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Conflict Resolution: The SEC Adopts Final Rule 192 (Conflicts of Interest in Securitization Transactions)

WHITE PAPER

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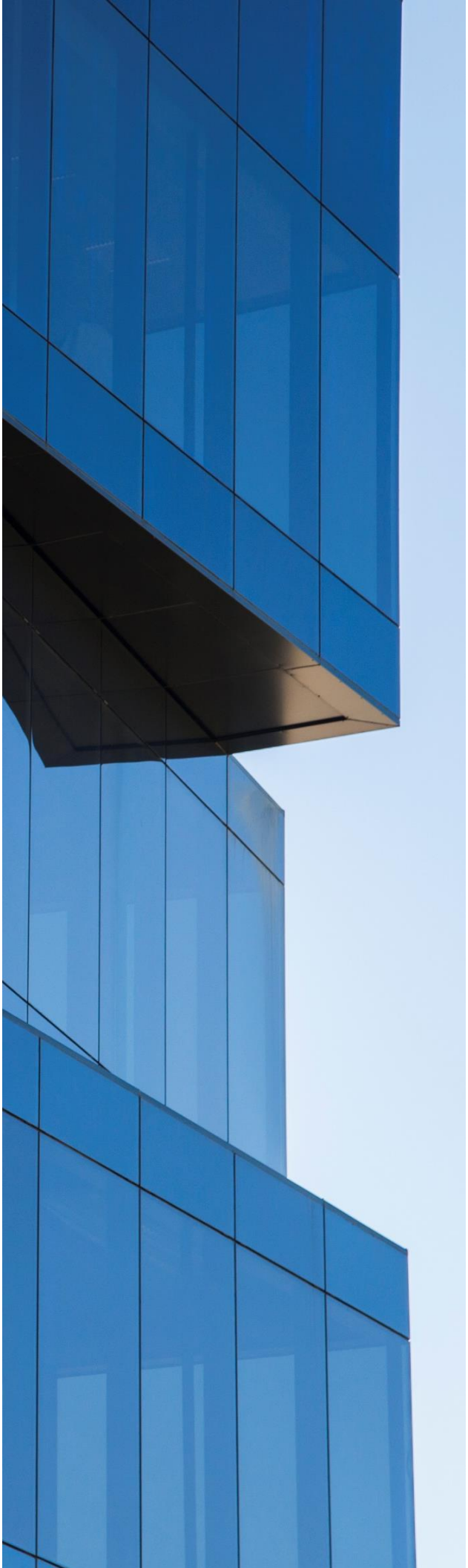

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Highlights

On November 27, 2023, the US Securities Exchange Commission ("**SEC**") adopted final Securities Act Rule 192 ("**Final Rule 192**") prohibiting certain conflicts of interest in securitization transactions.

> The text of Final Rule 192, marked against Proposed Rule 192, is set forth in ***Appendix A***.

In general, Final Rule 192 prohibits a "securitization participant" with respect to an "asset-backed security" ("**ABS**") from directly or indirectly engaging in any "conflicted transaction" during the applicable prohibition period.

Final Rule 192 becomes effective on the date that is 60 days after the date of publication in the *Federal Register*. Compliance with Final Rule 192 is required with respect to any ABS the first closing of the sale of which occurs 18 months after the date of publication in the *Federal Register*.

In general, the final rule is a significant improvement over the proposed rule. However, some ambiguities and compliance challenges remain. Below is a summary of the most significant changes from the proposed rule:

1. The catchall provision of the definition of "conflicted transaction" has been changed to refer to transactions that are "substantially the economic equivalent" of either a short sale of, or a credit derivative on, the relevant ABS. The preamble to the adopting release provides some interpretive guidance, but important questions remain.
2. The anti-circumvention provision that did not require intent has been removed and replaced with an anti-evasion provision that applies only to the exceptions and requires a "plan or scheme" to evade.
3. The risk mitigating hedging activities exception has been modified to permit the issuance of synthetic ABS for hedging purposes, including bank credit risk transfer ("**CRT**") transactions. The ongoing recalibration condition has been retained but is qualified by a materiality standard. The use of synthetic ABS where a securitization participant receives payments based on poor performance of the ABS or its underlying assets, for purposes other than hedging, is generally prohibited.

4. The final rule limits the definition of "securitization participant" to affiliates and subsidiaries who (1) act in coordination with the underwriter, placement agent, initial purchaser, or sponsor or (2) have access to, or receive information about, the ABS or the underlying pool. The preamble to the adopting release provides some interpretive guidance, but important questions remain.
5. The "substantial steps" to reach an agreement to become a securitization participant have been removed. Under the final rule, an agreement is required to trigger the commencement of the prohibition period. However, the preamble to the adopting release indicates that an oral "agreement in principle" is sufficient to trigger the compliance period.
6. Long-only investors have been carved out of the definition of "sponsor," but the final rule's definition of "sponsor" remains much broader than under other securitization regulations, such as Regulation AB and Regulation RR.
7. The final rule includes a safe harbor for foreign transactions.

Now that a final rule has been issued and a transition period specified, securitization participants can begin taking steps to ensure that they are ready to comply with Final Rule 192.

- ✓ **Everyone who is a securitization participant will need a Final Rule 192 compliance program.**
- ✓ **Any securitization participant who seeks to rely on the exception for risk-mitigating hedging activities or bona fide market-making activities will need the additional compliance programs required by those exceptions.**

Introduction and Background

On November 27, 2023, the SEC adopted Final Rule 192 prohibiting certain conflicts of interest in securitization transactions.

[1] Final 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 ("**Securities Act**").[2]

Final Rule 192 was adopted ten months after the SEC issued proposed Rule 192 ("**Proposed Rule 192**").[3] The SEC received over 900 comment letters on Proposed Rule 192,[4] and indicated that it considered all of the comments it received, including those submitted after the March 27, 2023, comment deadline.[5]

The text of Final Rule 192, marked against Proposed Rule 192, is set forth in ***Appendix A***.

Commenters had urged the SEC to issue a re-proposal rather than a final rule.[6] The Adopting Release briefly acknowledges those comments, but states that the SEC does not believe that a re-proposal of the rule is necessary.[7] Notably, SEC Commissioner Hester M. Peirce disagreed, stating in her dissent that "[a]s burdensome as it would have been for the [SEC] and commenters to formally re-engage, the consequences of getting this rule wrong loom large enough to warrant one more round of comments."[8]

Below, we answer some of the key questions that securitization participants are likely to have about Final Rule 192:

- When does Final Rule 192 become effective and when is compliance required?
- What is the prohibition period?
- What transactions are prohibited?
- What types of asset-backed securities are covered?
- Who is covered?
- What are the exceptions?
- Are bank CRT deals permitted? What about other types of synthetic securitizations?
- Does Final Rule 192 apply to foreign transactions?
- What can securitization participants do to prepare for Final Rule 192?

When does Final Rule 192 become effective and when is compliance required?

Final Rule 192 becomes effective on the date that is 60 days after the date of publication in the *Federal Register*. However, compliance with Final Rule 192 will be required with respect to any ABS the first closing of the sale of which occurs 18 months after the date of publication in the *Federal Register*.[9]

Question to consider about the compliance date:

If the first closing of the sale of an ABS occurs after the 18-month period ends but a securitization participant enters into a conflicted transaction prior to the end of the 18-month period, is that conflicted transaction subject to Final Rule 192?

WHAT IS THE PROHIBITION PERIOD?

Under Final Rule 192, the period of time securitization participants will be prohibited from entering into a conflicted transaction:

- begins "on the date on which such person has reached an agreement that such person will become a securitization participant with respect to an asset-backed security;" and
- ends on the "date that is one year after the date of the first closing of the sale of such asset-backed security."

The end date for the prohibition period comes directly from Section 27B and is reasonably clear on its face. The beginning date for prohibition period, on the other hand, is not directly specified by Section 27B.

Proposed Rule 192 specified the beginning date of the prohibition period as the date on which a person "has taken substantial steps" to reach an agreement to become a securitization participant. Proposed Rule 192 did not, however, define "substantial steps" and instead indicated that the determination as to whether substantial steps were taken will be a "facts and circumstances" analysis of the securitization participant's actions.[10]

At the request of market participants, the SEC removed the substantial steps trigger. Thus, an agreement to become a securitization participant is required. Final Rule 192 does not define "agreement," but the Adopting Release contains guidance that diminishes to some extent the certainty that marked participants were hoping for:

> For purposes of Rule 192, "agreement" refers to an ***agreement in principle*** (including oral agreements and facts and circumstances constituting an agreement) as to the material terms of the arrangement by which such person will become a securitization participant. An executed written agreement, such as an engagement letter, is not required; whether there has been an agreement to become a securitization participant will depend on the facts and circumstances of the securitization transaction and the parties involved.[11]

Questions to consider about the prohibition period:

When does a sponsor become a securitization participant? That is, with whom does it reach agreement to become a securitization participant?

How will market participants know when they have reached an "agreement in principle"? Is an "agreement in principle" sufficiently distinct from "substantial steps to reach agreement" so as to provide greater certainty?

WHAT TRANSACTIONS ARE PROHIBITED?

Final Rule 192 provides that a securitization participant shall not, during the prohibition period, directly or indirectly engage in any transaction that would involve or result in a "material conflict of interest" between the securitization participant and an investor in an ABS. Under Final Rule 192, a transaction would result in a material conflict of interest between a securitization participant and an investor in an ABS if that transaction is a "conflicted transaction."

The "prohibition period" referred to above is the period commencing on the date on which a person has reached an agreement that such person will become a securitization participant with respect to an ABS and ending on the date that is one year after the date of the first closing of the sale of such ABS.[12]

Definition of "Conflicted Transaction"

Final Rule 192 defines "conflicted transaction" as:

> [A]ny 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 that is substantially the economic equivalent of a transaction described in paragraph (a)(3)(i) or (a)(3)(ii) of this section, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk.

Catchall Provision

The definition of conflicted transaction in Final Rule 192 is the same as that set forth in Proposed Rule 192, except with respect to clause (iii) ("**catchall provision**").

Proposed Rule 192 – Catchall Provision	*Final Rule 192 – Catchall Provision*
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.	The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that is ***substantially the economic equivalent*** of a transaction described in paragraph (a)(3)(i) or (a)(3)(ii) of this section, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk.

According to the Adopting Release, the "substantial economic equivalence" standard is intended to address the concern of market participants that the catchall capture "direct bets" against the ABS[13] as opposed to merely correlated trades. The Adopting Release provides some elaboration on how direct the bet must be:

> We disagree with commenters who said that the scope of Rule 192(a)(3)(iii) should be limited to transactions that are entered into with respect to the relevant ABS or the asset pool supporting or referenced by such ABS. Such an approach would be underinclusive. For example, it would allow a securitization participant to enter into a short with respect to a pool of assets with characteristics that ***replicate the idiosyncratic credit performance of the asset pool supporting the relevant ABS***. We do not believe that it would be appropriate to exclude such transactions as securitizations participants would still have an opportunity to bet against the performance of their ABS by being allowed to enter into such transactions. Whether a short transaction entered into with respect to a similar pool of assets is a conflicted transaction under the final rule will be a facts and circumstances determination. If such a short position with respect to a similar pool of assets would be substantially the economic equivalent of a short sale of the relevant ABS itself or a CDS or 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 ABS, then it would be a conflicted transaction.

However, ***this standard is designed to not capture transactions entered into by a securitization participant with respect to an asset pool that has characteristics that are sufficiently distinct from the idiosyncratic credit risk of the asset pool that supports or is referenced by the relevant ABS***. Such transactions do not give rise to the investor protection concerns that Section 27B is designed to address.[14]

The substantial economic equivalence standard, when coupled with this SEC commentary, is, perhaps, less clear than market participants had hoped for.[15] In developing compliance programs, securitization participants will need to weigh whether transactions may replicate the idiosyncratic, or unique, credit performance of the asset pool supporting the ABS or whether they merely have some correlation but is otherwise sufficiently distinct from such credit performance.

The Super Catchall (Anti-Circumvention)

Proposed Rule 192 had a very broad anti-circumvention provision. Under that provision, any transaction that "circumvents" the prohibition against material conflicts of interest would be deemed to violate the rule. In a sense, this provision was a "super catchall" that would have made it nearly impossible for securitization participants to design a reliable compliance program or otherwise have the requisite legal certainty to conduct many of their normal securitization-related activities.

Fortunately, the SEC eliminated the anti-circumvention provision and, in accordance with a comment from SIFMA,[16] replaced it with an anti-evasion provision that applies only with respect to the exceptions. Such an approach is much more consistent with other security law rules, including Regulation RR. The SEC noted that:

> We are persuaded that an anti-circumvention provision could have the potential to be both overinclusive and vague in this particular circumstance given the other elements of the rule, and that an anti-evasion standard that focuses on the actions of the securitization participants as part of [a] scheme to evade the rule's prohibition would be more appropriate. We are also persuaded by the suggestion of certain commenters that the anti-evasion provision should only apply to a securitization participant's claimed compliance with one of the exceptions to the rule.[17]

The anti-evasion provision in Final Rule 192 provides that:

> Anti-evasion. If a securitization participant engages in a transaction or a series of related transactions that, although in technical compliance with [the exceptions for risk mitigating hedging activities, liquidity commitments and bona fide market-making activities], is part of a plan or scheme to evade the prohibition in paragraph (a)(1) of this section, that transaction or series of related transactions will be deemed to violate paragraph (a)(1) of this section.

The Reasonable Investor Standard

Section 27B directs the SEC to adopt a rule prohibiting transactions that would involve or result in any "material" conflict of interest between a securitization participant and an investor. Consistent with its approach in Proposed Rule 192, the SEC implemented this directive by incorporating the following standard of materiality into the definition of "conflicted transaction" in Final Rule 192:

> 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.

As the SEC acknowledged in the Proposing Release, this standard is based on the securities law disclosure standard set forth by the Supreme Court in *Basic v. Levinson*. However, as the American Bar Association pointed out in its comment letter, the "reasonable investor" standard for materiality is not well suited for this rule because it is a standard for what must be disclosed to investors and "not a standard that is appropriate for use in sorting transactions into permissible and impermissible categories."[18]

Market participants had urged the SEC to adopt a "materially adverse to the interests of investors" standard like that used in the Volcker Rule.[19] The SEC rejected this approach, arguing that:

> [The reasonable investor] materiality standard is more appropriate for purposes of implementing Section 27B than the other suggested alternatives as it is focused on the perspective of the reasonable investor in the ABS (not the securitization participant) and, specifically, whether there is a substantial likelihood that such reasonable investor would consider the relevant transaction important to the investor's investment decision whether to acquire or retain the ABS. Also, given that Section 27B was designated as a part of the Securities Act, the existing materiality standard will be more familiar to the broad base of securitization participants that are subject to the rule that engage in the issuance of ABS as opposed to a new standard that is not based on any jurisprudence related to the Securities Act. In this regard, we note that the Volcker Rule and its application relates to the Bank Holding Company Act, which is primarily designed to address safety and soundness concerns applicable to bank holding companies, as opposed to the investor protection focus of the securities laws, including Section 27B.[20]

In developing compliance programs, securitization participants will need to contend with how to apply this standard, which is generally applied to disclosure, to a rule that sets forth a strict prohibition. Securitization participants will also face a new challenge in applying the reasonable investor standard to an investor's decision to retain a security.[21]

WHAT TYPES OF ASSET-BACKED SECURITIES ARE COVERED?

Under Final Rule 192, the term "asset-backed security" includes (1) an "asset-backed security" as defined under Section 3(a)(79) of the Securities Exchange Act of 1934[22] and (2) a synthetic asset-backed security or hybrid cash and synthetic asset-backed security.

Like Proposed Rule 192, Final Rule 192 does *not* provide a separate definition of "synthetic asset-backed security" or "hybrid cash and synthetic asset-backed security." Commenters had offered proposed definitions of "synthetic asset-backed security,"[23] but the SEC declined to include any definition, stating:

> Given the variation of suggested definitions provided by commenters, we do not believe that adopting any one of these definitions, or a combination thereof, would appropriately capture the scope of the various features of existing synthetic ABS and possible future structures or designs of synthetic ABS; *however, commenters' suggestions are consistent with the characteristics that we have previously identified as features of synthetic ABS*.[24]

Although it did not provide a formal definition in the rule text, the SEC did agree that guidance would be beneficial. Thus, in the preamble of the Adopting Release, the SEC stated that:

- [W]hile a synthetic ABS may be structured or designed in a variety of ways, we generally view a synthetic asset-backed security as a fixed income or other security issued by a special purpose entity that allows the holder of the security to receive payments that depend primarily on the performance of a reference self-liquidating financial asset or a reference pool of self-liquidating financial assets.[25]
- [W]hether a transaction is a 'synthetic ABS' subject to Rule 192 will depend on the nature of the transaction's structure and characteristics of the underlying or referenced assets.[26]

Helpfully, the preamble of the Adopting Release makes clear that "a corporate debt obligation is not a synthetic ABS for purposes of Rule 192."[27] Similarly, "a security-based swap is also not a synthetic ABS for purposes of Rule 192 because it is a financial contract between two counterparties without the issuance of a security from a special purpose entity."[28] In several places throughout the preamble of the Adopting Release, the SEC specifies that a synthetic ABS is a "security issued by a special-purpose vehicle," which at least provides some clarity in the type of structure that falls under Rule 192.[29]

Questions to consider about the prohibition:

What standards can securitization participants develop around the "substantial economic equivalent" test to ensure that a transaction does not fall within the catchall? Can any reasonable bright lines be established?

What standards can securitization participants develop around the "reasonable investor" test for materiality? Are there any categories of transaction that would consistently be unimportant to the reasonable investor?

Is the SEC's guidance on the meaning of "synthetic ABS" sufficiently clear?

WHO IS COVERED?

Final Rule 192 applies to transactions involving any "securitization participant." The term "securitization participant" is defined to mean:

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 ***if the affiliate or subsidiary****:*

A. Acts in coordination with a person described in paragraph (i) of this definition; or

B. Has access to information or receives information about the relevant asset-backed security or the asset pool underlying or referenced by the relevant asset-backed security prior to the first closing of the sale of the relevant asset-backed security.

Affiliates and Subsidiaries

Other than with respect to the italicized language above, this definition is the same as in Proposed Rule 192. The italicized language was added in an attempt to address the concerns of commenters about applying the prohibition to all affiliates and subsidiaries of each underwriter, placement agent, initial purchaser, and sponsor, no matter how remotely related, distinct in operation or uninvolved in the ABS transaction, and without regard to the use of information barriers or other indicia of separateness.

According to the Adopting Release, the new provision:

> is consistent with the commenter suggestions, as noted above, that affiliates or subsidiaries should only be subject to the prohibition if they have direct involvement in, or access to information about, the relevant ABS or are otherwise acting in coordination with the named securitization participant.[30]

Acting in coordination. The "acting in coordination" prong in clause (ii)(A) appears responsive to comments from SIFMA, SFA and LSTA suggesting an approach analogous to Rule 105 under Regulation M. Rule 105 prohibits short sales during the restricted period prior to a secondary offering but excludes from such prohibition short sales conducted by separate accounts "if decisions regarding securities transactions for each account are made separately and without coordination among or between accounts."[31]

Access to information. The Adopting Release does not give any guidance on what "access to information" means in the case of information that is made publicly available, or otherwise widely available to investors, prior to first closing of the sale of the relevant asset-backed security. For example, preliminary prospectuses and, when applicable, asset-level data are required to be filed with the SEC and are published on EDGAR at least three business days before the first sale in the offering.[32] If mere access to such publicly available information causes an affiliate or subsidiary to be a securitization participant under Final Rule 192, the carve-out in the final rule would be meaningless.

However, although very broad on its face, the access to information prong in clause (ii)(B) appears motivated primarily by concerns about an affiliate's or subsidiary's use of information about the ABS transaction to influence the assets included in the ABS transaction. The Adopting Release states that:

> If, for example, a securitization participant employs an information barrier, and the barrier fails, whether the affiliate or subsidiary is a securitization participant under Rule 192 will depend on the facts and circumstances. On one hand, if the failure was accidental, was quickly remedied upon discovery, *and the affiliate did not use the information to influence the assets included in the ABS*, then the affiliate would likely not be a securitization participant under Rule 192. On the other hand, even if the failure was accidental, *but the access to information led to the affiliate using the information to influence the assets included in the ABS*, then that affiliate would likely be a securitization participant for purposes of Rule 192.[33]

The provision above indicates that mere access to information about the ABS does ***not*** automatically cause an affiliate or subsidiary to become a securitization participant. Where an affiliate or subsidiary receives nonpublic information as the result of an information barrier failure, what the affiliate or subsidiary does with the information is the key consideration. Here, an affiliate's or subsidiary's use of information about the ABS to influence the composition of the pool assets is what turns an affiliate or subsidiary into a securitization participant.

Moreover, it would be quite incongruous with this guidance if an affiliate or subsidiary automatically becomes a securitization participant simply because it has access to *public* information about the ABS *via* EDGAR filings, rating agency presale reports, and the like. Presumably, if obtaining nonpublic information due to a firewall failure does not make an affiliate or subsidiary a securitization participant unless it uses that information to influence the pool composition, then simply having internet access or a subscription to industry publications should not cause it to become a securitization participant unless it uses the information to influence the pool composition.

Indicia of separateness. The SEC notes that "whether an affiliate or subsidiary acts in coordination with a securitization participant or had access to, or received, information about an ABS or its underlying asset pool or referenced asset pool prior to the closing date will depend on the facts and circumstances of a particular transaction."[34] The preamble to the Adopting Release goes on to provide an illustrative list of such facts as circumstances, which strongly resembles the SEC's guidance as to indicia of separateness under Rule 105 of Regulation M.[35]

> [A]n affiliate or subsidiary may not be a "securitization participant" if the named securitization participant, for example:
>
> - Has effective information barriers between it and the relevant affiliate or subsidiary (including written policies and procedures designed to prevent the flow of information between relevant entities, internal controls, physical separation of personnel, etc.),
> - Maintains separate trading accounts for the named securitization participant and the relevant affiliate or subsidiary,
> - Does not have common officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) between the named securitization participant and the relevant affiliate or subsidiary,
> - Is engaged in an unrelated business from the relevant affiliated entity and does not, in fact, communicate with such relevant affiliated entity, ***or***
> - Has personnel with oversight or managerial responsibility over accounts of both the named securitization participant and the affiliate or subsidiary, but such persons do not have authority to (and do not) execute trading in individual securities in the accounts or authority to (and do not) pre-approve trading decisions for the accounts.[36]

Definition of "Sponsor"

Under Final Rule 192, an ABS transaction "sponsor" is a securitization participant. Final Rule 192 defines "sponsor" to mean:

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 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 or referenced by the asset-backed security, other than a person who acts solely pursuant to such person's contractual rights as a holder of a long position in the asset-backed security.

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

iv. Notwithstanding paragraphs (i) and (ii) of this definition, 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.

This definition of "sponsor" is *significantly* narrower than the definition set forth in Proposed Rule 192. As explained below, the "directing sponsor" prong has been removed entirely and the "contractual rights sponsor" prong has been clarified to exclude investors who are simply exercising their contractual rights as holders of a long position in the ABS, such as consent rights over initiating foreclosure proceedings with respect to the securitized assets, the right to replace the special servicer of the ABS, or the right to direct or cause the direction of an optional redemption of the ABS.

Regulation AB-based sponsors. The sponsors described in clause (i) of this definition are referred to by the SEC as "Regulation AB-based sponsors," as the definition was derived from the definition of the term "sponsor" in Regulation AB.[37] As the definition of "sponsor" in Regulation AB is the ordinary meaning of that term in the context of securitization, it was generally supported by commenters.[38] The Regulation AB-based sponsors prong is unchanged from Proposed Rule 192.

Contractual rights sponsors. The sponsors described in clause (ii) are referred to as "contractual rights sponsors." The contractual rights sponsor prong is unchanged from Proposed Rule 192, with one exception.[39] The Adopting Release acknowledged concerns expressed in comment letters about investors being deemed sponsors simply by acting in accordance with contractual rights under the transaction documents.[40] As the Adopting Release correctly noted, "it is often the case that long investors purchasing the most senior or the most subordinated tranche of the relevant ABS negotiate for certain rights that are exercisable over the life of the securitization."

In response to these comments, Final Rule 192 excludes any person who acts solely pursuant to such person's contractual rights as holder of a long position in the ABS. The Adopting Release makes clear that "Rule 192 is not designed to discourage ABS investors from exercising contractual rights as a holder of a long position in the ABS."[41] As the Adopting Release explains:

> A person's contractual rights as a holder of a long position in the ABS could include, for example, consent rights over major decisions such as initiating foreclosure proceedings with respect to assets underlying the ABS, the right to replace the special servicer of the ABS, or the right to direct or cause the direction of an optional redemption of outstanding interests in the ABS. Rule 192 is not designed to impair an ABS investor's ability to negotiate for such contractual rights as a holder of a long position in the ABS. Nor is it designed to discourage investors from exercising such rights as a holder of a long position in the ABS. Therefore, we are adopting paragraph (ii) of the definition of "sponsor" to exclude from the definition of Contractual Rights Sponsor any person who acts solely pursuant to such person's contractual rights as a holder of a long position in the ABS.[42]

The Adopting Release makes clear that "a portfolio selection agent for a collateralized debt obligation ("CDO") transaction with a contractual right to direct or cause the direction of the composition of the

pool assets" would be considered a sponsor.[43] Similarly, "a collateral manager for a collateralized loan obligation with the contractual right to direct or cause the direction of asset purchases or sales on behalf of the CLO" would be considered a sponsor.[44]

Directing sponsors. In a significant narrowing of the definition of "sponsor," Final Rule 192 eliminates the "directing sponsor" prong that was in Proposed Rule 192. That prong included "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." The Adopting Release notes that removing the directing sponsor prong will help to mitigate commenter concerns about the number and types of entities that would be considered sponsors.[45]

The "directing sponsor" prong was particularly problematic because it would have, by the SEC's stated intent, captured any entity with "significant influence in the structure, composition, and management of an ABS."[46] As SIFMA noted, this category of sponsor, which it referred to as "influencers," "is so wide-ranging that it threatened to capture *investors* (the persons for who the securitization has been organized and initiated)"[47] and credit rating agencies.[48]

Service provider exclusion. Final Rule 192 contains an exclusion for entities that perform only "ongoing administration" services. These services "refer to the types of activities typically performed by servicers, trustees, custodians, paying agents, calculation agents, and other contractual service providers pursuant to their contractual obligations in a securitization transaction over the life of the ABS; it does not refer to active portfolio management or other such activity that would be subject to the 'sponsor' definition."[49]

Questions to consider about who is covered:

How can securitization participants ensure that their affiliates and subsidiaries do not have access to or receive information about the ABS? Does the SEC's guidance provide sufficient comfort on the limits of the information prong? Should securitization participants consider additional advocacy efforts to narrow or clarify the access to information prong?

Are the indicia of separateness provided by the SEC sufficiently clear and workable in establishing that an affiliate or subsidiary is not acting in coordination with a securitization participant and does not have access to information about the ABS?

Is it clear what parties have a "contractual right" to direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the asset pool?

WHAT ARE THE EXCEPTIONS?

Final Rule 192 contains the three exceptions as prescribed by Section 27B: (1) risk-mitigating hedging activities, (2) liquidity commitments, and (3) bona fide market-making activities.

Risk-Mitigating Hedging Activities

The exception for risk-mitigating hedging activities provides that a securitization participant's risk-mitigating hedging activities are permitted "in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization participant, including those arising out of its securitization activities, such as the origination or acquisition of asserts that it securitizes."

Final Rule 192 makes several important changes to the exception for risk-mitigating hedging activities.

- Final Rule 192 does not include the provision that the initial distribution of an asset-backed security is not risk-mitigating hedging activity for purposes of the exception. The Adopting Release explains that "[t]his change is intended to allow for the initial issuance of synthetic ABS that the relevant securitization participant enters into and maintains as a hedge."[50]
- Final Rule 192 does not require the hedge to relate to positions "arising out of" a securitization participant's securitization activities. Rather, it specifies that those positions may ***include those*** arising out of securitization activities. The Adopting Release explains that the addition of the phrase "including those" is "responsive to the concerns of certain commentators that stated that the risk-mitigating hedging activities exception should not be limited to the hedging of exposures arising out of a securitization participant's securitization activities."[51]
- Final Rule 192 loosens somewhat the condition that the risk-mitigating hedging activity is subject to ongoing calibration by specifying that such calibration must ensure that the hedge does not facilitate or create an opportunity to ***materially*** benefit from a conflicted transaction other than through risk reduction. The Adopting Release explains that the addition of the word "materially" is designed to address the concern that securitization participants may not immediately recalibrate their hedging positions and "not unduly disrupt normal course hedging activities that do not present material conflicts of interest with ABS investors."[52]

As discussed below in "Are Bank CRT Deals Permitted?", these changes are designed, in part, to facilitate the use of the risk-mitigating hedging exception by banks in connection with CRT transactions and other synthetic securitizations conducted for hedging purposes.

Liquidity Commitments

Final Rule 192 provides that "[p]urchases 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" are not prohibited transactions. Proposed Rule 192's exception for liquidity commitments drew relatively few comments, and no changes were made to that exception in Final Rule 192.

Bona Fide Market-Making Activities

Final Rule 192 contains an exception for a securitization participant's bona fide market-making activities. As requested by commenters, the SEC added a "if required" qualifier to the condition that the securitization participant is licensed or registered to engage in market-making activity.

Commenters sought the removal of the requirement that the exception for bona fide market making activities does not include the initial distribution of the ABS. Both SIFMA and SFA commented that the phrase is unclear in the context of market making.[53] The SEC rejected this request, reasoning that "in cases where the securitization participant enters into a conflicted transaction [*e.g.*, credit default swap that does not qualify for the risk mitigating hedging exception] as a complement of the initial distribution of the synthetic ABS, we do not believe that it would be appropriate to allow that conflicted transaction to be eligible for the bona fide market-making activities exception."[54]

Requested Exception for Pre-Securitization Activities

In their comments on Proposed Rule 192, commenters asked the SEC to make clear that transactions with respect to underlying assets that conclude on or before the date such assets are included in a securitization (*i.e.*, pre-securitization hedging transactions, financing transactions, transfers and other pre-securitization transactions) are not "conflicted transactions."[55] As SIFMA noted, a transaction with respect to assets that is concluded before those assets are securitized would not give rise to a conflict of interest concern.[56]

Somewhat surprisingly, the SEC did not accept this argument. The Adopting Release states that "[w]e do not believe that it would be appropriate to allow a securitization participant to bet against the performance of an asset pool while, for example, after reaching an agreement to become a securitization participant, simultaneously marketing an ABS to investors that references or is collateralized by that same asset pool even if the relevant bet is closed out prior to the issuance of the ABS."[57] If a transaction is closed out before the ABS is issued, it is unclear how such a transaction could constitute a conflicted transaction (*i.e.*, (i) a short sale of the relevant ABS, (ii) a synthetic short sale of the relevant ABS, or (iii) a transaction that is substantially the economic equivalent of (i) or (ii)).

Questions to consider about the exceptions:

Are the changes to the hedging exception sufficient to permit synthetic securitizations done for hedging purposes?

Should securitization participants develop market standards around compliance with the ongoing calibration condition to the hedging exception?

Is the ongoing calibration condition, which is now qualified by a materiality standard, consistent with bank regulatory capital rules and related law governing synthetic securitizations?

Are there any types of transactions that conclude before the ABS is issued (pre-securitization activities) that may not qualify for one of the exceptions?

ARE BANK CRT DEALS PERMITTED? WHAT ABOUT OTHER TYPES OF SYNTHETIC SECURITIZATIONS?

We preface this section by highlighting several key takeaways from the Final Rule 192:

1. If there is no special purpose entity ("**SPE**"), then Final Rule 192 does not apply. Directly issued credit-linked notes and bilateral or back-to-back credit default swaps with no SPE are not prohibited by Final Rule 192.
2. If there is an SPE that issues ABS and also provides credit protection to a securitization participant, then that transaction would be a "conflicted transaction" that violates Final Rule 192 unless an exception applies.
3. The risk-mitigating hedging activities exception is available for most bank CRT transactions that use an SPE, but such transactions will need to be structured to comply with that exception.
4. The ongoing recalibration condition to the risk-mitigating hedging activities exception is likely to create issues in some bank CRT transactions.
5. As discussed above, because of the narrowing of the definition of "sponsor," long investors in securities issued by the SPE will not typically be securitization participants.

When Proposed Rule 192 was issued, market participants were greatly concerned about the possibility that CRT transactions might be prohibited by the rule. Specifically, some CRT transactions are structured as synthetic securitizations that utilize an SPE as the protection seller and provide that:

- A bank enters into either a swap or financial guarantee with the SPE to provide credit protection to the bank with regard to its receivables, loans or other financial exposures;
- The SPE issues credit-linked notes ("**CLNs**") to investors and deposits the proceeds of the CLNs into a trust account; and
- Payments on the CLNs will be reduced if cash collateral is used to make credit protection payments to the bank.

Central to the design and intent of such a transaction is that if the reference assets perform poorly, the bank may be entitled to credit protection payments under the swap or financial guarantee issued by the SPE, and, as a result, the investors in the CLNs may incur a loss. Citing that feature, the preamble to Proposed Rule 192 suggested that such CRTs might be *per se* conflicted transactions.[58] Moreover, even though CRT transactions are important tools used by banks to hedge their credit risks, the risk-mitigating hedging activities exception in Proposed Rule 192 were not flexible enough to allow CRTs to qualify for that exception.[59]

Comment letters from SIFMA, SFA, the International Association of Credit Portfolio Managers and the American Bar Association, among others, urged the SEC to make clear in the final rule that bank CRTs involving SPEs are not "conflicted transactions." Fortunately, the SEC responded favorably to these comments.

As noted above, under Final Rule 192, the initial issuance of a synthetic ABS will now be eligible for the risk-mitigating hedging activities exception. The Adopting Release makes clear that "[t]his change

is intended to allow for the initial issuance of a synthetic ABS that the relevant securitization participant enters into and maintains as a hedge."[60]

It is important to note, however, that a bank must meet the various conditions to the use of the risk-mitigating hedging activities exception. Most notably, banks will need to consider whether the condition that the hedge be subject to ongoing calibration (required to prevent the opportunity to materially benefit from the hedge beyond risk reduction) is consistent with the applicable bank regulatory capital rules and related law pertaining to risk mitigation through synthetic securitization. In addition, banks will need to establish, implement, maintain, and enforce the internal compliance program required as a condition to the risk-mitigating hedging exception.

It is also important to note that the issuance of new synthetic ABS where a securitization participant is a buyer of credit protection and that does not otherwise qualify for the risk-mitigating hedging exception may be prohibited by Final Rule 192. The Adopting Release states:

> the relevant material conflict of interest in the context of the issuance of a new synthetic ABS arises when the securitization participant engages in a transaction (such as CDS contract(s) with the synthetic ABS issuer) where cash paid by investors to acquire the newly created synthetic ABS will fund the relevant contract(s) and be available to make a payment to the securitization participant upon the occurrence of an adverse event with respect to the assets included in the reference pool. In economic substance, if the reference pool for the synthetic ABS performs adversely, then the securitization participant benefits at the expense of the investors in the synthetic ABS. Pursuant to the final rule, this arrangement will result in a conflicted transaction with respect to the investors in the synthetic ABS because it is substantially the economic equivalent of a bet against such ABS itself.[61]

Are Questions to consider about bank CRT deals:
See above questions to consider about the exceptions.

Are the changes to the hedging exception sufficient to permit synthetic securitizations done for hedging purposes, such as bank CRT deals?

Is the ongoing calibration condition, which is now qualified by a materiality standard, consistent with bank regulatory capital rules and related law pertaining to synthetic securitizations?

DOES FINAL RULE 192 APPLY TO FOREIGN TRANSACTIONS?

In the Adopting Release, the SEC stated that "Consistent with [the territorial approach the SEC has applied], which is based on Supreme Court precedent …, the Commission understands the relevant domestic conduct that triggers the application of Section 27(B)(a)'s prohibition to be the sale in the United States of ABS. If

there are ABS sales in the United States to investors, the prohibition of Section 27B(a)—as implemented through the provisions of Rule 192—applies."[62]

Per the request of commenters, Final Rule 192 contains a safe harbor for foreign transactions. To qualify for the safe harbor:

- The asset-backed security must not be issued by a U.S. person (as defined in 17 CFR 230.902(k)); and
- The offer and sale of the asset-backed security (as defined by this section) must be in compliance with 17 CFR 230.901 through 905 (Regulation S).

Questions to consider about foreign transactions:

Should securitization participants develop market standards to help determine whether transactions that do not qualify for the safe harbor but have only tangential US nexus are covered by Final Rule 192?

WHAT CAN SECURITIZATION PARTICIPANTS DO TO PREPARE FOR FINAL RULE 192?

Securitization participants would be well advised to begin taking affirmative steps to ensure that they are ready to comply with Final Rule 192. These steps could include:

- Reviewing Final Rule 192 with counsel.
- Identifying the universe of potential entities that could be securitization participants.
- Identifying the potential types of transactions across the securitization participant's landscape that could be conflicted transactions.
- Identifying the applicable exceptions to Final Rule 192 (e.g., hedging, market making, liquidity, etc.).
- Preparing compliance policies across the institution, including the enforcement of those policies.
- Establishing an internal process to review and approve transactions.
- Designing executive and employee training to reinforce legal requirements and company policies.
- Establishing procedures for tracking and assessing ongoing compliance with legal requirements and company policies.
- Seeking advice on risk management considerations, management/supervisory structures, internal controls, and practical considerations relating to the implementation of risk management strategies and supervisory/control functions.

Conclusion

In general, Final Rule 192 is a significant improvement over Proposed Rule 192, in both clarity and scope. On the other hand, some ambiguities and compliance challenges remain. Fortunately, the transition period provided in Final Rule 192 affords some time for the market to reach consensus on reasonable interpretations and for securitization participants to design and implement compliance programs.

Appendix A

~~Proposed~~ Final Rule

§ 230.192 Conflicts of interest relating to certain securitizations.

(a) ***Unlawful activity*.**

(1) *Prohibition*. A securitization participant shall not, for a period commencing on the date on which ~~a~~ such 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 that is substantially the economic equivalent of a transaction described in paragraph (a)(3)(i) or (a)(3)(ii) of this section, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk. ~~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, including those arising out of its securitization activities, ~~including~~ such as 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 materially 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 or with respect to which the prohibition in paragraph (a)(1) of this section otherwise applies, 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, if required, 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 a synthetic asset-backed security ~~securities~~ and a hybrid cash and synthetic asset-backed security ~~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~~.~~ if the affiliate or subsidiary:

(A) Acts in coordination with a person described in paragraph (i) of this definition; or

(B) Has access to or receives information about the relevant asset-backed security or the asset pool underlying or referenced by the relevant asset-backed security prior to the first closing of the sale of the relevant asset-backed security.

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 or referenced by the asset-backed security~~; or~~, other than a person who acts solely pursuant to such person's contractual rights as a holder of a long position in the asset-backed security.

~~(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)~~ (iii) Notwithstanding paragraph~~s~~ (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, or ongoing administration of an asset-backed security or the composition of the pool of assets underlying or referenced by the asset-backed security will not be a sponsor for purposes of this rule.

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

~~(A) The~~ 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.~~

(d) ***Anti-evasion***. If a securitization participant engages in a transaction or a series of related transactions that, although in technical compliance with paragraph (b) of this section, is part of a plan or scheme to evade the prohibition in paragraph (a)(1) of this section, that transaction or series of related transactions will be deemed to violate paragraph (a)(1) of this section.

(e) ***Safe harbor for certain foreign transactions***. The prohibition in paragraph (a)(1) of this section shall not apply to any asset-backed security for which all of the following conditions are met:

(1) The asset-backed security (as defined in this section) is not issued by a U.S. person (as defined in 17 CFR 230.902(k)); and

(2) The offer and sale of the asset-backed security (as defined by this section) is in compliance with 17 CFR 230.901 through 905 (Regulation S).

Endnotes

[1] *See* SEC Release No. 33-11254 ("Prohibition Against Conflicts of Interest in Certain Securitizations") ("**Adopting Release**"), available at: https://www.sec.gov/files/rules/final/2023/33-11254.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 of 2010 ("**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.
>
> (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).
>
> (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 of 1934.
>
> (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.

[3] Proposed Rule 192 was released by the SEC on January 25, 2023. *See* SEC Release No. 33-11151, available at: https://www.sec.gov/rules/proposed/2023/33-11151.pdf. Proposed Rule 192 was subsequently published in the Federal Register on February 14, 2023. *See* 88 Fed. Reg. 9678 ("**Proposing Release**"). Section 27B directed the SEC to adopt implementing rules "not later than 270 days after July 21, 2010." On September 19, 2011, the SEC proposed Securities Act Rule 127B. *See* SEC Release No. 34-65355, available at: https://www.sec.gov/rules/proposed/2011/34-65355.pdf. Proposed Rule 127B drew many comments from market participants. After several months of deliberation, and several extensions of the comment period, the SEC took no further action on proposed Rule 127B, effectively withdrawing it from consideration.

[4] *See* Adopting Release, at p. 6. For an overview of Proposed Rule 192 and the comments thereon, *see* Christopher B. Horn and Jon A. Schlotterback, *Conflicts of Interest in Asset-Backed Securitization: An Analysis of Proposed Rule 192*, The Review of Securities & Commodities Regulation (Oct. 25, 2023), available at: https://www.retainedinterest.com/wp-content/uploads/sites/31/2023/11/Conflicts-of-Interest-in-Asset-Backed-Securitization.pdf.

[5] *See* Adopting Release, at p. 6 (fn. 9).

[6] *See, e.g.,* Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 7 (Mar. 27, 2023) ("**First SIFMA Letter**"), at p. 2, available at: https://www.sec.gov/comments/s7-01-23/s70123-20161806-330705.pdf.

[7] *See* Adopting Release, at p. 6 (fn. 9).

[8] *See* Unsettling End of an Era: Statement on Adoption of Rule Prohibiting Conflicts of Interest in Certain Securitizations, Commissioner Hester M. Peirce (Nov. 27, 2023), available at: https://www.sec.gov/news/statement/peirce-statement-securitizations-112723.

[9] *See* Adopting Release, at p. 170.

[10] *See* Proposing Release, at 9692.

[11] *See* Adopting Release, at 83 (emphasis added).

[12] See "What Is the Prohibition Period?" above for a discussion of the prohibition period.

[13] *See* Adopting Release, at p. 97.

[14] *Id*., at 100-101 (emphasis added).

[15] For example, SIFMA suggested: "The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that substantially replicates one or both of the types of transactions set forth in clause (i) or (ii) above by means of the securitization participant's shorting or buying protection on the asset pool underlying or referenced by the relevant asset-backed security." Second SIFMA Letter, at p. 4. Similarly, SFA suggested: The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that substantially replicates one or both of the types of transactions set forth in clause (i) or (ii) above by means of referencing the relevant asset-backed security or the asset pool underlying or referenced by the relevant asset-backed security; provided, that, for the avoidance of doubt, none of the following shall constitute a conflicted transaction: [listing various clarifying exceptions]. Second SFA Letter, at pp. A-1–A-2.

[16] *See* First SIFMA Letter, at p. 57.

[17] *See* Adopting Release, at p. 169.

[18] Am. Bar Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 32 (Apr. 5, 2023) ("**ABA Letter**"). *See also* First SIFMA Letter, at 47 ("The *Basic v. Levinson* standard is a standard for what must be disclosed, not a standard for what should be prohibited. Section 27B directs the Commission to adopt rules as to what types of transactions should be prohibited.").

[19] Under the Volcker Rule, "a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being *materially adverse* to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section." 17 C.F.R. § 255.7(b) (2023) (emphasis added).

[20] *See* Adopting Release, at pp. 118-119.

[21] *See, e.g.,* First SIFMA Letter, at pp. 46-47 ("the phrase 'including a decision whether to retain the asset-backed security' is not part of any existing materiality standard under the securities laws, at least insofar as the Associations are aware. To consider what an investor might find important at the time of its investment decision necessarily requires a consideration of the facts and circumstances existing at that time. To consider what an investor might find important in deciding whether to retain a security necessarily requires a consideration of the facts and circumstances existing at all times while the investor holds the security. Market participants are familiar with the former standard. The latter standard is impossible to apply and utterly unknown to market participants.")

[22] Section 3(a)(79) of the Securities Exchange Act of 1934 defines asset-backed security, in relevant part, as "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on the cash flow from the

asset." This is the same definition that applies to ABS covered by Regulation RR and many other securitization regulations. It covers both publicly offered and privately offered ABS.

[23] For example, SIFMA suggested the following definition: "Synthetic asset-backed security means a fixed-income or other security (a) issued by a special purpose entity, and (b) secured by (i) one or more credit derivatives or similar instruments that reference self-liquidating financial assets (including bonds, loans, leases, mortgages, secured or unsecured receivables, or asset-backed securities) ('reference pool') and (ii) financial collateral held by the SPV where performance on the note is primarily linked to the performance of the reference pool and the repayment of principal is dependent on the financial collateral held by the SPV. The term 'synthetic asset-backed security' shall not include any insurance or reinsurance policy, corporate debt, or swap or security-based swap where the counterparty is not a special purpose entity that issues a security to investors, whether or not payments thereunder are contingent on the performance of referenced financial assets. For avoidance of doubt, the term 'self-liquidating financial asset' (as used in this definition) shall not include any insurance or reinsurance contracts (or insurance or reinsurance risks)." *See* Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 10–11 (June 27, 2023) ("**Second SIFMA Letter**"). SFA proposed a substantially similar definition. *See* Structured Fin. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interests in Certain Securitizations, A-8 (July 13, 2023) ("**Second SFA Letter**").

[24] *Id*., at 23 (emphasis added).

[25] *Id*., at 24.

[26] *Id*., at 26.

[27] *Id*., at 25.

[28] *Id*.

[29] *Id*., at 22, 23 and 24.

[30] *See* Adopting Release, at p. 75.

[31] 17 C.F.R. §242.105(b)(2).

[32] 17 C.F.R. §230.424(h) and 17 C.F.R. §239.45.

[33] *See* Adopting Release, at p. 77 (fn. 307) (emphasis added).

[34] *Id*., at pp. 75-76.

[35] The SEC's guidance under Rule 105, as discussed in the First SIFMA Letter, at 30–31, includes that (1) the accounts have separate and distinct investment and trading strategies and objectives, (2) personnel for each account do not coordinate trading among or between the accounts, (3) information barriers separate the accounts, (4) information about securities positions or investment decisions is not shared between accounts, and (5) each account maintains a separate profit and loss statement. The guidance notes that "[d]epending on the facts and circumstances, accounts not satisfying each of these conditions may nonetheless fall within the exception." *Short Selling in Connection with a Public Offering: Amendments to Rule 105 of Regulation M*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/divisionsmarketregtmcompliancereg mrule105-secg.htm#foot1 (last modified May 21, 2008).

[36] *Id*., at pp. 76-77 (emphasis added).

[37] *Id*., at p. 39.

[38] *See* Adopting Release, at pp. 39-40.

[39] Final Rule 192 makes one technical change, which is to include assets "referenced by" the ABS, in order to ensure that the scope of the direct sponsor prong is sufficient to capture synthetic ABS.

[40] *See* Adopting Release, at p. 49.

[41] *Id*., at 43.

[42] *See* Adopting Release, at pp. 49-50.

[43] *Id*., at 39.

[44] *Id*.

[45] *Id*., at pp. 58-59.

[46] *See* Proposing Release, at 9686.

[47] *See* First SIFMA Letter, at p. 18.

[48] *Id*., at p. 19. As SIFMA noted, the directing sponsor prong "starts with 'a broad range of securitization participants, including collateral managers and other parties with significant influence in the structure, composition, and management of an ABS' (collectively 'influencers'); subtracts the influencers that perform only administrative, legal, due diligence, custodial, or ministerial acts; subtracts the influencers who are underwriters, initial purchasers and placement agents; and characterizes any remaining influencers as 'sponsors'." *Id.*, at p. 17.

[49] *Id*., at pp. 60-61.

[50] *Id*., at 125. Market participants expressed concern that such a provision could be read as making certain synthetic securitizations ineligible for the exception even where the issuance of the ABS in those deals is for risk mitigating purposes, such as in a bank CRT transaction.

[51] *Id*., at 128. As SIFMA pointed out, "[c]urtailing such hedging activities – what are unrelated to the relevant asset-backed security and are entered into as part of a securitization participant's risk management practices and not as a bet against a relevant asset-backed security – could have adverse and unintended effects on everyday operations and risk management practices of financial institutions and their affiliates. We don't believe it was the intention of Congress or the Commission to prevent banks and other financial entities from managing their risks, whether or not those risks arise out of the securitization activities of those entities." *See* Second SIFMA Letter, at 17–18. *See also* Second SFA Letter, at 24 ("Risk mitigating hedging is an imperative business function, and the unavailability of the exception for assets other than ABS would unduly limit the ability of securitization market participants to properly manage their risks.").

[52] *Id*., at 136. SIFMA questioned whether a "perfect" hedge is necessary and argued that it is unnecessary for the regulatory purpose of Rule 192 "for a securitization participant to lose the benefit of the hedging exception just because it couldn't construct a perfectly, consistently calibrated hedge." *See* Second SIFMA Letter, at p. 19. SIFMA suggested that the recalibration requirement be replaced with a requirement that "the primary benefit of such risk-mitigating hedging activity is risk reduction." *Id*., at p. 6. Similarly, SFA suggested that recalibration be replaced with a requirement that the "primary benefit of such risk-mitigating hedging activity is risk reduction and not the facilitation or creation of an opportunity to realize some other benefit from such activity." *See* Second SFA Letter, at A-3. The SEC rejected the "primary benefit" formulation, arguing that "the term 'primary benefit' implies that a securitization participant could, as a 'secondary benefit' to the activity, materially profit from a net short position with respect to the relevant ABS. This standard would allow a securitization participant to enter into a bet against the relevant ABS in contradiction to the statutory prohibition." *See* Adopting Release, at p. 137.

[53] Second SFA Letter, at 28; Second SIFMA Letter, at 19.

[54] *See* Adopting Release, at p. 153.

[55] Second SFA Letter, at 28–29; Second SIFMA Letter, at 19–20.

[56] First SIFMA Letter, at 49.

[57] *See* Adopting Release, at p. 108. The SEC did, however, reiterate that "a securitization participant may rely on the risk-mitigating hedging activities exception for transactions entered into prior to the issuance of the relevant ABS when the conditions to the exception are satisfied." *Id*.

[58] *See* Mayer Brown Legal Update "Significant Concerns about Credit Risk Transfers (CRTs) under SEC Proposed Rule 192" (Feb. 27, 2023), available at: https://www.mayerbrown.com/en/perspectives-events/publications/2023/02/significant-concerns-about-credit-risk-transfers-crts-under-sec-proposed-rule-192.

[59] We note that CRT transactions that reference previously securitized assets, and securitizations of assets that have been previously referenced in a synthetic securitization, require careful analysis, including with respect to Regulation RR. Such transactions are beyond the scope of this white paper.

[60] *See* Adopting Release, at p. 125. Footnote 432 on that page briefly summarizes the many comments from market participants on this point.

[61] *See* Adopting Release, at p. 110.

[62] *Id*., at 27.