



CALIFORNIA, 32ND DISTRICT

CONGRESSMAN BRAD SHERMAN

June 21, 2023

The Honorable Gary Gensler
Chair
U.S. Securities and Exchange Commission
100 F St. NE
Washington, D.C. 20549

Dear Chair Gensler,

I am writing to applaud you and the SEC for finalizing the “Conflict of Interest Rule,” but to also highlight the need for such a rule to strike the appropriate balance between preventing bad actors from profiting off a security designed to collapse, and the ability of market participants to hedge investments responsibly.

Section 621 of the Dodd-Frank Act required the SEC to prohibit conflicts of interest in the asset-backed securities space, which was a common problem at the time the legislation was passed. This requirement is known as the “Conflict of Interest Rule.” The rule was necessitated by situations where hedge funds worked with an issuer to intentionally design a security that would collapse in value. Issuers would short the security in the hopes that retail investors would take the long position. Investors who were sold the opposite side of this trade were harmed. As a result, trust was broken between investors and issuers since issuers were not acting in the best interest of all their clients. The rule rightly prevents issuers of securitization transactions from taking a direct bet against the security they are selling to their clients. Now after more than a decade since the passage of Dodd-Frank, the SEC is correctly finalizing the Conflict of Interest Rule. The intent is clear and justified, and I applaud you for that effort.

However, I am concerned that the rule as written would prevent market participants from effectively hedging risks without such a hedge being seen as a conflict of interest. Recent bank failures, such as the collapse of Silicon Valley Bank, First Republic, and Signature Bank, illustrate the disastrous consequences when a bank’s leadership does not effectively manage interest rate risk. Responsible market participants must hedge against the risk of market events such as rising interest rates, and such a hedge against market risk should not be prohibited by the SEC under the Conflict of Interest Rule.

The SEC’s Conflict of Interest Rule rightly included in its definition of a conflicted transaction both a short sale of the relevant asset-backed security and the purchase of a credit default swap or other credit derivative pursuant to which the securitization participant would be

entitled to receive payments upon the occurrence of specified credit events. However, the Conflict of Interest Rule would also consider 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 decline in the market value of the relevant asset-backed security to be a conflicted transaction. I am concerned that such a provision would prevent market participants from managing market risks like interest rate risk.

Regarding the Conflict of Interest Rule's effect on market participants' ability to hedge against risks, I pose the following questions and would greatly appreciate your response by July 17th:

1. Does the SEC's Conflict of Interest Rule prevent market participants from hedging against risks such as interest rate risk?
2. If not, are there options to make the proposed language clearer that hedging against market risks would not be considered a conflicted transaction?
3. Have market participants been contacted by the SEC to provide views on this issue? If so, what were some concerns expressed regarding the effect of the Conflict of Interest Rule on the ability of market participants to hedge against market risks?

Thank you for your attention to this matter and for finalizing the Conflict of Interest Rule and taking the necessary and required steps to protect investors from conflicted market participants. Nonetheless, the SEC's rule should balance the need for investor protection and the need for market participants to hedge against market risks. I look forward to your responses.

Sincerely,



BRAD SHERMAN
Member of Congress
Ranking Member, Subcommittee on Capital Markets

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