COPUBLISHED FEATURE

SEC RE-PROPOSES CONFLICT OF INTEREST RULE FOR ABS

On 25 January, the US Securities and Exchange Commission issued the proposed Securities Act rule 192, prohibiting certain conflicts of interest in securitisation transactions[1]*. Rule 192 is intended to implement the prohibition against such conflicts as set forth under section 27B of the Securities Act 1933*[2]*. These new regulations will likely have an impact on Australian securitisation transactions with US investors.*

Section 27B directed the Securities and Exchange Commission (SEC) to adopt implementing rules "not later than 270 days after 21 July 2010". In September 2011, the SEC proposed *Securities Act* rule 127B[3]. 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.

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 [asset-backed securities] 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"[4].

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.

Although rule 192 is much more prescriptive and detailed than proposed rule 127B, there remain significant points of ambiguity and concern.

SECURITISATION PARTICIPANTS

Rule 192 applies to each "securitisation 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 securitisation participants "are essential to the design, creation, marketing, and/or sale of an ABS"[5]. 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"[6].

On its face, the definition of securitisation 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.

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[7]. Unfortunately, rule 192 does not go into detail about foreign affiliates and subsidiaries, but rather only mentions that they could be scoped into the rule. This is of particular relevance to the Australian securitisation market. Questions to be asked include:

1. See SEC release No. 33-11151, available at: https://www.sec.gov/rules/proposed/2023/33-11151.pdf
2. Section 27B, which was added to the *Securities Act* by section 621 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*, 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 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.
(b) RULEMAKING. Not later than 270 days after the date of enactment of this section, the [SEC] shall issue rules for the purpose of implementing subsection (a).
(c) EXCEPTION. The prohibitions of subsection (a) shall not apply to:
(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
(2) Purchases or sales of asset-backed securities made pursuant to and consistent with:
(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
(B) *Bona fide* market-making in the asset backed security.
(d) RULE OF CONSTRUCTION. This subsection shall not otherwise limit the application of section 15G of the *Securities Exchange Act 1934*.
(e) EFFECTIVE DATE. Section 27B of the *Securities Act 1933*, as added by this section, shall take effect on the effective date of final rules issued by the [SEC] 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.
3. See SEC release No. 34-65355, available at: https://www.sec.gov/rules/proposed/2011/34-65355.pdf.
4. See proposing release at 7-8.
5. See proposing release at 19.
6. *Id.*
7. Note that the proposing release seeks comment on the extraterritorial application of rule 192. See request for comment number 31 in the proposing release at 53.

- How would a large entity with information barriers that are otherwise legally mandated ensure compliance with this rule while maintaining those barriers?
- How would a large organisation, 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 securitisation participant includes affiliates or subsidiaries, investment advisers that are affiliates or subsidiaries of an ABS underwriter, placement agent, initial purchaser or sponsor would also be considered securitisation participants. As such, rule 192 would go substantially further than the *Investment Advisers Act 1940* with respect to conflict resolution for investment advisers.

This latter act 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 securitisation 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 securitisation participant – let alone an investment adviser that is deemed to be a securitisation 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 securitisation participant as soon as that person "has reached, or has taken substantial steps to reach, an agreement that such person will become a securitisation participant with respect to an asset-backed security"[8]. Rule 192 does not define "agreement" or "substantial steps to reach . . . an agreement" in the context of the commencement point[9].

Fortunately, the SEC does clarify that rule 192 would not apply to a party that took substantial steps to reach an agreement but never actually reached such agreement, and thus never became a securitisation participant[10].

Rule 192 ceases to apply to a securitisation 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. The questions to consider and other ambiguity in this area include:

- As proposed, it appears that the determination of a commencement point would be backward-looking and 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?

DEFINITION OF ABS

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

Thus, ABS 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[11].

As noted, 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 [credit default swap], a total return swap or an ABS structure that replicates the terms of such a swap.We believe that our previous descriptions of synthetic securitisations 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."[12]

MATERIAL CONFLICTS OF INTEREST

Rule 192 states that a securitisation participant shall not "directly or indirectly[13] engage in any transaction that would involve or result in any material conflict of interest" between the securitisation participant and an investor in the ABS.

What is unclear is how a securitisation participant would be able to determine what a "reasonable investor" would consider to be material to an investment decision – especially when

8. The SEC states: "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.
9. See Proposing release at 57.
10. *Id.*
11. 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.
12. See proposing release at 14.
13. 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 securitisation 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 securitisation 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.

EXCEPTIONS AND RELATED CONDITIONS WITH 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.	This proposed exception would allow a securitisation participant to hedge retained ABS positions and exposures in connection with warehousing assets in advance of ABS issuance. Hedging can be on an aggregated basis and not only trade-by-trade[14].
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 securitisation participant, based on 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 securitisation participant to ensure the hedging activity satisfies the requirements pertaining to this exception and does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk reduction. C. The securitisation participant has established – and implements, maintains, and enforces – an internal compliance programme that is reasonably designed to ensure the securitisation 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.	To meet condition (A), the SEC makes clear that securitisation participants may not "overhedge" their risks – ie create a net short exposure to the relevant ABS[15]. The SEC emphasises that, in order to be permissible, the hedging activity must relate to "specific and identifiable" risks, not general risk or speculative activity[16]. The SEC describes condition (B) as requiring the securitisation participant to adjust its position during the rule 192 applicability period to ensure it is not overhedged[17]. According to the SEC, this "proposed condition is designed to promote robust compliance efforts... while also recognizing that securitisation participants are positioned to determine the particulars of effective risk-mitigating hedging activities, policies and procedures for their own business"[18]. The proposing release is silent as to how or to what extent, if any, the SEC will monitor requirement (C).
Liquidity commitments	**Proposing release discussion**
Purchases or sales of the ABS made pursuant to, and consistent with, commitments of the securitisation participant to provide liquidity for the ABS.	The SEC rejected a comment that the term "commitment" should be defined to mean a contractual obligation to provide liquidity[19].
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 securitisation 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[20]. Like the exception for permitted risk-mitigating hedging activities, and similar to the Volcker Rule, this exception does not need to be analysed on a trade-by-trade basis. Instead, the SEC is focused on overall market-making and "the reasonably expected near term demand of the securitisation 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 holds such ABS would qualify for the re-proposed exception". Conversely, the SEC states that this exception most likely does not permit "a securitisation participant to issue a synthetic securitisation and purchase the CDS protection through such issuance"[21].
Conditions. Bona fide market-making activities are permitted only if each of the following conditions is met: A. The securitisation 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 securitisation participant has established patterns of providing price quotations and trading with customers on each side of the market and is willing to facilitate customer needs in upward and downward moving markets. Like in the Volcker Rule, the SEC expects "commercially reasonable" to mean that the securitisation participant is "willing to quote and trade in sizes requested by market participants in the relevant market"[22]. The SEC states that satisfaction of condition (B) is a facts and circumstances determination and sets forth a nonexhaustive list of facts and circumstances that would be relevant: "Historical levels of

B. The securitisation 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.
C. The compensation arrangements of persons performing the foregoing activity are designed not to reward or incentivise conflicted transactions.
D. The securitisation 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 organisation rules.
E. The securitisation participant has established – and implements, maintains and enforces – an internal compliance programme that is reasonably designed to ensure the securitisation 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.

14. See proposing release at 85-86.
15. See proposing release at 88-89.
16. See proposing release at 88-89.
17. "For example, if a securitisation 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 securitisation 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 securitisation participant to adjust or recalibrate its hedge." See proposing release at 90.
18. See proposing release at 95.
19. See proposing release at 103.
20. See proposing release at 105-106.
21. See proposing release at 104-110.
22. See proposing release at 111-113.

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 condition (B). The SEC also specifies that the size of the trade is irrelevant to satisfaction of condition (B).

For condition (C), the SEC states that it "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 securitisation participant enters into for the benefit of its own account".

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).

The SEC specifies that to satisfy condition (E), the securitisation participant must have a compliance programme 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 least time possible.

The SEC believes the compliance programme in condition (E) reduces the risk of "speculative activity disguised as market-making". The proposing release is silent as to whether the SEC will monitor this through any kind of oversight or disclosure requirements.

only "substantial steps" have been taken by such a securitisation participant, but some of the material terms of the proposed ABS remain to be determined.

Will investors' historical acceptance of a securitisation participant entering into a particular type of ABS transaction mean there is not a substantial likelihood that a reasonable investor would consider such a transaction important to the investor's investment decision, including a decision whether to retain the ABS? Why is the determination not to be made after, or by giving effect to, typical ABS disclosure – or, if then available in the relevant case, the actual ABS disclosure?

It also remains to be seen whether there would be unanticipated consequences on the market from a blanket ban on using disclosure to cure potential conflicts of interest.

EXCEPTIONS AND CONCLUSION

Rule 192 exempts risk-mitigating hedging activities, liquidity commitments and *bona fide* market-making activities from the prohibition against material conflicts of interest, so long as they meet certain conditions (see table). This leaves the following questions to consider and other ambiguities:

- 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 securitisation 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 programmes?

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 with those provided in proposed rule 127B. However, 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. The proposing release contains 112 separate requests for comment, indicating that the SEC itself is cognisant that considerable public input and subsequent revisions will be required before rule 192 is ready for adoption. ■

◆ FOR MORE INFORMATION PLEASE CONTACT:

Amanda Baker Partner
amanda.baker@mayerbrown.com
+1 212 506 2544

Stuart Litwin Partner
slitwin@mayerbrown.com
+1 312 701 7373

Paul Jorissen Partner
pjorissen@mayerbrown.com
+1 212 506 2555

Jon Van Gorp Partner
jvangorp@mayerbrown.com
+1 312 701 7091