

New SEC Rule 192 on Conflict of Interest for ABS

March 20, 2023

On January 25, 2023, the **U.S. Securities and Exchange Commission** (“SEC”) issued a proposed rule to prevent and avoid material conflicts of interest in certain securitization transactions. The rule would prohibit securitization participants from engaging in certain transactions that could incentivize structuring an asset-backed securities (“ABS”) transaction in a way that would put the securitization participant’s interests ahead of the interests of the ABS investors.

Background

The proposed rule is a re-proposal of a rule that was first proposed in 2011 pursuant to Section 27B of the Securities Act of 1933, a provision originally added by Section 621 of the Dodd-Frank Act.

Securitization Participant

The proposed rule would apply to an **underwriter, placement agent, initial purchaser, or sponsor** of any ABS and any **affiliate** or **subsidiary**.

Prohibited Transactions

Re-proposed Rule 192 prohibits such securitization participants from initiating or taking substantial steps to initiate, directly or indirectly, any transaction that would involve or result in any material conflict of interest between the securitization participant and any investor in any ABS. Examples of prohibited transactions could include a short sale of the ABS, a credit default swap (“CDS”) or similar credit derivatives tied to the ABS or the related collateral pool.

A “conflicted transaction” is defined as having two components:

1. **being adverse to the ABS** (*i.e.*, transactions in which the securitization participant could receive an advantage if the ABS perform poorly or other than as expected, such as short sales of the ABS or purchase of CDS on the ABS); and
2. **being material to the investor in the ABS** (*i.e.*, whether the reasonable investor would consider the relevant transaction carried out by the securitization participant important or sufficiently relevant to the investor’s investment decision or strategy).

Exceptions

Section 27B of the proposed rule provides exceptions for:

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

These exceptions seem 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.

Anti-Evasion Provision

Rule 192(d) provides that, if a securitization participant engages in a transaction that circumvents or evades the prohibition, the transaction will be deemed to violate the rule.

Applicability and Compliance

Rule 192 applies to a securitization participant that “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 ceases to apply one year after the date of the closing of the sale of the related ABS.

The proposing release does not specify a compliance date yet. Unless the adopting release provides otherwise, Rule 192 is expected to become effective upon the issuance of the final rule.

Enforcement and Liability

Failure to disclose a person’s substantial role in selecting assets underlying any ABS and that person engaging in conflicted transactions would make a securitization participant potentially subject to enforcement actions under the anti-fraud provisions of the securities laws.¹

In addition, a securitization participant that is known to regularly engage in “conflicted transactions” as defined in proposed Rule 192(a)(3) would likely suffer harm to its reputation among investors, issuers and other participants in ABS transactions that it facilitates.

What’s Next

Many ambiguities and potential points of conflict remain between what the rule is intended to achieve and what it might incidentally achieve in the market. Over 120 separate comments have already been submitted to the SEC, and industry participants, including the Structured Finance Industry Group (“SFIG”), have requested that the SEC extend the comment period because they believe that considerable revisions will be required before Rule 192 is ready for adoption.

Deadline for Comments

The SEC is accepting comments regarding its approach to the implementation of Section 27B until March 27, 2023. As noted above, SFIG has requested an extension of the current deadline and has created a task force committee whose task is continuing to monitor the developments of Rule 192 and its application inputs.

For More Information

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- 1 In addition, an adviser to a hedge fund or other fund investing ABS has a duty of loyalty that requires it to **“make full and fair disclosure to its clients of all material facts relating to the advisory relationship”** and **“eliminate, or at least expose, through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.”** See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] at 33675.

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