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CONFLICTS OF INTEREST IN ASSET-BACKED SECURITIZATION: AN ANALYSIS OF PROPOSED RULE 192

On January 25, 2023, the SEC issued proposed Rule 192 (Conflicts of Interest Relating to Certain Securitizations). Proposed Rule 192 would implement the Dodd-Frank Act's prohibition of material conflicts of interest between securitization participants and investors. This article reviews Proposed Rule 192 and discusses some of the concerns and suggestions expressed by market participants in their comment letters. While the timing of the SEC's next step is uncertain, a final rule (or a re-proposed rule) could be forthcoming before the end of 2023.

By Christopher B. Horn and Jon A. Schlotterback *

On January 25, 2023, the Securities and Exchange Commission (the "Commission") released proposed Rule 192 (Conflicts of Interest Relating to Certain Securitizations) (the "Proposed Rule"). In this article, we discuss the Proposed Rule's provisions, definitions, and exceptions. We also highlight the reaction of certain market participants as expressed in comment letters submitted to the Commission.[1]

This article is organized by addressing questions that are important to practitioners as they anticipate the Commission's implementation of a final rule:

- What is Proposed Rule 192?
- When Does the Proposed Rule Take Effect?
- What Transactions are Prohibited?
- Who is Covered?
- What are the Exceptions?
- What is the Compliance Period?
- What Happens Next?

[1] To date, the Commission has received almost 200 comment letters on the Proposed Rule. This article does not purport to summarize or survey all of those letters. Rather, this article focuses primarily on the comment letters submitted by the Securities Industry and Financial Markets Association ("SIFMA"), the Structured Finance Association ("SFA"), The Loan Syndications and Trading Association ("LSTA"), and the American Bar Association ("ABA").

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WHAT IS PROPOSED RULE 192?

The Proposed Rule is a rule proposed by the Commission to implement Section 27B ("Section 27B") of the Securities Act of 1933 (the "Securities Act"). Section 27B directs the Commission to implement rules prohibiting an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security ("ABS") from engaging in any transaction that would involve or result in a material conflict of interest with any investor.

The Commission issued the pre-publication version of the proposing release for the Proposed Rule (the "Proposing Release") on January 25 2023[2] and subsequently published it in the Federal Register on February 14, 2023.[3] The comment period expired on March 27, 2023, although a number of organizations have submitted both initial and supplementary comment letters after that date.[4]

General Provisions of the Proposed Rule

Under the Proposed Rule:

> A securitization participant shall not, for a period commencing on the date on which a person has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant with respect to an asset-backed security and ending on the date that is one year after the date of the first closing of the sale of such asset-backed security, 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 such asset-backed security.[5]

The Proposed Rule defines a "material conflict of interest" as any ABS transaction between a "securitization participant" and an investor that is a "conflicted transaction." Further, the Proposed Rule defines a "conflicted transaction" as any one of three listed categories of transactions in which "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision."[6] The Proposed Rule provides three exceptions for transactions that would otherwise be considered conflicted transactions: risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities.[7]

Legislative History

The legislative history of Section 27B makes clear that Congress intended to prohibit securitization participants from betting against the ABS that they create. The Congressional Record notes that:

> The intent of [Section 27B] is to prohibit underwriters, sponsors, and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failure. . . . [T]he sponsors and underwriters of the asset-backed securities are the parties who select and understand the underlying assets, and who are best positioned to design a security to succeed or fail.[8]

[2] SEC Release No. 33-11151 (2023).

[3] Prohibition Against Conflicts of Interest in Certain Securitizations, 88 Fed. Reg. 9678 (Feb. 14, 2023) (to be codified at 17 C.F.R. pt. 192) (the "Proposing Release").

[4] Links to the comment letters submitted, as well as other useful background information, can be found at the "Conflicts of Interest – Proposed Rule 192 Resource Page" *at* www.retainedinterest.com.

[5] Proposing Release, *supra* note 3, at 9726.

[6] *Infra* "What Transactions are Prohibited?"

[7] *Infra* "What are the Exceptions?"

[8] 156 CONG. REC. S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).

Similarly, the Senate Financial Crisis Report[9] states that:

> The Dodd-Frank Act contains two conflict of interest prohibitions to restore the ethical bar against investment banks and other financial institutions profiting at the expense of their clients. The first is a broad prohibition that applies in any circumstances in which a firm trades for its own account, as explained above. The second, in Section 621, imposes a specific, explicit prohibition on any firm that underwrites, sponsors, or acts as a placement agent for an asset-backed security, including a synthetic asset-backed security, from engaging in a transaction 'that would involve or result in any material conflict of interest' with an investor in that security. Together, these two prohibitions, if well implemented, will protect market participants from the self-dealing that contributed to the financial crisis.[10]

The Senate Financial Crisis Report also provides that "[r]egulators implementing the conflict of interest prohibitions in Sections 619 and 621 should consider the types of conflicts of interest in the . . . case study, as identified in Chapter VI(C)(6) of this Report."[11] That case study identified a number of practices that raise conflict of interest concerns; including:

- Investment bank "shorting its own securities,"[12]
- Investment bank "failing to disclose key information to investors,"[13]
- Investment bank "failing to disclose client involvement,"[14] and
- Investment bank "selling securities designed to fail."[15]

Market participants have generally expressed strong support for a tailored rule that prohibits securitization participants from designing transactions to fail.[16] However, market participants have significant concerns that the Proposed Rule goes beyond the scope contemplated by the legislative history of Section 27B.[17]

Rulemaking History

Section 27B(b) required the Commission to adopt a rule thereunder "not later than 270 days after enactment

[9] PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFAIRS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (Comm. Print 2011) (the "Senate Financial Crisis Report").

[10] Senate Financial Crisis Report, *supra* note 9, at 638.

[11] Senate Financial Crisis Report, *supra* note 9, at 639.

[12] Senate Financial Crisis Report, *supra* note 9, at 602 (investment bank "marketed CDO securities to clients, took a substantial portion of the short side of the CDO, bet the CDO would fall in value, and profited from its short position at the expense of the clients to whom it sold the securities").

[13] *Id.* (investment bank "represented to potential investors that its interests 'were aligned' with theirs or advertised its retention of a portion of the CDO's equity tranche, without disclosing that it had an even larger short position in the CDO and held a

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financial interest directly adverse to the investors to whom it was selling the CDO securities").

[14] *Id.* (investment bank "enabled a client who was shorting the CDO to help select the CDO's assets, solicited investors to buy the [CDO] securities without disclosing the short party's asset selection role or investment objective, and helped the client gain a $1 billion profit at the expense of the investors to whom [the investment bank] sold the securities").

[15] *Id.* (investment bank "sold . . . securities to clients knowing the securities were designed to fall in value and benefit the short party, which was a client in . . . [one] case . . . and itself in the [other] case").

[16] *See, e.g.*, Structured Fin. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 1, 7 (Mar. 27, 2023) (the "First SFA Letter") ("SFA and its membership share the Commission's goal of maintaining investor confidence that market participants involved in the structuring of asset-backed securities . . . will be free from the influence of betting against the ABS."); Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 7 (Mar. 27, 2023) (the "First SIFMA Letter") ("[T]he Associations support a prohibition of the types of transactions that motivated Section 27B (*i.e.*, those structured to fail).").

[17] *See, e.g.*, First SIFMA Letter, *supra* note 16, at 7 (citing Senate Financial Crisis Report, *supra* note 9, at 638) (arguing that the Proposed Rule does not satisfy the clear guiding objective of the Senate committee's report that Section 27B "if well implemented, will protect market participants from the self-dealing that contributed to the financial crisis").

of this section."[18] The Commission originally proposed Rule 127B on September 19, 2011. Proposed Rule 127B drew many comments from market participants. After several months of deliberation, and several extensions of the comment period, the Commission took no further action on Proposed Rule 127B, effectively withdrawing it from consideration.

WHEN DOES THE PROPOSED RULE TAKE EFFECT?

For now, the Proposed Rule is just that – a proposal. No rule will take effect until the Commission issues a final rule under Section 27B.

The Proposed Rule does not currently provide for a transition period or otherwise specify a compliance date. Thus, if adopted as a final rule in its current form, the rule would take effect immediately. Prior rules with similar far-reaching applicability and impact have included transition periods. For example, Regulation RR included a 12-month transition period for residential mortgage ABS and a 24-month period for all other ABS before its requirements took effect.[19]

In its first comment letter on the Proposed Rule, SIFMA recommended a transition period of at least 12 months following the date of the final rule's publication in the Federal Register.[20] As SIFMA noted, "it is clear that securitization participants will have a significant number of questions about any final rule and will need adequate time to understand its terms and design policies and procedures to comply with it."[21]

[18] Section 27B was enacted on July 21, 2010 (*i.e.*, the date on which the Dodd-Frank Act was enacted).

[19] Credit Risk Retention, 79 Fed. Reg. 77602, 77603 (Dec. 24, 2014) ("Compliance with the final rule with respect to securitization transactions involving asset-backed securities collateralized by residential mortgages is required beginning one year after the date of publication in the Federal Register and with respect to securitization transactions involving all other classes of asset-backed securities is required beginning two years after the date of publication.").

[20] First SIFMA Letter, *supra* note 16, at 68. The current Proposed Rule also does not specify whether a final rule will only apply to ABS that is sold on or after its effective date. While retroactive applicability is unusual, it is possible that a final rule could apply to ABS sold before the final rule's effective date but that is still within the one-year period after the closing of the first sale of such ABS.

[21] *Id.*

WHAT TRANSACTIONS ARE PROHIBITED?

The Proposed Rule prohibits any securitization participant from engaging in any transaction that would result in a "material conflict of interest" between that securitization participant and an investor in an "asset-backed security." Under the Proposed Rule, a transaction would result in a material conflict of interest between a securitization participant and an investor in an ABS if that transaction is a "conflicted transaction."

Definition of "Asset-Backed Security"

Under the Proposed Rule, the term "asset-backed security" has the same meaning as in Section 3(a)(79) of the Securities Exchange Act of 1934, and also includes synthetic ABS. The Proposed Rule does not provide a separate definition for the term "synthetic asset-backed security." SIFMA suggested the following definition:

> Synthetic asset-backed security mean a fixed-income or other security (a) issued by a special purpose entity and (b) secured by (i) one or more credit derivatives or similar instruments that reference self-liquidating financial assets (including bonds, loans, leases, mortgages, secured or unsecured receivables, or asset-backed securities) ("reference pool") and (ii) financial collateral held by the SPV where performance on the note is primarily linked to the performance of the reference pool and the repayment of principal is dependent on the financial collateral held by the SPV. The term "synthetic asset-backed security" shall not include any insurance or reinsurance policy, corporate debt, or swap or security-based swap where the counterparty is not a special purpose entity that issues a security to investors, whether or not payments thereunder are contingent on the performance of referenced financial assets. For avoidance of doubt, the term "self-liquidating financial asset" (as used in this definition) shall not include any insurance or reinsurance contracts (or insurance or reinsurance risks).[22]

[22] Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 10–11 (June 27, 2023) (the "Second SIFMA Letter"). SFA proposed a substantially similar definition. Structured Fin. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, A-8 (July 13, 2023) (the "Second SFA Letter").

Definition of "Conflicted Transaction"

The Proposed Rule defines "conflicted transaction" as:

> any of the following transactions with respect to which there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision on whether to retain the asset-backed security:
>
> (i) A short sale of the relevant asset-backed security;
>
> (ii) The purchase of a credit default swap or other 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 asset-backed security; or
>
> (iii) The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated, or potential:
>
> (A) Adverse performance of the asset pool supporting or referenced by the relevant asset-backed security;
>
> (B) Loss of principal, monetary default, or early amortization event on the relevant asset-backed security; or
>
> (C) Decline in the market value of the relevant asset-backed security.

Market participants have expressed concerns about the broad scope of the proposed definition of "conflicted transaction." Most of those concerns pertain to clause (iii) (the "catchall" provision) and the "reasonable investor" standard for materiality.

The Catchall Provision

Clauses (i) and (ii) of the definition of "conflicted transaction" capture transactions that are commonly understood to be potentially problematic from a conflicts of interest perspective; namely, short sales and synthetic short sales, respectively, of the ABS.[23] Clause (iii) of the definition of "conflicted transaction," however, referred to as the "catchall" provision by market participants, captures a broader set of transactions whose connection to the ABS, and to any potential conflict of interest, is tenuous. As SFA noted:

> the definition of "conflicted transaction" is too broad and could encompass countless types of transactions that have little to do with Congress' concerns in enacting Section 621. For example, the definition could be read to capture transactions only tangentially related to the ABS, such as normal course transactions that are part of the customary rights and obligations under securitization transaction documents, including:
>
> - Transactions on behalf of a client or customer pursuant to a fiduciary duty;
> - Transactions unrelated to the credit risk of the ABS, including interest rate and currency hedges, and transactions in commercially available, widely recognized indices;
> - The release of the ABS collateral from a warehouse facility;
> - Activities in connection with financing provided to investors in the ABS;
> - Routine servicing activities;
> - Risk management transactions, such as credit risk transfer transactions and mortgage insurance linked notes; and
> - Sale of assets to initiate the securitization.[24]

The catchall provision is particularly problematic for CLO transactions because the underlying corporate loans are routinely traded, hedged, and otherwise managed. The LSTA's comment letters describe, in considerable detail, how the broad scope of the catchall provision may capture many of those routine activities and thereby

[23] *See, e.g.*, First SIFMA Letter, *supra* note 16, at 41 ("The Associations agree that a short sale of ABS by a securitization participant may create a conflict of interest between that securitization participant and investors.").

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[24] Second SFA Letter, *supra* note 22, at 6.

negatively impact both the corporate loan market and the corporate borrowers who rely on that market.[25]

The catchall may also hinder the ability of banks to manage their risks through credit risk transfer transactions ("CRTs"). Although the rule text itself does not appear to prohibit such transactions, the Commission's commentary suggests that the catchall provision applies to CRTs that utilize SPEs to provide banks with credit risk protection.[26] Comment letters from SIFMA, SFA, the International Association of Credit Portfolio Managers, and the ABA, among others, urged the Commission to make clear in the final rule that bank CRTs involving SPEs are not "conflicted transactions." As SIFMA noted:

> Banks use CRT transactions to manage their credit risks. If a bank is prevented from managing its credit risks effectively, the potential consequences extend far beyond that bank, as recent events have clearly demonstrated. The Associations firmly believe that Congress did not intend Section 27B to be construed to allow any implementing rule thereunder to hamper the ability of banks to manage their risks.[27]

In explaining the broad scope of the catchall provision, the Proposing Release stated that the catchall is intended to "help alleviate the risk of any attempted evasion of the rule that is premised on the form of the transaction rather than its substance."[28] These evasion concerns also led the Commission to omit a knowledge or intent qualifier in the Proposed Rule.[29] Moreover, the Proposing Release stated that it is not necessary for the securitization participant to have benefitted from the "conflicted transaction," but that "it would be sufficient that the transaction *creates an opportunity for the securitization participant to benefit* . . . from a decline in the market value of the ABS."[30]

Unfortunately, in seeking to prevent evasion, the broad catchall could hinder efforts to comply with the Proposed Rule, as market participants may be unable to reliably assess which transactions fall within its scope. This compliance difficulty is exacerbated by the Proposed Rule's definition of "securitization participant," which extends the prohibition to not only those transactions involving a sponsor, underwriter, initial purchaser, or placement agent involved in the ABS transaction but also to transactions involving any of their affiliates or subsidiaries, regardless of the use of information barriers or other indicia of separateness.[31]

Two notable proposals for narrowing the catchall provision have emerged from the comment letters.[32] The proposals of SIFMA and SFA seek to balance the Commission's concerns about evasion with the market's concerns about scope and compliance by limiting the catchall to those transactions that are the functional equivalent of shorting the ABS.

Under the SIFMA proposal, a prohibited transaction would include:

> The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that substantially replicates one or both of the types of transactions set forth in clause (i) or (ii) above[33] by means of the securitization participant's shorting or buying protection on

[25] *See, e.g.*, Loan Syndications and Trading Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 4 (Mar. 27, 2023).

[26] For a detailed discussion of the Proposed Rule's potential impact on CRTs, Julie A. Gillespie et al., *Significant Concerns about Credit Risk Transfers (CRTs) under SEC Proposed Rule 192*, MAYER BROWN LEGAL UPDATE (Feb. 27, 2023), https://www.mayerbrown.com/en/perspectives-events/publications/2023/02/significant-concerns-about-credit-risk-transfers-crts-under-sec-proposed-rule-192.

[27] First SIFMA Letter, *supra* note 16, at 40.

[28] Proposing Release, *supra* note 3, at 9695.

[29] *Id.* at 9697 ("We are not proposing an intentionally designed-to-fail test to determine what constitutes a material conflict of interest because we believe that such a test could lead to attempts to evade the rule. Moreover, the need to prove intent could make enforcement of the rule more difficult, thereby potentially weakening investor protection.").

[30] *Id.* at 9695 (emphasis added).

[31] *Infra* "Who is Covered?"

[32] That such proposals appear in comment letters does not imply that some form of catchall is necessary in the first instance. For example, SIFMA noted that it "do[es] not believe that any catchall provision is necessary, as the prohibition of a short sale of the ABS as described in clause (a)(3)(i) of the Proposed Rule or a synthetic short of the ABS as described in clause (a)(3)(ii) of the Proposed Rule accomplishes the goal of Section 27B." First SIMFA Letter, *supra* note 16, at 43.

[33] Clause (i) refers to a short sale of the ABS and clause (ii) refers to a synthetic short sale of the ABS.

the asset pool underlying or referenced by the relevant asset-backed security.[34]

Similarly, under the SFA proposal, a prohibited transaction would include:

- The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that substantially replicates one or both of the types of transactions set forth in clause (i) or (ii) above by means of referencing the relevant asset-backed security or the asset pool underlying or referenced by the relevant asset-backed security; provided, that, for the avoidance of doubt, none of the following shall constitute a conflicted transaction:

- Any such transaction with respect to any securitization participant with a fiduciary duty to the issuer of the asset-backed security pursuant to the Investment Advisers Act of 1940, which transaction is entered into by that securitization participant on behalf of another client, fund, or account managed by that securitization participant and conducted in accordance with that securitization participant's fiduciary duty to that client, fund, or account under the Investment Advisers Act of 1940;

- Any such transaction involving an account owned by a securitization participant that is managed by a third party with investment discretion, or advised by a securitization participant and sub-advised by a third party with investment discretion, and the transaction-specific investment decision was not directed by the securitization participant; or

- Any such transaction with respect to any securitization participant that is not related to the credit risk of an asset-backed security or the underlying assets thereof, including without limitation transactions related to overall market movements (such as movements of market interest rates, currency exchange rates or home prices).[35]

It is unclear whether and to what extent the Commission will narrow the catchall in a final rule. The authors are cautiously optimistic that the extensive focus on the catchall in the comment letters will lead to a better-tailored catchall provision.

The Reasonable Investor Standard

Section 27B directs the Commission to adopt a rule prohibiting transactions that would involve or result in any "material" conflict of interest between a securitization participant and an investor. In the Proposed Rule, the Commission implements this directive by incorporating the following standard of materiality into the definition of "conflicted transaction":

> there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision on whether to retain the asset-backed security.[36]

As the Commission acknowledged in the Proposing Release, this standard is based on the securities law disclosure standard set forth by the Supreme Court in *Basic v. Levinson*.[37] However, as the ABA pointed out in its comment letter, the "reasonable investor" standard for materiality is not well suited for the Proposed Rule because it is a standard for what must be disclosed to investors and "not a standard that is appropriate for use in sorting transactions into permissible and impermissible categories."[38]

The ABA and other market participants have urged the Commission to adopt a "materially adverse to the interests of investors" standard like that used in the Volcker Rule.[39] For example:

[34] Second SIFMA letter, *supra* note 22, at 4.

[35] Second SFA Letter, *supra* note 22, at A-1–A-2.

[36] Proposing Release, *supra* note 3, at 9726 (clause (a)(3) of the Proposed Rule).

[37] *Id.* at 9696.

[38] Am. Bar Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 32 (Apr. 5, 2023) (the "ABA Letter"). *See also* First SIFMA Letter, *supra* note 16, at 47 ("The *Basic v. Levinson* standard is a standard for what must be disclosed, not a standard for what should be prohibited. Section 27B directs the Commission to adopt rules as to what types of transactions should be prohibited.").

[39] Under the Volcker Rule, "a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in

- Under the ABA's proposal, "a conflicted transaction means any of the following transactions to the extent any such transaction is *materially adverse to the interests of investors.*"[40]

- Similarly, under SIFMA's proposal, "a conflicted transaction means any of the following transactions that would involve or result in the securitization participant's interests being *materially adverse to the interests of investors* in the relevant asset-backed security."[41]

- Finally, under SFA's slightly different hybrid proposal, "a conflicted transaction means any of the following transactions with respect to which there is a *substantial likelihood that a reasonable investor would consider the securitization participant's financial interest in the transaction being materially adverse to the interests of the investor* in the relevant asset-backed security."[42]

As with the catchall provision, it is unclear whether and to what extent the Commission will modify the Proposed Rule's disclosure-based materiality standard in a final rule. It is useful to recall that in the context of disclosure, the concept of "materiality" is a limiting principle. In codifying the *Basic v. Levinson* standard, Rule 405 of the Securities Act makes this clear by defining "material" as follows:

> The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered.[43]

Thus, "materiality" in the disclosure context merely excludes from any disclosure obligation such information that a reasonable investor would consider unimportant. A standard for categorizing information as either important or unimportant, therefore, does not function well as a standard for distinguishing between those substantive risks to which an investor may, and may not, be subject.

WHO IS COVERED?

The Proposed Rule applies to transactions involving any "securitization participant." The term "securitization participant" is defined to mean:

- An underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security; or

- Any affiliate (as defined in 17 CFR 230.405) or subsidiary (as defined in 17 CFR 230.405) of a person described in paragraph (i) of this definition.

This definition of "securitization participant" is concerning to market participants for two principal reasons. First, the Proposed Rule defines the term "sponsor" (which is used in the definition of "securitization participant") more broadly than its ordinary meaning. Second, the definition of "securitization participant" includes all of the participant's affiliates and subsidiaries. Each of these concerns is discussed below.

Definition of "Sponsor"

Under the Proposed Rule, an ABS transaction "sponsor" is a securitization participant. The Proposed Rule defines "sponsor" to mean:

- Any person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the entity that issues the asset-backed security; or

- Any person:

    A. with a contractual right to direct or cause the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security; or

    B. that directs or causes the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security.

    C. Notwithstanding paragraphs (ii)(A) and (ii)(B) of this definition, a person that

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paragraph (b)(2) of this section." 17 C.F.R. § 255.7(b) (2023) (emphasis added).

[40] ABA Letter, *supra* note 38, at 33 (emphasis added).

[41] Second SIFMA Letter, *supra* note 22, at 4 (emphasis added).

[42] Second SFA Letter, *supra* note 22, at A-1 (emphasis added).

[43] 17 C.F.R. § 230.405 (2023).

> performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of an asset-backed security or the composition of the pool of assets underlying the asset-backed security will not be a sponsor for purposes of this rule.[44]

The Proposed Rule's definition of "sponsor" is broader than the ordinary meaning of that term and any prior definition thereof in other securities law regulations relating to securitization.[45] Although clause (i) of the definition of "sponsor" follows the long-established and well-known definition found in other securities regulations such as Regulation AB and Regulation RR,[46] clause (ii) is new. The Proposing Release argues that a broad definition is needed "to ensure that the prohibition would apply to a broad range of securitization participants, including collateral managers and other parties with significant *influence* in the structure, composition, and management of an ABS."[47]

Under clause (ii), the definition of "sponsor" may potentially capture certain investors who, for example, express views about the quality of the composition of the pool of assets underlying the ABS. Furthermore, a person with a mere "contractual right" to influence an ABS may be considered a sponsor even if it has not exercised its right to do so.[48] Indeed, the scope of clause (ii) is sufficiently broad such that a carveout is required for "person[s] that perform[ ] only administrative, legal, due diligence, custodial, or ministerial acts."[49]

Market participants argue the inclusion of "contractual right sponsors" (entities described by clause (ii)(A)) and "directing sponsors" (entities described by clause (ii)(B)) make the definition of "sponsor" overly broad.[50] The ABA stated that "[w]e think that the definition of 'sponsor' for purposes of the Proposed Rule should be refined to correspond with the ordinary meaning of that term in the context of a securitization, particularly the 'organizing' and 'initiating' function that any entity must have in order to be considered a sponsor of a securitization transaction."[51] Similarly, SIFMA "agree[s] with the Commission's previous identification of the essential 'organize and initiate' element that distinguishes sponsors from mere influencers"[52] and argued that:

> because the term 'sponsor' is used in Section 27B and is not separately defined therein, and because the term 'sponsor' already has an ordinary and natural meaning . . . , the term 'sponsor' in the Proposed Rule must have the same meaning, not a new one.[53]

SFA argued that servicers and third-party asset sellers should be explicitly carved out of the definition of "sponsor," as well as any person involving in structuring, designing, or assembling an ABS, or the composition of the pool assets, "solely in connection with its acquisition of a long position" in that ABS.[54] Similarly, SIFMA urged the Commission to exclude "bona fide long investors" from the definition of "sponsor."[55]

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[44] Clause (iii) of the definition, which is omitted here, also excludes from the definition of "sponsor" certain federal agencies and GSEs.

[45] On the other hand, the Proposed Rule defines the terms "underwriter," "placement agent" and "initial purchaser" in a manner that is generally consistent with the ordinary meanings of those terms under the securities laws.

[46] 17 C.F.R. § 229.1101(l) (2023) (defining "sponsor" to mean "the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."). *See also* 17 C.F.R. § 246.2 (2023) (defining "sponsor" to mean "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity").

[47] Proposing Release, *supra* note 3, at 9686 (emphasis added).

[48] As SIFMA noted, "[a]n entity that has not actually done those things [*i.e.*, directed or caused the direction of the structure, design, or assembly of an ABS] could not be considered a sponsor of an asset-backed securities transaction under any

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definition that resembles the ordinary and natural meaning of that term." First SIFMA Letter, *supra* note 16, at 18.

[49] Proposing Release, *supra* note 3, at 9727 (clause (ii)(C) of the definition of "sponsor").

[50] ABA Letter, *supra* note 38, at 19.

[51] *Id.* at 21.

[52] First SIFMA Letter, *supra* note 16, at 17.

[53] *Id.* at 15.

[54] Second SFA Letter, *supra* note 22, at A-7.

[55] Second SIFMA Letter, *supra* note 22, at 10.

Affiliates and Subsidiaries as Securitization Participants

Section 27B(a) includes affiliates and subsidiaries of underwriters, placement agents, initial purchasers, and sponsors within the scope of the prohibition of conflicts of interest. The Proposed Rule's definition of "securitization participant" implements that general statutory language without limitation, such that the prohibition applies to all affiliates and subsidiaries of each underwriter, placement agent, initial purchaser, or sponsor, no matter how remotely related, distinct in operation or uninvolved in the ABS transaction, and without regard to the use of information barriers or other indicia of separateness. The Proposing Release explains that this broad scope "would help to prevent affiliates and subsidiaries from being used to evade the rule's prohibitions and would also be consistent with Section 27B."[56]

Although the Proposing Release acknowledges that "[i]nformation barriers . . . have been recognized in other areas of the Federal securities laws and the rules thereunder,"[57] the Proposed Rule does not permit the use of information barriers as a means of excluding transactions conducted by affiliates and subsidiaries that are not involved in the ABS offering.[58] As a result, affiliates and subsidiaries within large enterprises could unintentionally violate the Proposed Rule without knowing that their actions constitute a "material conflict of interest" under the Proposed Rule.

Whether a transaction conducted by an affiliate or subsidiary constitutes a conflict of interest is necessarily a facts and circumstances determination. In considering the extent to which transactions by affiliates and subsidiaries of an underwriter, placement agent, initial purchaser, or sponsor (or separate business units or trading desks within such entities) should fall within the scope of the Proposed Rule, the ABA comment letter set forth the following legal framework:

- As a matter of statutory construction, the key operative terms in Section 27B should be given their ordinary meanings.[59]
- "The ordinary meaning of 'conflict of interest' is a conflict between a legal duty and a personal interest."[60]
- Thus, "[i]n our view, there must be some element of coordination between a securitization participant and its affiliates or subsidiaries in order for the actions of such affiliates or subsidiaries to include or otherwise cause the securitization participant to breach a securities law duty pertaining to the securitization transaction."[61]

Echoing this "element of coordination" principle, both SIFMA and SFA suggested that the "indicia of separateness" paradigm under Rule 105 of Regulation M serves as a useful model for the Proposed Rule.[62] Rule 105 prohibits short sales during the restricted period prior to a secondary offering but excludes from such prohibition short sales conducted by separate accounts "if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between accounts."[63]

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[56] Proposing Release, *supra* note 3, at 9690.

[57] *Id.*

[58] The Proposing Release did, however, list, and invite comment on, five conditions for the use of information barriers *if* the Commission decides to add this exception in the final rule: (1) the securitization participant must establish, implement, maintain, enforce, and document an internal compliance program with written policies and procedures to prevent the flow of relevant information from the securitization participant to its affiliates and subsidiaries; (2) the securitization participant must establish, implement, maintain, enforce, and document a written internal control structure governing the information barrier policies and procedures; (3) the securitization participant must obtain an annual, independent assessment of the operation of the participant's policies, procedures, and internal control structure; (4) the securitization participant and affiliate or subsidiary must have no common officers (or other persons with similar responsibilities) and no common employees unless they perform solely clerical, ministerial, or support work; and (5) the securitization participant must not know or reasonably should have known that a particular transaction would result in a material conflict of interest. *Id.* at 9691.

[59] ABA Letter, *supra* note 38, at 8. *See also* First SIFMA Letter, *supra* note 16, at 11 ("[I]n the absence of a statutory definition, a statutory term is generally construed 'in accordance with its ordinary and natural meaning.' The terms 'sponsor' and 'conflict of interest' are not defined in Section 27B. Therefore, any definition of those terms in the rule that implements Section 27B must reflect their ordinary or natural meanings.").

[60] ABA Letter, *supra* note 38, at 8.

[61] *Id.* at 22.

[62] *See, e.g.*, First SIFMA Letter, *supra* note 16, at 30–32; Second SIFMA Letter, *supra* note 22, at 15; Second SFA Letter, *supra* note 22, at 10–11.

[63] 17 C.F.R. § 242.105(b)(2) (2023).

The indicia of separateness in the Commission's guidance under Rule 105 are particularly useful in the context of the Proposed Rule because they address the Commission's concerns about its having to prove intent and its reluctance to adopt information barriers as the means of compliance.[64] Notably, those indicia of separateness:

- "are objective and fact-based, *not* subjective or intent-based and

- *do not* specify information barriers as the means of compliance but *do* recognize information barriers as only one of several indicia of separateness and lack of coordination."[65]

An alternative approach to the multi-factor indicia of separateness test is the "rebuttable presumption" alternative. Versions of that alternative proposed by SIFMA and SFA, respectively, state:

- For purposes of this rule, a transaction described in clause (a)(3) that is entered into at the direction of a related person[66] will be presumed to be a conflicted transaction unless such related person demonstrates that such related person had no substantive role in the structuring, marketing, or selling [of] the asset-backed security or in the selection of the asset pool underlying or referenced by the relevant asset-backed security and did not otherwise coordinate with a party who did have a substantive role in the structuring, marketing, or selling [of] the asset-backed security or in the selection of the asset pool underlying or referenced by the relevant asset-backed security. The related person seeking to rebut the presumption will bear the burden of proof.[67]

- For purposes of this rule, a transaction described in clauses (a)(3)(i), (ii) or (iii) that is entered into at the direction of a related person will be presumed to be a conflicted transaction unless the related person demonstrates, by a preponderance of the evidence, that the related person had no substantive role in structuring, marketing, or selling the asset-backed security or in the selection of the asset pool underlying or referenced by the relevant asset-backed security.[68]

As SFA explained:

> [W]e believe that the related person should be able to rebut the initial presumption by proving . . . that it had no substantive role in structuring, marketing, or selling the ABS or in the selection of the related asset pool. A person with no substantive role in the design of a securitization cannot, by definition, design a securitization to fail. . . . In our view, this rebuttable presumption would be a safeguard against inadvertent, innocent transactions from triggering a rule that was not meant for them.[69]

The Proposed Rule's enterprise-wide scope is concerning from a compliance perspective. That broad scope may also trigger unintended regulatory consequences. As part of their existing compliance programs, many underwriters, placement agents, initial purchasers, and sponsors limit the information they share about securities offerings within their own enterprises (*e.g.*, through the use of information barriers, "need to know" policies, and the like). In order to comply with its broad scope, the Proposed Rule could require underwriters, placement agents, initial purchasers, and sponsors to share more information about prospective ABS offerings across their respective enterprises than they otherwise would in order to ensure that no entity within the enterprise enters into a conflicted transaction.

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[64] The SEC's guidance under Rule 105, as discussed in the First SIFMA Letter, *supra* note 16, at 30–31, includes that (1) the accounts have separate and distinct investment and trading strategies and objectives, (2) personnel for each account do not coordinate trading among or between the accounts, (3) information barriers separate the accounts, (4) information about securities positions or investment decisions is not shared between accounts, and (5) each account maintains a separate profit and loss statement. Importantly, the guidance notes that "[d]epending on the facts and circumstances, accounts not satisfying each of these conditions may nonetheless fall within the exception." *Short Selling in Connection with a Public Offering: Amendments to Rule 105 of Regulation M*, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/divisions marketregtmcomplianceregmrule105-secg.htm#foot1 (last modified May 21, 2008).

[65] Second SIFMA Letter, *supra* note 22, at 15.

[66] The term "related person" means "with respect to a securitization participant in connection with an asset-backed security, an employee, group, or business unit within the securitization participant other than the employees of the securitization participant that act as the underwriter, placement agent, initial purchaser, or sponsor of the asset-backed security." *Id.* at 9.

[67] *Id.* at 5–6.

[68] Second SFA Letter, *supra* note 22, at A-2.

[69] *Id.* at 9.

By effectively requiring a broad dissemination of information throughout the enterprise in order to prevent conflicted transactions from occurring anywhere within the enterprise, the Proposed Rule may increase the chance that sensitive information could be misused.

WHAT ARE THE EXCEPTIONS?

The Proposed Rule contains the three exceptions prescribed by Section 27B. In contrast to the Proposed Rule's expansive defined terms and prohibitions, its exceptions are narrow and place several conditions on their use. The Proposed Rule's three exceptions are:

1. Risk-mitigating hedging activities;

2. Liquidity commitments; and

3. Bona fide market-making activities.

Risk-Mitigating Hedging Activities

The exception for risk-mitigating hedging activities provides that a securitization participant's risk-mitigating hedging activities are permitted "in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization participant arising out of its securitization activities." This exception, however, is subject to three conditions:

A. At the inception of the hedging activity and at any time of any adjustments to the hedging activity, the risk-mitigating hedging activity is 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, based upon the facts and circumstances of the identified underlying and hedging positions . . . ;

B. The risk-mitigating hedging activity is subject, as appropriate, to ongoing recalibration . . . to ensure that the hedging activity satisfies the requirements [of the risk-mitigating hedging exception] . . . ; and

C. The securitization participant has established, and implements, maintains, and enforces, an internal compliance program that is reasonably designed to ensure the securitization participant's compliance with [the risk-mitigating hedging 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.[70]

Market participants have urged the Commission to eliminate the condition that the hedging must be "in connection with . . . positions, contracts, or other holdings of the securitization participant arising out of its securitization activities." As SIFMA pointed out:

> [c]urtailing such hedging activities – which are unrelated to the relevant asset-backed security and are entered into as part of a securitization participant's risk management practices and not as a bet against a relevant asset-backed security – could have adverse and unintended effects on everyday operations and risk management practices of financial institutions and their affiliates. We don't believe it was the intention of Congress or the Commission to prevent banks and other financial entities from managing their risks, whether or not those risks arise out of the securitization activities of those entities.[71]

In addition, market participants have commented on the requirement that permitted risk-mitigating hedging activity does not include the "initial distribution of an ABS." Of particular concern is that such a provision could be read as making certain synthetic securitizations ineligible for the exception even where the issuance of the ABS in those deals is for risk-mitigating purposes (such as in a bank CRT transaction). As SFA put it:

> we do not understand the policy rationale behind a prohibition of synthetic securitizations that are used for mitigating balance sheet risk. Synthetic securitizations are one form of CRT that banks, insurance companies, and corporations use to manage risks.[72]

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[70] Proposing Release, *supra* note 3, at 9726.

[71] Second SIFMA Letter, *supra* note 22, at 17–18. *See also* Second SFA Letter, *supra* note 22, at 24 ("Risk-mitigating hedging is an imperative business function, and the unavailability of the exception for assets other than ABS would unduly limit the ability of securitization market participants to properly manage their risks.").

[72] Second SFA Letter, *supra* note 22, at 25. *See also* Second SIFMA Letter, *supra* note 22, at 18 ("We believe that synthetic securitizations *should* fall under the risk-mitigating hedging exemption under most circumstances. In such a scenario, the actions of the securitization participant are entirely risk

Market participants have also argued that the risk-mitigating hedging exception should not be conditioned on ongoing recalibration. SIFMA questioned whether a "perfect" hedge is necessary and argued that it is unnecessary for the regulatory purpose of Rule 192 "for a securitization participant to lose the benefit of the hedging exception just because it couldn't construct a perfectly, consistently calibrated hedge."[73] SIFMA suggested that the recalibration requirement be replaced with a requirement that "the primary benefit of such risk-mitigating hedging activity is risk reduction."[74] Similarly, SFA suggested that recalibration be replaced with a requirement that the "primary benefit of such risk-mitigating hedging activity is risk reduction and not the facilitation or creation of an opportunity to realize some other benefit from such activity."[75]

The risk-mitigating hedging example, as demonstrated by its conditions, is quite complex and leaves market participants prone to unintentional errors. While the condition in clause (A) above is generally consistent with the terms in Section 27B, the conditions described in clauses (B) and (C) above are not contemplated by Section 27B. Accordingly, commenters to the Proposed Rule have requested that the Commission include a "reasonably designed" qualifier in clause (B) to protect market participants from slight deviations in hedging calibration.[76] Additionally, commenters have requested that the Commission remove the internal compliance program described in clause (C) as the requirement is not based on the text of Section 621 and would present an expensive, time-consuming burden for market participants seeking to engage in risk-mitigation activities.

Liquidity Commitments

The Proposed Rule provides that "[p]urchases or sales of the asset-backed security made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the asset-backed security" are not prohibited transactions.[77] While the liquidity commitments exception contains no conditions, the Commission declined to permit its expansion to include forms of liquidity commitments that do not involve purchases and sales of ABS.[78] The Proposed Rule's exception for liquidity commitments has drawn relatively few comments from market participants.

Bona Fide Market-Making Activities

The Proposed Rule contains an exception for a securitization participant's bona fide market-making activities. The bona fide market-making exception is subject to five conditions:

A. The securitization participant routinely stands ready to purchase and sell one or more types of ABS, underlying assets, or referencing financial instruments and is willing and available to quote, purchase, and sell such assets in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market;

B. The securitization participant's market-making activities must not be designed to consistently surpass the reasonably expected near-term demands of the participant's clients, customers, or counterparties;

C. The compensation arrangements of persons performing the foregoing activity are designed not to reward or incentivize conflicted transactions;

D. The securitization participant is licensed or registered to engage in market-making activity; and

E. The securitization participant has established and implemented written policies and procedures that ensure the securitization participant's compliance with the bona fide market-making exception.

Market participants have objected to the requirement that the exception for bona fide market-making activities does not include the initial distribution of the ABS. Both SIFMA and SFA commented that the phrase is unclear in the context of market making.[79]

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mitigation, because any benefit that such securitization participant may receive when the reference portfolio's performance declines would be directly offset by the reduced value of the assets in the reference portfolio which remain on [the] book.").

[73] Second SIFMA Letter, *supra* note 22, at 19.

[74] *Id.* at 6.

[75] Second SFA Letter, *supra* note 22, at A-3.

[76] First SIFMA Letter, *supra* note 16, at 62.

[77] Proposing Release, *supra* note 3, at 9726.

[78] *Id.* at 9704.

[79] Second SFA Letter, *supra* note 22, at 28; Second SIFMA Letter, *supra* note 22, at 19.

In addition to commenting on the three exceptions set forth in the Proposed Rule, market participants have also asked the Commission to make clear that transactions with respect to underlying assets that conclude on or before the date such assets are included in a securitization (*i.e.*, pre-securitization hedging transactions, financing transactions, transfers, and other pre-securitization transactions) are not "conflicted transactions."[80] As SIFMA noted, a transaction with respect to assets that is concluded before those assets are securitized would not give rise to a conflict of interest concern.[81]

Finally, market participants have suggested that certain additional exceptions should be added, including activities in connection with the financing of ABS (such as repurchase agreements whereby a securitization participant finances an investor's purchase of the ABS and under which the securitization participant, as repo buyer/lender, can make a "margin call" on the investor, as repo seller/borrower, if the related ABS declines in value).[82]

WHAT IS THE COMPLIANCE PERIOD?

Under the Proposed Rule, the compliance period with respect to a person:

- begins "on the date on which [such] person has reached, or taken substantial steps to reach, an agreement that such person will become a securitization participant with respect to an asset-backed security;"[83] and
- ends on the "date that is one year after the date of the first closing of the sale of such asset-backed security."[84]

The end date for compliance comes directly from Section 27B and is reasonably clear on its face. The beginning date for compliance, on the other hand, is not directly specified by Section 27B,[85] and the Proposed Rule's "substantial steps" approach renders the beginning date quite unclear.

The Proposing Release explains that the "substantial steps" approach is intended to prevent securitization participants from circumventing the Proposed Rule by engaging in conflicted transactions before the ABS closing date.[86] The Proposed Rule does not, however, define the term "substantial steps."[87] Instead, the Commission indicated that any determination whether a person has taken substantial steps to reach an agreement to be a securitization participant will be a "facts and circumstances" analysis of the participant's actions.[88]

SIFMA proposed that the commencement date should begin 30 days prior to the first closing of an ABS.[89] SIFMA believes that this bright-line standard "allows securitization participants to be able to construct a more rigorous compliance program while posing no risk that a

[80] Second SFA Letter, *supra* note 22, at 28–29; Second SFA Letter, *supra* note 22, at 19–20.

[81] First SIFMA Letter, *supra* note 16, at 49.

[82] Second SFA Letter, *supra* note 22, at 29–30; Second SIFMA Letter, *supra* note 22, at 20.

[83] Proposing Release, *supra* note 3, at 9726 (clause (a)(1) of the Proposed Rule).

[84] *Id.*

[85] As Section 27B is unambiguous in stating that it applies to underwriters, placement agents, initial purchasers, and sponsors, it seems unambiguous that Section 27B does not apply to a person who has not actually become an underwriter placement agent, initial purchaser, or sponsor. As SIFMA noted, "The terms 'underwriter,' 'placement agent,' 'initial purchaser' and 'sponsor' as used in Section 27B each have their own respective ordinary and natural meanings. None of those terms are ambiguous. No entity becomes an underwriter, placement agent, initial purchaser, or sponsor simply by taking substantial steps to become one. An entity that has taken 'substantial steps' to become the type of entity whose actions are regulated by Section 27B is not yet the type of entity whose actions are regulated by Section 27B." First SIFMA Letter, *supra* note 16, at 22.

[86] Proposing Release, *supra* note 3, at 9692–93.

[87] The Proposing Release states that a person would have taken substantial steps to reach an agreement after engaging in "substantial negotiations over the terms of an engagement letter or other agreement." *Id.* at 9692. However, this provides little clarity in that the Proposing Release does not provide guidance as to what would constitute "substantial negotiations." For example, it is not clear whether substantial negotiations begin on the first turn of a draft engagement letter or only when the parties are finalizing terms.

[88] *Id.*

[89] Second SIFMA Letter, *supra* note 22, at 4.

bad actor could use this definitive start to evade the prohibition."[90]

SFA suggested a definition of "commencement date" that turns on, among other factors, the date on which an engagement letter is signed with the rating agency (if applicable).[91] The SFA formulation is intended to "set[] a reasonable starting point for the prohibition for various types of securitization participants . . . [and] would begin at the time a particular securitization participant could possibly have an incentive to design the transaction to fail."[92]

WHAT HAPPENS NEXT?

One of three things is likely to happen next:

1. the Commission will issue a final rule;

2. the Commission will issue a re-proposed rule; or

3. the Commission will take no action.

Due to the complexity of the rule, market participants have urged the Commission to issue a re-proposal. Practitioners, however, should assume that the Commission will move directly to issuing a final rule as a re-proposal seems unlikely. Whether it is in the context of a re-proposal or a final rule, market participants expect that the Commission will make several changes to the Proposed Rule, including changes intended to clarify that certain regular-way market practices (*e.g.*, interest rate hedges and select pre-securitization activities such as warehouse take-outs) are not conflicted transactions.

The timing of the Commission's next step is uncertain. A final rule, or a re-proposed rule, could be forthcoming before the end of 2023. ■

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[90] *Id.* at 12. SIFMA noted that its 30-day standard is the same used under Rule 152 (integration of offerings, 17 C.F.R. § 230.152 (2023)) and under Rule 163A (safe harbor under the gun-jumping rules, 17 C.F.R. § 230.163A).

[91] Second SFA Letter, *supra* note 22, at A-5.

[92] *Id.* at 14.