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STRUCTURED FINANCE UPDATE | SEPTEMBER 30, 2011

SEC Proposes Rule Prohibiting Material Conflicts of Interest in Securitization Transactions

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On September 19, 2011, at an open meeting of the Securities and Exchange Commission (the "SEC"), the SEC unanimously approved for public comment a proposed rule under the Securities Act of 1933 (the "Securities Act") to implement the prohibition under Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") on material conflicts of interest in connection with certain securitizations. The deadline for comments on the proposed rule is December 19, 2011.

Section 621 of Dodd-Frank added a new Section 27B to the Securities Act and prohibits 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. The prohibition under Section 27B applies to both registered and unregistered ABS offerings.

According to Chairman Mary Schapiro, the implementing rule – proposed Rule 127B – is designed to ensure that those who create and sell ABS cannot profit by betting against those same securities at the expense of those who buy them. At the same time, the proposed rule is not intended to restrict traditional securitization practices.

In crafting proposed Rule 127B, the SEC has primarily incorporated the text of Securities Act Section 27B and, in doing so, has left a number of important aspects of the proposed rule, including the definition of a "material conflict of interest," to be determined through interpretation of the rule. The SEC expresses concern that any attempt to precisely define the scope of the proposed rule might be both over- and under-inclusive in terms of identifying the types of material conflicts of interest that Section 27B is intended to prohibit. As a result, the SEC does not propose bright line tests for determining compliance with the proposed rule, but instead proposes to establish an interpretive framework regarding application of the proposed rule. In the proposing release, the SEC provides several examples of hypothetical arrangements entered into in connection with, or relating to, securitization transactions and describes how the SEC would interpret the proposed rule to apply to those arrangements and transactions. Illustrations of the examples are provided in Annex A to this Client Alert.

We provide below a brief overview of (A) the conditions for application of the proposed rule, (B) the statutory exceptions to application of the proposed rule, (C) the examples regarding interpretation of the proposed rule provided in the proposing release, (D) SEC commentary regarding the relationship between the proposed rule and the Volcker Rule, and (E) SEC commentary regarding whether securitization participants should be permitted to employ information barriers and disclosure to manage conflicts of interest that would otherwise be prohibited.

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A. Conditions for Application of the Proposed Rule

The SEC proposes five conditions that define the circumstances in which the proposed rule might prohibit a material conflict of interest.

1. Covered Persons: The proposed rule would apply to specified securitization participants: the ABS underwriter, placement agent, initial purchaser or sponsor, or an affiliate or subsidiary of such entity. These persons are specified in Section 27B of the Securities Act in an effort to cover the transaction participants that structure the ABS and control the securitization process.

Although some of the terms for the covered persons are defined in the federal securities laws for other purposes, the SEC expresses concern that those definitions may be under-inclusive or confusing in the context of the proposed rule. The SEC believes that some of these terms are sufficiently understood within the marketplace that it is unnecessary to define them for purposes of the proposed rule. However, the SEC does request comment regarding whether one or more of the terms for the covered persons should be defined and, in particular, whether the term "sponsor" should be interpreted to include the collateral manager, servicer or others who, for a fee or some other benefit, play a substantial role in the creation of the ABS or in managing or servicing the assets underlying the ABS.

2. Covered Products: The proposed rule would apply to any asset-backed security, including a synthetic asset-backed security. The proposed rule incorporates the definition of "asset-backed security" utilized for several other purposes under Dodd-Frank and, therefore, is much broader than the definition of "asset-backed security" in Regulation AB. However, the proposed rule does not include a definition of "synthetic asset-backed security" and the SEC requests comment regarding whether a definition should be provided.

3. Covered Timeframe: The proposed rule would cover a transaction occurring in the period ending on the date that is one year after the date of the first closing of the sale of the ABS. Because the proposed rule does not specify the commencement point for the covered timeframe, it would cover transactions occurring prior to the date of the first closing of the sale of the ABS. The SEC requests comment regarding whether alternative approaches to defining the covered timeframe would be appropriate.

4. Covered Conflicts: The SEC proposes to delineate the scope of "conflicts of interest" that would potentially be covered by the proposed rule as described below.

- The proposed rule would cover only conflicts of interest between an entity that is a securitization participant and an entity that is an investor. As a result, a conflict arising solely among securitization participants or solely among investors would not be subject to the proposed rule. The SEC clarifies that a conflict arising solely among investors could include a securitization participant acting in its capacity as an investor so long as the conflict arises only from its interest as an investor.

- The proposed rule would cover only conflicts of interest that arise as a result of or in connection with the ABS transaction. Conversely, the proposed rule would not cover a conflict of interest that happens to arise between a securitization participant and an investor but that is unrelated to their status as securitization participant and investor in the ABS transaction.

- The proposed rule would cover only conflicts that arise in connection with a securitization party engaging in a transaction. For example, a securitization participant's purchase of credit default swap protection on an ABS would be "engaging in a transaction" and, therefore, would be covered by the proposed rule. However, a securitization participant's issuance of investment research would not be "engaging in a transaction."

5. Covered Materiality: The SEC proposes to a two-prong test for determining whether a transaction involves or results in a material conflict of interest. For purposes of the proposed rule, engaging in a transaction would involve or result in a material conflict of interest if both of the following conditions are satisfied:

Prong One: Either (a) a securitization participant benefits, directly or indirectly, from a short transaction; or (b) a securitization participant who controls the securitization transaction benefits from creating an opportunity for a third party to benefit from a short transaction.

- For purpose of the proposed rule, a "short transaction" includes the actual, anticipated or potential (a) adverse performance of the asset pool supporting or referenced by the ABS; (b) loss of principal, monetary default or early amortization event of the ABS; or (c) decline in market value of the relevant ABS.
- The proposed rule's prohibition would arise any time the securitization participant would benefit from an actual, anticipated or potential decline in the ABS it helped to create, regardless of whether the securitization participant intentionally designed the ABS to fail or default.
- The burden of compliance with the proposed regulation would fall on the securitization participant, regardless of whether the conflict arises as a result of the securitization participant's short transaction or as a result of a short transaction of a third party that participated in the structuring of the ABS or in the selection of assets underlying the ABS.

Prong Two: There is a substantial likelihood that a reasonable investor would consider the conflict important to his or her investment decision.

- The SEC indicates that it is not possible to designate in advance specific facts or occurrences that would be determinative of materiality in every instance. Instead, the SEC proposes that interpretation of whether a transaction complied with the proposed rule would require an assessment of the inferences that a reasonable investor would draw from the specific set of facts and circumstances that arise in that transaction.

B. Exceptions to Application of the Proposed Rule

The proposed rule includes three categories of activities that are excepted from the scope of the prohibition on material conflicts of interests under Section 27B of the Securities Act.

1. Risk-Mitigating Hedging Activities: The proposed rule does not apply to risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase or sponsorship of an ABS if those activities are designed to reduce the securitization participant's specific risks in connection with those positions or holdings. In other words, a securitization participant may enter into a hedge that mitigates the securitization participant's risk of loss but the securitization participant may not enter into a hedge to gain profit.

2. Liquidity Commitments: The proposed rule does not apply to purchases or sales of ABS made pursuant to commitments of a securitization participant, or any affiliate or subsidiary of a securitization participant, to provide liquidity for the ABS. In the proposing release, the SEC implies that, while the liquidity commitment exception is specifically written to address only purchases or sales, the SEC may be willing to interpret the exception to permit certain liquidity arrangements typical in the marketplace, such as liquidity provided in an asset-backed commercial paper program and liquidity provided by an underwriter to an ABS customer in committing to provide a repo arrangement for ABS purchased from that underwriter. The SEC requests comment regarding examples of liquidity arrangements that should fall within the scope of the exception.

3. Bona Fide Market-Making Exception: The proposed rule does not apply to purchases or sales of ABS by a securitization participant or its affiliate or subsidiary made pursuant to and consistent with bona fide market-making in the ABS. The SEC indicates that the following principles will be considered in determining whether an activity qualifies for this exception to the proposed rule:

- Purchasing and selling ABS from or to investors in the secondary market is a bona fide market-making activity;
- Holding oneself out as willing and available to provide liquidity on both sides of the market is a bona fide market-making activity;
- Bona fide market-making activities are driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers or market makers;
- Bona fide market-making activities are generally initiated by a counterparty and, if a customer initiated a customized transaction, it may include hedging activities if there is not matching offset;
- Activity that is related to speculative selling strategies or investment purposes of a dealer and that is disproportionate to the usual market-making patterns or practices of the dealer with respect to that ABS is not a bona fide market-making activity;
- Absent a change in a pattern of customer driven transactions, bona fide market-making activity typically does not result in a number of open positions that far exceed the open positions in the historical normal course of business;
- Bona fide market-making generally does not include actively accumulating a long or short position other than to facilitate customer trading interest; and
- Bona fide market-making 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.

C. SEC's Examples Regarding Interpretation of the Proposed Rule

In the proposing release, the SEC provides examples of hypothetical arrangements entered into in connection with, or relating to, securitization transactions and describes how the proposed rule and the SEC's proposed interpretations of the proposed rule would apply to determine whether the arrangements or transactions involve or result in a prohibited material conflict of interest. Illustrations of the examples are provided in Annex A to this Client Alert. Although these examples provide insight into the SEC's intent with respect to the proposed interpretive guidelines, it is important to note that neither the interpretive guidelines nor the examples described in the proposing release will have force or effect unless they are incorporated into a final SEC release adopting rules under Securities Act Section 27B.

D. SEC Commentary Regarding Relationship Between the Proposed Rule and Volcker Rule

In the proposing release, the SEC notes the similarities between the proposed rule and Section 619 of Dodd-Frank (commonly referred to as the "Volcker Rule"), which is also concerned with conflicts of interest and includes similar provisions permitting market-making related activities and risk-mitigating hedging activities. The SEC expresses a preliminary belief that the exceptions under the proposed rule should be applied consistently with the comparable exceptions under the Volcker Rule and requests comment regarding the potential interplay between the proposed rule and the SEC rules being considered to implement the Volcker Rule.

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E. SEC Commentary Regarding Use of Information Barriers and Disclosure

Although information barriers and disclosures are often used as tools for managing conflicts of interest in other areas of federal securities laws, the proposed rule does not expressly permit securitization participants to rely on these tools to engage in activities that would otherwise be prohibited. The SEC requests comment regarding whether and to what extent allowing securitization participants to manage conflicts of interest through the use of information barriers or the use of disclosure might be consistent with the Congressional mandate in Securities Act Section 27B.

Please feel free to contact **Mike Mitchell**, **Felicia Graham** or **Rachel George** if you have any questions or would like to discuss these proposed rules in greater detail.

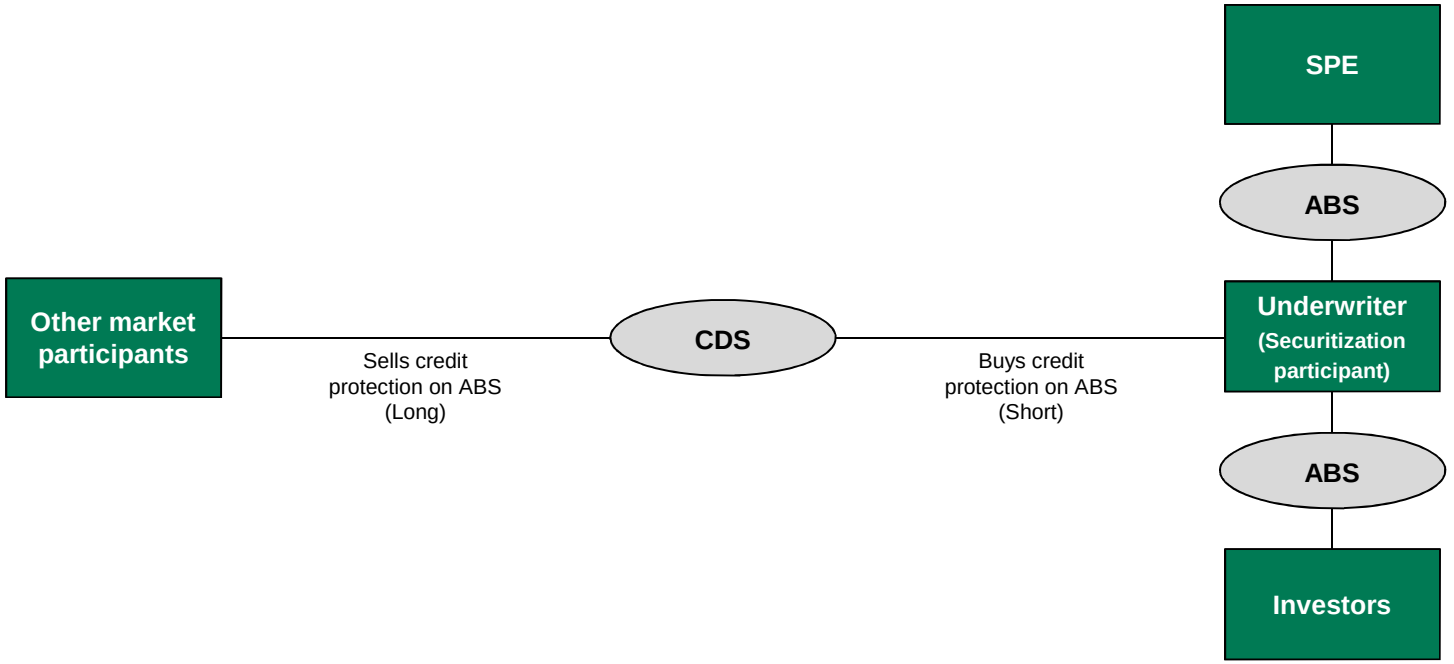
Annex A to this Client Alert is included on the pages that follow.

Structured Finance Update:
SEC Proposes Rule Prohibiting Material Conflicts of Interest in Securitization Transactions

Annex A

EXAMPLE 1:
SHORT TRANSACTION IN ABS

A securitization participant, in this case an ABS underwriter, purchases CDS protection on the ABS offered in the relevant transaction three months after the date of the first closing of sale of the ABS. The underwriter's purchase of the CDS protection was made solely for its own proprietary investment purposes.



SEC Commentary:

- The underwriter would profit from the adverse performance of the ABS and, therefore, the underwriter's purchase of the CDS protection is prohibited by the proposed rule.
- In this example, the SEC assumes the underwriter's purchase of the CDS protection does not qualify for any exception in the proposed rule.
- The SEC indicates that the bona fide market-making exception may be available where (A) the underwriter's client requested the long CDS exposure or (B) the underwriter purchased CDS protection from one customer to offset its sale of CDS protection to another customer.

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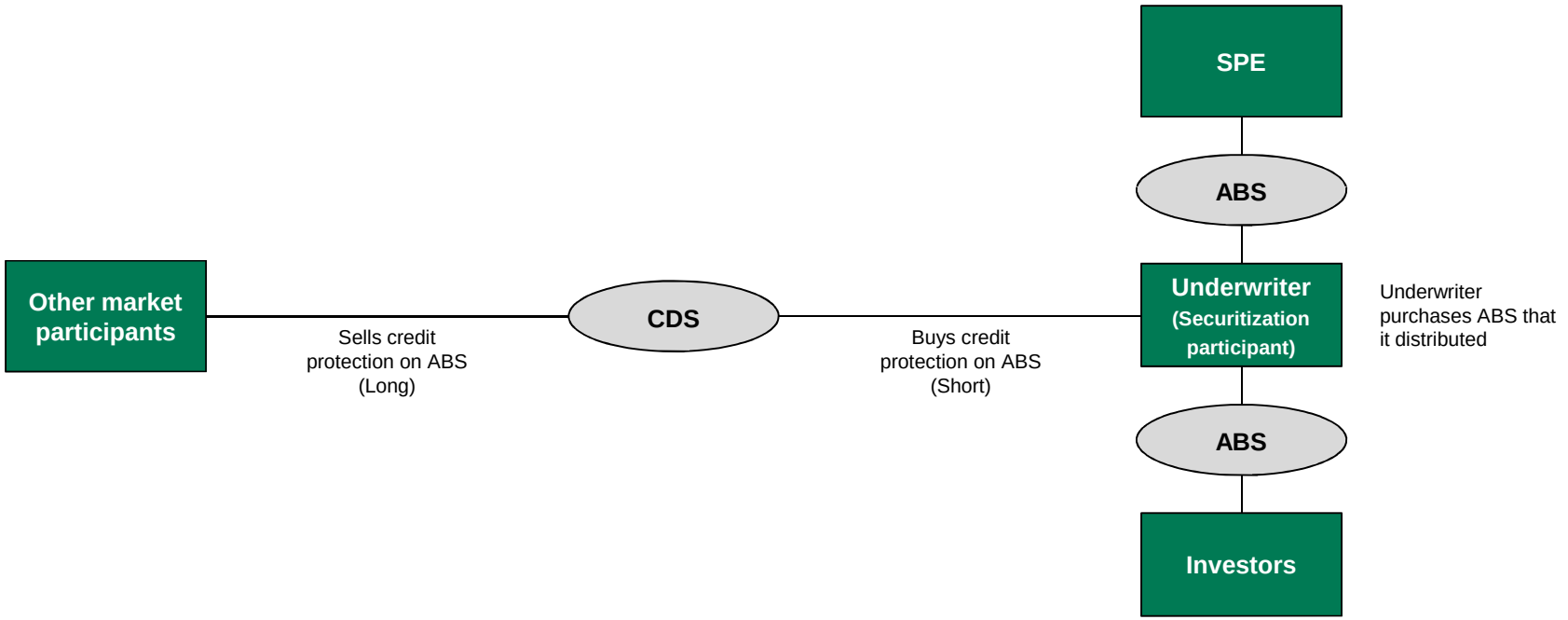
EXAMPLE 2:
HEDGE OF RETAINED INVESTMENT IN ABS

An ABS underwriter purchases ABS that it distributed and contemporaneously purchases CDS protection on the ABS. The underwriter's purchase of the CDS protection was made to hedge its ABS position on a delta neutral basis (such that the potential gains on the hedged positions are not appreciably larger than the potential losses on that portion of the ABS investment that is being hedged).



SEC Commentary:

The proposed risk-mitigating hedging activities exception could apply because the securitization participant is hedging a position arising out of the underwriting, placement, initial purchase or sponsorship of the ABS. However, if the CDS transaction is structured on other than a delta neutral basis (such that potential gains on the hedged positions are appreciably larger than the potential losses), the risk-mitigating hedging position would not apply.

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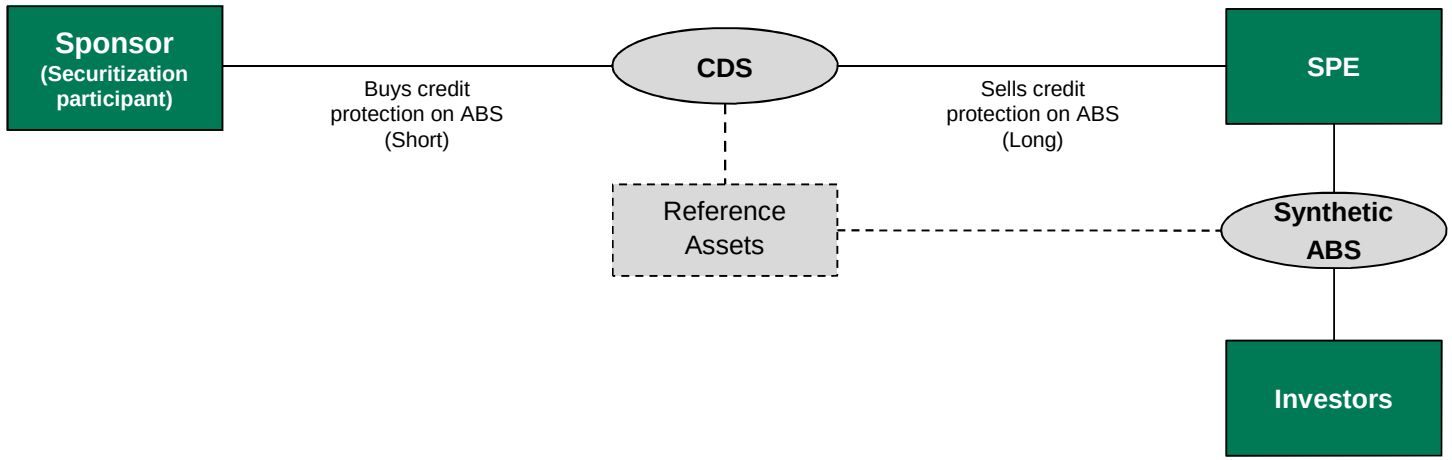
EXAMPLE 3A:
SYNTHETIC ABS TRANSACTION

Common Facts:

Securitization participant, in this case the sponsor, and SPE are parties to a CDS contract that references particular assets (*e.g.*, a single asset, a pool or an index). The sponsor purchases CDS protection on the reference assets underlying the ABS transaction.

Variant Facts:

The sponsor does not have any exposure to the ABS or underlying assets other than its short position through the CDS transaction.



SEC Commentary:

Entering into the CDS with the SPE would, by itself, generally involve or result in a material conflict of interest between the sponsor and the ABS investors because the sponsor would benefit through the CDS transaction from a potential decline in the ABS.

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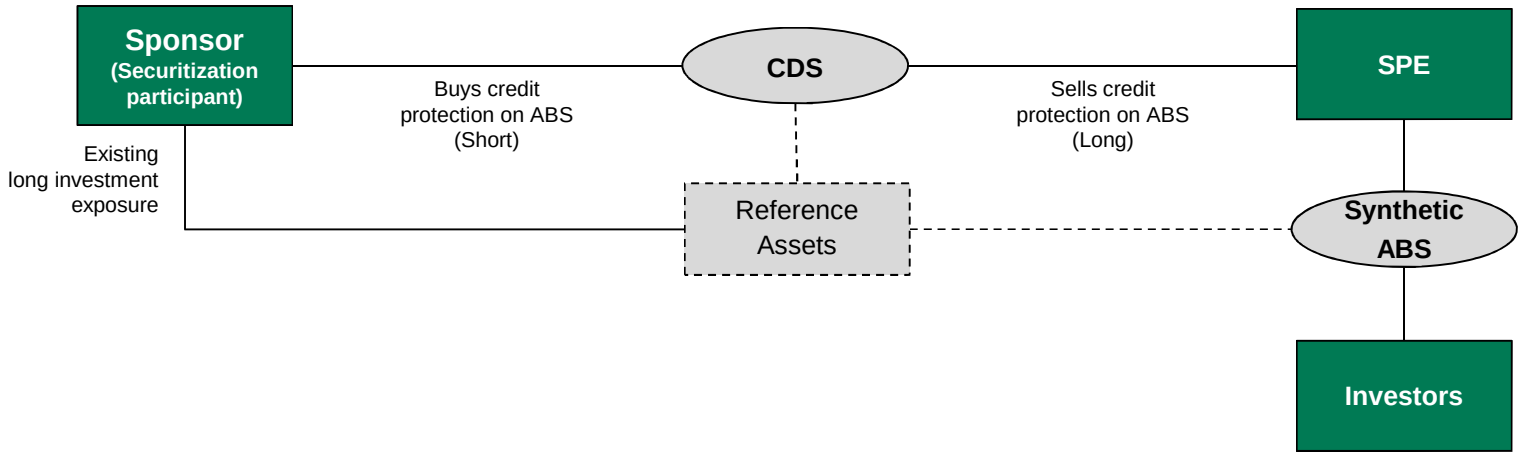
EXAMPLE 3B:
SYNTHETIC ABS TRANSACTION

Common Facts: See Example 3A

Variant Facts:

The sponsor's purchase of the CDS protection offsets its existing long investment exposure to the assets underlying the synthetic ABS. The sponsor transfers risk of its long position to ABS investors through a synthetic ABS because it believes the assets will perform poorly. Simultaneously, the sponsor markets the ABS securities to investors as a good investment opportunity.



SEC Commentary:

SEC's preliminary belief is that entering into the CDS transaction would result in a material conflict of interest between the sponsor and the ABS investors because the sponsor would benefit through the CDS transaction from a potential decline in the ABS.

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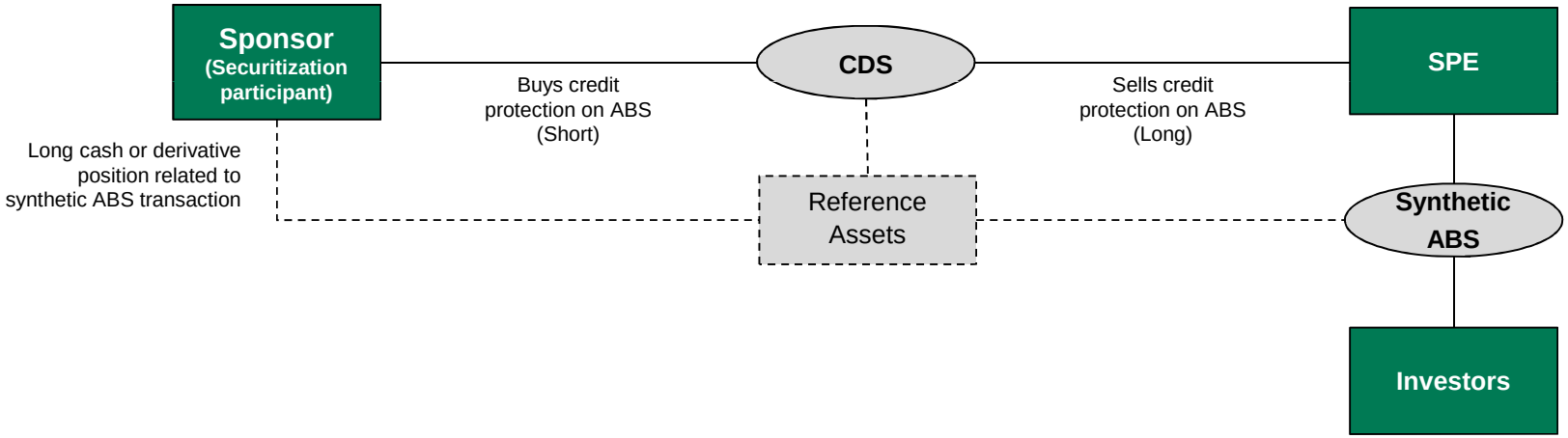
EXAMPLE 3C:
SYNTHETIC ABS TRANSACTION

Common Facts: See Example 3A

Variant Facts:

The sponsor has accumulated 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.



SEC Commentary:

- SEC's preliminary belief is that entering into the short CDS transaction would fall within the exception for risk-mitigating hedging activities, provided that there was no significant net basis risk, and that potential gains (or losses) by the sponsor from the CDS protection it purchased from the SPE would be directly offset by losses (or gains) from the long position accumulated to offset that exposure.
- The SEC acknowledged the practical difficulty of determining the sponsor's intent in accumulating positions and asked for comment on that topic.

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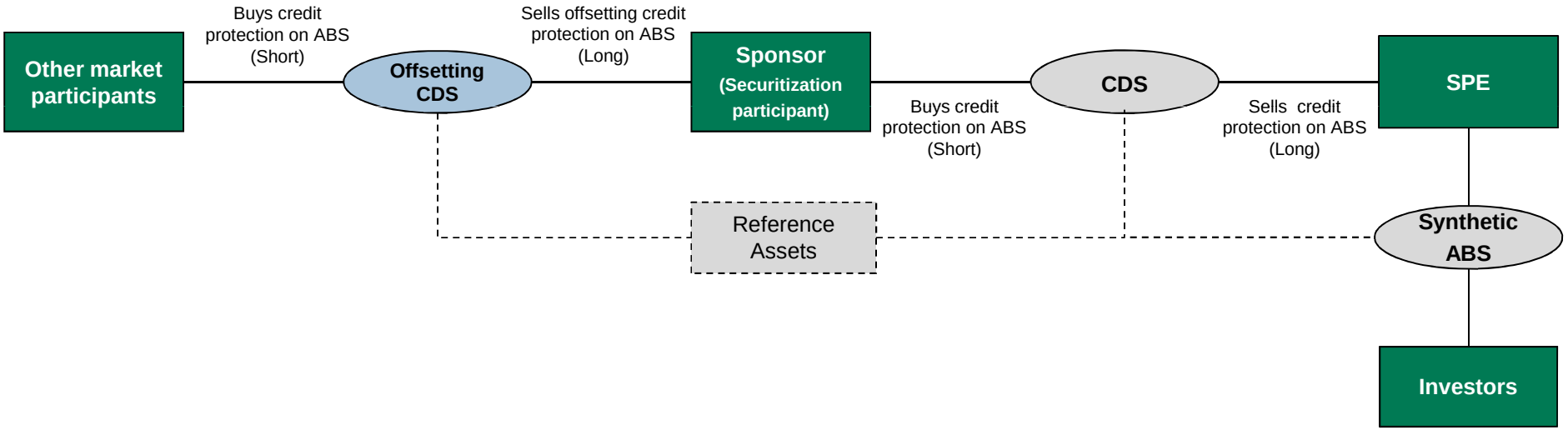
EXAMPLE 3D:
SYNTHETIC ABS TRANSACTION

Common Facts: See Example 3A

Variant Facts:

The sponsor has entered 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.



SEC Commentary:

- SEC's preliminary belief is that, under the risk-mitigating hedging exception, the sponsor would be permitted to enter into this combination of CDS and offsetting CDS transactions, provided that (A) the sponsor did not specifically select assets that were biased to enable the other market participants to profit from short positions, and (B) the sponsor's gains (or losses) from the CDS transaction would be directly offset by those from the offsetting CDS transactions.
- Conversely, if the offsetting CDS transactions were entered into before the ABS transaction, and for unrelated purposes, the risk-mitigating hedging exception would not apply.

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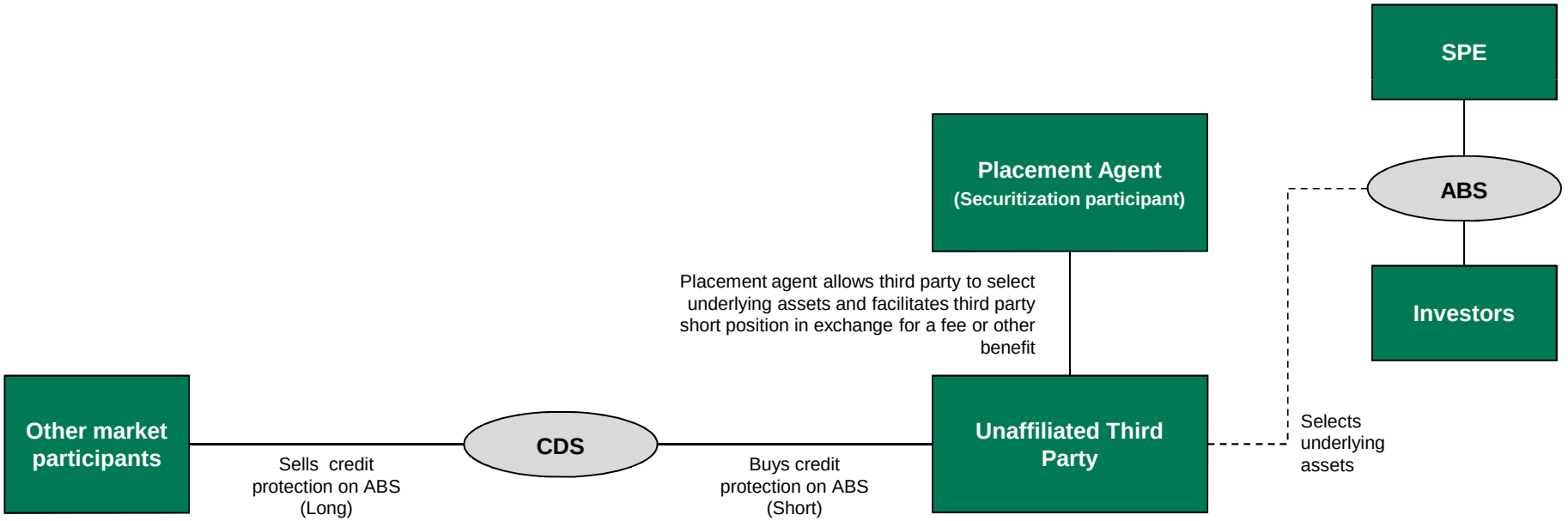
EXAMPLE 4A:
FACILITATION OF THIRD PARTY ACTIVITIES

Common Facts:

The securitization participant, in this case the placement agent, allows an unaffiliated third party to select the composition of the assets that underlie an ABS. Unaffiliated third party purchases CDS protection on the ABS.

Variant Facts:

The placement agent, for a fee, facilitates the unaffiliated third party's purchase of CDS protection on the ABS.



SEC Commentary:

By allowing the third party to select assets underlying the ABS, and then facilitating the third party taking a short position on the ABS or its underlying assets, the placement agent has engaged in a transaction that involves or results in a material conflict of interest between the placement agent and the ABS investors, and such activity would be prohibited under the proposed rule.

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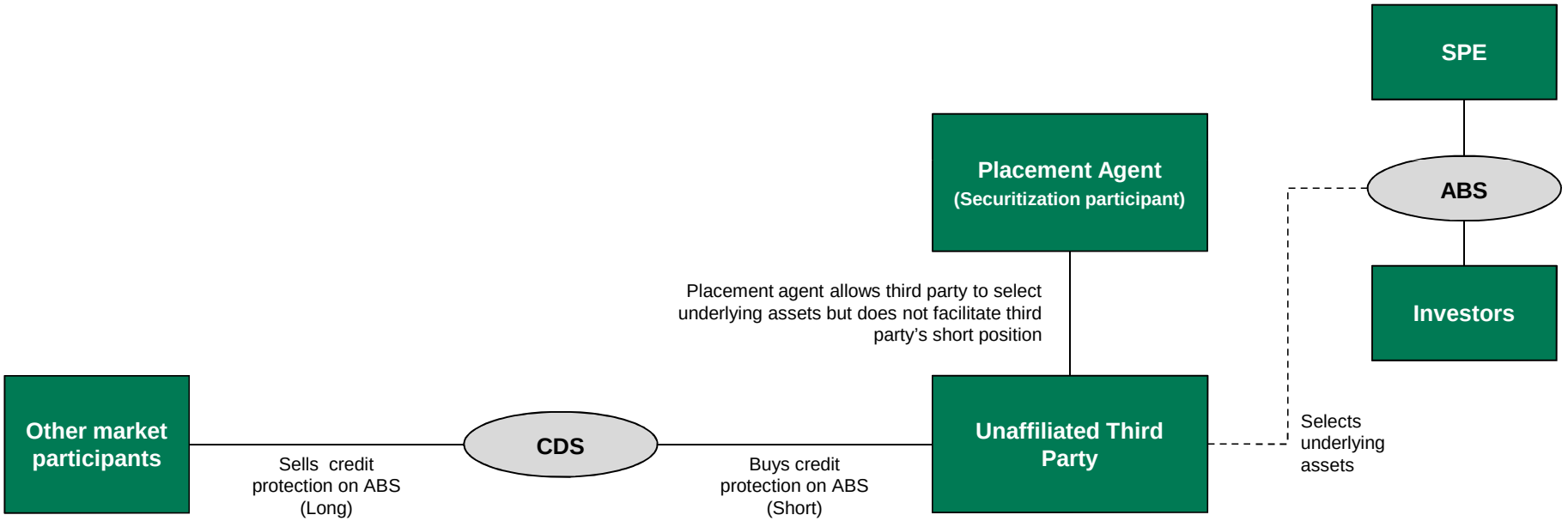
EXAMPLE 4B:
FACILITATION OF THIRD PARTY ACTIVITIES

Common Facts: See Example 4A

Variant Facts:

The placement agent does not facilitate unaffiliated third party's CDS transaction or receive a fee for doing so.



SEC Commentary:

SEC's preliminary belief is that it would be appropriate to impute a benefit to the placement agent for creating the opportunity for the third party to select the underlying assets and to purchase the CDS protection from which it would profit if the underlying assets perform poorly.

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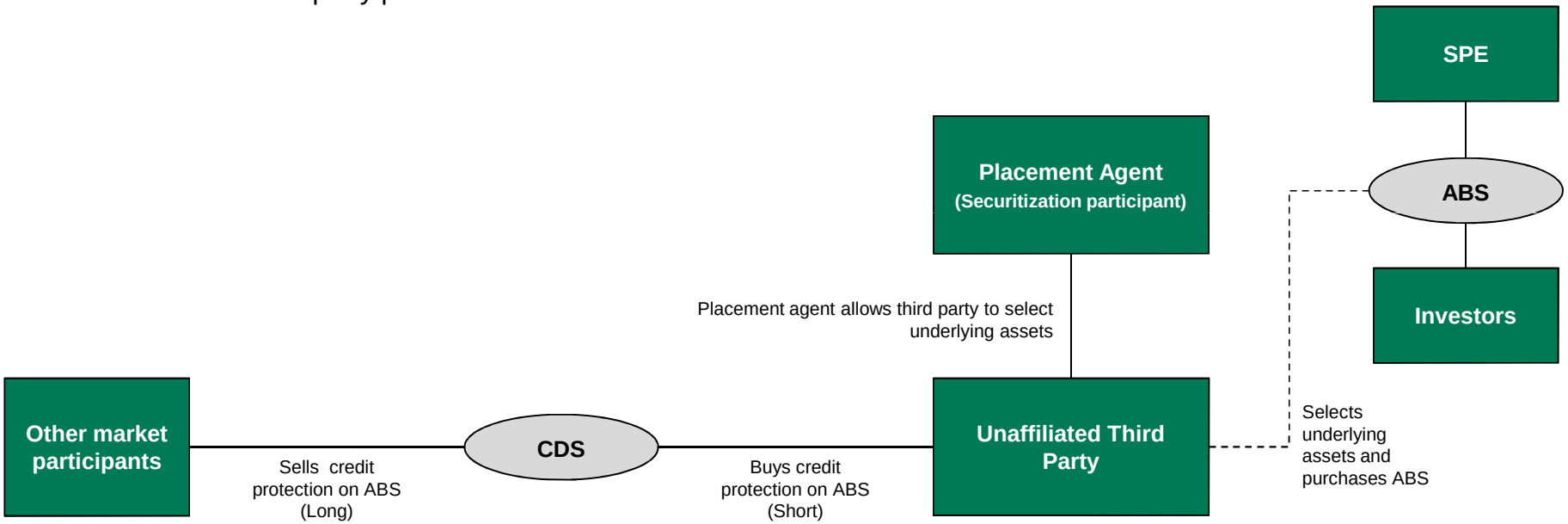
EXAMPLE 4C:
FACILITATION OF THIRD PARTY ACTIVITIES

Common Facts: See Example 4A

Variant Facts:

The unaffiliated third party purchases one or more of the securities offered in the ABS transaction.



SEC Commentary:

- SEC's preliminary belief is that activities in which investors who purchase one or more securities offered in an ABS transaction decide, at that time or later, to reduce or hedge their exposure to these investments through subsequent short transactions, such as purchasing CDS protection, would qualify for the risk-mitigating hedging exception.
- Further, the unaffiliated third party is in the same position as a securitization participation who selects the assets underlying the ABS, purchases the ABS and then seeks to hedge the ABS by buying CDS protection. Since, in that case, the securitization participant would qualify for the risk mitigating hedging exception, so would the unaffiliated third party. (See Example 2.)

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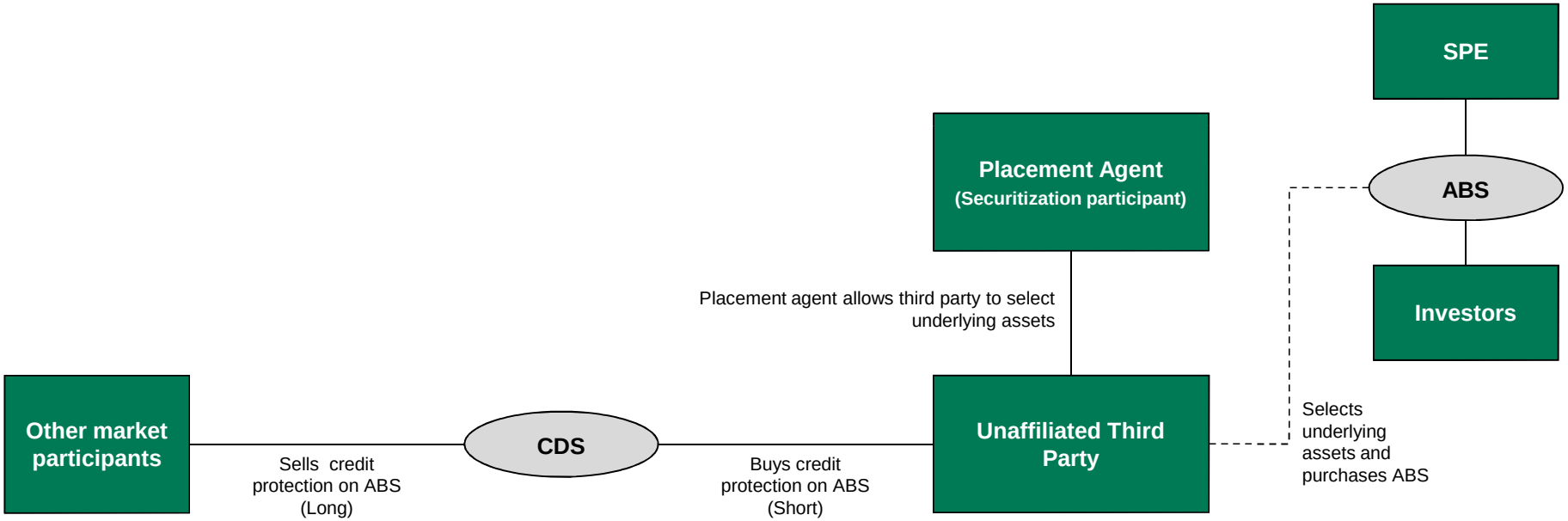
EXAMPLE 4D:
FACILITATION OF THIRD PARTY ACTIVITIES

Common Facts: See Example 4A

Variant Facts:

The unaffiliated third party purchasing one or more securities issued by the ABS also buys CDS protection on those same securities or other securities in the offering (or their underlying assets), in a manner such that the unaffiliated third party will profit more from the short position than it will lose on the long securities position.



SEC Commentary:

This activity would no longer qualify for the risk-mitigating hedging exception. By allowing an unaffiliated third party to select assets underlying an ABS in a way that facilitates that unaffiliated third party's ability to profit from a short position on the ABS or its underlying assets, the placement agent has engaged in a transaction that involves or results in a material conflict of interest between itself and investors in the ABS.

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