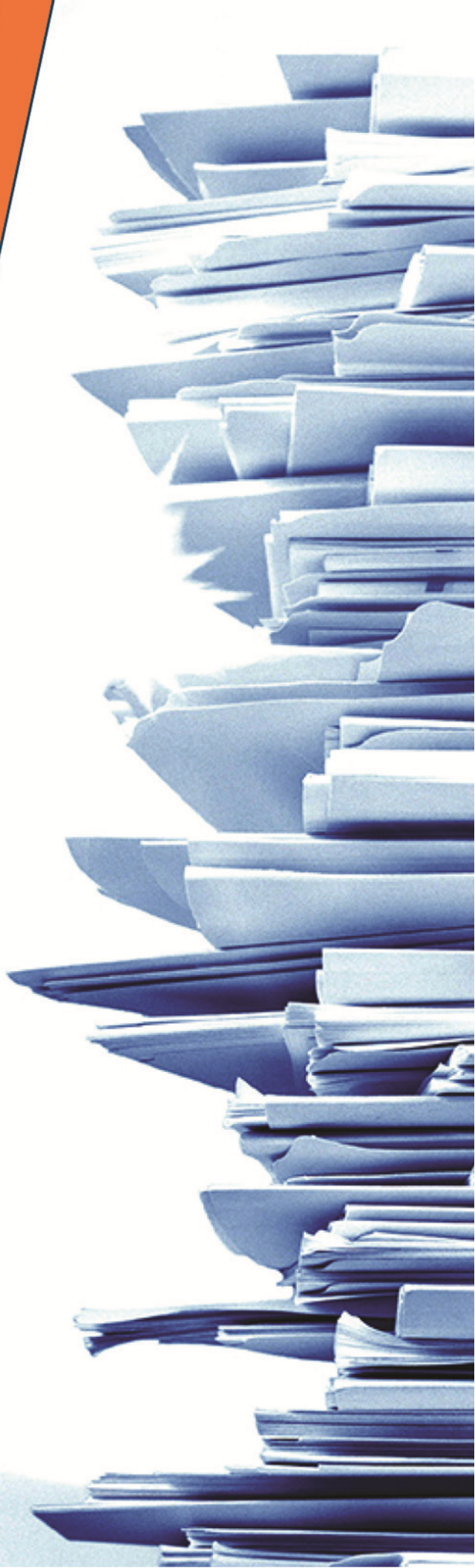
SEC Releases Final Rule 192 Relating to Conflicts of Interest in Securitization

Authored by Matthew J. Armstrong, Matthew H. Fischer, Sarah E. Milam, Jay Southgate, Devin M. Swaney, Bill Lee, Greg Renick and John Ludwig-Eagan

December 2023



Dechert LLP

SEC Releases Final Rule 192 Relating to Conflicts of Interest in Securitization

The SEC released the final Securities Act Rule 192 relating to conflicts of interest in asset-backed securities transactions on November 27, 2023. In this *OnPoint*, we summarize the provisions of the final Rule 192 and important commentary provided by the SEC in the adopting release, and we highlight key changes from the initial proposal.

Key Takeaways

- **Definition of "Sponsor"**: The final rule refines the definition of "sponsor," notably by eliminating the "directing sponsor" category and introducing an exception for certain long investors.
- **"Conflicted Transaction" Definition**: The final rule amends the potentially problematic clause (iii) of the "conflicted transaction" definition to include only transactions that are "substantially the economic equivalent" of an otherwise prohibited transaction.
- **Affiliates and Subsidiaries**: The final rule limits the affiliates and subsidiaries of securitization participants that are subject to the rule, including only those that either act in coordination with a named securitization participant or have access to information about the transaction prior to its closing.
- **Effective Date**: The rule takes effect 60 days after its publication in the Federal Register. Compliance will be required for securitization participants for any asset-backed security with respect to which the closing of the first sale occurs 18 months after the rule's publication in the Federal Register.

* * *

In 2010, Congress directed the U.S. Securities and Exchange Commission (the "SEC") to issue rules prohibiting certain conflicts of interest among participants in asset-backed securities ("ABS")[1] transactions.[2] After its initial proposal in 2011,[3] and after over a decade of regulatory inaction on the matter, in January 2023, the SEC revived its original rulemaking process and released the proposed Rule 192 (the "Proposal") for comment.[4] The Proposal

---

1 For purposes of readability, this *OnPoint* will use the term "ABS" in lieu of the term "asset-backed security," as defined in the Rule, even where quoting the Rule or other sources. See below for the definition of "ABS."

2 *See* Section 27B of the Securities Act of 1933, 15 U.S.C. § 77z-2a ("Section 27B"), added by Dodd-Frank Wall Street Reform and Consumer Protection Act § 621, Pub. L. No. 111-203 (July 21, 2010) ("Dodd-Frank").

3 *Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Release No. 34-65355 (Sept. 19, 2011) (proposing Securities Act Rule 127B); 76 Fed. Reg. 60320 (Sept. 28, 2011).

4 *Prohibition Against Conflicts of Interest in Certain Securitizations*, SEC Release No. 33-11151 (Jan. 25, 2023) (proposing Securities Act Rule 192); 88 Fed. Reg. 9678 (Feb. 14, 2023). For additional information regarding the Proposal, we refer you to *The Return of Dodd-Frank Rulemaking: SEC Proposes Expansive Prohibition on Conflicts of Interest in Securitization*, the *OnPoint* published on the subject in February 2023.

engendered a great deal of attention from the securitization industry, and the SEC received hundreds of comments.[5] Then, on November 27, 2023, the SEC issued the final Rule 192 (the "Rule" or "Rule 192") after a 4-1 vote.[6]

In this *OnPoint*, we summarize the provisions of the final Rule 192 and important commentary provided by the SEC in the adopting release, and we highlight key changes from the initial proposal.

* * *

1. Who is subject to the Rule?

The Rule applies to "securitization participant[s]."[7] A "securitization participant" is an underwriter, placement agent, initial purchaser or sponsor of an ABS.[8] The term "securitization participant" also includes any "affiliate" or "subsidiary" of an underwriter, placement agent, initial purchaser or sponsor of an ABS, if the affiliate or subsidiary (i) acts in coordination with an underwriter, placement agent, initial purchaser or sponsor of an ABS or (ii) has access to or receives information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS prior to the first closing of the sale of the relevant ABS.[9]

The Rule both narrows and clarifies the universe of regulated parties by making important changes to the definition of "sponsor" that was set forth in the Proposal, and by limiting the application of the Rule to only certain affiliates and subsidiaries.

A. Placement agents, underwriters and initial purchasers.

"Placement agent[s]," "underwriter[s]" and "initial purchaser[s]" are "securitization participant[s]." A "placement agent" or an "underwriter" is a "person who has agreed with an issuer or selling security holder to: (i) [p]urchase securities from the issuer or selling security holder for distribution; (ii) [e]ngage in a distribution for or on behalf of such issuer or selling security holder; or (iii) [m]anage or supervise a distribution for or on behalf of such issuer or selling security holder."[10] For purposes of this definition, "distribution" means: (i) an offering of securities, whether or not subject to registration under the Securities Act of 1933 (the "Securities Act"), that is distinguished from ordinary trading

---

5 For information regarding the comments submitted to the SEC regarding the Proposal, we refer you to *The Return of Dodd-Frank Rulemaking: SEC Proposes Expansive Prohibition on Conflicts of Interest in Securitization*, by Matthew Armstrong, Matthew H. Fischer, K. Susan Grafton, Richard D. Jones, Ralph R. Mazzeo, Sarah E. Milam, John M. Timperio, Jay Southgate, Laura Swihart and John Ludwig-Eagan, published in *The Investment Lawyer*, vol. 30, no. 6 (June 2023).

6 *Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Release No. 33-11254 (Nov. 27, 2023) (adopting the Rule) (the "Adopting Release"). A blackline of the text of the Rule, marked against the text of the proposed rule from the Proposal, is attached as an exhibit to this *OnPoint*.

7 Rule 192(a).

8 Rule 192(c) (definition of "securitization participant").

9 Rule 192(c) (definition of "securitization participant").

10 Rule 192(c) (definitions of "placement agent" and "underwriter").

transactions by the presence of special selling efforts and selling methods;[11] or (ii) an offering of securities made pursuant to an effective registration statement under the Securities Act.[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]

The Proposal's definitions of "underwriter," "initial purchaser" and "placement agent" were generally much less controversial than the definition of "sponsor," and were incorporated without revision in the Rule. Nonetheless, the SEC made several noteworthy clarifications in the Adopting Release.

As a general matter, the SEC emphasized in the Adopting Release, as it did in the Proposal,[14] that the definitions are intended to be "focused on the functional role that a person would assume in connection with a distribution of securities," rather than a formalistic or technical definition that might be found in certain other securities laws.[15] The SEC declined some commenters' invitation to except underwriters, placement agents and initial purchasers with no direct involvement with matters relating to the structuring of the ABS or the selection of the related asset pool, such as underwriting syndicate co-managers.[16] The SEC opined that such an exclusion would be inappropriate in light of the fact that even co-managers have an "agreement" with an issuer (or selling security holder) and would therefore be privy to certain information about the ABS or underlying assets, "giving them the *opportunity* to influence the structure of the relevant ABS and engage in a bet against it."[17] In contrast, the SEC noted that selling group members that have no such agreement or direct relationship with an issuer or selling security holder would not have the same ability to influence the design of the ABS, and therefore that selling group members who do not have such an agreement would not be considered underwriters, placement agents or initial purchasers.[18]

B. Sponsors.

"Sponsor[s]" are "securitization participant[s]." A "sponsor" means (i) any person who "organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the entity that issues the ABS" (a "Regulation AB Sponsor"); or (ii) 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 pool of assets underlying or referenced by the ABS, other than a person who acts solely pursuant to such person's contractual rights as a holder

---

[11] The SEC explained that "activities generally indicative of special selling efforts and methods include, but are not limited to, greater than normal sales compensation arrangements, delivering a sales document (*e.g.*, a prospectus or offering memorandum), and conducting road shows. A primary offering of ABS pursuant to an effective Securities Act registration statement would also be captured because such an offering is a primary issuance by an issuer immediately following the creation of the ABS, which is clearly distinguishable from an ordinary secondary trading transaction." Adopting Release, at 35 n.137.

[12] Rule 192(c) (definition of "distribution").

[13] Rule 192(c) (definition of "initial purchaser").

[14] Proposal, at 9683.

[15] Adopting Release, at 35.

[16] Adopting Release, at 36.

[17] Adopting Release, at 36-37 (emphasis added).

[18] Adopting Release, at 36.

of a long position in the ABS" (a "Contractual Rights Sponsor").[19] Notwithstanding clause (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 ABS or the composition of the pool of assets underlying or referenced by the ABS will not be a sponsor" for purposes of the Rule.[20] And notwithstanding clauses (i) and (ii) of this definition, "the United States or an agency of the United States" is not a sponsor for purposes of the Rule "with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by the United States."[21]

i. Directing sponsors not included.

The Proposal included a category of sponsors called "Directing Sponsors," which the Proposal defined as a person "[t]hat directs or causes the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS,"[22] notwithstanding the fact that such a person might not have any contractual right to so direct. However, the Rule eliminated this category.[23] The SEC explained that it removed the Directing Sponsor category in furtherance of its stated intent that "an ABS investor (that does not otherwise meet any of the other definitions of parties covered by the [Rule]) would not be a sponsor under the [Rule] merely because such investor expresses its preferences regarding the assets that would collateralize its ABS investment."[24]

ii. Contractual rights sponsors; exclusion for long investors.

With respect to the definition of "sponsor," the Rule maintains the Proposal's application to Regulation AB Sponsors and Contractual Rights Sponsors, but includes a new and important caveat to the definition of Contractual Rights Sponsor—a person is not a Contractual Rights Sponsor if the person "acts solely pursuant to such person's contractual rights as a holder of a long position in the ABS"[25] (the "long investor exception"). In the Proposal, the SEC took the position that an investor should not be considered to be a "sponsor" "merely because such investor expresses its preferences regarding the assets that would collateralize its ABS investment."[26] However, as many commenters noted, that intent was not clearly codified into the text of the proposed rule itself, which threatened regulatory uncertainty for long investors like b-piece buyers in commercial mortgage-backed securities ("CMBS") transactions who are customarily involved in asset pool selection.[27] In the Adopting Release, the SEC acknowledged

---

19 Rule 192(c) (definition of "sponsor").

20 Rule 192(c) (definition of "sponsor"). In this *OnPoint*, we will refer to this provision as the "ministerial exception."

21 Rule 192(c) (definition of "sponsor").

22 Proposal, at 9684.

23 Adopting Release, at 59.

24 Adopting Release, at 43.

25 Rule 192(c) (definition of "sponsor").

26 Proposal, at 9686.

27 *See, e.g.*, Comment Letter from Mortgage Bankers Association, at 2 (Mar. 27, 2023) ("MBA Comment"); *see also* Comment Letter from Commercial Real Estate Finance Council, at 5-6 (Mar. 27, 2023).

that long investors perform "important and beneficial market functions"[28] and clarified that the Rule is "not designed to discourage ABS investors from exercising contractual rights as a holder of a long position in an ABS."[29]

To avail itself of the long investor exception, an investor must act "*solely* pursuant to such person's contractual rights as a holder of a long position in the ABS."[30] The SEC advised that whether this is the case will depend on "the relevant facts and circumstances, including what other roles the long investor may have in the transaction."[31] However, the SEC did opine that a person's contractual rights as the holder of a long position "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."[32] In addition, the long investor exception only applies to the definition of "Contractual Rights Sponsor"; a long investor that is also a Regulation AB Sponsor is still a "sponsor" under the Rule, notwithstanding the availability of the long investor exception.

The SEC reiterated its guidance from the Proposal that the definition of "sponsor" would also include, for example, 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."[33]

iii. Exception for service providers.

The Rule also makes an important change to the ministerial exception. The Rule provides that a person that performs only "administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, assembly *or ongoing administration* of an ABS or the composition of the pool of assets underlying or referenced by the ABS" is not a "sponsor."[34] The addition of the term "ongoing administration" was made in response to industry feedback that service providers generally perform the bulk of their work after the securitization closes, and that such parties may not have been able to rely on the previous iteration of the exception in the Proposal, which applied only to those that performed such ministerial acts in connection with the "structure, design, or assembly" of the ABS or the related asset pool.[35]

---

[28] Adopting Release, at 49.

[29] However, as the Adopting Release cautions, to the extent that a b-piece buyer is an affiliate of a securitization participant, the b-piece buyer could be considered a securitization participant by virtue of its affiliation. Adopting Release, at 43, 51. The SEC cautions that, "if a [b]-piece buyer is also a special servicer for an ABS transaction, the [b]-piece buyer will not be acting 'solely' pursuant to its rights as a holder of a long position in the relevant ABS and will need to then consider whether the performance of its contractual obligations as special servicer will be sufficiently administrative or custodial in nature to be excluded from the definition [of 'sponsor']." Adopting Release, at 51-52.

[30] Adopting Release, at 50 (emphasis added).

[31] Adopting Release, at 50.

[32] Adopting Release, at 50.

[33] Adopting Release, at 39; *see also* Proposal, at 9684.

[34] Rule 192(c) (definition of "sponsor") (emphasis added).

[35] Adopting Release, at 60.

The SEC clarified that it interprets "ongoing administration" to 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,"[36] but caveated that "it does not refer to active portfolio management or other such activity that would be subject to the 'sponsor' definition."[37] The SEC also clarified that activities customarily performed by accountants and credit rating agencies—and much to the authors' relief, attorneys—would qualify for the ministerial exception.[38]

The SEC declined to include special servicers in the ministerial exception as a matter of right. Instead, a special servicer may qualify for the ministerial exception under a case-by-case analysis "depend[ing] on the nature of the special servicer's activities."[39] The SEC explained that "a special servicer can potentially have a significant role in the servicing and disposition of troubled assets in an asset pool, such as the ability to determine whether (and when) to negotiate a workout of a loan, take possession of the property collateralizing a loan, and purchase the loan out of the securitization at a discount and, therefore, the special servicer's activities may not be limited to the types of administrative or ministerial functions eligible for the exclusion."[40] As an example, the SEC noted that "if the special servicer for a CMBS transaction is also the [b]-piece buyer (or an affiliate or subsidiary of the [b]-piece buyer)" and can exercise its contractual rights "with respect to the asset pool without needing to obtain the consent of any unaffiliated investor or transaction party in the CMBS transaction, then the special servicer's activities are not only administrative, legal, due diligence, custodial, or ministerial in nature with respect to such CMBS transaction."[41]

One important thing to note is that a person qualifies for the ministerial exception "*only*" if they perform one or more of the enumerated ministerial duties.[42] The SEC acknowledged that certain activities performed by service providers might straddle the line between activities that would be expected of a Contractual Rights Sponsor and activities that would qualify for the ministerial exception.[43] However, the SEC stated that "so long as a person's activities with respect to the relevant ABS are only administrative, legal, due diligence, custodial, or ministerial in nature, the [ministerial exception] is available 'notwithstanding' the fact that such a person's contractual rights could also be understood to be captured by paragraph (ii) of the definition of sponsor."[44]

---

[36] Adopting Release, at 60-61. The parallel language from the Proposal excluded a reference to "servicers," noting instead that "[w]hether other parties to a securitization transaction, such as servicers, would meet the re-proposed rule's definition of 'sponsor' is a determination that would be based upon the specific facts and circumstances of the ABS transaction . . . ." Proposal, at 9684-85.

[37] Adopting Release, at 61.

[38] Adopting Release, at 59-60.

[39] Adopting Release, at 51.

[40] Adopting Release, at 62. However, as discussed below, the SEC clarified that many normal-course servicing activities would not constitute "conflicted transactions," even if the servicer or special servicer is determined to be a "securitization participant."

[41] Adopting Release, at 62 n.242.

[42] Adopting Release, at 61 (emphasis added).

[43] Adopting Release, at 61. As examples, the SEC cited "the drafting and negotiation of the operating and disclosure documents with respect to an ABS, setting fees to be paid to certain transaction parties, reviewing the asset pool, negotiating the priority of payments within an ABS transaction, potentially advising on how to structure an ABS to meet the objectives of the deal parties, collecting payments on underlying assets, and making distributions to bondholders." Adopting Release, at 61.

[44] Adopting Release, at 62.

iv. Governments and government-sponsored enterprises.

The Rule maintains an exception to the definition of "sponsor" for the United States and agencies of the United States with respect to an ABS that is fully guaranteed or fully insured as to the timely payment of principal and interest by the United States.[45] However, the Rule eliminated the proposed exceptions for the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac" and, together with Fannie Mae, the "Enterprises"), which would have provided that the Enterprises (or any limited-life regulated entity succeeding to the charter of either Enterprise) are not "sponsors" with respect to any ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by such entity, for so long as they operate under the conservatorship or receivership of the Federal Housing Finance Agency ("FHFA") with capital support from the United States.[46]

The SEC cited concerns that the Proposal lacked clarity concerning whether the Enterprises would be permitted to engage in credit risk transfer ("CRT") synthetic securitization transactions.[47] The SEC opted to remove the "sponsor" exclusion and to make clarifying changes to the risk-mitigating hedging exception, to "provide more certainty for the Enterprises and the market" and to "address commenter concerns with respect to the ability of the Enterprises to continue to engage in CRT transactions for purposes of managing their credit risk."[48]

Additionally, the SEC declined to exclude states and their political subdivisions from the definition of "sponsor," noting that the SEC was "not persuaded that issuers of municipal ABS are uniquely different from other securitization participants such that they should be excluded from the [Rule]."[49]

v. Other matters relating to the definition of "sponsor."

The SEC responded to, and rejected, various industry requests for more bespoke exclusions for certain parties from the definition of "sponsor." In particular, the SEC declined to carve out market participants "acting subject to a fiduciary duty to a client or customer," such as open-market CLO collateral managers, municipal advisors or other investment advisers.[50]

The SEC did take the opportunity to confirm that a "warehouse lender whose role is to engage in such routine lending activity"[51] (*i.e.*, "to finance the purchase of assets by a securitization participant in furtherance of the issuance of an ABS") with respect to an 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 [Rule]."[52] However, the

---

45 Rule 192(c) (definition of "sponsor").

46 Rule 192(c) (proposed) (definition of "sponsor"). Certain securities issued by the Government National Mortgage Association ("Ginnie Mae"), for example, are fully guaranteed, and Ginnie Mae's guarantees are supported by the full faith and credit of the United States. *See* Adopting Release, at 65 n.252 (citing 12 U.S.C. § 1716-1723); *see also* Proposal, at 9687.

47 Adopting Release, at 67.

48 Adopting Release, at 68-69.

49 Adopting Release, at 40.

50 Adopting Release, at 52. Similarly, the SEC declined to carve out conflicted transactions entered into pursuant to a fiduciary duty from clause (iii) of the definition of "conflicted transaction." *See* Adopting Release, at 114.

51 Adopting Release, at 56.

52 Adopting Release, at 56-57.

SEC here cautioned again that if the warehouse lender is an affiliate or subsidiary of a securitization participant, then the warehouse lender may be considered a securitization participant by virtue of that affiliation.[53] This is an important point to keep in mind, for example, in transactions where a sponsor securitizes assets financed through a warehouse or repurchase facility by a bank lender, and a broker-dealer affiliate of that lender acts as underwriter, initial purchaser or placement agent in connection with that securitization.

C. Affiliates and subsidiaries.

The Rule applies to any "affiliate" or "subsidiary" of an underwriter, placement agent, initial purchaser or sponsor of an ABS that (i) "[a]cts in coordination with" an underwriter, placement agent, initial purchaser or sponsor of an ABS or (ii) "[h]as access to or receives information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS prior to the first closing of the sale of the relevant ABS."[54] The term "affiliate," with respect to a specified person, means a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.[55] The term "subsidiary," with respect to a specified person, is an affiliate controlled by such person directly, or indirectly through one or more intermediaries.[56] For purposes of the definitions of "affiliate" and "subsidiary," the term "control" means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.[57]

Many commenters expressed concern about the far-reaching impacts of the broad inclusion of affiliates and subsidiaries in the definition of "securitization participant." The primary suggestion made by commenters,[58] at the SEC's invitation,[59] was to incorporate an "information barrier" exception to mitigate potential conflicts of interest. In response, the SEC limited the applicability of clause (ii) of the definition of "securitization participant" to an affiliate or subsidiary that either (i) "[a]cts in coordination with" an underwriter, placement agent, initial purchaser or sponsor of an ABS, or (ii) "[h]as access to or receives information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS prior to the first closing of the sale of the relevant ABS."[60] Any affiliate or subsidiary falling outside of this description will not be considered a "securitization participant" solely by virtue of its affiliation with another securitization participant.[61]

In a discussion about the "coordination" provision, the SEC cited an example presented by one commenter that an affiliate or subsidiary would be considered to "act in coordination with" a named securitization participant if it "(i)

---

53 Adopting Release, at 57.

54 Rule 192(c) (definition of "securitization participant").

55 Rule 192(c) (definition of "securitization participant") (citing Securities Act Rule 405, 17 C.F.R. § 230.405).

56 Rule 192(c) (definition of "securitization participant") (citing Securities Act Rule 405).

57 Securities Act Rule 405.

58 *See, e,g.*, Comment Letter from International Association of Credit Portfolio Managers, at 4-5 (Mar. 27, 2023) ("IACPM Comment"); Comment Letter from Alternative Investment Management Association and Alternative Credit Council, at 7 (Mar. 27, 2023) ("AIMA/ACC Comment"); Comment Letter from Securitization and Structured Finance Committee and Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association, at 23-24 (Apr. 5, 2023).

59 Proposal, at 9690-9692.

60 Rule 192(c) (definition of "securitization participant").

61 Of course, if the affiliate or subsidiary would qualify as a sponsor, underwriter, placement agent or initial purchaser in its own right, the affiliate or subsidiary would still be a "securitization participant" under clause (i) of the definition thereof.

directly engages in the structuring of or asset selection for the securitization, (ii) directly engages in other activities in support of the issuance and distribution of the ABS, or (iii) otherwise acts in concert with its affiliated securitization participant through, *e.g.*, coordination of trading activities."[62]

In a discussion about the informational access component of the definition of "securitization participant," the SEC offered two important bits of guidance. *First*, the SEC clarified that if an affiliate or subsidiary receives (or has access to) information only *after* the first closing of the sale of the ABS, then absent coordination with the securitization participant, that affiliate or subsidiary would not be considered a securitization participant.[63] *Second*, the SEC advised securitization participants to consider scenarios in which applicable information barriers fail to adequately prevent the flow of information among entities.[64] For example, if a barrier fails, the SEC cautioned that the affiliate or subsidiary may become a "securitization participant" depending on the facts and circumstances.[65] If the failure was "accidental" and "quickly remedied upon discovery," and "the affiliate did not use the information to influence the assets included in the ABS," then that failure likely would not cause the affiliate to become a "securitization participant."[66] On the other hand, if "the access to information led to the affiliate using the information to influence the assets included in the ABS," then even if the failure was accidental, "that affiliate would likely be a securitization participant . . . ."[67]

The SEC did not issue definitive guidance on precisely what indicia of separateness would be necessary to establish that a person is not an "affiliate" or "subsidiary." The SEC explained that was an intentional decision, with the goal of providing "flexibility to use information barriers or other mechanisms to prevent coordination or sharing of information with an affiliate or subsidiary, while still achieving the objective of prohibiting securitization participants from engaging in conflicted transactions."[68] However, the SEC did list certain examples of circumstances in which an affiliate or subsidiary may not be a "securitization participant," including if the named securitization participant:

- "Has effective information barriers between [the named securitization participant] 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.)";[69]
- "Maintains separate trading accounts for the named securitization participant and the relevant affiliate or subsidiary";

---

62 Adopting Release, at 69 n.276.

63 Adopting Release, at 76 n.303.

64 Adopting Release, at 77 n.307.

65 Adopting Release, at 77 n.307.

66 Adopting Release, at 77 n.307.

67 Adopting Release, at 77 n.307.

68 Adopting Release, at 78.

69 Adopting Release, at 76. The SEC clarified that an entity may be in compliance with this example, even if the relevant entity has a shared research desk that provides research to the named securitization participant and an affiliate fund, but the named securitization participant and the affiliated fund themselves do not share information with one another. Adopting Release, at 76 n.304.

- "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";[70] 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."[71]

The SEC followed this list with a word of caution:

> This list is not exhaustive and simply includes examples of the types of barriers that could be used by securitization participants and their affiliates and subsidiaries. We are not endorsing any one of these methods over another mechanism that may be used to prevent the flow of information between the relevant entities. While it is possible that one of these methods (or another method not listed here) may be sufficient for compliance with the [Rule], securitization participants may find that they need to utilize a combination of methods to establish an effective compliance program.[72]

It is important to note that the Rule provides no relief for securitization participants who undertake multiple activities or investment strategies in the name of the same entity. Any such entities would be subject to the prohibition on engaging in conflicted transactions, unless they can demonstrate the availability of an exception.

2. What types of securities are subject to the Rule?

A. Asset-backed securities.

The Rule applies to "asset-backed securities," which we refer to in this *OnPoint* as "ABS" for purposes of readability. The Rule incorporates a novel definition of "ABS," which has the same meaning as in Section 3(a)(79) of the

---

[70] The SEC explained that this example was included due to concerns of some commenters that some entities (for example, in the private equity sector) may technically be affiliated with one another by virtue of their common control by the same manager, but functionally operate as truly independent businesses and may not have any relationship or communication with one another. Adopting Release, at 76 n.305.

[71] Adopting Release, at 76-77.

[72] Adopting Release, at 77 n.306.

Exchange Act (an "Exchange Act ABS"),[73] but additionally includes "a synthetic asset-backed security and a hybrid cash and synthetic asset-backed security."[74]

The SEC declined to offer a formal definition of "synthetic ABS,"[75] but indicated that, "while a synthetic ABS may be structured or designed in a variety of ways, we generally view a synthetic ABS 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."[76] The SEC also noted that "a synthetic transaction could be effectuated through the use of derivatives or swaps but could also use some other feature or structure that replicates the terms of a derivative or swap."[77]

Given the novelty of the definition of "ABS" used in the Rule, many commenters asked the SEC to clarify whether various types of securities or other financial instruments would fall within the scope of the definition and, therefore, the prohibition set forth in the Rule.[78] In particular, the SEC opined as follows:

- A corporate debt obligation is not an ABS. "[A] corporate debt obligation is issued by, and offers investors recourse to, an operating entity that is not a special purpose entity. Therefore, a corporate debt obligation is not a synthetic ABS . . . ."[79]

- A security-based swap is not an ABS. A security-based swap "is a financial contract between two counterparties without issuance of a security from a special purpose entity. A security-based swap can represent a component of a synthetic ABS transaction where, for example, the relevant special purpose entity that issues the synthetic ABS enters into a security-based swap that collateralizes the synthetic ABS

---

73 An Exchange Act ABS is "(A) 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, including—(i) a collateralized mortgage obligation; (ii) a collateralized debt obligation; (iii) a collateralized bond obligation; (iv) a collateralized debt obligation of [Exchange Act ABS]; (v) a collateralized debt obligation of collateralized debt obligations; and (vi) a security that the [SEC], by rule, determines to be an [Exchange Act ABS] for purposes of [Section 3(a)(79) of the Exchange Act]; and (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company." Section 3(a)(79) of the Exchange Act, 15 U.S.C. § 78c(a)(79).

74 Rule 192(c) (definition of "asset-backed security").

75 Adopting Release, at 23.

76 Adopting Release, at 24; *cf.* Adopting Release, at 26 (noting that whether a transaction would constitute a "synthetic ABS" would "depend on the nature of the transaction's structure and characteristics of the underlying or referenced assets," and advising market participants to analyze, for example, "whether the assets that are transferred to or otherwise part of the asset pool are self-liquidating."). The SEC describes a "self-liquidating asset" as an asset which "by its terms converts into cash payments within a finite time period." *See, e.g.*, *Asset-Backed Securities*, SEC Release No. 33-8518 (Jan. 7, 2005) (adopting Regulation AB).

77 Adopting Release, at 26 n.94.

78 *See, e.g.*, AIMA/ACC Comment, at 8; MBA Comment, at 3; Comment Letter from Securities Industry and Financial Markets Association ("SIFMA"), SIFMA Asset Management Group and Bank Policy Institute, at 55-56 (Mar. 27, 2023) ("SIFMA/BPI Comment"); Comment Letter from Association for Financial Markets in Europe, at 5 (Mar. 27, 2023).

79 Adopting Release, at 25.

that it is issuing. However, the standalone security-based swap in such example is not a synthetic ABS; it is only one component of the broader synthetic ABS transaction."[80]

- A mortgage insurance-linked note ("MILN") is not an ABS. "In a typical MILN structure, the mortgage insurer enters into a reinsurance agreement with a special purpose insurer, which issues the MILNs to investors and places the proceeds from the sale of those securities in a reinsurance trust to make any required payments to the mortgage insurer under the reinsurance agreement, which requires payments based on certain losses incurred on a specified pool of mortgage insurance policies that are obligations of the mortgage insurer. The premiums paid by the mortgage insurer to the special purpose insurer are used to make interest payments to the holders of the MILNs."[81] Notwithstanding the fact that "MILNs create synthetic exposure to insurance contracts,"[82] the "underlying private mortgage insurance contracts are not self-liquidating" and therefore would not qualify as a "synthetic ABS."[83] As a result, "the reinsurance agreements executed between the mortgage insurer and the special purpose insurer" would not be considered "conflicted transactions."[84]

- An equity-linked or commodity-linked product is not an ABS because it does "not involve self-liquidating financial assets."[85]

B. Safe harbor for foreign transactions.

The Rule includes a safe harbor for certain foreign transactions with respect to which (i) the ABS is not issued by a U.S. person[86] *and* (ii) the offer and sale of the ABS is in compliance with Regulation S under the Securities Act.[87] The foreign transaction safe harbor is a helpful addition, particularly for market participants with broad, international presence. However, in the Adopting Release, the SEC advised:

> 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. Put simply, the existence of domestic ABS sales to investors means that securitization participants are prohibited pursuant to the terms of Rule 192 from engaging in their own separate transactions that would cause a material conflict with the ABS investors. And when domestic ABS sales exist, the prohibition on securitization participants engaging in separate transactions that would cause the material conflicts of interest applies *even if* the securitization participants seek to engage in those prohibited transactions exclusively overseas or if the securitization participant is itself a non-U.S. entity.[88]

---

80 Adopting Release, at 25-26.

81 Adopting Release, at 24 n.89.

82 Adopting Release, at 24.

83 Adopting Release, at 24.

84 Adopting Release, at 25.

85 Adopting Release, at 25.

86 The Rule refers to Regulation S for a definition of "U.S. person." Rule 192(e) (citing Securities Act Rule 902(k), 17 C.F.R. § 230.902).

87 Rule 192(e). Regulation S generally provides a safe harbor from the registration of securities under the Securities Act if the offers and sales of the related securities are made to non-U.S. persons in "offshore transactions."

88 Adopting Release, at 27 (emphasis original).

In addition, as with similar foreign transaction safe harbors found in Regulation RR[89] and Rule 15Ga-2,[90] the Rule's foreign transaction safe harbor imposes restrictions on the domicile of both the issuer and the purchaser, which may further limit its utility.

3. Barring an exception, what type of transaction is prohibited by the Rule?

During the period of time that the Rule's prohibition applies,[91] a securitization participant may not 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 ABS.[92] Within the meaning of the Rule, engaging in any transaction would involve or result in a "material conflict" of interest between a securitization participant for an ABS and an investor in such ABS if such a transaction is a "conflicted transaction."[93]

There are three prongs to the definition of "conflicted transaction." Each of the three prongs qualifies as a "conflicted transaction" only to the extent that "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 ABS."[94]

- Clause (i) includes "a short sale of the relevant ABS."[95]
- Clause (ii) includes 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 ABS."[96]
- Clause (iii) includes "the purchase or sale of any financial instrument (other than the relevant ABS)[97] or entry into a transaction that is substantially the economic equivalent of a transaction described in clauses (i) or (ii), other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk."[98]

The fact that a transaction may constitute a "conflicted transaction" does not necessarily mean that a securitization participant is precluded from entering into that transaction. It would, however, mean that the securitization participant

---

89 Regulation RR, 12 C.F.R. § 244.20.

90 Rule 15Ga-2, 17 C.F.R. § 240.15Ga-2.

91 The time period during which the Rule's prohibition applies is discussed below.

92 Rule 192(a)(1).

93 Rule 192(a)(2).

94 Rule 192(a)(3).

95 Rule 192(a)(3)(i).

96 Rule 192(a)(3)(ii).

97 The SEC explained that the inclusion of this parenthetical was "designed to specify that merely entering into an agreement to serve as a securitization participant with respect to an ABS and engaging in a purchase or sale of the ABS as an underwriter, placement agent, or initial purchaser for such ABS is not itself a conflicted transaction." Adopting Release, at 107-08.

98 Rule 192(a)(3)(iii).

would have to comply with one of the exceptions provided by the Rule, such as the risk-mitigating hedging exception, the liquidity commitment exception or the bona fide market-making activity exception, or would have to wait until one year after the date of the first closing of the sale of the ABS, in order to enter into the transaction.

The SEC declined commenters' requests to modify the core prohibition or the overarching materiality standard, but made material revisions to the potentially problematic clause (iii) of the Proposal that narrowed the Rule's reach to only those transactions that would resemble a bet against a securitization.

A. The core prohibition.

A securitization participant may not 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 ABS.[99] Some commenters requested that the SEC remove the phrase "directly or indirectly" from the core prohibition, but the SEC declined this request in order to minimize the risk of evasion. In particular, the SEC pointed to the existence of "orphan" ownership structures—*i.e.*, special-purpose structures used in many structured finance transactions where the entity at issue is nominally owned by a service provider and is therefore not an "affiliate" of the sponsoring entity—and confirmed that the phrase "directly or indirectly" is intended to capture this type of activity.[100]

B. Materiality standard.

A transaction qualifies as a "conflicted transaction" only to the extent that 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 ABS.[101] This materiality standard is borrowed from *Basic v. Levinson*,[102] a leading Supreme Court case on the application of Rule 10b-5. Many commenters remarked that using a disclosure-based materiality standard in a prohibitive rule would be inappropriate or confusing, but the SEC rejected these criticisms and maintained that the *Basic* formulation was fit for purpose.[103] It is important to note that the SEC's use of a disclosure-based standard does *not* permit securitization participants to cure or mitigate potentially problematic conflicted transactions by disclosing them to investors in the ABS, nor does it permit securitization participants to cleanse conflicts by permitting an investor to select or approve the assets included in the asset pool.[104]

C. Clause (i): Short sales.

Subject to the materiality qualifier, a "short sale of the relevant ABS" is a conflicted transaction.[105] The SEC considers a "short sale" to occur "when a securitization participant sells an ABS when it does not own it (or that it

---

99 Rule 192(a)(1).

100 Adopting Release, at 89 n.352.

101 Rule 192(a)(3).

102 485 U.S. 224 (1988).

103 Adopting Release, at 118.

104 Adopting Release, at 120.

105 Rule 192(a)(3)(i).

borrows for purposes of delivery)" and it is not relevant "whether the securitization participant makes a profit on the short sale."[106]

D. Clause (ii): Credit derivatives.

Subject to the materiality qualifier, 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 ABS" is a conflicted transaction.[107] The SEC stressed that the focus of this provision is on the "economic substance of the credit derivative as a bet against the relevant ABS without regard to the specific contractual form or structure of the derivative."[108] Here, the SEC specifically called out "any credit derivative entered into by the securitization participant with the special purpose entity issuer of a synthetic ABS where that credit derivative would entitle the securitization participant to receive payments upon the occurrence of a specified credit event with respect to an ABS that is referenced by such credit derivative and with respect to which the relevant person is a securitization participant under the [Rule]."[109] These structures are common in CRT transactions and other synthetic securitizations that aim to replicate the economic effects of traditional securitization transactions, without effecting an actual transfer of assets to a securitization vehicle, and the SEC is clear that it considers such arrangements to be "conflicted transactions" and therefore impermissible unless they satisfy an exception, such as an exception for risk-mitigating hedging.

E. Clause (iii): "Substantially the economic equivalent."

Subject to the materiality qualifier, the "purchase or sale of any financial instrument (other than the relevant ABS) or entry into a transaction that is substantially the economic equivalent of a transaction described in [clause (i) or (ii)], other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk," is a conflicted transaction.[110] The SEC explained that the goal of clause (iii) is to "capture the types of transactions through which the securitization participant could, in economic substance, bet against the ABS or the asset pool supporting or referenced by the relevant ABS in the same way as a short sale of the ABS or a CDS referencing the ABS but without regard to the particular form of the relevant transaction."[111]

The broad and ambiguous "catch-all" clause (iii) in the Proposal was the subject of the most criticism and concern among market participants.[112] Clause (iii) of the Rule is materially narrower than it was in the Proposal, and more closely focused on transactions that operate as a "bet against" an ABS. These revisions to clause (iii) should

---

106 Adopting Release, at 91. The SEC states that clause (iii) of the definition of "conflicted transaction" likewise is not "limited in scope to only prohibit transactions through which the securitization participant actually profits from its bet against the ABS . . . ." Adopting Release, at 116.

107 Rule 192(a)(3)(ii).

108 Adopting Release, at 92-93.

109 Adopting Release, at 93.

110 Rule 192(a)(3)(iii).

111 Adopting Release, at 102.

112 Under the Proposal, clause (iii) would have included: "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." Rule 192(a)(3)(iii) (proposed).

alleviate many concerns about the encroachment of the Rule on ordinary-course securitization-related activities; however, clause (iii) is still a catch-all provision that will require analysis based on the facts and circumstances in order to determine whether a transaction would constitute a "conflicted transaction."

i. Routine hedging and securitization-related activities.

The SEC took the opportunity in the Adopting Release to address commenters' concerns about particular types of transactions that might be inadvertently captured by clause (iii). The SEC made explicit in the text of clause (iii) that interest-rate hedging and currency hedging is not prohibited conduct, out of concern that failing to do so could "unnecessarily limit or discourage the prudent management of general interest rate and currency exchange risks by securitization participants."[113] The SEC also clarified that "reinsurance agreements, hedging of general market risk, or routine securitization activities (such as the provision of warehouse financing or the transfer of assets into a securitization vehicle)" are "unrelated to the idiosyncratic credit performance of the ABS" and therefore not prohibited by the Rule.[114] Additionally, the SEC clarified in the Adopting Release that the financing by a securitization participant of an investor's long purchase of an ABS would not constitute a conflicted transaction under clause (iii), notwithstanding that the borrower would typically be required to post additional collateral in the event of a decline in value of the ABS.[115] As the SEC explained, these are "customary mechanics of secured loans" and are "not substantially the economic equivalent of a transaction described in [clause (i) or (ii)]" because they do not "provide a mechanism for the financing provider to benefit from the adverse performance of the asset pool . . . ."[116]

ii. Credit risk transfer.

The SEC also opined that the familiar CRT structure involving "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" is a conflicted transaction under clause (iii) as it is "substantially the economic equivalent of a bet against such ABS itself."[117]

iii. Short positions with respect to the asset pool or similar asset pools.

The SEC also addressed scenarios where a securitization participant has a short position with respect to one or more assets underlying, or referenced by, an ABS, but not the ABS itself. The SEC took the position that economic

---

113 Adopting Release, at 105.

114 Adopting Release, at 94; *see also* Adopting Release, at 106-07; Adopting Release, at 127 ("hedges that are unrelated to the credit performance of the relevant ABS or the asset pool supporting or referenced by the relevant ABS will not be conflicted transactions . . . .").

115 Adopting Release, at 113-14.

116 Adopting Release, at 114.

117 Adopting Release, at 110. The SEC additionally opined that "if the reference pool for the synthetic ABS collateralizes a separate ABS with respect to which the relevant securitization participant is a securitization participant under the [Rule], this arrangement will result in a conflicted transaction with respect to the investors in the ABS collateralized by such reference pool as being substantially the economic equivalent of a bet against such ABS itself. Such transaction, in economic substance, is the same as the securitization participant entering into a bilateral CDS on the ABS that is collateralized by such reference pool." Adopting Release, at 110-11.

arrangements such as these are properly captured as a "conflicted transaction" depending on the facts and circumstances. The SEC explained:

> In the context of an ABS with an asset pool consisting of a large number of different and distinct obligations, we recognize that a short transaction with respect to a single asset or some *non-sizeable* portion of the assets in that pool would generally not result in a short position with respect to such asset or assets being 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. However, if the relevant assets do represent a *sizeable* portion of the asset pool supporting or referenced by the relevant ABS, then entering into a transaction with respect to such assets can present the same investor protection concerns that Section 27B was intended to address.[118]

We expect that much ink will be spilled in the coming days and years over just what "sizeable" means.

Importantly, the SEC opined that clause (iii) is *not* limited to transactions that are "entered into with respect to the relevant ABS or the asset pool supporting or referenced by such ABS."[119] A transaction could constitute a conflicted transaction if, based on the facts and circumstances, the transaction at issue is entered into "with respect to a pool of assets with characteristics that replicate the idiosyncratic credit performance of [a] pool of assets that is already underlying or referenced by the relevant ABS."[120] The SEC stated:

> Whether a short transaction entered into with respect to a similar pool of assets is a conflicted transaction under the [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.[121]

iv. Index-based hedging.

In a similar vein, the SEC additionally addressed the permissibility of "CDS index-based hedging strategies where the relevant ABS only represents a minimal component of the index."[122] In such a scenario, the SEC advised that the securitization participant would need to consider "the composition and characteristics of the relevant index,"[123] and opined that:

> If the relevant ABS or the asset pool supporting or referenced by such ABS does not represent a *sizeable* portion of the index, then entering into a transaction with respect to such index will not present the same investor protection concerns that Section 27B addresses. In such a scenario, the adverse performance of the asset pool supporting or referenced by such ABS would not have enough

---

118 Adopting Release, at 103 (emphasis added).

119 Adopting Release, at 100.

120 Adopting Release, at 109.

121 Adopting Release, at 100.

122 Adopting Release, at 104.

123 Adopting Release, at 104.

> of an economic impact on the performance of the relevant index for a short position with respect to that index to be substantially the economic equivalent of a transaction described in [clause (i) or (ii) of the definition of "conflicted transaction"]. However, if the relevant ABS or the asset pool does represent a *sizeable* portion of the index, then entering into a transaction with respect to such index presents the same investor protection concerns that Section 27B addresses. Under the [Rule], such a transaction could be a conflicted transaction based on the facts and circumstances.[124]

Interestingly, the SEC added in a footnote: "We also believe that it would be inconsistent for an index hedge that is permissible under [Rule 12(d) of Regulation RR] to be impermissible under this rule."[125] Rule 12 of Regulation RR governs the hedging of interests retained for purposes of compliance with risk retention regulations.[126] In general, Rule 12(d) permits a party holding a retained interest in a securitization to purchase or sell securities or other instruments with respect to which payments are based on an index of instruments that includes Exchange Act ABS, if (i) any class of "ABS interests" in the issuing entity included in the index represents "no more than 10 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index," and (ii) all classes of "ABS interests" in all issuing entities with respect to which the securitization sponsor is required to retain an interest pursuant to Regulation RR included in the index "represent, in the aggregate, no more than 20 percent of the dollar-weighted average (or corresponding weighted average in the currency in which the ABS interests are issued, as applicable) of all instruments included in the index."[127] In our view, the SEC's inclusion of this footnote signals a willingness to look to the more specific index-hedging regime under Regulation RR as a safe harbor of sorts, which offers more certainty regarding the permissibility of an index-based hedge.

v. Servicing.

In addition, the SEC recognized commenters' concerns regarding the possibility that the servicing of assets, and particularly distressed assets, could constitute a "conflicted transaction" under clause (iii) as proposed. The SEC acknowledged that servicers "may be entitled to additional income or expense reimbursement when servicing distressed assets," and that servicers carry out their responsibilities in accordance with a "servicing standard that is designed to direct the servicer to maximize the recovery value of the assets and, by extension, support the overall performance of the ABS for the benefit of the investors in such ABS."[128] On those grounds, the SEC opined that the Rule "will not prohibit such servicing activity as it is not substantially the economic equivalent of a transaction described in [clause (i) or (ii)]."[129]

---

[124] Adopting Release, at 104-05 (emphasis added).

[125] Adopting Release, at 104 n.386.

[126] Generally, Rule 12(b) prohibits a retaining sponsor, and its affiliates, from entering into certain enumerated transactions generally designed to limit the sponsor's exposure to the credit risk it is required to retain. Rule 12(c) imposes a similar prohibition on transactions entered into by the relevant issuing entity. Rule 12(d) carves out certain exceptions to the prohibitions in Rule 12(b) and (c).

[127] Regulation RR, Rule 12(d)(2).

[128] Adopting Release, at 112-13.

[129] Adopting Release, at 113. It is important to note that it is not necessary to determine whether or not servicing activity rises to the level of a "conflicted transaction" if the servicer is not a securitization participant (for example, if it qualifies for the ministerial exception and is otherwise not a covered affiliate or subsidiary of another securitization participant). *See* Adopting Release, at 113 ("We also note that, as discussed above . . . persons that only perform activities that are administrative, legal, due diligence, custodial, or ministerial in nature with respect to an ABS are excluded from the definition of 'sponsor.'").

4. What types of exceptions are available for conflicted transactions?

If a transaction is a "conflicted transaction," a securitization participant may nevertheless enter into the transaction if the transaction would constitute (i) a permitted risk-mitigating hedging activity,[130] (ii) a purchase or sale of an ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the ABS,[131] or (iii) a permitted bona fide market-making activity,[132] and in each case, satisfies certain conditions specified in the applicable exception. When analyzing a potentially conflicted transaction, the simplest way to conclude that a transaction is permitted is to determine that the transaction at issue does not fall under the definition of "conflicted transaction," as, in that case, a securitization participant would not need to satisfy the conditions to any of the exceptions in order to enter into the transaction. However, the provisions of the exceptions—specifically the risk-mitigating hedging exception—will prove critical to the ability of securitization participants to enter into hedging transactions, particularly with respect to CRTs and other synthetic products.

A. Risk-mitigating hedging activities.

The risk-mitigating hedging exception applies to "[r]isk-mitigating hedging activities of a securitization participant conducted in accordance with [the terms of the risk-mitigating hedging exception] 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 assets that it securitizes."[133] In order for a securitization participant to avail itself of the risk-mitigating hedging exception, each of the following conditions must be satisfied:

- The "risk-mitigation condition": "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."[134]

- The "recalibration condition": "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 [of

---

130 Rule 192(b)(1).

131 Rule 192(b)(2).

132 Rule 192(b)(3).

133 Rule 192(b)(1)(i).

134 Rule 192(b)(1)(ii)(A); *cf.* 17 C.F.R. § 255.5(b)(1)(ii)(B) (Volcker Rule) ("The risk-mitigating hedging activity: […] At the inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, is designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, 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 exception] and does not facilitate or create an opportunity to materially benefit from a conflicted transaction other than through risk-reduction."[135]

- The "hedging compliance condition": "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 the risk-mitigating hedging 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."[136]

The SEC made two important changes to the provision regarding the types of activities it considers to be "permitted risk-mitigating hedging activities." *First*, the SEC removed the requirement that the positions, contracts or holdings being hedged "aris[e] out of" the securitization participant's securitization activities, and provided instead that the positions, contracts or holdings that may be hedged *include* (but are not limited to) those that arise out of the securitization participant's securitization activities. The SEC explained that this change was designed "to not unnecessarily restrict the ability of an affiliate or subsidiary of a securitization participant to hedge exposures that it may originate, retain, acquire, or finance in connection with the ordinary course of its business but that may be unrelated to the securitization activities of the securitization participant."[137] *Second*, the initial issuance of an ABS (such as a synthetic ABS) will now qualify under the Rule for the risk-mitigating hedging exception. The SEC expressly noted that the 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,"[138] and opined that to the extent that synthetic ABS transactions undertaken for hedging purposes "mitigate a specific and identifiable risk exposure of the securitization participant, we agree that such transactions should be permitted under the risk-mitigating hedging exception."[139]

The three conditions for satisfying the risk-mitigating hedging exception in the Rule are almost identical to those included in the Proposal. With respect to the risk-mitigation condition, the SEC declined to remove the requirement that the mitigated risks be "specific and identifiable," on the grounds that it would be otherwise "impractical or

---

135 Rule 192(b)(1)(ii)(B); *cf.* 17 C.F.R. § 255.5(b)(2)(ii) (Volcker Rule) ("The risk-mitigating hedging activity: […] Is subject, as appropriate, to ongoing recalibration by the banking entity to ensure that the hedging activity satisfies the requirements set out in paragraph (b)(2) of this section and is not prohibited proprietary trading.").

136 Rule 192(b)(1)(ii)(C); *cf.* 17 C.F.R. § 255.5(b)(1)(i) (Volcker Rule) (imposing certain requirements concerning compliance programs necessary to satisfy the risk-mitigating hedging exception on banking entities with significant trading assets and liabilities).

137 Adopting Release, at 127-28. As an example, the SEC noted that, "if an underwriter of an ABS has an affiliate or subsidiary (that is subject to the [Rule]) that acquires, in its ordinary course of business, a long position in such ABS, the affiliate or subsidiary will be able to rely on the risk-mitigating hedging activities exception to hedge that long position, subject to the conditions of the exception."

138 Adopting Release, at 125.

139 Adopting Release, at 126. However, the SEC cautioned: "[T]he 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." Adopting Release, at 125-26.

impossible to determine whether the securitization participant has overhedged."[140] Though this language was not contained in the Adopting Release, the SEC explained in the Proposal that this condition would not be satisfied if the securitization participant entered into the hedge "for the purpose of hedging generalized risks that it believes to exist based on non-position specific modeling or other considerations."[141] For similar reasons, the SEC declined to permit the hedging of positions, contracts or holdings that do not exist at the time of the hedging activity, but may exist at some point in the future.[142]

With respect to the recalibration condition, requiring ongoing calibration of the risk-mitigating hedging activity "as appropriate,"[143] the SEC changed the Rule to provide that the recalibration should ensure that the hedge does not "facilitate or create an opportunity to *materially* benefit from a conflicted transaction other than through risk-reduction."[144] Except for the addition of the materiality qualifier, the SEC left the recalibration condition unchanged from the Proposal. The SEC defended the recalibration condition as necessary to "prevent a position that initially functions as a hedge to develop into a prohibited bet against the relevant ABS,"[145] but acknowledged that the lack of a materiality qualifier could render it impossible for a securitization participant to "immediately recalibrate its hedging positions given the liquidity, maturity, and depth of the relevant market for such hedging positions."[146] The SEC also explained that the relevant standard should not be interpreted as a "primary benefit" standard—*i.e.*, it is not the case that, in order to satisfy the recalibration condition, it would be sufficient for the "primary benefit" of the hedging activity to be risk reduction.[147] The SEC reasoned that it did not want to open the door for a securitization participant to be

---

[140] Adopting Release, at 133. As an example of the type of conduct the SEC is trying to prohibit with the "specific and identifiable" requirement, the SEC explained that the condition is intended to prohibit "a securitization participant from engaging in speculative activity that is designed to gain exposure to incremental risk by, for example, entering into a CDS contract referencing a retained ABS exposure where the notional amount of the CDS exceeds the amount of the securitization participant's relevant exposure to that ABS, and any other aggregated exposures, that are intended to be hedged." Adopting Release, at 133.

[141] Proposal, at 9701.

[142] Adopting Release, at 133-34.

[143] In response to comments regarding what it means to "calibrate" within the meaning of the recalibration condition, the SEC explained that the Rule "does not include an exact negative correlation standard"; however, "the presence of negative correlation will generally indicate that the hedging activity reduced the risks it was designed to address." Adopting Release, at 137-38. The SEC explains that no such standard was adopted "out of concern that such a standard could be unattainable in many circumstances given the complexity of positions, market conditions at the time of the hedge transaction, availability of hedging products, costs of hedging, and other circumstances at the time of the transaction that would make a hedge with exact negative correlation impractical or unworkable." Adopting Release, at 137.

[144] Rule 192 (b)(1)(ii)(B) (emphasis added); *cf.* Adopting Release, at 136 ("For example, if a securitization participant enters into a hedge that is permitted under the exception at inception and the risk exposure of the securitization participant is subsequently reduced such that its hedge fails to achieve its designed purpose and constitutes a bet against the relevant ABS, the securitization participant should be required to adjust or recalibrate its hedge to continue to rely on the exception. Otherwise, securitization participants could reduce their exposures after entering into a hedge in order to achieve a net short position, which would constitute a bet against the ABS.").

[145] Adopting Release, at 135.

[146] Adopting Release, at 136.

[147] Adopting Release, at 136.

able to "materially profit from a net short position with respect to the relevant ABS" as a "secondary benefit," which the SEC argued would be incongruous with the goal of the Rule.[148]

The hedging compliance condition, adopted as proposed, generally requires that any securitization participant making use of the risk-mitigating hedging exception implement, maintain and enforce a compliance program that is reasonably designed to ensure compliance with the requirements of the risk-mitigating hedging exception. Many commenters expressed concern[149] about the nature and scope of the type of compliance program the SEC would require. The SEC indicated that it does not intend the compliance program to be a "one-size-fits-all requirement" and acknowledged that securitization participants undertaking hedging activities are "well positioned to design [their] own individual internal compliance program" tailored to the "size, complexity, and activities of the securitization participants."[150] This is especially important in the context of the Rule because, unlike the Volcker Rule's[151] provisions requiring the implementation of certain compliance programs in connection with hedging activities, the hedging compliance condition in the Rule applies even to institutions that do not have "significant trading assets and liabilities."[152]

B. Transactions in support of liquidity commitments.

The liquidity commitment exception applies to "[p]urchases or sales of the ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the ABS."[153] There are no additional conditions that must be satisfied in order for a securitization participant to avail itself of the liquidity commitment exception.

The liquidity commitment exception was the subject of little commentary and was adopted as proposed. The SEC noted that "commitments to provide liquidity may take a variety of forms in addition to purchases and sales of the ABS, such as commitments to promote full and timely interest payments to ABS investors or to provide financing to accommodate differences in the payment dates between the ABS and the underlying assets."[154] Although parallel

---

148 Adopting Release, at 136-37.

149 *See, e,g.*, SIFMA/BPI Comment, at 62; AIMA/ACC Comment, at 7; Comment Letter from American Investment Council, at 20-21 (Mar. 27, 2023).

150 Adopting Release, at 142.

151 Dodd-Frank § 619, codified at 12 U.S.C. § 1851, generally prohibits banking entities from engaging in proprietary trading, subject to certain exceptions known as "permitted activities." *See* 12 U.S.C. § 1851(a)(1). One such "permitted activity" includes "[r]isk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings." 12 U.S.C. § 1851(d)(1)(C). In order to constitute a "permitted activity," risk-mitigating hedging activities must not, among other things, "involve or result in a material conflict of interest . . . between the banking entity and its clients, customers, or counterparties." 12 U.S.C. § 1851(d)(2)(A)(i). The statute was implemented by regulations promulgated by the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the SEC and the Commodity Futures Trading Commission and codified at, *inter alia*, 17 C.F.R. Part 255. Dodd-Frank § 619, together with such implementing regulations, are commonly referred to as the "Volcker Rule."

152 *Cf.* 17 C.F.R. § 255.5(b)(1)(i) (Volcker Rule) (imposing certain requirements concerning compliance programs necessary to satisfy the risk-mitigating hedging exception only on banking entities with significant trading assets and liabilities). Of course, another significant difference is that the Volcker Rule applies only to banking entities and certain other supervised institutions, whereas the Rule applies to banks and non-banks alike.

153 Rule 192(b)(2).

154 Adopting Release, at 145-46.

language was not included in the Adopting Release, the SEC noted in the Proposal that a liquidity commitment need not "take the form of a contractual obligation" to qualify for the exception.[155] The SEC clarified, in response to certain comments received, that the liquidity commitment exception would cover "dollar roll" transactions executed by the Enterprises, pursuant to which a seller enters into a short-term financing with respect to an ABS, similar to a repurchase agreement, except that "a similar security may be returned to the seller rather than the original security."[156]

C. Bona fide market-making activities.

The market-making exception applies to "[b]ona fide market-making activities, including market-making related hedging, of the securitization participant" conducted in accordance with the terms of the exception "in connection with and related to ABS with respect to which the prohibition [of paragraph (a)(2) of the Rule] applies, the assets underlying such ABS, or financial instruments that reference such ABS or underlying assets or with respect to which the prohibition [of paragraph (a)(1) of the Rule] otherwise applies" (collectively, "Applicable Instruments"), except that "the initial distribution of an ABS is not bona fide market-making activity" for purposes of the market-making exception.[157] In order for a securitization participant to avail itself of the market-making exception for bona fide market-making activities, each of the following conditions must be satisfied:

- The "stand-ready condition": "The securitization participant routinely stands ready to purchase and sell one or more types of [Applicable Instruments] 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."[158]

- The "client demand condition": "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 [Applicable Instruments]."[159]

- The "compensation condition": "The compensation arrangements of persons performing the foregoing activity are designed not to reward or incentivize conflicted transactions."[160]

- The "registration condition": "The securitization participant is licensed or registered, if required, to engage in the activity described [above relating to bona fide market-making activities] in accordance with applicable law and self-regulatory organization rules."[161]

---

155 Proposal, at 9704.

156 Adopting Release, at 146.

157 Rule 192(b)(3)(i).

158 Rule 192(b)(3)(ii)(A).

159 Rule 192(b)(3)(ii)(B).

160 Rule 192(b)(3)(ii)(C).

161 Rule 192(b)(3)(ii)(D).

- The "market-making compliance condition": "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 [the bona fide 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."[162]

The market-making exception was adopted by the SEC substantially as proposed. As discussed above, in the context of the risk-mitigating hedging exception, the SEC removed the carveout for the "initial distribution" of an ABS that would have precluded reliance upon the exception for hedges achieved by the issuance of an ABS, such as a synthetic ABS. However, the SEC declined to remove the parallel carveout from the market-making exception, with the result that a "securitization participant is not able to rely on the adopted exception for bona fide market-making activities in ABS for primary market activities, such as issuing a new synthetic ABS."[163]

The SEC also clarified that the market-making exception will not require the securitization participant to analyze the applicability of the exception on a "trade-by-trade basis," and the exception focuses instead on the "overall market-making related activities of a securitization participant."[164]

The SEC included several clarifying notes in the Adopting Release relating to the stand-ready condition. *First*, the SEC explained that the "routinely stands ready" standard is intended to be less stringent than an alternative "continuously purchases and sells" standard applicable under certain other regulatory regimes, such as Regulation SHO.[165] *Second*, the SEC explained that the "mere provision of liquidity" is not sufficient to satisfy the stand-ready condition; the stand-ready condition requires the securitization participant 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 further requires a securitization participant to "be willing to facilitate customer needs in both upward and downward moving markets and not only when it is favorable for the securitization participant to do so."[166] *Third*, the SEC advised that it would interpret the term "commercially reasonable" to require that the securitization participant be "willing to quote and trade in sizes requested by market participants in the relevant market."[167]

The client demand condition requires the securitization participant's market-making activities to be tied to reasonably expected near term demands of clients, customers or counterparties. The SEC advised that the client demand condition would require an analysis of facts and circumstances including "historical levels of customer demands,

---

[162] Rule 192(b)(3)(ii)(E).

[163] Adopting Release, at 151. The SEC further opined that an initial issuance would not qualify for the market-making exception anyway, as "even if the securitization participant purchased the CDS protection (*i.e.*, a short position) purportedly as part of its market-making activity, the creation and sale of the new ABS is primary, not secondary, market activity." Adopting Release, at 151 n.481.

[164] Adopting Release, at 155.

[165] Adopting Release, at 158. The Adopting Release explains that Regulation SHO's market-making exception requires the relevant broker-dealer to "generally be holding itself out as standing ready and willing to buy and sell the relevant security by continuously posting widely disseminated quotes that are near or at the market, and must be at economic risk for such quotes." Adopting Release, at 158 n.492.

[166] Adopting Release, at 158-59.

[167] Adopting Release, at 159.

current customer demand, and expectations of near-term customer demand based on reasonably anticipated near term market conditions, including, in each case, inter-dealer demand."[168]

The compensation condition governs the compensation arrangements of persons performing the market-making activities, which the SEC notes is intended to be similar to the approach to compensation taken by the Volcker Rule.[169] The SEC advised that "it would be consistent with [the compensation condition] if the relevant compensation arrangement is designed to reward effective and timely intermediation and liquidity to customers," but that it would *not* be consistent with the compensation condition if "the relevant compensation arrangement is instead designed to reward speculation in, and appreciation of, the market value of market-making positions that the securitization participant enters into for the benefit of its own account."[170]

The registration condition was adopted as proposed, with one clarification: The SEC clarified that licensure or registration to undertake market-making activities is only necessary to satisfy the exception if licensure or registration is required to undertake in the market-making activities at issue.[171] The SEC noted that the change was intended to acknowledge that certain persons who are exempt from registration or excluded from regulation should nonetheless be entitled to avail themselves of the market-making exception.[172] In the commentary, the SEC stated that a securitization participant that is a registered broker-dealer pursuant to the Exchange Act will satisfy the registration condition.[173]

The market-making compliance condition mirrors the hedging compliance condition, generally requiring that any securitization participant making use of the market-making exception implement, maintain and enforce of a compliance program that is reasonably designed to ensure compliance with the requirements of the market-making exception. As with the hedging compliance condition, the SEC noted its desire to "avoid imposing a one-size-fits-all requirement" and acknowledged that market-makers are "well positioned to design [their] own individual internal compliance program[s]" to reflect the market-maker's "size, complexity and activities."[174] The SEC advised that it would expect a responsively-designed compliance program to have the following features:

- The compliance program "set[s] forth the processes by which the relevant trading personnel will identify the financial instruments" described in the Rule's description of permissible market-making activities "related to

---

168 Adopting Release, at 160. The SEC goes on to state: "For example, a securitization participant facilitating a secondary market credit derivative transaction with respect to an ABS in response to a current customer demand will satisfy [the client demand] condition. However, if the securitization participant builds an inventory of CDS positions in the absence of current demand and without any reasonable basis to build that inventory based on either historical demand or anticipated demand based on expected near term market conditions, there will be no reasonably expected near term customer demand for those positions and that transaction will fail to satisfy [the client demand] condition." Adopting Release, at 160.

169 Adopting Release, at 161; *see also* Volcker Rule, 17 C.F.R. § 75.4(b)(2)(v).

170 Adopting Release, at 160-61.

171 Rule 192(b)(3)(ii)(D).

172 Adopting Release, at 161.

173 Adopting Release, at 161-62 ("Persons engaged in market-making activity in the securities markets in connection with ABS may be engaged in dealing activity. If so, absent an exception or exemption, these persons are required to register as 'dealers' pursuant to Section 15(a) of the Exchange Act, as 'government securities dealers' pursuant to Section 15C of the Exchange Act, or as 'security-based swap dealers' pursuant to Section 15F(a) of the Exchange Act. A securitization participant that is a registered broker-dealer will satisfy the market-making exception's registration condition.").

174 Adopting Release, at 164.

its securitization activities that the securitization participant may make a market in for its customers and the processes by which the securitization participant will determine the reasonably expected near term demand of customers for such products."[175]

- The compliance program "establish[es] internal controls and a system of ongoing monitoring and analysis that the securitization participant will utilize in order to effectively ensure the compliance of its trading personnel with its policies and procedures regarding permissible market-making under the [Rule]."[176]

- The written policies and procedures "demonstrate a process for prompt mitigation[177] of the risks of a securitization participant's positions and holdings that arise from market-making in ABS and the related financial instruments" described in the Rule's description of permissible market-making activities, such as "the risks of aged positions and holdings."[178]

D. Anti-evasion clause.

Lastly, it is important to note that the Rule contains an anti-evasion clause, which provides that, if a securitization participant engages in a transaction or a series of related transactions that, although in technical compliance with an exception, is part of a plan or scheme to evade the core prohibition of the Rule, that transaction or series of related transactions will be deemed to violate the core prohibition of the Rule.[179] The anti-evasion clause is a materially pared back version of the anti-circumvention clause in the Proposal, which would have more broadly prohibited any transaction that "circumvents" the prohibition of the Rule.[180] The SEC was persuaded by industry commentary that the proposed anti-circumvention clause had potential to be both "overinclusive and vague," and that the Rule already contains other elements designed to prevent attempted evasion (for example, the Rule's core prohibition on "directly or indirectly" engaging in prohibited conduct, and the "catch-all" clause (iii) of the definition of "conflicted transaction").[181]

5. When does the Rule become effective, and during what time frame does the prohibition of the Rule apply?

The Rule will become effective 60 days after its publication in the Federal Register.[182] Securitization participants will be required to comply with the Rule with respect to any ABS, the first closing of the sale of which occurs 18 months after the publication of the Rule in the Federal Register.[183] One important point here is that, as described below, the

---

175 Adopting Release, at 165-66.

176 Adopting Release, at 166.

177 The SEC elaborated that it interpreted "prompt mitigation" to require that "the mitigation occur without an unreasonable delay that will facilitate or create an opportunity to benefit from a conflicted transaction remaining in the securitization participant's market-making inventory considering the liquidity, maturity, and depth of the market for the relevant types of financial instruments." Adopting Release, at 166-67.

178 Adopting Release, at 166.

179 Rule 192(d).

180 Rule 192(d) (proposed).

181 Adopting Release, at 169-70.

182 Adopting Release, at 170. As of the publication of this *OnPoint*, the Rule has not yet been published in the Federal Register.

183 Adopting Release, at 170.

prohibition applies with respect to an ABS (and the related asset pool) even before that ABS is issued. So, for example, assuming that the Rule is published in the Federal Register on January 1, 2024, the Rule would apply to any ABS issued on or after July 1, 2025. In our view, however, with respect to an ABS issued on or after July 1, 2025, the Rule would prohibit a securitization participant from entering into a "conflicted transaction" from and after the time that such person has reached an agreement to become a securitization participant with respect to that ABS, and not just from and after the end of the 18-month compliance window. This means that the Rule would look back to the securitization participant's conduct after it reaches an agreement to become a securitization participant, even before the 18-month compliance window expires, and securitization participants should be prepared to comply with the provisions of the Rule before the end of the 18-month compliance window.

Once the Rule becomes effective, the Rule will apply with respect to any securitization participant on the date on which such 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.[184]

Otherwise, the only significant change to the time-frame prohibitions is that, under the Proposal, the prohibition would apply from the time that a person has "taken substantial steps" to reach an agreement to become a securitization participant. In response to criticism that the standard was vague and unworkable, the SEC removed the "substantial steps" trigger.[185]

The Rule does not define "agreement," but in the Adopting Release, the SEC opined that, within the meaning of the prohibition, an "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."[186] The SEC further opined that the existence of a signed engagement letter would constitute an "agreement," regardless of whether or not the engagement letter includes all of the material terms of the engagement.[187] But the SEC also explained that, though the existence of a written agreement is "sufficient" to establish an "agreement," it is not "necessary," and that there are other ways that an "agreement" can be reached within the meaning of the Rule.[188]

The SEC further clarified that, in the event that the sale of an ABS is not ultimately consummated, the Rule's prohibition would not apply, as there would be "no investors with respect to which a transaction could involve or result in a material conflict of interest"; however, if an ABS is in fact created and sold, then the Rule's prohibition would apply beginning on the date on which there was an agreement to become a securitization participant.[189] The SEC also clarified that the Rule's prohibition would apply in equal force even if the conflicted transaction at issue terminates on or prior to the date the assets at issue are included in the securitization.[190]

* * *

[184] Rule 192(a).

[185] Adopting Release, at 82.

[186] Adopting Release, at 83.

[187] Adopting Release, at 83 n.330.

[188] Adopting Release, at 83 n.330.

[189] Adopting Release, at 84.

[190] Adopting Release, at 108.

The Rule is materially narrower and clearer than the Proposal, and the SEC responded to many concerns raised by the industry concerning the Rule's scope and workability. However, as is the case with any rulemaking, questions and interpretive difficulties will no doubt arise as market participants work toward compliance. If you would like to discuss the Rule, please contact one of the Dechert attorneys listed below or any Dechert attorney with whom you regularly work.

The information in this OnPoint is not legal advice. The information in this OnPoint is presented for general informational purposes only. You should contact your attorney to obtain advice with respect to any particular legal matter.

This update was authored by:

Matthew J. Armstrong
Partner
New York
+1 212 698 3825
Send email

Matthew H. Fischer
Partner
New York
+1 212 698 3871
Send email

Sarah E. Milam
Partner
New York
+1 212 698 3866
Send email

Jay Southgate
Partner
New York
+1 212 698 3555
Send email

Devin M. Swaney
Partner
New York
+1 212 698 3661
Send email

Bill Lee
Counsel
New York
+1 212 698 3649
Send email

Greg Renick
Counsel
New York
+1 212 649 8763
Send email

John Ludwig-Eagan
Associate
New York
+1 212 641 5666
Send email

The authors would like to thank Frederieke Demas for her contributions to this OnPoint.

advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 27/F Henley Building, 5 Queen's Road Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000). Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Georgia, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at dechert.com on our Legal Notices page.

17 C.F.R. § 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 ~~through which the securitization participant would benefit from the actual, anticipated or potential:~~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.

~~**(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 ~~securities~~security and a hybrid cash and synthetic asset-backed ~~securities~~security.

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~~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~~; 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 ~~paragraphs~~paragraph (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) Notwithstanding paragraphs (i) and (ii) of this definition:~~

(~~A~~iv) ~~The~~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.

~~(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***~~***Anti-evasion***. If a securitization participant engages in a transaction ~~that circumvents~~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, ~~the~~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).