Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

May 16, 2023

Via Electronic Mail: rule-comments@sec.gov

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Prohibition Against Conflicts of Interest in Certain Securitizations, Rel. No. 33-11151, File No. S7-01-23 [RIN 3235-AL04]

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] is writing to the Securities and Exchange Commission ("**SEC**" or "**Commission**") in response to the above-captioned proposed rule ("**Proposed Rule**").[2] While we appreciate the Proposed Rule's objective of addressing potential material conflicts of interest among securitization participants, we are concerned that the Proposal contains provisions that could harm the securitization markets and, as a consequence, undermine the credit markets that depend upon securitization.

MFA members, who are some of the largest participants in the global hedge fund and alternative asset management industry, have a direct interest in the Proposed Rule as it relates to asset-backed securities ("**ABS**"), including collateralized loan obligations ("**CLOs**"). Our members, together with the funds they manage, participate in the ABS markets both as investors and as sponsors. As such, our members have a strong interest in ensuring the continuing health of the ABS markets, which as the Commission recognizes play an important role in the creation of

[1] MFA, based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] Prohibition Against Conflicts of Interest in Certain Securitizations, 88 Fed. Reg. 9678 (Feb. 14, 2023) ("**Proposal**"), available at: https://www.govinfo.gov/content/pkg/FR-2023-02-14/pdf/2023-02003.pdf.

credit by increasing the amount of capital available for the origination of loans and other receivables through the transfer of those assets to other market participants.[3]

We understand that the Commission is seeking to fulfill the statutory mandate in Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") by passing a rule prohibiting conflicts of interest in securitization transactions. However, the Proposed Rule goes well beyond a prohibition on obvious and specific speculative investements against securitizations that were the reason for Section 621 and instead contains a much broader prohibition that has created an enormous amount of concern and uncertainty among securitization market participants. Because of the many important benefits of the securitization process—including reduced cost of credit and expanded access to credit for borrowers[4]—and related activities (*e.g.*, hedging activity), it is essential that the Commission not adopt rules regarding securitization that would be disruptive to these markets.

I. Executive Summary

We appreciate the opportunity to share our views in connection with the Proposed Rules. The following is a summary of our recommendations, which we explain more fully below. MFA recommends that:

- The definition of "sponsor" should exclude investors taking a long position in an ABS because such investors do not implicate the policy concerns that drive the Proposed Rule.
- The definition of "securitization participant" should exclude (1) affiliates and subsidiaries and (2) non-securitization employees in primary securitization participants that are, in each case, behind information barriers, and those information barriers need to be workable.
- Any final rule should permit disclosure as a means of addressing conflicts of interest, consistent with the philosophy behind existing federal securities laws.
- The definition of "conflicted transaction" should be narrowed because it has the potential to encompass all kinds of transactional activity that falls short of the investments against ABS that were frequently cited as a reason for the rulemaking.
- The exception for risk-mitigating hedging activity should specifically include interest rate hedging, currency hedging, and non-credit related hedging, which provide no opportunity to profit from the adverse performance of an ABS or the asset pool supporting or referenced by the ABS.

[3] Proposal at 9711.

[4] *Id.* (also noting as benefits of the securitization process the ability to match risk profiles of securities to investors' specific demands and increased secondary market liquidity for loans and other receivables).

- The "substantial steps" test should be removed because the language is vague and hence would not provide enough clarity to securitization participants in complying with any final rule, and the compliance period should not begin more than 30 days prior to the date of the first closing of the sale of the related ABS.

- Any final rule should provide for a transition period.

II. Comments

A. The Definition of "Sponsor" Should Exclude Investors Taking a Long Position in an Asset-Backed Security.

The definition of "sponsor" in the Proposed Rule encompasses "any person…that directs or causes the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security."[5] This clause of the "sponsor" definition is too broad and has the potential to turn many investors into sponsors and thereby (i) limit the business activities they (and their subsidiaries and affiliates) may engage in and/or (ii) saddle them (and their subsidiaries and affiliates) with significant compliance burdens.

We note the commentary in the Proposed Rule indicates that "an ABS investor that is interested in acquiring a long position in an ABS would not be considered to direct the composition of assets merely because such investor expresses its preferences regarding the assets that would collateralize its ABS investment."[6] While that commentary may be helpful to some investors, it is not sufficient to fully protect all investors. Investors in an ABS could provide various kinds of input to ABS issuers in connection with a potential transaction, some of which could be seen as stronger than merely expressing preferences. Without certainty of protection from the Proposed Rule, investors may be loath to provide constructive feedback to potential issuers, and they might end up with ABS product offerings in which they are less interested and accordingly pay less for or do not purchase at all. This can make the ABS markets less efficient and could hinder capital formation.

Accordingly, we recommend that the definition of "sponsor" exclude investors taking a long position in an ABS.

B. The Definition of "Securitization Participant" Should Exclude (1) Affiliates and Subsidiaries and (2) Non-Securitization Employees in Primary Securitization Participants That in Each Case Are Behind Information Barriers; Those Information Barriers Need To Be Workable

The Proposed Rule's definition of "securitization participant" includes underwriters, placement agents, initial purchasers, and sponsors of ABS (collectively, "**ABS Actors**") and their affiliates and subsidiaries (collectively, "**Adjuncts**"), without recognizing information

[5] Proposal Rule 192(c), paragraph (ii)(B) of the definition of "sponsor."

[6] Proposal at 9686.

barriers that may exist (1) within ABS Actors between employees participating in the securitization process ("**Securitization Employees**") and employees not participating in the securitization process ("**Other Employees**") and (2) between ABS Actors and their Adjuncts.[7] Information barriers have long been recognized as a method of mitigating conflicts of interest, and they should be recognized in this context as well.[8]

ABS Actors are often (1) large institutions and/or (2) parts of larger enterprises. Accordingly, they often have Other Employees and/or Adjuncts who in each case do not have any knowledge of the securitization activities (particularly ABS structuring, issuing, and selling activities) of the Securitization Employees in the ABS Actors. Some of these Other Employees and Adjuncts operate behind information barriers that have been established to comply with other mandates under the U.S. securities laws and prevent the Other Employees and Adjuncts from knowing about the securitization activities of the Securitization Employees in the ABS Actors.[9] Bringing Other Employees and Adjuncts within the scope of the rule would in many cases require that existing information barriers be breached in order to notify them as to the securitization activities, which would be burdensome and would undermine the efficacy of the information barriers and the securities law mandates (such as not trading in securities based on MNPI) that they were established to support. It also might either prevent such Other Employees and Adjuncts from pursuing, or cause them to forego pursuing, bearish or pessimistic investment strategies with respect to ABS for fear of violating the Proposed Rules. As the Commission itself

---

[7] Proposal Rule 192(c).

[8] As the Proposing Release notes, information barriers "have been recognized in other areas of the Federal securities laws and the rules thereunder. For example, brokers and dealers have used information barriers to manage the potential misuse of material non-public information ["**MNPI**"] to adhere to Section 15(g) of the Exchange Act." Proposal at 9690.

[9] In addition to being used to manage the potential misuse of MNPI, information barriers form an integral part of the "separate accounts" exception in Rule 105 of Regulation M (dealing with short sales of an offered security during the restricted period prior to the offering). *See* Short Selling in Connection with a Public Offering: Amendments to Rule 105 of Regulation M, available at: https://www.sec.gov/divisionsmarketregtmcomplianceregmrule105-secg.htm (last modified May 21, 2008). The foregoing re-states the indicia of separate accounts as set forth in Short Selling in Connection with a Public Offering, 72 Fed. Reg. 45094, 45098 (Aug. 10, 2007).

Furthermore, information barriers were endorsed by the Commission and the other regulatory agencies in the Volcker Rule. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (79 Fed. Reg. 5536, 5660 (Jan. 31, 2014), available at: https://www.govinfo.gov/content/pkg/FR-2014-01-31/pdf/2013-31511.pdf (noting that, under the final rule, "a banking entity may address a conflict by establishing, maintaining, and enforcing information barriers reasonably designed to avoid a conflict's materially adverse effect . . ."). In particular, we note that the commentary in the Volcker Rule recognizes that information barriers can exist between separate business units *within the same entity*: "Information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities *among units of the entity*. *Id.* (emphasis added).

has recognized, short selling provides the market with important benefits such as market liquidity and pricing efficiency.[10]

Furthermore, any information barriers that any final rule does permit as a means of mitigating conflicts of interest need to be workable. While the Proposed Rule would not permit the use of information barriers as a means for affiliates and subsidiaries (much less Other Employees within ABS Actors) to mitigate conflicts of interest, the Proposal requests comment on five conditions for information barriers.[11] We believe these five conditions proposed by the Commission in the Proposed Rule to a potential information barriers exception are needlessly unwieldy and unworkable. For example, some comments to the Proposal have highlighted the

---

[10] *See, e.g.*, SEC Concept Release: Short Sales, 64 Fed. Reg. 57996 (Oct. 28, 1999), available at: https://www.govinfo.gov/content/pkg/FR-1999-10-28/pdf/99-27879.pdf; *see also* SEC Release: Short Position and Short Activity Reporting by Institutional Investment Managers, 51 Fed. Reg. 14950 (Mar. 16, 2022), available at: https://www.govinfo.gov/content/pkg/FR-2022-03-16/pdf/2022-04670.pdf; Phil Mackintosh, *How Short Selling Makes Markets More Efficient*, NASDAQ (Oct. 1, 2020), available at: https://www.nasdaq.com/articles/how-short-selling-makes-markets-more-efficient-2020-10-01.

[11] The Proposal provides the following five potential conditions for information barriers:

> (1) the underwriter, placement agent, initial purchaser, or sponsor of an ABS establish, implement, maintain, enforce, and document written policies and procedures to prevent the flow of information to and from such underwriter, placement agent, initial purchaser, or sponsor and its affiliates and subsidiaries, which policies and procedures could include (but would not be limited to):
>
> > a. Physical separation of personnel; and
> >
> > b. Restriction of a securitization participant's activities to only those activities necessary for it to act in its capacity as a securitization participant;
>
> (2) an underwriter, placement agent, initial purchaser, or sponsor of an ABS establish, implement, maintain, enforce, and document a written internal control structure governing the implementation and adherence to the policies and procedures required under the information barriers exception;
>
> (3) the securitization participant obtain an annual, independent assessment of the operation of the policies and procedures and internal control structure required under the information barriers exception;
>
> (4) the affiliate or subsidiary has no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) in common with the underwriter, initial purchaser, placement agent, or sponsor and was not involved in the creation, distribution, origination of the assets, or otherwise providing services with respect to the related ABS;
>
> (5) the information barriers exception would not be available if, in the case of any specific securitization, the underwriter, initial purchaser, placement agent, or sponsor knows or reasonably should know that, notwithstanding meeting the conditions described above, the transaction would involve or result in a material conflict of interest.

Proposal at 9691.

similarity of the proposed conditions to those housed in Rule 100 of Regulation M,[12] which conditions include an annual, independent assessment. We believe, as do some other commenters, that Rule 105 of Regulation M offers a better parallel.[13] That being said, however, not even Rule 100 requires a written internal control structure much less an annual independent assessment of the operation of such an internal control structure.

On top of that, the Volcker Rule provides an even more helpful contrast to highlight the unworkable nature of the potential information barriers. The information barrier provisions in the Volcker Rule[14] contain only analogs of the first and fifth conditions proposed by the Commission in the Proposed Rule and a suggestion of the fourth condition.[15] The Volcker Rule and its statutory underpinnings in the Dodd-Frank Act were designed to reduce risk to the banking system by preventing insured depository institutions from engaging in more speculative types of activities. If recent developments have shown us anything, it is the importance of maintaining the safety and soundness of the banking system. Meanwhile, the risk retention rules passed pursuant to the Dodd-Frank Act have all but eliminated the possibility that a person can structure an ABS transaction to fail. Furthermore, to the contrary, the Commission has identified no problematic conflicted securitization transactions—namely, speculative negative investments made by any securitization participant against its own transaction—since the financial crisis of 2008. Yet the Commission's contemplated conditions for any information barrier exception that it might choose to include in a final rule are far more stringent than the conditions that can be found in the Volcker Rule.

Requiring that securitization participants implement written policies and procedures, and removing the protection of the information barrier exception when barriers are breached, would provide sufficient protection. If the Commission decides, consistent with its fourth proposed condition noted above, to require separate officers and employees in any final rule, it should at

---

[12] *See, e.g.*, Letter from Securities Industry and Financial Markets Association, Securities Industry and Financial Markets Association—Asset Management Group, and Bank Policy Institute, dated March 27, 2023, available at: https://www.sec.gov/comments/s7-01-23/s70123-20161806-330705.pdf (hereinafter, "SIFMA Letter"), at 35.

[13] *See id*.

[14] *See* 17 C.F.R. §§ 255.7(b)(2)(ii) and 255.15(b)(2)(ii).

[15] Sections 255.7(b)(2)(ii) and 255.15(b)(2)(ii) of the Volcker Rule use the exact same text, providing that prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity "[h]as established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty."

least recognize that separate business units can exist within an entity, and that separate business units would not be seen as sharing officers and employees merely because they are part of the same entity.

C. Any Final Rule Should Permit Disclosure as a Means of Addressing Conflicts of Interest

The Proposed Rule does not include a disclosure-based exception for managing material conflicts of interest.[16] However, in Request for Comment 53 in the Proposal, the Commission asks if the proposed rule should allow securitization participants to manage potential conflicts of interest using disclosure or through obtaining investor approvals.[17]

We believe any final rule should permit securitization participants to use disclosure to address conflicts of interest. The federal securities laws are designed not to insulate investors from risks, but to inform investors of risks.[18] Meaningful disclosure of potential conflict of interest (as opposed to "vague boilerplate") would allow investors to make informed decisions prior to investing in ABS and would comport with the disclosure-based regime. The Volcker Rule again provides a useful approach, requiring "clear, timely, and effective disclosure of the conflict of interest" in a manner sufficient to permit the recipient to meaningfully understand the conflict of interest and to provide the recipient with the opportunity to negate, or substantially mitigate, any materially adverse effect on the recipient created by the conflict.[19]

The question of whether a securitization participant should be required to disclose that it has entered into a conflicted transaction seems like it should have an obvious "yes" answer. However, formulating effective disclosures seems an extremely difficult task given the breadth of the definition of "conflicted transaction" in the Proposed Rule as discussed above. Securitization participants could find themselves engaged in lengthy "issue spotting" exercises trying to imagine all of the ways that they could potentially derive some benefit from actual, anticipated or potential adverse events with respect to the ABS or the underlying asset pool.

---

[16] Proposal at 9696.

[17] *Id.* at 9698.

[18] *See, e.g.*, the preamble of the Securities Act of 1933 ("An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails…"; *see also Basic v. Levinson*, 485 U.S. 224, 234 (1988) ("a philosophy of full disclosure").

[19] Sections 255.7(b)(2)(i) and 255.15(b)(2)(i) use the exact same text, providing that prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity

> "(A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and
>
> (B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest."

Permitting securitization participants to address conflicts through disclosure is inextricably bound with a clear and concise definition of what exactly constitutes a "conflicted transaction."

The same holds true for disclosures made after the offering but within the timeframe of the prohibition—the clearer the definition of "conflicted transaction", the more effective that securitization participants will be able to provide clear, timely and effective disclosure.

Finally, allowing securitization participants to address conflicts of interest with disclosure would be consistent with Section 27B in that disclosure would render conflicts immaterial by virtue of the disclosure itself.[20]

D. The Definition of "Conflicted Transaction" Should Be Narrowed

We are also concerned about the breadth of the definition of "conflicted transaction." In particular, clause (iii) of the definition is very broadly worded, reading as follows (emphasis added):

> (iii) The purchase or sale of **any** financial instrument (other than the relevant asset-backed security) or entry into **a** transaction through which the securitization participant would benefit from the actual, anticipated, or **potential**:
>
> (A) Adverse performance of the asset pool supporting or referenced by the relevant asset-backed security;
>
> (B) Loss of principal, monetary default, or early amortization event on the relevant asset-backed security; or
>
> (C) Decline in the market value of the relevant asset-backed security.[21]

This wording has the potential to encompass all kinds of transactional activity that falls short of the investments against ABS that were frequently cited by Senators Merkley and Levin in their comments regarding the original proposal.[22]

One example of transactional activity that illustrates the problem with the breadth of clause (iii) comes from CLOs. "Corporate" CLOs typically feature asset pools that are comprised of dozens of corporate loan exposures ("**CLO Exposures**"). Many of the borrowers under those loans have other outstanding securities ("**Related Securities**"). The values of Related Securities sometimes move directionally with the values of the CLO Exposures.

CLO arrangers may include certain CLO Exposures in a CLO because they have positive views about those CLO Exposures. At the same time, however, they may have negative views on

[20] *See, e.g.*, SIFMA Letter at 53-54.

[21] Proposed Rule 192(a)(3) (emphasis added).

[22] *See* Letter from Senators Jeff Merkley and Carl Levin to Ms. Elizabeth M. Murphy (Jan. 12, 2012), available at: https://www.sec.gov/comments/s7-38-11/s73811-15.pdf.

Related Securities. Or, in the one-year period following the issuance of the CLO, they may come to have negative views on the Related Securities. Or other portfolio managers contained within an entity that is a securitization participant who are not involved with the structuring of the CLO may have a negative view on Related Securities. In any event, based on those negative views, they could enter into transactions where they would benefit from the actual, anticipated or adverse performance of the CLO Exposures, because such adverse performance could result in a decline in the market value of the Related Securities. Taking short positions in Related Securities should not be prohibited by the Proposed Rule, but the breadth of clause (iii) has led many CLO participants to question whether involvement in the structuring of CLOs would limit their ability to place short investments on Related Securities. They may choose to exit the corporate CLO markets so as not to restrict their ability to trade in Related Securities.

Accordingly, the Commission should eliminate clause (iii) and rely instead on clauses (i) and (ii) of the definition of "conflicted transaction" together with the anti-circumvention rule in paragraph (d) of the Proposed Rule. If the Commission elects to retain clause (iii), clause (iii) should be narrowed to replace "benefit" with "profit" and change "actual, anticipated or potential" to "actual."

E. The "Substantial Steps" Test Should Be Removed and the Compliance Period Should Not Begin More Than 30 Days Prior to the Date of the First Closing of the Sale of the Related ABS

The time frame of the prohibition contemplated by subsection (a)(1) of the Proposed Rule begins "on the date on which 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.[23] The "substantial steps" language is vague and hence would not provide enough clarity to securitization participants in complying with any final rule. For example, it is unclear what constitutes a "step" toward reaching an agreement to become a securitization participant. Similarly, it is unclear what distinguishes a substantial step from an insubstantial one. Furthermore, with respect to an entity that has taken substantial steps to reach an agreement to become a securitization participant but ultimately never reaches an agreement to become a securitization participant, it is unclear whether or how the Proposed Rule applies to any transaction that such entity might enter into.

Given the foregoing, we recommend that the "substantial steps" test be removed and replaced with a compliance period that does not begin until a person actually becomes an underwriter, placement agent, initial purchaser, or sponsor, and that the compliance period should not begin more than 30 days prior to the date of the first closing of the sale of the related ABS.[24]

[23] Proposed Rule 192(a)(1).

[24] *See* SIFMA Letter at 23-24.

F. The Exception for Risk-Mitigating Hedging Activity Should Specifically Include Interest Rate and Currency Hedging

Interest rate and, to a lesser extent, currency hedging are commonly used by securitization market participants to hedge risks attendant to the holding of fixed income positions. They provide no opportunity to profit from the adverse performance of an ABS or the asset pool supporting or referenced by the ABS. Although we do not believe that interest rate and currency hedging activities should be construed as "conflicted transactions" under any final rule, we believe such activities should be excluded in order to provide legal and operational clarity to the market.

Accordingly, we recommend that any final rule should expressly permit interest rate hedging, currency hedging, and other non-credit related hedging,[25] and that any compliance regime that applies to credit-related hedging should not apply to such interest rate, currency, and other non-credit related hedging activities.

G. Any Final Rule Should Provide For a Transition Period

As stated above, it is essential that the Commission not adopt rules regarding securitization that would be disruptive to the securitization markets. Accordingly, any final rule that the Commission adopts should provide for a transition period of at least 12 months to allow securitization market participants time to develop the systems necessary for compliance with any final rule.

IV. Conclusion

We recognize that the Commission is attempting to fulfill its statutory mandate with the Proposed Rule, and we understand the reasons why the Commission is concerned about such conflicts of interest. However, we believe that the Proposed Rule is overbroad and unduly cumbersome as currently written and that it has the potential to impede the orderly and efficient operation of the securitization markets. Accordingly, we suggest that any final rule be revised as discussed above.

[25] *See id.* at 61.

* * *

MFA appreciates the opportunity to comment on the Proposed Rule, and we would be happy to discuss our comments with the staff of the Commission if it would be helpful. If you have any questions or comments, please do not hesitate to contact Matthew Daigler, Vice President & Senior Counsel, or the undersigned, at (202) 730-2600.

Very truly yours,

/S/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

cc: The Hon. Gary Gensler, Chair
The Hon. Hester M. Peirce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Mark T. Uyeda, Commissioner
The Hon. Jaime Lizárraga, Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets