

Under The Hood Of The SEC Securitization Conflict Rule

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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 Nov. 27, 2023 — over 13 years after inclusion in the Dodd-Frank Act and 12 years after an earlier version of the rule was first proposed — the U.S. Securities and Exchange Commission adopted the securitization conflict rule under the Securities and Exchange Act, Rule 192.

The securitization conflict rule prohibits conflicts of interest in certain securitization transactions. It 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, or ABS, in a way that would put the participant's interest ahead of those of investors.

The securitization conflict 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.

The SEC received more than 900 comment letters on the initial rule proposed on Jan. 25, 2023, from market participants, institutional investors, issuers, professional associations, policy associations, trade associations, members of Congress, former federal government officials and academics.

The securitization conflict 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 and 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.

Some comments on the proposed rule expressed disagreement with the proposed definition of "conflicted transaction," claiming the term was overly broad and would capture too wide a range of activities that are necessary for the functioning and issuance of ABS markets and the risk management of securitization participants.

Others requested that the definition of "conflicted transaction" include an intent or knowledge requirement to narrow both the scope of a conflicted transaction and the application of the rule.

The SEC declined on both points, noting that narrowing the scope of "conflicted transactions" was inappropriate, as the statutory text explicitly prohibits material conflicts of interest in ABS transactions.

The statutory language does not require that an ABS transaction be intentionally designed to fail or that a securitization participant intends to profit to the detriment of investors.

The SEC further stated that the proposed definition of "conflicted transaction" is necessary to prevent the resurgence of the types of transactions that were so prevalent in the years leading up to the financial crisis of 2007-2009.

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 securitization conflict 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.

Many comments on the proposed rule requested a specific definition of "synthetic asset-backed security" and "hybrid cash and synthetic asset-backed security."

But because of the wide variation of definitions that were suggested, the SEC declined to adopt any one of these definitions. Instead, the SEC determined that a synthetic asset-backed security can be viewed as a fixed income or security issued by a special purpose entity.

This SEC determination allows the security holder to receive payments that depend principally on the performance of either a reference self-liquidating financial asset or a reference pool of self-liquidating financial assets.

Other comments asked for clarification about whether the securitization conflict rule applies to synthetic transactions not traditionally considered synthetic securitizations, specifically mortgage insurance-linked notes.

Because of this uncertainty, the SEC specifically states in the discussion of the final rule that mortgage insurance-linked notes do not meet the definition of ABS under the Exchange Act and therefore are not synthetic ABS subject to the securitization conflict rule.

Securitization participants are defined to include underwriters, placement agents, initial purchasers and sponsors of an ABS — each one a securitization participant.

For purposes of the new rule, securitization participants also include any affiliate or subsidiary of a securitization participant who either acts in coordination with the securitization participant, or has access to, or receives information about, the relevant ABS prior to the first closing.

Many commenters requested a more limited definition of "underwriter," "placement agent" and "initial purchaser" to apply only to those who are directly involved in structuring or selecting the assets underlying the ABS.

Underwriters, placement agents and initial purchasers are involved in issuing ABS to different degrees. However, the SEC declined to limit these definitions, because these categories of people are privy to information about the ABS or underlying assets that outsiders do not necessarily have access to, creating an asymmetry in information.

The proposed definition of "sponsor" was based on the definition of sponsor in Regulation AB, and also includes any person who directs the ABS or the composition of the pool of assets underlying such ABS or who has the right to do so contractually.

Some comments expressed apprehension that the proposed definition of "sponsor" might capture market participants that Congress did not intend to include and so requested that the rule allow use of information barriers to address these issues.

The SEC addressed these comments by making a few changes to the definition of "sponsor." First, the SEC did not adopt the proposed prong of the "sponsor" definition that would have captured any person directing or causing the direction of the ABS.

The SEC stated that this decision was made because the securitization conflict rule is not intended to discourage ABS investors from exercising their rights, nor is it meant to be overly broad.

People who act solely pursuant to their contractual rights as holders of a long position in the relevant ABS are now excluded from the definition of sponsor. The text was also altered to exclude those who perform only administrative, legal, due diligence, custodial or ministerial activities related to the ABS.

The SEC heeded comments and ruled to allow affiliates and subsidiaries covered by the rule to employ mechanisms, such as information barriers to prevent the sharing of information tailored to their organization. It is important to note, however, that a securitization participant cannot use information barriers to allow its own employees to enter into "conflicted transactions," even those not involved in structuring or managing the ABS.

The securitization conflict 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.

Exceptions to the Rule

Risk-Mitigating Hedging Activities

One exception to the rule: risk-mitigating hedging activities that, based upon the specific facts and circumstances, mitigate specific, identifiable risks that are periodically reassessed. Securitization participants relying on this exception must have internal compliance programs reasonably designed to monitor compliance.

The SEC rejected comments suggesting the compliance program requirement is unnecessarily burdensome given the rules focus on investor protection. In response to comments on the proposed rule, the securitization conflict rule provides that the initial issuance of a synthetic ABS may be eligible for this exception.

The securitization conflict rule also permits securitization participants to hedge exposure related to origination and warehousing of ABS assets prior to issuance. Hedges are not required to be done on a trade-by-trade basis and exact negative correlation is not required.

Hedging on a portfolio basis without identifying specific risks was rejected by the SEC as this could lead to overhedging and establishing speculative positions.

In response to comments on the proposed rule, the SEC clarified that affiliates and subsidiaries of securitization participants are not restricted from hedging exposures that may have been acquired in the ordinary course of business and unrelated to the securitization activities of the securitization participant.

Liquidity Commitments

A second exception: purchases or sales of the ABS made pursuant to commitments of the securitization participant to provide liquidity for the relevant ABS.

One commenter notably raised concerns about "dollar roll transactions" — a form of short-term financing similar to repurchase agreements — requesting that the commission confirm that these dollar roll transactions would fall within the liquidity commitments exception, since dollar rolls often only require that a similar security be returned to the seller.

In response to this comment, the SEC stated that, to the extent that the purchase and sales of the relevant ABS in a dollar roll transaction are consistent with a commitment of the securitization participant to provide liquidity for the relevant ABS, then such dollar roll transactions will be eligible for the liquidity commitment exception.

Bona Fide Market-Making Activities

Another exception: 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 establish and enforce internal compliance programs to ensure the securitization participant complies with the requirements of the exception and ensure that their compensation arrangements do not incentivize employees to enter into conflicted transactions.

Conclusion

The comments on the proposed rule requested clarity with respect to the rule's cross-border application, which ultimately convinced the SEC to include a safe harbor for certain foreign securitizations.

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.

Rule 192 became effective on Feb. 5, 2024, 60 days after its 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.

An analysis of the securitization conflict rule uncovers the "what" and "why" of the rule — what the rule entails and why it was adopted, but it still begs the question of why consumers should care.

In the mid 2000s, the combination of an increase in home sales with cheap credit and relaxed lending standards created a housing bubble. Lenders sold these loans, which were then packaged into mortgage-backed securities and collateralized debt obligations.

When interest rates began to rise, real estate prices began to drop, leading to increasing defaults on the mortgages underlying the mortgage-backed securities and collateralized debt obligations.

Certain investors were able to capitalize on this, often through shorting the security. Some of these investors worked with banks to select mortgages likely to default to place into the mortgage-backed security or collateralized debt obligation. These investors then shorted those securities.

By implementing the new securitization conflict rule, the SEC targets transactions that constituted ABS-related misconduct during the lead up to the financial crisis while still allowing for bona fide hedging and market making activity.

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