Statement

Unsettling End of an Era: Statement on Adoption of Rule Prohibiting Conflicts of Interest in Certain Securitizations

Commissioner Hester M. Peirce

Nov. 27, 2023

Although not covering as many eras as this year's most watched concert tour,[1] this rulemaking comes close. Like its musical counterpart, a rule that is more than a decade and multiple iterations in the making should be really good.[2] This rule, with its lingering ambiguities and over-breadth, may not be. It certainly is better than what we proposed, but it is also different enough from the proposal that public comment on the new approach is necessary to ensure that we got it right this time. Even a short comment period on the new rule text would have helped to ensure that the rule prohibits securitization participants from betting against securitizations without stopping risk mitigating hedging, market-making, and other ordinary course transactions. As burdensome as it would have been for the Commission and commenters to formally re-engage, the consequences of getting this rule wrong loom large enough to warrant one more round of comment.[3] Accordingly, I dissent.

Re-proposing this rule would have counteracted a troubling recent pattern from the Commission:[4]

- release an expansive, unworkable rule proposal that includes myriad questions;
- watch as concerned commenters expend available resources to mount an all-out attack on the most unrealistic and potentially catastrophic provisions in the proposed rule, leaving them with little to no remaining resources to address questions about other, less immediately alarming, yet also concerning provisions in the proposed rule;
- trim the rule's unworkable excesses when finalizing the rule after the comment period has closed; and
- cite to the proposal's myriad questions – both answered and unanswered – to support the contention that the rule is responsive to commenters and a logical outgrowth of the proposal.

Our pattern of proposing unrealistic rules with numerous questions, only to substantively revise the rule text after the comment period closes inhibits our ability to receive and consider comprehensive feedback, and thus write sound final rules. We faced this problem here.[5] Commenters pointed out the rule's overbreadth and unworkability.[6] The adopting release, recognizing the potential for certain elements of the rule to disrupt the securitization market and the multi-trillion dollar credit market that relies on it,[7] seeks to address some of these elements. I nevertheless continue to have concerns that we have not gotten the substance of the rule right. By "right," I mean implementing the congressional mandate in a way that stops the types of conflicted transactions that plagued financial crisis era securitizations without placing undue burdens on ordinary course transactions.

Unfortunately, I continue to be concerned that we did not get this right. The rule continues to be broader than necessary. The rule covers, for example, transactions that do not result in the securitization participant's interests being materially adverse to investors' interests.[8] The rule instead deems conflicted transactions "with respect to which there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision."[9] The rule excepts certain activities, but those exceptions are excessively narrow.[10] More generally, the Commission fails to use its exemptive authority to exclude from the rule securitizations for which exemptions might make sense.[11] The excesses in the market which drove the passage of Section 621 of Dodd-Frank are arguably no longer prevalent, so the rule should have been more targeted.[12]

The rule remains ambiguous in certain places. As one example, the starting date of the prohibition begins on the potentially ambiguous date the person agrees to become a securitization participant, which is triggered by "an agreement in principle," a vague standard which can include "oral agreements and facts and circumstances constituting an agreement."[13] As another example, the Commission declined to define in the regulatory text the key term "synthetic asset-backed security."[14] The Commission acknowledges that leaving this ambiguity unaddressed could "impose compliance costs on securitization participants who may seek legal advice and incur other costs" to see if they must comply with the final rule and that the uncertainty could deter the participants "from entering [certain] transactions" at all.[15]

Even as I dissent, I commend the staff's serious efforts to address problems raised by commenters. The staff's intense work on a technically difficult topic paid off in the form of a better rule than was proposed. Helpful changes include excluding long investors, narrowing some of the defined terms, clarifying that the rule does not apply to mortgage insurance linked-notes, and striking the proposed carve-out for Fannie Mae and Freddie Mac during conservatorship. I appreciate the work of the team in the Division of Corporation Finance under the capable and engaged leadership of Erik Gerding and Rolaine Bancroft. I also thank the staff in the Division of Economic and Risk Analysis, the Division of Trading and Markets, the Office of General Counsel, Corey Klemmer in the Chair's office, and others throughout the Commission for their efforts on this multi-year rulemaking. I look forward to working with staff and affected market participants on implementing the rule.

---

[1] *See* Ben Sisario, *How Taylor Swift's Eras Tour Conquered the World*, New York Times (Aug. 5, 2023), https://nytimes.com/2023/08/05/arts/music/taylor-swift-eras-tour.html.

[2] The Commission issued its first proposal over a decade ago. *See Prohibition against Conflicts of Interest in Certain Securitizations*, Release No. 34-65355 (Sept. 19, 2011) [76 FR 60320 (Sept. 28, 2011)].

[3] Multiple commenters called for the Commission to re-propose this rule. *See*, e.g., Letter from Andrew Davidson & Co. at 4 (Mar. 27, 2023), https://www.sec.gov/comments/s7-01-23/s70123-20161719-330591.pdf ("[T]he proposed rule goes too far and prohibits a wide range of risk reduction activities that are well understood by market participants and are necessary for the proper functioning of securitization markets. The Proposed Rule should be withdrawn and reproposed."); Letter from the Securities Industry and Financial Markets Association, the Asset Management Group of SIFMA, and the Bank Policy Institute at 43-44 (Mar. 27, 2023), https://www.sec.gov/comments/s7-01-23/s70123-20161806-330705.pdf ("SIFMA I") ("[I]f the Commission decides to retain the catchall concept [in the definition of conflicted transaction, as the final rule does in some form], we urge the Commission to do so in the form of a re-proposal of the rule, rather than in the form of a final rule. . . . A re-proposal would afford market participants the opportunity to provide the Commission with further comments to ensure that the rule is in a form that is amenable to operational compliance.").

[4] *See*, *e.g.*, *Share Repurchase Disclosure Modernization*, Release Nos. 34-97424; IC-34906 (May 3, 2023) [88 FR 36002 (Jun. 1, 2023)]; *Money Market Fund Reforms; Form PF Reporting Requirements for Large Liquidity Fund Advisers; Technical Amendments to Form N-CSR and Form N-1A*, Release Nos. 33-11211; 34-97876; IA-6344; IC-34959 (Jul. 12, 2023) [88 FR 51404 (Aug. 3, 2023)]; *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Release No. IA-6383 (Aug. 23, 2023) [88 FR 63206 (Sept. 14, 2023)]; *Modernization of Beneficial Ownership Reporting*, Release Nos. 33-11253; 34-98704 (Oct. 10, 2023) [88 FR 76896 (Nov. 11, 2023)].

[5] In support of fulfilling the statutory mandate, I voted for the most recent rule proposal, but not without reservation. *See* Commissioner Hester Peirce, *Statement on Proposed Rule: "Prohibition Against Conflicts of Interest in Certain Securitizations*," SEC (Jan. 25, 2023), https://www.sec.gov/news/statement/peirce-statement-prohibition-against-conflicts-interest-012523.

[6] *See*, *e.g.*, Letter from Structured Finance Association at 1 (Mar. 27, 2023), https://www.sec.gov/comments/s7-01-23/s70123-20161787-330610.pdf ("[T]he sweeping approach taken in the re-proposed rule would significantly impede and restrict vital activities across a wide-swath of the investor, bank, broker-dealer, corporate issuer and servicer communities – and all of their affiliates and subsidiaries") (emphasis omitted); Letter from the American Bar Association at 2 (Apr. 5, 2023), https://www.sec.gov/comments/s7-01-23/s70123-20163663-333899.pdf ("ABA") (expressing concern that "the Proposed Rule goes much further and would have a chilling effect on financial institutions' and other market participants' access to capital and ability to manage risks, with significant negative effects on financial stability, consumers' ability to borrow and the economy as a whole"); Letter from SIFMA I at 3 ("The Proposed Rule is significantly flawed – it is both excessively broad and vague. It goes far beyond the scope of the mandate of Section 27B to address certain conflicts of interest between securitization participants and institutional investors.").

[7] *See, e.g.*, Letter from American Property Casualty Insurance Association, et al. at 2 (Feb. 16, 2023), https://www.sec.gov/comments/s7-01-23/s70123-20157901-326057.pdf ("Businesses and consumers rely on securitization as a vital source of funding and risk management for over $13.8 trillion of consumer and business loans, including $12.2 trillion of residential and commercial mortgages and $900 billion of leveraged loans, and it is imperative that we all work together to avoid unintentionally harming these important market functions.").

[8] *See, e.g.*, Letter from ABA at 32 ("We note that whether a reasonable investor would consider a transaction important to its investment decision does not necessarily mean that a reasonable investor would consider any conflict of interest associated with that transaction to be important."). A materially adverse standard would be consistent with the Volcker Rule. *See* Letter from the Securities Industry and Financial Markets Association, the Asset Management Group of SIFMA, and the Bank Policy Institute at 13 (Jun. 27, 2023), https://www.sec.gov/comments/s7-01-23/s70123-213659-436182.pdf (SIFMA II) ("Section 621 of the Dodd-Frank Act was intended to be closely linked with Section 619 [which mandated the Volcker Rule]. As industry professionals are already familiar with Volcker Rule compliance, and therefore have an expectation of the standard's parameters, maintaining the same 'materially adverse' standard [found in the Volcker Rule] would help ensure orderly and efficient markets.").

[9] 17 CFR § 230.192(a)(3).

[10] For example, securitization participants that want to perform risk mitigating hedging must point to specific, identifiable risks, continuously recalibrate their activities, and maintain a strict compliance program, and cannot hedge for future positions. 17 CFR § 230.192(b)(1).

[11] For example, some commenters requested that municipal securitizations be exempted. *See, e.g.*, Letter from National Association of Bond Lawyers (NABL) et al. at 1, 3 (Mar. 27, 2023), https://www.sec.gov/comments/s7-01-23/s70123-20161786-330607.pdf ("We are particularly concerned about the proposal's impact on issuers— state and local governmental entities— which mostly access the municipal market to finance critical infrastructure and community resources. These issuers may now face unnecessary liability, cost, and compliance burdens if the proposal is enacted as drafted. As such, we maintain our position, previously outlined in prior rulemaking processes, that municipal securities should be broadly excluded from the definition of asset-backed securities . . ."); Letter from SIFMA I at 20, n. 47 (arguing for a municipal securities exclusion: "in addition to potential liability under Securities Act, underwriters and placement agents of municipal securities are subject to the general fairness obligation in MSRB Rule G-17 and, in connection therewith are required to provide issuers of municipal securities (including municipal issuers of asset backed securities that would be subject to the Proposed Rule) with a G-17 letter at the time of engagement where, among other things, they are required to disclose their actual and potential actual material conflicts of interest, including those related to the trading of credit default swaps, if relevant.").

[12] *See* Adopting Release at 7, n. 12 ("[C]ommenters cited the following as examples of the changes in securitization markets in that time period: the adoption and implementation of 17 CFR 246 ('Regulation RR'), 17 CFR 255 ('the Volcker Rule'), rules regulating swaps and security-based swaps, and changes in the regulation of nationally recognized statistical rating organizations ('NRSROs') to enhance transparency and address conflicts of interest in connection with the issuance of ABS.") (citing Letter from the ABA at 4-5; SIFMA I at 3, 8-9). The proposing released stated that "'current market practices may be generally consistent with the re-proposed rule requirements as a result of compliance with the existing rules described above' and that 'the current market equilibrium' is characterized by securitization participants who are incentivized to avoid conflicts due to existing rules and reputational concerns." SIFMA I at 9 (quoting the *Prohibition Against Conflicts of Interest in Certain Securitizations*, Release No. 33-11151 (Jan. 25, 2023) [88 Fed. Reg. 9678, 9713 (Feb. 14, 2023)].

[13] Adopting Release at 83. Commenters suggested more definitive ways to set the prohibition's start date. *See*, *e.g.*, Letter from ABA at 26 ("[W]e suggest that the Commission look both to the presence of an executed engagement letter and the commencement of marketing of the ABS. Without any standard that can be objectively determined by a securitization participant prior to becoming a securitization participant, the Commission introduces significant uncertainty into the market."); Letter from SIFMA II at 12 ("We recommend setting a definitive start date of the prohibition, at 30 days prior to the first closing of an asset-backed security, rather than requiring all securitization participants to make a facts-and-circumstances determination of when they have taken substantial steps to reach an agreement to become a securitization participant. We believe that this allows securitization participants to be able to construct a more rigorous compliance program while posing no risk that a bad actor could use this definitive start to evade the prohibition.").

[14] The Adopting Release provides helpful guidance about the definition of synthetic ABS, but guidance in an adopting release does not provide the same clarity that a regulatory definition would provide. *See* Adopting Release at 24 ("[W]e agree with commenters that guidance regarding synthetic ABS is beneficial. Accordingly, while a synthetic ABS may be structured or designed in a variety of ways, we generally view a synthetic asset-backed security as a fixed income or other security issued by a special purpose entity that allows the holder of the security to receive payments that depend primarily on the performance of a reference self-liquidating financial asset or a reference pool of self-liquidating financial assets.").

[15] Adopting Release at 211.