

ALERTS

SEC Proposal on Prohibition Against Conflicts of Interest in Certain Securitizations

September 22, 2011

On Sept. 19, 2011, the Securities and Exchange Commission (the “SEC”) issued, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), a notice of proposed rulemaking that addresses the prohibition of conflicts of interest in certain securitizations (the “Proposed Rule”). The deadline for submission of comments to the SEC on the Proposed Rule is Dec. 19, 2011.

Section 621 of the Dodd-Frank Act adds new Section 27B to the Securities Act of 1933 which prohibits an underwriter, placement agent, initial purchaser or sponsor of an asset-backed security, including a synthetic asset-backed security (or any of their affiliates) from engaging in a transaction that would result in a material conflict of interest vis-à-vis any investor in the asset-backed security for a period of one year following the initial closing date. Exceptions are available in the cases of (a) hedging activities engaged in by an underwriter, placement agent, initial purchaser or sponsor if the risk being hedged is specific to the party’s function in the securitization (e.g., shorting warehoused assets prior to closing); (b) commitments by any such party to provide liquidity for the asset-backed security; and (c) bona fide market-making in the asset-backed security. The language of the Proposed Rule (Rule 127B) is substantially similar to the language of existing Section 27B; however, in the Proposed Rule, the SEC clarifies the scope of the new prohibition.

The SEC explains that in order for the Rule 127B prohibition to apply to a transaction, five elements must be present:

1. Covered persons: “Covered persons” include underwriters, placement agents, initial purchasers, sponsors, or any of their subsidiaries or affiliates. The SEC notes that its interpretation of the definition of sponsor for Rule 127B purposes is broader than the Regulation AB definition of sponsor, since Regulation AB does not apply to synthetic asset-backed securities.
2. Covered products: “Covered products” include any asset-backed securities, registered or unregistered, including synthetic asset-backed securities. The Dodd-Frank Act definition of an asset-backed security is broad and includes traditional asset-backed securities as well as collateralized debt obligations.
3. Covered timeframe: The “covered timeframe” during which transactions are prohibited under Proposed Rule 127B ends one year after the first closing of the sale of the asset-backed security to the public. The SEC notes that the prohibition would apply to transactions that are effected prior to the closing date.
4. Covered conflict: The term “covered conflict” is defined as a conflict that arises between an underwriter, placement agent, initial purchaser or sponsor, on the one hand, and an investor, on the other hand, in their respective capacities in the securitization. Thus a conflict solely between two underwriters or between two investors would not qualify as a covered conflict. The Proposed Rule also explains that a covered conflict must arise out of a transaction. Activities that are not transactions — e.g., providing investment research — cannot give rise to covered conflicts.
5. Material conflict of interest: The Proposed Rule explains that for a conflict of interest to be a “material conflict of interest,” it must satisfy a two-prong test. First, the relevant party either (a) must benefit directly or indirectly from actual or potential losses on, or from a decline in the market value of, the asset-backed security (including the asset pool underlying the asset-backed security) or (b) must receive compensation or the promise of future business from a third party which is allowed to structure a transaction where the third party would benefit from losses or decline. Second, there must be a “substantial likelihood” that a “reasonable” investor would consider the conflict important in making his or her investment decision.

The full text of the Proposed Rule is available from the SEC's website at the following address: <http://www.sec.gov/rules/proposed/2011/34-65355.pdf>.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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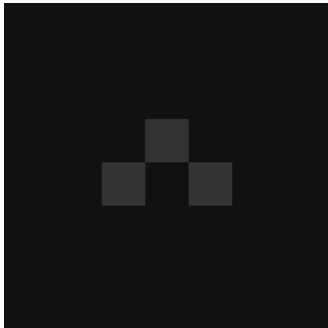
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