

Prohibition Against Conflicts of Interest in Certain Securitizations



The Securities and Exchange Commission proposed a rule to prohibit conflicts of interest in certain securitization transactions as required by Congress in the Dodd-Frank Act.

The proposed rule would prohibit securitization participants from engaging in certain transactions that could incentivize a securitization participant to structure an asset-backed security (ABS) in a way that would put the securitization participant's interests ahead of those of ABS investors.

Why This Matters

The Dodd-Frank Wall Street Reform and Consumer Protection Act added Section 27B to the Securities Act of 1933. Section 27B prohibits certain securitization participants from engaging in transactions that would involve or result in certain material conflicts of interest and requires the SEC to issue rules to implement the prohibition and related exceptions.

How This Rule Applies

New Securities Act Rule 192 would prohibit a securitization participant from engaging, directly or indirectly, in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor in an ABS, subject to certain exceptions. Prohibited transactions would include, for example, a short sale of the ABS or the purchase of a credit default swap or other credit derivative that entitles the securitization participant to receive payments upon the occurrence of specified credit events in respect of the ABS.

Asset-Backed Securities

The proposed rule would include within the definition of "asset-backed security" any ABS within the meaning set forth in Section 3 of the Exchange Act, as well as any synthetic ABS.

Securitization Participants

The proposed rule would apply to an underwriter, placement agent, initial purchaser, or sponsor of an ABS, each as defined in the proposed rule. It would also apply to any affiliate or subsidiary of any such entity.

Prohibited Transactions

The proposed rule would prohibit a securitization participant from entering into a “conflicted transaction” beginning when a person has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant with respect to an ABS and ending one year after the date of the first closing of the sale of the relevant ABS. “Conflicted transaction” is defined to include two main components.

One component is whether the transaction is:

- A short sale of the ABS;
- The purchase of a CDS or other credit derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of a specified adverse event with respect to the 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 ABS;
 - Loss of principal, default, or early amortization event on the ABS; or
 - Decline in the market value of the ABS.

The other component relates to materiality – *i.e.*, whether there is a substantial likelihood that a reasonable investor would consider the relevant transaction important to the investor’s investment decision, including a decision whether to retain the ABS.

Exceptions

As specified in Section 27B, the proposed rule would provide exceptions for:

- Risk-mitigating hedging activities;
- Bona fide market-making activities; and
- Liquidity commitments.

The proposed rule would require a securitization participant relying on certain exceptions to implement compliance programs reasonably designed to ensure the securitization participant’s compliance with the conditions applicable to those exceptions, including reasonably designed written policies and procedures. The proposed definitions in the proposed rule also contain certain exceptions and exclusions, each with conditions designed to protect investors and further the purposes of Section 27B.

Additional Information:

The public comment period will remain open for 60 days following publication of the proposing release on the SEC’s website or 30 days following publication of the proposing release in the Federal Register, whichever period is longer.