

## SEC Releases Final Rule 192 on Conflicts of Interest for ABS

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On November 27, 2023, the US Securities Exchange Commission (“SEC”) adopted final Securities Act Rule 192 (“Final Rule 192”) prohibiting certain conflicts of interest in securitization transactions. In general, Final Rule 192 prohibits a “securitization participant” with respect to an “asset-backed security” (“ABS”) from directly or indirectly engaging in any “conflicted transaction” during the applicable prohibition period.

### Securitization Participant

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The final rule will apply to an **underwriter, placement agent, initial purchaser, or sponsor** of any ABS and any **affiliate or subsidiary**. With respect to “affiliates” Final Rule 192 limits the definition of “securitization participant” to affiliates and subsidiaries who (1) act in coordination with the underwriter, placement agent, initial purchaser, or sponsor or (2) have access to, or receive information about, the ABS or the underlying pool.<sup>1</sup> Also, Final Rule 192 refines the definition of “sponsor,” notably by eliminating the “directing sponsor” category and introducing an exception for certain long investors if such long investor “acts solely pursuant to such person’s contractual rights as a holder of a long position in the ABS” (the “**long investor exception**”). The definition of “sponsor” also excludes any person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, assembly, or ongoing administration of an ABS or the composition of the underlying pool of assets.

### Prohibited Transactions and Compliance Period

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The broad provision of the definition of “conflicted transaction” has been revised to refer to transactions that are “substantially the economic equivalent” of either a short sale of, or credit default swap or other credit derivative on, the relevant ABS.

Transactions unrelated to the idiosyncratic credit performance of the ABS, such as reinsurance agreements, hedging of general market risk (such as interest rate and foreign exchange risks), or routine securitization activities (such as the provision of warehouse financing or the transfer of assets into a securitization vehicle) are not “conflicted transactions” as defined by Final Rule 192, and thus are not subject to the prohibition.

Under Final Rule 192, an agreement is required to trigger the commencement of the compliance period. An “**agreement in principle**” (including oral agreements and facts and circumstances constituting an agreement) can be sufficient to trigger the compliance period. However, the “substantial steps” to reach an agreement to become a securitization participant have been removed.

### Exceptions

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Section 27B of Final Rule 192 (subject to satisfaction of specific conditions), provides exceptions for:

1. **risk-mitigating hedging activities;**
2. **liquidity commitments; and**
3. **bona fide market-making activities.**

These exceptions remain focused on distinguishing the characteristics of such activities from speculative trading and aim to avoid disincentivizing current liquidity commitments, market-making and capital management strategies. The risk-mitigating hedging and bona fide market making exceptions, however, will require the establishment and implementation of an internal compliance program that could be costly and burdensome, particularly for those smaller

securitization participants who are not subject to the similar compliance program under the Volcker Rules. Lastly, the risk mitigating hedging activities exception has been modified by Final Rule 192 to permit the issuance of synthetic ABS for hedging purposes, including bank **credit risk transfer (“CRT”)** transactions. However, the use of synthetic ABS where a securitization participant receives payments based on poor performance of the ABS or its underlying assets, for purposes other than hedging, is generally prohibited.

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## Anti-Evasion Provision

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If a securitization participant engages in a transaction or a series of related transactions that, although in technical compliance with the exceptions for risk mitigating hedging activities, liquidity commitments and bona fide market-making activities, is part of a plan or scheme to evade the prohibition, that transaction or series of related transactions will be deemed to violate the prohibition. Therefore, according to Final Rule 192, the anti-evasion provision applies only to the exceptions and requires a “plan or scheme” to evade.

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## Safe Harbor for Foreign Transactions

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The final rule includes a safe harbor for certain foreign transactions with respect to which (i) the ABS is not issued by a U.S. person<sup>2</sup> and (ii) the offer and sale of the ABS is in compliance with Regulation S under the Securities Act<sup>3</sup>. This “safe harbor” will provide regulatory certainty for securitization participants in connection with securitizations occurring outside the United States and thus may help to reduce certain compliance costs. It is not expected to have a significant effect on the costs of U.S. securitization participants.

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## Effective Date

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The rule takes effect 60 days after its publication in the Federal Register.

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## Compliance

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Compliance with Final Rule 192 is required with respect to any ABS the first closing of the sale of which occurs 18 months after Final Rule 192’s date of publication in the *Federal Register*.

- Participants should consider implementing a compliance program in order to be ready to comply with the final rule.
- Any securitization participant who seeks to rely on the exception for risk-mitigating hedging activities or bona fide market-making activities will need the additional compliance programs required by those exceptions.

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## How to prepare for final Rule 192

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1. Review Final Rule 192 with legal counsel and identify the entities that could fall within the definition of “securitization participant”.
2. Identify the different types of transactions that could be conflicted transactions.
3. Analyze if one or more exceptions to Final Rule 192 (e.g., hedging, market making, liquidity) can apply to the relevant transaction.
4. Arrange for compliance policies and prepare training programs to reinforce legal requirements and approved company policies if relying on an exception.
5. Consider establishing internal processes to review/approve transactions and internal procedures for tracking and assessing ongoing compliance with legal requirements.

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## For More Information

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- 1 These limitations should be helpful to shield any affiliated entities of a securitization participant. However, such limitations do not apply to any business units or desks within a securitization participant even if there is an information barrier or wall that would prevent any information sharing or coordination between such units or desks.
  - 2 The Rule refers to Regulation S for a definition of "U.S. person." Rule 192(e) (citing Securities Act Rule 902(k), 17 C.F.R. § 230.902).
  - 3 Rule 192(e). Regulation S generally provides a safe harbor from the registration of securities under the Securities Act if the offers and sales of the related securities are made to non-U.S. persons in "offshore transactions."

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