ALERT MEMORANDUM

ABS Conflicts of Interest Rule: Potholes on the Road to Implementation

February 23, 2024

Summary

On November 27, 2023, the U.S. Securities and Exchange Commission (the "**SEC**") adopted Rule 192 (the "**Final Rule**")[1], which finally implemented the SEC's mandate under the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**") to issue rules that prohibit certain securitization participants ("**Securitization Participants**") in asset-backed securities ("**ABS**") transactions, and certain of their affiliates, from entering into transactions involving or resulting in a material conflict of interest ("**Conflicted Transactions**"). Conflicted Transactions cannot be cured by investor disclosure or consent.

The Final Rule revives aspects of proposed Rule 127B[2], which the SEC released in 2011 and later abandoned following extensive industry consultation. The almost 15-year gestation period between the passage of Dodd-Frank and the effective date for the Final Rule is a testament to the complexity of the SEC's remit. Industry participants are expecting to find implementation of the Final Rule no less complex. Despite implementing a statute passed more than 20 years ago, the Final Rule appears to be part of the SEC's current effort to restrict the conduct of market participants in the name of protecting sophisticated investors, who traditionally have enjoyed more freedom to contract with their counterparties.

The Final Rule became effective on February 5, 2024 and provides for an 18-month compliance period. Any Securitization Participant must comply with the prohibition and the requirements of the exceptions to the Final

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[1] Final Rule: Prohibition Against Conflicts of Interest in Certain Securitizations, 88 Fed. Reg. 85396 (December 7, 2023), codified at 17 C.F.R. § 230.192.
[2] Proposed Rule: Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 78181 (December 16, 2011).

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Rule with respect to any ABS which holds a first closing on or after June 9, 2025 (the "**Compliance Date**"). In this memorandum, we summarize notable takeaways and specific interpretive issues that Securitization Participants should consider during the compliance period.

Compliance Deadline: Sooner Than You Think

The SEC has taken a restrictive approach to grandfathering in its recent rule releases, and the Final Rule is no exception. While the Final Rule will apply only to an ABS transaction which holds a first closing on or after June 9, 2025, the adopting release (the "**Adopting Release**") does not expressly grandfather with respect to any ABS issuance any activities or agreements which occur prior to the compliance date. The "**Applicable Period**" for each ABS transaction begins on the date on which a person or entity has reached an agreement to become a Securitization Participant with respect to that ABS transaction and ends one year after the date of the first closing of the sale of the ABS. The rule requires merely an agreement in principle (including an oral agreement and facts and circumstances constituting an agreement) as to the material terms by which a party will participate in the ABS transaction. There is no "bright line" date as to when a party may be subject to the rule with respect to a particular ABS transaction, and the SEC expressly stated that an executed engagement letter is not necessary to establish an "agreement" for purposes of the Final Rule. While not necessary, the Adopting Release states that a signed engagement letter is "sufficient" to begin the Applicable Period, even if that engagement letter does not set forth all the material terms of a party's participation in the ABS transaction.

In practice, these provisions may result in a bumpy and prolonged implementation process for market participants as they reconcile their existing deal pipeline and portfolio of Conflicted Transactions with the requirements of the Final Rule. In particular:

- In the case of CLOs and other securitizations with long warehouse periods and uncertain closing timelines, an ABS issuance that has its first close on or after June 9, 2025, will have an Applicable Period which begins months or years prior to the first close date. As a result, parties will likely need to come into compliance well ahead of the Compliance Date or establish procedures to ensure that their activities with respect to pending ABS issuances come into compliance prior to the Compliance Date.
- Warehouse participants may want to reconsider the common practice of memorializing material ABS issuance terms in their warehouse engagement letters, and instead defer agreement on those terms closer to the securitization take-out, which could shorten the Applicable Period. This would be a substantial change to market practice in some markets, including CLOs, and would come at the cost of certainty of execution for the expected ABS issuance.
- For strategic partnerships and other standing relationships where parties agree to serve as Securitization Participants for multiple ABS issuances over an extended period, there are issues to consider as to whether the Applicable Period begins long before a particular ABS issuance is launched.
- Conflicted Transactions entered into prior to the Compliance Date, but which have termination dates that run after such date, are not expressly grandfathered and should likely be treated as subject to the Final Rule.

If an ABS transaction is commenced but not consummated and no securities are sold to investors (e.g., if a warehouse is liquidated without a CLO take out or a transaction fails to price) the Final Rule will not apply. This may be cold comfort to the Securitization Participants who have modulated their trading activity during what may be a lengthy Applicable Period prior to the failure of such ABS issuance. It is unclear whether this same relief would apply if an ABS transaction sells securities solely to affiliated investors, though the substance of a conflict of interest analysis may be much less restrictive in such a case.

Who Is a Covered Securitization Participant?

"**Securitization Participants**" is broadly defined in the Final Rule to include placement agents, underwriters, initial purchasers and sponsors, as well as any affiliates and subsidiaries who (a) act in coordination with such parties or (b) have access to or receive information about the relevant ABS or asset pool underlying or referenced by the ABS prior to such ABS' first closing.

Placement Agents, Underwriters and Initial Purchasers: The Final Rule adopts the definition of underwriter under Regulation M and the Volcker Rule and uses it for both "**Placement Agents**" and "**Underwriters**." This definition includes any 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 such issuer or selling security holder; or
3. Manage or supervise a distribution for or on behalf of such issuer or selling security holder.

A "**distribution**" for these purposes includes both a primary registered securities offering and an unregistered offering which is distinguished from ordinary course trading transactions by the presence of special selling efforts and selling methods. The Adopting Release notes that activities generally indicative of special selling efforts and methods include, but are not limited to, greater than normal sales compensation arrangements, delivering a sales document (e.g., a prospectus or offering memorandum), and conducting road shows.

"**Initial Purchasers**" in Rule 144A resale transactions are also included as Securitization Participants.

Notably, the Final Rule only applies to placement agents, underwriters, and initial purchasers who have entered into an agreement with an issuer or a selling securityholder, on the basis that those persons would have access to nonpublic information about the ABS or underlying assets. Distribution participants who do not have such an agreement with the issuer or selling securityholder (i.e., "**selling group members**"), for example parties who are engaged by another transaction participant, are not considered subject to the Final Rule. The determination of whether a party is a selling group member depends entirely on the existence of an agreement with the issuer or selling securityholder, and not on the terms of such agreement (such as their actual access to sensitive ABS information). Therefore it is not possible for Securitization Participants to limit their status to that of selling group members by, for example, tailoring the information sharing terms of their engagement letters.

Sponsors: A "**Sponsor**" is any person who:

1. Organizes and initiates an ABS transaction by directly or indirectly selling or transferring assets, including through an affiliate, to the entity that issues the ABS (a "**Regulation AB-based Sponsor**"); or
2. Has a contractual right to direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying or referenced by the ABS (a "**Contractual Rights Sponsor**"), other than a person who acts solely pursuant to such person's contractual rights as a holder of a long position in the ABS (a "**Long-only Investor**").

Service Provider Exclusion. The definition of Sponsor does not include a person who 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 pool of assets underlying or referenced by the ABS.

U.S. Government Exclusion. Also excluded from the definition of Sponsor is the United States or an agency of the United States with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by the United States. This exclusion will apply to Ginnie Mae in its role as sponsor of agency mortgage backed securitizations. However, in a notable change from the proposed rule, the SEC did not adopt an exclusion for Fannie Mae and Freddie Mac, who are subsequently considered Sponsors under the final rule with respect to any ABS they issue, whether or not it is fully guaranteed.

Affiliates, Subsidiaries and Information Barriers. For purposes of the Final Rule, an affiliate or subsidiary of a Securitization Participant is itself a Securitization Participant (x) if it acts in coordination with an Underwriter, Placement Agent, Initial Purchaser or Sponsor, or (y) if it has access to or has received information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS prior to the date of the first closing of the sale of the relevant ABS. Notably, the Final Rule does not include an express exception for the use of information barriers between affiliated entities. Instead, the Adopting Release notes that both tests above are based on the facts and circumstances of the relevant entities' structure and business dealings. Securitization Participants may therefore use information barriers and other indicia of separateness to demonstrate lack of involvement or control with their subsidiaries and affiliates and a lack of access to information regarding the ABS and pool of assets. Such information barriers should be supported by written policies and procedures designed to prevent the flow of information between relevant entities, internal controls, physical separation of personnel, and other measures familiar to compliance teams when complying with their securities law obligations. However, this relief applies only to entities as whole—not individuals, trading desks, or divisions within a legal entity. This will significantly reduce the usefulness of information barriers for many underwriters—for example, depending on the level of coordination between a broker-dealer and bank affiliate, it may be difficult to separate the bank from the broker-dealer for purposes of the Final Rule.

Other indicia of separateness between affiliated entities include:

- Maintaining separate trading accounts for the named Securitization Participant and the relevant affiliate or subsidiary,
- Avoiding common officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel),
- Demonstrating that the named Securitization Participant is engaged in an unrelated business from the relevant affiliated entity and does not, in fact, communicate with such relevant affiliated entity, or
- Where personnel have oversight or managerial responsibility over accounts of both the named Securitization Participant and the affiliate or subsidiary, such persons do not have authority to (and do not) execute trading in individual securities in the accounts or authority to (and do not) pre-approve trading decisions for the accounts.

The Adopting Release notes that an affiliate or subsidiary would be acting in coordination with a named Securitization Participant if it (i) directly engages in the structuring of or asset selection for the securitization, (ii) directly engages in other activities in support of the issuance and distribution of the ABS, or (iii) otherwise acts in concert with its affiliated securitization participant through, e.g., coordination of trading activities.

Warehouse Lenders. A warehouse lender engaged in routine secured lending activity with respect to a CLO

or other ABS transaction will generally not be considered a Securitization Participant that is subject to the Final Rule (although if such entity or an affiliate is engaged as underwriter on the ABS or is otherwise a Securitization Participant, then it would be subject to the Final Rule in that capacity). The proposed rule contained a broadly worded "catch-all" prong that arguably could have implicated ordinary course lending activities (e.g., amendments to underlying loans) or exercises of certain remedies (e.g., margin calls or borrowing base repayments). The SEC removed that prong in response to industry feedback and more narrowly tailored the Final Rule to address short sales, credit default derivatives, and similar transactions. Although Adopting Release expressed the general sentiment that ordinary course lending activities were not intended to fall within the scope of this Final Rule, it is drafted broadly enough that more novel financing arrangements (such as financing transactions that take the form of total return swaps) may be implicated.

Application to Fiduciaries. An investment adviser to an ABS vehicle also is likely to fall within the definition of Securitization Participant, either by acting as Sponsor (or another enumerated role), by acting in concert with an affiliated Securitization Participant or by having access to information regarding an ABS offered by its affiliated Securitization Participant (we anticipate that most asset managers and their personnel are not currently organized in a way that will allow them to readily exclude management entities from the Final Rule's prohibitions using information barriers and a lack of coordination). The Adopting Release notes that the SEC declined to exempt advisers in this circumstance, despite the fact that, where an adviser or affiliate of an adviser acts as manager in an ABS transaction, the adviser's conflicts of interest are subject to both fiduciary duties and the Antifraud Rules under the Investment Advisers Act of 1940. The SEC notes that the fiduciary duties run to the ABS vehicle (as the advisory client), not to investors, and the Final Rule is therefore necessary to provide investors with the protection from conflicts of interest required under Dodd-Frank. Because, in most cases, an adviser's fiduciary duties can be satisfied via disclosure or consent, cures which are not available under the Final Rule, advisers will in effect owe a higher duty to ABS investors with respect to Conflicted Transactions than they owe their advisory client or investors in non-ABS vehicles (including retail investors). It remains to be seen whether this new and higher standard for ABS investors will be more broadly adopted by the SEC in examinations and enforcement actions outside the ABS market.

Similarly, Securitization Participants who are registered broker-dealers will owe institutional investors in ABS vehicles a higher duty than owed to retail investors under Regulation Best Interest[3], where conflicts may also be cured through disclosure, consent or other mitigation or prevention (as opposed to merely being eliminated).

What Is a Covered ABS Transaction?

The Final Rule adopts the meaning of "**asset-backed security**" from Section 3 of the Securities Exchange Act of 1934, which defines an ABS as "a fixed-income or other security collateralized by any type of self-liquidating financing asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset…." This definition covers both registered and unregistered securities. The definition of ABS also includes synthetic ABS and ABS that are hybrid cash and synthetic.

Synthetic ABS: Notably, the Final Rule did not define the term "**Synthetic ABS**," with the Adopting Release claiming that the term is well understood in the market and any proposed definition risked being either over-

[3] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318 (July 12, 2019), codified at 17 C.F.R. § 240.

or underinclusive. The staff noted that it has previously described Synthetic ABS as securitizations that are designed to create exposure to an asset that is not transferred to or otherwise part of the asset pool, and that such transactions are generally implemented using derivatives such as credit default swaps ("**CDS**"), total return swaps or an ABS structure that functionally replicates such a swap. The Adopting Release notes, however, that staff generally view a Synthetic ABS as a fixed income or other security issued by a special purpose entity that allows the holder of the security to receive payments that depend primarily on the performance of a self-liquidating financial asset or a reference pool of self-liquidating financial assets. The staff's statement is significant given that a variety of transactions that might broadly be considered to create exposures comparable to a "synthetic" ABS do not involve special purpose entities or issuance of securities.

What Conflicted Transactions Are Prohibited?

The Final Rule prohibits Securitization Participants from directly or indirectly engaging in any transaction that would involve or result in any material conflict of interest between the Securitization Participant and an investor in the ABS. These "Conflicted Transactions" involve two components:

1. The transaction in question is:
    a. A short sale of the ABS;
    b. The purchase of a CDS or other derivative that would entitle the Securitization Participant to receive payments if specific adverse events occurred with respect to the ABS; or
    c. The purchase or sale of any financial instrument (other than the ABS itself) or entry into a transaction that is substantially the economic equivalent of the transaction described in points a. and b. other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk; and
2. There is a substantial likelihood that a reasonable investor would consider the relevant transaction important to the investor's investment decision, including a decision whether to retain the ABS.

The definition is intended to capture any financial instrument or transaction which effectively functions as a direct bet against the ABS, regardless of how it is described. For example, Securitization Participants cannot simply create a novel financial instrument to replicate the economic mechanics of a CDS in order to circumvent the Final Rule.

The Final Rule does not provide clear guidance on when shorting or credit protection with respect to a portion, but not all, of a pool of assets for a securitization becomes a Conflicted Transaction (absent an applicable exclusion). Securitization Participants will need to consider whether shorting and credit protection activities unrelated to any ABS could cause them to inadvertently violate the Final Rule and put measures into place to prevent this. The Final Rule preamble also did not expressly address transactions that may involve a "short" position as a matter of form but are in substance financing transactions (such as a total return swap), though it did note that "[c]ustomary transactions that are designed to protect the financing provider from a decline in the value of the collateral for its loan" should not raise conflicts concerns.

What Trading Activity Is Excepted?

The Final Rule includes exceptions for three specific types of activities that could otherwise fall under the definition Conflicted Transaction: risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities. The Adopting Release notes that these activities can be distinguished from speculative trading and the exceptions provided would help avoid disrupting current liquidity commitment, market-making, and balance sheet management activities that do not create risks for investors.

Risk-Mitigating Hedging Activities: Certain hedging activities designed to reduce the specific risks to the Securitization Participants may be excepted if they

satisfy three conditions (comparable to conditions under the Volcker Rule):

1. The activity is designed to reduce or mitigate one or more specific, identifiable risks related to identified positions, contracts or other holdings of a Securitization Participant,
2. The activity is subject to ongoing recalibration by the Securitization Participant to ensure that the activity satisfies the requirements of the first condition and does not create an opportunity to materially benefit from a Conflicted Transaction other than through risk-reduction, and
3. The Securitization Participant has established and maintains an internal compliance program that is reasonably designed to ensure the Securitization Participant's compliance with the requirements applicable to the exception.

Liquidity Commitments: Purchases or sales of ABS may be excepted when made by a Securitization Participant consistent with commitments of the Securitization Participant to provide liquidity for the relevant ABS. A contractual obligation is not necessary in order to be considered a "commitment."

Bona Fide Market-Making: Purchases or sales of ABS may be excepted when made by a Securitization Participant consistent with bona fide market-making in the ABS. The Final Rule includes five conditions (again, based on the Volcker Rule as well as the Exchange Act), that must be satisfied in order for a purchase or sale to be excepted:

1. The Securitization Participant "routinely stands ready to purchase and sell" one or more types of the financial instruments as part of its market-making related activities in such financial instruments,
2. 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,
3. The compensation arrangements of the persons performing the market-making activity of the Securitization Participant are designed not to reward or incentivize Conflicted Transactions,
4. The Securitization Participant must be licensed or registered, if required, to engage in the relevant market-making activity in accordance with applicable laws, and
5. The Securitization Participant is required to establish and maintain an internal compliance program with the requirements of the bona fide market-making activities exception.

All institutions that engage in hedging/shorting activities of ABS (or assets that are in the related asset pools) will need to consider their activities in light of the Final Rule. However, we expect that US banks may find it easier to establish compliance with the listed exceptions as those concepts are broadly similar to requirements applicable under the Volcker Rule, although under the Volcker Rule banks have not needed to apply these concepts in the context of loans, which are not subject to the proprietary trading restrictions of the Volcker Rule. Non-bank financial institutions with more limited operations and/or that are not subject to the Volcker Rule, however, may need to establish substantial internal infrastructure and related procedures to evidence compliance with any listed exceptions they wish to use. Any use of these exceptions requires a compliance policy that satisfies the requirements in the Final Rule.

Safe Harbor

The prohibition in the Final Rule will not apply to an asset-backed security if it is not issued by a U.S. person (as defined in Rule 902(k) of Regulation S) and the offer and sale of the asset-backed security is in compliance with Regulation S. This relief is not available to dual Reg S / Rule 144A offerings by a single ABS vehicle (as is common in the CLO market). The availability of the Regulation S safe harbor may serve as a disincentive to the inclusion of 144A offerings in non-US transactions unless the volume of expected US investor interest warrants the compliance costs.

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