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FINANCIAL SERVICES

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Rule 192

On January 25, 2023, the Securities and Exchange Commission ("SEC") issued a release reproposing new Rule 192 (the "Proposed Rule") under the Securities Act of 1933 (the "Securities Act"), which is intended to prevent the sale of asset-backed securities ("ABS") that are potentially tainted by material conflicts of interest. The Proposed Rule would implement the requirements of Section 27B of the Securities Act of 1933, a provision added by Section 621 of the Dodd-Frank Act, which requires the SEC to issue rules prohibiting certain actions thought to constitute material conflicts of interest with respect to ABS transactions.

The basic rule underlying the Proposed Rule is as follows:

"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."[1]

The Proposed Rule then proceeds to list activities that are deemed to constitute conflicted transactions, such as certain short sales, purchases of credit default swaps, or purchases or sales of other financial instruments that would allow the transacting party to benefit from adverse performance of the related ABS.

However, because these types of financial transactions can be executed for many purposes other than creating or exploiting conflicts, a list of exceptions follows, some of which reflect risk-mitigating activities permitted under the risk retention and Volcker rules, common liquidity-provision functions and ordinary market-making activities that are conducted within an adequate compliance program.

Any attempt to regulate such conflicts will require further consideration of the inherent challenges:

- Securitizations vary in scope and structure;
- Numerous parties are involved, sometimes with overlapping responsibilities;
- Many of the activities that might create conflicts of interest may overlap with commonly accepted and desired practices;
- Conflicts of interest are often constructed as something other than mere misrepresentation, even though in many cases a misrepresentation would be necessary to enable any conflicts (or set the stage for them);
- It is possible that the parties involved might desire to structure a securitization that allows each party to take a risk that it believes to be economically sensible but that might otherwise resemble a conflict of interest;
- Some regulations, such as risk retention and the Volcker Rule, already require actions or structures that either detect and prevent conflicts of interest or render certain conflicts economically senseless; and
- The terms often used to describe or characterize securitizations may not be suited, without adjustment, to properly defining the actions to be prohibited and the actors whose conduct is to be constrained.

Given these challenges, it will generally be necessary to choose provisions that roughly define the desired results or requirements, using or modifying existing terminology, and then adding a number of carefully chosen exceptions or exclusions. This is the approach taken in the Proposed Rule.

In certain instances, securitization participants may prefer explicit as opposed to interpretive guidance that their activities are not subject to the Proposed Rule. For example, underwriters sometimes serve in dual roles as both underwriter and some form of liquidity provider, providing crucial liquidity for debt service payments or other required items in the event of a temporary cash flow shortfall. ABS investors may rely on such a liquidity facility for certainty of payments, despite such backstop liquidity being subject to differing economic terms and repayment priorities while being supported by the same underlying collateral as the ABS. While a determination that such activities do not fall within the Proposed Rule likely follows from an early analysis of the Proposed Rule's scope, *i.e.*, "[the definition of conflicted transaction] is already appropriately focused on transactions that constitute a bet against the relevant ABS and would not encompass activity such as an extension of credit by a securitization participant that functions to support the performance of the securitization rather than to benefit from its adverse performance," the language is not completely definitive and notes that "an overly broad application of the exception could give rise to abusive conduct."[2] Certain liquidity providers may wish to pursue certainty during the comment period.

Additionally, as is quite common, a number of the terms utilized in establishing such a protective framework are defined within the Proposed Rule. Since these terms (such as "sponsor") are associated with slightly different meanings in different regulatory contexts, their meanings for the purposes of the Proposed Rule are narrowed by further exceptions. For example, administrators, attorneys, custodians and others are excluded from treatment as persons who direct or cause the direction of the structure and design of ABS, while the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association are excluded on the grounds that they are directly or indirectly guaranteed by the full faith and credit of the United States. However, ordinary retainers of risk under the risk-retention rule are not provided with any similar relief, despite the fact that the retention of such risk presumably would make conflicted transactions economically very costly.

During the comment period for the Proposed Rule, market participants in ABS transactions will need to not only examine the manner in which the general rule is set out but also carefully focus on the number and nature of the listed exceptions to the general rule. Precisely defining a conflicted transaction should be useful in allowing market participants to

understand how to structure their compliance activities; however, there may be certain market participants who prefer a more principles-based approached.

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[1] *See* SEC Release No. 33-11151, available at: https://www.sec.gov/rules/proposed/2023/33-11151.pdf (the "Proposing Release") at 182.
[2] *See* Proposed Release at 102.