material conflict of interest between the underwriter and the ABS investors.³¹ Further, if the underwriter’s short exposure under the CDS with the issuer offsets the underwriter’s existing long exposure to the same assets underlying the ABS because, perhaps, the underwriter seeks to reduce its long investment exposure to the relevant assets because it has come to believe that the assets will perform poorly, this hedging position would not be deemed to be associated with underwriting activities, but rather, it will be considered a hedge for an existing long position and would not be permissible. The Commission seeks comment on whether such an interpretation would always be appropriate.³²

In yet another example, a securitization participant accumulates a long cash or derivatives position in the underlying assets solely in anticipation of creating and selling a synthetic ABS – and not with a view to taking an investment position in those underlying assets. The

²⁸ *See id.* at 55.

²⁹ *Id.* at 69 (“Example 2”).

³⁰ *See id.*

³¹ *Id.* at 70 (“Example 3A”).

³² *Id.* at 70-71 (“Example 3B”).

securitization participant therefore enters into a CDS with the SPE as part of a synthetic ABS transaction to offset the exposure to the underlying reference portfolio that it in turn acquired for purposes of effecting the ABS transaction. The Proposing Release posits that such a transaction would be permissible as a risk-mitigating hedging activity provided there is no significant net basis risk, and that potential gains (or losses) by the securitization participant from the CDS protection it purchased from the issuer would be directly offset by losses (or gains) from the long position accumulated to offset that exposure.³³

It would also be permissible for a securitization participant that has entered into the short CDS transaction with the SPE to contemporaneously enter into one or more offsetting CDS transactions with other market participants that did not play a role in selecting the reference assets of the ABS, and did not have any influence on any aspect of the ABS transaction, provided the securitization participant did not itself select assets that were biased to facilitate the ability of these market participants to profit from short transactions. A second proviso is that the offsetting CDS transactions have no significant net basis risk, that is, potential gains (or losses) by the securitization participant from the CDS protection that it purchased from the issuer would have to be directly offset by losses (or gains) from the CDS transactions with third parties.³⁴

In a final interesting note about the risk-mitigating hedging exception, the Commission advises that it expects the risk mitigating hedging exception to the “Volcker Rule,” a pending rule which will significantly limit the proprietary trading activity of banks and certain other financial institutions – to mirror the scope of the risk-mitigating hedging exception in the ABS conflict of interest rules.³⁵

2. Exception for Liquidity Commitments

Under the liquidity commitments exception, the rule provides that the following would be allowed:

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.³⁶

Affiliates and subsidiaries of securitization participants would be able to utilize this exception. While the statutory language allowing this exception speaks to purchases or sales of ABS to fulfill liquidity commitments, the Proposing Release advises that some market

³³ *Id.* at 71-72

³⁴ *Id.* at 72-73 (“Example 3D”). For scenarios dealing with the role of placement agents in securitizations, *see id.* at 73-76 (“Example 4”).

³⁵ *See id.* at 81-82.

³⁶ *Id.* at 59.

participants may view liquidity commitments as encompassing a variety of activities, such as mechanisms “to promote full and timely interest payments to ABS investors.”³⁷ The Commission seeks comment on the accuracy of the Commission’s understanding of liquidity commitments and whether there other types of commitments that would be relevant for purposes of this exception.

3. Exception for Bona Fide Market-Making Activities

The exception for bona fide market-making activities will allow “purchases or sales of asset-backed securities made pursuant to and consistent with bona fide market-making in the asset-backed security,” including by affiliates and subsidiaries of securitization participants.³⁸

Here, the Commission only proffers a list of what it believes are the characteristics of “bona fide” market making activities, as follows:

- It includes purchasing and selling the ABS from or to investors in the secondary market.
- It includes holding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction).
- It is driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market-makers.
- It generally is initiated by a counterparty and if a customer initiated a customized transaction, it may include hedging if there is no matching offset.
- It does not include activity that is related to speculative selling strategies or investment purposes of a dealer, or that is disproportionate to the usual market-making patterns or practices of the dealer with respect to that ABS.
- Absent a change in a pattern of customer driven transactions, it typically does not result in a number of open positions that far exceed the open positions in the historical normal course of business.
- It generally does not include actively accumulating a long or short position other than to facilitate customer trading interest.
- It generally does not include accumulating positions that remain open and exposed to gains or losses for a period of time instead of being closed out promptly. In contrast,

³⁷ *Id.*

³⁸ *Id.* at 62.

an aged open position taken to facilitate customer trading interest would be hedged rather than exposed to gains and losses for a period of time.³⁹

The Proposing Release notes that to be bona fide, market making need not meet all of the requirements enumerated above, but it will probably be insufficient if the activity only meets one of the criteria.⁴⁰ The Commission advises that a criterion that will not be determinative, in any case, is whether the trading activity is carried out in a market-making account or on a market-making desk.⁴¹ The Commission seeks comment on whether these criteria accurately identify the characteristics of bona fide market making.

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³⁹ *Id.* at 62-63.

⁴⁰ *Id.* at 64.

⁴¹ *Id.* at 63.