

# SEC Proposes Rule to Prohibit Conflicts of Interest in Certain Securitizations

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On January 25, 2023, the U.S. Securities and Exchange Commission (“SEC”) issued a proposed rule to prohibit material conflicts of interest in the sale of asset-backed securities (“ABS”). The proposed rule is a re-proposal of a rule that was first proposed in 2011 and is required by section 27B of the Securities Act of 1933<sup>1</sup> (the “Securities Act”), a provision added by Section 621 of the Dodd-Frank Act. As the initial proposal was subject to substantial industry commentary, much of the preamble to the re-proposal is directed at addressing previous comments. If adopted this time, the proposed rule would prohibit specified securitization participants from engaging in certain “conflicted transactions” that could incentivize a securitization participant to structure an ABS such that the securitization participant’s interests would be placed ahead of those of the ABS investors.<sup>2</sup>

The key provisions of the proposed rule are further discussed below. The full text of the proposal is available [here](#).

**Key Elements of the Proposed Rule.** The proposed rule is intended to prevent conflicts of interest that may arise from securitization participants taking positions economically averse to the interests of ABS investors. The prohibition would extend broadly to affiliates as well as securitization participants themselves, begin when a person has reached or taken substantial steps to reach an agreement to become a securitization participant with respect to an ABS and end one year after the date of the first closing of the sale of the relevant ABS. The key elements of the proposed rule are as follows:

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<sup>1</sup> 15 U.S.C. § 77z-2a.

<sup>2</sup> The proposed rule includes within the definition of “asset-backed security” any ABS within the meaning set forth in Section 3 of the Securities Exchange Act of 1934 (the “Exchange Act”), as well as any synthetic ABS. Under Section 3 of the Exchange Act, the term “ABS” means a “fixed-income or other security collateralized by any type of self-liquidating financial asset . . . that allows the holder of the security to receive payments that depend primarily on cash flow from the asset,” including collateralized mortgage obligations, collateralized debt obligations and collateralized bond obligations. 15 U.S.C. § 78c(a)(79).

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- *In-scope participants.* The proposed rule’s prohibition on engaging in certain conflicted transactions would apply to “securitization participants,” defined as underwriters, placement agents, initial purchasers or sponsors of ABS. “Sponsor” would be broadly defined to include any person that organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, to the entity that issues the ABS. Under the proposed rule, a sponsor would also include any person that directs or causes the direction of the structure, design or assembly of an ABS or the composition of the pool of assets underlying the ABS, and any person with contractual rights to do so. However, there is a narrow safe harbor for those who perform only “administrative, legal, due diligence, custodial, or ministerial acts” in relation to the relevant ABS or the assets underlying the ABS.
  
  - *Conflicted transactions.* Under both the statute and the rule, a securitization participant would be prohibited from directly or indirectly engaging in any transaction that would involve or result in “a material conflict of interest” between the participant and an ABS investor for one year. The rule would specifically set out a set of “conflicted transactions” that would be deemed to create such conflicts per se. The following would be conflicted transactions, provided that there is a substantial likelihood that a reasonable investor would consider the transaction important to its investment decision (including a decision whether to retain an ABS):
    - a short sale of the relevant ABS;
  
    - the purchase of credit default swaps or other credit derivatives where the securitization participant would be entitled to receive payments upon the occurrence of a specified adverse event with respect to the ABS; and
  
    - 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, default or early amortization event on the relevant ABS; or
  
      - decline in the market value of the relevant ABS.

In addition, the proposed rule contains a general anti-evasion clause scoping in any other form of transaction that is not included in this list but that is economically equivalent.

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- *Exceptions.* As required by the statutory text under Section 27B, the proposed rule would exempt risk-mitigating hedging activities, liquidity commitments and bona fide market-making activities.
  - *Risk-mitigating hedging activities.* The proposed rule would provide that risk-mitigating hedging arising out of securitization activities (including the origination or acquisition of assets that are to be securitized) would be permitted only if:
    - (1) at the inception of the hedging activity and at the time of any subsequent adjustments, the hedging activity is designed to “reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with identified positions, contracts, or other holdings of the securitization participant”;
    - (2) the hedging activity is subject to ongoing “recalibration by the securitization participant” to ensure the permissibility of its risk-mitigating hedging activities and to avoid facilitating or creating “an opportunity to benefit from a conflicted transaction other than through risk-reduction”; and
    - (3) the securitization participant has established and enforces an internal compliance program to ensure the securitization participant engages only in permitted risk-mitigating hedging activities, including reasonably designed policies and procedures that provide for the specific risk-mitigating hedging activities to be identified, documented and monitored.
  - *Liquidity commitments.* These would include purchases or sales of ABS made pursuant to commitments of the securitization participant to provide liquidity for the ABS.
  - *Bona fide market-making activities.* Bona fide market-making activities of the securitization participant, including market-making related hedging in connection with ABS, the assets underlying such ABS or financial instruments that reference such ABS or underlying assets, would be permitted only if:
    - (1) the securitization participant routinely stands ready to purchase and is willing and available to quote, purchase and sell such financial instruments in commercially reasonable amounts as a part of its market-making related activities;

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- (2) the securitization participant's market-making related activities are designed not to exceed the reasonably expected near-term demands of clients or counterparties;
  - (3) the compensation arrangements of persons performing the activity are designed not to reward or incentivize conflicted transactions;
  - (4) the securitization participant is licensed or registered to engage in market making activities in accordance with applicable law and self-regulatory organization rules; and
  - (5) the securitization participant has established and enforces an internal compliance program to ensure the securitization participant engages only in permitted market-making activities, including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks related to its market-making positions and holdings.

Notably, any transaction that provides a benefit that can be traced back to the actual, anticipated or potential adverse performance of the relevant ABS or its underlying asset pool would be a conflicted transaction under the proposed rule, regardless of its relationship to the securitization structure itself. For example, a synthetic ABS structure that involves a securitization participant or affiliate taking the other side of derivatives required to set up the structure would be prohibited, and the proposed rule does not include an exception based on disclosure of potential material conflicts of interest. As stated in the preamble to the proposed rule, while disclosure would reduce the likelihood that an investor would invest in a "tainted ABS," the incentive for a securitization participant to enter into the conflicted transaction would nevertheless remain.

**Effect on Private Fund Managers.** The breadth of the proposed rule would cover activities of collateralized loan obligations ("CLOs") or other ABS vehicle collateral managers and their affiliates, including credit, real estate and other private fund managers (as either "sponsors" of an ABS or "affiliates" of such persons). As a result, private fund managers who sponsor or manage CLOs or other ABS transactions and their affiliates would need to determine the types of related client or proprietary transactions that could be prohibited conflicted transactions, and adopt policies and procedures to ensure that they do not engage in those types of transactions. While the bona fide hedging and other exceptions may apply to certain conflicted transactions, the exceptions are drafted narrowly. Moreover, the proposed rule does not recognize disclosure and consent as a means to address any potential conflicted transaction—an approach that the SEC recognizes under the Investment Advisers Act of 1940, as amended, as a means to address conflicts of interest between investment advisers and

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their clients. Further, the proposed rule does not contain an exception allowing the use of information barriers to allow a private fund manager affiliated with CLO and ABS sponsors to engage in transactions that otherwise might be prohibited, although the SEC did acknowledge the possibility of such an exception and requested comments on the issue.

The comment period for the proposed rule is open until **March 27, 2023**. We welcome you to reach out to us with any questions or if you or your organization are interested in commenting on the Proposal.

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Please do not hesitate to contact us with any questions.

**NEW YORK**



Jeff Robins  
jlrbins@debevoise.com



Jeremy Lin (Law Clerk)  
jlin1@debevoise.com

**WASHINGTON, D.C.**



Marc Ponchione  
mponchione@debevoise.com