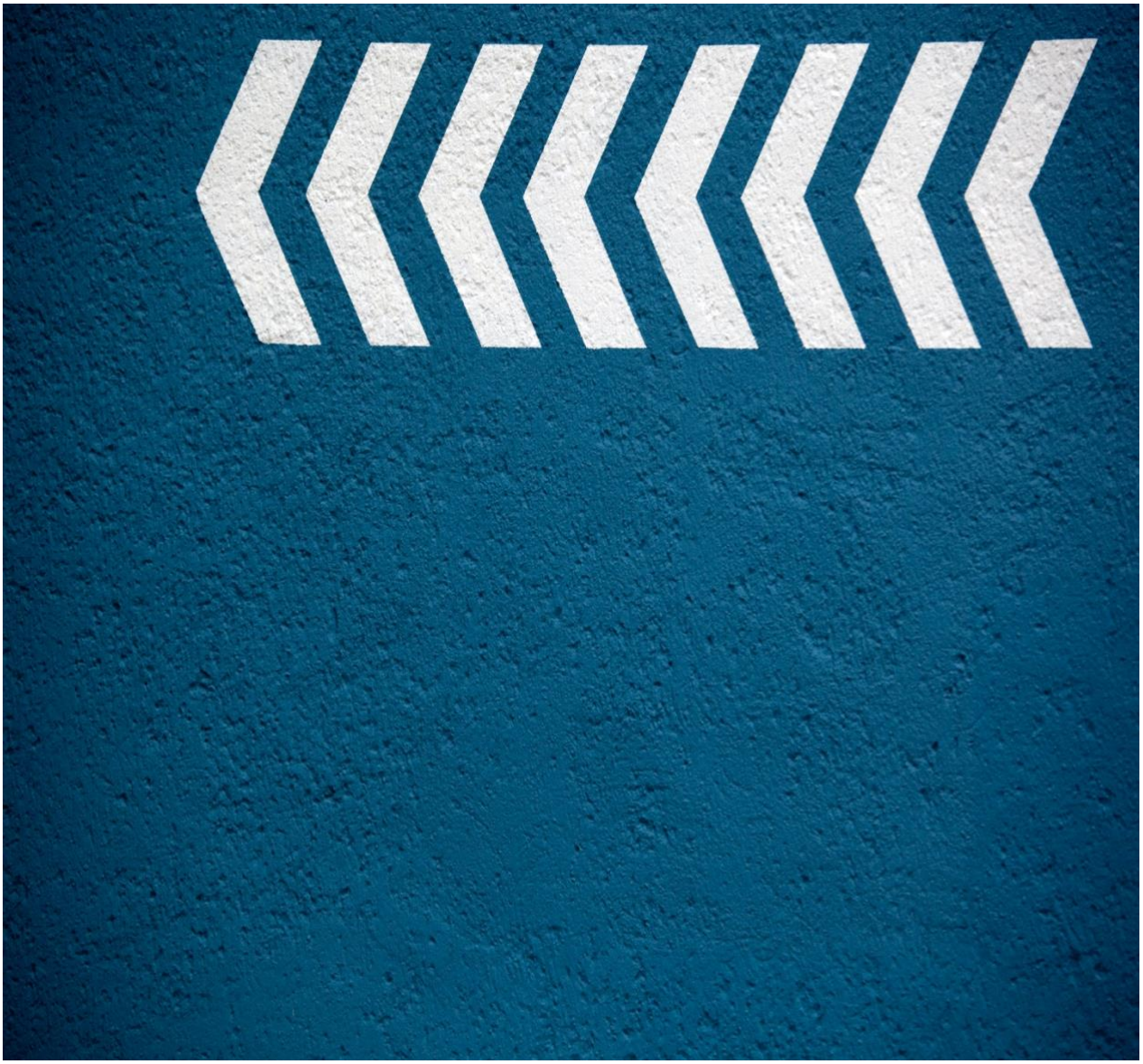
SUMMARY

Prohibition Against Conflicts of Interest in Securitization



1/ Overview

The U.S. Securities and Exchange Commission ("SEC") adopted Final Rule 192 on November 27, which prohibits certain conflicts of interest in securitization transactions.[1] Rule 192 implements Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[2]

Rule 192 prohibits a "securitization participant" from directly or indirectly engaging in a conflicted transaction with respect to an asset-backed security ("ABS") transaction during a specified prohibition period.

The Adopting Relase's definition of a "securitization participant" generally includes any underwriter, placement agent, initial purchaser and sponsor, along with any affiliate or subsidiary, but it does make a few minor changes to slightly narrow who would be considered a sponsor. For instance, the proposed definition of a "directing sponsor" was modified in the final rule to exclude long-only investors who solely act pursuant to their contractual rights as a holder of the ABS. Similarly, the final rule narrows the coverage of affiliates or subsidiaries to those that act in coordination with a securitization participant or who receive information about the ABS prior to the date of the first sale closing.

The definition of a conflicted transaction has two parts: first, either a short sale of the ABS or purchase of a derivative (or any substantially similar instrument) that would receive a payout upon the occurrence of an adverse event for the ABS; and second, 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. Of note, general interest rate and currency hedges, as well as any other hedge that is unrelated to the credit performance of the relevant ABS, are not considered conflicted transactions.

The prohibition against conflicted transactions begins with an agreement to become a securitization participant for a specific ABS and will last until one year after the first closing of the sale of that ABS. However, the final rule provides three prohibition exemptions for risk-mitigating hedging, certain market-making activities and liquidity commitments.

For hedges that are related to the performance of the ABS, Rule 192 imposes several conditions to qualify for the risk-mitigation hedging exemption. First, at its inception, the hedge must be designed to mitigate specific, identifiable risks related to the ABS. Second, the hedging activity must be subject to ongoing recalibration to avoid creating an opportunity to materially benefit from a conflicted transaction, such as a net short position. The third condition is that securitization participants must establish and maintain an internal compliance program reasonably designed to ensure the securitization participant's compliance with the conditions for each exemption.

The liquidity exemption is limited to the fulfillment of commitments made by the securitization participant to provide liquidity for the relevant ABS. The final rule exempts

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

[2] See Appendix B for the full text of Section 621 of the Dodd-Frank Act.

bona fide market-making activities to permit securitization participants to continue providing intermediation services in illiquid markets.

The final rule provides a safe harbor for non-U.S. ABS securitization participants in connection with securitizations that occur outside of the United States. The following conditions must be met to qualify for the exemption: the ABS offering must not be required to be registered under the Securities Act, the issuer must not be a U.S. person, and all offers and sales of the ABS must be made in compliance with Regulation S[3]. However, this means that securitization participants in a U.S. private placement transaction or a dual 144A/Reg S transaction cannot rely on the safe harbor.

Unfortunately, the final Rule 192 contains several key flaws. It fails to provide a clear definition for synthetic ABS, incorporates a vague catchall provision in the definition of a conflicted transaction, creates uncertainty about what affiliates may be excluded from the definition of an ABS sponsor, and excludes private placements from the foreign safe harbor provision. All of these will pose challenges to establishing effective compliance programs.

The final rule's effective date is February 5, 2024, but compliance will only be required with respect to any ABS the first closing of which occurs after June 7, 2025.

The Adopting Release made a significant modification to exempt long-only investors, but several unclear final provisions will make it difficult to ensure compliance.

2/ Scope of Rule 192

Definition of asset-backed security

Rule 192 includes both cash and synthetic ABS. Cash ABS is defined in accordance with Section 3 of the U.S. Securities Exchange Act of 1934 (i.e., a "fixed-income or other security collateralized by any type of self-liquidating financing 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…").[4] Second, Rule 192 scopes in synthetic or hybrid cash and synthetic ABS but does not provide a definition. Instead, the Adopting Release indicates that whether a synthetic ABS will be in scope for Rule 192 "will depend upon the nature of the transaction's structure and characteristics of the underlying or referenced assets."[5] The same kind of analysis will be required for a hybrid cash and synthetic ABS transaction.

While the SEC declined to provide a definition of a synthetic ABS, the Adopting Release indicates that the SEC "generally view[s] synthetic asset-backed security as a fixed income or other security issued by a special purpose entity that allows the holder of the security to receive payments that depend primarily on the performance of a reference self-liquidating financial asset or a reference pool of self-liquidating financial assets."[6] The SEC's failure to provide a precise definition of a synthetic ABS and preferred alternative

[3] *See* 17 CFR § 230.903, which spells out the SEC's requirements for a registration exemption when making an offshore offering of securities.

[4] Section 3(a)(79) of the Securities Exchange Act of 1934. This is the same definition as in Regulation RR and covers ABS offered publicly and privately.

[5] Adopting Release, *supra* note 1, at 26.

[6] *Id* at 25.

of a fact-specific analysis will likely prove to be problematic, as noted by SEC Commissioner Peirce in her dissent.[7]

Definition of securitization participant

Rule 192 applies to all securitization participants, which the Adopting Release defines as:

> i. An underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security; or
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> 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
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> B. Has access to information or receives information about the relevant asset-backed security or the asset pool underlying or referenced by the relevant asset-backed security prior to the first closing of the sale of the relevant asset-backed security.[8]

Subheadings ii A and B above were added in the final rule to address concerns about applying the prohibition to all affiliates of a securitization participant. As a result of this change, affiliates or subsidiaries of a sponsor, placement agent, underwriter or initial participant will not also become a securitization participant unless it acted in coordination with the securitization participant or had access to information from that securitization participant.

The Adopting Release substantially narrowed the definition of a sponsor in response to numerous comments and is now defined as:

> • 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 (a "Regulation AB-based Sponsor"); or
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> • 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 (a "Contractual Rights Sponsor"), other than a person who acts solely pursuant to such person's contractual rights as a holder of a long position in the ABS (a "Long-only Investor")
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> • But not including:
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> o A person who performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, assembly, or ongoing administration of an asset-backed security or the composition of

[7] See, Statement by SEC Commissioner Pierce, Unsettling End of an Era: Statement on Adoption of Rule Prohibiting Conflicts of Interest in Certain Securitizations, November 27, 2023, available at: https://www.sec.gov/news/statement/peirce-statement-securitizations-112723.

[8] Adopting Release, *supra* note 1, at 249.

the pool of assets underlying or referenced by the asset-backed security (the "Service Provider Exclusion"); or

o The United States or an agency of the United States 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 ("U.S. Government Exclusion").[9]

The definition of a Regulation AB-based Sponsor was not controversial and finalized as proposed. However, the Contractual Rights Sponsor definition was modified to exempt "long-only investors," whose control over the transaction is undertaken in accordance with the terms contained in the transaction documents as a holder of a long position in the ABS. The SEC notes that such contractual rights could be exercised throughout the life of the securitization and include, among others, rights over such major decisions as the right to initiate foreclosure actions, to replace the ABS servicer, or the redemption of outstanding interests in the ABS.[10] The SEC rejected requests to automatically exclude a B-piece purchaser but indicated that they could be excluded to the extent that they qualify as a long-only investor.

The revised definition also makes it clear that a person who performs only administrative, legal, due diligence, custodial, or ministerial acts is not a sponsor, nor is any agency of the U.S. government.

3/ Prohibition of securitization conflicts

As adopted, Rule 192 prohibits a securitization participant from directly or indirectly engaging in a transaction that would result in a material conflict of interest between the securitization participant and an investor in an ABS during the prohibition period. Any transaction that results in such a conflict would be deemed a "conflicted transaction."

Prohibition timeframe

The prohibition against conflicted transactions begins with an agreement to become a securitization participant for a specific ABS and will last until one year after the first closing of the sale of that ABS. Under the original proposal, the prohibition timeframe would have started as soon as "substantial steps" had been taken to become a securitization participant. In response to comments, the Adopting Release removed any reference to substantial steps. Instead, the trigger is now an "agreement in principle," which the SEC indicates requires a facts and circumstances analysis and does not necessarily require a written agreement.[11]

Prohibition against conflicted transactions

The definition of a conflicted transaction has two parts. First, there must be a substantial likelihood that a reasonable investor would consider the transaction important to their investment decision, and second, the securitization participant must enter into one of the following transactions:

9 *Id.* at 38.
10 *Id.* at 50.
11 *Id.* at 83.

i. A short sale of the relevant asset-backed security;

ii. The purchase of a credit default swap or other credit derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of specified credit events in respect of the relevant asset-backed security; or

iii. The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that is substantially the economic equivalent of a transaction described in paragraph (a)(3)(i) or (a)(3)(ii) of this section, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk.[12]

While the prohibitions on the direct short sale of an ABS or purchase of a credit default swap are relatively straightforward, the SEC added into the final rule the language in prong iii regarding a transaction that is substantially the economic equivalent of the first two prongs. This is intended to capture direct bets against an ABS by shorting a pool of assets with "characteristics that replicate the idiosyncratic credit performance of the asset pool supporting the relevant ABS."[13] This "catchall provision" will be determined using a facts and circumstances determination, which will make it difficult for compliance programs that must attempt to determine whether there is a mere correlation or actual replication of the idiosyncratic risk of the ABS.

From a compliance perspective, it will also be difficult to determine how to apply the reasonable investor standard, which is normally only applied to a disclosure standard rather than an outright prohibition.

4/ Exceptions to Prohibition

Rule 192 includes three exemptions from the prohibition on conflicted transactions.

Exception for risk-mitigating hedging activities

The Commission proposed that the prohibition on conflicted transactions would not apply to the risk-mitigating activities of a securitization participant in connection with and related to either individual or aggregated positions, contracts or other holdings of the securitization, including those (encompassing affiliates and subsidiaries) arising from securitization activities. This includes the origination or acquisition of assets it securitizes (including the initial issuance of a synthetic ABS). To distinguish permitted risk-mitigating hedging activities from prohibited conflicted transactions, the Commission established the following three conditions:

i. At inception of the hedging activity and at the time of any adjustments to the hedging activity, the risk-mitigating hedging activity of the securitization participant 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. Risk-mitigating hedging is subject to ongoing recalibration by the securitization

[12] *Id*. at 245-6.
[13] *Id*. at 100.

participant to ensure that the hedging activity satisfies the requirements of the exception and does not create an opportunity to benefit from a conflicted transaction other than through risk-reduction.

ii. 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) and does not facilitate or create an opportunity to materially benefit from a conflicted transaction other than through risk-reduction.

iii. 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), 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.[14]

Given that the accumulation of assets prior to the issuance of an ABS is a fundamental component of assembling an ABS prior to its sale, the Commission included hedge exposures arising out of the assets that are originated or acquired by the securitization participant in connection with warehousing assets in advance of an ABS issuance. Additionally, the final risk-mitigating hedging activities exception allows for the relevant hedging activity related to a securitization participant's activity to be done on an aggregated basis and does not require the exempt hedging to be conducted on a trade-by-trade basis.

In a change from the Commission's proposal, the initial issuance of a synthetic ABS is eligible for the risk-mitigating hedging activities exemption. However, if any investment activities are not made for the purposes of hedging an exposure, then such investment activities will not qualify for the risk-mitigating hedging exception.

The Commission affirmed that interest rate and currency hedging are not considered conflicted transactions. Providing financing to a long purchaser of an ABS is also not considered a conflicted transaction.

Exception for liquidity commitments

The prohibition will not apply when a securitization participant engages in purchases or sales of ABS made pursuant to and consistent with commitments of the securitization participant to provide liquidity for the relevant ABS. This approach is consistent with Section 27B(c), which provides that the prohibition in Section 27B(a) does not apply to purchases or sales of ABS made pursuant to, and consistent with, commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the ABS.[15]

Exception for bona fide market-making activities

The prohibition will not apply to certain bona fide market-making activities conducted by a securitization participant. This approach was consistent with Section 27B(c), which

[14] *Id*. at 122.
[15] *Id*. at 147.

provides that the prohibition in Section 27B(a) does not apply to purchases or sales of ABS made pursuant to and consistent with bona fide market-making in the ABS. Subject to specified conditions, the proposed exception would apply to bona fide market-making activity, including market-making related hedging, of a securitization participant conducted in connection with and related to an ABS, the assets underlying such ABS, or financial instruments that reference such ABS or underlying assets. In order to distinguish permitted bona fide market-making activity from prohibited conflicted transactions, the Commission proposed the following five conditions:

i. The securitization participant routinely stands ready to purchase and sell one or more types of the financial instruments described in paragraph (b)(3)(i) 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.

ii. 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).

iii. The compensation arrangements of persons performing the foregoing activity are designed not to reward or incentivize conflicted transactions.

iv. The securitization participant is licensed or registered, if required, to engage in the activity described in paragraph (b)(3) in accordance with applicable law and self-regulatory organization rules.

v. 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), including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.[16]

Anti-evasion prohibition

The original proposal included an anti-circumvention provision to the definition of a conflicted transaction. The Adopting Release eliminates the proposed anti-circumvention provision and replaces it with an anti-evasion provision that applies to the permitted exemptions. The anti-evasion provision in final Rule 192 states that, "if a securitization participant engages in a transaction or series of related transactions that, although in technical compliance with the Rule's exceptions, is a part of a plan or scheme to evade the prohibition in Rule 192(a)(1), then the transaction will be deemed to violate the final rule's prohibition."[17]

[16] *Id*. at 149.
[17] *Id.* at 196.

Foreign safe harbor

The Adopting Release includes a safe harbor provision for non-U.S. ABS securitization participants in connection with securitizations that occur outside of the United States. The following conditions must be met to qualify for the exemption: the ABS offering must not be required to be registered under the Securities Act, the issuer must not be a U.S. person, and all offers and sales of the ABS must be made in compliance with Regulation S. However, that means that Rule 192 would still apply to securitization participants in a U.S. private placement transaction or a dual 144A/Reg S transaction, even if such entities are located outside the United States.

Appendix A: About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$3 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs, and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage over US$1 trillion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).www.aima.org.

Appendix B: Text of Section 621 of the Dodd-Frank Act

(a) IN GENERAL.—An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C.
78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

(b) RULEMAKING.—Not later than 270 days after the date of enactment of this section, the Commission shall issue rules for the purpose of implementing subsection (a).

(c) EXCEPTION.—The prohibitions of subsection (a) shall not apply to—

(1) risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an asset-backed security, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship; or

(2) purchases or sales of asset-backed securities made pursuant to and consistent with—

(A) commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the asset-backed security, or

(B) bona fide market-making in the asset-backed security.

(d) RULE OF CONSTRUCTION.—This subsection shall not otherwise limit the application of section 15G of the Securities Exchange Act of 1934.

(e) EFFECTIVE DATE.—Section 27B of the Securities Act of 1933, as added by this section, shall take effect on the effective date of final rules issued by the Commission under subsection (b) of such section 27B, except that subsections (b) and (d) of such section 27B shall take effect on the date of enactment of this Act.