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SEC Proposes Expansive Conflict of Interest Rules

Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] was a reaction to securitizations structured such that the parties involved in arranging and marketing the transaction could profit from circumstances that might result in losses to the investors in the transaction. Section 621 prohibits certain persons who create and distribute asset-backed securities ("ABS") from engaging in transactions during a period of one year following the initial closing of the sale of such ABS that would involve or result in material conflicts of interest with respect to any investor in the ABS. On September 19, 2011, the Commissioners of the Securities and Exchange Commission (the "Commission" or the "SEC") voted unanimously at an open meeting to approve a notice of proposed rulemaking ("NPR") to implement this prohibition.[2] In the press release accompanying the NPR, the Commission reiterated that proposed Rule 127B was designed to prohibit abusive structures and was not "intended to prohibit traditional securitization practices."[3] However, the proposed rule itself is broadly worded, employs a number of abstract and vaguely defined concepts and relies heavily on interpretive guidance and illustrative examples in an effort to outline the rule's coverage. The result is a rule with the potential to reach the traditional securitization practices stated to be outside its purview. Possibly reflecting the Commission's concern with the potentially expansive coverage of the rule, the NPR includes a large number of requests for comments (over 100) for a single rule. Responses to these requests are due by December 19, 2011. This *DechertOnPoint* summarizes the proposed rule as presented in the NPR.

In the NPR, the Commission rarely strays far from the language of Section 621. In outlining the proposed rule, the SEC identifies the five conditions required for its application to an ABS transaction in terms that echo the terms of Section 621. These conditions are: the involvement of (1) covered persons and (2) covered products, (3) during the covered timeframe, resulting in (4) covered conflicts of interest that are (5) material.[4] The NPR also reiterates the exceptions provided by Section 621 to this general prohibition, which are intended to permit hedging, liquidity commitment and market making activities customary in securitization transactions. A brief outline of each of these factors is warranted, focusing, as does the NPR, on the determination of covered conflicts and the assessment of their materiality.

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1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 621, 124 Stat. 1376, 1632 (2010).

2 Securities Exchange Commission, Release No. 34-65355—Prohibition against Conflicts of Interest in Certain Securitizations—Proposed Rule, available at http://www.sec.gov/rules/proposed/2011/34-65355.pdf.

3 Release by the Securities Exchange Commission—2011-185, September 19, 2011, available at http://www.sec.gov/news/press/2011/2011-185.htm.

4 Release No. 34.65355, at 19.

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Covered Persons

Section 621 indicates that its conflict of interest prohibition applies to any underwriter, placement agent, initial purchaser or sponsor (along with any affiliate or subsidiary thereof) with respect to an asset-backed security (collectively, "securitization participants"). Proposed Rule 127B adopts this language as well, providing the rationale that securitization participants are the parties who typically structure ABS and control the securitization process and are therefore in positions with the greatest potential for engaging in the activities sought to be prevented by the proposed rule.[5] The Commission declined at this stage to further define the terms employed to identify the covered persons in the proposed rule, indicating its concern that relying on existing securities law definitions might yield over- or under-inclusive definitions and ultimately concluding that the undefined terms are sufficiently well understood by market participants to form a basis for the proposed rule. The Commission's intent, however, appears to be to have the covered persons described broadly enough to include any party occupying a structuring or controlling role. For example, the NPR indicates that the SEC considers that it would be appropriate to include collateral managers as covered persons, possibly falling under the coverage of the term "sponsor" for this purpose.[6]

Covered Products; Covered Timeframe

The covered products and covered timeframe elements of the proposed rule receive straightforward treatment in the NPR. Covered products include "asset-backed securities" as defined in Section 3(a)(77) of the Exchange Act[7] and specifically include synthetic ABS.[8]

The Commission notes that this is a more expansive definition than that found in Securities Act Regulation AB and includes securities typically sold in transactions exempt from registration under the Securities Act. The covered timeframe is described in proposed Rule 127B in language identical to that found in Section 621: "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." The Commission notes that the commencement of this timeframe is not specified and that therefore it would cover transactions effected *before* the first closing of the sale of the ABS.[9] The Commission seeks comment as to whether this approach might be over-inclusive.

Covered Conflicts of Interest

For a transaction to be subject to the proposed rule's prohibition, it must give rise to a material conflict of interest between a securitization participant and an investor in the subject ABS. The NPR frames the covered conflict of interest concept as having three components: (1) the conflict arises between a securitization participant, on the one hand, and investors, on the other, (2) the conflict results from or relates to the subject ABS transaction and (3) the conflict arises in connection with a securitization participant's "engag[ing] in any transaction."[10] Under this construction, a conflict between an investor and a securitization participant could arise regardless of whether such investor purchased the ABS from such securitization participant. However, conflicts of interest would not be covered if they arose strictly among investors or strictly among securitization participants in their respective capacities as such, or if they were unrelated to the subject ABS transaction, regardless of what parties were involved. Nor would conflicts of interest between investors and securitization participants that merely reflect their respective positions in an ABS transaction be covered—the conflict must arise in connection with a securitization participant's "engag[ing] in any transaction."

This concept of "engag[ing] in any transaction" is not particularly well-defined in the NPR. Although the idea certainly requires that a covered conflict of interest be rooted in some transaction entered into by a securitiza-

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5 *Id.* at 20.

6 *Id.* at 21.

7 Under Section 3(a)(77) of the Exchange Act, "asset-backed security" means "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—(i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv)a collateralized debt obligation of asset-backed securities; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of [Section 3(a)(77)]."

8 *Id.* at 26.

9 *Id.* at 30.

10 *Id.* at 31.

tion participant, the Commission will rely on interpretive guidance to identify what transactions will and will not be covered by the proposed rule. Examples of transactions that would give rise to a conflict of interest include a securitization participant's effecting a short sale of the securities offered in the ABS transaction or its purchase of credit default swaps with respect to such securities.[11] The Commission recognizes that not all activities undertaken by a securitization participant would be covered by the proposed rule and offers the example of a securitization participant's issuance of investment research. Because of its concern that this somewhat amorphous concept could be subject to widely divergent interpretations, the Commission has requested comment regarding whether it should be broadly or narrowly construed.

Materiality

Finally, for a conflict of interest to be prohibited by the proposed rule, it must also be material. The determination of when such a conflict is a material conflict requires the satisfaction of two criteria. First, a securitization participant, by engaging in such transaction, would stand to benefit from (1) the adverse performance of the securitized assets, (2) a loss of principal, monetary default or early amortization of the ABS or (3) a deterioration in the market value of the ABS (any such transaction, a "short transaction").[12] The first criterion would also be satisfied if a securitization participant with the ability to control the structure of the ABS or the selection of the securitized assets would stand to benefit (whether from fees, business generation or other remuneration) by permitting a third party to structure the ABS or select the securitized assets in a manner that would facilitate or create an opportunity for such third party to benefit from a short transaction with respect to the ABS. This aspect of the first criterion is intended to prevent a securitization participant from accomplishing through a third party what it would be prohibited from doing directly. The burden of compliance with this requirement falls on the securitization participant who permits or facilitates the involvement of such third party in an ABS transaction—regardless of whether such securitization participant is aware of such third party's short transaction, such securitization participant would be deemed to have a prohibited conflict of interest.

The Commission acknowledges that the first prong of the materiality determination could easily trend toward over-inclusiveness and prevent transactions motivated by *bona fide* purposes reflecting the divergent interests of investors and securitization participants with respect to any given ABS transaction. While the NPR seeks comment regarding this potential problem, the interpretive guidance it offers does little to address this concern. Thus, the Commission emphasizes that the prohibition is meant to apply whether or not a securitization participant's or third party's benefit from a short transaction is intentional. The NPR further indicates that the assessment of materiality would be made without regard to whether the benefit of a short transaction to a securitization participant were direct or indirect and without regard to whether such benefit actually occurs or is merely potential or anticipated. In all such cases, the conflict would meet the first criterion.

The second criterion in assessing materiality relies on the standard securities law metric: there must be a substantial likelihood that a reasonable investor would consider such conflict to be important to his or her decision to invest in, or retain an interest in, the ABS.[13] This determination will be made on a case-by-case basis, with no facts or occurrences being determinative in every instance. The Commission notes that while the materiality formula used in the proposed rule will be familiar to market participants from federal securities law disclosure rules, this formulation should *not* be taken to suggest that a transaction otherwise prohibited under the proposed rule would be permitted if adequately disclosed to investors. While noting the practical difficulties of relying on disclosure to render a conflict immaterial (especially where the conflict arises after the sale of ABS), the Commission does acknowledge that disclosure may have some bearing on an assessment of materiality. It is therefore possible that an investor's decision to purchase ABS despite adequate disclosure of a potential conflict of interest between investors and securitization participants relating to such ABS could preclude a finding that such conflict was material. The Commission offers no guidance as to the circumstances where this might apply but solicits comment on the appropriate impact of adequate disclosure on the proposed rule.

11 *Id.* at 33.

12 *Id.* at 37.

13 *Id.* at 44.

Statutory Exceptions: Hedging, Liquidity Commitments and *Bona Fide* Market-Making

Following the lead of Section 621, the proposed rule would provide exemptions to the prohibition for risk-mitigating hedging activities, liquidity commitments and *bona fide* market-making.[14] In each case, proposed Rule 127B(b) incorporates the language from Section 621 while offering limited guidance in interpreting this language. For example, with respect to hedging activities, the NPR indicates that the Commission interprets the exception as extending to subsidiaries and affiliates of a securitization participant, clarifies that the hedge must be designed to offset risk and not to earn a profit, and suggests that, to be eligible for the exception, a hedge should not be significantly greater than the exposure being addressed. In the case of liquidity commitments, the NPR suggests that the exception should be read broadly to apply to more than just the "purchases and sales" of ABS covered in the statutory language. Similarly, with respect to market-making activities, the Commission offers a list of eight principals it considers to be characteristic of *bona fide* ABS market-making (*e.g.*, activities including purchasing and selling ABS in the secondary market, holding oneself out as providing liquidity on both sides of the market, or *not* actively accumulating a long or short position other than to facilitate investor trading interests).

[14] *Id.* at 52.

Conclusion

It is clear that the Commission was influenced by the preliminary comments it received with respect to Section 621 in preparing the NPR. The Commission is careful to indicate the focus of the proposed rule is abusive securitization transactions rather than conflicts of interest inherent in securitization transactions and makes repeated reference to concerns expressed regarding the statute's extensive reach. While these comments probably helped to narrow the proposed rule, the rule as drafted remains very broad. This situation is aggravated by the NPR's reliance on examples and interpretive guidance to clarify the open-ended concepts employed. This combination presents fertile ground for unintended consequences. For instance, with the proposed rule's broad coverage and the NPR's reliance on examples to delineate the rule's limitations, it could be difficult to determine whether a given transaction structure conflicted with the proposed rule unless it were addressed squarely in one of the examples. This, in turn, could result in the inability of some law firms to give clean "no conflicts" opinions or restrict them to heavily reasoned opinions. The Commission is seeking comments on the NPR by December 19, 2011; there will doubtless be extensive responses from the market as it seeks to secure more definitive boundaries on the proposed rules. We will continue to update you as appropriate throughout this process.

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This update was authored by Patrick D. Dolan (+1 212 698 3555; patrick.dolan@dechert.com) and Joshua A.O. Strathman (+1 949 442 6000; joshua.strathman@dechert.com).

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. If you would like to receive any of our other *DechertOnPoints*, please click here.

Lawrence V. Berkovich
Charlotte
+1 704 339 3154
lawrence.berkovich@dechert.com

Lewis A. Burleigh
Boston
+1 617 654 8601
lewis.burleigh@dechert.com

Laura G. Ciabarra
Hartford
+1 860 524 3926
laura.ciabarra@dechert.com

Timothy J. Boyce
Charlotte
+1 704 339 3129
timothy.boyce@dechert.com

Katherine A. Burroughs
Hartford
+1 860 524 3953
katherine.burroughs@dechert.com

Matthew T. Clark
Boston
+1 617 728 7118
matthew.clark@dechert.com

Patrick D. Dolan
New York
+1 212 698 3555
patrick.dolan@dechert.com

Malcolm S. Dorris
New York
+1 212 698 3519
malcolm.dorris@dechert.com

Dr. Olaf Fasshauer
Munich
+49 89 21 21 63 28
olaf.fasshauer@dechert.com

Steven A. Fogel
London
+44 20 7184 7444
steven.fogel@dechert.com

David W. Forti
Philadelphia
+1 215 994 2647
david.forti@dechert.com

William Fryzer
London
+44 20 7184 7454
william.fryzer@dechert.com

Joseph B. Heil
San Francisco
+1 415 262 4510
joseph.heil@dechert.com

Bruce D. Hickey
Boston
+1 617 654 8602
bruce.hickey@dechert.com

Geoffrey K. Hurley
New York
+1 212 698 3598
geoffrey.hurley@dechert.com

Andrew Hutchinson
London
+44 20 7184 7428
andrew.hutchinson@dechert.com

Richard D. Jones
Philadelphia
+1 212 698 3844
richard.jones@dechert.com

David M. Linder
San Francisco
+1 415 262 4511
david.linder@dechert.com

Ralph R. Mazzeo
Philadelphia
+1 215 994 2417
ralph.mazzeo@dechert.com

Jason S. Rozes
Philadelphia
+1 215 994 2830
jason.rozes@dechert.com

Jodi Schwimmer
New York
+1 212 698 3505
jodi.schwimmer@dechert.com

Timothy A. Stafford
New York
+1 212 698 3504
timothy.stafford@dechert.com

Laura Swihart
New York
+1 212 698 3644
laura.swihart@dechert.com

Barry J. Thorne
London
+44 20 7184 7413
barry.thorne@dechert.com

John M. Timperio
Charlotte
+1 704 339 3180
john.timperio@dechert.com

Cynthia J. Williams
Boston
+1 617 654 8604
cindy.williams@dechert.com

Jay Zagoren
Philadelphia
+1 215 994 2644
jay.zagoren@dechert.com

Dechert LLP

www.dechert.com

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