ALERTS

SEC Adopts Final Rule to Prohibit Conflicts of Interest in Certain Securitizations

December 15, 2023

Introduction

On Nov. 27, 2023, the Securities and Exchange Commission ("SEC") adopted Securities Act Rule 192 ("Rule")[1] to implement Section 27B of the Securities Act of 1933 ("Securities Act"), a provision added by Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Rule is intended to prevent the sale of asset-backed securities ("ABS") that are affected by material conflicts of interest, and to that end prohibits a securitization participant, for a specified period of time, from engaging, directly or indirectly, in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor in the relevant ABS ("conflicted transaction").[2]

The original proposed rule to restrict material conflicts of interest in ABS sales (by implementing Section 27B of the Securities Act) was released more than a dozen years ago when the SEC proposed Rule 127B[3]. The initial proposal faced significant criticism from the industry, leading to a lack of further action by the SEC at that time. An update to the original proposed rule was released on Jan. 25, 2023 ("Proposed Rule")[4], and that Proposed Rule again elicited many comments from industry participants.

Overview

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The final Rule was adopted with various amendments and updates to the Proposed Rule based upon the SEC's updated analysis and market feedback. Under the Rule, a securitization participant is prohibited from engaging in conflicted transactions.[5] This prohibition commences on the date such person has reached an agreement to become a securitization participant with respect to the ABS, and ends on the date which is one year after the first closing of the sale of the ABS.[6] It should be noted that the final Rule does not require the agreement to be in writing, and therefore the commencement date, and the Rule's prohibitions, may begin prior to any written agreement.

Conflicted Transactions

A conflicted transaction is defined as any one of three delineated activities: (i) a short sale of the relevant ABS, (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 ABS and (iii) the purchase or sale of any financial instrument (other than the ABS) that is substantially the economic equivalent of a either (i) or (ii) above (other than transactions that only hedge the general interest rate or currency exchange risk).[7] The catch-all provision in clause (iii) (conflicted transactions based on "substantially the economic equivalent of" transactions) is a substantial clarification and narrowing of the range of possible covered transactions originally included in the Proposed Rule.

The SEC's release accompanying the Rule states that in cases where the asset pool comprises a large number of different and distinct obligations, engaging in 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 which is "substantially the economic equivalent" of a short of the ABS itself (or a credit default swap or other credit derivative where the participant would be entitled to receive payment on specified credit events on the ABS).[8] However, if the assets of such a transaction constitute a "sizeable portion"[9] of the overall asset pool supporting or referenced by the relevant ABS, the transaction may be a conflicted transaction based on the specific facts and circumstances. If the transaction is deemed a conflicted transaction based on the foregoing, it could still be eligible for the risk-mitigating hedging activities exception discussed below.

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The definition of a "conflicted transaction" also contains a materiality standard, which requires that there be "a substantial likelihood that a reasonable investor would consider the relevant transaction important to the investor's investment decision, including a decision whether to retain the asset-backed security."[10]

Exceptions

The Rule provides exceptions for risk-mitigating hedging activities, liquidity commitments and bona fide market-making activities of a securitization participant, permitting market participants to engage in such market activities subject to satisfaction of specified conditions.[11] These have remained largely unchanged from the language of the Proposed Rule.

Exception for Risk-Mitigating Hedging Activities

"Risk-mitigating hedging activities" are defined as transactions entered into 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[12]. Such risk-mitigating hedging activities are only permitted if certain conditions are satisfied, including: (i) the risk-mitigating hedging activity is designed to reduce or mitigate specific, identifiable risks of the identified positions, contracts, or other holdings of the securitization participant; (ii) the risk-mitigating hedging activity is subject to ongoing calibration by the securitization participant to ensure it continues to satisfy the defined permitted uses; and (iii) the securitization participant establishes, implements, maintains and enforces an internal compliance program reasonably designed to ensure compliance with the defined permitted uses.[13]

Exception for Liquidity Commitments

Purchases or sales of the ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the ABS are not prohibited by the final Rule. Such activities may include 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.[14] An extension of credit by a securitization participant that functions to support the performance of the securitization rather than to benefit from

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its adverse performance will not be a conflicted transaction under the final Rule.[15]

Exception for Bona Fide Market-Making Activities

Certain bona fide market-making activities, including market-making related to hedging, in connection with the ABS, the assets underlying the ABS or financial instruments that reference such ABS or the underlying assets, are in each case allowed (where the initial distribution of ABS is not considered bona fide market-making). Bona fide market-making is permitted if: (i) the securitization participant is ready to purchase and sell bona fide market-making financial instruments in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity and depth of the market; (ii) the market-making activities are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties; (iii) the compensation arrangements do not reward or incentivize conflicted transactions; (iv) the securitization participant is registered, if required, to engage in such activities; and (v) the securitization participant establishes, implements, maintains and enforces an internal compliance program reasonably designed to ensure compliance with the permitted bona fide market-making activity.[16]

Anti-Evasion

The Proposed Rule contained an "Anti-circumvention"[17] clause which has been amended to now be an "Anti-evasion" clause in the final Rule.[18] This narrowing has resulted in such "evasion" requiring an actual "scheme" to evade, as opposed to any transaction itself being previously able to trigger an "anti-circumvention" violation.

Securitization Participant

The definition of "securitization participant", which includes (i) an underwriter, placement agent, initial purchaser or sponsor of the ABS and (ii) any affiliate or subsidiary thereof, was also narrowed to clarify that any such affiliate or subsidiary must also (A) act in coordination with the underwriter, placement agent, initial purchaser or sponsor or (B) have access to or receive information about the ABS or the underlying asset pool prior to the first closing of sale of the relevant ABS.[19] This narrowing provides some relief to large institutions which would have otherwise had subsidiaries or affiliates, even those not involved with the ABS, at risk of

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being captured by the definition of securitization participant under the Proposed Rule; however, these institutions will need to devise appropriate compliance rules and mechanisms to accommodate this and to prevent the coordination or sharing of information tailored to their respective organizations.[20] We discuss the Rule's applicability to affiliates and subsidiaries in further detail below.

Underwriter, Placement Agent and Initial Purchaser

The Rule defines "placement agent" and "underwriter" as 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.[21]

"Distribution" as used in the definitions for "underwriter" and "placement agent" means: "an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary course trading transactions by the presence of special selling efforts and selling methods; or an offering of securities made pursuant to an effective registration statement under the Securities Act."[22]

The definition of "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."[23]

These definitions were not modified from the Proposed Rule.

Sponsor

The definition of "sponsor" under the Rule now 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; and (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 of a long position in the ABS; except that (A) a person that performs only administrative, legal, due diligence, custodial

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or ministerial acts related to the structure, design or 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; and (B) the United States or its agency will not be a sponsor with respect to an ABS that it fully insures or fully guarantees.[24] As such, "a person who meets the definitional criteria of Rule 192(c) can be a 'sponsor' regardless of whether it is referred to as the 'sponsor' or some other title (e.g., issuer, depositor, originator or collateral manager)."[25] The definition of "sponsor" has been narrowed from the original Proposed Rule definition by excluding anyone who 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.[26] It has also narrowed those who are considered sponsors due to having a "contractual right" (as noted above) by excluding a person who so acts as a holder of a long position in the ABS.

Affiliates and Subsidiaries

An affiliate or subsidiary qualifies as a securitization participant for purposes of the Rule only if it (i) acts in coordination with an underwriter, placement agent, initial purchaser or sponsor 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 date of the first closing of the sale of the relevant ABS.[27] Whether the affiliate or subsidiary acts in coordination with a securitization participant or had access to, or received, information about an ABS or its underlying asset pool or reference asset pool prior to the closing date will depend on the facts and circumstance of the transaction.[28] Among the set of particular facts and circumstances that would lead an affiliate or subsidiary of a securitization participant to not be deemed a "securitization participant" are[29]:

- Having effective information barriers between the securitization participant and the relevant affiliate or subsidiary;
- Maintaining separate trading accounts for the participant and the relevant affiliate or subsidiary;
- Not having common officers or employees (other than clerical, ministerial or support personnel);
- Engaging in unrelated businesses and not communicating with such relevant affiliated entity; or

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- If it has personnel with oversight or managerial responsibility over accounts of both the participant and affiliate or subsidiary, then such persons do not have trading (or pre-approval of trading) authority in the accounts.

Safe Harbor

A safe harbor has been added to the Rule such that it will not apply to any ABS which is (i) not issued by a U.S. person (as defined in 17 CFR 230.902(k)[30]) and (ii) the offer and sale of the ABS is in compliance with 17 CFR 230.901 through 905 (Regulation S)[31].

Compliance Date

The Rule will become effective 60 days after publication in the Federal Register. However, compliance with the Rule will be required with respect to any ABS the first closing of the sale of which occurs 18 months after the date of publication in the Federal Register.[32]

Authored by *Phillip J. Azzollini, Daniel V. Oshinsky, Craig Stein* and *Atul Joshi.*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] For the text of the Rule, see https://www.sec.gov/files/rules/final/2023/33-11254.pdf ("Rule").

[2] For the SEC's press release announcing the adopted rule, see https://www.sec.gov/news/press-release/2023-240 ("Release").

[3] See Prohibition against Conflicts of Interest in Certain Securitizations, SEC Release No. 34-65355; File No. s7-38-11; (Sept. 19, 2011), 76 Fed. Reg. 60320 (Sept. 28, 2011) ("2011 Release").

[4] For the text of the Proposed Rule, see https://www.sec.gov/files/rules/proposed/2023/33-11151.pdf

[5] Rule at § 230.192(a).

[6] Id. at § 230.192(a)(1).

[7] Rule § 230.192(a)(3).

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[8] Release, at 103.

[9] The term "sizeable" is an undefined term under the Release, but market participants will likely develop a consensus as familiarity with the final Rule in practice develops.

[10] Rule at § 230.192(a)(3).

[11] Rule at § 230.192(b).

[12] Id. at § 230.192(b)(1).

[13] Id. at § 230.192(b)(2).

[14] Release, at 146.

[15] Release, at 146.

[16] Id. at § 230.192(b)(3).

[17] Proposed Rule at 189.

[18] Rule § 230.192(d).

[19] Id. at § 230.192(c).

[20] Release at 54-55.

[21] Release at 34.

[22] Id. at 34.

[23] Id. at 35.

[24] Rule § 230.192(c).

[25] Id. at

[26] Proposed Rule at 187.

[27] Release at 69.

[28] Id. at 75.

[29] Id. at 76 stating that effective information barriers include ". . . written policies and procedures designed to prevent the flow of information

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between relevant entities, internal controls, physical separation of personnel, etc. . . ."

[30] Rule at § 230.192(e).

[31] Id.

[32] Release at 170-171.

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Phillip Azzollini

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Partner

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Finance & Derivatives Counsel

New York

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