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SEC Adopts New Rule Prohibiting Conflicts of Interest in Certain Securitizations

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Following the financial crisis of 2007-2009 and Congressional investigations into the securitization market, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 prohibited securitization participants from engaging in any transaction that would result in a material conflict of interest with investors in the securitization. On November 27, 2023, the Securities and Exchange Commission (the "SEC") adopted a new rule under the Securities and Exchange Act (the "Exchange Act"), Rule 192, prohibiting conflicts of interest in certain securitization transactions. Rule 192 is intended to prohibit securitization participants from entering into transactions that bet against the securitization or could incentivize the participant to structure an asset-backed security ("ABS") in a way that would put the participant's interest ahead of those of investors. The rule is designed to protect investors and the integrity of the ABS markets by limiting the information asymmetry and therefore the ability of securitization participants to exploit such information at the expense of ABS investors.

What is Prohibited?

The new rule prohibits any transaction that would involve or result in any material conflict of interest between the securitization participant (defined below) and an investor in the relevant ABS if there is a reasonable likelihood that a reasonable investor would consider the securitization participant's transaction important to the investor's decision to purchase or retain the relevant ABS. Conflicted transactions include short sales of the relevant ABS, credit default swaps or other credit derivatives that entitle the securitization participant to receive payments upon the occurrence of specified credit events concerning the ABS or any transaction that is substantially the economic equivalent of the aforementioned transactions. The rule prohibits such conflicted transactions for a period beginning on the date on which a person has agreed to become a securitization participant with respect to the ABS and ending on the date one year after the date of the first closing of the sale of the ABS in question. The rule applies to all ABS within the meaning of Section 3 of the Exchange Act, as well as synthetic ABS and hybrid cash and synthetic ABS.

Whom Does the New Rule Apply to?

Underwriters, placement agents, initial purchasers and sponsors of an ABS (each a "securitization participant") are prohibited from entering into conflicted transactions for a period beginning on the date on which such person has agreed to become a securitization participant with respect to the ABS and ending on the date one year after the date of the first closing of the sale of the relevant ABS. For purposes of the new rule, "securitization participant" also includes any affiliate or subsidiary of a securitization participant who acts in coordination with the securitization participant or has access to, or receives information about, the relevant ABS prior to the first closing.

Are There Any Exceptions?

The rule expressly states that any transactions that only hedge general interest rate or currency exchange risk with respect to the ABS are not considered "conflicted transactions" for purposes of the rule. The rule also provides exceptions for:

- *Risk-Mitigating Hedging Activities* - Risk-mitigating hedging activities that, based upon the specific facts and circumstances, mitigate specific, identifiable risks that are periodically reassessed.
- *Liquidity Commitments* – Purchases or sales of the ABS made pursuant to commitments of the securitization participant to provide liquidity for the relevant

ABS.

- *Bona Fide Market-Making Activities* – Bona fide market-making activities (including market-making related hedging) that are designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of market participants, taking into account the liquidity and depth of the market for the relevant ABS. Market-makers relying on this exception must ensure that their compensation arrangements do not incentivize employees to enter into conflicted transactions.

If a securitization participant will be entering into a transaction in reliance on the risk-mitigating hedging or bona fide market-making activities exceptions, the securitization participant must establish and enforce internal compliance programs to ensure the securitization participant complies with the requirements of the exception.

Does the Rule Apply to Foreign ABS?

With respect to the cross-border application of the rule, the SEC is taking a territorial approach consistent with other provisions of securities laws. Consistent with that approach, the new rule would apply to any ABS sold in the U.S. To provide certainty to market participants, the SEC included a safe harbor for ABS not issued by a U.S. person (as defined in Rule 902 of Regulation S), so long as the offer and sale of the ABS are in compliance with Regulation S.

When Does the Rule Become Effective?

Rule 192 will become effective 60 days after the publication in the Federal Register. Securitization participants will need to comply with the new rule with respect to any ABS the first closing of the sale of which occurs 18 months after the effective date.

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