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New SEC Rule 192: Prohibition Against Conflicts of Interest in Certain Securitizations

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Background

In 2010, Congress directed the U.S. Securities and Exchange Commission (SEC) to issue rules prohibiting certain conflicts of interest among participants in asset-backed security (ABS) transactions as defined by the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] When they were initially proposed in 2011,[2] the rules received critical industry feedback. The SEC did not further pursue the related rulemaking for over a decade.

In January 2023, the SEC released proposed Rule 192,[3] and industry participants, including institutional investors, issuers, and trade associations, provided substantive feedback.

Respondents raised concerns that the proposed rule was overly broad, susceptible to significant unintended consequences, and did not take into account the positive significant changes in the market since Dodd-Frank was enacted. On November 27, 2023, the SEC adopted Rule 192 under the Securities Act of 1933 (the "Rule" or the "Final Rule").[4] The comments had a meaningful impact because the Rule addressed several industry recommendations and concerns. While some uncertainties and issues remain, progress was made, and the Rule's implementation will be delayed for 18 months, which will allow industry participants to develop and onboard internal compliance policies and procedures.

Summary of Rule 192

The Rule prohibits, for a specified period of time, a securitization participant from engaging, directly or indirectly, in any transaction that would involve or result in any material conflict of interest between the

[1] 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").

[2] *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).

[3] *Prohibition Against Conflicts of Interest in Certain Securitizations*, SEC Release No. 33-11151 (Jan. 25, 2023) (proposing Securities Act Rule 192).

[4] *Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Release No. 33-11254 (Nov. 27, 2023) ("Final Rule Release").

securitization participant and an investor in the relevant ABS, subject to certain exceptions.[5]

Rule 192 became effective on February 5, 2024, and compliance is required with respect to any ABS on the first closing of the sale that occurs on or after Monday, June 9, 2025, or 18 months after the date of publication in the *Federal Register*.[6]

Under the Rule, a securitization participant shall not, for a period beginning on the date on which the person has reached an agreement to 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 the ABS, directly or indirectly engage in any transaction that would involve or result in a **material conflict of interest** between the securitization participant and an investor in the ABS.[7] There is uncertainty about when an agreement has been reached, as discussed below.

A material conflict of interest occurs if the securitization participant engages in a conflicted transaction. A conflicted transaction includes any of the below transactions as described in Section 230.192(a)(3) of the Rule, 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 ABS:

1. A **short sale** of the relevant ABS.

2. 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.

3. 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 above, **other than** any transaction that only hedges general interest rate or currency exchange risk.

For this purpose, ABS 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 ABS and a hybrid cash and synthetic ABS. The Rule, however, does not define the term synthetic security.

Section 230.192(b)(1) of the Rule specifies three types of exempted transactions, listed below, and includes certain criteria and conditions for two of the exempted transactions.

1. **Permitted risk-mitigating hedging activities**: A securitization participant's risk-mitigating hedging activities that are entered 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.

   Risk-mitigating hedging activities are permitted only if:

   - At the beginning of the hedging activity and at the time of any modifications to such hedging

[5] Final Rule Release at p. 9.
[6] Final Rule Release at p. 170.
[7] §230.192(a)(1).

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;

- Such 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

- The related 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 ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the related ABS.[8]

3. **Bona fide market-making activities**. Bona fide market-making activities, including market-making related hedging, of the securitization participant conducted in accordance with paragraph (b)(3) of the Rule in connection with and related to the ABS with respect to which the related prohibition in paragraph (a)(1) 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 related prohibition in paragraph (a)(1) of the Rule otherwise applies, except that the initial distribution of an ABS is not bona fide market-making activity for purposes of paragraph (b)(3) of the Rule.[9]

   Bona fide market-making activities are permitted under paragraph (b)(3) of the Rule if the following five conditions, as listed in Section 230.192(b)(3)(ii) of the Rule, are satisfied:[10]

   - 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 the Rule as a part of its market-making related activities in such financial instruments, and is willing and available to quote, purchase, and sell, or otherwise enter into long and short positions in those types of financial instruments, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments.

   - The 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

[8] §230.192(b)(2).
[9] §230.192(b)(3).
[10] §230.192(b)(3)(ii).

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 the Rule.

- The compensation arrangements of persons performing the foregoing activity are designed not to reward or incentivize conflicted transactions.
- The securitization participant is licensed or registered, if required, to engage in the activity described in paragraph (b)(3) of the Rule in accordance with applicable law and self-regulatory organization rules.
- 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 the Rule, including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.

Who Does Rule 192 Apply To?[11]

A securitization participant is (1) an underwriter, placement agent, initial purchaser, or sponsor of an ABS; or (2) any affiliate or subsidiary of a person described above if the affiliate or subsidiary:

- Acts in coordination with a person described in this definition; or
- Has access to or receives information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS before the first closing of the sale of the relevant ABS.

A sponsor is (1) 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; or (2) 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 of a long position in the ABS.

- Notwithstanding the second prong 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.
- Further, notwithstanding the first and second prongs of this definition, the United States or an agency of the United States will not be 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.

While the Rule excludes a person acting solely pursuant to its "contractual rights" that is a long investor,

[11] The terms discussed in this section have been defined according to §230.192(c) of the Rule and analyzed in accordance with the Final Rule Release.

that did not resolve the issue raised for B-piece investors in commercial mortgage-backed securities ("CMBS") who may be affiliated with the special servicer. The SEC indicated that determination would depend on the related facts and circumstances.[12]

Scope of Affiliates or Subsidiaries Named as Securitization Participant Is Limited

An affiliate or subsidiary would act in coordination with a named securitization participant if it (1) directly engages in the structuring of or asset selection for the securitization; (2) directly engages in other activities in support of the issuance and distribution of the ABS; or (3) otherwise acts in concert with its affiliated securitization participant through, e.g., coordination of trading activities.[13]

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.[14]

Securitization participants are advised to consider the organization structure and information sharing mechanisms to adequately prevent the flow of information among entities in compliance with the Rule.[15]

Evidence suggesting an affiliate or subsidiary is not a securitization participant, as described in the Final Rule Release, includes an affiliate or subsidiary that:

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

[12] Final Rule Release at pp. 50-52.
[13] Final Rule Release at p. 69 n.276 (Citing with approval a comment letter from the ABA).
[14] Final Rule Release at p. 76 n.303.
[15] See, e.g., Final Rule Release at p. 77 n.307.

to (and do not) pre-approve trading decisions for the accounts.[16]

Anti-Evasion

If a securitization participant engages in a transaction or a series of related transactions that, although in technical compliance with paragraph (a)(1) of the Rule, is part of a plan or scheme to evade the prohibition set forth in paragraph (a)(1) of the Rule, that transaction or series of related transactions will be deemed to violate such paragraph of the Rule.[17]

Safe Harbor for Certain Foreign Transactions

The Rule shall not apply to any ABS that is not issued by a U.S. person and the offer and sale of the ABS complies with Regulation S.[18]

Unresolved Issues

Commencing of the Prohibition Period, in Relation to Agreement

The Rule does not define "agreement" or "substantial steps"; however, the Rule's adopting release notes that "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."[19] Rather, an executed written agreement such as an engagement letter does not need to be in place.[20]

The Rule's adopting release also notes that "whether a person has taken 'substantial steps to reach an agreement to become a securitization participant' would be a facts and circumstances determination based on the actions of such person in furtherance of becoming a securitization participant."[21]

Materiality Requirement in Prohibition

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. The SEC stated that "the prohibition will apply to transactions that are bets against the relevant ABS whether or not such transactions are disclosed to investors," and that the prohibition will apply even if "the investor selects or approves the asset underlying the relevant ABS."[22]

Meaning of Synthetic ABS

The SEC declined to provide a definition but noted that "while a synthetic ABS may be structured or designed in a variety of ways, we generally view a synthetic asset-backed security as a fixed income or other security issued by a special purpose entity that allows the holder of the security to receive

[16] Final Rule Release at p. 76-77.
[17] §230.192(d).
[18] §230.192(e).
[19] Final Rule Release at p. 83.
[20] Final Rule Release at p. 83.
[21] Final Rule Release at p. 79.
[22] Final Rule Release at pp. 120-121.

payments that depend primarily on the performance of a reference self-liquidating financial asset or a reference pool of self-liquidating financial assets."[23]

The SEC also offered the following guidance:

1. Determining "whether a transaction is a 'synthetic ABS' subject to Rule 192 will depend on the nature of the transaction's structure and characteristics of the underlying or referenced assets."[24]

2. "[A] corporate debt obligation is not a synthetic ABS."[25]

Meaning of Sizeable in Assessing a Conflicted Transaction

Is taking a short position in an asset pool underlying an ABS, or in some portion of the underlying asset pool a conflicted transaction? The SEC adopted the position that 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. Under the final rule, such a transaction can be a conflicted transaction based on the facts and circumstances."[26]

Pre-Securitization Activities

The SEC stated that it did "not believe that it would be appropriate to allow a securitization participant to bet against the performance of an asset pool while, for example, after reaching an agreement to become a securitization participant, simultaneously marketing an ABS to investors that references or is collateralized by that same asset pool even if the relevant bet is closed out prior to the issuance of the relevant ABS."[27]

Next Steps and Onboarding Compliance

Industry participants have more guidance with the SEC's adoption of the Rule, but a number of issues will need to be addressed over the ensuing 18 months, including those mentioned above. Additionally, engaging in risk mitigating hedging activities and bona fide market making activities will both require participants to have a robust internal compliance program. Trade associations have been on the leading edge of seeking clarity and guidance from the SEC, writing several letters outlining related issues and concerns. The discussion in the Rule's adopting release makes clear the benefit and impact of those

[23] Final Rule Release at p. 24.
[24] Final Rule Release at p. 26.
[25] Final Rule Release at p. 25.
[26] Final Rule Release at p.103-04.
[27] Final Rule Release at p. 108.

efforts. It's anticipated that such efforts will certainly continue over the coming months as the industry prepares for and implements procedures to meet the new conflict of interest rules.

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