The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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SEC Adopts Rule Prohibiting ABS Conflicts of Interest

[35541]

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TO: ETF Advisory Committee
Investment Advisers Committee
Money Market Funds Advisory Committee
SEC Rules Committee SUBJECTS: Bank Regulation
Compensation/Remuneration
Compliance
Fixed Income Securities
Investment Advisers
Money Market Funds
Trading and Markets RE: SEC Adopts Rule Prohibiting ABS Conflicts of Interest

On November 27, 2023, the Securities and Exchange Commission (SEC or "Commission"), on a 4-1 vote by seriatim, adopted Rule 192 ("Final Rule") under the Securities Act of 1933 ("Securities Act"), which implements the prohibition under Section 621 of the Dodd-Frank Act on material conflicts of interest in connection with certain securitizations.[1] The Final Rule, which is summarized below, includes several significant changes from the Proposed Rule. We were pleased that the Final Rule reflects ICI's comments and addresses members' key concerns.[2]

Consistent with text of Section 27B and the Proposed Rule, the Final Rule prohibits a "securitization participant" for a specified time period with respect to an asset-backed security (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. The Final Rule: (1) defines the

ABS subject to the prohibition; (2) defines the persons subject to the prohibition; (3)

defines the scope of the prohibition itself; (4) clarifies the timeframe of the prohibition; (5) provides certain exceptions from the prohibition; and (6) addresses evasion of the exceptions. The changes in the Final Rule generally are intended to address operational challenges commenters, including ICI, raised with the Proposed Rule, and clarify and narrow certain aspects of the Final Rule to provide greater certainty for market participants.

Scope of ABS Subject to the Final Rule

The Final Rule defines an "asset-backed security," for purposes of the rule, to mean an ABS as defined in the Securities Exchange Act of 1934 ("Exchange Act"), a synthetic ABS, and hybrid cash and synthetic ABS. As proposed, ABS subject to the Final Rule include both registered and privately offered ABS. The definition of asset-backed security adopted in the Final Rule does not change the Exchange Act definition of ABS, nor does it affect existing Commission guidance or staff positions regarding that definition. The Adopting Release provides guidance regarding synthetic ABS, noting that the Commission generally views "a synthetic ABS to be 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."[3] Further, the Adopting Release clarifies that mortgage insurance-linked notes (MILNs) are not synthetic ABS under the Final Rule and that the reinsurance agreements embedded in the MILN transactions are not "conflicted transactions" under the Final Rule. Similarly, the Adopting Release confirms that synthetic ABS for purposes of the Final Rule do not include equity-linked or commodity-linked products, corporate debt obligations or security-based swaps.

The Commission addresses the cross-border application of the Final Rule, explaining that, if there are ABS sales in the United States to investors, the prohibitions under the Final Rule apply, even if a securitization participant seeks to engage in transactions prohibited by the rule exclusively overseas or if the securitization participant itself is a non-US entity. The Commission, however, recognizes the need for market clarity regarding the cross-border applicability of the Final Rule and includes an explicit safe harbor to address commenter concerns regarding this issue. The foreign transaction safe harbor in the Final Rule therefore provides that the rule's prohibitions will not apply to an ABS if it is not issued by a US person (as that term is defined in Regulation S under the Securities Act) and the offer and sale of such ABS is in compliance with Regulation S.

Scope of "Securitization Participant"

Consistent with Section 27B of the Dodd-Frank Act, the Commission had proposed that the prohibition in Rule 192 would apply to transactions entered into by an underwriter, placement agent, initial purchaser, or sponsor of a covered ABS, as well as any of their affiliates or subsidiaries, each of which would be a "securitization participant" as defined in Rule 192(c). The Commission included definitions in the Proposed Rule for each of these terms. In the Final Rule, the Commission adopts the definitions of "underwriter," "placement agent," "initial purchaser," and "distribution"[4] as proposed.

Sponsor of a Covered ABS

The Commission revises the proposed definition of "sponsor" to address concerns of ICI and other commenters regarding the scope of the definition with respect to a person who acts solely pursuant to such person's contractual rights as a holder of a long position in an ABS, such as a registered fund. The Commission re-affirms its intent that an ABS investor that does not otherwise meet the definition of a "securitization participant" would not be a sponsor under the Final Rule "merely because such investor expresses its preferences regarding the assets that would collateralize its ABS investment."[5] The Commission also states that the Final Rule is not intended to discourage ABS investors from exercising their contractual rights as holders of long positions in ABS.

Relatedly, in response to comments of ICI and others, the Commission declines to adopt

proposed paragraph (ii)(B) of the "sponsor" definition, which would have treated as a sponsor any person that 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. The Commission agrees that active negotiations by long investors regarding deal structures and underlying asset pools are important and beneficial, and should not, absent additional activity, cause an investor to be treated as a sponsor for purposes of the Final Rule. The SEC explains that, whether a long investor is acting "solely" pursuant to its contractual rights as a holder of a long position in the relevant ABS will depend on the relevant facts and circumstances, including what other roles the long investor may have in the transaction. The Commission provides, as an example, a holder of "B-piece" bonds (the "B-piece buyer") in commercial mortgage backed securities (CMBS) transactions, stating that "[w]hether a B-piece buyer in a CMBS transaction is a 'sponsor' for purposes of Rule 192 or satisfies the condition of the exclusion for Long-only Investors will depend on the facts and circumstances of a given transaction and B-piece buyer."[6]

The Commission addresses concerns that were raised by commenters regarding uncertainty about the Proposed Rule's treatment of credit risk transfer (CRT) transactions by Fannie Mae and Freddie Mac (together, "Enterprises") by removing the specific exclusion from the definition of "sponsor" in the Proposed Rule for the Enterprises while they are operating under the conservatorship or receivership of the Federal Housing Finance Agency with capital support from the United States and, instead, addressing treatment of CRTs through the risk-mitigating hedging exception described below.

In response to comments, the Commission excludes from the definition of "sponsor" a person's administrative and ministerial activities related to the ongoing administration of an ABS.

In addition, as proposed, the Final Rule excludes from the definition of "sponsor" the United States or an agency of the United States with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by the United States.

Affiliate or Subsidiary of an ABS Underwriter, Placement Agent, Initial Purchaser, or Sponsor

ICI and other commenters had raised significant concerns regarding the Commission's overly broad approach in the Proposed Rule of affiliates and subsidiaries, which would have included affiliates and subsidiaries of entities that engage in securitization transactions, when such affiliates and subsidiaries are not involved in those securitizations and have no knowledge of them. ICI was particularly concerned about advisers and registered funds that are part of a multi-service financial firm and would have been prohibited under the Proposed Rule from investing in ABS in the ordinary course of business. The Proposed Rule also would not have recognized the use of information barriers that would prevent the types of conflicts Rule 192 seeks to address. ICI explained that an information barriers exception would prevent the enormous and unwarranted compliance burden that such affiliates and subsidiaries would face if any final rule does not reflect current practices and account for the separation between a securitization participant's activities and the independent activities of its affiliates and subsidiaries that are not involved in structuring or distributing of ABS.[7]

The Commission was persuaded by these concerns. In the Final Rule, the Commission narrows the definition of "securitization participant" to limit it to any affiliate or subsidiary (each, as defined in Rule 405 under the Securities Act), if the affiliate or subsidiary: (A) acts

in coordination with an ABS underwriter, placement agent initial purchaser, or sponsor; or (B) has access to or receives information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS prior to the first closing of the sale of the ABS. The Commission explains that, by revising the definition of "securitization participant" in this way, the Final Rule "aims to capture the range of affiliates and subsidiaries with the opportunity and incentive to engage in conflicted transactions without frustrating market participants' ability to meet their obligations under other Federal- and State-level laws that require the use of information barriers or other such firewalls."[8] The Commission explains that this approach is consistent with commenters' recommendations, including those that suggested that affiliates or subsidiaries should only be subject to the prohibition if they have direct involvement in, or access to information about, the relevant ABS and that those that suggested that the Final Rule permit securitization participants to demonstrate lack of involvement or control through the presence and effectiveness of information barriers. The Adopting Release notes, however, that any preventative measures put into place must effectively prevent the affiliate or subsidiary from "acting in coordination with the named securitization participant or from accessing information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS."[9]

Prohibited Activities Under the Final Rule

Consistent with the Proposed Rule, the Final Rule provides that a securitization participant shall not, for a specified period of time, directly or indirectly engage in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor in the ABS. Additional elements of the Final Rule were adopted as proposed, including the description of what constitutes a transaction involving or resulting in a material conflict of interest, and the prohibition against short-selling or purchasing a credit default swap or other credit derivative that entitles the securitization participant to receive payments upon the occurrence of specified credit events in respect of the ABS. In response to comments, the scope of Final Rule 192(a)(3)(iii) was narrowed to cover the purchase or sale of any financial instrument (other than the relevant ABS) or entry into a transaction that is substantially the economic equivalent of a short sale or credit default swap against an ABS, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk.

ICI had requested that the Commission clarify that funds' and advisers' ordinary course hedging activities through ABS indices would not be treated as conflicted transactions under the Final Rule.[10] In a discussion in the Adopting Release of CDS index-based hedging strategies where the relevant ABS only represents a minimal component of the index, the Commission notes that "whether or not a transaction with respect to such index is a conflicted transaction under the Final Rule will be a facts and circumstances determination based on the composition and characteristics of the relevant index."[11] The Commission further states that securitization participants "will need to determine if a short position with respect to such index is substantially the economic equivalent of a short sale of the relevant ABS itself or a CDS or credit derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of specified credit events in respect of the relevant ABS."[12] The Final Rule permits any transaction that only hedges general interest rate or currency exchange risk.

Clarification of the Prohibition Timeframe

Under the Final Rule, the prohibition against entering into conflicted transactions will commence on the date on which a person has reached an agreement to become a securitization participant with respect to an ABS and will end one year after the date of the

first closing of the sale of the relevant ABS. For purposes of the Final Rule, "agreement" refers to an agreement in principle (including oral agreements and facts and circumstances constituting an agreement) as to the material terms of the arrangement by which such person will become a securitization participant. As indicated in the Adopting Release, an executed written agreement is not required, and if the subject ABS is never sold to investors, the prohibition will not apply.

Exceptions from the Prohibition

The Final Rule, as required by Section 27B of the Dodd-Frank Act, includes exceptions for risk-mitigating hedging, liquidity commitments, and bona fide market-making activities. These exceptions were adopted largely as proposed, but with some changes in response to comments.

Risk-Mitigating Hedging Activities

Subject to conditions, the Final Rule provides an exception for risk-mitigating hedging activities of a securitization participant in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization participant, including those arising out of its securitization activities, such as the origination or acquisition of assets that it securitizes. In a change from the Proposed Rule, the initial issuance of a synthetic ABS will be eligible for the risk-mitigating hedging activities exception. In another change from the Proposed Rule, the risk-mitigating hedging activities exception in the Final Rule applies to the risk-mitigating hedging activities of a securitization participant in connection with and related to individual or aggregated positions, contracts or other holdings of the securitization participant, including those arising out of its securitization activities.

The Final Rule includes as conditions to the risk-mitigating hedging activities exception requirements that: (i) the risk-mitigating hedging activity is designed to reduce one or more specific, identifiable risks; (ii) the risk-mitigating hedging activity is subject to ongoing recalibration that the hedging activity satisfies the requirements of the exception and does not facilitate or create an opportunity to materially benefit from a conflicted transaction; and (iii) the securitization participant has an internal compliance program that is reasonably designed to ensure the securitization participant's compliance with the requirements of the exception.

Although some commenters had requested that the risk-mitigating hedging activities exception explicitly address the ability to hedge with respect to the underlying assets of a tender offer bond (TOB) trust, the Commission declines to provide a special exception for TOBs. The Commission explains that an explicit exception for TOBs is not necessary because the risk-mitigating hedging activities exception generally allows for the risk-mitigating hedging activities of a securitization participant in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization participant, including those arising out of its securitization activities. To the extent that the hedging activity of a securitization participant in connection with a TOB satisfies the conditions applicable to the exception, then such hedging activity will be treated as permitted risk-mitigating hedging activity for purposes of the Final Rule.

The Commission also confirms that Fannie Mae and Freddie Mac are sponsors under the Final Rule with respect to any ABS they issue, whether or not it is fully guaranteed. The Adopting Release notes that treating these entities as sponsors and permitting credit risk transfer transactions so long as they meet the conditions enumerated in the risk-mitigating

hedging exception would provide certainty for these entities and the market. The Commission notes that, as sponsors—and, thus, securitization participants—subject to the prohibition in the Final Rule against engaging in conflicted transactions, these entities are subject to the same limitations on such behavior as private market participants.

Liquidity Commitments

Adopted as proposed, purchases or sales of the relevant ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for such ABS are not prohibited by the Final Rule.

Bona Fide Market-Making Activities

Adopted largely as proposed, the Final Rule provides an exception for bona fide market-making activities, including market-making related hedging, of a securitization participant conducted in connection with and related to ABS with respect to which the prohibition applies, the assets underlying such ABS, or financial instruments that reference such ABS or underlying assets or with respect to which the prohibition applies. However, the initial distribution of an ABS is not bona fide market-making activity for purposes of the Final Rule.

Anti-Evasion Provision

In a change from the Proposed Rule, which included an anti-circumvention provision, the Final Rule includes an anti-evasion provision that will apply only if an exception is used as part of a plan or scheme to evade the Final Rule's prohibitions. Specifically, the Final Rule provides that if a securitization participant engages in a transaction or a series of related transactions that, although in technical compliance with one of the exceptions included in the Final Rule, is part of a plan or scheme to evade the rule's prohibitions, that transaction or series of related transactions will be deemed to violate the Final Rule. The Commission notes that the Final Rule's prohibitions include certain provisions designed to prevent attempted evasion. The Commission was persuaded that an anti-circumvention provision could have the potential to be both overinclusive and vague, and that an anti-evasion standard that focuses on the actions of the securitization participants as part of scheme to evade the rule's prohibition would be more appropriate.

The Commission explains that the anti-evasion provision is designed to address those situations in which securitization participants engage in efforts to evade the Final Rule's prohibition by claiming technical compliance with one of the exceptions to the Final Rule when, in fact, such securitization participant's conduct constitutes part of a plan or scheme to evade the Final Rule's prohibitions.

Compliance Dates

The Final Rule is effective February 5, 2024. A securitization participant must comply with the prohibitions and the requirements of the exceptions to the Final Rule, as applicable, with respect to any ABS the first closing of the sale of which occurs on or after June 9, 2025.

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Notes

[1] See Prohibition Against Conflicts of Interest in Certain Securitizations, Securities Act Rel. No. 33-11254, 88 Fed. Reg. 85396 (Dec. 7, 2023) ("Adopting Release"). For statements on the Final Rule, please see Chair Gensler's Statement, Commissioner Peirce's Statement (Commissioner Peirce dissented), Commissioner Uyeda's Statement, and Commissioner Lizárraga's Statement. For a summary of the proposed rule ("Proposed Rule"), which was a re-proposal of a rule the SEC initially had proposed in 2011, please see ICI Memorandum No. 34859 (Feb. 6, 2023), available at https://www.ici.org/memo34859.

[2] For a summary of, and a link to, ICI's comment letter, please see ICI Memorandum No. 35217 (Mar. 27, 2023), available at https://www.ici.org/memo35217.

[3] Adopting Release at 85402.

[4] The definition of "distribution" is relevant to the definition of "placement agent" and "underwriter." See Rule 192(c).

[5] Adopting Release at 85407.

[6] Adopting Release at 85409. The Commission further stated that "if the B-piece buyer exercises such rights solely pursuant to its contractual rights as a holder of a long position in the ABS, then the B-piece buyer will satisfy the conditions for the Long-only Investor carve-out from the definition of Contractual Rights Sponsor as adopted and, therefore, will not be subject to the prohibition in [the Final Rule]."

[7] See Letter from Sarah Bessin, Deputy General Counsel, ICI, to Vanessa Countryman, Secretary, Securities and Exchange Commission (Mar. 27, 2023) at 8, available at https://www.sec.gov/comments/s7-01-23/s70123-20161728-330619.pdf ("ICI Letter").

[8] Adopting Release at 85417.

[9] Id.

[10] ICI Letter at 6.

[11] Adopting Release at 85424.

[12] Id.