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The Return of Dodd-Frank Rulemaking: SEC Proposes Expansive Prohibition on Conflicts of Interest in Securitization

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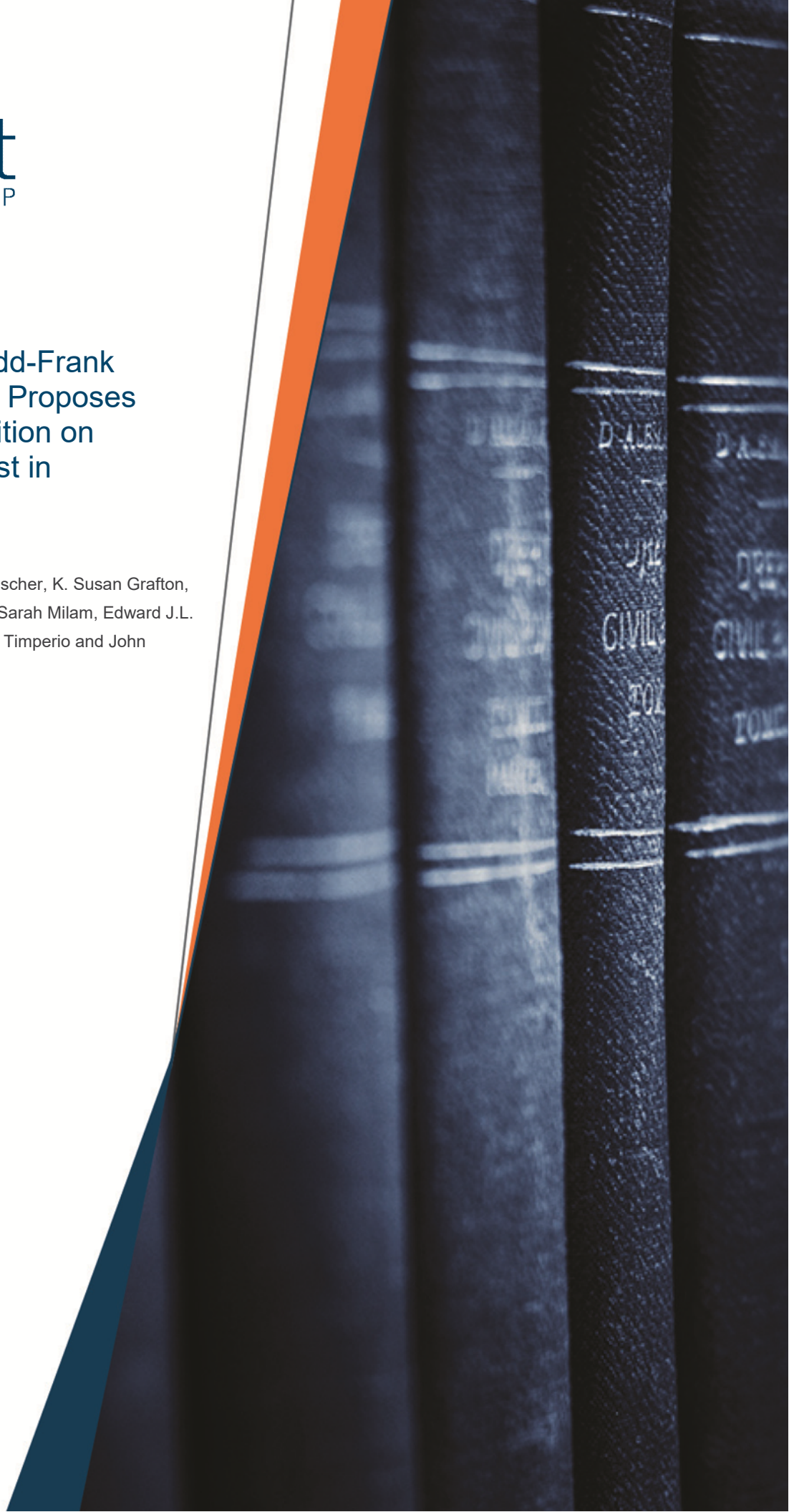

The Return of Dodd-Frank Rulemaking: SEC Proposes Expansive Prohibition on Conflicts of Interest in Securitization

Key Takeaways

- After a decade of regulatory inaction on the matter, the SEC recently re-proposed regulations implementing the Dodd-Frank Act's prohibition on material conflicts of interest in securitization transactions.
- The proposed rule is wide-reaching in a number of respects; in particular, the definition of "sponsor" is significantly broader than the definition used in other ABS regulation, and industry participants are digesting both the implications of the applicability of the rule to affiliates and subsidiaries, and the scope of the exceptions to the prohibition.
- The SEC's comment deadline is March 27, 2023, or 30 days after the date the proposed rule is published in the Federal Register, whichever period is longer.

Introduction

In 2010, Congress directed the U.S. Securities and Exchange Commission (the "SEC") to issue rules prohibiting certain conflicts of interest among securitization participants. After its initial proposal in 2011, and after a decade of regulatory inaction on the matter, in January, the SEC revived its original rulemaking process and released Rule 192 for comment.

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The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[1] enacted in 2010, ushered in a host of changes to the way the securitization markets function. For example, sponsor risk retention, the Volcker Rule and the Consumer Financial Protection Bureau ("CFPB") exist due to Dodd-Frank and rulemaking thereunder. Section 621 of Dodd-Frank provided that underwriters, placement agents, initial purchasers and sponsors—and their affiliates and subsidiaries—are prohibited from engaging in transactions that would result in or involve a material conflict of interest with an investor in an asset-backed securitization transaction.[2] The prohibition extends for one year from the first closing of the sale of an asset-backed security, subject to certain exceptions relating to hedging, liquidity commitments and market-making.[3]

Section 621 also required the SEC to issue rules implementing the prohibition within 270 days.[4] The SEC proposed implementing regulations in 2011 (the "2011 Proposing Release"), which essentially restated the language of the statute.[5] Industry reaction was largely negative, and the effort was abandoned. On January 25, 2023, the SEC

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1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010).

2 Dodd-Frank § 621, codified at Section 27B of the Securities Act of 1933, 15 U.S.C. § 77z-2a.

3 Dodd-Frank § 621(a).

4 Dodd-Frank § 621(b).

5 *Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Release No. 34-65355 (Sept. 19, 2011) (proposing Securities Act Rule 127B).

considered whether to move forward with the "unfinished business" of Section 621, and unanimously approved the release of the significantly revamped proposed Rule 192 (the "2023 Proposing Release").[6]

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Generally, proposed Rule 192 would prohibit securitization participants—that is, underwriters, placement agents, initial purchasers, sponsors and their affiliates and subsidiaries—from directly or indirectly engaging in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor in an asset-backed security ("ABS").[7] This prohibition begins "on the date on which a person has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant" with respect to that ABS, and ends "one year after the date of the first closing of the sale" of that ABS.[8]

A "material conflict of interest" is, generally speaking, a "conflicted transaction,"[9] and a "conflicted transaction" means any of the transactions in the list below, so long as there is a "*substantial likelihood* that a *reasonable investor* would consider the transaction important to the investor's investment decision, including a decision whether to retain the [ABS]"[10]:

- A short sale of the relevant ABS;
- The purchase of a credit default swap (CDS) or other credit derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of specified credit events in respect of the relevant ABS; or
- The purchase or sale of any financial instrument (other than the relevant ABS) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated, or potential:
  - Adverse performance of the asset pool supporting or referenced by the relevant ABS;
  - Loss of principal, monetary default, or early amortization event on the relevant ABS; or
  - Decline in the market value of the relevant ABS.[11]

As required by Dodd-Frank,[12] proposed Rule 192 makes room for three exceptions from the prohibition. The first such exception is for "risk-mitigating hedging activities."[13] These permitted activities include a securitization participant's

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6 *Prohibition Against Conflicts of Interest in Certain Securitizations*, SEC Release No. 33-11151 (Jan. 25, 2023) (proposing Securities Act Rule 192).

7 Rule 192(a)(1) (proposed). The proposed Rule 192 defines "asset-backed security" the same way that the term is defined in the Exchange Act, but additionally includes "synthetic asset-backed securities and hybrid cash and synthetic asset-backed securities." Rule 192(c) (proposed).

8 Rule 192(a)(1) (proposed).

9 Rule 192(a)(2) (proposed).

10 Rule 192(a)(3) (proposed) (emphasis added).

11 Rule 192(a)(3) (proposed).

12 Dodd-Frank § 621(c).

13 Rule 192(b)(1) (proposed).

risk-mitigating hedging activities "related to individual or aggregated positions, contracts, or other holdings of the securitization participant arising out of its securitization activities, including the origination or acquisition of assets that it securitizes," but expressly *excludes* "the initial distribution of an [ABS]."[14] To qualify for the hedging exception, securitization participants must satisfy a number of conditions, including:

- At the inception of the hedging activity and at the time of any adjustments to the hedging activity, the activity is "designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, contracts, or other holdings of the securitization participant, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof."

- The hedging activity is subject, as appropriate, to ongoing recalibration designed to ensure that the hedging activity continues to meet the exception's conditions, and does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk-reduction.

- The securitization participant establishes, implements, maintains and enforces internal programs reasonably designed to ensure compliance with the exception's conditions, including reasonably designed written policies and procedures that provide for the specific risk and risk-mitigating hedging activity to be identified, documented and monitored.[15]

The second exception is for "liquidity commitments." Proposed Rule 192 provides that "[p]urchases or sales of the [ABS] made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the [ABS]" are not prohibited.[16]

The third exception is for "bona fide market making activities," and permits bona fide market-making activities, including market-making related hedging, with respect to the ABS, the assets underlying the ABS or any financial instruments that reference the ABS or underlying assets.[17] As with the hedging exception, securitization participants may not avail themselves of this exception in connection with the initial distribution of an ABS.[18]

The conditions for this exception include:

- The securitization participant "routinely stands ready to purchase and sell" one or more types of the financial instruments described above as a part of its market-making related activities in such financial instruments, and is "willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments."

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[14] Rule 192(b)(1)(i) (proposed).

[15] Rule 192(b)(1)(ii) (proposed).

[16] Rule 192(b)(2) (proposed).

[17] Rule 192(b)(3)(i) (proposed).

[18] Rule 192(b)(3)(i) (proposed).

- The market-making activities are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers or counterparties, taking into account the liquidity, maturity and depth of the market for the relevant types of financial instruments described above.

- The compensation arrangements of the persons performing the market-making activities are designed not to reward or incentivize conflicted transactions.

- The securitization participant is licensed or registered to engage in bona fide market-making activity in accordance with applicable law and self-regulatory organizational rules.

- The securitization participant establishes, implements, maintains and enforces internal programs reasonably designed to ensure compliance with the conditions of the exception, including having reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.[19]

Lastly, proposed Rule 192 includes an anti-evasion provision, which provides that a transaction will be deemed to violate the prohibition on conflicted transactions if a "securitization participant engages in a transaction that circumvents the prohibition" of the rule.[20]

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If it seems the SEC has a more "maximalist" philosophy concerning conflicts of interest than it did in 2011, that appears to be by design. The Chief Economist and Director of the Division of Economic Risk Analysis expressly acknowledged in the SEC's open meeting that proposed Rule 192, if adopted, would preclude entire types of securitization transactions from happening.[21] The SEC's 2023 proposal is notably expansive in a few key areas.

First, the definition of "sponsor." A sponsor is "[a]ny person who organizes and initiates an [ABS] transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the entity that issues the [ABS]."[22] That part should sound familiar, as it largely mirrors the definition of "sponsor" found in the risk retention rules and in Regulation AB. However, proposed Rule 192 goes even further—under the proposal, a "sponsor" will also include any person that directs or causes the direction of, or has a contractual right to direct or cause the direction of, "the structure, design, or assembly of an [ABS] or the composition of the pool of assets underlying the [ABS]."[23] The only exceptions are for "a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of an [ABS] or the composition of the pool of assets underlying the [ABS]"; the United States and instrumentalities thereof with respect to securities fully insured or guaranteed by the United States; and Fannie Mae and Freddie Mac, so long as they operate under the

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19 Rule 192(b)(3)(i) (proposed).

20 Rule 192(d) (proposed).

21 This is also acknowledged in the SEC's economic analysis of the proposed rule, which also acknowledges potentially significant compliance and monitoring costs, the possibility of increased cost of capital for borrowers and lower liquidity and expected returns for investors, as well as the possible loss of clientele and other relationship disruptions for securitization participants. *See* 2023 Proposing Release, at 125-67.

22 Rule 192(c) (proposed).

23 Rule 192(c) (proposed).

conservatorship or receivership of FHFA with capital support from the United States, but only with respect to an ABS that is fully insured or guaranteed as to the timely payment of principal and interest by that entity.[24]

The exceptions notwithstanding, the proposed definition of "sponsor" is quite broad. According to the 2023 Proposing Release, it would deliberately include portfolio selection agents for CDOs, collateral managers for CLOs, or hedge fund managers or other private fund managers that direct the structure of the ABS or the composition of the pool of assets, and could even include servicers in some circumstances.[25] In the risk retention context, the U.S. Court of Appeals for the D.C. Circuit has already ruled in the *LSTA* decision that regulators were not justified in "stretching the definition of a 'sponsor' to cover those who do not […] have a relationship to the assets such that one can reasonably say that they 'transfer' the assets and could be required to 'retain' a portion of the assets' risk," and called the agencies' attempt to do so "an astonishing stretch of language."[26] The *LSTA* decision makes the SEC's decision to revisit this issue surprising. In the January open meeting, Commissioner Hester Peirce questioned whether the SEC had the legal authority to define the term "sponsor" more broadly than it has done in the past. Commissioner Peirce did not appear convinced that it was appropriate for the SEC to deviate from statutory text in service of Congressional intent.

Though the 2023 Proposing Release is silent on the issue, the definition of "sponsor" is so broad that it has the potential to encompass, in certain circumstances, directing certificateholders, subordinate class representatives or other "b-piece buyers" that are involved in certain asset selection and bond structuring decisions. For example, in the commercial mortgage-backed securities ("CMBS") asset class, b-piece buyers play important gatekeeping roles from the inception of the transaction, the theory being that, due to their first-loss position in the ABS, they are most incentivized to diligence assets and to direct the removal of riskier ones to the benefit of all investors. This investor-protective feature arguably gives b-piece buyers the power to direct or cause the direction of the composition of the pool of assets underlying the ABS, and it is therefore arguable that a b-piece buyer—an investor in the ABS—is now a "sponsor" subject to the proposed Rule 192's prohibitions. The result could be an increased scrutiny of any fee-sharing arrangements that may exist between servicers and b-piece buyers.

In separate statements, both Commissioners Peirce[27] and Lizárraga[28] indicated their particular interest in public input on the scope of "securitization participants" covered by this rule, and we expect that the industry will do so, as it represents a sea change in the scope of regulated parties.

Second, the trigger for Rule 192's prohibitions. Proposed Rule 192's prohibitions would apply beginning "on the date on which a person has reached, or has taken substantial steps to reach, an agreement that such person will become

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[24] Rule 192(c) (proposed). In 2012, Senators Jeff Merkley and Carl Levin, the authors of Section 621, urged the SEC to go even further and include within the definition of "sponsor" "any person (including a collateral manager, servicer, or custodian) who, for a fee or other renumeration or benefit, participates in the design, composition, assembly, sale or management of the ABS." *See* Letter from Senators Jeff Merkley and Carl Levin to Elizabeth Murphy, Secretary of Securities and Exchange Commission, *Proposed Rule to Prohibit Conflicts of Interest in Asset-Backed Securitizations*, File No. S7-38-11 (Jan. 12, 2012).

[25] 2023 Proposing Release, at 27.

[26] *The Loan Syndications and Trading Association v. Securities and Exchange Commission and Board of Governors of the Federal Reserve System*, No. 17-5004 (D.C. Cir. Feb. 9, 2018), at 10, 14.

[27] *See* Commissioner Hester M. Peirce, U.S. Securities and Exchange Commission, *Statement on Proposed Rule: "Prohibition Against Conflicts of Interest in Certain Securitizations"* (Jan. 25, 2023), ("Peirce Statement").

[28] *See* Commissioner Jaime Lizárraga, U.S. Securities and Exchange Commission, *Statement on Prohibiting Conflicts of Interest in Certain Securitizations* (Jan. 25, 2023), ("Lizárraga Statement")

a securitization participant with respect to an [ABS]."[29] During the January open meeting and in their subsequent statements, Commissioners Peirce[30] and Uyeda[31] voiced concern about the vagueness of this language, and in particular, were skeptical that securitization participants would, at any moment in time, be able to determine whether they have crossed the "substantial steps" threshold. As Commissioner Uyeda asked rhetorically in his statement, "does an organization's receipt of a preliminary term sheet to join the underwriting syndicate fall within or outside of 'substantial steps?'"[32] Both Commissioners Peirce and Uyeda indicated their interest in feedback on the proposed trigger, and we anticipate significant industry comment on its ambiguities.

Third, the definition of "conflicted transaction." The SEC included a catch-all provision to identify the types of transactions that would constitute "conflicted transactions": The entry into a transaction through which a securitization participant would benefit from the *actual, anticipated or potential* occurrence of specified adverse events with respect to the ABS or underlying assets, provided that there is a *substantial likelihood* that a *reasonable investor* would consider the transaction important to the investor's investment decision.[33] There are a lot of open questions embedded in this provision, and nowhere does proposed Rule 192 require the securitization participant to have an intent to design the ABS to fail, nor any knowledge of the relevant ABS transaction at all, in order to be liable. One particular concern is the issue of competing transactions—*e.g.*, if an underwriter or placement agent markets two similar issuances in the period during which conflicts are prohibited, one of which entitles it to a more attractive compensation arrangement, one could argue that it could be incentivized to market that issuance more aggressively to the detriment of the other.

Fourth, the definitions of "underwriter" and "placement agent." For purposes of the proposed Rule 192, an "underwriter" or "placement agent" is a person that has agreed with an issuer (or selling securityholder) to (i) purchase securities for distribution; (ii) engage in a distribution for on or on behalf of the issuer (or selling securityholder); or (iii) manage or supervise a distribution for or on behalf of such issuer or selling securityholder.[34] During the initial rulemaking, commenters made the point that, in the ABS markets, passive participants such as co-managers often do not participate in structuring decisions and may not end up placing any orders at all.[35] The SEC responded in the 2023 Proposing Release that the proposed definition should mitigate concerns that it would inadvertently capture "entities that do not have an agreement with the issuer or the selling security holder and have no ability to influence the design of the relevant ABS."[36] But it is not all that clear that the proposal addresses the

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29 Rule 192(a)(1) (proposed).

30 *See* Peirce Statement.

31 *See* Commissioner Mark T. Uyeda, U.S. Securities and Exchange Commission, *Statement on the Proposed Rule: Prohibition against Conflicts of Interest in Certain Securitizations* (Jan. 25, 2023) ("Uyeda Statement").

32 *See* Uyeda Statement.

33 Rule 192(a)(3) (proposed) (emphasis added).

34 Rule 192(c) (proposed). A "distribution" is (i) an offering of securities, registered or unregistered, that is "distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods," or (ii) any registered offering. Rule 192(c) (proposed). The SEC explains that the intent is to "distinguish an offering of ABS from secondary trading," and that "[a]ctivities generally indicative of special selling efforts and selling methods include, but are not limited to, greater than normal sales compensation arrangements, delivering a sales document (such as a prospectus), and conducting road shows." 2023 Proposing Release, at 22-23.

35 Securities Industry and Financial Markets Association (SIFMA), *Letter to SEC* (Feb. 13, 2012).

36 2023 Proposing Release, at 21 n.49.

concern, and the facts and circumstances of the particular transaction at issue will determine whether any co-manager will be subject to the proposed Rule 192.

Fifth, the inclusion of affiliates and subsidiaries. The definition of "securitization participants" includes not just underwriters, placement agents, initial purchasers, sponsors, but also their affiliates and subsidiaries. Though this language also appears in Dodd-Frank, commissioners raised concerns based on feedback on the 2011 Proposing Release that, for larger financial institutions, the left hand may not know what the right hand is doing, and in some circumstances, different silos may even be legally precluded from communicating with one another due to informational barriers or "firewalls." Proposed Rule 192 makes no exception for financial institutions with informational barriers in place, although Commissioners Peirce,[37] Crenshaw[38] and Uyeda[39] each indicated their interest in receiving feedback on whether such exceptions should be included.

Sixth, the conditions to the exceptions. In particular, the hedging and market-making exceptions each require securitization participations relying thereon to develop and enforce programs to ensure compliance on an ongoing basis. The hedging exception requires "ongoing calibration" to ensure that the hedging activity "does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk reduction."[40] The conditions necessary to satisfy the market-making exception require that the activities are "designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, taking into account the liquidity, maturity, and depth of the market,"[41] which will likely be difficult to forecast with meaningful confidence. The market-making exception also requires securitization participants to analyze the compensation arrangements of the employees involved in that activity.[42] Even assuming that a securitization participant is able to satisfy these conditions, they will make compliance a more complicated and costly endeavor.

Seventh, the anti-evasion provision. As Commissioner Peirce noted during the January open meeting, anti-evasion provisions are not a novel concept for the federal securities laws. These provisions are generally designed with the intent to prevent market participants from "building a better mousetrap" by avoiding compliance based on technicalities. However, Commissioner Peirce was skeptical as to the utility of an anti-evasion provision in this context, and was concerned that the incorporation of a provision such as this one could "unnecessarily cloud the rule's parameters" and could chill otherwise legitimate market activity.[43] In response to Commissioner Peirce's questioning during the January open meeting, Renee Jones, the SEC's then-Director of the Division of Corporation Finance, indicated that the provision was intended to prevent securitization participants from devising new or novel structures that are economically equivalent to prohibited types of transactions, like short sales or credit default swaps, but have a different legal form or bear a different name in order to circumvent the prohibition. Ms. Jones also indicated that the provision was designed to prevent securitization participants from engaging in two or more seemingly unrelated transactions to avoid what would have been prohibited had it been done in one singular

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37 *See* Peirce Statement.

38 *See* Commissioner Caroline A. Crenshaw, U.S. Securities and Exchange Commission, *Statement on the Prohibition against Conflicts of Interest in Certain Securitizations Re-proposal* (Jan. 25, 2023) ("Crenshaw Statement").

39 *See* Uyeda Statement.

40 Rule 192(b)(1)(ii)(B) (proposed).

41 Rule 192(b)(3)(ii)(B) (proposed)

42 Rule 192(b)(1)(ii)(C) (proposed).

43 *See* Peirce Statement.

transaction. Commissioner Peirce's statement indicates her interest on receiving feedback on whether the language of the provision could be more closely tailored to the types of transactions it seeks to prohibit.[44]

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The proposing release solicits public feedback on over 112 different questions. However, in their statements,[45] the Commissioners have expressed particular interest in receiving comments on the following topics:

- The definitions of "securitization participants" subject to the proposed rule; in particular, the broad definition of "sponsor" and the SEC's authority to impose such a broad definition.
- Whether the "substantial steps" trigger is overly vague, and whether securitization participants have a meaningful way of understanding where the line is drawn.
- Whether affiliates and subsidiaries should be excluded from the rule if informational barriers are in place; whether informational barriers could be effectively designed and implemented to prevent potential conflicts; and what those conditions should be.[46]
- Whether the scope of the proposed exceptions is appropriate, and whether securitization participants would practically be able to satisfy the proposed conditions of those exemptions, with a particular focus on the "market making" exception.
- Whether use of an anti-evasion provision in this context is appropriate.
- What specificity would be required in the compliance policies of securitization participants relying on the exemptions.
- Whether certain conflicts of interest could be cured by disclosure rather than prohibited altogether.
- Whether the exemption for GSEs is appropriate, and whether the rule is adequately tailored for smaller institutions and municipal entities.
- Whether the proposed rule creates any disharmony with the Volcker Rule.

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44 *See* Peirce Statement

45 *See* Peirce Statement; Uyeda Statement; Crenshaw Statement and Lizárraga Statement; *see also* Chair Gary Gensler, U.S. Securities and Exchange Commission, *Statement on Prohibiting Conflicts of Interest in Securitizations* (Jan. 25, 2023).

46 The 2023 Proposing Release floats five possible conditions that an "informational barrier" exception could include: (1) the securitization participant establishes, implements, maintains, enforces and documents written policies and procedures to prevent the flow of information that might result in a violation of the rule between the securitization participant and its affiliates and subsidiaries; (2) the securitization participant establishes, implements, maintains, enforces and documents a written internal control structure governing the implementation and adherence to those policies and procedures; (3) the securitization participant obtains an annual independent assessment of those policies, procedures and operational controls; (4) there is no overlap of officers or employees between the securitization participant and the affiliate or subsidiary, and was not involved in the creation, distribution or origination of the assets, or the provision of other services with respect to the ABS; and (5) the securitization participant does not know, or should not reasonably know, that the transaction at issue would otherwise constitute a material conflict of interest. 2023 Proposing Release, at 47-52.

Comments can be submitted by clicking this link, by emailing rule-comments@sec.gov with "File Number S7-01-23" in the subject line, or by regular mail. Comments are due on March 27, 2023, or 30 days after the date the proposed rule is published in the Federal Register, whichever period is longer.

If you would like to discuss the proposed rule, or would like any additional information about the proposed rule, please contact one of the Dechert attorneys listed below or any Dechert attorney with whom you regularly work.

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