

MEMO# 34859

February 6, 2023

SEC Re-Proposes Rule Prohibiting ABS Conflicts of Interest

[34859]

TO: ETF Advisory Committee
Money Market Funds Advisory Committee
SEC Rules Committee RE: SEC Re-Proposes Rule Prohibiting ABS Conflicts of Interest

On January 25, the Securities and Exchange Commission (the SEC or "Commission") re-proposed a rule that was initially proposed in September 2011 (the "2011 Proposal") to implement the prohibition under Section 621 of the Dodd-Frank Act on material conflicts of interest in connection with certain securitizations (the "Re-Proposal").^[1] The Commission notes that the Re-Proposal takes into account developments in the asset-backed security (ABS) market since 2011 and comments received in response to the 2011 Proposal.

Comments on the Re-Proposal are due on March 27, 2023, or 30 days after publication of the Re-Proposal in the Federal Register, whichever is later. ICI anticipates submitting a comment letter on the Re-Proposal and has scheduled a members-only call on Friday, February 10 from 2-3 pm ET to discuss potential comments. If you would like to participate in that call, the Zoom participation information is:

<https://ici-org.zoom.us/j/95090519848?pwd=N1RlOXJUZkdXNEdjMGtKaGVQTQW1wUT09>

Meeting ID: 950 9051 9848

Passcode: 509672

Background

Section 621 of the Dodd-Frank Act added Section 27B to the Securities Act of 1933 ("Securities Act"). Section 27B prohibits an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity of an ABS (as defined in Section 3 of the Securities Exchange Act of 1934 ("Exchange Act")),^[2] including a synthetic ABS, from engaging in a transaction that would involve or result in certain material conflicts of interest.^[3] The prohibition applies both to registered and unregistered offerings of ABS, and applies during the period ending on the date that is one year after the date of the first closing of the sale of the ABS. Section 27B provides exceptions from the prohibition for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making, and directs the SEC to engage in rulemaking to implement the section's prohibition.

Re-Proposed Rule

Consistent with text of Section 27B, proposed rule 192 (the "Re-Proposed Rule")[\[4\]](#) would prohibit a "securitization participant" for a specified time period with respect to an ABS, from engaging in any transaction that would result in a "material conflict of interest" between the securitization participant and an investor in the ABS.[\[5\]](#) Proposed rule 192 would: (1) define the ABS subject to the prohibition (2) expressly define the persons subject to the prohibition; (3) clarify the timeframe of the prohibition; (4) provide that a transaction would present a material conflict of interest if it is a "conflicted transaction;" and (5) provide certain exceptions from the prohibition.

Scope of the Prohibition

Asset-Backed Securities - Consistent with Section 27B, proposed rule 192(c) would expressly define an ABS to have the same meaning as in Section 3 of the Exchange Act, and to include synthetic ABS as well as hybrid cash and synthetic ABS.[\[6\]](#) The Re-Proposal would not define the term "synthetic ABS," as the Commission believes that its previous descriptions of "synthetic securitizations" are well understood by market participants.[\[7\]](#) Like Section 27B, the Re-Proposed Rule would apply to both registered and exempt ABS offerings.

Securitization Participants - The Re-Proposed Rule's prohibition would apply to a "securitization participant," which, consistent with Section 27B, would be defined as (i) an underwriter, placement agent, initial purchaser, or sponsor of an ABS, or (ii) any affiliate or subsidiary of any such entity. As ICI recommended, the Re-Proposed Rule would expressly define some of these terms.[\[8\]](#) The Commission notes that the proposed definitions are based on existing definitions under the federal securities laws and are designed to reflect the functions of these entities in ABS transactions, rather than their titles.

Information Barriers

Notably, the Re-Proposal does not provide for the use of information barriers to prevent overinclusion of affiliates and subsidiaries that should not be treated as securitization participants for purposes of the rule. The Commission explains that it is "concerned about the potential to use an affiliate or subsidiary to evade the re-proposed rule's prohibition." The Commission acknowledges that ICI and other commenters on the 2011 Proposal recommended the use of information barriers to mitigate the Re-Proposed Rule's potential overinclusion of affiliates and subsidiaries of securitization participants.[\[9\]](#) The Re-Proposal asks several questions regarding the use of information barriers, including whether the Commission should include an exception for an affiliate or subsidiary of an underwriter, placement agent, initial purchaser, or sponsor of an ABS if each of the following conditions is satisfied:[\[10\]](#)

- the underwriter, placement agent, initial purchaser, or sponsor of the ABS establishes, implements, maintains, enforces, and documents written policies and procedures to prevent the flow of information to and from the affiliate or subsidiary that might result in a violation of the Re-Proposed Rule;
- the underwriter, placement agent, initial purchaser, or sponsor of the ABS establishes, implements, maintains, enforces, and documents a written internal control structure governing the implementation of, and adherence to, the written policies and procedures;
- the underwriter, placement agent, initial purchaser, or sponsor of the ABS obtains an annual, independent assessment of the operation of such policies and procedures and

internal control structure;

- the affiliate or subsidiary has no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) in common with the underwriter, placement agent, initial purchaser, or sponsor of the ABS, and was not involved in the creation or distribution of, or otherwise involved in providing services with respect to, the related ABS; and
- a person may not rely on the exception if, in the case of any specific securitization, the person knows or reasonably should know that notwithstanding satisfying the conditions, a transaction would involve or result in a material conflict of interest.

Timeframe of Prohibition

The proposed timeframe for the prohibition on conflicted transactions would (i) begin on the date on which a person has reached, or has taken substantial steps to reach, an agreement to become a securitization participant ("commencement point"), and (ii) end one year after the date of the first closing of the sale of the relevant ABS.[\[11\]](#) The end point for the covered timeframe incorporates the language of Section 27B. Under the Re-Proposed Rule, whether a person has taken substantial steps to reach an agreement to become a securitization participant would be a facts and circumstances determination.

The Commission requests comment on the covered timeframe, including on the implications of the commencement point on affiliates and subsidiaries of a person seeking to become a securitization participant. For instance, the Commission asks how the affiliate or subsidiary would know that the person had taken substantial steps to reach an agreement to become a securitization participant, such that a conflicted transaction entered into by the affiliate or subsidiary would be prohibited by the Re-Proposed Rule if the person ultimately reaches an agreement to become a securitization participant?[\[12\]](#)

Prohibited Conduct and Anti-Circumvention Provision

The Re-Proposed Rule would prohibit a securitization participant from engaging in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor if such a transaction is a "conflicted transaction."[\[13\]](#) Proposed Rule 192(a)(3) would define a conflicted transaction as one (i) with respect to which there is a substantial likelihood that a reasonable investor would consider it important to the investor's investment decision, including a decision whether to retain the ABS ("the materiality component"), and (ii) such transaction is:

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

The Commission notes that the proposed definition of "conflicted transaction"[\[14\]](#) is limited

in scope to transactions that are effectively a bet against the relevant ABS or its underlying pool of assets, so the Re-Proposed Rule would not apply to transactions that are wholly independent of the relevant ABS. The Commission likewise states that the prohibition would apply regardless of whether a conflicted transaction is disclosed to investors in the ABS. The Commission requests comment on the scope of prohibited activity under the Re-Proposed Rule, including the impact of the proposed definition of "conflicted transaction" on entities with multiple affiliates or subsidiaries.[\[15\]](#)

Anti-Circumvention - Proposed Rule 192(d) would provide that, if a securitization participant engages in a transaction that circumvents the prohibition in proposed Rule 192(a)(1), the transaction would be deemed to violate such prohibition. The Commission requests comment on this anti-circumvention provision, including whether it would be overinclusive or otherwise result in uncertainty about the transactions covered by the Re-Proposed Rule's prohibition.[\[16\]](#)

Exceptions

Consistent with Section 27B, the Proposed Rule would provide exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making. The Commission notes that the proposed exceptions would focus on distinguishing the characteristics of such activities from speculative trading. The proposed exceptions are intended to avoid disrupting current liquidity commitment, market-making, and balance sheet management activities that the Commission does not believe would give rise to the risks that Section 27B was intended to address.

Risk-Mitigating Hedging Activities - This exception would apply when a securitization participant engages, subject to certain conditions, in risk-mitigating hedging activities in connection with its securitization activities.[\[17\]](#) Risk-mitigating hedging activities permitted under the Re-Proposed Rule would include hedging in connection with and related to individual or aggregate positions, contracts, or other holdings of the securitization participant.[\[18\]](#) The Re-Proposed Rule lists the conditions for a securitization participant to qualify for this exception, which include (i) specific risk identification and calibration requirements; and (ii) a compliance program requirement.[\[19\]](#)

Liquidity Commitments - Similar to the 2011 Proposal, this exception tracks the language of Section 27B and would permit securitization participants and their affiliates to provide liquidity pursuant to a liquidity commitment. The Re-Proposal does not implement ICI's recommendations to include in the exception those liquidity arrangements that are typical for asset-backed commercial paper (ACBP) programs and to specify in the rule that liquidity may be provided through means other than just purchases and sales of an ABS. The Commission states that expanding this exception to accommodate such activities should not be necessary, as the proposed definition of "conflicted transaction" focuses on transactions that constitute a bet against the relevant ABS and would not cover activity such as a securitization participant's extension of credit to support the performance of the ABS rather than to benefit from its adverse performance.[\[20\]](#)

Bona Fide Market-Making Activities - This exception would permit a securitization participant to engage in certain bona fide market-making activities subject to five specified conditions included in the Re-Proposed Rule.[\[21\]](#) The Commission notes that the proposed conditions draw from the concept of market-making in the Volker Rule and the definition of "market maker" under the Exchange Act, and are intended to account for and accommodate the unique characteristics of market-making in the ABS market.[\[22\]](#)

The Commission requests comments on all the proposed exceptions.^[23] Notably, this includes seeking comment on whether the exception for liquidity commitments should apply to activity other than purchases and sales of the ABS, such as a commitment to provide loans pursuant to a liquidity facility.^[24]

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Notes

^[1] Prohibition Against Conflicts of Interest in Certain Securitizations, Securities Act Release No. 33-11151 (Jan. 26, 2023) ("Proposing Release"), available at <https://www.sec.gov/rules/proposed/2023/33-11151.pdf>. For a summary of the 2011 Proposal and ICI's comment letter on the 2011 Proposal, please see ICI Memorandum No. 25549 and Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC (Feb. 13, 2012) ("ICI Letter"), available at <https://www.sec.gov/comments/s7-38-11/s73811-27.pdf>.

^[2] The definition of an ABS for purposes of the re-proposed rule would be the same as under Section 3(a)(79) of the Exchange Act, which is broader than the definition of an ABS under Regulation AB under the Securities Act.

^[3] See Section 27B of the Securities Act.

^[4] In the 2011 Proposal, the proposed rule was designated as rule 127B.

^[5] Proposed Rule 192(a)(1).

^[6] The 2011 Proposal provided a similar definition of an ABS in the release, rather than on the rule text. In the ICI Letter, ICI recommended that the Commission clarify that securities issued by registered investment companies would not be treated as ABS under the rule; however, the Re-Proposal does not address this recommendation.

^[7] See Proposing Release at 14 (citing Asset-Backed Securities, Release No. 33-8518 (Dec. 22, 2004), 70 Fed. Reg. 1506, 1513-1515 (Jan. 7, 2005) ("2004 Regulation AB Adopting Release"), available at <https://www.govinfo.gov/content/pkg/FR-2005-01-07/pdf/05-53.pdf>.

^[8] In contrast to the 2011 Proposal, Proposed Rule 192(c) would expressly define the terms "placement agent," "underwriter," "initial purchaser," and "sponsor." Notably, the Commission proposes to define "initial purchaser," consistent with the Commission's prior use of the term, 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." This is consistent with ICI's recommendation. See Proposing Release at 23-24, n. 55.

^[9] ICI specifically recommended the use of an information barriers regime with respect to

investment companies and investment advisers that are affiliates or subsidiaries of securitization participants.

[10] See Proposing Release at 52-56, Questions 30, 32-33, 36.

[11] The prohibition under the 2011 Proposal would have applied at any time during the period prior to one year after the date of the first closing of the sale of the ABS.

[12] See Proposing Release at 60-62, Question 42.

[13] This contrasts with the 2011 Proposal, which did not propose to define the term "material conflict of interest" in the rule text, but rather proposed an interpretation of the term in the release. The Re-Proposal does not address ICI's recommendation in the ICI Letter that the Commission clarify that covered conflicts of interest should exclude those potential conflicts arising from actions taken by a registered investment company, through its investment adviser in a fiduciary capacity, in connection with investing in an ABS.

[14] In a change from the 2011 Proposal, the Re-Proposed Rule would not define a conflicted transaction to include a situation in which a securitization participant would benefit directly or indirectly (e.g., from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration) from allowing a third party to structure the relevant ABS or select assets underlying the ABS in a way that creates an opportunity for that third party to benefit from a short transaction. Instead, the Commission seeks to address such possible conflicts by proposing to define the term "sponsor" in a manner such that the Re-Proposed Rule's prohibition would apply directly to most of the parties whose conduct would have been covered by the 2011 Proposal.

[15] See Proposing Release at 75-82, Questions 52, 59, 61.

[16] See Proposing Release at 83-84, Question 66.

[17] Proposed Rule 192(b)(1). In contrast, this exception in the 2011 Proposal used the same language as Section 27B and did not include any conditions for a securitization participant to rely on the exception.

[18] The Re-Proposal states, however, that this standard would not modify the requirements applicable to a securitization participant pursuant to Regulation RR. The Commission also notes that this proposed exception would allow for the relevant hedging activity to be done on an aggregated basis and would not require that the exempt hedging be conducted on a trade-by-trade basis.

[19] See Proposing Release at 87-96 and Proposed Rule 192(b)(1)(ii). The Commission notes that certain of the proposed conditions to the risk-mitigating hedging activities exception are similar to those under the equivalent exception to the Volcker Rule's proprietary trading prohibition. See 17 CFR 255.5; Proposing Release at 98.

[20] See Proposing Release at 101-102. ICI's comments on the 2011 Proposal also expressed concern about how the proposed exception for liquidity commitments would relate to the potential application of certain restrictions under the Volcker Rule Proposal. We note, however, that the Final Volcker Rule contains an exclusion from the definition of "covered fund" for ABCP programs. See ICI Memorandum No. 27804 (Dec. 20, 2013), available at <https://www.ici.org/memo27804>.

[\[21\]](#) Proposing Release at 104-120 and Proposed Rule 192(b)(3). In contrast, this exception in the 2011 Proposal closely tracked the language of Section 27B, and the Commission enumerated eight principles that it believed were characteristics of bona fide market-making in ABS but did not include them as conditions in the proposed rule text.

[\[22\]](#) The Re-Proposal clarifies that activity that would be bona fide market-making activity under the proposed exception may not necessarily be market-making for purposes of other laws or regulations, including the Volcker Rule, other provisions of the Exchange Act, or the rules and regulations thereunder.

[\[23\]](#) See Proposing Release at 96-101, 103-104, 120-125, Questions 75, 80, 81, 93.

[\[24\]](#) See Proposing Release at 103, Question 83.