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Legal Update

SEC Re-Proposes Conflict of Interest Rule for Asset-Backed Securities

Executive Summary

- The Securities and Exchange Commission (the "SEC") has issued proposed Rule 192 pursuant to Section 27B of the Securities Act of 1933. Section 27B requires the SEC to issue rules for the purpose of implementing that section's prohibition against a securitization participant's entering into a transaction that would involve or result in a material conflict of interest with any investor.
  - Proposed Rule 192 revises and re-proposes the previously proposed Rule 127B.
  - Rule 127B was proposed by the SEC in 2011. The SEC received over 40 comment letters and had nine meetings on that proposal.
- General Rule. Proposed Rule 192 prohibits a "securitization participant" from directly or indirectly engaging in any transaction that would involve or result in a "material conflict of interest" between the securitization participant and an investor.
  - Applicable Period. This prohibition is in effect as soon as the securitization participant has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant with respect to an asset-backed security ("**ABS**") and ends on the date that is one year after the date of the first closing of the sale of such ABS.
    - The rule does not define "substantial steps" and states that this is a "facts and circumstances" determination.
    - The SEC requests comments on indicia of whether a person has reached an agreement to become a securitization participant, or taken substantial steps to reach such an agreement, and whether such indicia should be specified in the rule.
  - Securitization Participant. Proposed Rule 192 defines "securitization participant" as an underwriter, placement agent, initial purchaser, sponsor or any affiliate or subsidiary of any such party.
    - The definitions of underwriter, placement agent, initial purchaser, and sponsor are provided in the rule.
    - The definition of "sponsor" in proposed Rule 192 is broader than the definition used in the Dodd-Frank Act, Regulation AB and Regulation RR.[1] Under proposed Rule 192, the term sponsor captures all parties that, whether by contractual right or otherwise, play a

[1] Notably, Section 27B itself does not define the term "sponsor."

non-administrative role in directing or causing the direction of the ABS or the composition of the pool assets.
    - The United States is exempt from the definition of sponsor, and Fannie Mae and Freddie Mac will be exempt but only while they are under federal conservatorship.
  - Affiliates, Subsidiaries and Information Barriers. As noted above, an affiliate or subsidiary of an underwriter, placement agent, initial purchaser or sponsor of ABS is also a securitization participant under proposed Rule 192.
    - The terms "affiliate" and "subsidiary" have the definitions given to such terms in Securities Act Rule 405.
    - Proposed Rule 192 makes no exceptions for affiliates and subsidiaries who are walled off by information barriers. However, many of the SEC's requests for comment relate to this topic.
  - Material Conflict of Interest. A "material conflict of interest" is defined as a "conflicted transaction." Conflicted transactions are defined as any of the transaction types listed below with respect to which there is a "substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision":
    - Short sales of the ABS,
    - Credit default swaps and other credit derivatives pursuant to which the securitization participant would be entitled to receive payments from credit events related to the ABS, or
    - A catch-all category of financial instruments which would allow the securitization participant to benefit from the adverse performance of the ABS or the pool assets.
- Exceptions; Compliance Program. Rule 192 contains exceptions for (1) risk-mitigating hedging activities, (2) liquidity commitments and (3) bona-fide market making activities.
  - Rule 192 requires a securitization participant relying on these exceptions to meet certain conditions, most of which will require the securitization participant to implement tailored compliance programs.
- Scope. Rule 192 applies to "asset-backed securities" as defined by section 3(a)(79) of the Securities Exchange Act of 1934 (the "**Exchange Act**") and also includes synthetic and hybrid cash and synthetic ABS (neither of which terms are defined in Proposed Rule 192 or elsewhere under applicable securities laws).
  - Both public and private offerings are covered.
  - Rule 192 contains no safe harbor for foreign issuers or foreign transactions.
- Anti-Circumvention. Proposed Rule 192 includes a broad "anti-circumvention" provision that prohibits a securitization participant from engaging in any other transaction that circumvents the prohibition on transactions that create a material conflict of interest.
- Deadline for Comments. Comments are due by March 27, 2023 or 30 days following publication of the proposing release in the *Federal Register*, whichever period is longer.
- Compliance Date. The proposing release does not specify a compliance date. Unless the adopting release provides otherwise, Rule 192 will become effective upon the issuance of the final rule.

Introduction and Background

On January 25, 2023, the SEC issued proposed Securities Act Rule 192 ("**Rule 192**") prohibiting certain conflicts of interest in securitization transactions.[2] Rule 192 is intended to implement the prohibition against such conflicts as set forth under Section 27B ("**Section 27B**") of the Securities Act of 1933 (the "**Securities Act**").[3]

Section 27B directed the SEC to adopt implementing rules "not later than 270 days after July 21, 2010." In September 2011, the SEC proposed Securities Act Rule 127B ("**Rule 127B**").[4] Proposed Rule 127B tracked almost identically the broad provisions of Section 27B and did not define key terms or otherwise provide the additional specificity and nuance that implementing rules typically contain. Instead, the Rule 127B proposing release offered, and requested comment on, "interpretive guidance" relating to Rule 127B**.**

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[2] *See* SEC Release No. 33-11151, available at: https://www.sec.gov/rules/proposed/2023/33-11151.pdf (the "**Proposing Release**").

[3] Section 27B, which was added to the Securities Act by Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), reads as follows:

> (a) IN GENERAL.—An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, 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 asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.
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> (b) RULEMAKING.—Not later than 270 days after the date of enactment of this section, the Commission shall issue rules for the purpose of implementing subsection (a).
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> (c) EXCEPTION.—The prohibitions of subsection (a) shall not apply to—
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> (1) risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or
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> (2) purchases or sales of asset-backed securities made pursuant to and consistent with—
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> (A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or
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> (B) bona fide market-making in the asset backed security.
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> (d) RULE OF CONSTRUCTION.—This subsection shall not otherwise limit the application of section 15G of the Securities Exchange Act of 1934.
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> (e) EFFECTIVE DATE.—Section 27B of the Securities Act of 1933, as added by this section, shall take effect on the effective date of final rules issued by the Commission under subsection (b) of such section 27B, except that subsections (b) and (d) of such section 27B shall take effect on the date of enactment of this Act.

[4] *See* SEC Release No. 34-65355, available at: https://www.sec.gov/rules/proposed/2011/34-65355.pdf (the "**Original Proposal**").

Ultimately, the SEC did not adopt proposed Rule 127B and did not issue any alternative proposal until now. According to the Proposing Release, Rule 192 "takes into account developments in the ABS market since 2011 and the comments received in response to the 2011 proposed rule to provide greater clarity regarding the scope of prohibited and permitted conduct."[5]

Compliance Date

The Proposing Release does not specify a compliance date. Unless the adopting release provides otherwise, Rule 192 will become effective upon the issuance of final rule.

Overview of Rule 192

The text of Rule 192 is set forth in ***Appendix A***. Although Rule 192 is much more prescriptive and detailed than proposed Rule 127B, there remain significant points of ambiguity and concern. In the following discussion, we identify some of these points and highlight relevant portions of the SEC's commentary in the Proposing Release.

SECURITIZATION PARTICIPANTS

Rule 192 applies to each "securitization participant," which is defined as:

- an "underwriter," "placement agent," "initial purchaser" or "sponsor" of an ABS, or
- any ***"affiliate"*** or ***"subsidiary"*** of any such person.

The Proposing Release states that the functions performed by securitization participants "are essential to the design, creation, marketing, and/or sale of an ABS."[6] The SEC goes on to state that Rule 192 is focused on parties that could have "the incentive to market or structure ABS and/or construct underlying asset pools in a way that would position them to benefit from the actual, anticipated, or potential adverse performance of the relevant ABS or its underlying asset pool."[7]

On its face, the definition of "securitization participant" under Rule 192 mirrors the provisions of Section 27B and proposed Rule 127B. However, unlike Section 27B and proposed Rule 127B, Rule 192 includes definitions of key terms. Some of those definitions (particularly the definition of "sponsor") expand the scope of the rule beyond that implied by the commonly-understood meaning of the related terms.

The component terms used in Rule 192's definition of "securitization participant" are discussed in the table below.

TERM	RULE 192 DEFINITION	PROPOSING RELEASE DISCUSSION
Placement Agent and ***Underwriter***	A person who has agreed with an issuer or selling security holder to:	The SEC has given the terms underwriter and placement agent the same definition, stating that "the functional roles of the persons who

[5] *See* Proposing Release at 7-8.
[6] *See* Proposing Release at 19.
[7] *Id.*

	(i) Purchase securities from the issuer or selling security holder for ***distribution***; (ii) Engage in a ***distribution*** for or on behalf of such issuer or selling security holder; or (iii) Manage or supervise a ***distribution*** for or on behalf of such issuer or selling security holder.	act as a placement agent or an underwriter are the same."[8] The SEC goes on to state that this definition is intentionally narrower than the definition of underwriter in Section 2(a)(11) of the Securities Act and the Volcker Rule, which include additional language that captures parties that "may not have an agreement with the issuer or selling security holder" and, therefore, little to no influence over "the design of the relevant ABS."[9]
Distribution (as used in definition of placement agent and underwriter)	(i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or (ii) An offering of securities made pursuant to an effective registration statement under the Securities Act.	The SEC notes that this is the same definition used in the Volcker Rule and that the focus on "special selling efforts and selling methods would help to distinguish an offering of ABS from secondary trading and helps to target the re-proposed rule to persons engaged in selling an ABS offering to investors once such ABS is created."[10] The SEC points to factors such as "greater than normal sales compensation arrangements, delivering a sales document (such as a prospectus), and conducting road shows" as indicative of "special selling efforts and selling methods."[11]
Initial Purchaser	A person who has agreed with an issuer to purchase a security from the issuer for resale to other purchasers in transactions that are not required to be registered under	The SEC states that it has based this definition on its own prior usage of the term initial purchaser[12] and its understanding of the common use of that term in the securitization industry.[13]

[8] *See* Proposing Release at 21.
[9] *See* Proposing Release at 21-22.
[10] *See* Proposing Release at 22.
[11] *See* Proposing Release at 22-23.
[12] *See* Proposing Release at 23 (citing the proposing release for Regulation AB 2. *See Asset-Backed Securities*, Release No. 33-9117 (Apr. 7, 2010)).
[13] *See* Proposing Release at 23-24.

	the Securities Act in reliance on Rule 144A or that are otherwise not required to be registered because they do not involve any public offering.	
Sponsor	(i) Any person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the entity that issues the ABS; or	This clause (i) is the familiar definition of "sponsor" as that term is used in the Dodd-Frank Act, Regulation AB and Regulation RR. The SEC states that the proposed definition "would include, but would not be limited to, a sponsor as defined in Regulation AB."[14]
	(ii) Any person: (A) With a contractual right to direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS; or (B) 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.	The SEC states that the definition of "sponsor" would include "a portfolio selection agent for a CDO transaction, a collateral manager for a CLO transaction with the contractual right to direct asset purchases or sales on behalf of the CLO, or a hedge fund manager or other private fund manager who directs the structure of the ABS or the composition of the pool of assets underlying the ABS."[15] For a "contractual rights sponsor" under (ii)(A), the SEC uses examples of portfolio selection agents, collateral managers, hedge fund managers and private fund managers who could "benefit through a bet against the ABS or the underlying assets by selecting assets that such person believes will perform poorly."[16] The SEC states that the prohibition attaches to a "contractual rights sponsor" regardless of whether they exercised their contractual right to structure the securitization. The SEC states that the definition of a

[14] *See* Proposing Release at 29.

[15] *See* Proposing Release at 30. Recall that CLO managers are not considered "sponsors" as that term is used in Regulation RR. *See The Loan Syndications & Trading Ass'n v. S.E.C.*, 88 F.3d 220 (D.C. Cir. 2018).

[16] *See* Proposing Release at 30.

		"directing sponsor" under paragraph (ii)(B) is essentially intended to cover the same circumstance as a "contractual rights sponsor" when there is no formal contract in place. A determination of the relationship would be based on facts and circumstances.
	Exclusions: A person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security will not be a sponsor for purposes of this rule. The definition of "sponsor" excludes the United States and agencies of the United States, as well as Fannie Mae and Freddie Mac (while under conservatorship).	The Proposing Release states that while the determination of who is covered by the clause (ii)(C) exclusion from the definition of "sponsor," is based on facts and circumstances, the SEC believes that "the activities customarily performed by accountants, attorneys, and credit rating agencies … and the activities customarily performed by trustees, custodians, paying agents, calculation agents, and other contractual service providers … are the sorts of activities that would typically fall within the exclusion from the definition of the proposed definition of the term 'sponsor.'"[17] The SEC leaves it up to a facts and circumstances determination as to whether other parties to a securitization transaction, such as servicers, "would qualify for the exclusion in clause (C) of the proposed definition of 'sponsor' for a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS."[18]
Affiliate; Subsidiary; Information Barriers	The definitions of "affiliate" and "subsidiary" in Rule 192 refer to	The SEC, while conceding that affiliate and subsidiary exceptions for information barriers have been recognized in other areas of federal

[17] *See* Proposing Release at 28-34.
[18] *See* Proposing Release at 27.

	the familiar definitions of those terms in Rule 405. • An affiliate of, or person affiliated with, a specified person is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified. • A subsidiary of a specified person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries.	securities law and rules, states that Rule 192 "does not include the use of information barriers as an exception for affiliates and subsidiaries because we are concerned about the potential to use an affiliate or subsidiary to evade the re-proposed rule's prohibition."[19] The SEC does indicate that it could be open to adding an information barrier exception if it met five conditions: (1) written policies and procedures to prevent the flow of information; (2) a written internal control structure governing the implementation and adherence to such policies and procedures; (3) an annual, independent assessment of the operation of such policies and procedures and internal control structure; (4) no cross-pollination of officers and employees; and (5) the information barriers exception would not be available if, in the case of any specific securitization, a securitization participant knows or reasonably should know that, notwithstanding meeting the other conditions, the transaction would involve or result in a material conflict of interest.[20]

Questions to Consider and Other Ambiguity

- As proposed, Rule 192 applies to foreign affiliates and subsidiaries. This raises a number of legal and practical issues, not least of which being whether the SEC has such authority over foreign entities.[21]
- How would a large entity with information barriers that are otherwise legally mandated ensure compliance with this rule while maintaining those barriers?

[19] *See* Proposing Release at 50.

[20] *See* Proposing Release at 47-52. See also requests for comment #32 through #38 in the Proposing Release at 53-56.

[21] Note that the Proposing Release seeks comment on the extraterritorial application of Rule 192. *See* request for comment #31 in the Proposing Release at 53.

- How would a large organization, even in the absence of information barriers, ensure compliance across a wide range of divisions that have no interaction with one another?
- It is unclear when Rule 192 would apply to third-party servicers. Will they need to cease entering into certain transactions based on the possibility that they could fall within the definition of sponsor?
- Given that the proposed definition of "securitization participant" includes affiliates or subsidiaries, investment advisers who are affiliates or subsidiaries of an ABS underwriter, placement agent, initial purchaser or sponsor would also be considered "securitization participants." As such, Rule 192 would go substantially further than the Investment Advisers Act of 1940 (the "Advisers Act") with respect to conflict resolution for investment advisers, which generally focuses on appropriate disclosure to advisory clients and informed client consent. Under Rule 192, disclosure and consent would not be sufficient to address any putative conflict between the investment adviser (as a deemed securitization participant) and an ABS investor, as Rule 192 contemplates absolute prohibitions with only limited, conditional exceptions. This result is particularly incongruous because an investment adviser has a fiduciary duty to its advisory clients but the Advisers Act nevertheless generally permits investment advisers to address conflicts with advisory clients through disclosure and consent. On the other hand, no securitization participant (let alone an investment adviser that is deemed to be a securitization participant merely because of its affiliation with an ABS underwriter, for example) has a fiduciary duty to ABS investors.

PERIOD OF APPLICABILITY

Rule 192 applies to a securitization participant as soon as that person "has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant with respect to an asset-backed security." [22] Rule 192 does not define "agreement" or "substantial steps to reach . . . an agreement" in the context of the commencement point.[23] Fortunately, the SEC does clarify that Rule 192 would not apply to a party who took substantial steps to reach an agreement but never actually reached such agreement (and thus never became a securitization participant).[24]

Rule 192 ceases to apply to a securitization participant one year after the date of the first closing of the sale of the related ABS. This end date comes directly from the statutory text of Section 27B.

Questions to Consider and Other Ambiguity

- As proposed, it appears that the determination of a commencement point would be backward-looking and would be difficult to determine at the time investment decisions are being made.
- How would a facts and circumstance analysis of "substantial steps" be possible without guidelines about what they might be?

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[22] The SEC states that "an 'agreement' need not constitute an executed written agreement, such as an engagement letter. Oral agreements and facts and circumstances constituting an agreement, even absent an executed engagement letter, can be an agreement for purposes of the rule. We expect that market participants would know and understand when an agreement has been reached." *See* Proposing Release at 56, fn 101.

[23] *See* Proposing Release at 57.

[24] *Id.*

DEFINITION OF ASSET-BACKED SECURITY

The term "asset-backed security" is defined in Rule 192 to have the same meaning as set forth in Section 3(a)(79) of the Securities Exchange Act of 1934, except that it also includes (but does not separately define) synthetic ABS as well as hybrid cash and synthetic ABS.

Thus, asset-backed securities under Rule 192 refer to ABS issued in registered public offerings, as well as ABS issued in unregistered private offerings, such as those that rely on Rule 144A.[25]

As noted above, Rule 192 does not define the term "synthetic ABS." Instead, the SEC states that "synthetic transactions are generally effectuated through the use of derivatives such as a CDS, a total return swap or an ABS structure that replicates the terms of such a swap. We believe that our previous descriptions of synthetic securitizations are well understood by market participants and adequately address the key issues raised by commenters, and that market participants have been able to readily distinguish synthetic ABS from other types of transactions."[26]

MATERIAL CONFLICTS OF INTEREST; CONFLICTED TRANSACTIONS

Rule 192 states that a securitization participant shall not "directly or indirectly[27] engage in any transaction that would involve or result in any material conflict of interest" between the securitization participant and an investor in the ABS. Rule 192 provides that a transaction would constitute a material conflict of interest if such transaction is a "conflicted transaction."

The definition of "conflicted transaction" in Rule 192 is discussed in the table below, together with certain relevant discussion from the Proposing Release.

CONFLICTED TRANSACTION DEFINITION	PROPOSING RELEASE DISCUSSION
A conflicted transaction means any of the following transactions with respect to which there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's	The SEC notes that the "substantial likelihood" test is intended to reflect Section 27B's focus on conflicts that are "material."[28]

[25] In addition, the SEC states that although most municipal entities do not typically issue ABS, a municipal entity that satisfies the definition of "sponsor" and that issues Exchange Act ABS would be subject to the requirements of Rule 192. See Proposing Release at 12, fn 29.

[26] *See* Proposing Release at 14.

[27] The SEC notes that it chose not to use the "directly or indirectly" modifier in Rule 192(a)(3)(iii), the catch-all provision dealing with the purchase or sale of any instrument or entry into any transaction by which the securitization participant stands to benefit from the adverse performance of the ABS or the asset pool. The SEC reasoned that the use of the "directly or indirectly" modifier in that context is "unnecessary because any transaction under which a securitization participant would receive 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 already be captured by proposed Rule 192(a)(3)(iii)." *See* Proposing Release at 69. However, the SEC does not explain why the "directly or indirectly" modifier is used in the general statement of the prohibition against conflicts as set forth in clause (a)(1) of Rule 192 or how that use is different from the unnecessary use cited by the SEC with respect to clause (a)(3)(iii). Note also that the "directly or indirectly" modifier is not found in Section 27B (the statutory basis for Rule 192) nor in the previously proposed Rule 127B.

[28] *See* Proposing Release at 71.

investment decision, including a decision whether to retain the asset-backed security:	In determining which conflicts are material, the SEC refers to the "reasonable investor" standard of materiality from *Basic v. Levinson*.[29] The SEC states that the use of this standard does not imply that an otherwise prohibited transaction would be permitted if adequate disclosure is made to the investor or if the investor is permitted to select or approve the assets.[30]
(i) A short sale of the relevant asset-backed security;	The SEC describes this as a classic short sale where, "if the price of the ABS declines, then the short selling securitization participant could buy the ABS at the lower price to cover its short and make a profit." However, a profit is not required for such a transaction to be a conflicted transaction under Rule 192; rather, "[i]t is sufficient that the securitization participant sells the ABS short."[31]
(ii) 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 in respect of the relevant asset-backed security; or	The SEC describes this as a "direct bet" against an ABS where the securitization participant would profit after a credit event related to the ABS. The form of the credit derivative is irrelevant to the applicability of this section of the definition.[32]
(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:	This provision is effectively a "catch-all" for any other kind of transaction that a securitization participant could enter into that would allow it to benefit from an event adverse to the ABS or the asset pool. Examples given by the SEC include "entering into the short-side of a derivative (with the special purpose entity issuer of a synthetic CDO

[29] *See* Proposing Release at 71 (citing *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988)). Referring to *Basic v. Levinson* and to its proposing release for Rule 127B, the SEC states that "in considering whether there is a substantial likelihood that a reasonable investor would consider the conflict important to their investment decision, it is not possible to designate in advance certain facts or occurrences as determinative in every instance." *See* Proposing Release at 71, fn 119.

[30] *See* Proposing Release. at 72-73.

[31] *See* Proposing Release. at 64.

[32] *See* Proposing Release. at 65.

(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.	or otherwise) that references the performance of the pool of assets underlying the ABS with respect to which the person is a securitization participant under the re-proposed rule and pursuant to which the securitization participant would benefit if the referenced asset pool performs adversely" and "a security-based swap, such as a total return swap, that, in economic substance, creates an opportunity to benefit from the adverse performance of the relevant ABS or the pool of assets underlying the relevant ABS." [33] The SEC notes that this clause focuses on the "economic substance of the transaction" and actual benefit to the securitization participant is not necessary for a transaction to fall under the definition of conflicted transaction.[34]

Questions to Consider and Other Ambiguity

- How would a securitization participant be able to determine what a "reasonable investor" would consider to be material to an investment decision? Especially when only "substantial steps" have been taken by such securitization participant, but some of the material terms of the proposed ABS remain to be determined? Will investors' historical acceptance of a securitization participant entering into a particular type of ABS transaction mean that there is not a substantial likelihood that a reasonable investor would consider such transaction important to the investor's investment decision, including a decision whether to retain the asset-backed security? Why isn't the determination to be made after, or by giving effect to, typical ABS disclosure (or, if then available in the relevant case, the actual ABS disclosure)?
- Are there any unanticipated consequences on the market by making a blanket prohibition on using disclosure to cure potential conflicts of interest?

EXCEPTIONS

Rule 192 exempts (1) risk-mitigating hedging activities, (2) liquidity commitments and (3) bona fide market-making activities from the prohibition against material conflicts of interest, so long as they meet certain conditions.

[33] *See* Proposing Release. at 66-67.
[34] *See* Proposing Release. at 67.

The following charts describe these exceptions and related conditions, and provide relevant discussion from the Proposing Release:

Risk-Mitigating Hedging Activities	Proposing Release Discussion
Permitted Risk-Mitigating Hedging Activities. Risk-mitigating hedging activities are generally permitted so long as they meet certain conditions.	The SEC states that this proposed exception would allow a securitization participant to hedge both retained ABS positions and exposures in connection with warehousing assets in advance of an ABS issuance. Hedging can be on an aggregated basis and not only trade-by-trade.[35]
Conditions. Risk-mitigating hedging activities are permitted only if each of the following conditions is met. (A) At the inception of the hedging activity and at the time of any adjustments to the hedging activity, the risk-mitigating hedging activity is designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, contracts, or other holdings of the securitization participant, based on the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof.	To meet condition (A), the SEC makes clear that securitization participants may not "overhedge" their risks (i.e., create a net short exposure to the relevant ABS).[36] The SEC emphasizes that, in order to be permissible, the hedging activity must relate to "specific and identifiable" risks, not general risk or speculative activity.[37]
(B) The risk-mitigating hedging activity is subject, as appropriate, to ongoing recalibration by the securitization participant to ensure that the hedging activity satisfies the requirements pertaining to this exception and does not facilitate or create an opportunity to benefit	The SEC describes condition (B) as requiring the securitization participant to adjust its position during the Rule 192 applicability period to ensure it is not overhedged.[38]

[35] *See* Proposing Release at 85-86.

[36] *See* Proposing Release at 88-89.

[37] *See* Proposing Release at 88-89.

[38] "For example, if a securitization participant enters into a hedge that would be permitted under the exception and subsequent to that hedge, the risk exposure is reduced, under the proposed condition, the securitization participant would be required to ensure that it is not "overhedged" so that the position would not constitute a bet against the relevant ABS, which could require the securitization participant to adjust or recalibrate its hedge." *See* Proposing Release at 90.

from a conflicted transaction other than through risk-reduction.	
(C) The securitization participant has established, and implements, maintains, and enforces, an internal compliance program that is reasonably designed to ensure the securitization participant's compliance with the requirements pertaining to this exception, including reasonably designed written policies and procedures regarding the risk-mitigating hedging activities that provide for the specific risk and risk-mitigating hedging activity to be identified, documented, and monitored.	According to the SEC, "[t]his proposed condition is designed to promote robust compliance efforts … while also recognizing that securitization participants are positioned to determine the particulars of effective risk-mitigating hedging activities policies and procedures for their own business."[39] The Proposing Release is silent as to how or to what extent, if any, the SEC will monitor this requirement.

Liquidity Commitments	**Proposing Release Discussion**
Purchases or sales of the asset-backed security made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the asset-backed security.	The SEC rejected a comment that the term "commitment" should be defined to mean a contractual obligation to provide liquidity.[40]

Market-Making Activities	**Proposing Release Discussion**
Permitted bona fide market-making activities. Subject to conditions, bona fide market-making activities, including market-making related hedging, of the securitization participant relating to the ABS, the underlying assets or financial instruments that reference the ABS and underlying assets.	The SEC acknowledges that the bona fide market-making activity exception to Rule 192 is drawn from, but differs in certain respects from, similar exceptions found in the Volcker Rule, other Exchange Act provisions and other rules and regulations.[41] Like the exception for permitted risk-mitigating hedging activities, and similar to the Volcker Rule, this exception does not need to be analyzed on a trade-by-trade basis; instead, the SEC is focused on overall market-making and "the reasonably expected near term demand of the securitization participant's customers." The SEC explicitly states that "hedging the risk of a price decline of market-making-related ABS positions and holdings while the market maker

[39] *See* Proposing Release at 95.
[40] See Proposing Release at 103.
[41] *See* Proposing Release at 105-106.

	holds such ABS would qualify for the re-proposed exception." Conversely, the SEC states that this exception most likely does not permit "a securitization participant to issue a synthetic securitization and purchase the CDS protection through such issuance."[42]
Conditions. Bona fide market-making activities are permitted only if each of the following conditions is met: (A) The securitization participant routinely stands ready to purchase and sell one or more types of the financial instruments described above as a part of its market-making related activities in such financial instruments and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments.	The SEC notes that "the mere provision of liquidity" may not be sufficient to meet condition (A). The SEC explains that satisfaction of condition (A) requires that the securitization participant (i) have established patterns of providing price quotations and trading with customers on each side of the market and (ii) be willing to facilitate customer needs in both upward and downward moving markets. Like in the Volcker Rule, the SEC expects "commercially reasonable" to mean that the securitization participant is "willing to quote and trade in sizes requested by market participants in the relevant market."[43]
(B) The securitization participant's market-making related activities are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, taking into account the liquidity, maturity, and depth of the market for the relevant types of financial instruments described above.	The SEC states that satisfaction of condition (B) is a facts and circumstances determination and sets forth a non-exhaustive list of facts and circumstances that would be relevant: "historical levels of customer demands, current customer demand, and expectations of near term customer demand based on reasonably anticipated near term market conditions, including, in each case, inter-dealer demand." Providing an example, the SEC states that facilitating a secondary market credit derivative transaction with respect to an ABS in response to a current customer demand would satisfy condition (B) but building an inventory of CDS positions in the absence of current demand and without any reasonable historical or anticipated basis to build that inventory would fail to satisfy

[42] *See* Proposing Release at 104-110.
[43] *See* Proposing Release at 111-113.

	condition (B). The SEC also specifies that the size of the trade is irrelevant to satisfaction of condition (B).[44]
(C) The compensation arrangements of persons performing the foregoing activity are designed not to reward or incentivize conflicted transactions.	For condition (C), the SEC states that "[i]t would be consistent with this proposed condition if the relevant compensation arrangement is designed to reward effective and timely intermediation and liquidity to customers. It would be inconsistent with this proposed condition if the relevant compensation arrangement is instead designed to reward speculation in, and appreciation of, the market value of market-making positions that the securitization participant enters into for the benefit of its own account."[45]
(D) The securitization participant is licensed or registered to engage in the activity described in the market-making activities described in this exception in accordance with applicable law and self-regulatory organization rules.	For condition (D), the SEC states that ABS market-makers engaged in dealing activity are required to register under one or more of Sections 15(a), 15C and 15F(a) of the Exchange Act, barring an exception or exemption. The SEC goes on to note that registered broker-dealers, licensed banks and registered security-based swap dealers meet condition (D).[46]
(E) The securitization participant has established, and implements, maintains, and enforces, an internal compliance program that is reasonably designed to ensure the securitization participant's compliance with the requirements of this exception, including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.	The SEC specifies that to satisfy condition (E), the securitization participant must have a compliance program that clearly identifies the market-making financial instruments that may be used and the processes for determining customers' near-term demand for such instruments. Internal controls and a system of ongoing monitoring and analysis is also required. Although "prompt" is not defined, the SEC expects that otherwise excepted market-making activity that may be adverse to the relevant ABS remain open for the shortest amount of time possible. The SEC believes that the compliance program in condition (E) reduces the risk of "speculative activity

[44] *See* Proposing Release at 113-115.
[45] *See* Proposing Release at 115.
[46] *See* Proposing Release at 116-117.

	disguised as market-making."[47] The Proposing Release is silent as to whether the SEC will monitor this through any kind of oversight or disclosure requirements.

Questions to Consider and Other Ambiguity

- While Rule 192 has more defined parameters than the Original Proposal and Rule 127B, it still requires a substantial amount of facts and circumstances determinations by securitization participants. How would these determinations be made across various industry participants in the market?
- To what extent will the SEC be reviewing and monitoring required internal compliance programs?

Anti-circumvention

Rule 192 ends with a catch-all section for transactions that go against the spirit, but not the letter, of the rule. In the Proposing Release, the SEC briefly explains that the intent is to capture transactions that fall outside the parameters of the definition of conflicted transaction but are "economically equivalent" to such transactions.[48]

Questions to Consider and Other Ambiguity

- This anti-circumvention provision arguably changes the scope of Rule 192 from the more prescriptive and measurable terms set forth in the other provisions of the rule and puts the burden on the securitization participants to make potentially costly and time-consuming determinations about whether any and all transactions related to an ABS are "economically equivalent" to prohibited transactions without any clear guidance on how to do so.

Conclusion

Rule 192 and the Proposing Release provide significantly more detail about the scope and nature of the prohibition on material conflicts of interest as compared to those provided in proposed Rule 127B. On the other hand, certain aspects of Rule 192, such as the definition of "sponsor," expand the potential scope of the rule far beyond that contemplated by Rule 127B. There remain many ambiguities and potential points of conflict between what the rule is intended to achieve and what it might incidentally achieve in the market. The Proposing Release contains 112 separate requests for comment, indicating that the SEC itself is cognizant that considerable public input and subsequent revisions will be required before Rule 192 is ready for adoption.

[47] *See* Proposing Release at 117-119.
[48] *See* Proposing Release at 83.

Appendix A

§ 230.192 Conflicts of interest relating to certain securitizations.

Unlawful activity.

(1) *Prohibition*. A securitization participant shall not, for a period commencing 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 asset-backed security and ending on the date that is one year after the date of the first closing of the sale of such asset-backed security, directly or indirectly engage in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor in such asset-backed security.

(2) *Material conflict of interest*. For purposes of this section, engaging in any transaction would involve or result in a material conflict of interest between a securitization participant for an asset-backed security and an investor in such asset-backed security if such a transaction is a conflicted transaction.

(3) *Conflicted transaction*. For purposes of this section, a conflicted transaction means any of the following 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, including a decision whether to retain the asset-backed security:

(i) A short sale of the relevant asset-backed security;

(ii) 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 in respect of the relevant asset-backed security; or

(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.

(b) ***Excepted activity.*** The following activities are not prohibited by paragraph (a) of this section:

(1) *Risk-mitigating hedging activities*.

(i) *Permitted risk-mitigating hedging activities*. Risk-mitigating hedging activities of a securitization participant conducted in accordance with this paragraph (b)(1) in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization

participant arising out of its securitization activities, including the origination or acquisition of assets that it securitizes, except that the initial distribution of an asset-backed security is not risk-mitigating hedging activity for purposes of paragraph (b)(1) of this section.

(ii) *Conditions*. Risk-mitigating hedging activities are permitted under paragraph (b)(1) of this section only if:

(A) At the inception of the hedging activity and at the time of any adjustments to the hedging activity, the risk-mitigating hedging activity is designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, contracts, or other holdings of the securitization participant, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof;

(B) The risk-mitigating hedging activity is subject, as appropriate, to ongoing recalibration by the securitization participant to ensure that the hedging activity satisfies the requirements set out in paragraph (b)(1) of this section and does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk-reduction; and

(C) The securitization participant has established, and implements, maintains, and enforces, an internal compliance program that is reasonably designed to ensure the securitization participant's compliance with the requirements set out in paragraph (b)(1) of this section, including reasonably designed written policies and procedures regarding the risk-mitigating hedging activities that provide for the specific risk and risk-mitigating hedging activity to be identified, documented, and monitored.

(2) *Liquidity commitments*. Purchases or sales of the asset-backed security made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the asset-backed security.

(3) *Bona fide market-making activities*.

(i) *Permitted bona fide market-making activities*. Bona fide market-making activities, including market-making related hedging, of the securitization participant conducted in accordance with this paragraph (b)(3) in connection with and related to asset-backed securities with respect to which the prohibition in paragraph (a)(1) of this section applies, the assets underlying such asset-backed securities, or financial instruments that reference such asset-backed securities or underlying assets, except that the initial distribution of an asset-backed security is not bona fide market-making activity for purposes of paragraph (b)(3) of this section.

(ii) *Conditions*. Bona fide market-making activities are permitted under paragraph (b)(3) of this section only if:

(A) The securitization participant routinely stands ready to purchase and sell one or more types of the financial instruments described in paragraph (b)(3)(i) of this section as a part of its market-making related activities in such financial instruments, and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;

(B) The securitization participant's market-making related activities are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, taking into account the liquidity, maturity, and depth of the market for the relevant types of financial instruments described in paragraph (b)(3)(i) of this section;

(C) The compensation arrangements of persons performing the foregoing activity are designed not to reward or incentivize conflicted transactions;

(D) The securitization participant is licensed or registered to engage in the activity described in paragraph (b)(3) of this section in accordance with applicable law and self-regulatory organization rules; and

(E) The securitization participant has established, and implements, maintains, and enforces, an internal compliance program that is reasonably designed to ensure the securitization participant's compliance with the requirements of paragraph (b)(3) of this section, including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.

(c) ***Definitions***. For purposes of this section:

Asset-backed security has the same meaning as in section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)), and also includes synthetic asset-backed securities and hybrid cash and synthetic asset-backed securities.

Distribution means:

(i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.

Initial purchaser means a person who has agreed with an issuer to purchase a security from the issuer for resale to other purchasers in transactions that are not required to be registered under the Securities Act in reliance upon 17 CFR 230.144A or that are otherwise not required to be registered because they do not involve any public offering.

Placement agent and *underwriter* each mean a person who has agreed with an issuer or selling security holder to:

(i) Purchase securities from the issuer or selling security holder for distribution;

(ii) Engage in a distribution for or on behalf of such issuer or selling security holder; or

(iii) Manage or supervise a distribution for or on behalf of such issuer or selling security holder.

Securitization participant means:

(i) An underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security; or

(ii) Any affiliate (as defined in 17 CFR 230.405) or subsidiary (as defined in 17 CFR 230.405) of a person described in paragraph (i) of this definition.

Sponsor means:

(i) Any person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the entity that issues the asset-backed security; or

(ii) Any person:

(A) with a contractual right to direct or cause 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; or

(B) 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.

(C) Notwithstanding paragraphs (ii)(A) and (ii)(B) of this definition, a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security will not be a sponsor for purposes of this rule.

(iii) Notwithstanding paragraphs (i) and (ii) of this definition:

(A) The United States or an agency of the United States will not be a sponsor for purposes of this rule with respect to an asset-backed security that is fully insured or fully guaranteed as to the timely payment of principal and interest by the United States.

(B) The Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation operating under the conservatorship or receivership of the Federal Housing Finance Agency pursuant to section 1367 of the Federal

Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617) with capital support from the United States; or any limited-life regulated entity succeeding to the charter of either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation pursuant to section 1367(i) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617(i)), provided that the entity is operating with capital support from the United States; will not be a sponsor for purposes of this rule with respect to an asset-backed security that is fully insured or fully guaranteed as to the timely payment of principal and interest by such entity.

(d) ***Anti-circumvention***. If a securitization participant engages in a transaction that circumvents the prohibition in paragraph (a)(1) of this section, the transaction will be deemed to violate paragraph (a)(1) of this section.

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