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A GUIDE TO THE SECURITIZATION CONFLICTS OF INTEREST RULE

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A GUIDE TO THE SECURITIZATION CONFLICTS OF INTEREST RULE

More than a decade after its initial proposal,[1] the US Securities and Exchange Commission (SEC) has at long last adopted a final rule[2] under the Securities Act of 1933, as amended (the Securities Act), prohibiting material conflicts of interest in asset-backed securities (ABS) transactions, as required by Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act).

The final rule, denominated as Rule 192 under the Securities Act, prohibits an underwriter, placement agent, initial purchaser, or sponsor of any ABS (including synthetic ABS), and certain affiliates and subsidiaries of such entities, from engaging in any transaction that would involve or result in a material conflict of interest as defined by the SEC. The new rule provides for a number of exceptions, including for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities.

The rule will become effective 60 days after publication in the *Federal Register*, but compliance will be required only for ABS transactions that close 18 months or more after that publication date.

THE COMPLICATED HISTORY OF THE RULE

In 2011, the SEC first approached its mandated rulemaking by proposing a brief rule that closely followed the language of Section 27B of the Securities Act, as added by Section 621 of the Dodd-Frank Act, and then provided extensive interpretative guidance. The scope of, and difficulty of compliance with, the original proposal generated many critical comments from industry participants. The SEC did not take any further action on the original proposal.

The SEC re-proposed the conflicts of interest rule in January 2023.[3] After such a long quiet period, the re-proposal came as a surprise to many industry participants. The SEC's expressed intent behind the renewed rulemaking was to fulfill a long-outstanding congressional mandate to address one of the perceived roots of the financial crisis.[4]

According to the Re-Proposing Release, "[t]he re-proposed rule target[ed] transactions that effectively represent a bet against a securitization and focuse[d] on the types of transactions that were the subject

[1] Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Rel. No. 34-65355, 76 Fed. Reg. 60,320 (Sept. 28, 2011) (the Original Proposing Release); see our LawFlash on the Original Proposing Release, SEC Proposes Rule Regarding Prohibition Against Conflicts of Interest in Certain Securitizations.

[2] Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Rel. No. 33-11254 (Nov. 27, 2023) (the Adopting Release).

[3] Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Rel. No. 33-11151, 88 Fed. Reg. 9678 (Feb. 14, 2023) (the Re-Proposing Release); see our Report on the Re-Proposing Release, Everything Old is New Again: SEC Re-Proposes Securitization Conflicts of Interest Rule.

[4] Press Release, SEC Proposes Rule to Prohibit Conflicts of Interest in Certain Securitizations (Jan. 25, 2023).

of regulatory and Congressional investigations and were among the most widely cited examples of ABS-related misconduct during the lead up to the financial crisis of 2007-2009."[5]

While the SEC at the time of the re-proposal acknowledged that "[s]ecuritization markets have undergone various changes since that time, including as a result of other rules that regulate securitization activity," and that it "[did] not have data on the extent of such conduct following the financial crisis of 2007-2009," it nonetheless "believe[d] that securitization transactions continue to present securitization participants with the opportunity to engage in the conduct that is prohibited by Section 27B."[6]

Industry reaction to the re-proposal also was highly critical, with a broad consensus that "the scope of the proposal was overly broad and could have unintended consequences on the securitization markets as a whole" and that "the rule as proposed was not appropriately balanced to the current state of the securitization markets in light of the evolution of those markets since the enactment of the Dodd-Frank Act."[7]

In response, the SEC stated that it "continue[s] to believe that the adopted rule is necessary to prevent the resurgence of the types of transactions that were prevalent leading up to [the financial crisis],"[8] but it made a number of important changes from the re-proposal. While areas of uncertainty remain, the SEC's efforts appear to have resulted in significant improvements from the re-proposal.

TRANSACTION TYPE

The definition of "asset-backed security" in the rule incorporates the broad definition in Section 2(a)(79) of the Securities Exchange Act of 1934, as amended (the Exchange Act), which was added by the Dodd-Frank Act: 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 cash flow from the asset." This definition will be quite familiar to market participants as it is used for many other purposes, including the credit risk retention rules and the due diligence reporting rules.

In addition, the rule scopes in synthetic ABS and hybrid cash and synthetic ABS. The re-proposed rule did not define "synthetic" for this purpose, an omission that was noted by several commenters.

While the SEC did not include a definition in the final rule because it did not believe that a definition "would appropriately capture the scope of the various features of existing synthetic ABS and possible future structures or designs of synthetic ABS,"[9] the SEC stated that it "generally view[s] a synthetic asset-backed security as a fixed income or other security issued by a special purpose entity that allows the

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[5] Re-Proposing Release, 88 Fed. Reg. at 9679.

[6] Re-Proposing Release, 88 Fed. Reg. at 9680.

[7] Adopting Release, at 7.

[8] *Id.*

[9] Adopting Release, at 23.

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."[10]

SECURITIZATION PARTICIPANTS

The rule applies to any "securitization participant," which includes any "underwriter," "placement agent," "initial purchaser," and "sponsor," as well as certain of their subsidiaries and affiliates.

Placement Agents, Underwriters, and Initial Purchasers

A "placement agent" or "underwriter" is defined as a person who has agreed with an issuer or selling security holder to:

- purchase securities from the issuer or selling security holder for distribution;
- engage in a distribution for or on behalf of such issuer or selling security holder; or
- manage or supervise a distribution for or on behalf of such issuer or selling security holder.[11]

"Distribution" means "an offering of securities made pursuant to an effective registration statement under the Securities Act" or any offering (whether registered or not) that is "distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods."[12]

An "initial purchaser" is "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 Rule 144A or that are otherwise not required to be registered because they do not involve any public offering."[13]

These definitions, which were not changed from the re-proposal, could have some surprising consequences. A purchaser of a significant amount of retained ABS from an issuer—or even a purchaser on the secondary market—could get swept into the rule when exiting its position, as could a broker-dealer facilitating such a trade or the resale of those ABS as an intermediary. These determinations will depend on the scope of each entity's activities in connection with its resale of ABS and whether those activities were the subject of an agreement with the issuer or selling security holder.[14]

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[10] Adopting Release, at 24.

[11] Adopting Release, at 34.

[12] Adopting Release, at 35.

[13] *Id.*

[14] "[T]he prohibition . . . only applies to such persons if they have entered into an agreement with an issuer (or, with respect to underwriters and placement agents, a selling security holder) because those persons would likely be privy to certain information about the ABS or underlying assets. Conversely, underwriters, placement agents, and initial purchasers with no such agreement with the issuer or selling security holder ('selling group members'), as applicable, . . . do not have a direct relationship with the issuer or selling security holder and, thus, are unlikely to have the same ability to influence the design of the relevant ABS. Therefore, selling group members who do not have such an agreement are not underwriters, placement agents, or initial purchasers." Adopting Release, at 36 (citations omitted).

Sponsors

The term "sponsor" tracks the well-understood definition of the term under Regulation AB and under the credit risk retention rules, that is, any person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.[15] More broadly, it also captures what the SEC calls, colloquially, "contractual rights sponsors." A contractual rights sponsor is any person with 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,[16] subject to certain exceptions.

According to the SEC, "any person with a contractual right to structure, design, or assemble an ABS or the underlying or referenced pool of assets—whether those rights are exercised or not—would have access to information about the ABS or its underlying or referenced assets prior to the sale of the ABS and would therefore have the opportunity to use that information to engage in a conflicted transaction with respect to such ABS or underlying or referenced assets." As a result, "a person who meets the definitional criteria . . . can be a '[contractual rights] sponsor' regardless of whether it is referred to as the sponsor or some other title (e.g., issuer, depositor, originator, collateral manager)."[17]

The SEC emphasized that a contractual rights sponsor includes "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 of assets on behalf of the CDO or a collateral manager for a collateralized loan obligation ('CLO') transaction with the contractual right to direct or cause the direction of asset purchases or sales on behalf of the CLO."[18] We can infer that the contractual rights sponsor construct appears to be at least partially in response to the *LSTA* case, which excluded collateral managers of open-market CLOs from being covered as "sponsors" under the risk retention rules.[19]

As originally re-proposed, the definition of "sponsor" also would have included a "directing sponsor," which was defined as any person who actually directs, or causes the direction of, the structure, design, or assembly of an ABS or the composition of the asset pool.[20] Among the objections raised by commenters on this provision was that it would capture long investors, which routinely express their views on these matters to deal participants. According to the SEC, "these negotiations are important and beneficial market functions," and as such it declined to include the "directing sponsor" concept in the final rule "to help ensure that Rule 192 is not an impediment to an investor's negotiating power."[21]

The SEC adopted an exclusion from the definition of "contractual sponsor" for any person that acts solely pursuant to its contractual rights as a holder of a long position in the ABS. Whether a long investor is

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[15] Adopting Release, at 39-40.

[16] Re-Proposing Release, 88 Fed. Reg. at 9585-86.

[17] Adopting Release, at 58.

[18] Adopting Release, at 39.

[19] *See Loan Syndications & Trading Ass'n v. SEC & Bd. of Governors of the Fed. Rsrv. Sys.*, 882 F.3d 220 (D.C. Cir. 2018) (*LSTA*). The SEC rejected arguments that the holding in the definition of "sponsor" in the conflicts of interest rule should be limited by the holding in *LSTA.* Adopting Release, at 46-47.

[20] Re-Proposing Release, 88 Fed. Reg. at 9684.

[21] Adopting Release, at 49.

acting "solely" pursuant to its contractual rights as a holder of a long position in the relevant ABS will depend on the relevant facts and circumstances. In particular, the SEC noted that whether holders of "B-piece" bonds (B-piece buyers) in commercial mortgage-backed securities (CMBS) transactions are not considered "sponsors" under the general definition, or would be excluded under the exception for long-only investors, will depend on the facts and circumstances of the transaction.[22]

There is an exclusion from the definition of "sponsor" for a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, assembly, or ongoing administration of the ABS or the composition of the pool of assets underlying or referenced by the ABS. This is intended to carve out accountants, attorneys, credit rating agencies, trustees, custodians, paying agents, calculation agents, third-party servicers, and other contractual service providers.[23]

"Ongoing administration" refers to the types of activities typically performed by such service providers, not any type of active portfolio management.[24] While these types of activities may contribute to the direction of the structure, design, or assembly of an ABS or an asset pool, they will fall under the service provider exclusion so long as they are performed only in connection with administrative, legal, due diligence, custodial, or ministerial activities.[25]

While not specified in the rule itself, the SEC noted that "[a] warehouse lender whose role is to engage in such routine lending activity with respect to the ABS, including the lender's right to determine which assets it is or is not willing to finance pursuant to its underwriting standards, does not meet the definition of 'sponsor' under the final rule."[26] Nor does a third party that sells assets to a securitizer and "do[es] not have ongoing roles or contractual rights or duties with respect to the assets or the ultimate ABS."[27]

The final rule includes the proposed exclusion from the definition of "sponsor" for the United States or an agency of the United States with respect to its ABS that are fully insured or fully guaranteed as to the timely payment of principal and interest, but the SEC did not extend that exclusion to the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac and, together with Fannie Mae, the Enterprises) while they are under conservatorship, as had been proposed.[28] The SEC concluded that, while "investors in their guaranteed ABS are not exposed to the

[22] Adopting Release, at 54.

[23] Adopting Release, at 59-60.

[24] Adopting Release, at 61.

[25] Adopting Release, at 62.

[26] Adopting Release, at 56-57.

[27] Adopting Release, at 63-64. So-called "reconstitution" provisions in an asset sale agreement often delineate some of the conditions under which a purchaser may subsequently securitize those assets. These provisions will need to be considered carefully.

[28] Adopting Release, at 64, 68.

same types of risk that existed in certain ABS transactions leading up the financial crisis of 2007-2009, that would not be the case once the Enterprises exit conservatorship."[29]

Commenters on the re-proposal suggested a number of other exceptions to the definition of "sponsor" that were rejected by the SEC, including exceptions for market participants acting pursuant to a fiduciary duty to a client or customer[30] and for municipal advisors.[31]

Affiliates and Subsidiaries

The final rule includes affiliates and subsidiaries of underwriters, placement agents, initial purchasers, and sponsors as securitization participants, but only if they act in coordination with those parties or have access to or receive information regarding the ABS or the underlying asset pool before the first closing of the sale of those ABS.[32]

As re-proposed, the rule would not have contained the coordination/access condition for affiliates, though the SEC did ask whether including all affiliates and subsidiaries would be unduly burdensome and whether the permitted use of information barriers could mitigate those concerns.

At the time, the SEC was "concerned about the potential to use an affiliate or subsidiary to evade the re-proposed rule's prohibition," but it "[sought] comment . . . on whether an exception utilizing information barriers to exclude affiliates and subsidiaries could be implemented in a way that would be consistent with Section 27B of the Securities Act,"[33] including the possibility of a number of strictly prescribed conditions. Many commenters noted that, without information barriers or other limits on the application of the rule to affiliates and subsidiaries of other securitization participants, it would be extremely difficult to implement effective compliance programs to monitor and prevent conflicted transactions from occurring.[34]

While the SEC ultimately decided not to include a specific information barrier exception, it noted that effective information barriers were among the facts and circumstances that could indicate that a subsidiary or affiliate has not coordinated or had access to information with a securitization participant. Other such facts and circumstances could include

- separate trading accounts;
- no common officers or nonclerical, ministerial, or support employees;
- engagement in an unrelated business without communication; or
- any common oversight personnel do not have trading authority.

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[29] Adopting Release, at 68 (citations omitted). The SEC dealt with the issue raised by many commenters regarding the Enterprises' credit risk transfer (CRT) transactions in the context of the exception for risk-mitigating hedging activities, as described below.

[30] Adopting Release, at 52.

[31] Adopting Release, at 55-56.

[32] Adopting Release, at 69.

[33] Re-Proposing Release, 88 Fed. Reg. at 9690.

[34] Adopting Release, at 70.

These mechanisms must effectively prevent the affiliate or subsidiary from acting in coordination with the securitization participant or from accessing or receiving information about the relevant ABS or its asset pool. Each securitization participant has the flexibility to create its own barriers or other mechanisms to prevent coordination or sharing of information, but if they are ineffective it will call into question whether an affiliate or subsidiary actually coordinates or shares information.[35]

The coordination/access condition only helps to shield other entities that are affiliates and subsidiaries of a securitization participant. It does not apply to business groups or units within an underwriter, placement agent, initial purchaser, or sponsor—all personnel at these entities must comply with the rule.

TIMEFRAME OF PROHIBITION

The prohibition on conflicted transactions will begin on the date on which a person has reached an agreement that they will become a securitization participant and will end one year after the date of the first closing of the sale of the ABS.[36] While the end point is set forth in the statute, the commencement point is not.[37]

The rule does not contain a definition of "agreement," but the commentary states that it means "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."[38]

As re-proposed, the prohibition also would have commenced when a securitization participant had taken "substantial steps" to reach such an agreement. This prong was heavily criticized for its lack of clarity, and for that reason was not included in the final rule.[39]

The SEC notes that even if an agreement to become a securitization has been reached, if the transaction does not close and the ABS are not sold there can be no conflict of interest and the rule will not apply. If the ABS are created and sold, the rule will apply retroactively to the date on which an agreement was reached.[40]

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[35] Adopting Release, at 76-78.

[36] Adopting Release, at 81-82.

[37] And, in fact, the original proposed rule did not have a commencement point—it would have applied at any time up until the end date.

[38] Adopting Release, at 83.

[39] Adopting Release, at 80-81.

[40] Adopting Release, at 84.

CONFLICTED TRANSACTIONS

The rule prohibits any material conflict of interest between a securitization participant and an investor in an ABS during the applicable prohibition period. Engaging in a transaction will involve a material conflict of interest if it is a conflicted transaction.[41]

The first part of the definition of a "conflicted transaction" has three prongs:

- a short sale of the relevant ABS;
- the purchase of a credit default swap (CDS) or other derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of a specified adverse event with respect to the ABS; and
- the purchase or sale of any financial instrument (other than the ABS) or entry into a transaction that is "substantially the economic equivalent" of a prohibited short sale or CDS, other than (for the avoidance of doubt) a transaction that only hedges general interest rate or currency exchange risk.[42]

This prohibition is "designed to capture transactions that are bets against the relevant ABS or the asset pool supporting or referenced by such ABS."[43]

The first two prongs are fairly clear and straightforward and were adopted as re-proposed with relatively little industry comment.[44]

The third prong differs substantially from the re-proposal, where it would have scoped in any transaction through which a securitization participant would benefit from the actual, anticipated, or potential occurrence of

- adverse performance of the asset pool;
- loss of principal, monetary default, or an early amortization event with respect to the ABS; or
- decline in the market value of the ABS.[45]

This prior formulation, which also formed the core of the prohibition in the original 2011 rule proposal, was intended to capture "events [that] would be adverse to investors in the ABS as [they] would negatively impact the distributions on the relevant ABS and/or its market value"[46]—in other words, any

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[41] Adopting Release, at 88-90.

[42] Adopting Release, at 90-91.

[43] Adopting Release, at 88.

[44] Adopting Release, at 87.

[45] Re-Proposing Release, 88 Fed. Reg. at 9694.

[46] Re-Proposing Release, 88 Fed. Reg. at 9695.

indirect "bet" against the ABS. According to the SEC, it was designed to "help alleviate the risk of any attempted evasion of the rule that is premised on the form of the transaction rather than its substance."[47]

As re-proposed, the third prong drew heavy criticism from commenters, who pointed out that it was so broad that it could encompass almost any transaction that ended up having any kind of negative correlation with the performance of the ABS, including "a wide range of activities that are essential to the functioning and issuance of ABS and the routine risk management of securitization participants."[48] The revised formulation that was adopted appears to be much more narrowly tailored, though the phrase "substantially the economic equivalent" is undefined.

According to the SEC, this standard was adopted in lieu of commenter-suggested alternatives such as "substantially replicates" or "functional trading equivalent" to avoid the ability of a securitization participant to "design bets against the relevant ABS or the asset pool supporting or referenced by the relevant ABS that are documented to have payment profiles or terms that are sufficiently different from those of market-standard short sales or CDS in order to not trigger such suggested standards but that are nevertheless bets against the relevant ABS in economic substance."[49]

As noted above, the third prong explicitly excludes a transaction that only hedges general interest rate or currency exchange risk, but the commentary states that it is not intended to capture any other type of transaction "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," as "[s]uch transactions do not give rise to the investor protection concerns that Section 27B is designed to address."[50]

Where the asset pool consists of a large number of different and distinct obligations, a "short transaction with respect to a single asset or some non-sizeable portion of the assets in that pool" generally would be permitted, but if those assets "represent a sizeable portion of the asset pool" then, depending on the fact and circumstances, it may not.[51] Similarly, transactions in an index where "the relevant ABS or the asset pool does not represent a sizeable portion of the index" generally would be permitted, but "if the relevant ABS or the asset pool does represent a sizeable portion of the index" then, depending on the facts and circumstances, it may not.[52]

Other types of transactions that the SEC indicated generally would not violate the prohibition of the rule include:

- ordinary-course pre-securitization and issuance activities such as warehouse financing activities and the transfer of the pool assets to the issuing entity;[53]

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[47] *Id.*

[48] Adopting Release, at 87.

[49] Adopting Release, at 100.

[50] Adopting Release, at 101.

[51] Adopting Release, at 103.

[52] Adopting Release, at 104.

[53] Adopting Release, at 106.

- third-party servicing activities;[54] and
- activities in connection with financing the ABS on behalf of investors.[55]

The prohibition "captures the relevant conflict of interest in the context of the issuance of a new synthetic ABS."[56] A number of commenters requested that CRT and other synthetic transactions used to mitigate balance sheet risk be excluded from the prohibition.[57] The SEC did not adopt an exception specific to these transactions, but, as described below, did make changes to the exception for risk-mitigating hedging activities in an effort to accommodate them.

The SEC did not adopt some commenters' suggestions to exempt transactions that terminate before the issuance of the ABS,[58] or to provide for a specific mechanism to approve other exceptions, reasoning that if it "determines that additional exceptions are needed in the future, it can utilize available authorities under its governing statutes, including Section 28 of the Securities Act, to provide such exceptions."[59]

The second part of the proposed definition of a "conflicted transaction" is the materiality standard, which, consistent with the re-proposal, requires that there be a substantial likelihood that a reasonable investor would consider the relevant transaction important to the investor's investment decision whether to acquire the ABS.

Because this test is based on the materiality definition in the seminal disclosure case *Basic v. Levinson*,[60] commenters argued that it is not appropriate in a context other than disclosure. The SEC disagreed, indicating that "the prohibition will apply to transactions that are bets against the relevant ABS whether or not such transactions are disclosed to investors,"[61] and that the prohibition will apply even if "the investor selects or approves the assets underlying the ABS."[62]

EXCEPTIONS

Exception for Risk-Mitigating Hedging Activities

Consistent with Section 27B(c)(1) of the Securities Act, the rule does not apply when a securitization participant engages in certain risk-mitigating hedging activities. Hedging is permitted when conducted in

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[54] Which may also be included in the exception for administrative, legal, due diligence, custodial, or ministerial activities. Adopting Release, at 112-13.

[55] Adopting Release, at 113-14.

[56] Adopting Release, at 110.

[57] Adopting Release, at 109-11.

[58] Adopting Release, at 108.

[59] Adopting Release, at 117-18.

[60] Adopting Release, at 118 (*citing Basic v. Levinson*, 485 U.S. 224, 231-32 (1988)).

[61] Adopting Release, at 119.

[62] Adopting Release, at 121.

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, subject to several conditions. Hedging is permitted on an aggregated basis.[63]

As re-proposed, an initial distribution of an ABS would not have been eligible for this exception. Because the SEC rescinded this exclusion, the final rule "allow[s] for the initial issuance of a synthetic ABS that the relevant securitization participant enters into and maintains as a hedge."[64] The use of synthetic ABS structures for hedging purposes by the Enterprises and others will be permitted so long as they "mitigate a specific and identifiable risk exposure of the securitization participant."[65]

As described by the SEC:

> 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 would 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. If such activity is not entered into for purposes of hedging an exposure of the securitization participant to the assets included in the reference pool, then such activity will not qualify for the risk-mitigating hedging exception.[66]

The re-proposal also would have limited the exception to hedging activities arising out of the securitization participant's securitization activities. Commenters argued that the ability of securitization participants to appropriately hedge their risks should not be limited to those arising out of their securitization activities, which persuaded the Commission to take this position in the adopted rule.[67]

The conditions to the hedging exception, which were adopted substantially as re-proposed, are as follows:

- At inception of the hedging activity and at the time of any adjustments to the hedging activity, the activity must be 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 arising out of its securitization activities, based upon the facts and circumstances of the identified underlying and hedging positions, contracts, or other holdings and the risks and liquidity thereof.
- The risk-mitigating hedging activity must be subject, as appropriate, to ongoing recalibration to ensure that the activity satisfies the foregoing requirement and does not facilitate or create an opportunity to materially benefit from a conflicted transaction other than through risk reduction.

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[63] Adopting Release, at 124.

[64] Adopting Release, at 125.

[65] Adopting Release, at 126.

[66] Adopting Release, at 125.

[67] Adopting Release, at 127-28.

- The securitization participant must establish, implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure its compliance with the requirements of the 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.

The design and recalibration conditions do not permit a securitization participant to enter into a transaction that "result[s] in an overhedged position that constitutes a bet against the relevant ABS or the asset pool."[68] Risks may be hedged on an aggregated basis to address more than one exposure, but "such risks need to be specific and identifiable at the inception of the hedging activity, as well as at the time of any adjustments to the hedging activity, and must arise in connection with and be related to identified positions, contracts, or other holdings of the securitization participant" because, otherwise, "it would be impractical or impossible to determine whether the securitization participant has overhedged."[69]

A number of commenters noted that the costs of implementing the compliance programs required to make use of this exception would accrue more heavily to institutions that are not presently subject to requirements (such as the Volcker Rule) that already require them to have such programs.

The SEC acknowledged that the costs of a compliance program may have a proportionally greater effect on small entities but that the condition is necessary to ensure that the activities of a securitization participant are not the type of transactions that would involve or result in a material conflict of interest. The SEC also believes that "smaller and less complex" securitization and other activities of smaller entities will enable them to design less complex compliance programs, and that the other changes made to reduce the footprint of the final rule also should ease the compliance burden.[70]

Exception for Liquidity Commitments

The rule will not apply when a securitization participant engages in purchases or sales of ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the relevant ABS. The commitment is not required to take the form of a contractual obligation.[71]

Exception for Bona Fide Market-Making Activities

There is an exception for certain bona fide market-making activities conducted by a securitization participant that is licensed or registered to engage in such activities in accordance with applicable law and self-regulatory organization (SRO) rules. This exception would apply to bona fide market-making activity, including market-making related hedging, conducted in connection with and related to an ABS, the underlying pool assets, financial instruments that reference such ABS or underlying assets, or any other financial instruments to which the prohibition of the rule would otherwise apply.[72]

There are five conditions to this exception:

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[68] Adopting Release, at 139.

[69] Adopting Release, at 133.

[70] Adopting Release, at 141-42.

[71] Adopting Release, at 145-46.

[72] Adopting Release, at 150.

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- The securitization participant must routinely stand ready to purchase and sell one or more types of the relevant financial instruments as a part of its market-making related activities and be 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.[73]
- The securitization participant's market-making related activities must be 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 relevant financial instruments.[74]
- The compensation arrangements of involved persons must be designed not to reward or incentivize conflicted transactions.[75]
- The securitization participant must be licensed or registered, if required, to engage in the applicable activity under applicable law and SRO rules.[76]
- The securitization participant must establish, implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure its compliance with the market-making 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.[77]

The "routinely stands ready" condition takes into account the actual liquidity and depth of the applicable markets. It would not apply to a securitization participant only providing quotations that are wide of (in comparison to the bid-ask spread) one or both sides of the market relative to prevailing market conditions. The securitization participant would need to have an established pattern of providing price quotations on either side of the market and a pattern of trading with customers on each side of the market and be willing to facilitate customer needs in both upward- and downward-moving markets and in amounts requested by market participants.[78]

The stated purpose of the "reasonably expected near term demand" condition is to distinguish activity that is characteristic of bona fide market-making activities from a securitization participant entering into a conflicted transaction to bet against the relevant ABS for the benefit of its own account, while still allowing securitization participants to make a market in the relevant instruments.[79]

[73] Adopting Release, at 157.

[74] Adopting Release, at 159.

[75] Adopting Release, at 160.

[76] Adopting Release, at 161.

[77] Adopting Release, at 162.

[78] Adopting Release, at 158-59.

[79] Adopting Release, at 159.

The compensation condition is designed not to reward or incentivize conflicted transactions,[80] and the registration condition is designed to limit reliance on the exception to only those persons with the authority to engage in market-making activity under applicable laws and SRO rules.[81]

The compliance program condition is designed to ensure that the activities of a securitization participant are indeed bona fide market-making activities.[82] The SEC believes that a securitization participant's "individual internal compliance program [should] reflect the size, complexity, and activities of the securitization participant."[83]

The SEC also believes "[i]t is important that the reasonably designed written policies and procedures demonstrate a process for prompt mitigation of the risks of a securitization participant's positions and holdings that arise from market-making in ABS and the related financial instruments . . ., such as the risks of aged positions and holdings, because doing so would help to prevent a securitization participant from engaging in a transaction and maintaining a position that is adverse to the relevant ABS that remains open and exposed to potential gains for a prolonged period of time."[84] However, the SEC did not attempt to define what is meant by "prompt" mitigation.

ANTI-EVASION

The final rule contains an anti-evasion provision, which prohibits any transaction or a series of related transactions that, while in technical compliance with one of the exceptions described above, is part of a "plan or scheme to evade" the prohibition of the rule.[85]

The anti-evasion provision replaced a provision in the re-proposal that would have prohibited a securitization participant from engaging in any transaction that "circumvented" the rule, but did not define "circumvent." The SEC was "persuaded that an anti-circumvention provision could have the potential to be both overinclusive and vague . . . 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 scheme to evade the rule's prohibition would be more appropriate."[86]

In contrast to the re-proposal, the adopted anti-evasion provision clearly includes an element of intent and "only applies to a securitization participant's claimed compliance with one of the exceptions to the rule."[87]

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[80] Adopting Release, at 160.

[81] Adopting Release, at 161.

[82] Adopting Release, at 162.

[83] Adopting Release, at 164.

[84] Adopting Release, at 166.

[85] Adopting Release, at 168-69.

[86] Adopting Release, at 169.

[87] *Id.*

FOREIGN SAFE HARBOR

The final rule includes a safe harbor for foreign transactions, under which the prohibition will not apply to any ABS that is not issued by a U.S. person (as defined in Rule 902 of Regulation S) and the offer and sale of the ABS complies with Regulation S.[88]

[88] Adopting Release, at 30.

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