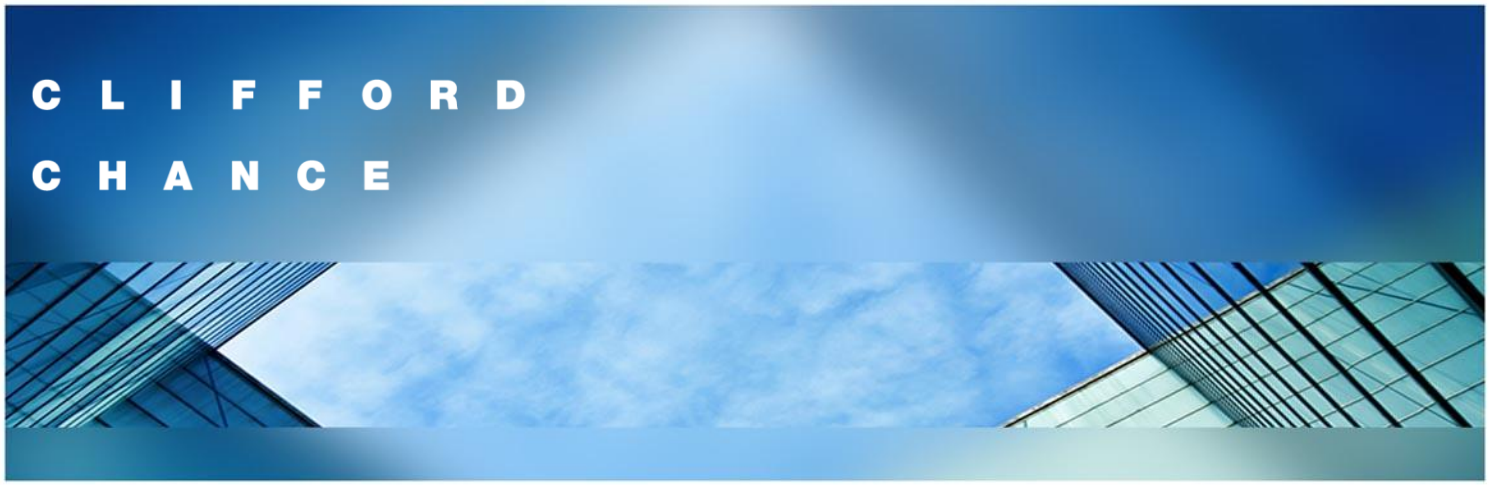

IMPACT OF SEC CONFLICTS OF INTEREST RULE ON CRT TRANSACTIONS

The U.S. Securities and Exchange Commission (the "**SEC**") recently adopted a new Rule 192 (the "**Final Rule**") under the Securities Act of 1933, as amended (the "**Securities Act**") to prohibit conflicts of interest in certain securitizations.[1] While the SEC's original re-proposal of the rule in January 2023 (the "**Proposed Rule**")[2] raised a number of concerns for banks and other entities engaging in credit risk transfer ("**CRT**") transactions for risk-management and capital relief purposes, the Final Rule includes important changes that limit the impact on such transactions. The compliance date for the Final Rule is June 9, 2025. This client briefing will provide an overview of aspects of the Final Rule that are particularly important for banks and other entities participating in CRT transactions as they prepare for the compliance date.

BACKGROUND

In January 2023, the SEC issued the Proposed Rule to implement the prohibition in Section 27B of the Securities Act (added by Section 621 of the Dodd-Frank Act) providing that, subject to certain exceptions, an underwriter, placement agent, initial purchaser, or sponsor (or any of their affiliates or subsidiaries), of an asset-backed security ("**ABS**," which for these purposes includes synthetic securitizations), shall not, 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 ABS, engage in any

1 SEC, Prohibition Against Conflicts of Interest in Certain Securitizations, Securities Act Release No. 33-11254, 88 FR 85396 (Dec. 7, 2023) ("**Adopting Release**"). The Final Rule applies to "securitization participants," which includes (i) an underwriter, placement agent, initial purchaser or sponsor of an ABS and (ii) any affiliate or subsidiary of any such person that (A) acts in coordination with such person or (B) has access to or receives information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS prior to the first closing of the sale of the relevant ABS. 17 CFR § 230.192(c). In a synthetic securitization CRT transaction, a special purpose entity ("**SPE**") provides credit protection to a bank with respect to certain of its assets through a credit derivative or financial guarantee entered into between the bank and the SPE and the SPE issues credit-linked notes ("**CLNs**") to investors. For purposes of the rule, in such a transaction the bank would be a "securitization participant" as a "sponsor" of the CLN, a synthetic ABS the performance of which is linked to a reference pool of bank assets.

2 SEC, Prohibition Against Conflicts of Interest in Certain Securitizations, Securities Act Release No. 33-11151, 88 FR 9678 (Jan. 25, 2023) (the "Proposing Release"). The SEC had originally proposed a rule in September 2011 designed to implement Section 27B, but no further action was taken following the proposal.

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 (a "**Conflicted Transaction**").[3] The terms of the Proposed Rule, along with the SEC's commentary in the Proposing Release, caused concern among CRT market participants about how CRT transactions would be treated for purposes of the Proposed Rule's requirements related to Conflicted Transactions.

The Proposed Rule defined[4] a Conflicted Transaction extremely broadly as:

…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:

- A short sale of the relevant asset-backed security;
- 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
- 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:
    - Adverse performance of the asset pool supporting or referenced by the relevant asset-backed security;
    - Loss of principal, monetary default, or early amortization event on the relevant asset-backed security; or
    - Decline in the market value of the relevant asset-backed security.

Prong (iii) of the definition (the "**Catch-All Provision**") was drafted to encompass a very broad range of transactions involving not only the relevant ABS itself, but also the underlying assets, including potentially unrelated trading activity carried out by trading desks and affiliates unaware of the existence of the ABS. Additionally, while the Proposed Rule would have excepted certain "risk-mitigating hedging activities" from being Conflicted Transactions, the SEC stated in the Proposing Release that such an activity would not include the initial issuance of a synthetic ABS, and, therefore, a securitization participant would have been prohibited from creating and/or selling a new synthetic ABS to hedge a position or holding.[5]

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

4 Proposing Release, *supra* note 2, at 9726.

5 *Id*. at 9700. The Proposing Release's discussion of CRT transactions conducted by Fannie Mae and Freddie Mac (the "**Enterprises**") introduced further uncertainty as to the treatment of CRT, because, while the SEC excluded the Enterprises from the definition of "sponsor" with respect to ABS that they fully insure or guarantee (because investors in such an ABS would not be subject to credit risk due to the U.S. government backstop), it noted that "because a CRT security issued in a security-based CRT transaction is not guaranteed by the relevant Enterprise, investors in a CRT security would bear credit risk" and that "because the CRT security is not fully insured or fully guaranteed by an Enterprise, the proposed exclusion from the definition of 'sponsor' for the Enterprises with respect to Enterprise-guaranteed ABS would not apply to a CRT security itself." Id. at 9688. Accordingly, the Enterprises would have been treated as "sponsors" of CRT securities for purposes of the Proposed Rule and thus prohibited from engaging in prohibited Conflicted Transactions with respect to investors in such CRT securities.

In response to the Proposed Rule, commenters expressed concerns that the breadth of the definition of Conflicted Transaction and the narrow scope of the risk-mitigating hedging activities exception would effectively result in CRT transactions used by banks, insurers and other entities being deemed *per se* prohibited Conflicted Transactions, despite the fact that in both their purpose and their structure, such transactions differ materially from the types of securitizations that the SEC likely sought to address in the rulemaking.[6]

CRT TRANSACTIONS UNDER THE FINAL RULE

The SEC made changes in the Final Rule that address some of the key concerns about the Proposed Rule raised by CRT market participants. We believe that these changes reduce – although do not eliminate – the risk that CRT transactions and transactions involving the underlying asset pool will be treated as prohibited Conflicted Transactions.

First, the SEC helpfully clarified that, for purposes of the Final Rule, the undefined term "synthetic ABS" refers to "a synthetic asset-backed security 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 reference self-liquidating financial asset or a reference pool of self-liquidating financial assets."[7] The SEC also clarified that "a corporate debt obligation is issued by, and offers investors recourse to, an operating entity that is not a special purpose entity. Therefore, a corporate debt obligation is not a synthetic ABS for purposes of Rule 192. Similarly, a security-based swap is also not a synthetic ABS for purposes of Rule 192 because it is a financial contract between two counterparties without issuance of a security from a special purpose entity."[8]

Given that many CRT transactions take the form of a direct-issued credit-linked note or a bilateral portfolio credit derivative transaction, the clarification is helpful (even taken in the context of the Federal Reserve Board's lukewarm approach to CRT in the form of a bank-issued CLN).[9]

Secondly, within the Final Rule itself, the most significant change is that the SEC narrowed the Catch-All Provision as follows:

- The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that is substantially the economic equivalent of a transaction described in paragraph [(i) or (ii)] of this section, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk.

While the narrower definition is helpful, it still leaves some scope for interpretation. In particular, the determination of whether a transaction is "substantially the economic equivalent" of one of the other types of enumerated in paragraphs (i) and (ii) of the definition will depend on the facts and circumstances. In the Adopting Release, the SEC clarified that such a transaction must effectively be a

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6 *See, e.g.,* Structured Finance Association, SFA Comments on Re-Proposed Securitization Conflicts of Interest Rule, at 22-23 (March 27, 2023).
7 Adopting Release, *supra* note 1, at 85402.
8 *Id*.
9 *See*, e.g., Federal Reserve Board, *Frequently Asked Questions about Regulation Q* (September 28, 2023), available at https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm.

"direct bet against" the relevant ABS in economic substance.[10] In that context, the Adopting Release states that a transaction where a securitization participant enters into "a short with respect to a pool of assets with characteristics that replicate the idiosyncratic credit performance of the asset pool supporting the relevant ABS" would be a Conflicted Transaction. The SEC continues by stating that this standard is not meant to "capture transactions entered into with respect to an asset pool that has sufficiently distinct characteristics from the idiosyncratic credit risk of the asset pool both supporting or referenced by the relevant ABS.[11]

Under this standard, therefore, it is fairly clear that a sponsor of a synthetic securitization involving a portfolio of identified corporate loans is not restricted from buying credit protection on corporate loans individually or on portfolios comprising different loans. It is less clear, however, whether the bank could, for example, execute a second transaction based on exactly, or substantially, the same portfolio (corporate loan transactions are often subject to portfolio guidelines that limit the dollar amount of exposure to each loan). Similarly, there is no guidance as to how a bank should consider pools of assets that have generally homogeneous terms.

These are interpretive issues that sponsors will need to consider in the context of their own risk management policies. Critically, the SEC did not accommodate requests to include an element of intent in the definition of Conflicted Transaction:

- We believe that narrowing the scope of the final rule to add an element of intent or knowledge is not appropriate because the statute is clear in mandating the prohibition of material conflicts of interest in ABS transactions. Narrowing the scope of the rule to require knowledge or intent would frustrate the statutory mandate of Section 27B.[12]

In the absence of an intent requirement, therefore, securitization participants will need to make their own determination based on the SEC's rather limited guidance as to whether transactions involving the underlying assets are "substantially equivalent" to a short sale or credit derivative against the relevant ABS or "sufficiently distinct" so as to not constitute a Conflicted Transaction.

Thirdly, the SEC expanded the exception for certain risk-mitigating hedging activities. Under the Final Rule, the exception will apply to such activities of a securitization participant in connection with and related to individual or aggregated positions, contracts or other holdings of the securitization, *including those* arising out of the participant's securitization activities, rather than, as in the Proposed Rule, *only those* arising out of such securitization activities. This change was intended, in part, to address concerns that the proposed exception would unduly limit the ability of financial institutions and their affiliates to hedge risks unrelated to securitization exposures and would affect other risk-management practices, including, presumably, CRT transactions.[13] Another important modification was to *include* within such excepted activities the initial distribution of an ABS, which had been carved out of the exception in the Proposed Rule.[14] According to the SEC,

10 Adopting Release, *supra* note 1, at 85423.
11 *Id*. at 85423.
12 *Id*. at 85405.
13 *Id*. at 85431.
14 *Id*. at 85459.

this change was "intended in large part to *permit CRT transactions*…"[15] The SEC further acknowledged that because CRTs will be eligible for this exception, it "do[es] not expect economic effects in the synthetic securitization markets to be substantial."[16]

We expect that most banks and other entities conducting CRT transactions will be able to rely on the risk-mitigating hedging activities exception in connection with most CRT transactions. However, the Final Rule will still impose certain conditions on such entities if they seek to rely on the exception. Specifically, in order to rely on the exception, a securitization participant must:

- ensure, at the inception of the hedging activity and at the time of any adjustments to the hedging activity, that the 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;
- recalibrate the hedging activity, as appropriate, on an ongoing basis to ensure that the hedging activity satisfies the requirements of the exception and does not facilitate or create an opportunity to materially benefit from a Conflicted Transaction *other than through risk-reduction*; and
- establish, implement, maintain and enforce an internal compliance program that is reasonably designed to ensure compliance with the exception, *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*.[17]

The compliance burden associated with implementing the risk-mitigating hedging activities exception is significant in the context of CRT transactions and may pose particular challenges for banks that execute CRT transactions infrequently or to address specific risks such as exposure to a single counterparty. Moreover, the requirement to "recalibrate" the hedge "on an ongoing basis" is hard to reconcile with the requirements for recognizing credit risk mitigants under applicable bank capital rules, which generally do not permit a bank to reduce the size of the hedge or provide other credit enhancement or otherwise materially modify the risk transfer instrument after the CRT transaction has closed.[18]

Finally, the SEC narrowed the definition of "sponsor" under the Final Rule such that long investors in ABS transactions will not generally be considered securitization participants for purposes of the rule so long as they are acting pursuant to their contractual rights.[19]

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15 *Id*. at 85455 (emphasis added).
16 *Id*.
17 17 CFR § 230.192(b)(1)(ii).
18 *See*, *e.g.,* 12 CFR § 217.41(b)(2)(v).
19 Adopting Release, *supra* note 1, at 85398.

Importantly for foreign ABS issuers, the Final Rule includes a safe harbor for certain foreign securitizations. Specifically, the prohibition in the Final Rule will not apply with respect to an ABS (i) that is not issued by a U.S. person (as that term is defined in Regulation S under the Securities Act) and (ii) the offer and sale of which is made in compliance with Regulation S (i.e., it is made only to non-U.S. persons in an offshore transaction).[20]

CONCLUSION

The Final Rule contains important changes from the Proposed Rule that should reduce the impact on banks engaging in CRT transactions. However, banks will need to monitor and manage transactions involving the underlying asset pool in a way that they do not presently, and, if a bank relies on the Final Rule's risk-mitigating hedging activity exception to conduct CRT transactions, it will need to ensure that such transactions are subject to ongoing recalibration (consistent with both the Final Rule and other bank regulatory requirements which, as discussed above, is likely to present challenges in the context of CRT transactions) and establish, maintain and enforce an effective compliance program (including adopting written policies and procedures) to continuously monitor such transactions for continued compliance with the exception.

Securitization participants will need to begin complying with the Final Rule with respect to any ABS the first closing of the sale of which occurs on or after June 9, 2025. During the transition period, we encourage you to reach out to us with any questions regarding the Final Rule and its applicability to CRT transactions.

[20] 17 CFR § 230.192(e).

CLIFFORD
CHANCE

CONTACTS

Jeff Berman
Partner

T +1 212 878 3460
E jeffrey.berman
@cliffordchance.com

Gareth Old
Partner

T +1 212 878 8539
E gareth.old
@cliffordchance.com

Young Kim
Counsel

T +1 212 878 4902
E young.kim
@cliffordchance.com

Eric Bernstein
Associate

T +1 212 878 3411
E eric.bernstein
@cliffordchance.com

www.cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

Clifford Chance US LLP

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