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EVERYTHING OLD IS NEW AGAIN: SEC RE-PROPOSES SECURITIZATION CONFLICTS OF INTEREST RULE

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EVERYTHING OLD IS NEW AGAIN: SEC RE-PROPOSES SECURITIZATION CONFLICTS OF INTEREST RULE

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

Newly proposed Rule 192 would prohibit an underwriter, placement agent, initial purchaser, or sponsor of any ABS (including a synthetic ABS), or any affiliate or subsidiary of any such entity, from engaging in any transaction that would involve or result in certain material conflicts of interest. The term "sponsor" in particular would be specifically (and broadly) defined for the purposes of the re-proposed rule, potentially encompassing securitization participants that are not commonly considered to be sponsors. The re-proposed rule would provide exceptions for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities.

The comment period on the new proposal remains open for 60 days following publication of the Re-Proposing Release on the SEC's website on January 25, 2023, or 30 days following publication of the Re-Proposing Release in the *Federal Register*, whichever period is longer.

THE ROOTS OF THE RE-PROPOSED RULE

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

After such a long quiet period, the re-proposal came as a bit of a surprise to many industry participants. The SEC's expressed intent behind the renewed rulemaking is to fulfill a long-outstanding congressional mandate to address one of the perceived roots of the financial crisis.[3] According to the Re-Proposing Release, "[t]he re-proposed rule targets transactions that effectively represent a bet against a securitization and focuses on the types of transactions that were the subject of regulatory and Congressional investigations and were among the most widely cited examples of ABS-related misconduct during the lead up to the financial crisis of 2007-2009."[4]

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

[2] Prohibition Against Conflicts of Interest in Certain Securitizations, SEC Rel. No. 333-11514-65355 (Jan. 25, 2023).

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

[4] Re-Proposing Release, at 6.

While the SEC acknowledged that "[s]ecuritization markets have undergone various changes since that time, including as a result of other rules that regulate securitization activity," and that it "do[es] not have data on the extent of such conduct following the financial crisis of 2007-2009," it nonetheless "believe[s] that securitization transactions continue to present securitization participants with the opportunity to engage in the conduct that is prohibited by Section 27B."[5]

TRANSACTION TYPE

The definition of "asset-backed security" in the re-proposed rule would specifically incorporate the broad definition in Section 2(a)(79) of the Securities Exchange Act of 1934, as amended (the Exchange Act), which was added by the Dodd-Frank Act: a "fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset."

This definition is quite familiar to market participants, as it is used for many other purposes, including the credit risk retention rules and the due diligence reporting rules. Additionally, the re-proposed rule would scope in synthetic ABS and hybrid cash and synthetic ABS.

SECURITIZATION PARTICIPANTS

The re-proposed rule would apply to any "securitization participant," which would be defined to include any "underwriter," "placement agent," "initial purchaser," and "sponsor," as well as their subsidiaries and affiliates. According to the SEC, "[t]he functions performed by such persons are essential to the design, creation, marketing, and/or sale of an ABS" and "[t]he reproposed rule focuses on transactions that could give such persons the incentive to market or structure ABS and/or construct underlying asset pools in a way that would position them to benefit from the actual, anticipated, or potential adverse performance of the relevant ABS or its underlying asset pool."[6]

Placement Agents, Underwriters, and Initial Purchasers

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

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

"Distribution" would mean "an offering of securities that is registered under the Securities Act, or any offering (whether registered or not) that is "distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods."[7]

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[5] Re-Proposing Release, at 7.

[6] Re-Proposing Release, at 19.

[7] Re-Proposing Release, at 22.

An "initial purchaser" would be defined as "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."[8]

The breadth of these definitions could have a number of surprising consequences. A purchaser could get swept into the rule after acquiring retained ABS from an issuer, or for purchasing ABS from a third party in a secondary-market trade, as could a broker-dealer facilitating such a trade or the resale of those ABS as an intermediary, depending on the scope of its activities in connection with the resale of those securities and whether those activities were the subject of an agreement with the issuer or selling securityholder.[9]

Sponsors

The term "sponsor" would be defined to include the well-understood definition of the term under Regulation AB and under the credit risk retention rules, i.e., any person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. More broadly, it also would capture what the Proposing Release calls, colloquially, "contractual rights sponsors" and "directing sponsors." A contractual rights sponsor would be 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 asset pool, and a directing sponsor would be any person who actually so directs or causes direction, whether or not pursuant to a contractual right,[10] each subject to certain exceptions.

Therefore, a contractual rights sponsor would include "parties with a significant role in asset selection for an ABS transaction, whether before or after the initial issuance of the relevant ABS, such as a portfolio selection agent for a CDO transaction, a collateral manager for a CLO transaction with the contractual right to direct asset purchases or sales on behalf of the CLO, or a hedge fund manager or other private fund manager with substantial involvement in the selection."[11] While unspoken, this concept appears to be at least partially a reaction to the *LSTA* case, which excluded collateral managers of open-market CLOs from being covered as "sponsors" under the risk retention rules.[12] The reference to private fund managers appears to be a reaction to "certain well-known examples of synthetic CDOs that were issued in the lead up to the financial crisis of 2007-2009, hedge funds that desired to take short positions in synthetic CDO securities (i.e., so that the hedge fund could benefit if the synthetic CDO securities

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[8] Re-Proposing Release, at 23.

[9] "The definition that we are proposing . . . would be limited to persons that have agreed with an issuer or a selling security holder to perform such functions, and selling group members who have no agreement with an issuer or selling security holder to engage in such functions would not be a 'placement agent' or 'underwriter' for purposes of the re-proposed rule." Re-Proposing Release, at 21-22.

[10] Re-Proposing Release, at 30-32.

[11] Re-Proposing Release, at 30.

[12] *See Loan Syndications & Trading Ass'n v. SEC and Bd. of Governors of the Fed. Rsrv. Sys.*, 882 F.3d 220 (D.C. Cir. 2018).

performed adversely) would direct or cause the direction of the composition of the portfolio assets in ways that would increase the likelihood of realizing an ultimate gain on their short position."[13]

According to the SEC, "a person [c]ould be a sponsor for purposes of the re-proposed rule . . . , regardless of whether the person is referred to as the sponsor of the ABS or by some other title (e.g., issuer, depositor, originator, or collateral manager), and even if the person does not have a named role in the ABS transaction, and is not a party to any of the transaction agreements. . . . For example, if a person is designated an 'issuer' of a transaction, the person could also be a "sponsor" if the person performs the functions specified in the proposed definition."[14] Other types of entities that routinely participate to some degree in the securitization process that also could be covered might include, for example, a seller of a pool of assets to an unrelated third party that then securitizes them—even if it not a "co-sponsor" for risk retention purposes—and affiliates of a risk retention sponsor that provide services to that sponsor in connection with the structuring of the securitization or selection of the asset pool.

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

There also would be exclusions for the United States, any agency of the United States, and Fannie Mae or Freddie Mac (herein, the Enterprises) operating under the conservatorship or receivership of the Federal Housing Finance Agency (FHFA) with capital support from the United States, with respect to ABS that are fully insured or fully guaranteed as to the timely payment of principal and interest by the United States or that Enterprise, as applicable.

The SEC did not propose an exemption for the Enterprises' security-based credit risk transfer (CRT) transactions. These typically involve the issuance of unguaranteed ABS by a special purpose trust whose performance is linked to the performance of a reference pool of mortgage loans that collateralize Enterprise-guaranteed MBS, and in which the Enterprise and the trust agree that the trust will pay the Enterprise upon the occurrence of certain adverse events with respect to the referenced mortgages. Because the Enterprise would not be a sponsor of its MBS for purposes of the re-proposed rule, these contractual arrangements would not be prohibited with respect to that transaction. However, "because the CRT security is not fully insured or fully guaranteed by an Enterprise, the proposed exclusion . . . would not apply to a CRT security itself . . . . [T]he Enterprises would be 'sponsors' of CRT securities for purposes of the re-proposed rule and [they] would be prohibited from engaging in conflicted transactions . . . with respect to . . . such CRT securities."[15]

Affiliates and Subsidiaries

Finally, the SEC proposed to include affiliates and subsidiaries of underwriters, placement agents, initial purchasers, and sponsors as securitization participants. The SEC noted that it had received comments on the original proposal that including these persons would be unduly burdensome, some of which also suggested that the permitted use of information barriers could mitigate these concerns. The SEC did not propose an exception for affiliates that are walled off by appropriate information barriers because it was

[13] Re-Proposing Release, at 31.

[14] Re-Proposing Release, at 33.

[15] Re-Proposing Release, at 41.

“concerned about the potential to use an affiliate or subsidiary to evade the re-proposed rule’s prohibition,” but it “seek[s] comment . . . on whether an exception utilizing information barriers to exclude affiliates and subsidiaries could be implemented in a way that would be consistent with Section 27B of the Securities Act.[16]

The SEC noted that the requirements of such an exemption could include a number of conditions, such as

- a requirement that the barrier be documented in written policies and procedures that are established, implemented, and enforced by the underwriter, placement agent, initial purchaser, or sponsor;
- a requirement that the underwriter, placement agent, initial purchaser, or sponsor establish, implement, maintain, enforce, and document a written internal control structure governing the foregoing procedures;
- a requirement for an annual, independent assessment of the operation of the required policies and procedures and internal control structure;
- a requirement that there be no overlapping officers or employees (other than clerical, ministerial, or support personnel) with the affiliate or subsidiary, and that the affiliate or subsidiary not be involved in the securitization process; and
- a carve-out from the exemption if the underwriter, initial purchaser, placement agent, or sponsor knows or reasonably should know that, notwithstanding meeting the other conditions of the exemption, the transaction would involve or result in a material conflict of interest.

TIMEFRAME OF PROHIBITION

The prohibition on conflicted transactions would begin on the date a person has reached, or has taken substantial steps to reach, an agreement that they will become a securitization participant, and would end one year after the date of the first closing of the sale of the ABS. While the end point is set forth in the statute, the commencement point is not.[17] The “substantial steps” determination would be based on facts and circumstances, but the SEC gives the example that “a person who has engaged in substantial negotiations over the terms of an engagement letter or other agreement to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS would be subject to the prohibition in the re-proposed rule.”[18]

The SEC notes that even if substantial steps have been taken, unless the transaction closes and ABS are sold to investors, there can be no conflict of interest and the rule would not apply. Further, if the person never reaches an agreement to become a securitization participant, the rule would not apply. Once such an agreement has been reached, the rule would apply retroactively to the date on which substantial steps had been undertaken.

[16] Re-Proposing Release, at 50.

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

[18] Re-Proposing Release, at 57.

CONFLICTED TRANSACTIONS

The re-proposed rule would prohibit any material conflict of interest between a securitization participant and an investor in an ABS during the applicable prohibition period. Engaging in a transaction would involve a material conflict of interest if it were a conflicted transaction.

The first prong of the definition of a "conflicted transaction" would encompass

- a short sale of the relevant ABS;
- the purchase of a credit default swap (CDS) or other derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of a specified adverse event with respect to the ABS; or
- the purchase or sale of any financial instrument (other than the ABS) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated, or potential occurrence of any of the following with respect to the ABS:
  - adverse performance of the asset pool;
  - loss of principal, monetary default, or early amortization event; or
  - decline in the market value.

The first two components "would capture transactions that constitute direct bets against the relevant ABS itself,"[19] and are fairly clear and straightforward.

The third component, which formed the core of the prohibition in the original rule proposal, sweeps much broader. It is intended to capture "events [that] would be adverse to investors in the ABS as [they] would negatively impact the distributions on the relevant ABS and/or its market value"[20]—in other words, any indirect "bet" against the ABS. Effectively, it is a catch-all provision, which the SEC believes "should help alleviate the risk of any attempted evasion of the rule that is premised on the form of the transaction rather than its substance."[21]

There is no exclusion for obligations of securitization participants under the transaction documents: "any transaction that the securitization participant enters into with respect to the creation or sale of such ABS (e.g., a transaction whereby a securitization participant takes the short position in connection with the creation of a synthetic ABS) would need to be analyzed to determine if it would be a 'conflicted transaction' under the re-proposed rule."[22] It would not be necessary for the securitization participant to actually benefit from a conflicted transaction—it need only have an opportunity to benefit to run afoul of the rule.

The second prong of the proposed definition of a "conflicted transaction" requires that there be a substantial likelihood that a reasonable investor would consider the relevant transaction important to the investor's investment decision whether to acquire the asset-backed security, a test that is based on the

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[19] Re-Proposing Release, at 64.

[20] Re-Proposing Release, at 66.

[21] Re-Proposing Release, at 67.

[22] Re-Proposing Release, at 68.

materiality definition in the seminal disclosure case *Basic v. Levinson*.[23] The use of this materiality standard does not mean, however, that a material conflict of interest could be cured by disclosure to investors. Further, "the use of the reasonable investor standard would not imply that a transaction otherwise prohibited by the re-proposed rule would be permitted if an investor selected or approved the assets underlying the ABS."[24]

The re-proposed rule, like the originally proposed rule, would cover conflicted transactions with respect to ABS that are designed to fail, but it is not limited to such transactions because the SEC "believe[s] that such a test could lead to attempts to evade the rule" and "could make enforcement of the rule more difficult."[25]

Among the comments requested by the SEC on the scope of the definition of "conflicted transaction" are

- whether to require some or all securitization participants to have documented policies and procedures in place that are reasonably designed to prevent it from violating the rule; and
- whether to include safe harbors for securitization participants that have no involvement in the structure, design, or assembly of an ABS or the composition of the asset pool, or that rely on the judgment of a "governance specialist" as to whether a transaction is conflicted.

ANTI-CIRCUMVENTION

The re-proposed rule would prohibit a securitization participant from engaging in any transaction that circumvents the rule. "Circumvent" is not defined for this purpose.

The SEC appears to recognize how broad this prohibition would be, asking whether it would "be overinclusive or otherwise result in potential uncertainty as to [its] coverage."[26] It also requested comment on alternative formulations, either containing a "knows or has reason to know" standard, or prohibiting any transaction or series of related transactions as part of a plan or scheme to evade the rule.

EXEMPTIONS

Exemption for Risk-Mitigating Hedging Activities

Consistent with Section 27B(c)(1) of the Securities Act, the re-proposed rule would not apply when a securitization participant engages in certain risk-mitigating hedging activities in connection with its securitization activities. Permitted hedging would include hedging conducted in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization participant arising out of its securitization activities, including the origination or acquisition and warehousing of securitized assets. Hedging would be permitted on an aggregated basis. The issuance of an ABS itself, such as synthetic ABS, would not fall under the exemption.

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[23] *See* Re-Proposing Release, at 71, *citing Basic v. Levinson*, 485 U.S. 224, 231-32 (1988).

[24] Re-Proposing Release, at 73.

[25] Re-Proposing Release, at 74.

[26] Re-Proposing Release, at 84.

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The conditions to the proposed hedging exemption are as follows:

- At inception of the hedging activity and at the time of any adjustments to the hedging activity, the activity must be designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising in connection with and related to identified positions, contracts, or other holdings of the securitization participant arising out of its securitization activities, based upon the facts and circumstances of the identified underlying and hedging positions, contracts, or other holdings and the risks and liquidity thereof.
- The risk-mitigating hedging activity must be subject, as appropriate, to ongoing recalibration to ensure that the activity satisfies the foregoing requirement and does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk reduction.
- The securitization participant must establish, implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure its compliance with the requirements of the exception, including reasonably designed written policies and procedures regarding the risk-mitigating hedging activities that provide for the specific risk and risk-mitigating hedging activity to be identified, documented, and monitored.

The design condition would not permit a securitization participant to "'overhedge' . . . risks in a way that would result in a net short exposure to the relevant ABS."[27] This condition also would not permit hedging an ABS interest that is designed "for the purpose of hedging generalized risks that it believes to exist based on non-position specific modeling or other considerations"[28]—hedging would need to be tied to specific, existing, identifiable exposures. This condition would apply not only at the inception of the hedging activity but also whenever it is subsequently adjusted.

The recalibration condition would not impose any specific time requirement on recalibration, but the securitization participant would have to adjust its hedging any time the risk exposure is reduced "to ensure that it is not 'overhedged' so that the position would not constitute a bet against the relevant ABS."[29]

The SEC believes that the design and calibration conditions "should not unduly disrupt normal course hedging activities that do not present material conflicts of interest with ABS investors and therefore should reduce the compliance burden of the proposed exception."[30] The SEC recognizes that the compliance program condition "may result in certain costs,"[31] but gave this problem short shrift on the basis "that this requirement would promote compliance with the re-proposed rule" and "that it is important for this condition to apply to all securitization participants that seek to rely on this exception given that the focus of Section 27B is investor protection."[32]

The SEC noted that this exemption is similar to the risk-mitigating hedging activities exemption from the proprietary trading restrictions imposed on banking entities by the Volcker Rule, and asked whether there

[27] Re-Proposing Release, at 88.

[28] Re-Proposing Release, at 89.

[29] Re-Proposing Release, at 90.

[30] Re-Proposing Release, at 91.

[31] Re-Proposing Release, at 95.

[32] Re-Proposing Release, at 95.

are securitization participants that are not subject to or familiar with the Volker rule requirement that would be meaningfully disadvantaged. It also asked whether smaller securitization participants should be exempt from certain elements of the compliance program condition, similar to the equivalent exception to the Volcker Rule.

Exemption for Liquidity Commitments

Consistent with Section 27B(c), the re-proposed rule would not apply when a securitization participant engages in purchases or sales of ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the relevant ABS. The commitment would not be required to take the form of a contractual obligation.

Exemption for Bona Fide Market-Making Activities

Consistent with Section 27B(c)(2)(B), there would be an exception for certain bona fide market-making activities conducted by a securitization participant that is licensed or registered to engage in such activities in accordance with applicable law and self-regulatory organization (SRO) rules. This exemption would apply to bona fide market-making activity, including market-making related hedging, conducted in connection with and related to an ABS, the underlying pool assets, or financial instruments that reference such ABS or underlying assets.

There would be five conditions to this exemption:

- The securitization participant must routinely stand ready to purchase and sell one or more types of the relevant financial instruments as a part of its market-making related activities, and be willing and available to quote, purchase, and sell, or otherwise enter into long and short positions in those types of financial instruments, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments.
- The securitization participant's market-making related activities must be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, taking into account the liquidity, maturity, and depth of the market for the relevant types of relevant financial instruments.
- The compensation arrangements of involved persons must be designed not to reward or incentivize conflicted transactions.
- The securitization participant must be licensed or registered to engage in the applicable activity under applicable law and SRO rules.
- The securitization participant must establish, implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure its compliance with the market-making exemption, including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.

The SEC notes that the exemption is based on both the market-making exemption to the proprietary trading restrictions of the Volcker Rule and the definition of "market maker" in the Exchange Act, and believes that the proposed condition is "adapted to the characteristics of the markets involved" by "utiliz[ing] elements of Volcker Rule market-making given the limited liquidity and decreased reliance on

quotation media in parts of the ABS market while adding novel characteristics to accommodate market-making in ABS."[33]

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

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

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

The compliance program condition is designed to ensure that the activities of a securitization participant are indeed bona fide market-making activities, and not the type of transactions that would involve or result in a prohibited conflict of interest between a securitization participant for an ABS and an investor in such ABS.

The SEC believes that a securitization participant's "individual internal compliance program [should] reflect the size, complexity, and activities of the securitization participant."[34] The SEC also "believe[s] it is important that the reasonably designed written policies and procedures demonstrate a process for prompt mitigation of the risks of a securitization participant's positions and holdings that arise from market-making in ABS and the related financial instruments . . . , such as the risks of aged positions and holdings, because doing so would help to prevent a securitization participant from engaging in a transaction and maintaining a position that is adverse to the relevant ABS that remains open and exposed to potential gains for a prolonged period of time."[35] However, the SEC did not attempt to define what is meant by "prompt" mitigation.

The SEC asked if smaller securitization participants should be exempt from certain elements of the compliance program condition, or whether implementation should be delayed for those smaller entities.

[33] Re-Proposing Release, at 105-06.

[34] Re-Proposing Release, at 117-18.

[35] Re-Proposing Release, at 118.

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