Clients&FriendsMemo

SEC Re-Proposes a Rule Prohibiting Conflicts of Interest in Certain Securitizations

February 9, 2023

On January 25, 2023, the Securities and Exchange Commission ("**SEC**" or "**Commission**") issued a release (the "**Re-Proposal**")[1] proposing Rule 192 under the Securities Act of 1933, as amended (the "**Securities Act**"), a rule that is designed to prohibit "material conflicts of interest" in certain securitizations. Proposed Rule 192 is intended to implement Section 621 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"),[2] which was codified as Section 27B ("**Section 27B**")[3] of the Securities Act. Subject to certain exceptions, Section 27B prohibits certain participants in asset-backed securities ("**ABS**")[4] securitization transactions from engaging in transactions within a designated time period that would involve or result in any "material conflict of interest." Section 27B directs the Commission to issue rules implementing this prohibition no later than 270 days after the enactment of Dodd-Frank (*i.e.,* within 270 days of July 21, 2010).[5]

Rule 192 is intended to supersede proposed Rule 127B, which was proposed by the Commission on September 19, 2011,[6] but never adopted. While proposed Rule 127B largely tracked the text of Section 27B, the Re-Proposal asserts that Rule 192 is designed to "provide greater clarity regarding the scope of prohibited and permitted conduct."[7]

---

1 See *Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Release No. 33-11151; File No. s7-01-23; (Jan. 25, 2023) (the "**Re-Proposal**"), available at https://www.sec.gov/rules/proposed/2023/33-11151.pdf.

2 Pub. L. 111-203, 124 Stat. 1376 (2010).

3 15 U.S.C. 77z-2a.

4 Proposed Rule 192(c) defines "**ABS**" to mean an asset-backed security as defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (the "**Exchange Act**"), as well as synthetic asset-backed securities and hybrid cash and synthetic asset-backed securities.

5 15 U.S.C. 77z-2a(b).

6 See *Prohibition against Conflicts of Interest in Certain Securitizations*, SEC Release No. 34-65355; File No. s7-38-11; (Sept. 19, 2011), 76 Fed. Reg. 60320 (Sept. 28, 2011) (the "**2011 Release")**, available at http://www.sec.gov/rules/proposed/2011/34-65355fr.pdf.

7 Re-Proposal, *supra* note 1, at 7-8.

The Re-Proposal is seeking comments regarding numerous aspects of the proposed rule and the Commission's approach to the implementation of Section 27B. Comments are due by the later of March 27, 2023 or 30 days after the Re-Proposal is published in the Federal Register (unless the Commission subsequently extends this comment period). The text of proposed Rule 192 is set forth in Appendix A hereto.

BRIEF OVERVIEW

1. SCOPE and PROHIBITION

Proposed Rule 192 would prohibit:

- an underwriter, placement agent, initial purchaser, or sponsor of an ABS, or any affiliate or subsidiary of such an entity (collectively, "**Securitization Participants**");
- 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 ABS and ending on the date that is one year after the date of the first closing of the sale of such ABS; and
- from directly or indirectly engaging in any transaction that would involve or result in a "material conflict of interest" between the securitization participant and an investor in such ABS (*i.e.*, a "**Conflicted Transaction**").

2. EXCEPTED ACTIVITIES

As provided in Section 27B, the following three categories of activities would be excluded from the prohibition in proposed Rule 192:

- risk-mitigating hedging transactions designed to reduce specific risks to a Securitization Participant arising out of participation in the securitization;
- purchases or sales made pursuant to commitments of Securitization Participants to provide liquidity for the ABS; and
- purchases or sales made pursuant to bona fide market-making in the ABS.

3. KEY DIFFERENCES from PROPOSED RULE 127B

Proposed Rule 192 expands upon proposed Rule 127B by, among other things:

- defining each type of entity as to which proposed Rule 192 would apply;

- delineating the types of transactions that involve a material conflict of interest and are thus deemed to be Conflicted Transactions:
- providing a more specific commencement point for the prohibition on Conflicted Transactions;
- providing a specific standard for determining the "materiality" component of the term Conflicted Transaction;
- providing more specificity with respect to the risk-mitigating hedging exception and the bona fide market-making exception and imposing conditions on the availability of those exceptions; and
- including an "anti-circumvention" provision.

BACKGROUND

Section 27B was enacted to prohibit underwriters, sponsors and others who assemble and sell ABS from profiting from the securities' failure.[8] The Re-Proposal characterizes this objective as prohibiting "transactions that effectively represent a bet against a securitization."[9] However, the Re-Proposal acknowledges that the securitization markets have undergone various changes since Section 27B was enacted and that the Commission does "not have data on the [current] extent of" the conduct that gave rise to that provision.[10] This acknowledgement appears to place particular importance on the need to assure that the proposed rule does not place an unwarranted burden on ABS market participants or unnecessarily inhibit economically beneficial transactions.

The Re-Proposal expresses the view that the proposed rule's focus on transactions that represent a bet against the performance of an ABS "would provide strong protection against material conflicts of interest while not unnecessarily hindering routine securitization activities that do not give rise to the risks Section 27B was designed to address."[11] However, comments offered in response to the 2011 Release emphasized the extent to which a broad reading of Section 27B could threaten ordinary and essential securitization practices.[12] Given that twelve years have elapsed since Rule 127B was proposed, implementing the amorphous language of Section 27B has demonstrably proven to be a very difficult task. In that regard, Commissioner Peirce emphasized that "an overly broad rule . . . could harm the securitization market and, thus, the credit markets they support" and

---

8 Congressional Record, S5899 (July 15, 2010) (statement of Sen. Carl Levin).

9 Re-Proposal, *supra* note 1, at 6.

10 *Id.* at 7.

11 *Id.* at 8.

12 *See, e.g.*, comment letter from Stephen H. McElhennon, Vice President and Deputy General Counsel, Legal Department, Federal National Mortgage Association (hereinafter, **"Fannie Mae Letter"**) (Jan. 17, 2012), at 2; comment letter from Salvatore P. Palazzolo, Deutsche Bank (hereinafter, **"Deutsche Bank Letter"**) (Feb. 9, 2012), at 3-4.

expressed hope that "the thoughtful feedback commenters will supply . . . will enable [the SEC] to draft a workable final rule."[13] Commissioner Uyeda similarly expressed the view that "a rule prohibiting [as opposed to regulating] transactions must especially balance protecting investors from harmful conflicts with ensuring that market participants can engage in transactions that do not cause such harm."[14]

KEY COMPONENTS OF PROHIBITION

Consistent with Section 27B, proposed Rule 192 would apply (unless an exception is available) when a transaction: (1) involves an asset-backed security; (2) is effected by a covered person (*i.e.*, a Securitization Participant); (3) is deemed to involve a "conflict of interest" that is "material"; and (4) is effected during a covered timeframe. Proposed Rule 192 attempts to bring clarity with respect to, and seek comment regarding, each of those concepts.

1. COVERED PERSONS

Proposed Rule 127B merely incorporated the Section 27B reference to "underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity," without defining any of those terms. By contrast, "in order to facilitate compliance,"[15] proposed Rule 192(c) includes specific definitions for the terms underwriter, placement agent, initial purchaser and sponsor; and it defines the terms "affiliate" and "subsidiary" by reference to the definitions in Rule 405 under the Securities Act.

"Underwriter," "Placement Agent" and "Initial Purchaser" Definitions:

The terms "underwriter" and "placement agent" would be identically defined in proposed Rule 192(c) as a person who has agreed with an issuer or selling security holder to: (1) purchase securities from the issuer or selling security holder for distribution; (2) engage in a distribution for or on behalf of the issuer or selling security holder; or (3) manage or supervise a distribution for or on behalf of such issuer or selling security holder. The term "distribution" would, in turn, be defined to mean: (1) "an offering of securities, whether or not registered under the Securities Act, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods"; and (2) an offering of securities made pursuant to an effective Securities Act registration statement. The Re-Proposal notes that the focus on "special selling efforts and selling

---

[13] Commissioner Hester M. Peirce, Statement on Proposed Rule: "Prohibition Against Conflicts of Interest in Certain Securitizations" (Jan. 25, 2023) (hereinafter, "**Peirce Statement**").

[14] Commissioner Mark T. Uyeda, Statement on the Proposed Rule: Prohibition against Conflicts of Interest in Certain Securitizations (Jan. 25, 2023) (hereinafter, "**Uyeda Statement**").

[15] Re-Proposal, *supra* note 1, at 20.

methods" is designed to distinguish an ABS offering from secondary trading and that indicia of those efforts and methods include greater than normal sales compensation, delivering a sales document and conducting road shows.[16]

The term "initial purchaser" would be separately defined in proposed Rule 192(c), to capture a person that has agreed with an issuer to purchase securities from the issuer for resale to other purchasers in transactions that are not required to be registered under the Securities Act in reliance upon Rule 144A under the Securities Act or because they do not involve any public offering.

The Re-Proposal notes that the foregoing definitions are based on the functions a person performs, rather than the title ascribed to that person's role, and do **not** exclude an underwriter, placement agent or initial purchaser that was not directly involved in structuring an ABS transaction or selecting the assets underlying the ABS.[17] The Re-Proposal expresses the view that "[e]ven if, for example, the relevant 'sponsor' is the person most directly involved in the selection of assets, the relevant underwriter, placement agent or initial purchaser would also be in a position to influence the structure of the relevant ABS . . . "[18]

"Sponsor" Definition:

With respect to the term "sponsor," subparagraph (i) of the proposed Rule 192(c) definition essentially incorporates the Regulation AB definition of that term, defining a "sponsor" as: "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."

However, subparagraphs (ii)(A) and (ii)(B) of the proposed definition significantly expand upon the Regulation AB definition by including: (1) "any person 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" (a "**Contractual Right Sponsor**"); as well as (2) any person that "directs or causes" the foregoing, whether or not such person has a contractual right to do so (a "**Non-Contractual Right Sponsor**").[19] The Re-Proposal notes that Contractual Right Sponsors could include, among others, a collateral manager for a collateralized loan obligation ("**CLO**") or a private fund manager "with substantial involvement in the selection of the assets underlying an ABS (other than in connection with its acquisition of a long position in the

[16] Re-Proposal, *supra* note 1, at 22-23.

[17] Re-Proposal, *supra* note 1, at 24.

[18] *Id.* at 25.

[19] Text of proposed Rule 192, *infra, Appendix A* at § 230.192(c) (emphasis added).

relevant ABS)."[20] The Re-Proposal explains the Contractual Right Sponsor provision as a way to address the concern that: "participating in asset selection for an ABS provides the opportunity for a person to benefit through a bet against the ABS or the underlying assets by selecting assets that such person believes will perform poorly."[21] The Re-Proposal states that the actual exercise of a contractual right is not necessary for purposes of this definition.[22]

The Re-Proposal indicates that determining whether a person is a Non-Contractual Right Sponsor depends upon the "specific facts and circumstances."[23] The Re-Proposal suggests that the "good" or "bad" intent of the person plays a role in this determination. In this regard, the Re-Proposal indicates that an ABS investor would not be deemed to be a "sponsor" "merely because such investor expresses its preferences regarding the assets that would collateralize its ABS investment."[24] The Re-Proposal also suggests that a private fund manager that directs or causes the direction of the structure, design, or assembly of an ABS would not be a "sponsor" if its objective were to acquire a long position in the ABS, but would be a sponsor if its intention were to cause the selection of assets that would perform poorly and to benefit from that poor performance by acquiring a short position in the ABS.[25]

Persons that perform only "administrative, legal, due diligence, custodial, or ministerial acts" related to the structure, design, or assembly of an ABS would be excluded from the Rule 192(c) sponsor definition. As noted in the "Covered ABS Transactions" section below, Freddie Mac, Fannie Mae and Ginnie Mae also would be excluded from the "sponsor" definition under certain circumstances.

Potential Issue:

- *The Re-Proposal creates ambiguity as to the role "bad intent" plays in "sponsor" status, particularly in the case of Contractual Right Sponsors and Non-Contractual Right Sponsors. Although the Re-Proposal states that sponsor status is based upon the function a person performs,[26] the Commission's discussion suggests this may not be case if the person's intention is to acquire a long position, rather than to select or direct the selection of assets the person believes will perform poorly.*

---

[20] Re-Proposal, *supra* note 1, at 30-31.

[21] *Id.* at 30.

[22] *Id.* at 31.

[23] *Id.*

[24] *Id.* at 32.

[25] *Id.* at 32-33.

[26] *Id.* at 24.

• *The Re-Proposal's failure to acknowledge, on a consistent basis, the fundamental role "bad intent" plays in identifying the "material conflict of interest" transactions Section 27B was designed to prohibit is a recurring problem that causes certain portions of proposed Rule 192 to be both unclear as to scope and to sweep too broadly.*

• *The Re-Proposal's suggestion that involvement in the selection of ABS assets will not result in "sponsor" status if the person's intention is to acquire a long position in the ABS is helpful for ABS investors, such as "B-piece buyers" in CMBS issuances. However, to provide clarity to the market, we believe the contours of this exception should be expressly included in the proposed rule.*

"Affiliate" and "Subsidiary" Definitions; Possible Use of Information Barriers:

With respect to the proposed definitions of "affiliate" and "subsidiary," the Re-Proposal expresses the view that including those entities in the rule would "help to prevent affiliates and subsidiaries from being used to evade the rule's prohibitions and would be consistent with Section 27B."[27] However, defining those terms by reference to Rule 405 under the Securities Act, as proposed Rule 192(c) would do, would cause those terms to sweep very broadly.[28]

Even before Rule 405 was specifically incorporated, certain commenters to the 2011 Release suggested that the use of information barriers would mitigate the potential over-inclusiveness of referencing affiliates and subsidiaries.[29] The Re-Proposal acknowledges that "[i]nformation barriers . . . have been recognized in other areas of the Federal securities laws and the rules thereunder," referencing, in particular, in the context of preventing the misuse of material, nonpublic information and in the context of Regulation M.[30] Nonetheless, the Re-Proposal indicates that the proposed rule does not incorporate the use of information barriers due to concern "about the potential to use an affiliate or subsidiary to evade the re-proposed rule's prohibition."[31] The Re-Proposal does, however, seek comment as to whether an information barrier exclusion could be implemented in a

---

[27] *Id.* at 47.

[28] Under Rule 405, an "affiliate" of a specified person is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified. A "subsidiary" of a specified person is an affiliate controlled by such person directly, or indirectly through one or more intermediaries. "Control" means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. *See* 17 C.F.R. 230.405.

[29] *Id.* at 48-49 (citing comment letter from American Bar Association (Feb. 13, 2012), at 11-12; comment letter from American Securitization Forum (Feb. 13, 2012) (hereinafter, "**ASF Letter**"), at 10-11; comment letter from The Financial Services Roundtable (Feb. 13, 2012), at 10; comment letter from The Securities Industry and Financial Markets Association (Feb. 13, 2012) (hereinafter, "**SIFMA Letter**"), at 14-15).

[30] Re-Proposal, *supra* note 1, at 49.

[31] *Id.*

way that would be consistent with Section 27B.[32] The Re-Proposal also seeks comment as to the specific features an information barrier could be required to contain, including, potentially, "an annual independent assessment of the operation of" the information barrier and the absence of officer/employee interlocks.[33]

Potential Issues:

• *The scope of the "sponsor" definition is particularly significant because of the broad definition of "affiliate" in the Re-Proposal, the current absence of information barriers and the proposed "catch-all" and "anti-circumvention" provisions discussed below.*

• *In the case of Securitization Participants that are part of a large corporate group – as is often the case – the ability to rely upon information barriers appears to be essential to avoiding a host of problems that would arise from the adoption of proposed Rule 192. Ironically, the absence of an information barriers exception could have the counter-productive effect of requiring difficult-to-achieve interactions among affiliates that normally operate independently, including affiliates that operate outside the U.S.*

• *In the event proposed Rule 192 is revised to include an information barrier exception, the regulatory conditions relating to those barriers should not be unreasonably difficult for Securitization Participants to implement or depart significantly from approaches with which the Commission has been comfortable in other contexts.*

2. COVERED ABS TRANSACTIONS

As required by Section 27B, proposed Rule 192(c) would apply to any asset-backed security, as that term is defined in Section 3(a)(79) of the Exchange Act, as well as to any synthetic ABS. Unlike proposed Rule 127B, proposed Rule 192(c) also would apply to any hybrid cash and synthetic ABS.[34] The Re-Proposal highlights the fact that the definition includes both ABS sold in registered and exempt offerings, noting that both types of offerings could result in potential conflicts of interest.[35]

---

[32] *Id.* at 53.

[33] *Id.* at 54.

[34] *See* Re-Proposal, *supra* note 1, at 15 (noting that, given that the prohibition in Section 27B applies to both Exchange Act ABS and synthetic ABS, "it would be inconsistent for the rule not to apply to a hybrid ABS that has characteristics of both cash ABS and synthetic ABS.").

[35] *Id.* at 11.

Municipal Entity Securitizations:

In response to the 2011 Release, the SEC received comment requesting clarification as to whether certain types of municipal securitizations and certain other products would be ABS.[36] The Re-Proposal expressed the view that proposed Rule 192's definition of "asset-backed security" is sufficiently clear in addressing these questions because "market participants are familiar with analyzing whether such a security meets the Exchange Act ABS definition[.]"[37] However, Commissioner Peirce commented that "municipal entities are unlikely to engage in conflicted transactions" and therefore suggested that consideration should be given to exempting those entities from the prohibition altogether.[38] The Re-Proposal thus solicits comment regarding this point.[39]

Fannie Mae, Freddie Mac and Ginnie Mae Securitizations:

The Commission also received comments to proposed Rule 127B stating that not excluding securities issued or guaranteed by Freddie Mac and Fannie Mae (the "**Enterprises**") and securities guaranteed by Ginnie Mae from the scope of the rule could have significant economic impacts.[40] The Re-Proposal notes that, while these entities would not be expressly excluded from proposed Rule 192, the definition of "sponsor" in proposed Rule 192(c) contains an exclusion for "the United States or an agency of the United States" with respect to any ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by the United States.[41] The definition of "sponsor" also includes an exclusion for the Enterprises with respect to securities that are fully insured or fully guaranteed by them as to the timely payment of interest, but only for so long as they are operating under the conservatorship or receivership of the Federal Housing Finance Agency.

Synthetic CLOs and Other Synthetic ABS:

The Re-Proposal notes that portfolio managers at large banks and CLO investors had suggested that certain synthetic balance sheet CLOs utilized as risk management tools should be excluded

---

[36] *See* SIFMA Letter, *supra* note 29 at 18-19.

[37] *Id.* at 12-13.

[38] *See* Peirce Statement, *supra* note 13 (noting that, in the event a municipal entity elects to establish compliance procedures as a defense against an enforcement investigation, it would incur "unnecessary costs").

[39] *Id.* at 18.

[40] *See* SIFMA Letter, *supra* note 29, at 18-19.

[41] *See* Re-Proposal, *supra* note 1, at 16.

from the prohibition of proposed Rule 127B.[42] The Re-Proposal does not include such an exception, expressing concern that such an exception could weaken protection for ABS investors "because the relevant securitization participant could structure synthetic ABS products that entitle the securitization participant to receive cash payments in the event that the referenced ABS, which the securitization participant also structured and sold to investors, fails."[43] However, the Re-Proposal requests comment as to whether an exception for certain synthetic balance sheet CLOs should be added to the rule.[44]

The Commission also rejected suggestions that the term "synthetic ABS" should be defined, expressing the view that this concept is well understood by market participants and that any potential definition might be susceptible to over-inclusiveness or under-inclusiveness.[45] However, the Re-Proposal requests comment on this point.[46]

The Re-Proposal also requests comment regarding whether a catch-all provision should be added to the ABS definition to cover any product that functions as the equivalent of a cash ABS, synthetic ABS or a hybrid cash and synthetic ABS.[47]

Potential Issues:

• As discussed in the Proposed Treatment of Credit Risk TransferTransactions section below, we believe the Re-Proposal's treatment of synthetic balance sheet CLOs and other synthetic ABS sweeps too broadly and indiscriminately and that the proposed rule should include an exception for synthetic ABS that are unlikely to entail the sort of conflict of interest Section 27B was designed to prohibit.

3. COVERED TIMEFRAME

As is the case with respect to Section 27B, proposed Rule 127B would have applied to parties who engaged in a prohibited transaction "**at any time** for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security[.]"[48] It did not include

---

[42] Re-Proposal, *supra* note 1, at 16 (citing Deutsche Bank Letter, *supra* note 12, at 1-8; comment letter from The International Association of Credit Portfolio Managers (June 28, 2012) at 1-4; and comment letter from PGGM Investments (June 20, 2012) at 1-3).

[43] *Id.* at 16.

[44] Re-Proposal, *supra* note 1, at 18

[45] *Id.* at 14 (citing ASF Letter, *supra* note 29, at 23).

[46] *Id.* at 17.

[47] *Id.* at 17.

[48] *See* 2011 Release, *supra* note 6, at 117 (emphasis added).

a specified commencement date, but clearly would have encompassed prohibited transactions occurring before the issuance of the relevant ABS.

Proposed Rule 192(a)(1) also would apply to pre-issuance prohibited transactions and would employ the same "end-date" as does Section 27B. However, it attempts to provide more clarity as to the commencement date. In that regard, it would apply to Securitization Participants that engage in a Conflicted Transaction "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[.]" The Re-Proposal makes clear that an agreement can exist even if not codified in writing.[49] It also makes clear that the proposed rule does not apply to a party that may have taken "substantial steps to reach an agreement" but doesn't actually become a Securitization Participant.[50]

The Re-Proposal seeks comment regarding whether a **specific** date should be designated as the commencement point.[51] However, it expresses concern that selecting a specific commencement point -- such as the date of the first marketing or offering materials or the pricing date -- might be under-inclusive.[52]

The Re-Proposal expresses the view that the point at which an entity has reached, or taken substantial steps to reach, an agreement that the entity will become a Securitization Participant is the appropriate commencement point because "this is the point at which a person may be incentivized and/or can act on an incentive to engage in the misconduct that Section 27B is designed to prevent."[53] The Re-Proposal notes that whether a person has taken substantial steps to become a Securitization Participant would be a "facts and circumstances determination[.]"[54] To that point, both Commissioners Peirce and Uyeda questioned whether market participants would understand the specific activities that constitute "substantial steps" for purposes of the proposed rule.[55] In recognition of this concern, the Re-Proposal solicits comment regarding specific indicia

---

[49] Re-Proposal, *supra* note 1, at 57.

[50] *Id.* at 57-58.

[51] *Id.* at 60-61.

[52] *Id.* at 59.

[53] *Id.* at 56.

[54] *Id.* at 57.

[55] Peirce Statement, *supra* note 13; Uyeda Statement, *supra* note 14.

that a person has reached an agreement or taken "substantial steps" to reach an agreement to becoming a securitization participant and whether such indicia should be included in the rule.[56]

Potential Issues:

• *As there is no securities law precedent for the proposed "substantial steps to reach" trigger and as an "agreement" can exist in the absence of a written document, we believe more guidance regarding this trigger will be essential.*

4. COVERED "CONFLICT OF INTEREST" TRANSACTIONS

Proposed Rule 127B would have prohibited a transaction "that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity."[57] It did not delineate the types of transactions that could be deemed to involve a "material conflict of interest." A number of commenters therefore recommended that the SEC provide more specific guidance regarding the types of transactions the rule would cover.[58]

Proposed Rule 192(a)(2) attempts to address this issue by providing that "engaging in any transaction would involve or result in a material conflict of interest . . . if such transaction is a [Conflicted Transaction]." The term Conflicted Transaction would be defined in Rule 192(a)(3) to encompass three categories of activity and would incorporate a standard for determining "materiality" (see Section 5. below). Those three categories of activity would be:

(1) Short Sales

Pursuant to proposed Rule 192(a)(3), a Conflicted Transaction would include short sales of the relevant ABS. The Re-Proposal explains that a Securitization Participant that sells an ABS it does not own (or that it would borrow to make delivery) would be making a direct bet against the ABS.[59] Under proposed Rule 192, it would be immaterial whether the Securitization Participant makes a profit on a short-sale of the ABS; the act of selling short would be sufficient.[60]

---

[56] *Id.* at 60.

[57] *See* 2011 Release, *supra* note 6, at 117.

[58] *See, e.g.*, comment letter from The Financial Services Roundtable (Feb. 13, 2012), at 5 ("[T]he revised guidance should clearly distinguish conflicts of interest arising generally in ABS transactions from abusive structures where sponsors, distribution participants, or a third party stand to profit from an ABS transaction they designed to fail or default.").

[59] Re-Proposal, *supra* note 1, at 64.

[60] *Id.*

(2) Credit Default Swaps

The term Conflicted Transaction also would include the purchase of a credit default swap or other credit derivative pursuant to which a Securitization Participant would be entitled to receive payments upon the occurrence of specified credit events in respect of the relevant asset-backed security. The Re-Proposal describes such a transaction as a "direct bet" against the ABS and notes that it would be irrelevant whether the credit derivative is in the form of a credit default swap or other credit derivative product "because the focus is on the economic substance of the credit derivative as a bet against the relevant ABS[.]"[61] It would be irrelevant whether the Securitization Participant actually benefits from the transaction.[62]

(3) Potential to Benefit from Adverse Performance of ABS

Additionally, proposed Rule 192(a)(3) includes a broad, catch-all category of Conflicted Transaction that would encompass "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: (1) adverse performance of the asset pool supporting or referenced by the relevant ABS; (2) the loss of principal, monetary default, or early amortization event of an ABS; or (3) the decline in market value of an ABS. The Re-Proposal describes this category as capturing transactions "the terms of which are substantially the economic equivalent of a direct bet against the relevant ABS."[63] The Re-Proposal cites, as an example, entering into the short-side of a derivative (*e.g.*, with the special purpose entity issuing a synthetic CDO) that references the performance of the pool of assets underlying an ABS with respect to which the person is a Securitization Participant and pursuant to which the Securitization Participant would benefit if the referenced asset pool performs poorly.[64]

As is the case with short sales and credit default swaps, it is not necessary that the Securitization Participant actually benefit from a transaction deemed to fall within this catch-all category. The Re-Proposal notes that this category does not include the qualifier "directly or indirectly" when referencing benefits received by a Securitization Participant, on the theory that this category – coupled with the proposed rule's anti-circumvention

[61] Re-Proposal, *supra* note 1, at 65.

[62] *Id.* at 68.

[63] Re-Proposal, *supra* note 1, at 65.

[64] *Id.*

provision – would be sufficiently broad to capture the types of indirect benefits that the proposed rule seeks to preclude.[65]

The Re-Proposal emphasizes that "because the proposed definition of Conflicted Transaction is limited in scope to transactions that are effectively a bet against the relevant ABS or its underlying pool of assets, the re-proposed rule would not apply to transactions that are wholly independent of, and not in connection to, the relevant securitization."[66]

Potential Issues:

• *Although proposed Rule 192 brings some specificity to the elusive Section 27B concept of "material conflict of interest," significant uncertainty remains due to the breadth and vagueness of the catch-all category. Moreover, the "wholly independent of, and not in connection to, the relevant securitization" test, while seemingly helpful, appears to raise significant interpretive questions.*

5. MATERIALITY

Pursuant to proposed Rule 192, a transaction would only be a Conflicted Transaction if the transaction is deemed to be "material." Paragraph (a)(3) of the proposed rule would deem "materiality" to exist if "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision[.]"

In the 2011 Release, the Commission expressed its concern that including a definition for materiality could cause the rule to be over-inclusive or under-inclusive.[67] However, some commenters noted that market participants may face uncertainty in determining whether their activity is subject to the rule if a definition is not included.[68] Other commenters were concerned that, absent a definition, courts may interpret "materiality" much more broadly than the Commission intends.[69] In response, proposed Rule 192 includes a materiality standard that relies on the

---

[65] *Id.* at 69. We note that the prohibition in paragraph (a)(1) of the proposed rule includes a "directly or indirectly" component, and it is unclear why this provision wouldn't be equally applicable to such a fact pattern.

[66] *Id.* at 70.

[67] 2011 Release, *supra* note 6, at 35.

[68] *See, e.g.*, comment letter by the Commercial Real Estate Finance Council (Feb. 13, 2012), at 3 ("Our members are . . . concerned that the proposed regulatory text lacks definitions of key terms such as "material conflict of interest," and that the Commission would instead rely on interpretive discussion and examples in material accompanying the regulatory text to provide the bulk of the Commission's guidance to market participants on conflicts of interest.").

[69] *See* comment letter by Jeffrey W. Rubin, Chair, Federal Regulation of Securities Committee and Martin Fingerhut, Chair, Securitization and Structured Finance Committee (Feb. 13, 2012), at 3-4.

"reasonable investor" standard of materiality utilized by some courts as a touchstone for "materiality" in the context of "insider trading" decisions.[70]

The Re-Proposal emphasizes that this standard would not allow Securitization Participants to avoid subjecting certain transactions to the prohibitions of proposed Rule 192 through the use of disclosures.[71] The Re-Proposal asserts that, while adequate disclosures could reduce the likelihood that an investor would invest in an ABS that is affected by a conflict of interest, disclosures would not entirely eliminate the incentive for Securitization Participants to enter into conflicted transactions.[72] The Re-Proposal asserts that such an approach also would "fail to align with Section 27B . . . "[73]

Similarly, the Re-Proposal notes that the use of a "reasonable investor" standard should not be interpreted to imply that an otherwise prohibited transaction would be permissible if the investor selects or approves of the assets underlying the ABS. The Re-Proposal notes, in this regard, that, even if an investor were given adequate information regarding the pool of assets and consents to that asset pool, a Securitization Participant could nonetheless "structure the ABS . . . in a way that would position the securitization participant to benefit from the adverse performance of" the underlying assets.[74]

The Re-Proposal also notes that certain commenters to the 2011 proposal recommended that a rule implementing Section 27B be limited to ABS transactions that are intentionally designed to fail.[75] However, the Re-Proposal asserts that proposed Rule 192 is not limited in that fashion because "such a test could lead to attempts to evade the rule," would "make enforcement more difficult" and would not be consistent with Section 27B, "which is not limited only to ABS that are intentionally designed to fail."[76]

---

[70] Re-Proposal, *supra* note 1, at 71. The "reasonable investor" standard of materiality was articulated in Basic v. Levinson, 485 U.S. 224, 231-32 (1988).

[71] *Id.* at 72.

[72] *Id.* at 72-73.

[73] *Id.* at 73.

[74] *Id.*

[75] *Id.* at 74 (citing ASF Letter, *supra* note 29, at 11; Fannie Mae Letter, *supra* note 12, at 1-2; SIFMA Letter, *supra* note 29, at 27-28).

[76] *Id.*

The SEC requests comments regarding whether the proposed definition of "material conflicts of interest" accurately captures the types of transactions that Section 27B is designed to address or whether an alternative definition should be used.[77]

Potential Issues:

• As noted above, the Re-Proposal acknowledges the significance of intent in the context of the definition of "sponsor." Although the Commission's desire to establish a bright-line approach to the implementation of Section 27B could well make enforcement less difficult, such an approach would have serious adverse consequences for the financial markets – and potentially the economy as a whole – because transactions that are economically beneficial and non-abusive would either be prohibited or be deemed to entail too much regulatory uncertainty.

• Moreover, because Section 27B was motivated by a desire to prohibit transactions that constitute a "bet against" the applicable ABS, we believe it would be overbroad to apply that section in the context of ABS that are designed to hedge bona fide business risks, rather than to give a Securitization Participant the opportunity to "profit from" poor performance.

• Rather, we believe it would be appropriate for the Commission to rely upon a disclosure requirement – rather than a categoric prohibition – in the case of ABS that are designed to hedge a bona fide lending or other business risk of the Securitization Participant (such as balance sheet CLOs and other synthetic ABS), as those transactions are not designed to "bet" against the ABS. In that scenario, the Re-Proposal's concern that disclosure would be insufficient to completely protect investors from a Securitization Participant's "bad intent" would not exist.

• Although the inclusion of a "materiality" standard provides some clarity, a "reasonable investor" standard may be difficult to apply in practice. Additional guidance would therefore be helpful.

6. ANTI-CIRCUMVENTION

Certain of the comment letters received in response to the 2011 Release recommended that proposed Rule 127B address potential evasion of the rule's prohibitions.[78] The Re-Proposal expresses the Commission's agreement with this suggestion. Accordingly, proposed Rule 192(d) provides that "[i]f a securitization participant engages in a transaction that circumvents the

[77] *Id.* at 75.

[78] Re-Proposal, *supra* note 1, at 82 (citing comment letter from Better Markets, Inc. (Feb. 13, 2012), at 3-5; comment letter from Morgan Stanley (Feb. 10, 2012), at 4; comment letter from Akshat Tewary, Esq. (Dec. 2, 2011), at 7).

prohibition in paragraph (a)(1) of this section, the transaction will be deemed to violate paragraph (a)(1) of this section."

The Re-Proposal indicates that, although proposed Rule 192(a)(3) identifies three specific categories of Conflicted Transactions that are "common types of transactions that a person might utilize in order to 'bet' against the performance of a financial asset," the anti-circumvention provision would address transactions that are structured to fall outside of the proposed Rule 192 prohibition on material conflicts of interest but be "economically equivalent to" a Conflicted Transaction. The Re-Proposal expresses the view that the Rule 192 prohibition should be "premised on the substance of the transaction rather than on its form, label, or written documentation."[79] However, Commissioner Peirce questioned whether the proposed anti-circumvention provision "unnecessarily cloud[s] the rule's perimeters," suggesting that the stated purpose of the anti-circumvention provision is unnecessary given the breadth of the proposed Rule 192 prohibition.[80]

The Re-Proposal requests comment as to whether the proposed anti-circumvention provision would result in uncertainty regarding the scope of proposed Rule 192's prohibition.[81] The Re-Proposal also requests comment on whether the anti-circumvention provision should be modified to apply only if the Securitization Participant "knows or has reason to know that the transaction is undertaken for the purpose of circumventing" the re-proposed rule's prohibition.[82]

Potential Issues:

• *As is the case with the broad catch-all category of Conflicted Transaction, the anti-evasion standard appears to create significant ambiguity regarding the transactions that would be captured by proposed Rule 192. Moreover, the anti-evasion provision appears to be duplicative of the catch-all category.*

EXCEPTIONS TO PROHIBITION

Consistent with Section 27B, proposed Rule 192(b) provides exceptions for risk-mitigating hedging activities, liquidity commitments and bona fide market-making. However, unlike proposed Rule 127B, proposed Rule 192(b) provides specific guidance as to the contours of those exceptions and imposes certain conditions to satisfying the risk-mitigating hedging exception and the bona fide market-making exception.

---

[79] Re-Proposal, *supra* note 1, at 83.

[80] Peirce Statement, *supra* note 13.

[81] Re-Proposal, *supra* note 1, at 83-84.

[82] Re-Proposal, *supra* note 1, at 83.

1. RISK-MITIGATING HEDGING ACTIVITIES

Section 27B(c) describes "risk-mitigating hedging activities" as "activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS, provided that those activities are "designed to reduce the **specific risks** to the relevant securitization participant associated with positions or holdings arising out of" the applicable activities.[83] The Re-Proposal makes clear that the positions could be hedged on an individual or aggregated basis and could include the origination or acquisition of assets that the Securitization Participant securitizes.[84] However, proposed Rule 192(b)(1) specifies that the initial distribution of an asset-backed security (such as a synthetic ABS) is not risk-mitigating hedging activity.

The Re-Proposal indicates that the stated goal of the proposed definition is to allow a Securitization Participant to hedge retained ABS positions (to the extent not inconsistent with Regulation RR, the SEC's risk retention rule) and to hedge exposures arising out of the assets that are originated or acquired by the Securitization Participant in connection with warehousing assets.[85] In an effort to distinguish permitted risk-mitigating hedging activity from Conflicted Transactions, proposed Rule 192(b)(1) would permit risk-mitigating hedging activities only if each of the following conditions is satisfied:

(1) Significant Mitigation of Specific, Identifiable Risks

When the hedging activity is commenced and at the time of any adjustments, the activity is designed to "reduce or otherwise **significantly mitigate** one or more **specific, identifiable** risks related to identified positions, contracts, or other holdings" of a securitization participant.[86]

(2) Ongoing Recalibration

The activity is subject, as appropriate, to **ongoing recalibration** by the Securitization Participant to ensure the activity satisfies the requirements of the risk-mitigating exception and "does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk reduction.

(3) Compliance Program

---

[83] 15 U.S.C. 77z-2a(c) (emphasis added).

[84] Re-Proposal, *supra* note 1 at 85-86.

[85] Id.

[86] Text of proposed Rule 192, *infra* Appendix A, at § 230.192(b)(1)(ii)(A) (emphasis added).

> The Securitization Participant establishes, maintains and enforces an internal compliance program that is reasonably designed to ensure compliance with the risk-mitigating hedging exception, including reasonably designed procedures that provide for the specific hedging activity to be "identified, documented, and monitored."

The Re-Proposal emphasizes that a Securitization Participant cannot "over-hedge" its risks in a way that would result in a net short exposure to the relevant ABS or otherwise constitute "speculative activity."[87] The Re-Proposal also notes that, although hedging may occur on an aggregate basis, the requirement that the risks must be "specific" and "identifiable" means that a Securitization Participant would be unable to rely upon the risk-mitigating hedging exception if it were to enter into a CDS referencing a retained ABS, but designed to hedge "generalized risks that it believes to exist based on non-position specific modeling or other considerations."[88] The Re-Proposal notes that whether a risk is "specific and identifiable" involves a "facts and circumstances" analysis and requests comment with respect to indicia that might be pertinent to such an assessment.[89]

The Re-Proposal asserts that a risk-mitigating hedge need not have "an exact negative correlation" with the exposure being hedged, acknowledges that a Securitization Participant may have to enter into an index-based hedging transaction and indicates that "the presence of negative correlation would generally indicate that the hedging activity reduced the risks it was designed to address."[90] However, the Re-Proposal requests comment as to whether a certification requirement should be required if exact negative correlation cannot be achieved.[91] It also solicits comment as to whether a certification requirement as to overall compliance with the conditions of the proposed rule should be required.[92]

The Re-Proposal requests comment as to whether the proposed rule should specify the exact frequency as to which a Securitization Participant should be required to "recalibrate" its hedge.[93] It also notes that certain of the proposed conditions to the risk-mitigating hedging exception are similar to those that are applicable to the equivalent exception to the Volcker Rule's proprietary trading prohibition and requests comment as to whether a Securitization Participant that is in

---

87 Re-Proposal, *supra* note 1, at 88.

88 *Id.* at 89.

89 *Id.*

90 *Id.* at 92.

91 *Id.* at 97.

92 *Id.* at 98-99.

93 *Id.* at 97.

compliance with the Volcker Rule conditions should presumptively be deemed to be in compliance with the risk-mitigating hedging exception in proposed Rule 192.[94]

Potential Issues:

• *Although proposed Rule 192(b)(1) would bring some clarity to the contours of the risk-mitigating hedging exception, complying with this paragraph in its proposed form, would still involve a fair amount of uncertainty and a potentially significant compliance burden. For example, identifying the contours of "specific" and "identifiable" risk – as opposed to "generalized risks . . . based on non-position specific modeling" – could prove to be a challenge.*

• *Given that the Re-Proposal acknowledges that entry into a CDS can potentially serve as a permissible risk-mitigating hedge, we believe it should be equally permissible for a Securitization Participant to utilize an appropriately-constructed synthetic ABS as a risk-mitigating hedge because such an ABS would serve precisely the same risk-mitigating function as does a CDS.*

2. LIQUIDITY COMMITMENTS

Consistent with Section 27B, the second Rule 192(b) exception is for purchases or sales of ABS made pursuant to and consistent with commitments of a Securitization Participant to provide liquidity for the ABS.[95] Proposed Rule 192(b)(2) essentially tracks the language of Section 27B. The Re-Proposal notes that, as is the case under Section 27B, a liquidity "commitment" need not take the form of a contractual obligation.[96]

3. BONA FIDE MARKET-MAKING

The final exception to the proposed Rule 192(a) prohibition permits certain bona fide market-making in the ABS. As is the case with Section 27B, proposed Rule 127B did not define this concept. In response to comments requesting clarification,[97] proposed Rule 192(b)(3) would permit bona fide market-making activities -- including market-making related hedging -- conducted in accordance with five conditions set forth in the proposed rule. Under proposed Rule 192(b)(3), the exception would apply to market-making with respect to the applicable ABS, the assets underlying those ABS and financial instruments, such as CDS, that reference those ABS or assets (collectively, the "**Relevant Instruments**"). As is the case with respect to the risk-mitigating

[94] *Id.* at 98.

[95] Re-Proposal, *supra* note 1, at 101.

[96] *Id.* at 102.

[97] *Id.* at 105 (citing SIFMA Letter, *supra* note 29, at 34-35).

hedging exception, the bona fide market-making exception could not be relied upon in the case of the initial issuance of the ABS (*e.g.*, in connection with the issuance of a synthetic ABS).

The Re-Proposal makes clear that hedging activity relating to market-making activity does not need to separately qualify for the risk-mitigating hedging exception, noting that the latter exception is "principally designed to address the hedging of retained exposures rather than market-making positions that are entered into in connection with customer demand."[98] The Re-Proposal also notes that the bona fide market-making activity exception, as proposed, does not include a requirement to analyze the applicability of the exception on a trade-by-trade basis.[99] Rather, the Re-Proposal indicates that the rule is "focused on the overall market-making related activities of a securitization participant," with a condition that those activities are "related to satisfying the reasonably expected near term demand of the securitization participant's customers."[100]

Pursuant to proposed Rule 192(b)(3) the five conditions that would need to be satisfied -- which draw from the concept of market-making in both the Volcker Rule[101] and the Exchange Act -- are as follows:

(1) Conduct Evidencing Market-Maker Role

The first condition would require that the Securitization Participant "**routinely stands ready** to purchase and sell one or more types" of the Relevant Instruments and be "willing and available to quote, purchase and sell, or otherwise enter into long and short positions in [the Relevant Instruments] in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for" the Relevant Instruments. The SEC notes that proposed Rule 192(b)(3) employs a "routinely stands ready" standard, as opposed to a stricter standard, to avoid causing a chilling effect on a Securitization Participant's ability to act as a market-maker in a less liquid market.[102] The Re-Proposal acknowledges, in this regard, that market-makers in illiquid markets "likely do not trade continuously, but trade only intermittently or at the request of customers."[103] However, the Re-Proposal notes that, in order to satisfy this condition, the Securitization Participant would need to have "an established pattern of providing price quotations on either side of the market and a pattern of trading with customers on each side of the

[98] *Id.* at 108-09.

[99] *Id.* at 108.

[100] *Id.*

[101] *See* 17 CFR 255.4(b)(2)(i).

[102] Re-Proposal, *supra* note 1, at 111-112.

[103] *Id.* at 112.

market."[104] It further notes that the Securitization Participant would need to be willing to facilitate customer needs in both upward and downward moving markets.[105] The Re-Proposal indicates, as well, that the Securitization Participant must be willing to quote and trade in sizes requested by market participants, as this would evidence the Securitization Participant's willingness to provide intermediation services.[106]

(2) Nexus to Near-Term Client Demand

Pursuant to proposed Rule 192(b)(3), the Securitization Participant's activities also would need to be "designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, taking into account the liquidity, maturity, and depth of the market for" the Relevant Instruments. This condition is identical to that of the Volcker Rule.[107] The Re-Proposal indicates that this condition is designed to distinguish activity conducted for the purpose of building inventory in less liquid instruments from activity conducted to bet against the relevant ABS.[108] The Re-Proposal notes that determining whether this condition has been satisfied would require a facts and circumstances analysis.[109]

(3) Non-Incentivizing Compensation

Pursuant to proposed Rule 192(b)(3), the compensation arrangements for persons performing the activity would need to be designed to not reward or incentivize Conflicted Transactions. The Re-Proposal notes that a compensation arrangement that is designed to reward "speculation in, and appreciation of, the market value of market-making positions" would not be consistent with the bona fide market-making exception.[110]

(4) Registration/Licensing

Pursuant to proposed Rule 192(b)(3), the Securitization Participant would need to be licensed or registered, under applicable law and self-regulatory organization ("**SRO**") rules, to engage in the activity described in the bona fide market-making definition. The Re-

[104] *Id.*

[105] Re-Proposal, *supra* note 1, at 112.

[106] *Id.*

[107] *Id.* at 113.

[108] *Id.* at 113-14.

[109] *Id.* at 114.

[110] *Id.* at 115.

Proposal suggests that a person that is exempt from registration or excluded from regulation under applicable law and SRO rules also could satisfy this condition; however, the proposed rule could be clearer on this point.[111]

(5) Compliance Program

The fifth condition of proposed Rule 192(b)(3) is that the Securitization Participant would need to establish, maintain and enforce an internal compliance program that is reasonably designed to ensure the Securitization Participant's compliance with the requirements of the bona fide market-making exception. Proposed Rule 192(b)(3) would require that the compliance program contain "reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks" of the Securitization Participant's market-making positions and holdings. The Re-Proposal notes that a reasonably designed compliance program should identify the processes by which the Securitization Participant identifies the Relevant Instruments with respect to which the participant may make a market and the processes by which the participant would determine the reasonably expected near term demand for those instruments.[112] With respect to the need for processes relating to "prompt mitigation," the Re-Proposal cites "aged positions" as an example of the positions that might require mitigation actions and seeks comment as to the precise indicia of "prompt mitigation."[113]

As is the case with respect to the risk-mitigating hedging exception, the Re-Proposal seeks comment as to whether compliance with the equivalent Volcker Rule conditions presumptively evidence compliance with the bona fide market-making exception.[114] The Re-Proposal also seeks comment as to whether the rule should include a certification requirement.[115]

Potential Issues:

• As is the case with the risk, proposed Rule 192(b)(3) would bring some clarity to the bona fide market-making exception; however, efforts to comply with this exception, as proposed, would still create a significant amount of uncertainty, as well as a substantial compliance burden.

---

[111] *See* Re-Proposal, *supra* note 1, at 116.

[112] *Id.* at 118.

[113] *Id.* at 119.

[114] *Id.* at 122-23.

[115] *Id.* at 124.

• *Among other things, it would be important to confirm that standard offering document disclaimers regarding the ability to discontinue market-making at any time would not preclude a Securitization Participant from relying upon this exception.*

PROPOSED TREATMENT OF CREDIT RISK TRANSFER SECURITIZATIONS

The Re-Proposal asserts, in multiple places, that proposed Rule 192 "prohibits a securitization participant from creating and/or selling a new synthetic ABS to hedge a position or holding."[116] It notes that, in these transactions, a Securitization Participant is typically a party to a CDS contract with the ABS issuer. The Re-Proposal expresses concern that "such activity could weaken the conflicts of interest protection of [proposed Rule 192] by allowing a securitization participant to engage in a transaction (the CDS contract(s) with the issuer) where cash paid by ABS investors to acquire the newly created synthetic ABS would fund the relevant CDS contract(s) and be available to make a payment to the securitization participant upon the occurrence of an adverse event."[117] The Re-Proposal expresses the belief that, in addition to potential payments under the CDS, the relevant Securitization Participant "would likely obtain additional benefits such as arranger or manager compensation."[118]

At the same time, the Re-Proposal solicits comment as to whether the proposed rule should contain an exception for certain synthetic balance sheet CLOs that would permit a Securitization Participant that is a lender to hedge a portfolio of its originated loans and extensions of credit by purchasing a CDS contract from the special purpose vehicle that issues a synthetic ABS.[119] The Re-Proposal requests comment as to the types of synthetic balance sheet CLOs that should not be deemed to be Conflicted Transactions and the conditions that should be satisfied in order to ensure that the CLOs would be used "solely as a risk mitigation tool, rather than a speculative investment."[120] It also requests comment as to how such an exception would be consistent with Section 27B.

With respect to that request, we believe the Commission should be encouraged to adopt an exclusion for synthetic ABS that: (1) demonstrably mitigate risk incurred in connection with a bona fide lending or other business that employs responsible asset origination/operating procedures; and (2) involves the random selection of reference assets relating to that bona fide business, rather than

[116] Re-Proposal, *supra* note 1, at 87, 109.

[117] *Id.* at 87.

[118] *Id.*

[119] *Id.* at 18.

[120] *Id.*

the selection of assets in the hope or expectation that those assets will perform poorly. In our view, that type of synthetic ABS would not present the sort of conflict of interest Section 27B was designed to prohibit, as it would not represent a "bet against" the assets referenced in the ABS. That is, it would not provide a Securitization Participant with the ability to "profit from" the poor performance of those assets.

Moreover, the mere fact that Section 27B directs the Commission to adopt "implementing" rules, makes clear that the Commission has the latitude to conclude that certain types of transactions do not entail a "material conflict of interest." Indeed, Section 27B has been difficult to implement precisely because the "material conflict of interest" concept is so inchoate and, thus, so vulnerable to overly broad interpretation.

* * *

If you have any questions, please feel free to contact the following Cadwalader attorneys or any of your Cadwalader contacts.

Maurine Bartlett	+1 212 504 6218	maurine.bartlett@cwt.com
Joseph Beach	+1 704 348 5171	joseph.beach@cwt.com
David Burkholder	+1 704 348 5309	david.burkholder@cwt.com
Michael S. Gambro	+1 212 504 6825	michael.gambro@cwt.com
Anna H. Glick	+1 212 504 6309	anna.glick@cwt.com
Stuart N. Goldstein	+1 704 348 5258	stuart.goldstein@cwt.com
Gregg S. Jubin	+1 202 862 2485	gregg.jubin@cwt.com
Henry A. LaBrun	+1 704 348 5149	henry.labrun@cwt.com
Ivan Loncar	+1 212 504 6339	ivan.loncar@cwt.com
Daniel Meade	+1 202 862 2294	daniel.meade@cwt.com
Jed Miller	+1 212 504 6821	jed.miller@cwt.com
Lisa J. Pauquette	+1 212 504 6298	lisa.pauquette@cwt.com

Frank Polverino	+1 212 504 6820	frank.polverino@cwt.com
Y. Jeffrey Rotblat	+1 212 504 6401	jeffrey.rotblat@cwt.com
Michael Ruder	+1 704 348-5303	michael.ruder@cwt.com
Neil J. Weidner	+1 212 504 6065	neil.weidner@cwt.com

APPENDIX A – TEXT OF PROPOSED RULE 192

§ 230.192 Conflicts of interest relating to certain securitizations

(a) *Unlawful activity.*

(1) *Prohibition.* 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.

(2) *Material conflict of interest.* For purposes of this section, engaging in any transaction would involve or result in a material conflict of interest between a securitization participant for an asset-backed security and an investor in such asset-backed security if such a transaction is a conflicted transaction.

(3) *Conflicted transaction.* For purposes of this section, 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 transaction important to the investor's investment decision, including a decision 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.

(b) *Excepted activity.* The following activities are not prohibited by paragraph (a) of this section:

(1) *Risk-mitigating hedging activities.*

(i) *Permitted risk-mitigating hedging activities.* Risk-mitigating hedging activities of a securitization participant conducted in accordance with this paragraph (b)(1) in connection with and related to individual or aggregated positions, contracts, or other holdings of the securitization participant arising out of its securitization activities, including the origination or acquisition of assets that it securitizes, except that the initial distribution of an asset-backed security is not risk-mitigating hedging activity for purposes of paragraph (b)(1) of this section.

(ii) *Conditions.* Risk-mitigating hedging activities are permitted under paragraph (b)(1) of this section only if:

(A) At the inception of the hedging activity and at the 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, contracts or other holdings and the risks and liquidity thereof;

(B) The risk-mitigating hedging activity is subject, as appropriate, to ongoing recalibration by the securitization participant to ensure that the hedging activity satisfies the requirements set out in paragraph (b)(1) of this section and does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk-reduction; 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 requirements set out in paragraph (b)(1) of this section, 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.

(2) *Liquidity commitments.* Purchases 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.

(3) *Bona fide market-making activities.*

(i) *Permitted bona fide market-making activities.* Bona fide market-making activities, including market-making related hedging, of the securitization participant conducted in accordance with this paragraph (b)(3) in connection with and related to asset-backed securities with respect to which the prohibition in paragraph (a)(1) of this section applies, the assets underlying such asset-backed securities, or financial instruments that reference such asset-backed securities or underlying assets, except that the initial distribution of an asset-backed security is not bona fide market-making activity for purposes of paragraph (b)(3) of this section.

(ii) *Conditions.* Bona fide market-making activities are permitted under paragraph (b)(3) of this section only if:

(A) The securitization participant routinely stands ready to purchase and sell one or more types of the financial instruments described in paragraph (b)(3)(i) of this section as a part of its market-making related activities in such financial instruments, and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;

(B) The securitization participant's market-making related activities are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, taking into account the liquidity, maturity, and depth of the market for the relevant types of financial instruments described in paragraph (b)(3)(i) of this section;

(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 the activity described in paragraph (b)(3) of this section in accordance with applicable law and self-regulatory organization rules; and

(E) 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 requirements of paragraph (b)(3) of this section, including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.

(c) *Definitions.* For purposes of this section:

Asset-backed security has the same meaning as in section 3(a)(79) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(79)), and also includes synthetic asset-backed securities and hybrid cash and synthetic asset-backed securities.

Distribution means:

(i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.

Initial purchaser means a person who has agreed with an issuer to purchase a security from the issuer for resale to other purchasers in transactions that are not required to be registered under the Securities Act in reliance upon 17 CFR 230.144A or that are otherwise not required to be registered because they do not involve any public offering.

Placement agent and *underwriter* each mean a person who has agreed with an issuer or selling security holder to:

(i) Purchase securities from the issuer or selling security holder for distribution;

(ii) Engage in a distribution for or on behalf of such issuer or selling security holder; or

(iii) Manage or supervise a distribution for or on behalf of such issuer or selling security holder.

Securitization participant means:

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

(ii) 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.

Sponsor means:

(i) 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

(ii) 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 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.

(iii) Notwithstanding paragraphs (i) and (ii) of this definition:

(A) The United States or an agency of the United States will not be a sponsor for purposes of this rule with respect to an asset-backed security that is fully insured or fully guaranteed as to the timely payment of principal and interest by the United States.

(B) The Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation operating under the conservatorship or receivership of the Federal Housing Finance Agency pursuant to section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617) with capital support from the United States; or any limited-life regulated entity succeeding to the charter of either the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation pursuant to section 1367(i) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 U.S.C. 4617(i)), provided that the entity is operating with capital support from the United States; will not be a sponsor for purposes of this rule with respect to an asset-backed security that is fully insured or fully guaranteed as to the timely payment of principal and interest by such entity.

(d) *Anti-circumvention.* If a securitization participant engages in a transaction that circumvents the prohibition in paragraph (a)(1) of this section, the transaction will be deemed to violate paragraph (a)(1) of this section.