

Prohibition Against Conflicts of Interest in Certain Securitizations



The Securities and Exchange Commission adopted a rule on Nov. 27, 2023, to prohibit conflicts of interest in certain securitization transactions as required by Congress in the Dodd-Frank Act.

The rule prohibits securitization participants from engaging in certain transactions that could incentivize a securitization participant to structure an asset-backed security (ABS) in a way that would put the securitization participant's interests ahead of those of ABS investors.

Why This Matters

The Dodd-Frank Wall Street Reform and Consumer Protection Act added Section 27B to the Securities Act of 1933 to prohibit certain securitization participants from engaging in transactions that would involve or result in certain material conflicts of interest. Section 27B requires the SEC to issue rules to implement the prohibition and related exceptions.

How This Rule Applies

New Securities Act Rule 192 prohibits, for a specified period of time, a securitization participant from engaging, directly or indirectly, in any transaction that would involve or result in any material conflict of interest between the securitization participant and an investor in the relevant ABS, subject to certain exceptions.

Asset-Backed Securities

The rule defines "asset-backed security" to include any ABS within the meaning of Section 3 of the Exchange Act, as well as any synthetic ABS and hybrid cash and synthetic ABS.

Securitization Participants

The rule applies to any underwriter, placement agent, initial purchaser, or sponsor of an ABS, each as defined in the final rule. It also applies to any affiliate or subsidiary that acts in coordination with one of the aforementioned parties or that has access to, or receives information about, the ABS or asset pool underlying or referenced by the ABS prior to the first closing of the sale of the relevant ABS.

Prohibited Transactions

The rule prohibits a securitization participant from entering into a “conflicted transaction” for a period beginning on the date on which such person has reached an agreement to become a securitization participant with respect to an ABS and ending one year after the date of the first closing of the ABS’s sale. For purposes of the rule, the term “conflicted transaction” is defined to include two main components:

- The first component is whether the transaction is:
 - A short sale of the ABS;
 - The purchase of a credit default swap or other credit derivative that entitles the securitization participant to receive payments upon the occurrence of specified credit events with respect to the ABS; or
 - The purchase or sale of any financial instrument (other than the relevant ABS) or entry into a transaction that is substantially the economic equivalent of a transaction described in the first two bullet points above, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk.
- The second component is related to materiality—*i.e.*, whether there is a substantial likelihood a reasonable investor would consider the relevant transaction important to the investor’s investment decision, including a decision whether to retain the ABS.

Exceptions

As specified in Section 27B, the rule provides exceptions for risk-mitigating hedging activities, bona fide market-making activities, and liquidity commitments.

The rule specifies certain conditions that must be satisfied for a securitization participant to rely on these exceptions. With respect to risk-mitigating hedging activities and bona fide market-making activities exceptions, one of these conditions is that the securitization participant establish, and implement, maintain, and enforce, an internal compliance program reasonably designed to ensure the securitization participant’s compliance with the conditions of the relevant exception, including reasonably designed written policies and procedures. The rule’s definitions also contain certain exceptions and exclusions, each with conditions designed to protect investors and further the purposes of Section 27B.

In addition to exceptions, the final rule also provides a safe harbor for certain foreign transactions. Additionally, the rule includes a provision prohibiting a securitization participant from engaging in a transaction or a series of related transactions that, although in technical compliance with certain exceptions in the rule, is part of a plan or scheme to evade the rule’s prohibition.

What’s Next

The adopting release has been published on SEC.gov and will be published in the Federal Register. Compliance will be required with respect to any ABS the first closing of the sale of which occurs 18 months after publication in the Federal Register.