
*ADDENDUM TO
ASSET-BACKED
SECURITIZATION AND
CREDIT RATING AGENCIES*

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The article included in the Capital Markets Symposium book – “Asset-Backed Securitization and Credit Rating Agencies” is current as of September 7, 2011.

On September 19, 2011, the SEC proposed a comprehensive set of rules to implement the Dodd-Frank directive regarding conflicts of interest which may arise between ABS sponsors and other “securitization participants”, on the one hand, and ABS investors.

The proposed rules would prohibit “securitization participants” – ABS underwriters, placement agents, initial purchasers, sponsors and possibly collateral managers – from engaging in transactions involving a “material conflict of interest” at any time for a period ending on the date that is one year after the date of the first closing of the sale of the ABS. The starting point for this time period is not specified in the proposed rules. The rules would apply to both public and private ABSs, including synthetic ABSs.

The conflicts of interest targeted by the SEC include transactions in which a securitization participant effects a short sale of, or purchases CDS (credit default swap) protection on, the ABS securities or the underlying financial assets. Transactions would also include the selection of assets for the ABS’s underlying pool and the sale of those assets to the ABS issuer. “Material conflicts of interest”, which would be prohibited, are those in which the securitization participant benefits from the adverse performance of the asset pool, losses on the ABSs, or declines in the market value of the ABSs.

“Material conflicts of interest” would also include situations in which the securitization participant receives remuneration from a third party who is permitted by the securitization participant to structure the ABS transaction, or to select financial assets for the ABS transaction, in way which permits the third party to benefit from a short transaction. In all of the foregoing cases, there must be a “substantial likelihood” that a “reasonable” investor would consider the conflict important to his or her investment decision.

As demonstrated by the examples provided by the SEC in its proposal release, the potential scope of the conflict of interest rules is quite broad. In some cases, the rules would prohibit a sponsoring bank from providing the CDS product which is essential to the formation of a synthetic ABS.

The SEC has solicited numerous comments on its proposed rules, and has set a deadline of December 19, 2011 for receipt of comments. Voluminous comments from the securitization industry should be expected.