

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 230**

[Release No. 33–11151; File No. S7–01–23]

RIN 3235–AL04

**Prohibition Against Conflicts of Interest in Certain Securitizations**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Supplemental proposed rule.

**SUMMARY:** The Securities and Exchange Commission (“SEC” or “Commission”) is reissuing and revising a proposal that was initially published in September 2011 that would implement a provision under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) prohibiting an underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security (including a synthetic asset-backed security), or any affiliate or subsidiary of any such entity, from engaging in any transaction that would involve or result in certain material conflicts of interest.

**DATES:** Comments should be received on or before March 27, 2023.

**ADDRESSES:** Comments may be submitted by any of the following methods:

*Electronic Comments*

- Use the Commission’s internet comment form (<http://www.sec.gov/rules/submitcomments.htm>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7–01–23 on the subject line.

*Paper Comments*

- Send paper comments to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549–1090. All submissions should refer to File Number S7–01–23. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s website (<http://www.sec.gov/rules/proposed.shtml>). Comments also are available for website viewing and printing in the Commission’s Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Operating conditions

may limit access to the Commission’s Public Reference Room. All comments received will be posted without change. Persons submitting comments are cautioned that we do not edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such items will be made available on our website. To ensure direct electronic receipt of such notifications, sign up through the “Stay Connected” option at [www.sec.gov](http://www.sec.gov) to receive notifications by email.

**FOR FURTHER INFORMATION CONTACT:** Benjamin Meeks, Special Counsel, or Brandon Figg, Attorney-Adviser, in the Office of Structured Finance, Division of Corporation Finance at (202) 551–3850, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** We are proposing to add the following rule under 15 U.S.C. 77a *et seq.* (“Securities Act”):

Commission reference		CFR citation (17 CFR)
General Rules and Regulations, Securities Act of 1933 .....	Rule 192 .....	§ 230.192

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**I. Introduction**

*A. Background*

Section 621 of the Dodd-Frank Act<sup>1</sup> added Section 27B to the Securities Act (“Section 27B”). Section 27B(a) provides that an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity (collectively, “securitization

<sup>1</sup> Sec. 621, Public Law 111–203, 124 Stat. 1376, 1632.

participants”),<sup>2</sup> of an asset-backed security, including a synthetic asset-backed security (“ABS”), 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 asset-backed security, engage in any 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.<sup>3</sup> Section 27B(b) further requires that the Commission issue rules for the purpose of implementing the prohibition in Section 27B(a).<sup>4</sup> Section 27B(c) provides exceptions from the prohibition in Section 27B(a) for certain risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities.<sup>5</sup>

In September 2011, the Commission proposed for comment a rule designed to implement Section 27B.<sup>6</sup> The 2011 proposed rule was based substantially on the text of Section 27B and would have made it unlawful for a securitization participant to engage in any transaction that would involve or result in any material conflict of interest between the securitization participant and any investor in an ABS that the securitization participant created or sold 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.<sup>7</sup> Consistent with Section 27B, the 2011 proposed rule would have provided exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities.

### B. Overview

We are proposing new Rule 192 (the “re-proposed rule”) pursuant to Section 27B(b), which requires the Commission to issue rules for the purpose of implementing the prohibition in Section 27B(a).<sup>8</sup> Senator Carl Levin stated that the “conflict of interest prohibition . . . is intended to prevent firms that assemble, underwrite, place or sponsor

these instruments from making proprietary bets against those same instruments.”<sup>9</sup> The re-proposed rule targets transactions that effectively represent a bet against a securitization and focuses on the types of transactions that were the subject of regulatory and Congressional investigations and were among the most widely cited examples of ABS-related misconduct during the lead up to the financial crisis of 2007–2009.<sup>10</sup> For example, according to a Senate report, Goldman Sachs used net short positions to benefit from the downturn in the mortgage market, and designed, marketed, and sold collateralized debt obligation (“CDO”) securities in ways that created conflicts of interest with the firm’s clients.<sup>11</sup> In the 2011 Proposing Release, the Commission recognized that securitization participants may in some circumstances engage in a range of different activities and transactions that give rise to potential conflicts of interest.<sup>12</sup> Securitization markets have undergone various changes since that time, including as a result of other rules that regulate securitization activity that the Commission adopted following the publication of the 2011 Proposing Release.<sup>13</sup> As discussed below in Section III.B.3., while we do not have data on the extent of such conduct following the financial crisis of 2007–2009, we believe that securitization transactions continue to present securitization participants with the opportunity to engage in the conduct that is prohibited by Section 27B.

<sup>9</sup> See 156 Cong. Rec. S3470 (daily ed. May 10, 2010) (statement of Sen. Levin).

<sup>10</sup> See, e.g., 156 Cong. Rec. S3470 (daily ed. May 10, 2010) (statement of Sen. Levin) (“Goldman Sachs assembled and sold mortgage-related financial instruments, then placed large bets, for the firm’s own accounts, against those very same instruments.”); see also 156 Cong. Rec. S1363 (daily ed. Mar. 10, 2010) (statement of Sen. Levin) (“As has been widely reported, some institutions at the height of the boom in asset-backed securities were creating these securities, selling them to investors, and then placing bets that their product would fail. Phil Angelides, the chairman of the Financial Crisis Inquiry Commission, has likened this practice to selling customers a car with faulty brakes, and then buying life insurance on the driver.”).

<sup>11</sup> See Wall Street and The Financial Crisis: Anatomy of a Financial Collapse, Majority and Minority Staff Report, Permanent Subcommittee on Investigations, United States Senate (Apr. 13, 2011) (“Senate Financial Crisis Report”) (describing the role of Goldman Sachs in various transactions, including Abacus 2007–AC1 where “Goldman did not take the short position, but allowed a hedge fund . . . that planned on shorting the CDO to play a major but hidden role in selecting the assets” and that “Goldman marketed Abacus securities to its clients, knowing the CDO was designed to lose value”).

<sup>12</sup> See 2011 Proposing Release at 60324.

<sup>13</sup> See, e.g., discussion of other rules applicable to securitization transactions in Sections II.A. and III.B.3.

Implementing the prohibition in Section 27B would provide an important safeguard against the misconduct that led up to the 2007–2009 financial crisis. The re-proposed rule would complement the existing Federal securities laws that specifically apply to securitization, as well as the general anti-fraud and anti-manipulation provisions of the Federal securities laws, by explicitly protecting ABS investors against material conflicts of interest.

The re-proposed rule takes into account developments in the ABS market since 2011 and the comments received in response to the 2011 proposed rule to provide greater clarity regarding the scope of prohibited and permitted conduct.<sup>14</sup> Fundamentally, the re-proposed rule is intended to prevent the sale of ABS that are tainted by material conflicts of interest. It seeks to accomplish this goal by prohibiting securitization participants<sup>15</sup> from engaging in certain transactions that could incentivize a securitization participant to structure an ABS in a way that would put the securitization participant’s interests ahead of those of ABS investors. By focusing on transactions that represent a “bet” against the performance of an ABS, the re-proposed rule seeks to provide an explicit standard for determining which types of transactions would be prohibited. We believe this standard would provide strong protection against material conflicts of interest while not unnecessarily hindering routine securitization activities that do not give rise to the risks that Section 27B was intended to address.

To achieve these objectives, the re-proposed rule would:

- *Prohibit, for a specified period, a securitization participant from engaging in any transaction that would result in a “material conflict of interest” between the securitization participant and an investor in the relevant ABS.* A securitization participant could not, for a period ending on the date that is one year after the date of the first closing of the sale of an ABS, 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 ABS. Under the re-proposed rule, such transactions would be “conflicted transactions” and would include, for example, a short sale of the relevant ABS or the purchase of a credit default

<sup>14</sup> Comments received on the 2011 proposed rule are available on our website at <https://www.sec.gov/comments/s7-38-11/s73811.shtml>.

<sup>15</sup> See Section II.B.

<sup>2</sup> The proposed definition of “securitization participant” for purposes of the re-proposed rule is discussed below in Section II.B.

<sup>3</sup> 15 U.S.C. 77z–2a(a).

<sup>4</sup> 15 U.S.C. 77z–2a(b).

<sup>5</sup> 15 U.S.C. 77z–2a(c).

<sup>6</sup> See *Prohibition against Conflicts of Interest in Certain Securitizations*, Release No. 34–65355 (Sept. 19, 2011) [76 FR 60320 (Sept. 28, 2011)] (“2011 Proposing Release” or “2011 proposed rule”). Section 27B is not effective until the adoption of final rules issued by the Commission. Section 621(b) of the Dodd-Frank Act states that “Section 27B of the Securities Act of 1933, as added by this section, shall take effect on the effective date of final rules issued by the Commission . . . .”

<sup>7</sup> See 2011 Proposing Release at 60320.

<sup>8</sup> The numbering of the proposed rule under the 2011 Proposing Release was Rule 127B. Under this re-proposal, the numbering of the re-proposed rule is Rule 192.

swap or other credit derivative that entitles the securitization participant to receive payments upon the occurrence of specified credit events in respect of the ABS;<sup>16</sup>

- *Define the persons that would be subject to the re-proposed rule.* The terms “underwriter,” “placement agent,” “initial purchaser,” and “sponsor” (collectively, together with their affiliates and subsidiaries, “securitization participants”) would capture the persons subject to the re-proposed rule and would be functional definitions based on a person’s activities in connection with a securitization, which would generally be based on existing definitions of such terms under the Federal securities laws and the rules thereunder to ease compliance with the re-proposed rule;<sup>17</sup>

- *Define asset-backed securities that would be subject to the prohibition.* Prohibited transactions would be those with respect to an “asset-backed security.” An “asset-backed security”, for purposes of the re-proposed rule, would be defined based on the Section 3 definition of asset-backed security in the Securities Exchange Act of 1934 (“Exchange Act”)<sup>18</sup> and also would specifically include synthetic ABS, as well as hybrid cash and synthetic ABS,<sup>19</sup> which is consistent with Section 27B;<sup>20</sup> and

- *Provide certain exceptions to the prohibition.* The re-proposed rule would implement certain exceptions for risk-mitigating hedging activities, bona fide

<sup>16</sup> The proposed definition of “conflicted transaction” would also include any purchase or sale of any other financial instrument (other than the relevant ABS) or entry into a transaction through which the securitization participant would benefit from certain actual, anticipated, or potential adverse events with respect to the relevant ABS or its underlying asset pool. See Section II.D.

<sup>17</sup> The proposed definition of the term “sponsor” would not include the United States or an agency of the United States with respect to any asset-backed security that is fully insured or fully guaranteed as to the timely payment of principal and interest by the United States. The proposed definition of “sponsor” would also not include the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) and, together with Fannie Mae, the “Enterprises”) while operating under conservatorship or receivership of the Federal Housing Finance Agency (“FHFA”) with capital support from the United States with respect to any asset-backed security that is fully insured or fully guaranteed as to the timely payment of principal and interest by such entity. See Section II.B.

<sup>18</sup> 15 U.S.C. 78a et seq.

<sup>19</sup> For purposes of this release, we use the term “cash ABS” to refer to ABS where the underlying pool consists of one or more financial assets. We use the term “hybrid cash and synthetic ABS” to refer to ABS where the underlying pool consists of one or more financial assets as well as synthetic exposure to other assets.

<sup>20</sup> See Section II.A.

market-making activities, and liquidity commitments as specified in Section 27B. The proposed exceptions would focus on distinguishing the characteristics of such activities from speculative trading. The proposed exceptions would also seek to avoid disrupting current liquidity commitment, market-making, and balance sheet management activities that we do not believe would give rise to the risks that Section 27B was intended to address.<sup>21</sup>

We believe that the re-proposed rule would help to prevent the abusive conduct that Section 27B is designed to prevent by reducing the incentive for a securitization participant to structure an ABS in a way that would put the securitization participant’s interests ahead of those of ABS investors.

## II. Discussion of Proposed Rule 192

### A. Scope: Transactions With Respect to ABS

Under proposed Rule 192(a)(1), a securitization participant would be prohibited, for a specified time period with respect to an asset-backed security, from engaging in any transaction that would involve or result in a material conflict of interest between such securitization participant and an investor in such asset-backed security. For purposes of the re-proposed rule, the term “asset-backed security” would be defined in proposed Rule 192(c) to have the same meaning as set forth in Section 3 of the Exchange Act<sup>22</sup> (“Exchange Act ABS”) (which, by extension, means that the re-proposed rule would cover both registered and unregistered offerings) and also would include synthetic ABS as well as hybrid cash and synthetic ABS. This approach is consistent with Section 27B<sup>23</sup> and the views of certain commenters who supported the 2011 proposed rule’s definition of asset-backed security, which was based on the Exchange Act ABS definition<sup>24</sup> and also included synthetic ABS.<sup>25</sup> The Exchange Act ABS

<sup>21</sup> For example, the proposed exceptions for risk-mitigating hedging activities and bona fide market-making activities are similar to the equivalent exceptions under other rules applicable to certain securitization participants and other financial institutions. See discussion below in Sections II.E. through II.G.

<sup>22</sup> 17 U.S.C. 78c(a)(79).

<sup>23</sup> Section 27B applies to an “asset-backed security (as such term is defined in section 3 of the Securities and Exchange Act of 1934 . . . which for purposes of this section shall include a synthetic asset-backed security).”

<sup>24</sup> See comment letter from Better Markets, Inc. (Feb. 13, 2012) (“Better Markets Letter”) at 4; comment letter from U.S. Senators Jeff Merkley and Carl Levin (Jan. 12, 2012) (“Merkley-Levin Letter”) at 4.

<sup>25</sup> See Merkley-Levin Letter at 4.

definition captures fixed-income and other securities that are collateralized by any type of self-liquidating asset,<sup>26</sup> regardless of whether the ABS is registered with the Commission under the Securities Act. We are proposing a definition of the term “asset-backed security” that includes Exchange Act ABS primarily for consistency with Section 27B(a). Additionally, we believe that it is appropriate for the definition to apply both to ABS sold in offerings registered with the Commission and ABS sold in offerings that are exempt from registration because both types of offerings could present securitization participants with the opportunity to engage in the conduct that is prohibited by Section 27B. In particular, we note that a number of the transactions that were the subject of regulatory and Congressional investigations in the wake of the financial crisis of 2007–2009 involved unregistered ABS offerings.<sup>27</sup>

We received comment in response to the 2011 proposed rule requesting clarification whether certain products, such as certain types of municipal securities, would be Exchange Act ABS.<sup>28</sup> Municipal securitizations<sup>29</sup> that are collateralized by any type of self-liquidating financial asset that allows the holder of the security to receive payments that depend primarily on the cash flow from such self-liquidating financial asset fall within the Exchange Act ABS definition and are, for example, already subject to the rules adopted in 2011 to implement Section 943 of the Dodd-Frank Act<sup>30</sup> and the

<sup>26</sup> The Commission has described a “self-liquidating asset” as an asset that by its terms converts into cash payments within a finite time period. See Section III.A.2. of *Asset-Backed Securities*, Release No. 33–8518 (Dec. 22, 2004) [70 FR 1506 (Jan. 7, 2005)] (“2004 Regulation AB Adopting Release”).

<sup>27</sup> See *supra* note 10.

<sup>28</sup> See comment letter from The Securities Industry and Financial Markets Association (Feb. 13, 2012) (“SIFMA Letter”) at 17.

<sup>29</sup> Most municipal entities do not typically issue ABS directly. Under the re-proposed rule, a municipal entity would be a sponsor of municipal ABS if the municipal entity met the proposed definition of “sponsor.” Further, a municipal entity would be subject to the re-proposed rule’s prohibition to the extent the municipal entity was a sponsor and the municipal ABS were Exchange Act ABS. See Section II.B. for discussion of the proposed definition of “sponsor” and its application to municipal entities. See also request for comment 9 regarding other parties related to a municipal securitization that could be “securitization participants” under the re-proposed rule.

<sup>30</sup> See Sections II.A.1. and II.A.3. of *Disclosure For Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Release No. 33–9175 (Jan. 20, 2011) [76 FR 4489 (Jan. 26, 2011)] (stating the broader definition of Exchange Act ABS and its application to municipal securities, such as student

rules adopted in 2014 to implement the credit risk retention requirements of Section 941 of the Dodd-Frank Act.<sup>31</sup> In this regard, we believe that market participants are familiar with analyzing whether such a security meets the Exchange Act ABS definition as the Commission has adopted other rules and regulations under the Securities Act and the Exchange Act that use the Exchange Act ABS definition or a substantially similar definition.<sup>32</sup> Therefore, we believe that the re-proposed rule's definition of "asset-backed security" is sufficiently clear. We seek comment below on whether the re-proposed rule should provide additional specificity regarding the types of ABS that would be covered by the re-proposed rule.

We also received comment suggesting an exclusion from the rule for certain types of ABS, including ABS with underlying assets for which information is readily available or where the investor is involved in asset selection.<sup>33</sup> However, even if an investor is involved in asset selection or has access to information regarding the underlying assets, such investor may not know of the involvement of other parties with a potential conflict of interest. Such an investor would not necessarily know to be alert for potential selection of assets or structuring of an ABS that might disadvantage such investor.<sup>34</sup> Also, the

loan bonds, housing, and mortgage bonds). For a discussion of municipal securitizations, see generally Robert A. Fipinger, *The Securities Law of Public Finance*, Chapter 4 (3rd. ed. Practising Law Institute, Sept. 2011, Supplement Oct. 2022).

<sup>31</sup> 17 CFR 246 ("Regulation RR"). See *Credit Risk Retention*, Release No. 34-73407 (Oct. 22, 2014) [79 FR 77602 (Dec. 24, 2014)] ("RR Adopting Release") at 77661 (adopting certain provisions that apply to municipal tender option bonds). See also Section IV.A.D.6. of *Credit Risk Retention*, Release No. 34-70277 (Aug. 28, 2013) [78 FR 57928 (Sept. 20, 2013)] (explaining why an exemption from risk retention for securitizations of tax lien-backed securities sponsored by municipal entities was not proposed). Also, an ABS that is backed by a single asset or one or more obligations of a single borrower (often referred to as "single asset, single borrower" or "SASB" transactions) meets the definition of an Exchange Act ABS. See RR Adopting Release at 77680 (explaining why separate loan underwriting criteria for single borrower or single credit commercial mortgage transactions were not adopted).

<sup>32</sup> See, e.g., 17 CFR 240.15Ga-1(a), 17 CFR 240.17g-7(a)(1)(ii)(N), and 17 CFR 246.2. Similarly, regarding a commenter's request that we also specify whether mutual funds, exchange traded funds, or certain other products would be Exchange Act ABS (see SIFMA Letter at 17), we believe that there is a common market understanding of whether such products are Exchange Act ABS and whether other rules that use the definition of Exchange Act ABS, such as Regulation RR, apply to them.

<sup>33</sup> See, e.g., SIFMA Letter at 37-38.

<sup>34</sup> Moreover, even if an investor were aware of a potential conflict of interest, the re-proposed rule does not include an exception based on disclosure

participation of one investor in asset selection would not necessarily protect any other investors. Accordingly, the Commission does not believe that such an exclusion would be appropriate.

We also received comment on the 2011 proposed rule recommending that the rule should only cover synthetic ABS because greater risk arises out of synthetic ABS.<sup>35</sup> However, Section 27B specifies that the prohibition applies to both Exchange Act ABS and synthetic ABS, and the misconduct that Section 27B is designed to prevent can occur with respect to both synthetic ABS and non-synthetic ABS. For example, a securitization participant could enter into a bilateral credit default swap ("CDS") contract referencing a non-synthetic ABS in order to bet against the performance of the ABS. Therefore, excluding non-synthetic ABS from the re-proposed rule would be inconsistent with the conflict of interest protection intended by Section 27B.

With regard to synthetic ABS, we received comment suggesting that the term "synthetic ABS" should be defined.<sup>36</sup> In contrast, we also received comment that a definition of the term "synthetic ABS" is not warranted because the term is well understood.<sup>37</sup> The re-proposed rule does not define "synthetic ABS." We have previously described synthetic securitizations, in general, as securitizations that are designed to create exposure to an asset that is not transferred to or otherwise part of the asset pool.<sup>38</sup> These synthetic transactions are generally effectuated through the use of derivatives such as a CDS or a total return swap, or an ABS structure that replicates the terms of such a swap. We believe that our previous descriptions of synthetic securitizations are well understood by market participants and adequately address the key issues raised by commenters, and that market participants have been able to readily

of material conflicts of interest, as discussed below in Section II.D.

<sup>35</sup> See comment letter from Association of Institutional Investors (Feb. 13, 2012) ("AII Letter") at 4-5.

<sup>36</sup> See comment letter from Americans for Financial Reform (Feb. 13, 2012) ("AFR Letter") at 7; comment letter from Chris Barnard (Sept. 28, 2011) ("Barnard Letter") at 2; Better Markets Letter at 4; Merkley-Levin Letter at 5 (suggesting as a possible definition a "fixed-income or other security that references any type of financial assets . . . and allows the holder of the security to receive payments that depend primarily on the value or performance of the referenced assets").

<sup>37</sup> See comment letter from American Securitization Forum (Feb. 13, 2012) ("ASF Letter") at 23.

<sup>38</sup> For a general discussion of synthetic securitizations, see Section III.A.2. of 2004 Regulation AB Adopting Release.

distinguish synthetic ABS from other types of transactions. We are concerned that any particular definition of "synthetic ABS" that we might propose would be susceptible to potential overinclusiveness or underinclusiveness. Because of the inherent complexity of the transactions involved in a synthetic ABS, we are also concerned that a securitization participant might attempt to evade the re-proposed rule's prohibition by structuring such transactions around any particular definition of "synthetic ABS" while nonetheless creating a product that would be a synthetic ABS within the commonly-understood meaning of the term, which would weaken the re-proposed rule's conflict of interest protection for investors.

We received comment in response to the 2011 proposed rule that the rule should explicitly cover hybrid ABS that contain a mix of financial and synthetic assets.<sup>39</sup> Given that Section 27B specified that the prohibition 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. Furthermore, the ability and incentive for a person to engage in the type of conduct that Section 27B is intended to prevent are present with respect to hybrid ABS. Therefore, the definition of the term "asset-backed security" in the re-proposed rule would explicitly cover hybrid cash and synthetic ABS that contain a mix of underlying financial and synthetic assets.

We also received comment recommending that the rule include a catch-all provision to cover any product that functions as the economic equivalent of a cash ABS, synthetic ABS, or hybrid ABS.<sup>40</sup> However, Section 27B prohibits material conflicts of interest with respect to Exchange Act ABS and synthetic ABS, and consistent with Section 27B, the re-proposed rule covers Exchange Act ABS as well as synthetic ABS and hybrid ABS. A security that functions as the economic equivalent of a cash ABS, synthetic ABS, or hybrid ABS, as contemplated by these comments, should already meet the re-proposed rule's definition of ABS. Therefore, we do not believe a catch-all provision to capture other products beyond the proposed definition of "asset-backed security" is necessary.

We received comment on the 2011 proposed rule from portfolio managers

<sup>39</sup> See Merkley-Levin Letter at 5.

<sup>40</sup> See Better Markets Letter at 4; Merkley-Levin Letter at 5.

at large banks<sup>41</sup> and collateralized loan obligation (“CLO”) investors<sup>42</sup> that suggested an exception for certain synthetic balance sheet CLOs to retain the use of such CLOs as a risk management tool and an investment.<sup>43</sup> We are concerned that an exception for such a product has the potential to weaken conflict of interest protections 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. Therefore, we have not included such an exception.

Finally, we received comment on the 2011 proposal stating that not excluding Enterprise or Ginnie Mae ABS from the scope of the rule would have significant economic and market impacts.<sup>44</sup> As discussed below, the re-proposed rule does not include an exception for Enterprise or Ginnie Mae ABS.<sup>45</sup> However, the proposed definition of “sponsor” does include an exception that, subject to certain conditions, would apply to the Enterprises and Ginnie Mae with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by such entity.

#### Request for Comment

1. We seek comment on the proposed definition of asset-backed security for purposes of proposed Rule 192. Is it necessary to further clarify components of the proposed definition?

2. Are market participants familiar with which securities products fall under the definition of Exchange Act ABS? Should the re-proposed rule provide more specificity regarding the types of ABS that would be subject to the re-proposed rule?

3. Should we add a catch-all provision to the proposed definition of asset-backed security to cover any product that functions as the economic equivalent of a cash ABS, synthetic ABS, or hybrid cash and synthetic ABS?

<sup>41</sup> See, e.g., comment letter from The International Association of Credit Portfolio Managers (Feb. 6, 2012) (“IACPM 1 Letter”) at 2.

<sup>42</sup> See, e.g., comment letter from Orchard Global Asset Management (June 28, 2012) (“Orchard Letter”).

<sup>43</sup> See, e.g., comment letter from Deutsche Bank AG (Feb. 9, 2012) (“Deutsche Bank Letter”) at 1–8; comment letter from The International Association of Credit Portfolio Managers (June 28, 2012) (“IACPM 2 Letter”) at 1–4; and comment letter from PGGM Investments (June 20, 2012) (“PGGM Letter”) at 1–3.

<sup>44</sup> See SIFMA Letter at 18–21.

<sup>45</sup> See Section II.B.2.

Please comment on the advantages or disadvantages. If so, what additional types of securities or transactions should be included that would not be covered by the definition of asset-backed security in the re-proposed rule?

4. The re-proposed rule does not define “synthetic ABS,” and we are not providing specific guidance regarding whether any particular products are “synthetic ABS.” As stated above, we have described synthetic securitizations as securitizations that are designed to create exposure to an asset that is not transferred to or otherwise part of an asset pool, such as through a CDS or a total return swap. Should we define “synthetic ABS” to incorporate that description or otherwise define such term as a fixed-income or other security that references any type of financial asset and allows the holder of the security to receive payments that depend primarily on the value or performance of the referenced assets? Are there particular products (1) where additional clarity is necessary as to whether such products are “synthetic ABS” or (2) that the rule should expressly state are not “synthetic ABS”? Please identify any such products and explain why additional clarification is needed. Furthermore, is additional clarification needed regarding what is or is not a hybrid cash and synthetic asset-backed security?

5. Should proposed Rule 192(b) contain an additional exception from the prohibition on material conflicts of interest for certain synthetic balance sheet CLOs, as suggested by commenters to the 2011 proposed rule,<sup>46</sup> 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 entity that issues a synthetic ABS? If so, please explain what types of synthetic balance sheet CLOs should not be covered by the rule, and what conditions should have to be satisfied in order to ensure that such CLOs would be used solely as a risk mitigation tool rather than a speculative investment. Please also explain how such an exception would be consistent with Section 27B.

6. As stated above, municipal securitizations that are Exchange Act ABS would fall within the definition of asset-backed security for purposes of the re-proposed rule. Should we clarify in rule text or through guidance the types of municipal securitizations that would be covered by the re-proposed rule? If so, please identify those types of municipal securitizations that you

believe require clarification and explain why. Are there types of municipal securitizations that should be exempt from the re-proposed rule? If so, please explain why they should be exempt, including whether the opportunity exists for securitization participants to engage in the type of conduct the re-proposed rule is designed to prohibit with respect to such municipal securitizations.

7. Are there types of government-guaranteed securities that should be exempt from the re-proposed rule? Please explain why they should be exempt, including whether the opportunity exists for securitization participants to engage in the type of conduct that the re-proposed rule is designed to prohibit with respect to such securities.

#### B. Scope: Securitization Participants

Consistent with Section 27B(a), the prohibition in the re-proposed rule would apply to transactions entered into by certain key participants involved in the creation and sale of an ABS, namely an underwriter, placement agent, initial purchaser, or sponsor, each of which would be a “securitization participant” as defined in proposed Rule 192(c). The functions performed by such persons are essential to the design, creation, marketing, and/or sale of an ABS. The re-proposed rule focuses on transactions that could give such persons the incentive to market or structure ABS and/or construct underlying asset pools in a way that would position them to benefit from the actual, anticipated, or potential adverse performance of the relevant ABS or its underlying asset pool. Also, consistent with Section 27B(a) and to help prevent potential evasion, the prohibition in the re-proposed rule would apply to the transactions entered into by the affiliates and subsidiaries of any such person. Subject to certain exceptions discussed below, each of the foregoing entities would be captured by the definition of “securitization participant” in the re-proposed rule.

The Commission did not propose definitions of the terms “underwriter,” “placement agent,” “initial purchaser,” and “sponsor” in the 2011 proposed rule, and we received comment to the 2011 proposed rule that we should refrain from providing definitions for certain persons.<sup>47</sup> However, certain other commenters to the 2011 proposed rule expressed support for defining these terms to specify the persons

<sup>47</sup> See, e.g., comment letter from Akshat Tewary, Esq. (Dec. 2, 2011) (“Tewary Letter 1”) at 4.

<sup>46</sup> See, e.g., IACPM 1 Letter at 2; Orchard Letter.

covered by the rule.<sup>48</sup> In order to facilitate compliance, as discussed below, we are proposing definitions for the terms “underwriter,” “placement agent,” “initial purchaser,” and “sponsor” that, with a few exceptions, are generally based on existing definitions and are designed to reflect the functions of such market participants in ABS transactions and not merely their formal labels.

#### Request for Comment

8. Should we modify the proposed definition of the term “securitization participant,” and if so, how? Are any modifications necessary or advisable to mitigate any unintended consequences?

9. As discussed above in Section II.A., municipal securitizations that are Exchange Act ABS would fall within the definition of asset-backed security for purposes of the re-proposed rule.

Therefore, parties related to a municipal securitization that are “securitization participants” would be subject to the re-proposed rule. For example, under the re-proposed rule a “municipal advisor” under 17 CFR 240.15Ba1–1(d)(1) could be a “securitization participant” under the re-proposed rule based on the functions that it performs in connection with a municipal securitization. Should certain parties related to a municipal securitization be excluded from the scope of the re-proposed rule? If so, how would those exclusions be consistent with Section 27B? Are there any special considerations related to municipal advisors that should be considered in applying the re-proposed rule?

#### 1. Placement Agent, Underwriter, and Initial Purchaser

Proposed Rule 192(c) would define a “placement agent” or “underwriter” as a person who has agreed with an issuer or selling security holder to:

- Purchase securities from the issuer or selling security holder for distribution;
- Engage in a distribution for or on behalf of such issuer or selling security holder; or
- Manage or supervise a distribution for or on behalf of such issuer or selling security holder.

The terms “placement agent” and “underwriter” would have the same definition in the re-proposed rule because the functional roles of the persons who act as a placement agent or an underwriter are the same. These definitional prongs are focused on the functional role of a person in connection with a distribution of

securities and should cover the activities of a placement agent or underwriter that has agreed with an issuer or selling security holder to facilitate an offering of securities.<sup>49</sup> These definitional prongs are also used for purposes of the definition of the term “underwriter” under 17 CFR 255 (“Volcker Rule”)<sup>50</sup> and 17 CFR 242.100 through 105 (“Regulation M”);<sup>51</sup> however, the Volcker Rule’s definition of “underwriter” includes an additional prong that is intended to capture selling group members that may not have an agreement with the issuer or selling security holder.<sup>52</sup> The definition that we are proposing for purposes of the re-proposed rule would be limited to persons that have agreed with an issuer or a selling security holder to perform such functions, and selling group members who have no agreement with an issuer or selling security holder to engage in such functions would not be a “placement agent” or “underwriter” for purposes of the re-proposed rule. Although selling group members may help facilitate a successful distribution of securities to a wider variety of purchasers, such as regional purchasers that the underwriter or placement agent may not be able to access as easily, selling group members do not have a direct relationship with the issuer or selling security holder and are therefore unlikely to have the same ability to influence the design of the relevant ABS.

Proposed Rule 192(c) would define “distribution” as used in the proposed definitions of “underwriter” or “placement agent” to mean:

- An offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or
- An offering of securities made pursuant to an effective registration statement under the Securities Act.

<sup>49</sup> We also believe that the prongs included in the proposed definition would mitigate concerns raised by a commenter on the 2011 proposed rule about the potential overinclusiveness of the definition of “underwriter” in Section 2(a)(11) of the Securities Act, which could potentially include entities that do not have an agreement with the issuer or the selling security holder and have no ability to influence the design of the relevant ABS. See SIFMA Letter at 10–11. The definition of underwriter for purposes of the re-proposed rule would have no impact on the definition, responsibility, or liability of an underwriter under Section 2(a)(11).

<sup>50</sup> 17 CFR 255.4(a)(4). The re-proposed rule would have no impact on the definition of “underwriter” in the Volcker Rule.

<sup>51</sup> 17 CFR 242.100(b). The re-proposed rule would have no impact on the definition of “underwriter” in Regulation M.

<sup>52</sup> 17 CFR 255.4(a)(4).

This proposed definition is the same as the definition of “distribution” under the Volcker Rule, which is focused on the presence of special selling efforts and selling methods. We believe that focusing on special selling efforts and selling methods would help to distinguish an offering of ABS from secondary trading and helps to target the re-proposed rule to persons engaged in selling an ABS offering to investors once such ABS is created. Activities generally indicative of special selling efforts and selling methods include, but are not limited to, greater than normal sales compensation arrangements, delivering a sales document (such as a prospectus), and conducting road shows.<sup>53</sup> A primary offering of an ABS made pursuant to an effective registration statement under the Securities Act would also be captured under the proposed definition of “distribution” because, in the context of Section 27B, such an offering would be a primary issuance by an issuer immediately following the creation of the relevant ABS, which would be clearly distinguishable from an ordinary secondary trading transaction and, therefore, an identification of special selling efforts or selling method would be unnecessary in this context.

Proposed Rule 192(c) would define “initial purchaser” in a manner consistent with the Commission’s prior use of that term in the context of ABS.<sup>54</sup> Specifically, the re-proposed rule would define the term “initial purchaser” as “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 Rule 144A or that are otherwise not required to be registered because they do not involve any public

<sup>53</sup> See *Review of Anti-manipulation Regulation of Securities Offerings*, Release No. 34–33924 (Apr. 19, 1994) [59 FR 21681 (Apr. 26, 1994)] at 21685; see also *Trading Practices Concerning Securities Offerings*, Release No. 34–37094 (Apr. 11, 1996) [61 FR 17108 (Apr. 18, 1996)], *Anti-manipulation Rules Concerning Securities Offerings*, Release No. 34–38067 (Dec. 20, 1996) [62 FR 520 (Jan. 3, 1997)], and *Securities Offering Reform*, Release No. 33–8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)].

<sup>54</sup> While not defined in rules adopted by the Commission, the Commission has used the term when describing the distribution of an asset-backed security. See, e.g., *Asset-Backed Securities*, Release No. 33–9117 (Apr. 7, 2010) [75 FR 23328 (May 3, 2010)] at 23332 (stating that CDOs are typically sold by the issuer in a private placement to one or more initial purchaser or purchasers in reliance upon the Section 4(2) private offering exemption in the Securities Act, which is available only to the issuer, followed by resales of the securities to “qualified institutional buyers” in reliance upon Rule 144A); *id.* at 23393 (stating that the initial purchaser is typically a registered broker-dealer). The definition of “initial purchaser” in the re-proposed rule would have no impact on the application of Rule 144A.

<sup>48</sup> See, e.g., SIFMA Letter at 10–11; Merkley-Levin Letter at 3.

offering.” This definition is also consistent with industry use of the term “initial purchaser” in the context of private placement transactions to mean a person (typically a broker-dealer) who, pursuant to an agreement with the issuer, performs the function of acquiring securities from an issuer in a private placement and reselling those securities to qualified institutional buyers in reliance on Rule 144A or to purchasers in sales that otherwise do not involve any public offering.<sup>55</sup> Proposing to define the term “initial purchaser” in a manner consistent with the Commission’s prior use of that term in the context of ABS and also the common industry understanding of the term should ease compliance with the re-proposed rule because market participants are familiar with that usage of the term and should already have mechanisms in place to determine when the proposed definition is met.

The proposed definitions of the terms “underwriter,” “placement agent,” and “initial purchaser” in the re-proposed rule would identify persons by their function in connection with a securitization as suggested by certain commenters to the 2011 proposed rule.<sup>56</sup> We believe that function-based definitions would encompass those persons who have a key role in the creation or sale of an ABS transaction, which would help prevent evasion by persons seeking to avoid the re-proposed rule’s prohibitions by using a different title to refer to themselves, even though they perform the function described in the definition. These function-based definitions should address evasion concerns raised by certain commenters.<sup>57</sup>

The proposed definitions of the terms “underwriter,” “placement agent,” and “initial purchaser” 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, as requested by a commenter to the 2011 proposed rule.<sup>58</sup> As discussed above, the proposed definitions of those terms

in the re-proposed rule are functional definitions that are based on such a person entering into an agreement with the relevant ABS issuer to perform specific functions. Such specific functions are essential to the successful issuance of the relevant ABS and, even 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 given its role in the transaction. Therefore, we do not believe that including the requested exclusion would be appropriate.

#### Request for Comment

10. Are the proposed definitions of the terms “initial purchaser,” “placement agent,” and “underwriter” overinclusive or underinclusive, and why? If you believe that any of the proposed definitions are overinclusive or underinclusive, please provide an alternative definition and explain why you believe it is appropriate.

11. Should we modify the proposed definition of the terms “placement agent” and “underwriter,” and if so, how should the proposed definition be modified and why? Specifically, is it appropriate to use the same definition for such terms? If not, please explain why and suggest revisions. Should we modify the proposed definition to provide for functions in addition to the functions specified in the proposed definition?

12. As discussed above, the proposed definition of the terms “placement agent” and “underwriter” would be limited to persons that have agreed with an issuer or a selling security holder to perform the functions detailed in the proposed definition. Should the proposed definition be expanded to include selling group members who have no such agreement with an issuer or selling security holder? Why or why not?

13. Should the proposed definition of the term “distribution” be modified? If so, please explain why and provide an alternative definition. In particular, should “the presence of special selling efforts and selling methods” be included in the proposed definition? Additionally, should the magnitude of the offering be considered as part of the proposed definition?<sup>59</sup> Why or why not? If so, please describe the factors that should be considered when

determining the magnitude of an offering (e.g., the aggregate principal or notional amount of ABS to be sold, either in absolute terms or relative to the aggregate outstanding principal or notional amount of ABS issued by the issuer of the ABS and/or the normal trading volume of the ABS).

14. Should we modify the proposed definition of the term “initial purchaser,” and if so, how should the proposed definition be modified and why?

#### 2. Sponsor

Proposed Rule 192(c) would, subject to certain exceptions,<sup>60</sup> define the term “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; or
  - 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; or
    - 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.
- Thus, a person who organizes and initiates an ABS transaction, or who directs or causes the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS (or who has the contractual right to do so), would, subject to the exceptions described below, be a sponsor for purposes of the re-proposed rule. This would include, for example, a portfolio selection agent for a CDO transaction, a collateral manager for a CLO transaction with the contractual right to direct asset purchases or sales on behalf of the CLO, or a hedge fund manager or other private fund manager who directs the structure of the ABS or the composition of the pool of assets underlying the ABS as described in the definition. Whether other parties to a securitization transaction, such as servicers, would

<sup>60</sup> As discussed below in Section II.B.2.b., the proposed definition of “sponsor” excludes 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. As discussed below in Section II.B.2.c., the proposed definition of “sponsor” also excludes certain U.S. Federal government entities and the Enterprises, subject to certain conditions.

<sup>55</sup> See comment letter from The Investment Company Institute (Feb. 13, 2012) (“ICI Letter”) at 3; SIFMA Letter at 11. These commenters suggested that the definition incorporate a specific reference to the functions of an underwriter in connection with a Rule 144A transaction. As the proposed definition refers to a person agreeing to acquire a security from an issuer in a private placement for purposes of resales pursuant to Rule 144A, this proposed definition is appropriate and should capture the common industry understanding of “underwriting” a Rule 144A transaction.

<sup>56</sup> See, e.g., Better Markets Letter at 3; Merkley-Levin Letter at 3–4.

<sup>57</sup> See, e.g., Better Markets Letter at 3–4.

<sup>58</sup> See SIFMA Letter at 10.

<sup>59</sup> The definition of “distribution” in Regulation M considers the magnitude of the offering, in addition to the presence of special selling efforts and selling methods. See 17 CFR 242.100(b).

meet the re-proposed rule's definition of "sponsor" is a determination that would be based upon the specific facts and circumstances of the ABS transaction, including whether such a party would qualify for the exclusion in paragraph (ii)(C) of the proposed definition of "sponsor" for a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS, as discussed below in Section II.B.2.b.

Similar to the other proposed definitions discussed above, the proposed definition of the term "sponsor" is a functional definition that would apply regardless of the title bestowed upon the person (*e.g.*, an "issuer" of a municipal securitization would be a "sponsor" if its activities meet the re-proposed rule's definition).<sup>61</sup>

#### a. Sponsor in Regulation AB

Paragraph (i) of the proposed definition of "sponsor" in proposed Rule 192(c), which is derived from the definition of the term "sponsor" in Regulation AB,<sup>62</sup> includes 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, the definition in the re-proposed rule is not limited to the Regulation AB definition.<sup>63</sup> The Regulation AB definition was adopted to define who a sponsor is for purposes of the Regulation AB registration and reporting regime, and accordingly, that definition

was intended to identify the party or one of the parties that is responsible for complying with the offering and reporting requirements of Regulation AB.<sup>64</sup> Moreover, the Regulation AB definition of "sponsor" was adopted for the limited purpose and scope applicable only to those ABS eligible for registration under Regulation AB, and would not be appropriate to cover the full range of ABS that would be covered by the re-proposed rule, including those that are unregistered.<sup>65</sup> Accordingly, the proposed definition of "sponsor" in the re-proposed rule would include, but would not be limited to, a sponsor as defined in Regulation AB. As discussed below, we are proposing a definition of "sponsor" that would apply more broadly to also cover, subject to certain exceptions, any person that directs or causes the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS or has the contractual right to do so. This is because such a person is in a unique position to structure the ABS and/or construct the underlying asset pool or reference pool in a way that would position the person to benefit from the actual, anticipated, or potential adverse performance of the relevant ABS or its underlying asset pool if such person were to enter into a conflicted transaction.

#### b. Contractual Rights Sponsor and Directing Sponsor

Consistent with our concerns about the potential underinclusiveness of the Regulation AB definition of "sponsor" for purposes of the re-proposed rule, paragraph (ii) of the proposed definition of "sponsor" in proposed Rule 192(c) would apply more broadly to also cover, subject to certain exceptions, any person that directs or causes the direction of the structure, design, or assembly of an ABS or the composition of the pool of

assets underlying the ABS or has the contractual right to do so.

First, paragraph (ii)(A) of the proposed definition of "sponsor" would include, subject to certain exceptions, any person with 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 the ABS (a "contractual rights sponsor").<sup>66</sup> The definition of sponsor in the re-proposed rule refers to 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" because we believe that the structure of the ABS and the composition of the underlying asset pool are the factors that will most impact the performance of the ABS. Additionally, a person with the contractual right to direct or cause the direction of these aspects of an ABS that enters into a conflicted transaction would have the incentive and ability to engage in the conduct that is prohibited by Section 27B. For example, 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.<sup>67</sup> Therefore, the definition that we are proposing would cover various parties with a significant role in asset selection for an ABS transaction, whether before or after the initial issuance of the relevant ABS, such as a portfolio selection agent for a CDO transaction, a collateral manager for a CLO transaction with the contractual right to direct asset purchases or sales on behalf of the CLO, or a hedge fund manager or other 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 relevant ABS).

The re-proposed rule does not provide that an actual exercise of contractual rights would be necessary for purposes of the proposed definition of "sponsor." Our understanding of general industry practices based on our oversight of ABS markets is that there are a relatively small number of parties in a given ABS transaction with such contractual rights,

<sup>66</sup>This approach is consistent with a commenter's suggestion in response to the 2011 proposed rule to define the term "sponsor" broadly for purposes of Section 27B in order to ensure that the prohibition would apply to a broad range of persons with "significant influence in the structure, composition, and management of an ABS." See Merkle-Levin Letter at 3-4.

<sup>67</sup>See Section II.D. for a discussion of what would be a "conflicted transaction" under the re-proposed rule.

<sup>61</sup>See Section II.A. for discussion of the proposed definition of "asset-backed security" and its application to municipal securitizations.

<sup>62</sup>17 CFR 229.1101(l). Under the Regulation AB definition, a sponsor is the 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 issuing entity.

<sup>63</sup>Some commenters to the 2011 proposed rule supported adopting the Regulation AB definition of the term "sponsor." See SIFMA Letter at 11 (suggesting that the term "sponsor" be defined as "a person who organizes and initiates an ABS transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer."); see also ASF Letter at 22-23 n.36 (supporting the Regulation AB definition of sponsor and stating that "[w]e do not believe the definition of 'sponsor' should cover servicers, custodians or collateral managers, since those who merely service or manage the assets underlying an ABS, by definition, do not play a role in structuring an ABS and are not, therefore, in a position to design the ABS to default or fail"); comment letter from American Bar Association (Feb. 13, 2012) ("ABA Letter") at 4 (supporting the Regulation AB definition of the term "sponsor").

<sup>64</sup>See 2004 Regulation AB Adopting Release.

<sup>65</sup>Not all ABS are eligible for the specialized registration and reporting regime under Regulation AB. For example, because synthetic securitizations are primarily based on the performance of assets or indices not included in the ABS, synthetic securitizations are not eligible for the Regulation AB registration and reporting regime. See 2004 Regulation AB Adopting Release at 1513-14 (stating that in instances where ABS are not eligible, additional or different disclosures and/or registration and reporting treatment may be more appropriate and stating that synthetic securitizations do not meet the Regulation AB definition of ABS). Also as discussed in Section II.A., the definition of ABS for purposes of the re-proposed rule is broader than the definition of ABS in Regulation AB. For example, the re-proposed rule's definition of ABS includes synthetic ABS as required by Section 27B, whereas Regulation AB's definition of ABS does not.

and that in most instances a party with such contractual rights (e.g., a portfolio selection agent or collateral manager) would in fact exercise (and often has a contractual duty to exercise) those contractual rights with respect to the ABS. Accordingly, we believe it is appropriate for the proposed definition of “sponsor” to capture contractual rights sponsors without requiring a factual determination of whether a contractual rights sponsor has exercised its 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 the ABS.

We understand that there may be instances where a person that does not have a contractual right to do so may nevertheless direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS. For example, in connection with certain well-known examples of synthetic CDOs that were issued in the lead up to the financial crisis of 2007–2009, hedge funds that desired to take short positions in synthetic CDO securities (i.e., so that the hedge fund could benefit if the synthetic CDO securities performed adversely) would direct or cause the direction of the composition of the portfolio assets in ways that would increase the likelihood of realizing an ultimate gain on their short position.<sup>68</sup> Paragraph (ii)(B) of the proposed definition of “sponsor” would therefore also include any person that directs or causes the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS even if that person does not have a contractual right to do so (a “directing sponsor”). A determination that a person meets the definition of sponsor for this reason would be based upon the specific facts and circumstances.

As stated above, 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. Therefore, the definition that we are proposing would cover a person, such as a private fund manager, who selects all or a portion of the assets underlying the ABS by directing the relevant person with the contractual right to do so and, based on its ability to select assets that are expected to perform poorly, enters into a transaction to short the ABS. The facts and circumstances regarding the actions of

such a person would be distinguishable from that of an ABS investor that is acquiring a long position in the relevant ABS. An ABS investor that is acquiring a long position in the relevant ABS would be expected to provide input with respect to the structure of the ABS investment or the underlying pool of assets for the purpose of maximizing the expected value of its ABS investment. For example, investors in certain ABS markets may have stipulations regarding general characteristics of the composition of the underlying pool of an ABS that must be satisfied in order for that investor to agree to acquire the relevant securities, including to ensure that the ABS investment would comply with its investment guidelines. Therefore, an ABS investor that is interested in acquiring a long position in an ABS would not be considered to direct the composition of assets merely because such investor expresses its preferences regarding the assets that would collateralize its ABS investment. Paragraph (ii)(B) of the proposed definition of “sponsor” is not intended to capture such investors as a “sponsor” and is intended to capture only those persons—such as the hedge fund managers in the examples referred to above—that direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS other than in connection with their acquisition of a long position in the ABS.

The proposed definition of “sponsor” is a functional definition that would apply regardless of the title bestowed upon such person. Accordingly, a person would be a sponsor for purposes of the re-proposed rule if such person organized and initiated the ABS transaction or directed or had the contractual right to direct the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS, regardless of whether the person is referred to as the sponsor of the ABS or by some other title (e.g., issuer, depositor, originator, or collateral manager),<sup>69</sup> and even if the person does not have a named role in the ABS transaction and is not a party to any of the transaction agreements. This is consistent with a commenter’s suggestion in response to the 2011 proposed rule to define the term “sponsor” broadly for purposes of Section 27B in order to ensure that the prohibition would apply to a broad range of securitization participants,

<sup>69</sup> For example, if a person is designated an “issuer” of a transaction, the person could also be a “sponsor” if the person performs the functions specified in the proposed definition.

including collateral managers and other parties with significant influence in the structure, composition, and management of an ABS.<sup>70</sup>

To avoid having the scope of the proposed definition of “sponsor” extend beyond those persons with the incentive and ability to engage in the conduct that is prohibited by Section 27B, paragraph (ii)(C) of the proposed definition of “sponsor” would exclude a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS. Whether a person performs only such functions is a determination that would be based upon the specific facts and circumstances of an ABS transaction. For example, we believe that the activities customarily performed by accountants, attorneys, and credit rating agencies with respect to the creation and sale of an ABS, and the activities customarily performed by trustees, custodians, paying agents, calculation agents, and other contractual service providers relating to the ongoing management and administration of the entity that issues the ABS, are the sorts of activities that would typically fall within the exclusion from the definition of the proposed definition of the term “sponsor.” This exclusion should address the concerns of a commenter that the persons defined to be subject to the prohibition of the re-proposed rule should not inadvertently include trustees, servicers, law firms, accountants, and diligence providers.<sup>71</sup> This exclusion should also mitigate concerns about the potential overinclusiveness of a definition of the term “sponsor,” including concerns raised by certain commenters on the 2011 proposed rule about a definition that is broader than the Regulation AB definition.<sup>72</sup> While we received comment to the 2011 proposed rule that the definition of “sponsor” should include a catch-all to cover “any other person that makes a material contribution to the design, composition, assembly, sale, or management of an asset-backed security,”<sup>73</sup> we believe that such a catch-all provision would be overly broad as it could potentially include trustees, attorneys, or others that, for the reasons discussed above, should not be treated as “sponsors” under the re-proposed rule.

<sup>70</sup> See Merkley-Levin Letter at 3–4.

<sup>71</sup> See SIFMA Letter at 9.

<sup>72</sup> See ASF Letter at 23 n.36; and ABA Letter at 4–5.

<sup>73</sup> See, e.g., Better Markets Letter at 3; Merkley-Levin Letter at 3–4.

<sup>68</sup> See Senate Financial Crisis Report.

c. Federal Government Entities and Certain Other Entities Backed by the Federal Government Would Not Be Defined To Be a Sponsor of Fully Insured or Fully Guaranteed ABS

Paragraph (iii)(A) of the proposed definition of “sponsor” in proposed Rule 192(c) would provide that the United States or an agency of the United States would not be a “sponsor” for purposes of the re-proposed rule with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest<sup>74</sup> by the United States. Additionally, under paragraph (iii)(B) of the proposed definition of “sponsor,” Fannie Mae or Freddie Mac operating under the conservatorship or receivership of FHFA with capital support from the United States<sup>75</sup> would not be a “sponsor” for purposes of the re-proposed rule with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by such entity.<sup>76</sup>

As discussed below, with respect to the types of fully insured or fully guaranteed securities of which the United States, an agency of the United States, or the Enterprises might otherwise be a sponsor absent these proposed exclusions, it is the United States that is exposed to the credit risk of the underlying assets. Therefore, if these entities were to enter into the types of conflicted transactions that this rule is intended to address, investors would ultimately not be exposed to credit risks stemming from such transactions.

Each of these exclusions would apply only to the entities specified in the relevant exclusion, and any other securitization participants involved with an ABS issued or guaranteed by such entity (e.g., an underwriter or a non-governmental sponsor) would be subject to the re-proposed rule. Additionally, each of these exclusions is subject to certain conditions. If those conditions are not satisfied with respect to certain ABS (e.g., an ABS is not fully

insured or fully guaranteed by the relevant entity), then any securitization participant with respect to such ABS would still be subject to the prohibition of the re-proposed rule.

i. United States Government and Agencies

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, the United States or an agency of the United States would not be a “sponsor” under paragraph (iii)(A) of the proposed definition of “sponsor” in proposed Rule 192(c). These ABS would include mortgage-backed securities (“MBS”) guaranteed by the Government National Mortgage Association (“Ginnie Mae”), a wholly owned U.S. Government corporation that guarantees investors the timely payment of principal and interest on MBS backed by Federally insured or guaranteed loans, including mortgage loans insured by the Federal Housing Administration or guaranteed by the Department of Veterans Affairs. As a result of the proposed exception in paragraph (iii)(A) of the proposed definition of “sponsor,” Ginnie Mae would not be a “sponsor” with respect to its guaranteed ABS. Ginnie Mae’s guarantee is backed by the full faith and credit of the United States. Given that Ginnie Mae sets certain guidelines and serves as guarantor for the MBS that it guarantees,<sup>77</sup> Ginnie Mae would, absent the proposed exception, be a sponsor of the ABS that it guarantees for purposes of the re-proposed rule.

As guarantor, the United States is exposed to the full credit risk related to the underlying assets. In turn, investors in ABS that are fully backed by the United States government rely on the support provided by the full faith and credit of the United States and not on the creditworthiness of the obligors on the underlying assets, and therefore are not exposed to the credit risk of the underlying assets. As a result, investors in such ABS are not exposed to the risk that was present in certain ABS transactions prior to the financial crisis of 2007–2009 where investors suffered credit-based losses due to the poor performance of the relevant asset pool while key securitization parties entered into transactions to profit from such poor performance.

ii. Enterprises

Similar to the reasons for excepting the United States government and

agencies thereof, under paragraph (iii)(B) of the proposed definition of “sponsor” in proposed Rule 192(c), Fannie Mae and Freddie Mac, in each case, for so long as the applicable Enterprise is operating under conservatorship or receivership<sup>78</sup> of FHFA with capital support from the United States,<sup>79</sup> would not be defined as a “sponsor” for purposes of the re-proposed rule with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by such Enterprise.

The Enterprises act as mortgage loan seller, master servicer, and, at times, trustee for collateralized mortgage obligations and other MBS. The Enterprises select and manage the assets in the asset pools underlying the securities and set the selection criteria and servicing guidelines for the securities. The Enterprises serve as guarantors for MBS, and, as guarantors, they are required to make principal and interest payments on the securities regardless of credit losses on the underlying mortgages.

Because some of these activities fall within the proposed definition of “sponsor,” Fannie Mae or Freddie Mac (or a successor limited-life regulated entity) would, absent an exception, be the sponsor of the ABS that it issues for purposes of the re-proposed rule. However, because such entities would be excluded from the definition of “sponsor” under, and subject to the conditions of, paragraph (iii) of the proposed definition of “sponsor,” neither Enterprise would be subject to the rule’s prohibition with respect to the relevant Enterprise-guaranteed ABS. We believe that this is appropriate where Fannie Mae and Freddie Mac operate with capital support from the United States and fully guarantee the timely payment of principal and interest on their guaranteed ABS. This is because Fannie Mae and Freddie Mac are exposed to the entire credit risk of the mortgages that collateralize such ABS instead of investors, and an Enterprise’s

<sup>74</sup> The re-proposed rule does not define what “fully insured or fully guaranteed as to the timely payment of principal and interest” means in this context as we believe that concept is commonly understood by market participants with respect to the relevant security.

<sup>75</sup> This would also include any limited-life regulated entity succeeding to the charter of either Fannie Mae or Freddie Mac 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 such entity is operating with capital support from the United States.

<sup>76</sup> One commenter to the 2011 proposal stated that not excluding Enterprise or Ginnie Mae ABS from the scope of the rule would have significant economic and market impacts. See SIFMA Letter at 18–21.

<sup>77</sup> See, e.g., 24 CFR 320 and the Ginnie Mae MBS Guide, available at [https://www.ginniemae.gov/issuers/program\\_guidelines/Pages/mbs\\_guide.aspx](https://www.ginniemae.gov/issuers/program_guidelines/Pages/mbs_guide.aspx).

<sup>78</sup> Under the Federal Housing Enterprises Safety and Soundness Act of 1992, FHFA may be appointed as the conservator or receiver for an Enterprise. Although Fannie Mae and Freddie Mac have been operating under the conservatorship of FHFA since September 6, 2008, the re-proposed rule includes the reference to “receivership” in order to align with the statutory authority of FHFA under the Federal Housing Enterprises Safety and Soundness Act of 1992.

<sup>79</sup> This would also include any limited-life regulated entity succeeding to the charter of either Enterprise pursuant to the authority of FHFA as conservator or receiver in respect of such Enterprise under the Federal Housing Enterprises Safety and Soundness Act of 1992, provided that such successor entity is operating with capital support from the United States.

guarantee would protect investors fully against the risk of credit losses on the underlying assets, at least for so long as the Enterprise remains in conservatorship with capital support from the United States as discussed below.

Both Fannie Mae and Freddie Mac have been operating under the conservatorship of FHFA since September 6, 2008. Concurrently with being placed in conservatorship under Section 1367 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, each Enterprise entered into a Senior Preferred Stock Purchase Agreement (“PSPA”) with the United States Department of the Treasury (“Treasury”). Under each PSPA, Treasury provided capital support to the Enterprises through the purchase of senior preferred stock of each Enterprise.<sup>80</sup> While the Enterprises are in conservatorship, due to the unique nature of the authority and oversight of FHFA over their operations as a result of such status, the Enterprises are not expected to act in a manner that would result in conflicted transactions that would benefit private parties, and, thus, are not expected to engage in the adverse selection of assets for their ABS. Moreover, because of the capital support provided by Treasury under the PSPAs, each Enterprise’s guarantee fully protects investors against the risk of credit losses on the underlying assets consistent with the goals and intent of Section 27B. Accordingly, we are proposing to exclude the Enterprises from the definition of “sponsor” with respect to Enterprise-guaranteed ABS while the Enterprises are in conservatorship or receivership with capital support from the United States. We recognize the ongoing activity related to reform of the Enterprises and, if appropriate, we may revisit and modify the proposed exception if and when the future of the Enterprises and of the statutory and regulatory framework post-conservatorship for the Enterprises becomes clearer.<sup>81</sup>

One commenter to the 2011 proposed rule also suggested an exception for the Enterprises’ security-based credit risk transfer (“CRT”) transactions to allow for efficient mitigation of the Enterprises’ retained credit risk

associated with their holdings of residential and commercial mortgages and MBS.<sup>82</sup> A security-based CRT transaction typically involves the issuance of unguaranteed ABS by a special purpose trust where the performance of such ABS is linked to the performance of a reference pool of mortgage loans that collateralize Enterprise guaranteed-MBS.<sup>83</sup> As a part of a security-based CRT transaction structure, the relevant Enterprise enters into an agreement with the special purpose trust pursuant to which the trust has a contractual obligation to pay the Enterprise upon the occurrence of certain adverse events with respect to the referenced mortgage loans.<sup>84</sup>

The proposed exclusion of the Enterprises, subject to certain conditions, from the definition of “sponsor” with respect to Enterprise-guaranteed ABS should address concerns that, absent such an exception, an Enterprise might be prohibited from engaging in a security-based CRT transaction, which could be a “conflicted transaction” under the re-proposed rule with respect to an Enterprise’s guaranteed ABS.<sup>85</sup> Again, the investors in ABS fully insured or fully guaranteed by an Enterprise would not be subject to credit risk so long as an Enterprise’s guarantee is backed by the full faith and credit of the United States. As such, we do not believe that such investors bear significant risk of conflicted transactions. Accordingly, under the re-proposed rule, the relevant Enterprise, subject to the conditions discussed above, would not be defined as a “sponsor” of its Enterprise-guaranteed ABS and would, therefore, not be a “securitization participant” under the re-proposed rule with respect to its Enterprise-guaranteed ABS.

We note, however, 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. Furthermore, 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.

Therefore, the Enterprises would be “sponsors” of CRT securities for purposes of the re-proposed rule and would be prohibited from engaging in conflicted transactions that would be prohibited by the re-proposed rule with respect to investors in such CRT securities.

#### Request for Comment

15. Is the proposed definition of the term “sponsor” overinclusive or underinclusive? Please explain why or why not.

16. We seek comment on the concept in the definition of the term “sponsor” of a person directing or causing the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS. Is this concept, in the context of a person that does not have a contractual right to exercise such direction, overinclusive or underinclusive, and why? In particular, is the reference to “causes the direction of” necessary in order to capture direction given through a third party, or is the reference unnecessary because of the inclusion of the anti-circumvention provision in proposed Rule 192(d)? Why or why not? Are there additional indicia that should be included or referenced for purposes of the facts and circumstances that would be relevant to this determination? What parties that have a role in a securitization could fall within the proposed definition of “sponsor” because they direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying an ABS? Should all of these parties be included? Should other parties be included in the definition of “sponsor”? Which of these parties would not be a sponsor because of the exclusion in paragraph (ii)(C) of the proposed definition of “sponsor” for a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS? The proposed definition of the term “sponsor” includes, but is not limited to, a sponsor as defined in Regulation AB. If the rule were limited to the Regulation AB definition of “sponsor,” would that make the rule underinclusive? Would it be clear how to determine which party or parties would be a sponsor when applying the Regulation AB definition of “sponsor” to the wider population of ABS that are not subject to Regulation AB, but are

<sup>80</sup> For a discussion of Enterprise operations under conservatorship or receivership with capital support from the United States, see RR Adopting Release at 77649.

<sup>81</sup> The RR Adopting Release similarly states that the application of the credit risk retention rules to the Enterprises will be revisited and, if appropriate, modified after the future of the Enterprises and of the statutory and regulatory framework for the Enterprises becomes clearer. See *id.* at 77650.

<sup>82</sup> See comment letter from Fannie Mae and Freddie Mac (Dec. 21, 2015) (“Fannie Mae/Freddie Mac Letter”) at 3–8.

<sup>83</sup> See, e.g., the relevant legal documentation and other related information about Freddie Mac’s single-family transactions, available at <https://capitalmarkets.freddiemac.com/crt/securities/deal-documents>.

<sup>84</sup> See *id.*

<sup>85</sup> See Section II.D. for a discussion of what would be a “conflicted transaction” for purposes of the re-proposed rule.

subject to the prohibitions of Section 27B?<sup>86</sup>

17. We seek comment on an alternative definition of the term “sponsor” where paragraph (ii) of the proposed definition of “sponsor” would include a contractual rights sponsor described in paragraph (ii)(A) of the proposed definition of “sponsor” but would not include a directing sponsor described in paragraph (ii)(B) of the proposed definition of “sponsor.” Would this alternative definition better address concerns of commenters on the 2011 proposed rule about potential overinclusiveness of the definition of the term “sponsor” by covering only persons with a contractual relationship with the entity that issues the ABS (or with one or more of the other securitization participants)? Would this alternative definition be underinclusive because it would not cover all the parties that could direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS, such as a hedge fund manager or other private fund manager that would have an opportunity to benefit from a bet against the performance of the ABS or the underlying assets? If paragraph (ii) of the definition of “sponsor” were limited to a contractual rights sponsor, even if it might not cover the full range of potentially culpable parties, would it nonetheless prevent most conflicted transactions from occurring because of its interaction with other provisions of the rule? Further, should the definition of the term “sponsor” be limited to refer to only a contractual rights sponsor that has actually exercised its relevant contractual rights?

18. We seek comment on an alternative definition of the term “sponsor” that would include an additional catch-all prong that would include “any other person that makes a material contribution to the design, composition, assembly, sale, or management of an asset-backed security” as suggested by certain commenters to the 2011 proposed rule.<sup>87</sup> Would this catch-all better capture all parties that could engage in conduct prohibited by Section 27B? What parties that have a role in a securitization would be captured by this catch-all that would not otherwise be subject to the re-proposed rule? Should such parties, if any, be subject to the re-proposed rule’s prohibition on material conflicts of interest? Please explain why or why not. Would such a catch-all be

overinclusive, or would it unduly burden parties that would not have the incentive or ability to engage in conduct prohibited by Section 27B? Please also explain whether and how such a catch-all would be consistent with Section 27B.

19. Is the exclusion in paragraph (ii)(C) of the proposed definition of “sponsor” for a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design, or assembly of the ABS or the composition of the pool of assets overinclusive or underinclusive, and why? Are there additional administrative activities and functions in the context of ABS that should be addressed? Is it clear whether servicers or other contractual service providers with ongoing managerial or administrative roles with respect to the securitization, but limited discretion over the structure, design, or assembly of the ABS or the composition of the pool of assets underlying the ABS, would qualify for the proposed exclusion? Please explain why or why not. Should the exclusion be modified to provide more detail on the types of activities that can be provided by a party while continuing to qualify for the exclusion from the proposed definition of “sponsor”? If so, please explain how the exclusion should be modified, including which types of activities the exclusion should reference.

20. Should we modify the proposed exception from the definition of “sponsor” for the United States or an agency of the United States with respect to an ABS that is fully insured or fully guaranteed by the United States? If so, describe any suggested modifications or deletions to the exception and explain why they would be necessary and how they would be consistent with Section 27B.

21. Should we modify the proposed exception from the definition of “sponsor” for the United States or an agency of the United States to apply not only with respect to an ABS that is fully insured or fully guaranteed by the United States but also an ABS that is not fully insured or fully guaranteed by the United States? If so, describe any suggested modifications or deletions to the exception and explain why they would be necessary and how they would be consistent with Section 27B.

22. The proposed exceptions from the definition of “sponsor” in paragraph (iii) of the proposed definition of “sponsor” are premised on the fact that the United States, and not investors in such ABS, is exposed to the credit risk of the underlying assets because of the credit support provided by the United

States. Are there other types of non-credit-related risks, such as interest rate risk or prepayment risk, that we should also address in the context of such fully insured or fully guaranteed ABS transactions for purposes of the prohibition, and if so, how should these proposed exceptions be modified to address such risks?

23. Should we modify the proposed exception from the definition of “sponsor” in paragraph (iii)(B) of the proposed definition of “sponsor” for the Enterprises with respect to an ABS that is fully insured or fully guaranteed by the relevant entity? Please describe any suggested modifications or deletions to the exception and explain why they would be necessary and how they would be consistent with Section 27B.

24. The proposed exception from the definition of “sponsor” for the Enterprises in paragraph (iii)(B) of the proposed definition of “sponsor” would apply only for so long as the applicable Enterprise is operating under conservatorship or receivership of FHFA with capital support from the United States. Should it apply beyond that time period? If so, why, and how would that be consistent with Section 27B?

25. If so, then investors in Enterprise-guaranteed ABS would be relying solely on the Enterprise guarantee due to the lack of the capital support from the United States. If the exception were to extend beyond conservatorship, then are there any ways that the rule could address the credit risk related to the Enterprise guarantee and the conflicts that could arise from securitization participants engaging in conflicted transactions? Should the exception for the Enterprises be subject to any other conditions?

26. In addition to or in lieu of the proposed exceptions from the definition of “sponsor” in paragraph (iii) of the proposed definition of “sponsor” discussed above, should there be an exception for ABS that is fully insured or fully guaranteed by, or collateralized solely by obligations issued, fully insured, or fully guaranteed by, the United States or an agency of the United States? If so, should it be an exception to the definition of “asset-backed security,” or should it be an exception to the re-proposed rule’s prohibition? Please explain why any such exception would be necessary and what conditions, if any, should apply to the application of that exception. How would such an exception be consistent with Section 27B?

27. In addition to or in lieu of the proposed exceptions from the definition of “sponsor” in paragraph (iii) of the

<sup>86</sup> See discussion in Section II.A.

<sup>87</sup> See, e.g., Better Markets Letter at 3; Merkley-Levin Letter at 3–4.

proposed definition of “sponsor” discussed above, should there be an exception to the definition of “asset-backed security” for an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by the Enterprises while operating under the conservatorship or receivership of FHFA with capital support from the United States? If so, please explain why such an exception would be necessary, how such an exception would be consistent with Section 27B, and if any conditions should apply to the application of such an exception.

28. Are there any other types of government entities, including municipal entities, that should be exempt from the re-proposed rule? Please explain why they should be exempt and how such an exemption would be consistent with Section 27B. If the relevant ABS are not fully insured or fully guaranteed by a government or government-controlled entity, then please explain why securitization participants that would be covered by the re-proposed rule should be exempt, including whether the opportunity exists to engage in the type of conduct prohibited by the re-proposed rule.

### 3. Affiliates and Subsidiaries

Consistent with Section 27B(a), the proposed definition of “securitization participant” in proposed Rule 192(c) would extend to affiliates and subsidiaries of an underwriter, placement agent, initial purchaser, or sponsor of an ABS. Including affiliates and subsidiaries in the re-proposed rule would help to prevent affiliates and subsidiaries from being used to evade the rule’s prohibitions and would also be consistent with Section 27B.

Proposed Rule 192 is being proposed under the Securities Act, and the rule refers to the definitions of the terms “affiliate” and “subsidiary” under 17 CFR 230.405 (“Securities Act Rule 405”). Under Securities Act 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, and a “subsidiary” of a specified person means an affiliate controlled by such person directly, or indirectly through one or more intermediaries.<sup>88</sup> Also, under Securities Act Rule 405, the term “control” is defined to mean 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.<sup>89</sup>

We believe that these definitions are commonly understood by market participants and would help to prevent evasion of the re-proposed rule. The re-proposed rule is designed to prevent securitization participants from entering into transactions that are bets against the ABS that they create or sell to investors, and it would be inconsistent with the intent of the re-proposed rule if the prohibition did not extend to cover a transaction structure where a securitization participant directs, either directly or through one or more intermediaries, an affiliate or subsidiary to enter into such a bet against the relevant ABS. We believe that, to cover the various ways in which an affiliate or subsidiary relationship may be effectuated, the re-proposed rule should cover such a scenario whether the securitization participant’s ability to direct the management and policies of the relevant entity are through the ownership of voting securities, by contract, or otherwise.

The inclusion of affiliates and subsidiaries in the re-proposed rule means that persons in addition to underwriters, placement agents, initial purchasers, or sponsors of an ABS would be securitization participants for purposes of the re-proposed rule if they are an affiliate or subsidiary of an underwriter, placement agent, initial purchaser, or sponsor of an ABS. For example, a servicer that is a sponsor’s affiliate would fall within the scope of the re-proposed rule even if the servicer’s role in connection with the securitization would not meet the re-proposed rule’s definition of the term “sponsor.”<sup>90</sup>

We received comments to the 2011 proposed rule that including affiliates and subsidiaries would be overinclusive and that it would impose an unduly burdensome impact on certain persons.<sup>91</sup> Certain commenters to the 2011 proposed rule suggested that the use of information barriers would mitigate the re-proposed rule’s potential overinclusion of affiliates and

subsidiaries of securitization participants.<sup>92</sup> One commenter to the 2011 proposed rule specifically supported the use of an information barriers regime with respect to investment companies and investment advisers that are affiliates or subsidiaries of securitization participants.<sup>93</sup> However, other commenters opposed the use of information barriers to manage material conflicts of interest in connection with the 2011 proposed rule for reasons such as perceived permeability, limited utility, and difficulties associated with monitoring and enforcing information barriers in addition to their weakening impact on the prohibition set forth in Section 27B.<sup>94</sup>

Information barriers, in the form of written, reasonably designed policies and procedures, have been recognized in others areas of the Federal securities laws and the rules thereunder. For example, brokers and dealers have used information barriers to manage the potential misuse of material non-public information to adhere to Section 15(g) of the Exchange Act.<sup>95</sup> Also, Regulation M contains an exception for affiliated purchasers if, among other requirements, the affiliate maintains and enforces written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate that might result in a violation of Regulation M.<sup>96</sup>

The re-proposed rule does not include the use of information barriers as an exception for affiliates and subsidiaries because we are concerned about the potential to use an affiliate or subsidiary to evade the re-proposed rule’s prohibition. However, we seek comment below on whether an exception utilizing information barriers to exclude affiliates and subsidiaries could be implemented in a way that would be consistent with Section 27B. Responses to such questions would provide further insight

<sup>92</sup> See, e.g., ABA Letter at 11–12; ASF Letter at 10–11; comment letter from The Financial Services Roundtable (Feb. 13, 2012) (“Roundtable Letter”) at 10; SIFMA Letter at 14–15.

<sup>93</sup> See, e.g., ICI Letter at 5–7.

<sup>94</sup> See Barnard Letter at 2 (stating that, although information barriers and disclosure may be useful to mitigate conflicts of interest, short transactions should be absolutely prohibited); Better Markets Letter at 9 n.23 (stating that history had proved that information barriers are not reliable and are difficult for regulators to monitor and enforce); comment letter from Public Citizen (Feb. 13, 2012) (“Public Citizen Letter”) at 1, 4–5 (stating that information barriers invite abuse and present major enforcement problems); Tewary Letter 1 at 13–14 (stating that academic studies have found that, even where information barriers are erected, regulators are routinely unaware of when such barriers have been breached).

<sup>95</sup> 17 U.S.C. 78o(g).

<sup>96</sup> 17 CFR 242.100–105; 17 CFR 242.100(b).

<sup>89</sup> *Id.*

<sup>90</sup> We understand that servicers are often affiliated with the sponsor of an ABS. See, e.g., 2004 Regulation AB Adopting Release at 1511 (stating that because the issuing entity is designed to be a passive entity, one or more “servicers,” often affiliated with the sponsor, are generally necessary to collect payments from obligors of the pool assets, to carry out the other important functions involved in administering the assets, and to calculate and pay the amounts net of fees due to the investors that hold the ABS to the trustee, which actually makes the payments to investors).

<sup>91</sup> See, e.g., ABA Letter at 11–12; SIFMA Letter at 12–15.

<sup>88</sup> 17 CFR 230.405.

on commenters' views on the 2011 proposed rule that supported the use of information barriers, including whether such an approach would be appropriate with respect to investment companies and investment advisers that are affiliates or subsidiaries of certain securitization participants.<sup>97</sup>

An information barriers exception could contain conditions that must be met to qualify for such exception, which would help ensure that the relevant affiliates or subsidiaries of a securitization participant would not engage in transactions that would involve or result in a material conflict of interest. For example, an information barrier-based exception could contain a condition requiring that an underwriter, placement agent, initial purchaser, or sponsor of an ABS establish, implement, maintain, enforce, and document written policies and procedures to prevent the flow of information to and from such underwriter, placement agent, initial purchaser, or sponsor and its affiliates and subsidiaries that might result in a violation of the re-proposed rule. Such written policies and procedures could aid the underwriter, initial purchaser, placement agent, and sponsor in monitoring and enforcing the applicable information barriers. For example, the policies and procedures could include a physical separation of personnel which could help to restrict information flow, for example, between a securitization participant and its affiliates and subsidiaries, and could promote a barrier between activities related to securitization and other activities that are unrelated to the creation and distribution of ABS. Additionally, policies and procedures could restrict the activities of an underwriter, placement agent, initial purchaser, or sponsor in the context of an ABS transaction to only those activities necessary for it to act in such capacity, such that the securitization participant would be further limited in its ability to engage in activity that Section 27B is designed to prevent.

A second condition to an information barriers exception could be to require that an underwriter, placement agent, initial purchaser, or sponsor of an ABS establish, implement, maintain, enforce, and document a written internal control structure governing the implementation and adherence to the policies and procedures required under the information barriers exception. An internal control condition would aid the underwriter, initial purchaser, placement agent, and sponsor in monitoring, identifying, and

remediating non-compliance with the applicable information barriers. For example, an internal control structure would help identify whether policies and procedures would need to be modified so that they achieve their intended purpose.

A third condition could be that the securitization participant obtains an annual, independent assessment of the operation of the policies and procedures and internal control structure required under the information barriers exception. This condition would also aid the underwriter, initial purchaser, placement agent, and sponsor in monitoring, identifying, and remediating non-compliance with the applicable information barriers that are not identified by the internal control structure.

A fourth condition could be that the affiliate or subsidiary has no officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) in common with the underwriter, initial purchaser, placement agent, or sponsor and was not involved in the creation, distribution, origination of the assets, or otherwise providing services with respect to the related ABS. For example, originators and servicers that are affiliates or subsidiaries of an underwriter, placement agent, initial purchaser, or sponsor would not meet the elements of this condition. This condition would recognize that it would be nearly impossible to have an effective information barrier to prevent the flow of information if the affiliates or subsidiary shared common officers or employees, was involved in the creation, distribution, or origination of the assets, or is otherwise providing services related to the ABS.

A fifth condition could be that the information barriers exception would not be available if, in the case of any specific securitization, the underwriter, initial purchaser, placement agent, or sponsor knows or reasonably should know that, notwithstanding meeting the conditions described above, the transaction would involve or result in a material conflict of interest. We seek commenters' views on an information barriers exception with the conditions described above. We also seek comment on other or different conditions below.

#### Request for Comment

29. Is it appropriate for the Securities Act Rule 405 definitions of the terms "affiliate," "subsidiary," and "control" to apply for purposes of the re-proposed rule? If not, please explain why and provide alternative definitions of these terms that should be used.

30. If a securitization participant that is an investment adviser "controls" a fund that it manages for purposes of the re-proposed rule, then such fund would be an "affiliate" or "subsidiary" of such investment adviser and subject to the re-proposed rule. Is this appropriate? If not, please explain why, provide alternative definitions of the relevant terms that should be used, and explain how the modifications would be consistent with Section 27B.

31. The proposed definitions of the terms "affiliate" and "subsidiary" could include a securitization participant's non-U.S. affiliates and subsidiaries. Would the inclusion of affiliates and subsidiaries within the scope of the re-proposed rule result in the rule having an unnecessary and highly burdensome global reach, as suggested by one commenter to the 2011 proposed rule?<sup>98</sup> Why or why not?

32. As discussed above, information barriers are used as tools to manage conflicts of interest in other areas of the Federal securities laws and the rules thereunder.<sup>99</sup> We seek comment on whether information barriers could be designed to effectively mitigate prohibited conflicts of interest and provide adequate protection in this context, whether the use of such barriers would effectively implement Section 27B, and whether internal information barriers are vulnerable to breach. If the re-proposed rule were to include the use of information barriers, should there be an exception for an affiliate or subsidiary of an underwriter, placement agent, initial purchaser, or sponsor of an ABS if each of the following conditions is satisfied: (1) the underwriter, placement agent, initial purchaser, or sponsor of the ABS establishes, implements, maintains, enforces, and documents written policies and procedures to prevent the flow of information to and from the affiliate or subsidiary that might result in a violation of the re-proposed rule; (2) the underwriter, placement agent, initial purchaser, or sponsor of the ABS establishes, implements, maintains, enforces, and documents a written internal control structure governing the implementation of, and adherence to, the written policies and procedures; (3) the underwriter, placement agent, initial purchaser, or sponsor of the ABS obtains an annual, independent assessment of the operation of such policies and procedures and internal control structure; (4) the affiliate or subsidiary has no officers (or persons performing similar functions) or

<sup>97</sup> See, e.g., ICI Letter at 5-7.

<sup>98</sup> See SIFMA Letter at 15.

<sup>99</sup> See Section II.B.3.

employees (other than clerical, ministerial, or support personnel) in common with the underwriter, placement agent, initial purchaser, or sponsor of the ABS, and was not involved in the creation or distribution of, or otherwise involved in providing services with respect to, the related ABS; and (5) a person may not rely on the exception if, in the case of any specific securitization, the person knows or reasonably should know that notwithstanding satisfying the conditions, a transaction would involve or result in a material conflict of interest? How would this exception be consistent with Section 27B?

33. Please identify any additional conditions that would be appropriate for a potential information barriers exception to include in order to help maintain strong conflict of interest protection while permitting normal course business activities for certain affiliates and subsidiaries, and how those conditions would be consistent with Section 27B.

34. Should any of the conditions described in question 32 be modified if the final rule were to include an information barriers exception? For example, should condition (1) be modified to specify that policies and procedures such as physical separation of personnel and functions and limitations on the types of permissible activities of an underwriter, initial purchaser, placement agent, or sponsor (and its affiliates and subsidiaries) could satisfy this condition? Should condition (1) be modified to specify that the policies and procedures must take into consideration the nature of the entity's business? Should any of the conditions be deleted? If so, explain why, including why the removal of any such conditions would be consistent with Section 27B if the final rule were to include an information barriers exception.

35. Should the potential information barriers exception described in question 32 include a condition that the offering document for the ABS must disclose the types of transactions that the affiliate or subsidiary could engage in as part of its normal, ordinary course of business? How could any such disclosure condition be structured so that the resulting disclosure would not contain vague boilerplate language? How could such disclosure be provided to investors if the transactions occur after the offering but within the timeframe of the prohibition? How would any such disclosure conditions be consistent with Section 27B?

36. Should the potential information barriers exception described in question 32 provide an exception for specific

types of businesses that are unrelated to the creation and distribution of ABS such that only affiliates and subsidiaries engaged in those specific businesses would be eligible for the exception? If yes, please explain and provide a list of specific businesses unrelated to the creation and distribution of ABS that should be listed in any such exception (for example, mutual fund asset-management, investment advisers acting on behalf of clients, foreign trading desks facilitating customer trades). Also, please explain how any such exceptions would be consistent with Section 27B. If no, please explain.

37. Should the potential information barriers exception described in question 32 provide an exception if the affiliate or subsidiary already would be subject to existing rules and regulation that provide for conflict management or restricting information flow as the requirements of such rules and regulations could help to achieve the policy objectives of the re-proposed rule? Please list specific rules and regulations that provide for managing conflicts of interest or restricting information flow at the affiliate or subsidiary as a condition to qualifying for such exception.

38. Should the re-proposed rule include an information barriers exception as described by one commenter to the 2011 proposed rule?<sup>100</sup> How would such an exception be consistent with Section 27B? Should any conditions that were suggested by that commenter be added to the information barriers exception described in question 32? In lieu of condition (3) in question 32, should a potential information barriers exception instead require periodic internal audits of compliance with policies and procedures? If so, how often should that assessment be? For example, should it be monthly, annually, or quarterly and why? Is there a particular actor within an organization that should perform the internal audit? If so, who would that be and why?

### C. Timeframe of Prohibition

We are proposing in Rule 192(a)(1) that the prohibition on conflicted transactions would commence on the date on which a person has reached, or has taken substantial steps to reach, an agreement<sup>101</sup> that such person will

<sup>100</sup> See SIFMA Letter at 15 (describing a safe harbor that would permit a financial institution to design its own information barriers).

<sup>101</sup> For purposes of the re-proposed rule, an "agreement" need not constitute an executed written agreement, such as an engagement letter. Oral agreements and facts and circumstances constituting an agreement, even absent an executed

become a securitization participant ("commencement point") and would end one year after the date of the first closing of the sale of the relevant ABS. This end point for the covered timeframe is set forth in the statutory language of Section 27B, and the re-proposed rule incorporates that statutory language. The prohibition in the 2011 proposed rule would have applied 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.

The re-proposed rule's approach to the commencement point is designed to reduce the circumstances in which a person could engage in prohibited conduct prior to the issuance of the relevant ABS. We preliminarily believe that the point at which a securitization participant has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant is the appropriate commencement point for the prohibition in the re-proposed rule because that 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.

Whether a person has taken substantial steps to reach an agreement to become a securitization participant would be a facts and circumstances determination based on the actions of such person in furtherance of becoming a securitization participant. For example, a person who has engaged in substantial negotiations over the terms of an engagement letter or other agreement to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS would be subject to the prohibition in the re-proposed rule by virtue of having taken substantial steps to reach an agreement to become a securitization participant. The re-proposed rule does not define "agreement" or "substantial steps to reach . . . an agreement" in the context of the commencement point. However, we seek comment below on indicia of whether a person has reached an agreement to become a securitization participant, or taken substantial steps to reach such an agreement, and whether such indicia should be specified in the rule.

Proposed Rule 192(a)(1) prohibits a securitization participant from engaging in any transaction that would involve or result in any material conflict of interest

engagement letter, can be an agreement for purposes of the rule. We expect that market participants would know and understand when an agreement has been reached.

between the securitization participant and an investor in the relevant ABS. In order for the prohibition in proposed Rule 192(a)(1) to apply to a potentially conflicted transaction, an ABS must have been created and sold to one or more investors; in the absence of the creation and sale of an ABS, there would be no investors in an ABS with respect to which a potentially conflicted transaction could involve or result in a material conflict of interest.

Additionally, the prohibition in proposed Rule 192(a)(1) applies only to a securitization participant (*i.e.*, an underwriter, placement agent, initial purchaser, or sponsor of an ABS or any affiliate or subsidiary of any such person). Therefore, under the re-proposed rule, the prohibition on material conflicts of interest would not apply to a person that never reaches an agreement to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS, even if such person were to take substantial steps to reach such an agreement.<sup>102</sup> However, once a person has become a securitization participant and an ABS has been created and sold, the re-proposed rule's prohibition would apply to such person commencing on the date on which such person reached, or took substantial steps to reach, an agreement to become a securitization participant. As a practical matter, this means that if a person were to enter into a potentially conflicted transaction prior to becoming a securitization participant, *e.g.*, while engaged in negotiations to become a securitization participant, the person could avoid violating the re-proposed rule by withdrawing from the transaction prior to becoming a securitization participant. However, if the person were to become a securitization participant with respect to an ABS after having engaged in a potentially conflicted transaction, the person would be in violation of the re-proposed rule by virtue of being a securitization participant that had engaged in a conflicted transaction during the period specified in proposed Rule 192(a)(1). We preliminarily believe that this approach to the commencement point would help prevent conduct that the re-proposed rule is designed to prohibit that occurs

<sup>102</sup> We note, however, that if such person were to direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS, such person would be a directing sponsor under paragraph (ii)(B) of the proposed definition of "sponsor" (which, by extension, means that such person would be subject to the re-proposed rule's prohibition) even if such person had no contractual right to do so. See Section II.B.2.

prior to a person having reached an agreement to become a securitization participant.

Certain commenters to the 2011 proposed rule supported specific dates as the commencement point (*e.g.*, the date of the first marketing or offering materials for the ABS,<sup>103</sup> the pricing date for the ABS,<sup>104</sup> or the point in time when an issuer engages those involved in structuring and marketing the ABS<sup>105</sup>). We also received comment that supported leaving the commencement point unspecified because, for example, specific commencement points may be underinclusive.<sup>106</sup> We believe that a commencement point that begins on the date of the first marketing or offering materials for the ABS, the pricing date for the ABS, or the point in time when an issuer engages those involved in structuring and marketing the ABS could be underinclusive because a securitization participant could engage in the misconduct that Section 27B is designed to prevent just prior to such commencement points and the rule would, as a result, not cover misconduct prior to those dates. Therefore, we believe that the commencement point should begin at an early point in time when a securitization participant may first have the opportunity to engage in the misconduct that Section 27B is designed to prevent.

#### Request for Comment

39. We seek commenters' views regarding the approach to the covered timeframe in the re-proposed rule. Should we modify the proposed covered timeframe in the re-proposed rule, and if so, how and why?

40. In particular, we seek comment on the proposed commencement point of the re-proposed rule's prohibition on material conflicts of interest. Is it appropriate for the re-proposed rule's prohibition to commence at the point at which a person has reached, or has taken substantial steps to reach, an agreement that such person will become a securitization participant, and why? Are there modifications to the commencement point that might be necessary or advisable to mitigate any unintended consequences? Should the rule specify when a person has reached an agreement to become a securitization participant? For example, should the rule specify that "agreement" refers to a formal, written agreement to become a

securitization participant, or should it instead specify that "agreement" refers to an agreement in principle as to the major terms of the arrangement by which such person will become a securitization participant, and why? Should the rule identify specific activities that would constitute "substantial steps" to becoming an underwriter, placement agent, initial purchaser, or sponsor of an ABS? Why or why not? Please provide comment on specific activities that you believe constitute "substantial steps" to becoming an underwriter, placement agent, initial purchaser, or sponsor of an ABS, and whether any or all of such activities should be specified in the rule.

41. We seek comment on whether we should specify additional factors that would indicate when a person has reached an agreement to become a securitization participant. Should an "agreement" arise only through an executed engagement letter or the oral equivalent of an executed engagement letter, or should the facts and circumstances of the situation dictate when an agreement has been reached?

42. We seek comment on the implications of the commencement point of the re-proposed rule's prohibition on affiliates and subsidiaries of a person seeking to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS. How would an affiliate or a subsidiary of such a person know that the person had taken substantial steps to reach an agreement to become a securitization participant, such that a conflicted transaction entered into by the affiliate or subsidiary would be prohibited by the re-proposed rule if the person seeking to become a securitization participant were to ultimately reach an agreement to become a securitization participant? Are there existing information barriers in place within certain regulated firms that would prevent the person seeking to become a securitization participant from informing its affiliates and subsidiaries that it had taken substantial steps to reach an agreement to become a securitization participant? For these or other reasons, should the re-proposed rule be modified to prohibit conflicted transactions by affiliates or subsidiaries of a person seeking to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS only after such person has reached an agreement to become a securitization participant, and why? If so, please explain how the re-proposed rule should be modified, and how such

<sup>103</sup> See ASF Letter at 24; SIFMA Letter at 23.

<sup>104</sup> See SIFMA Letter at 23.

<sup>105</sup> See ASF Letter at 24.

<sup>106</sup> See AFR Letter at 7; Barnard Letter at 3; Better Markets Letter at 5; Merkley-Levin Letter at 6.

modifications would be consistent with Section 27B.

43. How should the rule treat a person that never reaches an agreement to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS, despite having taken substantial steps to reach such an agreement? As discussed above, the re-proposed rule's prohibition generally would not apply to a person that does not reach an agreement to become an underwriter, placement agent, initial purchaser, or sponsor of an ABS, even if such person were to take substantial steps to reach such an agreement. However, once a person has become a securitization participant, the rule's prohibition would apply to such person commencing on the date on which such person reached, or took substantial steps to reach, an agreement to become a securitization participant. Would this approach be underinclusive because it would not cover parties that might have had a significant role in determining the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS? Why or why not? Are any such concerns about potential underinclusiveness adequately mitigated by the anti-circumvention provision in proposed Rule 192(d)?

#### D. Prohibition

Section 27B(a) provides that an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an ABS, including a synthetic ABS, 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 asset-backed security, engage in any 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.<sup>107</sup>

#### 1. Prohibited Conduct

Consistent with Section 27B(a), the prohibition in proposed Rule 192(a)(1) provides that 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. As set forth in proposed Rule 192(a)(2), engaging in any transaction would involve or result in any material conflict of interest between a securitization participant and an investor if such transaction is a "conflicted transaction" as defined in proposed Rule 192(a)(3). This formulation is designed to effectuate Section 27B by prohibiting a securitization participant from entering into a conflicted transaction that is, in effect, a bet against the ABS that such securitization participant created and/or sold to investors. We believe that this prohibition in the re-proposed rule, along with the proposed definitions of "conflicted transaction" discussed below,<sup>108</sup> would provide strong investor protection against such misconduct, while also providing an explicit standard for determining which types of transactions would be prohibited by the re-proposed rule in order to address concerns expressed by commenters to the 2011 proposed rule about not unnecessarily prohibiting or restricting activities routinely undertaken in connection with the securitization process, as well as routine transactions in the types of financial assets underlying covered securitizations.

The prohibition in the re-proposed rule applies to a "conflicted transaction" entered into by a securitization participant. This is defined under proposed Rule 192(a)(3) to include two main components. One component is whether the transaction is:

- A short sale of the relevant ABS;
- The purchase of a CDS or other credit derivative pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of a specified adverse event with respect to 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 ABS;
  - Loss of principal, monetary default, or early amortization event on the relevant ABS; or
  - Decline in the market value of the relevant ABS.

The other component relates to materiality—*i.e.*, whether 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.

Paragraphs (i) and (ii) of the proposed definition of "conflicted transaction" in proposed Rule 192(a)(3) would capture transactions that constitute direct bets against the relevant ABS itself. In the case of proposed Rule 192(a)(3)(i), such a direct bet against an ABS would be a short sale where the securitization participant sells an ABS that it does not own (or that it will borrow for purposes of delivery). In such a situation, if the price of the ABS declines, then the short selling securitization participant could buy the ABS at the lower price to cover its short and make a profit. However, it is not relevant for purposes of the re-proposed rule whether the securitization participant makes a profit on the short sale. It is sufficient that the securitization participant sells the ABS short. In the case of proposed Rule 192(a)(3)(ii), a direct bet against an ABS would be entering into a credit derivative that references such ABS and entitles the securitization participant to receive a payment upon the occurrence of an adverse event with respect to the ABS such as a failure to pay, restructuring or any other adverse event that would trigger a payment on the derivative contract. It would be irrelevant for the purpose of proposed Rule 192(a)(3)(ii) whether the credit derivative is in the form of a CDS or other credit derivative product because the focus is on the economic substance of the credit derivative as a bet against the relevant ABS without regard to the specific contractual form or structure of the derivative. Proposed Rule 192(a)(3)(ii) would also capture any credit derivative entered into by the securitization participant with the special purpose entity issuer of a synthetic CDO where that credit derivative would entitle the securitization participant to receive payments upon the occurrence of a specified adverse event with respect to an ABS that is referenced by such credit derivative and with respect to which the relevant person is a securitization participant under the re-proposed rule.

Clause (iii) of the proposed definition of "conflicted transaction" would capture the purchase or sale of any other financial instrument or entry into a transaction the terms of which are substantially the economic equivalent of a direct bet against the relevant ABS. Specifically, proposed Rule 192(a)(3)(iii) would capture the purchase or sale of any financial instrument (other than the relevant ABS) or entry into a transaction

<sup>108</sup>The proposed definitions of "conflicted transaction" and "material conflict of interest" would apply solely for purposes of the re-proposed rule. See proposed Rule 192(a)(2) and (3).

<sup>107</sup> 15 U.S.C. 77z-2a(a).

through which the securitization participant would benefit from certain actual, anticipated, or potential adverse events with respect to the relevant ABS or its underlying asset pool. The events specified in items (A) through (C) of proposed Rule 192(a)(3)(iii) would capture the various situations pursuant to which an ABS or its underlying asset pool could perform adversely, which would include the actual, anticipated, or potential:

- Adverse performance of the asset pool supporting or referenced by the relevant ABS;
- Loss of principal, monetary default, or early amortization event on the relevant ABS; or
- Decline in the market value of the relevant ABS.

Each of these events would be adverse to investors in the ABS as it would negatively impact the distributions on the relevant ABS and/or its market value. Given that, for example, a security-based swap or other contractual agreement could be structured to reference only one of such events occurring, the proposed definition would capture any such event being referenced as a payment trigger.

The financial instruments captured under proposed Rule 192(a)(3)(iii) would, for example, include entering into the short-side of a derivative (with the special purpose entity issuer of a synthetic CDO or otherwise) that references the performance of the pool of assets underlying the ABS with respect to which the person is a securitization participant under the re-proposed rule and pursuant to which the securitization participant would benefit if the referenced asset pool performs adversely. This is intended to address comments to the 2011 proposed rule in support of a definition of the term “transaction” that would include not only a short sale of the relevant ABS or the purchase of CDS protection on the relevant ABS, but would also include the purchase or sale of products that are linked to, or otherwise create an opportunity to benefit from the actual, anticipated, or potential adverse performance of, the pool of assets underlying the relevant ABS.<sup>109</sup> Furthermore, given the potential ability of market participants to craft novel financial structures that can replicate the economic mechanics of the types of transactions described in proposed Rule 192(a)(3)(i) and (ii) without triggering

those prongs, proposed Rule 192(a)(3)(iii) should help alleviate the risk of any attempted evasion of the rule that is premised on the form of the transaction rather than its substance. For example, a security-based swap, such as a total return swap, that, in economic substance, creates an opportunity to benefit from the adverse performance of the relevant ABS or the pool of assets underlying the relevant ABS would be captured by proposed Rule 192(a)(3)(iii) regardless of whether the securitization participant attempts to structure such security-based swap in a way to avoid triggering proposed Rule 192(a)(3)(ii).

In addition to the purchase or sale of such financial instruments, proposed Rule 192(a)(3)(iii) would also capture the “entry into a transaction” through which the securitization participant would benefit from certain actual, anticipated, or potential adverse events with respect to the relevant ABS or its underlying asset pool. This should similarly help alleviate the risk of any attempted evasion of the rule that is premised on the form of the transaction rather than its substance. For example, in certain synthetic ABS structures, the relevant agreement that the securitization participant enters into with the special purpose entity that issues the synthetic ABS may in some circumstances not be documented in the form of a swap; however, the terms of such agreement are structured to replicate the terms of a swap pursuant to which the special purpose entity that issues the synthetic ABS is obligated to make a payment to the securitization participant upon the occurrence of certain adverse events in respect of the ABS for which the person is a securitization participant under the re-proposed rule. Proposed Rule 192(a)(iii) would capture such an agreement based on the economic substance of the transaction.

We received comment to the 2011 proposed rule that the scope of prohibited transactions should be limited to transactions other than those that are an integral part of the creation and sale of the relevant ABS.<sup>110</sup> We are not including such a standard in the re-proposed rule. Under the re-proposed rule, entering into an agreement to serve as a securitization participant with respect to an ABS would not itself be a “conflicted transaction.” However, any

transaction that the securitization participant enters into with respect to the creation or sale of such ABS (e.g., a transaction whereby a securitization participant takes the short position in connection with the creation of a synthetic ABS) would need to be analyzed to determine if it would be a “conflicted transaction” under the re-proposed rule. Proposed Rule 192(a)(3)(iii) would not capture the purchase or sale of the ABS with respect to which the person is a securitization participant under the re-proposed rule. The short sale of the relevant ABS would be separately covered under proposed Rule 192(a)(3)(i), and the sale of ABS to investors by an underwriter, placement agent, or initial purchaser would not be captured as a conflicted transaction. Also, the re-proposed rule is not intended to disincorporate a securitization participant from retaining portions of an ABS that it creates or sells.

Under proposed Rule 192(a)(3)(iii), it would not be necessary for the securitization participant to actually benefit from a conflicted transaction. Rather, it would be sufficient that the transaction creates an opportunity for the securitization participant to benefit, for example, from a decline in the market value of the ABS. The relevant transaction would be a “conflicted transaction” even absent such a decline in market value.

We received comments both in opposition to and in support of including the modifier “directly or indirectly” as used in the relevant interpretation in the 2011 proposed rule<sup>111</sup> when describing benefits accruing to the securitization participant. One commenter stated that, given that the rule applies to affiliates and subsidiaries and that there are many inherent conflicts of interest in securitizations, it is difficult to determine many circumstances where there are indirect benefits and that, if indirect benefits are to be addressed, they should be limited to those that are known or reasonably foreseeable.<sup>112</sup> Another commenter stated that securitization participants have no way to ascertain the scope or meaning of benefiting indirectly from a specified short transaction.<sup>113</sup> However, another commenter stated that securitization participants should not be allowed to perform indirectly what they are barred from doing directly.<sup>114</sup> For example, a

<sup>109</sup> See, e.g., Merkley-Levin Letter at 8 (expressing support for approach that would capture a securitization participant directly or indirectly benefiting from the adverse performance of the relevant asset pool).

<sup>110</sup> See ASF Letter at 17 (stating that the statutory reference to engaging in “any transaction” was intended to mean a transaction other than the ABS transaction itself, and accordingly, that the rule should not prohibit a firm from taking the short position in connection with the creation of a synthetic ABS).

<sup>111</sup> See 2011 Proposing Release at 60330.

<sup>112</sup> ABA Letter at 5–6.

<sup>113</sup> SIFMA Letter at 28.

<sup>114</sup> Tewary Letter 1 at 7.

transaction structure could route CDS payments to the securitization participant through a variety of different legal entities that are structured to not be affiliates or subsidiaries of the securitization participant or could attempt to recharacterize such payments in a way so as to obscure the ultimate economics of a conflicted transaction. Such a transaction structure would still be captured by proposed Rule 192(a)(3)(iii) because the securitization participant is receiving a benefit that can be traced back to the actual, anticipated or potential adverse performance of the relevant ABS or its underlying asset pool. Accordingly, we have not included the modifier “directly or indirectly” in proposed Rule 192(a)(3)(iii) when describing benefits accruing to the securitization participant. We believe such reference to be unnecessary because any transaction under which a securitization participant would receive a benefit that can be traced back to the actual, anticipated, or potential adverse performance of the relevant ABS or its underlying asset pool would already be captured by proposed Rule 192(a)(3)(iii). Moreover, we believe that the anti-circumvention language in proposed Rule 192(d) would help to address concerns about attempts to evade the re-proposed rule’s prohibition if a securitization participant were to route payments through multiple transactions or recharacterize payments so as to obscure the economics of a conflicted transaction.

In a change from the 2011 proposed rule, the re-proposed rule would not define a conflicted transaction to include the scenario in which a securitization participant would benefit directly or indirectly (e.g., from fees or other forms of remuneration, or the promise of future business, fees, or other forms of remuneration) as a result of allowing a third party, directly or indirectly, to structure the relevant ABS or select assets underlying the ABS in a way that facilitates or creates an opportunity for that third party to benefit from a short transaction.<sup>115</sup> Instead, we are taking a different approach to address possible conflicts by proposing to define the term “sponsor” in a manner such that the re-proposed rule’s prohibition on engaging

<sup>115</sup> See 2011 Proposing Release at 60331 (explaining that a third party might directly or indirectly select assets underlying an ABS through its relationship with a securitization participant and that such third party, rather than the securitization participant, may attempt to enter into a short transaction of the type that the securitization participant would be prohibited from entering into itself under the 2011 proposed rule).

in conflicted transactions would apply directly to most of the parties whose conduct would have been covered by the 2011 proposed rule. The definition of the term “sponsor” is discussed in Section II.B.2. above.

Certain commenters to the 2011 proposed rule requested clarification regarding how prohibited activity would be distinguished from activity undertaken independently of, and not in connection with, a securitization.<sup>116</sup> Other commenters expressed concerns about unnecessarily prohibiting or restricting activities routinely undertaken in connection with the securitization process.<sup>117</sup> The re-proposed rule would address these concerns by providing additional specificity about the scope of transactions that would be covered by the rule through the proposed definition of the term “conflicted transaction.” 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. Moreover, as discussed above, those persons that only perform activities that are administrative, legal, due diligence, custodial, or ministerial in nature with respect to an ABS would be excluded from the definition of “sponsor.”<sup>118</sup>

Consistent with Section 27B’s prohibition of conflicts of interest that are “material,” the definition of “conflicted transaction” in proposed Rule 192(a)(3) requires that there is a substantial likelihood that a reasonable investor would consider the relevant transaction important to the investor’s investment decision whether to acquire the asset-backed security. This is similar to the discussion in the release for the 2011 proposed rule,<sup>119</sup> which relied on

<sup>116</sup> See, e.g., comment letter from Commercial Real Estate Financial Council (Feb. 13, 2012) (“CRE Letter”) at 4–5; SIFMA Letter at 6, 25; ASF Letter at 8–10.

<sup>117</sup> See, e.g., ASF Letter at 4–6; comment letter from Association for Financial Markets in Europe, Asia Securities Industry & Financial Markets Association, and International Capital Market Association (Feb. 13, 2012) (“AFME/ASIFMA/ICMA Letter”) at 6; CRE Letter at 4–5; SIFMA Letter at 8, 18–21; comment letter from Northwest Farm Credit Services, FLCA (Feb. 10, 2012) (“Northwest Letter”) at 4; comment letter from Fannie Mae (Jan. 17, 2012) (“Fannie Mae Letter”) at 2–8.

<sup>118</sup> See Section II.B.2.

<sup>119</sup> See 2011 Proposing Release at 60331 (citing to *Basic v. Levinson* and stating that, in considering whether there is a substantial likelihood that a reasonable investor would consider the conflict important to their investment decision, it is not possible to designate in advance certain facts or occurrences as determinative in every instance).

the “reasonable investor” standard of materiality articulated in *Basic v. Levinson*.<sup>120</sup>

The use of this standard would not in this context imply that a transaction otherwise prohibited under the re-proposed rule would be permitted if there were adequate disclosure made by the securitization participant to the relevant investor. The prohibition would apply to transactions that are bets against the relevant ABS whether or not such transactions are disclosed to investors in the ABS. While certain commenters to the 2011 proposed rule supported the use of disclosure to manage material conflicts of interest,<sup>121</sup> other commenters opposed the use of disclosure to manage material conflicts of interest.<sup>122</sup> One commenter to the 2011 proposed rule stated that disclosure alone could not cure material conflicts of interest with respect to synthetic ABS but that disclosure would be sufficient to manage material conflicts of interest in connection with non-synthetic ABS.<sup>123</sup> We have not included an exception to the re-proposed rule based on disclosure of potential material conflicts of interest because we believe that such disclosure would be insufficient in this context as the re-proposed rule is designed to prevent the sale of ABS that are tainted by material conflicts of interest by prohibiting a securitization participant from entering into a conflicted transaction with respect to ABS that it creates or sells to investors. If the re-proposed rule were to include a disclosure-based exception, then securitization participants would still be allowed to enter into a transaction that constitutes a bet against the same ABS that they are creating or selling to investors so long as such conflicted transaction is disclosed. Even if disclosure of a conflicted transaction would reduce the likelihood that an investor would invest in a tainted ABS, the incentive for a securitization participant to enter into the conflicted transaction would not be wholly

<sup>120</sup> See *Basic v. Levinson*, 485 U.S. 224, 231–32 (1988) (citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

<sup>121</sup> See, e.g., ABA Letter at 6–8.

<sup>122</sup> See, e.g., AFR Letter at 8; Barnard Letter at 2; Better Markets Letter at 8–9; Public Citizen Letter at 2–3; Tewary Letter 1 at 15; Merkley-Levin Letter at 21. Certain of these commenters, however, felt that if providing disclosure were nevertheless permitted to manage conflicts, the disclosure should satisfy strict requirements, including that it should: be in written form; be delivered to investors a specific time period prior to investment; contain particular information; require investor acknowledgment of receipt of such disclosure and consent to the conflict; and be prominent, clear, and comprehensive.

<sup>123</sup> See AII Letter at 3–4.

eliminated. Furthermore, a disclosure-based exception to the re-proposed rule would fail to align with Section 27B given that the proposed prohibition would apply for one year after the date of the first closing of the sale of the relevant ABS.

Similarly, the use of the reasonable investor standard would not imply that a transaction otherwise prohibited by the re-proposed rule would be permitted if an investor selected or approved the assets underlying the ABS. Although certain commenters to the 2011 proposed rule suggested that the rule should not prohibit conflicts of interest between a securitization participant and an investor in an ABS if the investor was involved in selecting the underlying assets or approving the underlying portfolio,<sup>124</sup> we do not believe that investor consent would provide adequate protection against misconduct. Even if an investor in an ABS is given accurate information about the pool of assets underlying the ABS, and consents to the asset pool on the basis of such information, a securitization participant could nonetheless structure the ABS or construct the underlying asset pool in a way that would position the securitization participant to benefit from the adverse performance of the assets underlying the ABS. Additionally, we are concerned that an exclusion on the basis of investor consent could cause some securitization participants to pressure investors to provide written consent to the portfolio of underlying assets as a condition to participating in an ABS offering, which would undermine the effectiveness and purpose of such disclosure and the meaningfulness of the investor's consent. For these reasons, we are not including such an exclusion in the re-proposed rule.

Also, although certain commenters to the 2011 proposed rule supported limiting the scope of material conflicts of interest to ABS transactions that are intentionally designed to fail,<sup>125</sup> other commenters to the 2011 proposed rule were opposed to an intentionally designed-to-fail approach to determine what constitutes a material conflict of interest.<sup>126</sup>

Under the re-proposed rule, a securitization participant would be prohibited from designing an ABS to intentionally fail and then entering into a conflicted transaction in order to profit from the adverse performance of the ABS; however, the re-proposed rule would not apply only to ABS that are intentionally designed to fail. We are not proposing an intentionally designed-to-fail test to determine what constitutes a material conflict of interest because we believe that such a test could lead to attempts to evade the rule. Moreover, the need to prove intent could make enforcement of the rule more difficult, thereby potentially weakening investor protection. We believe that the proposed definition of "material conflict of interest" in the re-proposed rule is consistent with Section 27B, which is not limited only to ABS that are intentionally designed to fail.

As discussed below, both the proposed risk-mitigating hedging activities exception and the proposed bona fide market-making activities exception to the re-proposed rule include a requirement that a securitization participant have certain documented policies and procedures in place related to its compliance with the requirements of the relevant exception. However, the re-proposed rule does not include a more generalized requirement that a securitization participant would be required to have documented policies and procedures in place that are reasonably designed to prevent the securitization participant from violating the re-proposed rule's prohibition with respect to conflicted transactions regardless of whether the securitization participant is relying on an exception from the re-proposed rule. This is because, unlike the exceptions that would include specific requirements that would need to be satisfied in order for securitization participants to meet such exceptions, the prohibition in the re-proposed rule is a general prohibition on entering into conflicted transactions that cannot be waived on the basis of certain documented policies and procedures. We seek comment below on whether such a requirement should be included in the re-proposed rule.

#### Request for Comment

44. Are there any changes we should make to clarify the application of proposed Rule 192(a)? If so, what changes should we make and why? Should we revise the approach to defining the unlawful activity that is subject to the prohibition under the re-proposed rule? If you believe that the approach should be different, please provide an alternative approach and

explain why such approach would be preferable and how it would be consistent with the prohibition on material conflicts of interest in Section 27B.

45. Does the re-proposed definition of "material conflicts of interest" accurately capture the material conflicts of interest that Section 27B is designed to address? If you believe that there is a definition that better identifies the material conflicts of interest that Section 27B is designed to address, please provide a revised definition and an explanation for the revisions. For example, would it clarify the application of proposed Rule 192(a) if the qualification about the transaction being important to a reasonable investor's investment decision were included in the definition of "material conflict of interest" in proposed Rule 192(a)(2) rather than, or in addition to, in the definition of "conflicted transaction" in proposed Rule 192(a)(3)?

46. Proposed Rule 192(a)(1) refers to "directly or indirectly" engaging in a transaction involving or resulting in a material conflict of interest. Is the reference to "directly or indirectly" necessary in order to capture multi-step transactions or conflicted transactions entered into by a securitization participant through a third party? Is the reference to "directly or indirectly" unnecessary because any such attempts to "indirectly" engage in a conflicted transaction would be covered by the anti-circumvention provision in proposed Rule 192(d)? In your responses to each of these questions, please explain why or why not.

47. Is there activity that securitization participants currently engage in with respect to ABS that would fall within the definition of "conflicted transaction"? If so, please provide a detailed explanation of such activity, the securitization participants involved with respect thereto, and the frequency as to which such activity is engaged in by such securitization participants. Please describe how that activity is or is not consistent with Section 27B.

48. Is there any activity that you believe would fall within the scope of the proposed definition of "conflicted transaction" but is not the type of transaction that Section 27B is intended to prohibit? Please provide a detailed description of how the rule could define this activity and those transactions, and the conditions that should attach to any such exemption in order to protect investors from the misconduct that is targeted by Section 27B.

49. Is there any activity that you believe would not fall within the scope of the proposed definition of "conflicted

<sup>124</sup> See Morgan Stanley Letter at 13, 15–17; SIFMA Letter at 24.

<sup>125</sup> See ASF Letter at 11; Fannie Mae Letter at 1–2; SIFMA Letter at 27–28. For example, an ABS transaction in which one or more securitization participants structure the ABS transaction or select the underlying assets with the intent or expectation that the ABS securities will default or decline in value would be intentionally designed to fail.

<sup>126</sup> See AFR Letter at 5; Better Markets Letter at 7; Merkle-Levin Letter at 9–10.

transaction” but that is the type of transaction that Section 27B is intended to prohibit? If so, please explain why and provide a detailed description of such activity or transactions.

50. Is it appropriate for proposed Rule 192(a)(3)(ii) to cover the purchase of a credit default swap or any 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 ABS? Should proposed Rule 192(a)(3)(ii) also apply to the purchase of any security-based swap pursuant to which the securitization participant would be entitled to receive payments upon the occurrence of a decline in price of the relevant ABS? Would such an approach be overinclusive or otherwise result in significant overlap with the coverage of proposed Rule 192(a)(3)(iii)?

51. Are there any special considerations regarding the use of total return swaps that should be addressed in the context of the proposed definition of “conflicted transaction”?

52. Please discuss the impact of the proposed definition of “conflicted transaction” on entities with multiple affiliates or subsidiaries, particularly with respect to how a securitization participant would benefit from certain actual, anticipated, or potential adverse events with respect to the relevant ABS or its underlying asset pool under proposed Rule 192(a)(3)(iii). Is the proposed definition of “conflicted transaction” as applied to entities with multiple affiliates or subsidiaries appropriate? If not, please explain why and provide a description of any additional qualifying language or alternative that would be more appropriate and consistent with Section 27B.

53. The re-proposed rule does not include a disclosure-based or investor approval-based exception for managing material conflicts of interest. If you believe that the re-proposed rule should allow securitization participants to manage potential conflicts of interest using disclosure or through obtaining investor approvals, then please explain how disclosure or investor approval of such potential conflicts of interest would adequately protect investors against the risks associated with such conflicts of interest, particularly in light of the concerns expressed in this re-proposal. How could a disclosure exception be structured so that the resulting disclosure would not contain vague boilerplate language? Should the rule also require that a securitization participant disclose that it entered into a transaction that would be a conflicted

transaction? How could this disclosure be provided to investors if the securitization participants engage in transactions that occur after the offering but within the timeframe of the prohibition? Please also explain how disclosure or investor approval would be consistent with Section 27B.

54. The re-proposed rule would not be limited to only capturing designed-to-fail transactions and therefore would not include a designed-to-fail standard for what constitutes a material conflict of interest. If you believe that a designed-to-fail standard should be the relevant standard instead of the one that is included in the re-proposed rule, then please explain how such standard would adequately protect investors against the risks associated with such conflicts of interest, particularly in light of the concerns expressed in the re-proposal. Please also explain how such a standard would be consistent with Section 27B.

55. As discussed above, the re-proposed rule does not expressly prohibit actions of third parties in the proposed definition of the term “material conflict of interest” and takes a different approach to address possible conflicts than the approach described in the interpretations included in the 2011 Proposing Release by defining the term “sponsor” in a manner that we believe would directly capture most of the parties whose conduct would have been covered by the 2011 proposed rule.<sup>127</sup> If you believe that, instead of the proposed approach, we should revise the definition of the term “material conflict of interest” to cover the actions of a third party consistent with the 2011 proposed rule, please tell us what activities should or should not be within the scope of “allowing a third party, directly or indirectly, to influence the structure, design, or assembly of the relevant asset-backed security or the composition of the pool of assets underlying the relevant asset-backed security in a way that facilitates or creates an opportunity for that third party to benefit from a conflicted transaction” as described in the release for the 2011 proposed rule and why. Also tell us whether this alternative would directly capture the conduct of parties that the re-proposed rule intends to cover. If you support such a revised definition, please explain whether and how it is consistent with Section 27B.

56. Are there any unintended effects on securitizations from the proposed definitions of the terms “material

conflicts of interest” and “conflicted transaction”? If so, please provide alternative definitions designed to minimize such effects, and explain how those alternative definitions would be consistent with Section 27B.

57. Under the re-proposed rule, the issuance of a synthetic ABS where a securitization participant enters into the short side of the transaction with the issuing entity of the synthetic ABS would be a “conflicted transaction” because the securitization participant would be entitled to payment if the referenced assets, and thus the ABS, perform poorly. Is this the appropriate result? Please explain why or why not. Are there examples of synthetic ABS where a securitization participant taking the short position in the referenced assets would not necessarily benefit from the adverse performance of the underlying asset pool, the loss of principal, monetary default, or early amortization event, or decline in the market value of the relevant ABS? If so, should the definition of “conflicted transaction” exclude the issuance of such synthetic ABS? If so, please explain how such exclusion would be consistent with Section 27B.

58. Are there transactions that would be “conflicted transactions” under the re-proposed rule that occur with respect to municipal ABS? If so, please describe those transactions, the relevant persons that are parties thereto, and the frequency as to which they are entered into by such persons.

59. Should the re-proposed rule include a requirement that a securitization participant have documented policies and procedures in place that are reasonably designed to prevent the securitization participant from violating the re-proposed rule’s prohibition with respect to conflicted transactions? What should the consequences be for a securitization participant that did not follow such procedures? Would such a requirement provide effective protection for investors? Should such a requirement be in addition to or in lieu of the proposed compliance program requirements discussed below with respect to the risk-mitigating hedging activities exception and the bona fide market-making activities exception?

60. If a general compliance program requirement as described in question 59 were to be included in the re-proposed rule, are there any types of securitization participants that should be exempted from such requirement? For example, should government entities (including municipal entities) and/or smaller securitization participants be exempt from such

<sup>127</sup> See 2011 Proposing Release at 60331 (describing Item 1(B) of the material conflict of interest test).

requirement, or should the specific requirements or conditions of such requirement vary based on the type of entity? Alternatively, should the implementation of such requirement as applied to government entities and/or smaller securitization participants be delayed in order to give such entities more time to comply with the requirement? In your responses, please explain how “smaller securitization participant” should be defined for purposes of any such exemption or delayed implementation.

61. We seek comment on whether the re-proposed rule should include a safe harbor whereby a person that meets the proposed definition of “securitization participant” but nonetheless has no involvement in the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS would be exempt from the re-proposed rule’s prohibition on material conflicts of interest. Would such a safe harbor address concerns that the re-proposed rule might unduly burden parties that would not have the incentive or ability to engage in conduct prohibited by Section 27B? Would it weaken the conflicts of interest protection of the re-proposed rule, and if so, how? Are there specific conditions that could be included in the safe harbor in order to address any such concerns? If so, please identify any such conditions. Please also explain whether and how such a safe harbor would be consistent with Section 27B.

62. We seek comment on whether the re-proposed rule should include a safe harbor whereby a securitization participant could rely on the judgment of a governance specialist as to whether a transaction would be a “conflicted transaction” for purposes of the re-proposed rule, in the manner suggested by one commenter to the 2011 proposed rule.<sup>128</sup> Would such a safe harbor minimize any market disruption that might result from any potential ambiguity about whether a transaction would be a “conflicted transaction”? Would it undermine the effectiveness of the re-proposed rule by permitting reliance on the judgment of a third-party to determine compliance with the rule? How could we help ensure the independence of a third-party specialist that receives compensation directly or indirectly from securitization participants to pass judgment on whether a transaction is a “conflicted transaction”? Is this a workable framework to reduce conflicts of

interest? Please explain why or why not. If you believe the re-proposed rule should include such a safe harbor, please address the benefits of the safe harbor and identify any conditions that should be included in the safe harbor (e.g., a limitation on the types of entities that could serve as a governance specialist, any minimum qualifications for an entity to qualify to serve in such capacity, and/or a condition that the conclusion reached by the governance specialist be reasonable in light of the facts and circumstances of the transaction). Please provide an estimate of the anticipated costs associated with retaining the services of a governance specialist for this purpose. Please also explain whether and how such a safe harbor would be consistent with Section 27B.

## 2. Anti-Circumvention

We received comment on the 2011 proposed rule that the rule should address potential evasion of the rule’s prohibition on material conflicts of interest, and commenters noted a variety of ways in which a securitization participant might attempt to evade the re-proposed rule’s prohibition.<sup>129</sup> We agree with such commenters that potential evasion of the re-proposed rule could weaken the re-proposed rule’s conflict of interest protection. Accordingly, we are proposing Rule 192(d), which provides that, if a securitization participant engages in a transaction that circumvents the prohibition in proposed Rule 192(a)(1), the transaction will be deemed to violate proposed Rule 192(a)(1). For example, proposed Rule 192(a)(3) defines “conflicted transaction” as three specific categories of transactions because they are common types of transactions that a person might utilize in order to “bet” against the performance of a financial asset. We believe that the re-proposed rule’s prohibition should be premised on the substance of the transaction rather than on its form, label, or written documentation. Proposed Rule 192(d) would address a securitization

<sup>129</sup> See, e.g., Better Markets Letter at 3–5 (stating that the re-proposed rule should include functional definitions and descriptions to prevent evasion of the rule through labeling or the creation of novel financial instruments or novel categories of securitization participants that appear to fall outside the purview of the rule but in reality and substance should be subject to the restrictions in Section 27B); Morgan Stanley Letter at 4 (stating that anti-evasion principles could be applied where counterparties enter into security based swap transactions solely to avoid application of the prohibition); Tewary Letter 1 at 7 (stating that the Commission would not want to enable securitization participants to perform indirectly what they are barred from doing directly).

participant circumventing the re-proposed rule’s prohibition on material conflicts of interest by structuring one or more transactions to fall outside of the prohibition (including its permitted exceptions) while nonetheless engaging in a transaction that is economically equivalent to a type of transaction specified in the proposed definition of “conflicted transaction.”

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63. We seek commenters’ views regarding the anti-circumvention provision in proposed Rule 192(d). Is it appropriate for the re-proposed rule to prohibit transactions that circumvent the prohibition in proposed Rule 192(a)(1) by deeming such transactions to violate proposed Rule 192(a)(1)? Why or why not?

64. Should proposed Rule 192(d) be modified such that a transaction circumventing the re-proposed rule’s prohibition will only be deemed to violate proposed Rule 192(a)(1) 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? Please explain why or why not.

65. Should proposed Rule 192(d) be modified in order to address other ways in which a person might attempt to evade the prohibition in the re-proposed rule, including with regard to the proposed exceptions for risk-mitigating hedging activities, liquidity commitments, or bona fide market-making activities? If so, how should proposed Rule 192(d) be modified and why?

66. Would proposed Rule 192(d) be overinclusive or otherwise result in potential uncertainty as to the coverage of the re-proposed rule’s prohibition, and if so, how should proposed Rule 192(d) be modified to address such concerns? Are there examples of transactions that proposed Rule 192(d) would prohibit but should not? Please explain how any such modifications to proposed Rule 192(d) would be consistent with Section 27B.

67. We seek comment on whether the relationship between proposed Rule 192(d) and the proposed exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities should be clarified. If so, please explain what clarifications are necessary, and why.

68. We seek comment on an alternative anti-circumvention provision that would instead provide that, if a securitization participant engages in a transaction or a series of related transactions as part of a plan or scheme

<sup>128</sup> See comment letter from Pentalpha Surveillance LLC (Sept. 1, 2021) (“Pentalpha Letter”) at 2.

to evade the prohibition in proposed Rule 192(a)(1), such transaction or series of related transactions will be deemed to violate proposed Rule 192(a)(1). Would this alternative anti-circumvention provision address any concerns about potential overinclusiveness of proposed Rule 192(d), including the absence of a knowledge qualifier?

#### *E. Exception for Risk-Mitigating Hedging Activities*

Section 27B(c) provides that the prohibition in Section 27B(a) does not apply to risk-mitigating hedging activities in connection with positions or holdings arising out of the underwriting, placement, initial purchase, or sponsorship of an ABS, provided that such activities are designed to reduce the specific risks to the underwriter, placement agent, initial purchaser, or sponsor associated with positions or holdings arising out of such underwriting, placement, initial purchase, or sponsorship.<sup>130</sup> Consistent with Section 27B(c)(1), we are proposing that the prohibition not apply when a securitization participant engages, subject to certain conditions, in risk-mitigating hedging activities in connection with its securitization activities. The proposed risk-mitigating hedging activities exception would be conditioned on the securitization participant satisfying all three proposed conditions included in proposed Rule 192(b)(1)(ii), as discussed below.

Risk-mitigating hedging activities of a securitization participant permitted under the proposed exception would include hedging conducted 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.<sup>131</sup> Given that the accumulation of assets prior to the issuance of an ABS is a fundamental component of assembling an ABS prior to its sale, the proposed risk-mitigating hedging activities exception would allow for a securitization participant to not only hedge retained ABS positions (in compliance, as applicable, with Regulation RR) but also hedge exposures arising out of the assets that are originated or acquired by the securitization participant in connection with warehousing assets in advance of an ABS issuance. The proposed risk-mitigating hedging activities exception

would also allow for the relevant hedging activity related to a securitization participant's securitization activity to be done on an aggregated basis and would not require that the exempt hedging be conducted on a trade-by-trade basis. Given the nature of the ABS market and the types of assets that collateralize ABS (such as receivables or mortgages), it may not be possible for a securitization participant to enter into a hedge with respect to an ABS or any of its underlying assets on an individualized basis. Therefore, we believe that this approach to the risk-mitigating hedge exception should allow securitization participants sufficient flexibility to design their securitization-related hedging activities in a way that is not unduly complicated or cost prohibitive.

In order to distinguish permitted risk-mitigating hedging activity under the re-proposed exception from prohibited conflicted transactions that would constitute a bet against the relevant ABS, we are proposing certain conditions that would have to be satisfied in order for the risk-mitigating hedging activity exception to apply. We believe that this proposed approach is consistent with views of certain commenters to the 2011 proposed rule that recommended a narrow risk-mitigating hedging activities exception that is designed to reduce specific risks and that includes robust conditions.<sup>132</sup> Each of these conditions is discussed in detail below.

Under the re-proposed exception, the initial issuance of an ABS, such as a synthetic ABS, would not be risk-mitigating hedging activity.<sup>133</sup> Although we received comment that securitization participants should be permitted to enter into a synthetic ABS transaction pursuant to the risk-mitigating hedging activities exception because such transaction is the economic equivalent of a bilateral CDS transaction where the counterparty to the CDS is not an ABS issuer,<sup>134</sup> the re-proposed rule prohibits a securitization participant from creating and/or selling a new synthetic ABS to hedge a position or holding. In these synthetic ABS transactions, a securitization participant is typically a party to a CDS contract with the issuing entity of the ABS. We are concerned

<sup>132</sup> See Barnard Letter at 2; Better Markets Letter at 9–12; Merkley-Levin Letter at 16–18; Tewary Letter 1 at 10.

<sup>133</sup> As discussed above in Section II.D., the proposed definition of the term “conflicted transaction” does not exclude the issuance of synthetic ABS.

<sup>134</sup> See ASF Letter at 25–26; comment letter from Cadwalader, Wickersham & Taft LLP (Feb. 13, 2012) (“Cadwalader Letter”) at 2–6; SIFMA Letter at 22–23.

that such activity would weaken the conflicts of interest protection of the re-proposed rule 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. This type of transaction was the focus of Congressional scrutiny in connection with the financial crisis of 2007–2009.<sup>135</sup> Moreover, the securitization participant would perform a central role in creating, structuring, and/or marketing the relevant synthetic ABS that is being issued and, in connection with such role, would likely obtain additional benefits such as arranger or manager compensation. These factors would go beyond engaging in risk-mitigating hedging activity that is designed to reduce specific risks to the securitization participant in connection with positions or holdings arising out of its securitization activities and could raise conflicts of interest with investors in the new synthetic ABS that we believe Section 27B is intended to prohibit.

#### 1. Specific Risk Identification and Calibration Requirements

We are proposing in Rule 192(b)(1)(ii)(A) that the first condition of the exception be that, at inception of the hedging activity and at the time of any adjustments to the hedging activity, the risk-mitigating hedging activity of the securitization participant 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 arising out of its securitization activities, based upon the facts and circumstances of the identified underlying and hedging positions, contracts, or other holdings and the risks and liquidity thereof. This condition would be the essential requirement of the proposed exception that the relevant hedging activity is risk-mitigating. Various activities of a securitization participant, such as acquiring a portfolio of assets in anticipation of issuing an ABS or retaining a portion of an ABS issuance with respect to which it is a securitization participant, expose the securitization participant to the risk that such positions could decline in value. Permissible risk-mitigating hedging

<sup>135</sup> See Senate Financial Crisis Report.

<sup>130</sup> 15 U.S.C. 77z–2a(c)(1).

<sup>131</sup> This standard would not broaden, limit, or otherwise modify the requirements applicable to a securitization participant pursuant to Regulation RR.

activity, under the re-proposed rule, would be required to be designed to reduce or significantly mitigate such risks<sup>136</sup> and could not “overhedge” such risks in a way that would result in a net short exposure to the relevant ABS. This proposed condition is designed to preclude a securitization participant from engaging in speculative activity that is designed to gain exposure to incremental risk by, for example, entering into a CDS contract referencing a retained exposure where the notional amount of the CDS exceeds the amount of the relevant exposure intended to be hedged. Such a transaction would provide the securitization participant with an opportunity to profit from a decline in the value of the relevant retained exposure rather than simply to reduce its risk to it. Therefore, although the relevant risks arising from a securitization participant’s securitization activity would be permitted to be hedged on an aggregated basis to address more than one exposure arising from such activity, such risks would need to be specific and identifiable at the outset of the hedging activity. The proposed requirement that the risks must be specific and identifiable means that a securitization participant would not be permitted to rely on the proposed risk-mitigating hedging activities exception if it were to enter into a CDS contract referencing a retained ABS interest for the purpose of hedging generalized risks that it believes to exist based on non-position specific modeling or other considerations. In order to make a determination of whether the hedge is designed so as not to “overhedge” positions related to a securitization participant’s securitization activities, the hedge would need to be tied to specific exposures that exist and are specifically identifiable. Otherwise, it would be impractical or impossible to make that determination, and the proposed exception should not apply. Whether a risk is “specific” and “identifiable” depends on the facts and circumstances of the positions, contracts, or other holdings of the securitization participant, and these terms are not defined in the re-proposed rule. However, we seek comment below on indicia of whether a risk is specific and identifiable, and whether such indicia should be specified in the rule.

<sup>136</sup> For example, such risks would include the market risk of the price decline of warehoused assets or the interest rate risk arising between the interest rate accruing on a retained ABS position and any financing used to acquire it.

We recognize that the risks of the relevant exposures are dynamic and may change over time and that new risks may emerge in a way that would make the hedging activity that was designed at inception less effective. The prohibition of the re-proposed rule only applies for a limited timeframe,<sup>137</sup> and this proposed condition does not restrict making adjustments to a hedge over time. However, in order to prevent evasion, the requirements of this proposed condition would apply not only at the inception of the hedging activity but also whenever such hedging activity is subsequently adjusted during the time period in which the prohibition applies.<sup>138</sup> Therefore, any changed or new risks that are being hedged would need to be specifically identified, and the adjusted hedging activity would need to be tied to them.

Similarly, we are proposing in Rule 192(b)(1)(ii)(B) that the second condition of the exception be that the risk-mitigating hedging activity would be required to be subject, as appropriate, to ongoing recalibration by the securitization participant to ensure that such hedging activity satisfies the requirements applicable to the first condition of the exception and does not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk-reduction. For example, if a securitization participant enters into a hedge that would be permitted under the exception and subsequent to that hedge, the risk exposure is reduced, under the proposed condition, the securitization participant would be required to ensure that it is not “overhedged” so that the position would not constitute a bet against the relevant ABS, which could require the securitization participant to adjust or recalibrate its hedge. We believe that this condition would help minimize the ability of a securitization participant to engage in hedging activity that could create material conflicts of interest with investors in the relevant ABS. The second condition does not specify an exact frequency as to which a securitization participant would be required to recalibrate its hedge; however, we seek comment regarding this below.

In addition, both the first and second conditions described above are consistent with comments to the 2011 proposed rule recommending we clarify that speculative or profit-making activity would be inconsistent with activity that should be eligible to qualify

<sup>137</sup> See Section II.C. for a discussion of the time period during which the prohibition applies.

<sup>138</sup> *Id.*

for the risk-mitigating hedging activities exception,<sup>139</sup> that risk-mitigating hedging activities should not result in exposure to incremental risk,<sup>140</sup> and that the risk-mitigating hedging activities exception should not permit profiting from a decline in the value of the ABS.<sup>141</sup>

The first and second proposed conditions also set forth a principle-based approach that should not unduly disrupt normal course hedging activities that do not present material conflicts of interest with ABS investors and therefore should reduce the compliance burden of the proposed exception. For example, we received comment to the 2011 proposed rule that a securitization participant may not be able to create a hedge that exactly offsets any exposure arising from a specific risk.<sup>142</sup> The re-proposed exception would not require that a risk-mitigating hedge have an exact negative correlation with the exposure being hedged, as that might create an unattainable standard for securitization participants seeking to rely on the risk-mitigating hedging activities exception. Instead, the proposed first and second conditions to the exception are premised on the relevant hedging activity being designed to reduce the specific risks to the securitization participant associated with its positions or holdings and not facilitating or creating an opportunity to benefit from a conflicted transaction other than through such risk-reduction.

On the other hand, we did receive a comment to the 2011 proposed rule that there should be exact negative correlation between the risk being hedged and the corresponding hedge position rather than rough negative correlation, and if exact negative correlation were impossible, the commenter recommended that the rule require that a securitization participant provide an explanation, certified by the chief executive officer and chief compliance officer of the securitization participant, of the reasons for why exact negative correlation was impossible.<sup>143</sup> We did not add an exact negative correlation standard to the re-proposed risk-mitigating hedging activities exception out of concern that such a standard could be unattainable in many circumstances given the potential complexity of positions, market conditions at the time of the hedge transaction, availability of hedging products, costs of hedging, and other

<sup>139</sup> See Tewary Letter 1 at 10.

<sup>140</sup> See AFR Letter at 9.

<sup>141</sup> See Merkle-Levin Letter at 17.

<sup>142</sup> See AII Letter at 2.

<sup>143</sup> See Better Markets Letter at 11.

circumstances at the time of the transaction that would make a hedge with exact negative correlation impractical or unworkable. For example, a securitization participant may not be able to hedge its exposure on an individualized basis and may have to enter into an index-based hedging transaction. However, the presence of negative correlation would generally indicate that the hedging activity reduced the risks it was designed to address, and the first and second conditions to the proposed risk-mitigating hedging activities exception would serve to promote risk-mitigating hedging activity where there is negative correlation between the risk being hedged and the corresponding hedged position because the relevant risk would be required to be specifically identified and the risk-mitigating hedging activity could not facilitate or create an opportunity to benefit from a conflicted transaction other than through risk reduction. The first and second conditions to the proposed risk-mitigating hedging activities exception would also allow for consideration of the facts and circumstances of the particular exposure or exposures and the related hedging activity, including the type of position being hedged, market conditions, depth and liquidity of the market for the underlying and hedging positions, and type of risk being hedged.

We also did not include a condition in the proposed risk-mitigating hedging activities exception that no employee receive compensation arising from or related in any way to any income generated by any hedging activity as suggested by one commenter to the 2011 proposed rule<sup>144</sup> because both the first and second conditions would preclude income generating activity by requiring that the risk-mitigating hedging activity could not facilitate or create the opportunity to benefit from a conflicted transaction other than through risk-reduction.

The proposed risk-mitigating hedging activities exception would also not require that a hedge be entered into contemporaneously, *i.e.*, at the exact time that a risk is incurred or within a prescribed time period after a risk is incurred. Rather, both the first and second proposed conditions are premised on the relevant hedging activity, whenever it is entered into or adjusted, being designed to mitigate a specifically identified risk and not to function as a bet against the relevant ABS. We received a comment to the 2011 proposed rule stating that the

duration of the hedge must not exceed the offering period, for instance by the closing of the underwriting book.<sup>145</sup> However, we believe that the more appropriate standard, which we are proposing, is that the hedging activity would cease to qualify for the re-proposed risk-mitigating hedging activities exception if it were no longer reducing a specific risk to the securitization participant in connection with the relevant ABS activity, for example if the securitization participant failed to unwind its risk-mitigating hedging activities after disposing of the position or holding being hedged. This is because the securitization participant would no longer be engaged in risk-mitigating hedging activities in connection with such position or holding.

We also received a comment to the 2011 proposed rule that a securitization participant should be permitted to hedge a retained investment in a cash ABS on a periodic basis (*e.g.*, hedging quarterly or semiannually) consistent with the securitization participant's hedging policy and not on an intermittent basis.<sup>146</sup> The proposed risk-mitigating hedging activities exception does not include any specific requirement regarding the timing of when the relevant hedging activity must begin. Instead, the first and second conditions are intended to help ensure that the permitted risk-mitigating hedging activity would be required to hedge specifically identified risks and not function as a bet against the relevant ABS. Therefore, whether periodic hedging of retained ABS interests would qualify for the proposed risk-mitigating hedging activities exception is a facts and circumstances determination, and we are not providing specific guidance as to whether hedging on any specific periodic basis (*e.g.*, monthly, quarterly, or semiannually) would be permissible. Although the intent of the re-proposed exception is not necessarily to require a securitization participant to change its existing schedule for hedging risks associated with its retained ABS interests, to the extent that periodic hedging on a delayed basis results in an "overhedged" position that constitutes a bet against the relevant ABS, then that hedging activity would not satisfy either of the first or second conditions applicable to the exception.

We also received a comment to the 2011 proposed rule asking for clarity that the risk-mitigating hedging activities exception would be available throughout the time period during

which the rule is applicable.<sup>147</sup> The risk-mitigating hedging activities exception in the re-proposed rule would be available to a securitization participant throughout the time period during which the re-proposed rule would be applicable, 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 the ABS, if the conditions of the exception are satisfied.

## 2. Compliance Program Requirement

We are proposing in Rule 192(b)(1)(ii)(C) that the third condition to the exception be that 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 applicable to 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. This proposed condition is designed to promote robust compliance efforts and to help ensure that activity that would qualify for the re-proposed exception is indeed risk-mitigating while also recognizing that securitization participants are positioned to determine the particulars of effective risk-mitigating hedging activities policies and procedures for their own business. We believe it is important that reasonably designed written policies and procedures provide for the specific risk and the risk-mitigating hedging activities to be identified, documented, and monitored to help facilitate the securitization participant's compliance with the conditions specified in proposed Rule 192(b)(1)(ii)(A) and (B), which require that the risk-mitigating hedging activity be tied to such risks at inception and over the time period that the prohibition of the re-proposed rule would apply. While we recognize that this documentation requirement may result in certain costs,<sup>148</sup> we believe that this requirement would promote compliance with the re-proposed rule. We also believe that it is important for this condition to apply to all securitization participants that seek to rely on this exception given that the

<sup>144</sup> See Better Markets Letter at 12.

<sup>145</sup> See AFR Letter at 9.

<sup>146</sup> See Cadwalader Letter at 6.

<sup>147</sup> See SIFMA Letter at 32.

<sup>148</sup> See Section IV.

focus of Section 27B is investor protection.

We received a comment to the 2011 proposed rule that any securitization participant relying on the proposed exception for risk-mitigating hedging activities should be required to affirmatively certify that it is undertaking such activity for the sole purpose of hedging a risk arising in connection with its securitization activities, and not for the purpose of generating speculative profits.<sup>149</sup> We did not include a certification requirement in the proposed exception, but we seek comment below on whether a certification requirement would be appropriate, and if so, what form such a certification should take and when it should be required to be made.

#### Request for Comment

69. Is the scope of the proposed risk-mitigating hedging activities exception appropriate, or is it overinclusive or underinclusive, and why? Please provide specific examples of any activity that should be included in or excluded from the scope of the exception and provide a justification as to why and how such inclusion or exclusion would be consistent with Section 27B.

70. Should any of the proposed conditions applicable to the risk-mitigating hedging activities exception be modified? If yes, please provide the suggested modification and explain how such modification is consistent with Section 27B.

71. Is the condition in proposed Rule 192(b)(1)(ii)(A) that risk-mitigating hedging activities must be 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 appropriate? Please explain why or why not. Is there sufficient clarity as to what risks are “specific” and “identifiable” for purposes of this condition? If not, please identify any specific indicia that should be included or referenced for purposes of this determination.

72. Should the proposed condition regarding a securitization participant’s ongoing recalibration of its hedging activities specify how frequently a securitization participant should do such recalibrating? Should the proposed condition specify certain thresholds or triggers for such recalibration? What are the implications for a securitization participant if its hedge counterparty refuses to adjust the hedge?

73. Is it appropriate that the proposed risk-mitigating hedging activities exception would allow for the relevant hedging activity to be conducted on an aggregated basis? Are there any particular evasion concerns that could arise with respect to this approach?

74. Should the proposed risk-mitigating hedging activities exception require that a risk-mitigating hedge have an exact negative correlation with the exposure being hedged? If so, and if exact negative correlation were impossible, should the exception require that a securitization participant relying on the exception provide a certification explaining why exact negative correlation was impossible? If so, what form should such a certification take, and why? For example, should the certification be required to be filed with, or otherwise furnished to, the Commission, or should it instead be required to be retained in the files of the securitization participant in accordance with its written policies and procedures? Should the exception require that such certification be made by the chief executive officer and chief compliance officer of the securitization participant as suggested by a commenter to the 2011 proposed rule,<sup>150</sup> or would it be more appropriate for the certification to be made by some other officer of the securitization participant that is more familiar with the transaction or transactions at issue and the securitization participant’s risk-mitigating hedging activities generally (e.g., the head of the relevant trading desk)? In your responses to each of these questions, please explain why or why not. Please also explain whether such a requirement would be attainable or practical for securitization participants, and how such a requirement would be consistent with Section 27B.

75. As discussed above, certain of the proposed conditions to the proposed risk-mitigating hedging activities exception are similar to those that are applicable to the equivalent exception to the Volcker Rule’s proprietary trading prohibition.<sup>151</sup> What are the potential benefits and drawbacks to having conditions similar to the Volcker Rule prohibition? Should a securitization participant that is in compliance with the conditions applicable to the equivalent Volcker Rule exception be deemed to be presumptively in compliance with the proposed conditions applicable under the risk-mitigating hedging activities exception to the re-proposed rule? Are there entities that are not subject to the

Volcker Rule’s proprietary trading prohibition and/or the associated compliance requirements, including smaller securitization participants, that would seek to avail themselves of the risk-mitigating exception to the re-proposed rule and that would be meaningfully disadvantaged by this approach? If so, please explain why and suggest an alternative approach that would be consistent with Section 27B. If your suggested alternative approach includes different compliance requirements for different types of entities, please explain how any such entity types should be defined for purposes of your suggested alternative approach.

76. Should the proposed risk-mitigating hedging activities exception require a securitization participant relying on the exception to affirmatively certify that it is undertaking such activity for the purpose of hedging a risk arising in connection with its securitization activities and that it has complied with the relevant conditions in the re-proposed rule? If so, what form should such a certification take, and when should it be required to be made? For example, should the certification be required to be filed with, or otherwise furnished to, the Commission, or should it instead be required to be retained in the files of the securitization participant in accordance with its written policies and procedures? Should the certification requirement permit a securitization participant to make the required certification on a periodic basis with respect to all risk-mitigating hedging activity occurring during that period, and if so, how frequently should the certification be required to be made? Please explain whether and how such a certification requirement would be practical for securitization participants given that the proposed exception would permit hedging conducted 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 its origination or acquisition of assets in anticipation of securitization.

77. Should any additional conditions apply to the proposed risk-mitigating hedging activities exception? If yes, please provide a specific description of any such additional condition and how such additional condition would be consistent with Section 27B.

78. Are the proposed conditions of the risk-mitigating hedging activities exception adequate to address any potential misuse and evasion of the exception? What are the ways in which a securitization participant could

<sup>149</sup> See Better Markets Letter at 11.

<sup>150</sup> See Better Markets Letter at 11.

<sup>151</sup> See 17 CFR 255.5.

attempt to utilize the proposed exception in order to disguise speculative activity as risk-mitigating hedging? Are any such concerns about potential misuse or evasion of the exception adequately mitigated by the anti-circumvention provision in proposed Rule 192(d)? Should an explicit anti-abuse provision be added as a condition to the proposed exception requiring that “the hedging activity must not be conducted or designed to evade the requirements” of proposed Rule 192, or would such a provision be unnecessary because of the anti-circumvention language in proposed Rule 192(d)?

79. Is the proposed condition applicable to the risk-mitigating hedging activities exception regarding compliance and monitoring appropriate? Should such a condition include more or less stringent requirements? The proposed condition requires 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. Is there sufficient clarity as to what risks are specific and identifiable at the outset of the risk-mitigating hedging activity? If not, please explain what further guidance or clarification would be helpful in this context. Please identify any additional conditions that should be required as part of the compliance program condition.

80. Should smaller securitization participants be exempt from certain elements of the compliance program condition, such that those elements of the condition would apply only to securitization participants with significant trading assets and liabilities similar to the equivalent exception to the Volcker Rule, or should all elements of the compliance program condition apply to all securitization participants in order to adequately protect ABS investors? Alternatively, should the implementation of the compliance program requirement applicable to smaller securitization participants be delayed in order to give such entities more time to comply with the requirement? Why or why not? In your responses, please explain how “smaller securitization participant” should be defined for purposes of any such exemption or delayed implementation.

81. Are there other potential positive or negative consequences of the proposed risk-mitigating hedging activities exception? How might the proposed risk-mitigating hedging activities exception impact affiliates or subsidiaries of a securitization

participant? What investment strategies of affiliates or subsidiaries might be impacted, and how might they be impacted? In particular, how might the proposed exception impact the hedging strategies of affiliated private funds and/or their investment advisers?

#### F. Exception for Liquidity Commitments

Section 27B(c) provides that the prohibition in Section 27B(a) does not apply to purchases or sales of ABS made pursuant to and consistent with commitments of the underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, to provide liquidity for the ABS.<sup>152</sup> Consistent with Section 27B(c)(2)(A), we are proposing in proposed Rule 192(b)(2) that the prohibition would not apply when a securitization participant engages in purchases or sales of ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the relevant ABS. We received comments in response to the 2011 proposed rule that the exception should permit commitments to provide liquidity through means other than purchases and sales of ABS.<sup>153</sup> We understand that commitments to provide liquidity may take a variety of forms in addition to purchases and sales of the ABS, such as commitments to promote full and timely interest payments to ABS investors or to provide financing to accommodate differences in the payment dates between the ABS and the underlying assets.<sup>154</sup> However, expanding the exception for liquidity commitments to accommodate such activities should not be necessary as the definition of “conflicted transaction” discussed above is already appropriately focused on transactions that constitute a bet against the relevant ABS and would not encompass activity such as an extension of credit by a securitization participant that functions to support the

<sup>152</sup> 15 U.S.C. 77z-2a(c)(2)(A).

<sup>153</sup> See, e.g., ICI Letter at 7–9 (stating that the exception should encompass those liquidity arrangements that are typical in the marketplace for asset-backed commercial paper (“ABCP”) and that the rule should specify that liquidity may be provided through means other than just purchases and sales of ABS); ASF Letter at 26–27 (stating that various forms of liquidity commitments operate to support the relevant ABS and thus serve a valid and important market function that should be permitted by the rule).

<sup>154</sup> For example, a sponsor of ABCP may provide a liquidity facility if a tranche of \$3 million of the ABCP matures on the 30th day of the month, yet only \$2 million of the underlying receivables match that maturity. If there is an inability to repay the \$1 million shortfall by issuing new commercial paper, the sponsor may provide a loan secured by the receivables to provide for the \$1 million shortfall.

performance of the securitization rather than to benefit from its adverse performance. We received comments in response to the 2011 proposed rule that a broad application of the exception could give rise to abusive conduct if a vast range of activities would qualify for the exception.<sup>155</sup> Without taking a position on whether the specific transactions cited by these commenters would constitute “conflicted transactions” as defined in proposed Rule 192(c), we agree as a general matter that an overly broad application of the exception could give rise to abusive conduct. We are accordingly proposing to limit the exception to purchases and sales of the ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the ABS, consistent with the language of Section 27B(c)(2).

We also received a comment that the term “commitment” should be defined to mean a contractual obligation to provide liquidity.<sup>156</sup> Consistent with Section 27B, however, the re-proposed exception does not require that a liquidity commitment take the form of a contractual obligation. We seek further commenter input on this issue below.

#### Request for Comment

82. Is the proposed scope of the liquidity commitments exception appropriate, or is it overinclusive or underinclusive? Is further guidance or clarification necessary regarding the meaning of the term “commitment” or the scope of permissible liquidity commitments? Why or why not?

83. Should the proposed exception for liquidity commitments apply only to purchases and sales of the ABS made pursuant to, and consistent with, the commitments of the securitization participant to provide liquidity for the ABS, as proposed, or should the exception apply to activity other than purchases and sales of the ABS, such as a commitment to provide loans pursuant to a liquidity facility, and why?

84. In addition to the examples provided above, are there other activities that should be covered by the re-proposed exception for liquidity

<sup>155</sup> See Better Markets Letter at 12–13 (stating that it is possible that loan transactions could be structured with terms that would significantly benefit the lending entity upon default or poor performance of the assets); Merkley-Levin Letter at 18–19 (referring to the example of a collateral put provider for a synthetic securitization refusing to acquire new CDS collateral); Tewary Letter 1 at 11–12 (referring to an example of a placement agent structuring a loan transaction in order to effectively be a short position with respect to the relevant ABS).

<sup>156</sup> See AFR Letter at 9.

commitments? If so, please describe those activities and explain how such activities would satisfy the requirements of the re-proposed exception.

85. Should the Commission require that a commitment be evidenced by a contractual obligation? Please discuss whether such contractual obligations are a current practice and if there are particular benefits or drawbacks to including such a requirement.

86. We received a comment to the 2011 proposed rule inquiring if “dollar roll” transactions in the Enterprise ABS market would qualify for the liquidity commitments exception.<sup>157</sup> Please explain if the Commission should specify in the re-proposed rule that dollar roll transactions in the MBS market or other similar transactions would be purchases or sales of ABS made pursuant to, and consistent with, commitments of the securitization participant to provide liquidity for the relevant ABS. Please address if such transactions are effected primarily for financing or operational reasons or if such transactions are effected for other purposes.

87. Could the proposed exception for liquidity commitments in the re-proposed rule result in any adverse consequences? If yes, please explain.

### G. Exception for Bona Fide Market-Making Activities

Section 27B(c) provides that the prohibition in Section 27B(a) does not apply to purchases or sales of ABS made pursuant to and consistent with bona fide market-making in the ABS.<sup>158</sup> Consistent with Section 27B(c)(2)(B), we are proposing in Rule 192(b)(3) an exception for certain bona fide market-making activities conducted by a securitization participant that is licensed or registered to engage in such activities in accordance with applicable law and self-regulatory organization (“SRO”) rules. Subject to specified conditions, the proposed exception would apply to bona fide market-making activity, including market-making related hedging, of a securitization participant conducted in connection with and related to an ABS, the assets underlying such ABS, or financial instruments that reference such ABS or underlying assets. In order to distinguish permitted bona fide market-making activity from prohibited conflicted transactions, we are proposing to include five conditions

that must be satisfied in order for a securitization participant to rely on the bona fide market-making activities exception. Each of these conditions is discussed in further detail below.<sup>159</sup>

The requirements of the proposed bona fide market-making activities exception draw from the concept of market-making in both the Volcker Rule, designed to ensure that banking entities may continue to function in less liquid and illiquid markets,<sup>160</sup> as well as 15 U.S.C. 78c(a)(38), which defines “market maker” for purposes of the Exchange Act.<sup>161</sup> In each context the

<sup>159</sup> We received a comment to the 2011 proposed rule seeking clarification as to whether eligibility for the bona fide market-making exceptions of 17 CFR 242.200 through 204 (“Regulation SHO”) would be relevant to the bona fide market-making activities exception for ABS securitizations. SIFMA Letter at 34–35. The proposed bona fide market-making activities exception for purposes of the re-proposed rule and the bona fide market-making exception of Regulation SHO are designed to address different circumstances with different purposes. Activity that might be bona fide market-making activities for purposes of the re-proposed rule may not be bona fide market-making for purposes of other rules, including Regulation SHO, and vice versa. For example, Regulation SHO’s bona fide market-making exceptions are intended to be narrow exceptions to allow market makers to facilitate customer orders in a fast moving market without possible delays associated with complying with the Regulation SHO “locate” requirement. *See, e.g., Amendments to Regulation SHO*, Release No. 34–58775 (Oct. 14, 2008) [73 FR 61690 (Oct. 17, 2008)] (“2008 Regulation SHO Amendments”) at 61698; *Short Sales*, Release No. 34–50103 (Jul. 28, 2004) [69 FR 48008 (Aug. 6, 2004)] (“2004 Short Sales Release”) at 48015 n.67. For example, for purposes of the Regulation SHO exception, factors that indicate a market-maker is engaged in bona fide market-making include whether the market-maker incurs economic or market risk for a quotation with respect to a security. 2008 Regulation SHO Amendments at 61699. Thus, a market maker that continually executed short sales away from its posted quotes would generally be unable to rely on the bona-fide market making exceptions of Regulation SHO. *See* 2004 Short Sales Release at 48015 n.68. Further, broker-dealers that publish quotations but fill orders at different prices than those quoted would not be engaged in bona fide market-making for purposes of Regulation SHO. *See, e.g., Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer*, Release No. 34–94524 (Mar. 28, 2022) [87 FR 23054 (Apr. 18, 2022)] (“Dealer Release”) at 23068 n.157.

<sup>160</sup> *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds*, Release No. BHCA–1 (Dec. 10, 2013) [79 FR 5536 (Jan. 31, 2014)] (“Volcker Release”) at 5584.

<sup>161</sup> *See* Exchange Act Section 3(a)(38) (providing that “The term ‘market maker’ means . . . any dealer who, with respect to a security, holds himself out . . . as being willing to buy and sell such security for his own account on a regular and continuous basis.”). *See also Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to Close-Out Requirements for Short Sales and an Interpretation on Prompt Receipt and Delivery of Securities*, Release No. 34–32632 (July 14, 1993) [58 FR 39072 (July 21, 1993)] at 39074 (stating that “a bona fide market maker is

parameters of what constitutes market-making are adapted to the characteristics of the financial instruments and markets involved. For example, under the Volcker Rule, which was adopted under the Bank Holding Company Act, the key elements of market-making in a security include that a banking entity “routinely stands ready” to purchase and sell, that it is “willing and available to quote, purchase and sell, or otherwise enter into long and short positions for its own account,” and that such quoting and trading activity be in “commercially reasonable amounts and throughout market cycles, on a basis appropriate for the liquidity, maturity, and depth of the market.”<sup>162</sup> Under the Exchange Act, a “market maker” is defined as “any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out . . . as being willing to buy and sell such security for his own account on a regular or continuous basis.”<sup>163</sup> For example, Regulation SHO’s bona fide market-making exceptions, which apply only to equity securities, apply a “regular and continuous basis” requirement to the relatively more liquid market for short sales in order to “facilitate customer orders in a fast moving market.”<sup>164</sup> While drawing from both the Volcker Rule and Exchange Act definitions of market-making, the proposed bona fide market-making activities exception is intended to account for and accommodate the unique characteristics of ABS and the ABS market. Therefore, as discussed below, the proposed exception utilizes elements of Volcker Rule market-making given the limited liquidity and decreased reliance on quotation media in parts of the ABS market while adding novel characteristics to accommodate market-making in ABS and the transactions to which the exception can be applied.<sup>165</sup>

The prohibition in proposed Rule 192(a) would apply not only to short sales of the relevant ABS, but to a variety of conflicted transactions. For example, the prohibition would also

a broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security”).

<sup>162</sup> 17 CFR 255.4(b)(2)(i).

<sup>163</sup> 15 U.S.C. 78c(a)(38).

<sup>164</sup> *See* 2004 Short Sales Release at 48015 n.67.

<sup>165</sup> Activity that would be bona fide market-making activity under the proposed exception may not necessarily be market-making for purposes of other laws or regulations, including the Volcker Rule, other provisions of the Exchange Act, or the rules and regulations thereunder, such as Regulation SHO, or self-regulatory organization rules.

<sup>157</sup> *See* Fannie Mae Letter at 5 (stating that, in a dollar roll transaction, an investor commits to sell a security at a specified price and to purchase a similar security at a lower price on a specified date in the future).

<sup>158</sup> 15 U.S.C. 77z–2a(c)(2)(B).

extend to transactions such as the purchase of a credit derivative with respect to the relevant ABS or the assets underlying the relevant ABS.<sup>166</sup> Therefore, limiting the proposed bona fide market-making activities exception to only purchases and sales of the relevant ABS could result in an inconsistency between the scope of the prohibition and the scope of the exception. Accordingly, the proposed exception would apply to market-making in not only the ABS that would be subject to the prohibition of the proposed rule but, as described in proposed Rule 192(b)(3)(i), also the assets underlying such ABS as well as financial instruments that reference such ABS or the assets underlying such ABS; this would capture CDS or other credit derivative products with payment terms that are tied to the performance of the ABS or its underlying assets. This should address the concern of a commenter that if the proposed prohibition is to be applied to restrict transactions not only in the relevant ABS but also transactions in the underlying assets or related derivative exposures, then the bona fide market-making activities exception should be applied in a similar manner.<sup>167</sup> Although we received a comment that the bona fide market-making activities exception should not apply to market-making in CDS positions that reference the relevant ABS,<sup>168</sup> bona fide market-making activities in CDS positions where the relevant securitization participant is responding to customer demand does not implicate the types of material conflicts of interest the re-proposed rule is designed to address because the securitization participant is making a market in such positions for its customers rather than betting against the relevant ABS for its own account.

Furthermore, the proposed bona fide market-making activities exception does

<sup>166</sup> Given the nature of the ABS market and that the scope of the prohibition of the re-proposed rule would prohibit transactions that include not only entering into a short sale of ABS but also entering into CDS on the relevant ABS or the asset underlying such ABS, we are proposing that the bona fide market-making activities exception extend to bona fide market-making activity in financial instruments, such as CDS on the relevant ABS, that are conflicted transactions under the re-proposed rule. However, under the re-proposed rule, if the “conflicted transaction” is a short sale of the relevant ABS, then, in order to rely on the proposed exception, such sale would need to constitute bona fide market-making activity in such ABS. Similarly, if the relevant “conflicted transaction” is a purchase and sale of a CDS, then, in order to rely on the exception, such purchase and sale would need to constitute bona fide market-making activity of the securitization participant in such CDS.

<sup>167</sup> Morgan Stanley Letter at 10.

<sup>168</sup> Tewary Letter at 12.

not include a requirement to analyze the applicability of the exception on a trade-by-trade basis. Similar to the Volcker Rule, the proposed bona fide market-making activities exception is instead focused on the overall market-making related activities of a securitization participant in assets that would otherwise be conflicted transactions, with a condition that those activities are related to satisfying the reasonably expected near term demand of the securitization participant’s customers. The proposed exception is also designed to give a securitization participant that is a market maker the flexibility to acquire positions that hedge a securitization participant’s market-making inventory.

We received a comment to the 2011 proposed rule expressing concern that the 2011 proposed rule would prohibit hedging as part of permitted market-making, resulting in curtailed market-making and a reduction in market liquidity.<sup>169</sup> Under the re-proposed exception, hedging the risk of a price decline of market-making-related ABS positions and holdings while the market maker holds such ABS would qualify for the re-proposed exception without the additional complexity of separately needing to qualify for the risk-mitigating hedging activities exception in paragraph (b)(1), which is principally designed to address the hedging of retained exposures rather than market-making positions that are entered into in connection with customer demand. To facilitate monitoring and compliance, as discussed below in the context of the compliance program requirement, a securitization participant relying on the proposed exception for bona fide market-making activities would be required to have reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its positions and holdings. This approach is similar to that set forth in the Volcker Rule<sup>170</sup> and should allow securitization participants that are market makers to determine how best to manage the risks of their market-making activity without causing a reduction in liquidity, wider spreads, or increased trading costs for market makers and their customers.

We also received comment to the 2011 proposed rule in support of grounding the bona fide market-making activities exception in the secondary market and excluding a securitization participant’s initial recommendations and sales of a new ABS from qualifying

<sup>169</sup> See SIFMA Letter at 32.

<sup>170</sup> See Volcker Release at 5581 n.588.

for the exception.<sup>171</sup> This is consistent with the re-proposed exception under which the initial issuance of an ABS would not be bona fide market-making activity, which would mean that a securitization participant would not be able to rely on the re-proposed exception for bona fide market-making activities in ABS for primary market activities, such as issuing a new synthetic ABS.<sup>172</sup> This also is consistent with the view of a commenter that the exception should not apply to taking a short position in a synthetic ABS that a securitization participant itself created.<sup>173</sup>

We also received comment that the bona fide market-making exception should permit a securitization participant to issue a synthetic securitization and purchase the CDS protection through such issuance.<sup>174</sup> We are concerned, however, that such activity would weaken the conflicts of interest protection of the re-proposed rule by allowing a securitization participant to engage in a transaction (the CDS contract(s) with the issuer) where cash paid by 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 with respect to a cash ABS that it created or sold to other investors. Furthermore, the integral role played by a securitization participant in structuring and/or marketing the relevant ABS and the compensation associated with such new issuance activity would go beyond the scope of secondary market bona fide market-making activity and could raise material conflicts of interest with investors in the new synthetic ABS that would be the same as those raised by the synthetic CDO transactions that were the subject of Congressional scrutiny in connection with the financial crisis of 2007–2009.<sup>175</sup>

We also received comment to the 2011 proposed rule suggesting that the bona fide market-making activities exception could be strengthened to prevent misuse through an anti-abuse provision prohibiting use of the exception to circumvent the statutory

<sup>171</sup> See, e.g., Merkley-Levin Letter at 20.

<sup>172</sup> Furthermore, the activity would not qualify for the re-proposed exception because even if the securitization participant purchased the CDS protection (i.e., a short position) purportedly as part of its market-making activity, the creation and sale of the new ABS is primary, not secondary, market activity.

<sup>173</sup> See, e.g., Merkley-Levin Letter at 21.

<sup>174</sup> See Morgan Stanley Letter at 13.

<sup>175</sup> See Senate Financial Crisis Report.

prohibition.<sup>176</sup> The re-proposed rule does not include such an anti-abuse provision. Instead, the re-proposed rule sets forth certain conditions that would be required to be satisfied in order for the exception to apply, which is designed to permit only activity that is indeed bona fide market-making activity and not speculative activity disguised as market-making.

#### 1. Requirement To Routinely Stand Ready To Purchase and Sell

We are proposing in Rule 192(b)(3)(ii)(A) that the first condition to the exception be that the securitization participant routinely stands ready to purchase and sell one or more types of the financial instruments set forth in proposed Rule 192(b)(3)(i) 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 such financial instruments. However, similar to other rules,<sup>177</sup> the mere provision of liquidity would not necessarily be sufficient for a securitization participant to qualify for the proposed bona fide market-making activities exception.<sup>178</sup>

This “routinely stands ready” standard is based on the standard set forth in the Volcker Rule<sup>179</sup> and would help ensure that the relevant market-making activity is indeed bona fide while also taking into account the actual liquidity and depth of the relevant market for ABS and financial instruments related to ABS described in proposed Rule 192(b)(3)(i), which may be less liquid than, for example, listed equity securities. This “routinely stands ready” standard, as opposed to a more stringent standard such as “continuously purchases and sells,”<sup>180</sup>

is designed to not have a chilling effect on a person’s ability to act as a market maker in a less liquid market. We therefore preliminarily believe that the proposed “routinely stands ready” standard is appropriate for bona fide market-making activities in ABS and related financial instruments described in proposed Rule 192(b)(3)(i) because market makers in such illiquid markets likely do not trade continuously but trade only intermittently or at the request of customers. However, this proposed condition is also designed to help ensure that activity that would qualify for the exception in the re-proposed rule would not apply to a securitization participant only providing quotations that are wide of (in comparison to the bid-ask spread) one or both sides of the market relative to prevailing market conditions. 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 market. Furthermore, a securitization participant would need to be willing to facilitate customer needs in both upward and downward moving markets and not only when it is favorable for the securitization participant to do so in order for it to “routinely stand ready” to purchase and sell the relevant financial instruments throughout market cycles. This approach is consistent with certain comments received on the 2011 proposed rule that securitization participants must be willing to buy and sell throughout market cycles, including market cycles with adverse market conditions<sup>181</sup> and not simply take a position on one side of the market.<sup>182</sup> Also, in this context, “commercially reasonable” amounts would mean, similar to the equivalent concept in the Volcker Rule,<sup>183</sup> that the securitization

dealer should generally be holding itself out as standing ready and willing to buy and sell the relevant security by continuously posting widely disseminated quotes that are near or at the market, and must be at economic risk for such quotes. See 2008 Regulation SHO Amendments at 61690, 61699 (citing indicia including whether the market maker incurs any economic or market risk with respect to the securities (e.g., by putting their own capital at risk to provide continuous two-sided quotes)); see also Dealer Release, *supra* note 159, at 23068 n.157 (stating that broker-dealers that do not publish continuous quotations, or publish quotations that do not subject the broker-dealer to such risk (e.g., quotations that are not publicly accessible, are not near or at the market, or are skewed directionally towards one side of the market) would not be eligible for the bona fide market-maker exceptions under Regulation SHO).

<sup>181</sup> See Merkley-Levin Letter at 20; see also Better Markets Letter at 13.

<sup>182</sup> See Merkley-Levin Letter at 20.

<sup>183</sup> See Volcker Release at 5597.

participant would need to be willing to quote and trade in sizes requested by market participants in the relevant market. This would be indicative of the securitization participant’s willingness and availability to provide intermediation services for its clients, customers, or counterparties that is consistent with bona fide market-making activities in such market.

#### 2. Limited to Client, Customer, or Counterparty Demand Requirement

We are proposing in Rule 192(b)(3)(ii)(B) that the second condition to the exception be that 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. This proposed condition is the same as that included in the Volcker Rule, which is designed to identify activity that is characteristic of bona fide market-making activity and not speculative trading while still allowing subject entities to continue to make a market across less liquid asset classes.<sup>184</sup> This is similar to the purpose of the condition in the context of the re-proposed rule, which is to distinguish activity that is characteristic of bona fide market-making activities from a securitization participant entering into a conflicted transaction to bet against the relevant ABS for the benefit of its own account, while still allowing securitization participants to make a market in ABS and the related financial instruments described in paragraph (b)(3)(i), which may be relatively illiquid. In order to achieve these objectives, this would be a facts and circumstances determination that is focused on an analysis of the near term demand of customers while also recognizing that the liquidity, maturity, and depth of the relevant market may vary across asset types and classes. The recognition of these differences in the proposed conditions should avoid unduly impeding a market maker’s ability to build or retain inventory in less liquid instruments. The facts and circumstances that would be relevant to determine compliance with this proposed condition would include, but not be limited to, historical levels of customer demands, current customer demand, and expectations of near term customer demand based on reasonably anticipated near term market conditions, including, in each case,

<sup>184</sup> See *id.* at 5606.

<sup>176</sup> See Merkley-Levin Letter at 21.

<sup>177</sup> See, e.g., discussion at note 159.

<sup>178</sup> For example, because market makers typically provide liquidity on the opposite side of the market, if a security is experiencing significant downward price pressure, market makers engaged in bona fide market-making activities will tend to respond to market demand by buying not selling the security. See, e.g., *Amendments to Regulation SHO*, Release No. 34–61595 (Feb. 26, 2010) [75 FR 11232 (Mar. 10, 2010)] at 11273–4. See also 2008 Regulation SHO Amendments at 61699 (stating that a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity to customers or other broker-dealers would generally be an indication that a market maker is engaged in bona-fide market-making activity).

<sup>179</sup> 17 CFR 255.4(b)(2)(i).

<sup>180</sup> For example, under Regulation SHO’s bona fide market-making exceptions, the relevant broker-

inter-dealer demand. For example, a securitization participant facilitating a secondary market credit derivative transaction with respect to an ABS in response to a current customer demand would satisfy this proposed condition. However, if the securitization participant builds an inventory of CDS positions in the absence of current demand and without any reasonable basis to build that inventory expected on either historical demand or anticipated demand based on expected near term market conditions, there would be no reasonably expected near term customer demand for those positions and that transaction would fail to satisfy this proposed condition. This condition to the re-proposed exception aligns with a comment received in response to the 2011 proposal stating that requiring activity to be client-driven can help avoid a securitization participant providing a cover for activity that is not client-driven but rather is a bet against an ABS, which is activity that would not be designed to meet reasonably expected near term demand. While we received comment that trading activity should be required to be “reasonably substantial relative to the size of the market for the securities” to qualify for a bona fide market-maker exception,<sup>185</sup> the re-proposed standard focusing on the relevant transactions being entered into based on the reasonably expected near term demand of the relevant market, and not solely on the size of the trade in relation to the size of the market, is a more appropriate standard for distinguishing between bona fide market-making activities and speculative trading. This is because it would be unclear what a trade being “reasonably substantial relative to the size of the market for the securities” would mean in the context of ABS markets where the relevant cumulative outstanding amount of securities for the relevant ABS type may exceed a trillion dollars.<sup>186</sup> Facilitating a trade in or related to a portion of an ABS tranche pursuant to a current client request should satisfy this condition even if the size of the trade is small relative to the overall outstanding principal amount of the relevant ABS issuance or the cumulative outstanding principal amount of the relevant ABS sponsored by the same person on an aggregated basis.

### 3. Compensation Requirement

We are proposing in Rule 192(b)(3)(ii)(C) that the third condition of the exception be that the

compensation arrangements of the persons performing the market-making activity of the securitization participant are designed not to reward or incentivize conflicted transactions. It would be consistent with this proposed condition if the relevant compensation arrangement is designed to reward effective and timely intermediation and liquidity to customers. It would be inconsistent with this proposed condition if the relevant compensation arrangement is instead designed to reward speculation in, and appreciation of, the market value of market-making positions that the securitization participant enters into for the benefit of its own account. This approach is similar to that taken for purposes of the Volcker Rule.<sup>187</sup> We seek comment below on whether this condition should provide additional specificity regarding what it would mean for a compensation arrangement to be designed not to reward or incentivize conflicted transactions, including examples of acceptable and unacceptable compensation arrangements.

### 4. Registration Requirement

We are proposing in Rule 192(b)(3)(ii)(D) that the fourth condition of the exception be that the securitization participant would be required to be licensed or registered to engage in the relevant market-making activity, in accordance with applicable laws and SRO rules. This condition is designed to limit persons relying on the proposed exception for bona fide market-making activities to only those persons with the appropriate license or registration to engage in such activity in accordance with the requirements of applicable laws and SRO rules for such activity—unless the relevant person is exempt from registration or excluded from regulation with respect to such activity under applicable law and SRO rules.<sup>188</sup> Persons engaged in market-making activity in the securities markets in connection with ABS may be engaged in dealing activity, and so, absent an exception or exemption, are required to register as “dealers” pursuant to Section 15(a) of the Exchange Act, as “government securities dealers” pursuant to Section 15C of the Exchange Act, or as “security-based swap dealers” pursuant to Section 15F(a) of the Exchange Act.<sup>189</sup> A securitization

participant that is a registered broker-dealer would satisfy the market-making exception’s registration condition.<sup>190</sup> Similarly, a securitization participant licensed as a bank or registered as a security-based swap dealer in accordance with applicable law would also be eligible for the exception.

### 5. Compliance Program Requirement

We are proposing in Rule 192(b)(3)(ii)(E) that the fifth and final condition to the exception be that the securitization participant would be required to have established and must implement, 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 activities exception, including reasonably designed written policies and procedures that demonstrate a process for prompt mitigation of the risks of its positions and holdings. This proposed condition is designed to help ensure that the activities of a securitization participant relying on the bona fide market-making activities exception are indeed bona fide market-making activities, and not the type of transactions that would involve or result in a material conflict of interest between a securitization participant for an ABS and an investor in such ABS.

*Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934*, Release No. 34-46745 (Oct. 30, 2002) [67 FR 67496 (Nov. 5, 2002)] at 67498–67500; see also *Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,”* Release No. 34-66868 (Apr. 27, 2012) [77 FR 30596 (May 23, 2012)] at 30616–30619.

<sup>190</sup> Note, however, that the proposed bona fide market-making activities exception in the re-proposed rule is narrower than market-making activity that may require a person to register as a dealer. In other words, a securitization participant who does not meet all conditions of the re-proposed rule’s bona fide market-making activities exception may still be required to register as a broker-dealer. See *id.*; see also 15 U.S.C. 78c(a)(38) (defining the term “market maker” to mean any specialist permitted to act as a *dealer*, any *dealer* acting in the capacity of block positioner, and any *dealer* who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis). Further, definitions and the determination of eligibility for the bona fide market-making activities exception in the re-proposed rule are distinct from those available under other rules, such as Regulation SHO and recently proposed rules to include certain significant market participants as “dealers” or “government securities dealers.” See, e.g., Dealer Release, *supra* note 159, at 23068 n.131 (distinguishing the determination of eligibility for the bona fide market-making exceptions of Regulation SHO from the determination of whether a person’s trading activity indicates that such person is acting as a dealer or government securities dealer under the rule proposed in that Exchange Act Release).

<sup>187</sup> See Volcker Release at 5619.

<sup>188</sup> For example, a person meeting the conditions of the *de minimis* exception in Exchange Act Rule 3a71-2 would not need to be a registered security-based swap dealer to act as a market maker in security-based swaps. See 17 CFR 240.3a71-2.

<sup>189</sup> See, e.g., *Definition of Terms in and Specific Exemption for Banks, Savings Associations, and*

<sup>185</sup> See AFR Letter at 9.

<sup>186</sup> See Section III.

This condition also recognizes that a securitization participant that is a market maker in ABS and related financial instruments described in paragraph (b)(3)(i) is well positioned to design its own individual internal compliance program to reflect the size, complexity, and activities of the securitization participant. In order to create uniformity and predictability for a securitization participant to determine whether it satisfies the first and second conditions of the proposed exception, a reasonably designed compliance program of the securitization participant should set forth the processes by which the relevant trading personnel would identify the financial instruments described in Rule 192(b)(3)(i) related to its securitization activities that the securitization participant may make a market in for its customers and the processes by which the securitization participant would determine the reasonably expected near term demand of customers for such products. The identification of such instruments and the processes for determining the reasonably expected near term demand of customers for such instruments in the compliance program would help prevent trading personnel at the relevant securitization participant from taking positions in conflicted transactions that are not positions that the securitization participant expects to make a market in for customers or that are in an amount that would exceed the reasonably expected near term demands of customers. Furthermore, in order to create uniformity and predictability for a securitization participant to determine whether it satisfies the first and second conditions of the proposed exception on an ongoing basis, a reasonably designed compliance program of the securitization participant should also establish internal controls and a system of ongoing monitoring and analysis that the securitization participant would utilize in order to effectively ensure the compliance of its trading personnel with its policies and procedures regarding permissible market-making under the re-proposed rule.

We also believe it is important that the reasonably designed written policies and procedures demonstrate a process for prompt mitigation of the risks of a securitization participant's positions and holdings that arise from market-making in ABS and the related financial instruments described in Rule 192(b)(3)(i), such as the risks of aged positions and holdings, because doing so would help to prevent a securitization participant from engaging in a transaction and maintaining a

position that is adverse to the relevant ABS that remains open and exposed to potential gains for a prolonged period of time. The re-proposed rule does not define "prompt" mitigation in this context. While mitigating the risks of such positions and holdings would not be required to be contemporaneous with the acquisition of such positions or holdings, prompt mitigation would mean that the mitigation occur without delay that would facilitate or create an opportunity to benefit from a conflicted transaction remaining in the securitization participant's market-making inventory. We seek comment below on more precise indicia of "prompt" mitigation of such risks, and whether such indicia should be specified in the rule.

The proposed requirement that a process for such risk mitigation activity be included in a securitization participant's written policies and procedures would help ensure that activity is not speculative activity disguised as market-making by establishing the processes by which the relevant trading personnel would enter into, adjust, and unwind such hedging positions with respect to its market-making inventory. This approach is consistent with certain comments to the 2011 proposed rule supporting the inclusion of a compliance condition in the bona fide market-making activities exception<sup>191</sup> and including a written policies and procedures requirement.<sup>192</sup>

We received a comment to the 2011 proposed rule that any securitization participant relying on the proposed exception for bona fide market-making activities should be required to affirmatively certify that it is undertaking such activity for the sole purpose of market-making in connection with the securitization, and not for the purpose of generating speculative profits.<sup>193</sup> We did not include a certification requirement in the proposed exception, but we seek comment below on whether a certification requirement would be appropriate, and if so, what form such a certification should take and when it should be required to be made.

#### Request for Comment

88. Is the scope of the proposed bona fide market-making activities exception appropriate or is it overinclusive or underinclusive? Please provide specific examples of any activity that should be included in or excluded from the scope of the exception and provide a

justification as to why and how that modification would not compromise investor protection. For example, is it appropriate for the proposed exception to apply to market-making in the financial instruments described in proposed Rule 192(b)(3)(i) or should the scope of financial instruments be narrowed or expanded? Does market-making in CDS in response to customer demands implicate the types of material conflicts of interest that the re-proposed rule is designed to address?

89. Should any of the proposed conditions applicable to the proposed bona fide market-making activities exception be modified? If yes, please provide the suggested modification and explain how such modification would be consistent with statutory authority and how that modification would not compromise investor protection. For example, should the bona fide market-making activities exception be modified to align more closely with market-making in the context of Regulation SHO? If so, please explain how the exception should be modified and why, and how doing so would not compromise investor protection. Should the bona fide market-making activities exception in the re-proposed rule include a condition that the securitization participant analyze the applicability of the exception on a trade-by-trade basis? Is the proposed condition that 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 sufficient to prevent a securitization participant from providing a cover for activity that is not client driven but rather a bet against the relevant ABS? Should this condition include any additional requirements, such as the requirement that the securitization participant's market-making activities are driven by customer trading, customer liquidity needs, customer investment needs, or risk management by customers?

90. Is it appropriate to consider the liquidity, maturity, and depth of the market for the relevant financial instruments in determining whether a securitization participant routinely stands ready to purchase and sell such financial instruments for purposes of the proposed bona fide market-making activities exception? Would such considerations potentially allow a securitization participant to characterize only sporadic trading in illiquid financial instruments as market-making

<sup>191</sup> See Tewary Letter 1 at 12.

<sup>192</sup> See Better Markets Letter at 14.

<sup>193</sup> See Better Markets Letter at 11.

in an effort to evade the intent of the re-proposed rule? Are any such concerns about potential misuse or evasion of the exception adequately mitigated by the anti-circumvention provision in proposed Rule 192(d)? If you believe that there are unique characteristics of the ABS market that should be considered in the context of bona fide market-making activities in ABS and related financial instruments, such as lack of liquidity or increased settlement times compared to other asset classes, then please describe those in detail, provide supporting data, and explain if the proposed bona fide market-making activities exception, including the proposed conditions, is appropriate given such characteristics.

91. Should the compensation condition to the proposed bona fide market-making activities exception provide additional specificity regarding what it would mean for the compensation arrangements to be designed not to reward or incentivize conflicted transactions? If so, please explain what specific indicia or metrics would be appropriate for purposes of that determination and why, and please provide examples of acceptable and unacceptable compensation arrangements.

92. Are the proposed conditions of the bona fide market-making activities exception adequate to address any potential misuse and evasion of the exception? What are the ways in which a securitization participant could attempt to utilize the proposed exception in order to disguise speculative activity as bona fide market-making? Are any such concerns about potential misuse or evasion of the exception adequately mitigated by the anti-circumvention provision in proposed Rule 192(d)? Should an explicit anti-abuse provision be added as a condition to the proposed exception requiring that “the market-making activity must not be conducted or designed to evade the requirements” of proposed Rule 192, or would such a provision be unnecessary because of the anti-circumvention language in proposed Rule 192(d)?

93. As discussed above, certain of the conditions of the proposed bona fide market-making activities exception are similar to those that are applicable to the equivalent exception to the Volcker Rule’s proprietary trading prohibition.<sup>194</sup> What are the potential benefits and drawbacks to this approach? If a securitization participant is subject to the Volcker Rule and would also be subject to the re-proposed rule,

should a securitization participant that is in compliance with the conditions applicable to the equivalent Volcker Rule exception be deemed to be presumptively in compliance with the conditions applicable under the bona fide market-making activities exception to the re-proposed rule? Or are the purposes of the Volcker Rule and Section 27B sufficiently different that additional or different conditions are necessary for the re-proposed rule? Are there entities that are not subject to the Volcker Rule’s proprietary trading prohibition and/or the associated compliance requirements, including small broker-dealers, that would seek to avail themselves of the proposed bona fide market-making activities exception to the re-proposed rule and that would be meaningfully disadvantaged by this approach? If so, please explain why and suggest an alternative approach that would be consistent with Section 27B. If your suggested alternative approach includes different compliance requirements for different types of entities, please explain how any such entity types should be defined for purposes of your suggested alternative approach.

94. Is the proposed condition applicable to the bona fide market-making activities exception regarding compliance and monitoring appropriate? Should such a condition include more or less stringent requirements? For example, should the condition require that a securitization participant have reasonably designed policies and procedures in place that specifically identify, document, and monitor the risks of its market-making positions and holdings (including an accounting of any positions or holdings that would constitute conflicted transactions under the re-proposed rule in the absence of the proposed exception for bona fide market-making activities) and the actions taken to demonstrably mitigate promptly those risks? Please identify any additional conditions that should be required as part of the compliance program condition. Is there sufficient clarity as to whether mitigation of the risks of market-making positions and holdings would be considered “prompt” as required by the proposed condition? If not, please explain what further guidance or clarification would be helpful in this context, including any specific indicia that should be included or referenced for purposes of this determination.

95. Should the proposed bona fide market-making activities exception require a securitization participant relying on the exception to affirmatively

certify that it is undertaking such activity for the purpose of market-making in financial instruments permitted under the proposed exception and that it has complied with the relevant conditions in the re-proposed rule? If so, what form should such a certification take, and when should it be required to be made? For example, should the certification be required to be filed with, or otherwise furnished to, the Commission, or should it instead be required to be retained in the files of the securitization participant in accordance with its written policies and procedures? Should the certification requirement permit a securitization participant to make the required certification on a periodic basis with respect to all bona fide market-making activity occurring during that period, and if so, how frequently should the certification be required to be made? Please explain whether and how such a certification requirement would be practical for securitization participants.

96. Should smaller securitization participants be exempt from certain elements of the compliance program condition, such that those elements of the condition would apply only to securitization participants with significant trading assets and liabilities similar to the equivalent exception to the Volcker Rule, or should all elements of the compliance program condition apply to all securitization participants in order to adequately protect ABS investors? Alternatively, should the implementation of the compliance program requirement applicable to smaller securitization participants be delayed in order to give such entities more time to comply with the requirement? Why or why not? In your responses, please explain how “smaller securitization participant” should be defined for purposes of any such exemption or delayed implementation.

97. What are the positive or negative consequences of the bona fide market-making activities exception in the re-proposed rule?

#### *H. General Request for Comment*

We request and encourage any interested person to submit comments on any aspect of the re-proposed rule, other matters that might have an impact on the re-proposed rule, and any suggestions for additional changes. With respect to any comments, we note that they are of greatest assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments and by alternatives to our re-proposal where appropriate.

<sup>194</sup> See 17 CFR 255.4(b).

### III. Economic Analysis

#### A. Introduction

This re-proposed rule would implement the requirements of Section 27B,<sup>195</sup> as mandated under the Dodd-Frank Act. As discussed above, Section 621 of the Dodd-Frank Act added Section 27B to the Securities Act. Section 27B prohibits an underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an ABS, including a synthetic ABS, from engaging in any transaction that would involve or result in certain material conflicts of interest.<sup>196</sup> Section 27B also includes exceptions from this prohibition for certain risk-mitigating hedging activities, bona fide market-making activities, and liquidity commitments.<sup>197</sup> The re-proposed rule also would exclude from the definition of “sponsor” the United States, agencies of the United States, and the Enterprises, in each case with respect to an ABS that is fully insured or fully guaranteed as to the timely payment of principal and interest by the relevant entity.<sup>198</sup>

As discussed above in Section I.B., Section 27B requires that the Commission issue rules for the purpose of implementing the prohibition in Section 27B, and Section 27B specifies the ABS transactions and securitization participants to be covered by the re-proposed rule, as well as the timeframe of the re-proposed rule’s prohibition. We are sensitive to the economic impact, including the costs and benefits, imposed by its rules.<sup>199</sup> This section presents an analysis of the particular expected economic effects—including costs, benefits, and impact on efficiency, competition, and capital formation—that may result from the re-proposed rule, as well as possible alternatives to the re-proposed rule. Some of these effects, costs, and benefits would stem from statutory mandates, while others would be affected by the discretion exercised in implementing these mandates.

Where possible, we have sought to quantify the benefits, costs, and effects on efficiency, competition, and capital formation expected to result from the re-

proposed rule. However, we are unable to reliably quantify many of the economic effects due to limitations on available data. Therefore, parts of the discussion below are qualitative in nature, although we try to describe, where possible, the direction of these effects. We further note that even in cases where we have some data regarding certain economic effects, the quantification of these effects is particularly challenging due to the number of assumptions that we need to make to forecast how the ABS issuance practice would change in response to the re-proposed rule, and how those responses would, in turn, affect the broader ABS market. For example, the re-proposed rule’s effects would depend on how sponsors, borrowers, investors, and other parties to the ABS transactions (e.g., originators, trustees, underwriters, and other parties that facilitate transactions between borrowers, issuers, and investors) adjust on a long-term basis to this new rule and the resulting evolving market conditions. The ways in which these parties could adjust, and the associated effects, are complex and interrelated. As a result, we are unable to predict some of them with specificity or are unable to quantify them at all. We are soliciting comment and requesting data to assist it with assessing and quantifying economic effects of the re-proposed rule.<sup>200</sup>

#### B. Economic Baseline

The baseline we use to analyze the economic effects of the re-proposed rule is the current set of rules, regulations, and market practices. To the extent that they are not consistent with current market practices, the proposed requirements would impose new costs. The proposed requirements would affect ABS market participants, including securitization participants and investors in ABS, and would indirectly affect loan originators, consumers, and businesses that seek access to credit. The costs and benefits of the proposed requirements depend largely on the current market practices specific to each securitization market. The economic significance or the magnitude of the effects of the proposed requirements also depend on the overall size of the securitization market and the extent to which the requirements could affect access to, and the cost of, capital. Below, we describe our current understanding of the securitization markets that would be affected by this re-proposed rule.

#### 1. Overview of the Securitization Markets

The securitization markets are important for the U.S. economy and constitute a large fraction of the U.S. debt market.<sup>201</sup> Securitizations play an important role in the creation of credit by increasing the amount of capital available for the origination of loans and other receivables through the transfer of those assets—in exchange for new capital—to other market participants. The intended benefits of the securitization process include reduced cost of credit and expanded access to credit for borrowers, ability to match risk profiles of securities to investors’ specific demands, and increased secondary market liquidity for loans and other receivables.<sup>202</sup>

Since the re-proposed rule would apply to any person from the point at which it has reached, or has taken substantial steps to reach, an agreement to become a securitization participant until one year after the date of the first closing of the sale of the ABS, to estimate the number of affected parties and the size of the affected ABS market, we use ABS issuance information rather than information on ABS amounts outstanding. For the purposes of establishing an economic baseline and to estimate affected market size, we use data covering the most recent full calendar year 2021 to avoid any seasonal effects on estimates (“baseline period”).<sup>203</sup>

<sup>201</sup> See, e.g., SEC Staff Report, U.S. Credit Markets Interconnectedness and the Effects of the COVID-19 Economic Shock (Oct. 2020), available at [https://www.sec.gov/files/US-Credit-Markets\\_COVID-19\\_Report.pdf](https://www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf). Among other things, the report provides an overview of the various parts of the securitization markets and their connections to the broader U.S. financial markets. This is a report of the staff of the U.S. Securities and Exchange Commission, which represents the views of Commission staff, and is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved the content of this report and, like all staff statements, it has no legal force or effect, does not alter or amend applicable law, and creates no new or additional obligations for any person.

<sup>202</sup> See, e.g., Board of Governors of the Federal Reserve System, Report to the Congress on Risk Retention (Oct. 2010), available at <https://www.federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf>, and Financial Stability Oversight Council, Macroeconomic Effects of Risk Retention Requirements (Jan. 2011).

<sup>203</sup> The primary data source for our numeric estimates of issuance of private-label non-municipal ABS are the Green Street Asset-Backed Alert Database and the Green Street Commercial Mortgage Alert Database. The databases present the initial terms of all ABS, MBS, CMBS, and CLOs collateralized by assets of some kind, and synthetic CDOs, rated by at least one major credit rating agency, and placed anywhere in the world (however, only deals sold in the U.S. are included in our analysis). The databases identify the primary

Continued

<sup>195</sup> 15 U.S.C. 77z-2a.

<sup>196</sup> See Section II.A.

<sup>197</sup> See Sections II.E. through II.G.

<sup>198</sup> See Section II.B.2.c.

<sup>199</sup> Section 2(b) of the Securities Act [15 U.S.C. 77b(b)] requires us, when engaging in rulemaking that requires us to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

<sup>200</sup> See Section III.G.

We estimate that the baseline period annual issuance of private-label<sup>204</sup> non-municipal ABS in the U.S. was \$814 billion in 1,441 individual ABS deals and the baseline period annual issuance of municipal ABS in the U.S. was \$104 billion in 1,928 deals.<sup>205</sup> Out of private-label non-municipal ABS, 29 deals totaling \$11.5 billion were risk transfer ABS deals; some or all of these risk transfer ABS deals could be synthetic ABS or hybrid cash and synthetic ABS deals.<sup>206</sup> During the baseline period, Ginnie Mae provided a government guarantee to \$855 billion of newly issued MBS, and the Enterprises issued \$2.65 trillion of Enterprise-guaranteed MBS<sup>207</sup> and 16 CRT securities deals worth \$16.9 billion.<sup>208</sup> Currently, the Enterprises are in conservatorship with the U.S. Treasury and are regulated by the FHFA.<sup>209</sup>

## 2. Affected Parties

Parties potentially affected by the re-proposed rule include:

- Parties that have direct compliance obligations under the re-proposed rule with respect to the proposed prohibition, namely, underwriters, placement agents, initial purchasers, and sponsors, or any affiliates or subsidiaries of such entities (“securitization participants” as defined above).

participants in each transaction. The primary data source of our numeric estimates of issuance of municipal ABS is Mergent Municipal Bond Securities Database.

<sup>204</sup> Private-label ABS are ABS that are not sponsored or guaranteed by U.S. Government agencies or the Enterprises.

<sup>205</sup> Data drawn from the Green Street Asset-Backed Alert Database, the Green Street Commercial Mortgage Alert Database, and Mergent Municipal Bond Securities Database.

<sup>206</sup> Data drawn from the Green Street Asset-Backed Alert Database and the Green Street Commercial Mortgage Alert Database.

<sup>207</sup> See Laurie Goodman, *et al.*, *Housing Finance: At a Glance Monthly Chartbook, September 2022*, Urban Institute (Sept. 29, 2022), at 30, available at <https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-september-2022>.

<sup>208</sup> See The Green Street Asset-Backed Alert Database. Of the 16 CRT transactions in 2021, 13 were issued by Freddie Mac (\$13.82 billion) and 3 were issued by Fannie Mae (\$3.09 billion). Broadly, the Enterprise CRT programs transfer mortgage credit risk from the Enterprises to private investors. In doing so, CRT issuance lowers Enterprise capital requirements and increases their return on capital, while providing the Enterprises with market-based pricing information on Enterprise ABS credit risk. See Freddie Mac, CRTcast E4: CRT Then and Now, A Conversation with Don Layton (Nov. 17, 2021), available at <https://crt.freddiemac.com/assets/pdfs/insights/crtcast-episode-4-transcript.pdf>; Jonathan B. Glowacki, *CRT 101: Everything you need to know about Freddie Mac and Fannie Mae Credit Risk Transfer*, Milliman (Oct. 11, 2021), available at <https://www.milliman.com/en/insight/crt-101-everything-you-need-to-know-about-freddie-mac-and-fannie-mae-credit-risk-transfer>.

<sup>209</sup> See discussion in Section II.B.2.c.ii.

- U.S. agencies and the Enterprises with respect to certain types of ABS.<sup>210</sup>
- Other entities that provide services in the securitization process, including depositors, servicers and other service providers, as well as their domestic and foreign affiliates and subsidiaries.
- Counterparties that invest/deal in financial products, including derivatives, related to synthetic ABS (and hybrid cash and synthetic ABS). For example, dealers that trade CDS on the ABS to securitization participants.
- ABS investors, *e.g.*, pension funds, endowments, foundations, hedge funds, and mutual funds.
- Ultimate borrowers that rely on ABS markets for capital (*e.g.*, corporations, households) and participants in the markets where the borrowed capital is applied.
- Other market participants that could be affected by changes in securitization practices. For example, originators that retain residual interest in the reference asset pool or their creditors.

While one part of the proposed definition of the term “sponsor” is derived from the Regulation AB definition of sponsor, the definition in the re-proposed rule also includes any person that directs or causes the direction of the structure, design, or assembly of an ABS or the composition of the pool of assets underlying the ABS (a “directing sponsor”) or that has the contractual right to do so (a “contractual rights sponsor”). Whether a person is a directing sponsor would be based upon the specific facts and circumstances. This new definition of “sponsor” for purposes of the re-proposed rule has not been used before. Thus, the set of ABS sponsors would consist of three types of entities: those that organize and initiate an ABS transaction, those that are contractual rights sponsors, and those that are directing sponsors (for example, the latter two types might include Registered Investment Advisers (“RIAs”) that advise hedge funds, and that could also qualify as a sponsor under the re-proposed rule). We estimate that in the baseline period, there were 455 unique sponsors of the first type of private-label non-municipal ABS and there were 52 unique underwriters for such ABS deals; of these, we estimate that there were 14 unique sponsors and 16 unique underwriters of risk transfer ABS.<sup>211</sup> We also estimate that, in the baseline

<sup>210</sup> The proposed exception from the definition of “sponsor” with respect to those entities should lessen the impact of the re-proposed rule on these parties with respect to certain types of ABS, but these parties might still be otherwise affected.

<sup>211</sup> The Green Street Asset-Backed Alert Database.

period, there were 179 unique issuers of Ginnie Mae-guaranteed MBS,<sup>212</sup> 52 unique mortgage securities approved dealers of Freddie Mac-guaranteed MBS,<sup>213</sup> and 9 unique underwriters of Enterprise CRT securitizations.<sup>214</sup> We estimate that there were 478 unique municipal entities that sponsored municipal ABS, 104 unique underwriters of municipal ABS, and 112 unique municipal advisors.<sup>215</sup> There is an overlap between these categories of sponsors and underwriters since some sponsors and underwriters might perform multiple functions and might be active in multiple market segments and, thus, the total number of potentially affected sponsors and underwriters is lower than the sum of the numbers above. As for contractual rights sponsors and directing sponsors, we note that the proposed definition of sponsor captures persons that direct or cause the direction of the structure of ABS or the composition of the underlying asset pool even if they do not have contractual rights in connection with the ABS. Under this proposed definition, we lack data related to the number of such sponsors, as the proposed definition expands the concept to certain securitization participants that currently are not counted as sponsors in any existing database to the best of our knowledge. We believe that the number of such sponsors is limited as explained below, but we do not have data to quantitatively determine the number of such sponsors.

## 3. Current Relevant Statutory Provisions, Regulations, and Practices

Current market practices may be generally consistent with the re-proposed rule requirements as a result of market participants’ current compliance with the existing rules and reputational incentives described below.

As an initial matter, the general anti-fraud and anti-manipulation provisions of the Federal securities laws, including Section 17(a) of the Securities Act, Section 10(b) and Rule 10b–5 under the

<sup>212</sup> To arrive at the figure of 179 unique issuers, we compared the list of Ginnie Mae approved issuers (see Ginnie Mae Approved Issuers Directory, available at [https://www.ginniemae.gov/issuers/issuer\\_tools/Pages/issuers.aspx](https://www.ginniemae.gov/issuers/issuer_tools/Pages/issuers.aspx)) to the issuers that actually issued securities in the baseline period (see Ginnie Mae Single Family Loan Performance Data, available at [https://www.ginniemae.gov/investors/disclosures\\_and\\_reports/Pages/bulletins.aspx](https://www.ginniemae.gov/investors/disclosures_and_reports/Pages/bulletins.aspx)).

<sup>213</sup> See Freddie Mac Mortgage Securities Approved Dealer Group, available at <https://capitalmarkets.freddiemac.com/mbs/products/dealer-groups>.

<sup>214</sup> The Green Street Asset-Backed Alert Database.

<sup>215</sup> Mergent Municipal Bond Securities Database.

Exchange Act, apply to ABS transactions.

There were several ABS deals exhibiting conflicts of interest targeted by the re-proposed rule that were generally originated in the pre-financial crisis years, 2005–2007. These deals harmed investors, exposed conflicts of interest of certain securitization participants, and received increased attention from Congress, the market, and regulators in the 2010s.<sup>216</sup> However, despite the increased scrutiny at that time, we do not have data on the extent of securitization participants' participation in ABS transactions that are tainted by material conflicts of interest following the financial crisis of 2007–2009.

Following the financial crisis of 2007–2009, the Commission adopted several rules that reinforce the alignment of economic incentives of securitization participants and investors and reduce information asymmetries. Regulation RR, adopted by the Commission in 2014 for the purpose of implementing Section 941 of the Dodd-Frank Act, generally requires certain ABS sponsors (as defined under Regulation RR) to retain not less than 5 percent of the credit risk of the assets collateralizing an ABS for a period from five to seven years, after the date of closing of the securitization transaction, as specified by the rule.<sup>217</sup> Credit risk retention aligns the economic interest of ABS sponsors and long investors in an ABS by requiring ABS sponsors to retain financial exposure to the same credit risks as ABS investors and, in this regard, differs from the re-proposed rule, which does not require securitization participants to retain any exposure to securitization risks. Generally, a sponsor of an ABS deal that is required to retain exposure to the credit risk of the deal is not expected to engage in the transactions prohibited by the re-proposed rule because Regulation RR prohibits them from hedging the interest that they retain and, otherwise, such transactions would generally perform against the economic interest of the party resulting from the retained exposure.

Compared to the re-proposed rule, Regulation RR is narrower in its scope: it restricts the conduct of only those

securitization participants that are “sponsors” for purposes of Regulation RR, the definition of which is roughly analogous to paragraph (i) of the re-proposed rule’s multi-part definition of “sponsor.”<sup>218</sup> However, the re-proposed rule would not be limited to such “sponsors” and would thus apply to various securitization participants that are not sponsors under Regulation RR and that are not required to retain credit risk under Regulation RR. Additionally, Regulation RR does not apply to several types of securitizations (e.g., arbitrage or open-market CLO, synthetic ABS, or a security issued or guaranteed by any State, or by any political subdivision of a State, or by any public instrumentality of a State that is exempt from the registration requirements of the Securities Act by reason of Section 3(a)(2) of that Act) while the re-proposed rule applies to all types of ABS securitizations as discussed in Section II.A.

Further, SEC-registered ABS offerings must comply with the SEC’s registration, disclosure, and reporting requirements. Commission disclosure requirements, including asset-level disclosures for some asset classes,<sup>219</sup> reduce asymmetric information about securitization participants and underlying assets in ABS and allow investors easy access to data and tools to review ABS deals, including to assess underlying asset quality. While disclosure in the SEC-registered ABS offerings creates incentives for securitization participants to avoid potential conflicts of interest because such conflicts would be visible to a large set of potential investors, these disclosure rules only apply to SEC-registered ABS offerings. The re-proposed rule would apply to both registered ABS and unregistered ABS (including synthetic ABS as well as hybrid cash and synthetic ABS) that are not subject to the Commission’s disclosure requirements for registered offerings by prohibiting certain types of transactions involving registered ABS and unregistered ABS that involve or would result in a material conflict of interest. Furthermore, the re-proposed rule would apply to underwriters, placement agents, initial purchasers, and sponsors of an ABS, as well as to their affiliates and subsidiaries, such that it would prohibit misconduct by securitization participants that may or

may not have disclosure liability under the Federal securities laws.

As noted above, current market practices may be generally consistent with the re-proposed rule requirements as a result of compliance with the existing rules described above. Additionally, securitization participants might be incentivized to avoid conflicted transactions in order to maintain their industry reputation and avoid reputational harm. A securitization participant that is known to regularly engage in “conflicted transactions” as defined in proposed Rule 192(a)(3) might lose its reputation among investors and its participation in ABS deals that a participant facilitates. Failure to disclose a person’s substantial role in selecting assets underlying an ABS and that person engaging in conflicted transactions would make a securitization participant potentially subject to enforcement actions under the anti-fraud provisions of the securities laws.<sup>220</sup> On the other hand, disclosing conflicted transactions to investors would create negative reputation effects for securitization participants. Thus, as a baseline matter, securitization participants may be incentivized to avoid conflicts of interest and make assurances to ABS investors about the absence of such conflicts of interest, which might serve as a signal to some investors that securitization participants have investors’ interest in mind while facilitating ABS transactions and might increase investor participation in such deals; however, it may be difficult for investors to assess the credibility of those assurances.

We preliminarily believe that this is the current market equilibrium due to market participants’ obligation to comply with the existing rules and to reputational incentives. However, we do not have data on actual incidence of conflicted transactions, and it is possible that such transactions continue to occur.

### C. Broad Economic Considerations

Securitizations are an important part of the financial system, facilitating capital formation and capital flows from investors to borrowers. However, they

<sup>216</sup> See, e.g., Consent and Final Judgement as to Defendant J.P. Morgan Securities LLC in *SEC v. J.P. Morgan Securities LLC (f/k/a/J.P. Morgan Securities Inc.)*, 11 CV 4206 (S.D.N.Y. 2011) Litigation Release No. 22008 (June 21, 2011), 2010 WL 6796637; Consent and Final Judgement as to Defendant Goldman, Sachs & Co. in *SEC v. Goldman, Sachs & Co. and Fabrice Tourre*, 10 CV 3229 (S.D.N.Y. 2010) Litigation Release No. 21592 (July 15, 2010), 2010 WL 2799362 (July 15, 2010); Senate Financial Crisis Report, *supra* note 11.

<sup>217</sup> See RR Adopting Release, *supra* note 31.

<sup>218</sup> See Regulation RR, Subpart A.2., p. 77742, *supra* note 31.

<sup>219</sup> Asset-level requirements are specified in Item 1125 of Regulation AB, 17 CFR 229.1125.

<sup>220</sup> Further, an adviser to a hedge fund, as part of the adviser’s fiduciary duty to the hedge fund, has a duty of loyalty that requires it to “make full and fair disclosure to its clients of all material facts relating to the advisory relationship” and “eliminate, or at least expose, through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.” See *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA–5248 (June 5, 2019) [84 FR 33669 (July 12, 2019)] at 33675.

can generate significant risks to the economy and ABS investors. Specifically, securitization markets are characterized by information asymmetries between securitization participants and investors in the ABS, who are the ultimate providers of credit, and such information asymmetries may give rise to two groups of adverse effects.

First, asymmetric information can reduce the willingness of less informed market participants<sup>221</sup> to transact in a given market. This is a secondary effect of “adverse selection,” the situation in which information asymmetry benefits some market participants (*i.e.*, securitization participants) to the detriment of others (*i.e.*, ABS investors).<sup>222</sup> Adverse selection has been thoroughly documented in the economic literature, and its deleterious effects on market liquidity and efficiency are well known in sectors such as banking<sup>223</sup> and insurance.<sup>224</sup> In securitization markets, adverse selection could possibly manifest itself through a reduction in the number of investors, because investors would be less informed about the quality of underlying assets than loan originators or securitization sponsors, a consequence that reduces liquidity and increases transaction costs.<sup>225</sup>

Second, asymmetric information may increase risk-taking by more informed counterparties if they do not bear the adverse consequences of such risks—an effect commonly known as “moral hazard.”<sup>226</sup> In the realm of securitizations, loan originators,

securitization sponsors, and underwriters potentially create or increase risks in the underwriting or securitization process for which they do not bear the consequence, and about which the investor lacks information.<sup>227</sup>

Securitization participants have access to more information about the credit quality and other relevant borrower characteristics than the ultimate investors in the securitized assets. Securitization participants may also participate in the selection of assets for ABS. This information asymmetry can have adverse market effects to the extent that securitization participants seek to profit from their differential information. As observed above, prior to the financial crisis of 2007–2009, sponsors sold assets that they knew to be very risky, without conveying that information to ABS investors, and sometimes even while taking financial positions to benefit from adverse performance of underlying assets.

The patterns for adverse selection and misreporting low-quality assets were even more severe in CDOs and synthetic CDOs in the period prior to the financial crisis of 2007–2009.<sup>228</sup> One paper<sup>229</sup> finds evidence consistent with the tailoring of CDO structures for short bets and negative performance, and finds that the synthetic CDOs issued in 2005–2007 that were shorted in CDS contracts performed even worse in 2008–2010. This is consistent with incentives of underwriters to structure these securities so as to profit from short positions on such securities.

There are several possible ways, which can be complementary, to mitigate the effects of such information asymmetries in the securitization process. One way to partially offset information asymmetries is to require that sponsors retain some “skin in the game,” through which loan performance can affect sponsors’ profits as much as—or more than—those of the ABS investors: that is accomplished by the credit risk retention mandated by Regulation RR.<sup>230</sup> To the extent the Regulation RR reduces adverse selection costs and moral hazard, many currently issued ABS are less likely to be instruments used in conflicted

transactions. Another way to partially offset information asymmetries is to require securitization participants to have robust disclosures of information about ABS deals or individual assets. An additional approach to partially offset the effects of information asymmetries is to directly prohibit securitization participants from engaging in certain transactions through which they could benefit from that information asymmetry, which is what the re-proposed rule, as mandated under the Dodd-Frank Act, is designed to achieve.

The adverse selection problem may be especially severe when it is costly for investors to demand from securitization participants sufficient transparency about the assets or securitization structure to overcome informational differences between these securitization participants and investors or when it is costly for investors to process such information. In these cases, the securitization process can misalign incentives so that the welfare of some market participants is maximized at the expense of other market participants. Many of these risks are not adequately disclosed to investors in securitizations, an issue that is compounded as sponsors introduce increasingly complex structures like CDOs or synthetic ABS.

Thus, the re-proposal is designed to enhance investor protection and the integrity of the ABS markets by helping to constrain the ability of securitization participants to benefit from the information asymmetry and limiting their incentives to exploit the information asymmetry at the expense of ABS investors. In particular, securitization participants would further be precluded from benefitting from the actual, anticipated, or potential adverse performance of an ABS or assets underlying such ABS. And, the re-proposed rule would help prevent the sale of ABS that are tainted by the material conflicts of interest that Section 27B is designed to address, to the extent such sales currently occur, and would curb activity that is viewed as contributing to the financial crisis of 2007–2009. In this way, the re-proposal would help prevent conflicted transactions leading to the creation and sale of ABS that facilitate amplification of risk transfer from informed to uninformed parties and the spread of risks from low quality or riskier loans throughout the financial system.

Accordingly, the re-proposal might have economic effects on broader credit markets. ABS investors may be willing to pay more or accept a lower rate of return for bearing the credit risk, which

<sup>221</sup> The term “market participants” used in this section encompasses all participants in the ABS markets, including ABS investors, and is a broader term than the proposed defined term “securitization participant.”

<sup>222</sup> See George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 *The Quarterly J. of Econ.* 488–500 (1970).

<sup>223</sup> See Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 *The Am. Econ. Rev.* 393–410 (1981).

<sup>224</sup> See Amy Finkelstein & James Poterba, *Adverse Selection in Insurance Markets: Policyholder Evidence from the U.K. Annuity Market*, 112 *J. of Pol. Econ.* 183–208 (2004).

<sup>225</sup> See Adam B. Ashcraft & Til Schuermann, *Understanding the Securitization of Subprime Mortgage Credit*, Fed. Reserve Bank of N.Y. Staff Report No. 318 (2008) (identifying at least seven different frictions in the residential mortgage securitization chain that can cause agency and adverse selection problems in a securitization transaction and explaining that given that there are many different parties in a securitization, each with differing economic interests and incentives, the overarching friction that creates all other problems at every step in the securitization process is asymmetric information).

<sup>226</sup> See, *e.g.*, Bengt Holmstrom, *Moral hazard and observability*, *Bell Journal of Economics*, pp. 74–91 (1979) and references therein.

<sup>227</sup> See *supra* note 225.

<sup>228</sup> See, *e.g.*, Senate Financial Crisis Report.

<sup>229</sup> See Oliver Faltin-Traeger and Christopher Mayer, *Lemons and CDOs: Why Did So Many Lenders Issue Poorly Performing CDOs?*, Columbia Business School Working Paper (2012) (analyzing the characteristics and performance of underlying assets going into CDOs and synthetic CDOs issued in 2005–2007 and comparing the ABS observed in a CDO with other ABS not observed in a CDO).

<sup>230</sup> See discussion of current market practices with respect to credit risk retention in Section III.B.3.

in turn could reduce borrowing costs for underlying borrowers. The direction and magnitude of this possible impact on borrowing rates would depend on the tradeoff between the costs of complying with the re-proposed rule and how market participants may reprice ABS due to enhanced investor protection benefits in the re-proposed rule.

The economic considerations above are significantly less applicable to ABS backed by the full faith and credit of the United States government. Even though investment in such fully insured or fully guaranteed ABS is not risk free, investors in such ABS are not exposed to the credit risk of individual underlying assets and, thus, are not subject to the adverse selection and moral hazard issues described above.<sup>231</sup> As a result, such ABS are less susceptible to the conflicts of interest that the re-proposed rule intends to limit. Similarly, while the Enterprises are in conservatorship, due to the unique nature of the authority and oversight of FHFA over their operations as a result of such status, they are less likely to act in a manner that would result in prohibited transactions for the benefit of private parties, and, thus, the adverse selection issues described above would be less likely to apply to them. In addition to Enterprise-guaranteed ABS, Enterprises issue CRT securities. For these Enterprise-issued CRT transactions, the Enterprises would be “sponsors” for purposes of the re-proposed rule and therefore would be prohibited from engaging in conflicted transactions with respect to investors in CRT securities (e.g., a short sale of the relevant CRT security).

#### D. Costs and Benefits

Both overall costs and overall benefits of the re-proposed rule would depend on the extent to which the existing market practices are largely consistent with the re-proposed rule and the existing investor protection mechanisms via anti-fraud and anti-manipulation provisions of the securities laws. Costs and benefits are separately discussed in the next sections in more detail.<sup>232</sup>

##### 1. Benefits

Investors in ABS economically benefit from the performance of ABS that is commensurate with the level of risk that investors are willing to take and, generally, they do not benefit from the

adverse performance of ABS. The re-proposed rule would benefit investors by prohibiting securitization participants from engaging in certain transactions through which they would benefit from the actual, anticipated, or potential adverse performance of an ABS, or assets underlying such ABS, to the detriment of ABS investors. Additionally, the re-proposed rule would provide broad investor protection by prohibiting conflicted transactions and this protection could help alleviate investor concerns that the securities they purchase might be tainted by certain material conflicts of interest. It could also help reduce moral hazard and adverse selection costs in the ABS market, leading to better investor protection and lower cost of capital.<sup>233</sup>

The re-proposed rule could enhance market stability through reduced incentives to engage in conflicted transactions and other speculative activity in the ABS market. This effect could be especially pronounced for asset pools that are involved in re-securitizations or synthetic ABS because of their complexity and the relative difficulty of assessing information about underlying assets of such ABS. Enhanced market stability would reduce the variance of ABS prices in the primary market and volatility of ABS prices in the secondary market.

Lower adverse selection costs, higher expected liquidity, and lower expected volatility in ABS markets can lower the expected return required by ABS investors to invest in ABS and, in turn, that may lower credit costs in loan markets for households and corporations whose debts enter the reference asset pools underlying the asset-backed securitizations. For the reasons explained above, therefore, this re-proposal could lead to lower credit costs to the extent it would lower adverse selection costs, increase expected liquidity, and lower expected volatility.

We believe our proposed definitions of the terms “underwriter,” “placement agent,” “initial purchaser,” “sponsor,” “material conflict of interest,” and “conflicted transaction” in the re-proposed rule would capture with

precision the types of securitization participants and types of conflicts of interest at which Section 27B is aimed, would reduce asymmetric information between securitization participants and investors, and, in turn, may reduce evasion and better protect investors. In particular, the proposed definition of “sponsor” captures both the contractual rights associated with sponsoring ABS and a person’s function in connection with a securitization. The function prong in the proposed definition of sponsor relies on a determination of directing the structure of the ABS or the composition of its underlying asset pool rather than solely on contractual rights to exercise discretion over ABS. The proposed definition would reduce rule evasion executed through non-contractual control over the composition of the asset pool for ABS. All these effects would further reduce adverse selection costs in the ABS market and encourage investment in asset-backed securities to the extent that investors consider material conflicts of interest important in their investment decisions. Clearly defined terms also facilitate compliance with the rule and reduce compliance costs.

The re-proposed rule would commence application of the rule’s prohibition when a person has reached, or has taken substantial steps to reach, an agreement to become a securitization participant. This approach in the re-proposed rule would help prevent evasive conduct that might happen before closing of a securitization and, thus, further enhance investor protection benefits of the re-proposed rule. Similarly, covering affiliates or subsidiaries of securitization participants under the proposed definition of “securitization participant” would help ensure that the benefits of the re-proposed rule are not nullified through evasive conduct executed via such affiliates or subsidiaries.

In addition, the re-proposed rule would specify the scope of conflicts of interest through the proposed definitions of the terms “material conflict of interest” and “conflicted transaction.” “Material conflict of interest” would be defined as any transaction that would involve or result in a material conflict of interest between a securitization participant of an ABS and an investor in such ABS if such a transaction is a conflicted transaction. The proposed definition of “conflicted transaction” would include explicit descriptions of specific types of conflicting transactions and would also include any financial instrument through which the securitization

<sup>231</sup> See discussion in Section II.B.2.c.i.

<sup>232</sup> As discussed above, some commenters on the 2011 proposed rule discussed the proposal’s economic analysis. In light of the changes in the re-proposal, the economic analysis in this release addresses the costs and benefits of the re-proposal.

<sup>233</sup> Adverse selection in securitizations arises because securitization participants have information about the underlying asset selection process and the underlying asset quality that ABS investors do not have. Thus, the ABS offering price might exceed ABS private value known to securitization participants. ABS investors, therefore, might require a higher rate of return on ABS tranches to compensate them for the risk of buying lower valued assets, which is a cost of adverse selection. If the asymmetric information is reduced, the adverse selection costs might reduce as well. See *supra* note 225.

participant would benefit from the actual, anticipated, or potential adverse performance of an ABS or its underlying asset pool.<sup>234</sup> These aspects of the re-proposal would tailor the prohibition of the re-proposed rule to certain conflicts of interest. At the same time, however, the proposed anti-circumvention provision states that a transaction that circumvents the prohibition is a conflicted transaction even if the definitions do not address the form, label, or documentation of the transaction in question. In addition, the proposed definition of the term “material conflict of interest” looks to whether securitization participants who engage in an ABS would benefit from a “conflicted transaction” (as defined above) and whether a reasonable investor would consider the conflicted transaction important to the investor’s investment decisions. These elements of the re-proposal may capture certain types of material conflicts of interest that give rise to adverse selection and moral hazard costs. The magnitude of economic benefits from a reduction of these costs may be dampened to the degree that market participants already avoid such material conflicts of interest.

The re-proposed rule provides exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities, which are consistent with Section 27B. As discussed below, all of these exceptions taken together could improve market efficiency and facilitate investor protection without diluting the investor protection benefits of the re-proposed rule. The re-proposal’s conditions for the availability of these exceptions would permit valuable risk-mitigating hedging, liquidity provision, and bona fide market-making, while reducing the severity of conflicts of interest between securitization participants and investors in ABS, thus enhancing investor protections. Defining the scope of these exceptions may also ease compliance with the rule, although benefits from specificity could be dampened by the proposed anti-circumvention provision which states that a transaction circumventing the proposed prohibition will be deemed a conflicted transaction. To the extent the proposed anti-circumvention provision prevents misuse of the exceptions, however, that provision would strengthen investor protections.

Risk-mitigating hedging activities permit a securitization participant to fine-tune the amount of credit risk taken or to limit some of the consequences of

taking a risk. We believe that the proposed risk-mitigating hedging activities exception would promote the re-proposed rule’s benefits of investor protection without prohibiting securitization participants’ risk mitigation activities, unduly increasing securitization participants’ costs of engaging in such activities, or increasing barriers to entry in ABS markets. Thus, the proposed exception may improve efficiency of ABS markets and help protect ABS investors. The re-proposed rule’s conditions that risk-mitigating hedging activities do not facilitate or create an opportunity to benefit from a conflicted transaction, and that a securitization participant establishes an internal compliance program, enhance the benefits of the rule by assuring investors that risk-mitigating hedging activities of securitization participants would be less likely to create (intentionally or inadvertently) economic conflicts of interest with investors. Moreover, the policies and procedures in the proposed risk-mitigating hedging activities exception that provide for the identification, monitoring, and documentation of the risk and related hedging could be used by the Commission in its examination programs for regulated entities. Thus, the proposed risk-mitigating hedging activities exception would help ensure the investor protection benefits of the rule, while allowing risk-reducing actions of securitization participants.

The proposed exceptions for liquidity commitments and bona fide market-making activities may help prevent a loss of secondary liquidity and efficiency in the ABS market and, thus, benefit ABS investors. The re-proposed rule conditions for the availability of and limits on the liquidity commitments and bona fide market-making activities exceptions, as well as the requirement that a securitization participant establish an internal compliance program, may enhance the benefits of the re-proposal by assuring investors that such activities of securitization participants would be less likely to create (intentionally or inadvertently) economic conflicts of interest with investors.

The re-proposed rule also includes an exception from the proposed definition of “sponsor” for the United States, agencies of the United States, and, subject to certain conditions, the Enterprises, in each case with respect to an ABS that is fully insured or fully guaranteed by the relevant entity. While the Enterprises are in conservatorship with the U.S. Treasury and the Enterprises retain all credit risk associated with guaranteed ABS, market

participants perceive Enterprise-guaranteed ABS as having almost no credit risk.<sup>235</sup> Also, as discussed above in Section II.B.2.c.ii., while the Enterprises are in conservatorship, due to the unique nature of the authority and oversight of FHFA over their operations as a result of such status, as well as the capital support provided by Treasury under the PSPAs, the Enterprises are not expected to act in a manner that would result in conflicted transactions that would benefit private parties, and, thus, are not expected to engage in the adverse selection of assets for their ABS. Thus, this exception from the proposed definition of “sponsor” would not adversely affect investors, would help ensure that U.S. mortgage borrowers do not face any additional mortgage borrowing costs, and, in the case of the Enterprises, would continue to allow the Enterprises to transfer credit risk to private investors to lower the Enterprises’ capital requirements and increases the Enterprises’ return on capital.

## 2. Costs

The re-proposed rule would create direct compliance costs for securitization participants, some of which are discussed in detail in Section IV.C. The compliance costs could come from the need to establish policies, procedures, and informational barriers to implement the re-proposed rule, as well as associated legal review.<sup>236</sup> The re-proposed rule could also create higher monitoring costs in order to avoid entering into covered transactions. To the extent that market participants have compliance systems that could be modified to help ensure compliance with the re-proposed rule, these compliance costs would be lower.

Section IV below estimates the initial and ongoing compliance costs to implement, maintain, and enforce written policies and procedures for securitization participants that would be relying on the risk-mitigating hedging activities or bona fide market-making activities exceptions of the re-proposed rule.<sup>237</sup> As estimated in Section IV, we expect the industry-wide total annual paperwork burden of the re-proposed rule for securitization participants to prepare, review, and update the policies and procedures under the re-proposed

<sup>235</sup> See, e.g., Zhiguo He & Zhaogang Song, *Agency MBS as Safe Assets*, NBER Working Paper no. 29899 (2022).

<sup>236</sup> One commenter suggested that the rule would significantly increase costs, including legal costs. See ABA Letter at 15.

<sup>237</sup> See Section IV (discussing costs and burdens relating to the re-proposed rule for purposes of the Paperwork Reduction Act).

<sup>234</sup> See Section II.D for a more detailed discussion of possible conflicting transactions.

rule to be 45,540 burden hours. Using the same \$600 hourly cost of either retaining outside professionals or estimates of internal hourly salaries of senior compliance officers, we estimate that the total annual direct compliance cost would be \$27,324,000.

As required by Section 27B(a), the scope of securitization participants in the re-proposed rule includes affiliates and subsidiaries of underwriters, placement agents, initial purchasers, and sponsors. In some instances, the activities of an affiliate or subsidiary may not be known to the underwriter, placement agent, initial purchaser, or sponsor, and could, inadvertently, involve or result in a material conflict of interest with the investors in the ABS. Monitoring the activities of the affiliate or subsidiary for conflicts could be operationally difficult, especially when there are existing information barriers between the entities, including for reasons unrelated to the ABS (e.g., between investment banking and trading). This additional monitoring could also impose additional compliance costs for large groups of affiliated financial entities.

Despite the inclusion of the risk-mitigating hedging activities exception, restrictions under the re-proposed rule could limit risk mitigation and revenue-enhancing investment options available to affected securitization participants. For example, by restricting the type and extent of hedging allowed to those activities excepted from the re-proposed rule, securitization participants may not be able to actively hedge their portfolio exposure. This outcome could require securitization participants to increase their fees to compensate for the loss of ability to hedge some risks. Alternatively, such costs could be borne by securitization participants or passed to investors in the form of lower expected returns or to borrowers in the form of higher cost of capital.

We recognize that the re-proposed rule could affect the scope of some current activities undertaken by underwriters, sponsors, and other securitization participants, if they perceive such activities as conflicting with the re-proposed rule. For example, one commenter to the 2011 proposed rule suggested that financial firms might not be able to determine with a sufficient level of certainty that a conflict of interest exists or does not exist with respect to a transaction, and that this lack of clarity will provide significant disincentive for activity in ABS.<sup>238</sup> This commenter also stated that potential participants in ABS

transactions could be conflicted out and, as a result, securitization markets in some situations could function less effectively, which could ultimately be detrimental to consumers of credit, the economy, and investors.<sup>239</sup> Further, we recognize that curtailment or cessation of some activities, in turn, could lead to potential costs for such participants and the broader securitization market. As described below, material conflicts of interest might only arise between an investor and a particular securitization participant, which might lead the investor to seek a relationship with another securitization participant. However, other material conflicts of interest could arise as a result of the nature or structure of the transaction as a whole (without regard to the identity of the securitization participants involved), such that these types of transactions might be effectively prohibited. In such cases, there might be costs to the marketplace as a whole as investors and securitization participants seek alternative and potentially less efficient transaction structures to effect a similar investment strategy in a way that would not result in a material conflict of interest, or if investors and securitization participants were unable to effect their investment strategies at all.

Thus, the re-proposed rule could result in the loss of clientele for some securitization participants, especially diversified firms that service different risk-mitigation and investment needs of clients, customers, or counterparties. This could have an adverse impact on securitization participant revenues as well as costs, due to the nature of the business (for example, underwriting), where finding and retaining clientele could be an expensive activity.

At the same time, clients, customers, or counterparties of covered parties in the ABS market could also face higher search costs as they might need to find new, non-conflicted counterparties. The clients, customers, or counterparties also could bear undesirable costs by losing the ability to utilize firms with particular expertise or specialization in certain areas due to real or perceived material conflicts of interest. Clients, customers, or counterparties might also incur costs in searching for a different firm to consummate a transaction, where they have a preexisting relationship that they too have invested resources into developing. In addition, to retain their ability to utilize specific firms for non-asset-backed security

related transactions, some potential clients, customers, or counterparties might choose to forgo the ABS investment. We recognize that if the re-proposed rule were to cause an investor to forgo an ABS investment entirely, the investor could incur costs in seeking out alternative investments as well as the opportunity cost of the loss of return from the ABS investment.

Taken together, conflicting out certain relationships can reduce market liquidity and investor choice through a decline in the available set of investment opportunities. This decline could be more acute in the short-term when securitization participants and clients, customers, or counterparties realign their business practices to comply with the rule, but it could persist even in the long run.

The re-proposed rule could impose certain costs upon departments within a firm not directly involved with the securitization process, by influencing their ability to conduct transactions that could result in a material conflict of interest with investors in an asset-backed security for which the firm is a securitization participant. The scope of the re-proposed rule could require monitoring for potential material conflicts of interest within all or many departments of the firm. If any department's proposed transaction were determined to raise a potential material conflict of interest, that department would have to abandon the proposed transaction or wait until the re-proposed rule's prohibition period ended.

The re-proposed rule may have significant costs with respect to how firms and clients, customers, or counterparties establish, maintain, and benefit from relationships. For instance, because larger financial entities tend to be organized in an effort to achieve synergies and economies of scope in combining and offering multiple services, restrictions on such activities could lead to changes to their business activities that could reduce firm earnings. These potential changes could have some disruptive effect on the firms, their clients, customers, or counterparties, and the broader marketplace, reducing current efficiencies that may exist. Restricting the ability of securitization participants to maintain relationships that service multiple objectives could ultimately negatively affect both financial firms and their clients', customers', or counterparties' ability to conduct economically efficient activities.

As discussed above, we do not believe that there is a significant amount of activity in the synthetic or hybrid cash and synthetic securitization markets

<sup>239</sup> SIFMA Letter at 5–6, 22, 33. Similarly, another commenter also suggested that the rule could affect the availability of credit. CRE Letter at 3.

<sup>238</sup> See SIFMA Letter at 2, 22.

outside of the Enterprises' CRT market, and therefore, we do not believe that any economic effects stemming from the synthetic securitization markets would be substantial. We do, however, recognize that—to the extent that the re-proposed rule could curtail some prospective activity in the market—the transactions prohibited by the re-proposed rule may involve or result in a material conflict of interest that is prohibited by Section 27B, and as a result, there may be some investor protection benefits for synthetic securitizations associated with the re-proposed rule, as discussed above.

Paragraph (ii)(B) of the re-proposed definition of the term “sponsor”—proposing to define a “sponsor” functionally as any person that directs or causes the direction of the structure, design, or assembly or the composition of the pool of assets of an ABS—might increase securitization participants' costs because entities would have to determine, under the specific facts and circumstances, whether they fall under this definition. Such costs might arise even for entities that perform solely administrative, legal, due diligence, custodial, or ministerial functions because such entities would also need to determine whether they fall within the ministerial exception of the term “sponsor.”

The re-proposed rule would also commence application of the rule's prohibition when a person has reached, or has taken substantial steps to reach, an agreement to become a securitization participant. This commencement point would increase costs on securitization participants and those who seek to become securitization participants, because of the need to determine whether and at what point they are covered by prohibitions under the re-proposed rule. Additionally, some entities might avoid participation in some other market activities even if they are not participating in any securitizations, due to potential uncertainty and perceived difficulties in making the determination of whether they are securitization participants for purposes of the re-proposed rule, thus reducing the efficiency of those markets.

The re-proposed rule would also define the terms “material conflict of interest” and “conflicted transaction” by including explicit descriptions of specific types of conflicting transactions and also including any transaction through which the securitization participant would benefit from the actual, anticipated, or potential adverse performance of an ABS or its underlying asset pool. Although complying with the statutory prohibition could result in

the re-proposed rule imposing the costs discussed earlier in this section, these costs might be mitigated by the certainty and clarity provided by the proposed definitions of these key terms. In particular, the proposed detailed definitions of “material conflict of interest” and “conflicted transaction” might make it easier for securitization participants to evaluate a potentially conflicting transaction, including those covered by the proposed anti-circumvention provision.

Exceptions under the re-proposed rule might give rise to additional costs. As discussed above, the re-proposed rule provides exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities, which are consistent with Section 27B. As discussed in Section III.D.1., we believe that such exceptions would preserve the ability of securitization participants to reduce and mitigate specific risks that arise out of underwriting, placement, initial purchase, or sponsorship of an asset-backed security, and may preserve secondary market liquidity and efficiency, while enhancing investor protections. However, we recognize that securitization participants would bear additional costs in dedicating resources to determine whether their activities fall within these exceptions. Moreover, securitization participants would incur costs of complying with conditions for the availability of these exceptions, such as costs related to the policies and procedures requirement for risk-mitigating hedging activities and bona fide market-making activities exceptions, as discussed in greater detail in Section III.D.2.

Finally, the re-proposed rule would provide an exception for the Enterprises while the Enterprises are in conservatorship and when they act as sponsors of securitizations. If the Enterprises exit conservatorship, the Enterprises would likely face increased costs similar to those outlined above for private-label ABS issuers and might have to re-structure or abandon their CRT offerings to comply with the re-proposed rule. As a result, an Enterprise exit from conservatorship might result in increased costs for U.S. mortgage borrowers and higher Enterprise capital requirements.

#### *E. Anticipated Effects on Efficiency, Competition, and Capital Formation*

The scope of activities under the re-proposed rule that could constitute material conflicts of interest could potentially impact market efficiency, competition among asset-backed

securitization market participants, and capital formation via the ABS markets.

As discussed above in Section III.D.1., the re-proposed rule would generally lead to lower adverse selection costs, higher expected liquidity, and lower expected volatility in the ABS markets. Taken together, these benefits would improve the efficiency of the ABS markets.

Other factors could also affect efficiency. As an initial matter, larger entities with multiple business lines could have, as a result of their structure, unavoidable material conflicts of interest and such entities might abandon their participation in securitizations to avoid violating the re-proposed rule. An investor that utilizes such entities for multiple services could have to switch to competitors or, depending on the structure of asset-backed security, forgo the transaction. Thus, the re-proposed rule could increase competition amongst covered parties and relatively smaller entities might gain market share at the expense of relatively larger entities. The re-proposed rule could create competitive benefits for less diversified firms and firms that already have in place policies and procedures similar to the ones required by the re-proposed rule. One commenter to the 2011 proposed rule similarly stated that the rule could lead to increased competition among underwriters in the ABS market, which could in turn increase efficiency and help reduce moral hazard related to having fewer underwriters in the ABS market who may, therefore, be more inclined to take larger risks.<sup>240</sup> In addition, some of the parties and capital could move out of ABS market and into alternative markets that cater to customers' investment needs.

On the other hand, certain requirements of the re-proposed rule that would be applicable to the risk-mitigating hedging activity exception and bona fide market-making activities exception are similar to those under the Volcker Rule (see discussion in Sections I.E. and I.G.). Such similarity would be more beneficial to securitization participants that are already familiar with the Volcker Rule compliance issues and already have relevant programs in place, because these securitization participants would incur lower initial costs of compliance. Securitization participants of this type tend to be larger entities (e.g., bank holding companies). Accordingly, those that are not subject to the requirements of the Volcker Rule could incur larger initial compliance costs.

<sup>240</sup> See Tewary 1 Letter at 17.

ABS investors could incur additional search costs and enjoy less efficient business processes due to the loss of relationships with securitization participants described above. Securitization participants could also lose profits or fees that would have resulted from conflicting transactions,<sup>241</sup> and, potentially, future profits and fees if investors take future business to other securitization participants. In addition, investors and financial firms could both lose the financial benefits from established relationships with securitization participants. As firm-investor relationships are costly to develop, but valuable to maintain,<sup>242</sup> securitization participants and ABS investors might find application of the re-proposed rule to be disruptive in some circumstances of maintaining firm-investor relationships. Thus, the re-proposed rule may result in a contraction in securitization markets' size, liquidity, or efficiency, and these adverse effects may flow through to asset markets underlying ABS and investors in such asset markets.

Since the ABS offering process can involve multiple lead underwriters or underwriting syndicates with several members,<sup>243</sup> the re-proposed rule could have a multiplicative effect by conflicting out several unaffiliated financial institutions. Securitization participants may react to the re-proposed rule by reducing the number of parties involved in a securitization, which may negatively affect the manner in which ABS are structured and underwritten and may reduce the efficiency of the securitization process. As previously stated, the scope of the statutory prohibition could amplify the inability of departments within a securitization participant to conduct business as they have in the past, which could increase financial costs, as well as heighten market inefficiency. These inefficiencies could ultimately negatively impact investors in ABS, as well as the consumers whose loans back the ABS.

<sup>241</sup> This may result in reduced fees or a move of transaction activity to other securitization participants that offer similar services at lower fees, which may benefit ABS investors. *See also* Tewary 1 Letter at 16.

<sup>242</sup> *See, e.g.,* Murat M. Binay, Vladimir A. Gatchev, and Christo A. Pirinsky. *The Role of Underwriter-Investor Relationships in the IPO Process*, *Journal of Financial and Quantitative Analysis* 42, no. 3, 785–809 (2007), and the literature reviewed therein.

<sup>243</sup> We observe that out of 1,441 non-municipal ABS deals in the baseline period, 660 deals had more than one underwriter and out of 1,928 municipal ABS deals, 841 had more than one underwriter.

The re-proposed rule may reduce informational efficiency of ABS prices. Informed short positions of securitization participants can aid in price discovery and the re-proposal would reduce information about intrinsic values that would otherwise have been embedded in ABS prices due to informed trades of securitization participants. However, the re-proposed rule would also reduce the effects of information asymmetries between securitization participants and ABS investors, which may reduce adverse selection costs and may increase the willingness of ABS investors to engage in ABS transactions, thus, possibly improving informational efficiency of ABS prices.

The re-proposed rule could adversely impact short-term and medium-term operational efficiency of the ABS market because covered parties and their customers may seek less efficient transaction structures to effect investment strategies similar to the current baseline. However, as securitization participants adapt their transaction activity to avoid conflicted transactions, the ABS market is likely to become more accessible, more liquid, and less volatile. This may improve the longer-term operational efficiency of the ABS market and the underlying debt markets.

Enhanced investor protection and more stable ABS markets could result in greater investor participation, resulting in higher capital formation. To the extent that the re-proposed rule reduces the adverse selection costs and improves pricing efficiency that follow from the asymmetric information problem discussed in Section III.C. above, it would result in more efficient allocation of capital and thereby enhance capital formation.

However, the potential benefits of the re-proposal for capital formation could be offset by potential losses in investment opportunities due to disruptions in relationships with securitization participants, at least in the short-term. The re-proposed rule could negatively impact economic efficiency both from the point of view of securitization participants, and sometimes also from the point of view of investors who seek to invest in asset pools that back ABS, if certain ABS transactions did not occur because of the scope of the re-proposed rule.

The re-proposed rule also provides an exception from the proposed definition of “sponsor” for the United States or an agency of the United States or for the Enterprises, while the Enterprises are in conservatorship, when they act as sponsors of securitizations that are fully

guaranteed. If the Enterprises do exit conservatorship, additional frictions created by the need for the Enterprises to comply with the re-proposed rule requirements would likely weaken the competitive position of the Enterprises compared to private-label ABS issuers, in particular, increasing costs and possibly hampering capital formation in the mortgage market via the Enterprise channel. However, some of that capital formation could move to private-label ABS markets that might gain some competitive advantage if Enterprises have to incur additional costs. If the Enterprises were to become private entities and to maintain an exemption post conservatorship, that would disadvantage other private entities that would not enjoy such an exemption.

#### F. Reasonable Alternatives

We considered a number of alternative approaches, with some of the alternatives suggested by commenters to the 2011 proposed rule. This section considers potential economic effects of reasonable alternatives.

##### 1. Scope

We could change the scope of the definition for securitization participants. One alternative to our proposed definition would be to broaden the definition of the terms “placement agent” and “underwriter” to include language used in the Volcker Rule that would include “a person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.” While this approach could offer additional investor protections, we preliminarily believe that the benefits associated with applying the rule’s prohibitions to persons with an ancillary role in the distribution of an ABS, such as selling group members who have no direct relationship with an issuer or selling security holder, would not offer substantial benefit, and could substantially increase compliance costs. Alternatively, we could also narrow the scope of securitization participants. We could, for example, exclude persons who have only taken substantial steps to reach an agreement—but have not reached such agreements—to become an underwriter, placement agent, initial purchaser, or sponsor, of an ABS. This could reduce compliance costs associated with determining when the potential securitization participant has taken substantial steps to reach an agreement to participate. We believe, however, that this could increase the circumstances in which a person attempts to evade the rule by engaging

in prohibited conduct prior to when the person signed an agreement to be securitization participant. We could also narrow the scope of securitization participants, as suggested by some commenters, to exclude persons such as underwriters, initial purchasers, or placement agents who did not structure an ABS transaction or select the assets underlying the ABS.<sup>244</sup> We preliminarily believe, however, that this approach would not offer the investor protection benefits associated with including these persons, given that this could also create opportunities to evade the intended prohibition of Section 27B and the re-proposed rule.

As discussed above in Section II.A., the re-proposal would specify the scope of material conflicts of interest for purposes of the re-proposed rule as conflicts of interest that arise between a securitization participant for an ABS and investors in such ABS, as a result of engaging in any transaction through which the securitization participant would benefit from the actual, anticipated, or potential adverse performance of an ABS or its underlying asset pool. This aspect of the re-proposal would limit the scope of the prohibition to certain conflicts of interest, rather than extending the re-proposed rule's prohibition to broader conflicts of interest that are wholly independent of and unrelated to a specific ABS. Defining the scope of the re-proposed rule to broadly cover any conflict of interest between securitization participants and investors would significantly increase the costs of the rule and decrease efficiency of the securitization markets. Therefore, the tailoring of this prohibition in the re-proposed rule may reduce the economic costs of the re-proposal as discussed above.

## 2. Information Barriers

The re-proposal could have included an exception for affiliates or subsidiaries of securitization participants that rely on information barriers, under certain conditions. Such conditions could include a requirement that the affiliate or subsidiary is engaged in a business wholly unrelated to securitization; that the securitization participant establishes, maintains, and enforces information barriers, such as physical separation of personnel and functions, and limits permissible activities as memorialized in reasonably designed written policies and procedures; that existing rules and regulations already provide for managing conflicts of interest or restricting information flow

at the affiliate or subsidiary; and that offering documents for the ABS disclose the types of transaction that the affiliate or subsidiary could engage in as part of their normal, ordinary course of business.

As discussed above in Sections II.B.3. and III.D.2., the re-proposed rule may be significantly more costly for large and diversified securitization participants that have an extensive network of affiliates and subsidiaries, such as investment companies and investment advisers, engaged in unrelated businesses. Relative to the re-proposed rule, an information barriers exception could reduce the above costs of the prohibition for securitization participants with large affiliate and subsidiary networks, especially if the affiliate or subsidiary is already subject to existing rules and regulations that provide for conflict management or restricting information flow.<sup>245</sup> To the degree that such an alternative could reduce the scope of ABS transactions that would become conflicted, it could allow a greater number of securitization participants to retain relationships with ABS investors and continue transacting in ABS. Thus, the alternative may reduce disruptions to counterparty relationships, with potential beneficial effects on efficiency and capital formation in ABS and underlying asset markets.

However, an alternative that reduces the scope of conflicted transactions, but adds information barriers, may be insufficient to manage conflicts of interest intended to be addressed by the re-proposed rule and may be difficult to monitor and enforce.<sup>246</sup> Thus, such an alternative may reduce the scope of adverse selection and investor protection benefits relative to the re-proposal. However, conditions on the availability of the information barriers alternative, such as those listed above, could reduce those adverse effects of the alternative.

In addition, an information barriers alternative would give rise to its own costs related to the conditions for the applicability of the alternative exception, such as costs of physically separating personnel and functions, costs of designing related policies and procedures, and costs of monitoring and enforcing information barriers. Notably, under the alternative, securitization participants would choose to rely on such an exception only if costs of

complying with the information barriers exception would be lower than costs of complying with the re-proposed rule's prohibitions.

## 3. "Sponsor" Exceptions

Potential alternatives to excluding from the definition of "sponsor" the United States or an agency of the United States or the Enterprises, while the Enterprises are in conservatorship, and when they act as sponsors of securitizations that are fully guaranteed, would likely result in lower benefits or higher costs. Providing no exclusion from the definition for such entities as sponsors of government-guaranteed securitizations or for the Enterprises' securitizations may increase frictions in the government-guaranteed or the Enterprise ABS or CRT processes, perhaps increasing costs for U.S. mortgage borrowers or limiting the transfer of credit risk to investors, without attendant benefits of reducing the adverse selection problem in securitizations, which is alleviated by the government guarantee or the conservatorship. Making the Enterprise exclusion permanent (*e.g.*, keeping it regardless of whether the Enterprises are in conservatorship) may reduce investor benefits in the long run because post-conservatorship structure of the Enterprises might affect their incentives when they participate in securitizations. If the Enterprises were to become private entities and to maintain an exemption post conservatorship, that would also disadvantage other private entities that would not enjoy such an exemption. Indeed, uncertainty persists regarding the nature or timing of the Enterprises' exit from conservatorship, private or government participation in the Enterprises after conservatorship, or how any changes in Enterprise structure surrounding conservatorship may affect conflicts of interest. Finally, an alternative that would provide an exception for government-guaranteed securities and Enterprise-guaranteed securities accordingly would provide an exception to all participants in such securitizations (and not just the sponsors), which would reduce the scope of adverse selection and investor protection benefits relative to the re-proposal.

Another alternative exception concerns synthetic CLOs. As described in Section II.A., we received comments to the 2011 proposed rule that suggested an exception for certain synthetic balance sheet CLOs. Providing such exception would reduce compliance costs to certain banks and CLO managers who could use such CLOs as a risk management tool. However, such

<sup>245</sup> See, *e.g.*, ABA Letter at 11–12; ASF Letter at 10–11; Roundtable Letter at 10; SIFMA Letter at 14–15.

<sup>246</sup> See Barnard Letter at 2; Better Markets Letter at note 23; Public Citizen Letter at 1, 4–5; Tewary 1 Letter at 13–14.

<sup>244</sup> See SIFMA Letter at 10.

an alternative may reduce the scope of adverse selection and investor protection benefits relative to the re-proposal because a conflicted transaction could be structured using such instruments.

#### 4. Conditions of the Exceptions

We considered alternative conditions of the proposed exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities as described in detail in Sections II.E., II.F., and II.G., respectively, including alternatives suggested by the comments to the 2011 proposed rule. Generally, making the conditions for the exceptions less stringent would reduce investor protection benefits of the re-proposed rule while also reducing compliance costs. Conversely, making the exceptions more stringent (*e.g.*, making the exception for bona fide market-making activities more stringent than the equivalent concept in the Volcker Rule) would increase compliance costs and could restrict the relevant activities, although it may provide additional investor protection benefits. We believe that the re-proposed conditions, in particular their similarity to the existing rules (*e.g.*, in the case of the bona fide market-making activities exception, with the concept of market-making in both the Volcker Rule as well as 15 U.S.C. 78c(a)(38)), would strike the appropriate balance between investor protection benefits and compliance costs of the re-proposed rule. The re-proposed conditions would allow securitization participants sufficient flexibility to design their securitization related risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities in a way that is not unduly complicated or cost prohibitive.

We also considered proposing a certification requirement for using the risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities exceptions. Under this alternative, an officer within the securitization participant would certify that the conditions supporting the exception had been met. This additional step might provide additional investor protection, but might also create additional paperwork and procedural burdens associated with documenting the exception. To avoid these burdens, or perceived enforcement or liability risk, securitization participants might choose not to engage in the excepted activities even in legitimate circumstances.

#### G. Request for Comments

We request comment on all aspects of our economic analysis, including the potential costs and benefits of the re-proposed rule and alternatives thereto, and whether the rule, if we were to adopt it, would promote efficiency, competition, and capital formation. In addition, we request comments on our selection of data sources, empirical methodology, and the assumptions we have made throughout the analysis. Commenters are requested to provide empirical data, estimation methodologies, and other factual support for their views, in particular, on costs and benefits estimates. We especially appreciate comments that distinguish between costs and benefits that are attributed to Section 27B itself and costs and benefits that are a result of policy choices made by the Commission in implementing the statutory requirements. In particular, we request comments on the following questions on the Economic Analysis:

98. What additional qualitative or quantitative information should be considered as part of the baseline for the economic analysis of the re-proposed rule?

99. Are the costs and benefits of the re-proposed rule accurately characterized? If not, why not? Should any of the costs or benefits be modified? What, if any, other costs or benefits should be taken into account? If possible, please offer ways of estimating these costs and benefits. What additional considerations can be used to estimate the costs and benefits of the proposed amendments?

100. What would be the impact of the re-proposed rule on the ultimate borrowers (*e.g.*, households, businesses)? What aspects of the re-proposed rule would have the biggest impact, and how would the impact change if that aspect of the rule were revised? What would be the direction and magnitude of possible impact of the re-proposed rule on the borrowing rates and credit availability? What, if any, data could be used to estimate the impact?

101. Would the types, or extent, of any benefits or costs of the re-proposed rule differ between different types of securitizations? For example, do potential benefits or costs differ in their application to ABS backed by different types of assets? Do the types, or extent, of any benefits or costs from the re-proposed rule differ between ABS and synthetic ABS? If so, how do the benefits or costs differ?

102. Would the potential benefits and costs differ for securitizations of different size?

103. Are the costs and benefits of the re-proposed rule different between municipal ABS and non-municipal ABS? How does the re-proposed rule affect ultimate borrowers of loans that back municipal ABS?

104. Would potential benefits and costs differ for securitization participants of different size?

105. What potential costs might arise in relation to monitoring for transactions that would result in a material conflict of interest between a securitization participant and investors in the ABS? Do securitization participants have existing procedures that might help mitigate potential costs? What is the proportion of securitization participants that currently enter into contractual assurances that would be compliant with the re-proposed rule?

106. With respect to potential costs related to the re-proposed rule prohibiting transactions by affiliates, subsidiaries, or another department within the firm that would result in a material conflict of interest with investors in the ABS, is it possible to quantify the cost of not being permitted to undertake such transactions?

107. Are the effects on competition, efficiency, and capital formation arising from the proposed amendments accurately characterized? If not, why not?

108. Are the economic effects of the above alternatives accurately characterized? If not, why not? Should any of the costs or benefits be modified? What, if any, other costs or benefits should be taken into account?

109. Are there other reasonable alternatives to the proposed amendments that should be considered? What are the costs, benefits, and effects on competition, efficiency, and capital formation of any other alternatives?

110. Are there data sources or data sets that can help refine the estimates of the costs and benefits associated with the proposed amendments? If so, please identify them.

111. What are the benefits and costs of reasonable alternatives to the proposed conditions for the exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities? Are there alternative conditions we should include, and if so, why?

112. What benefits and costs might result from requiring an officer to certify that the conditions supporting the

exceptions for risk-mitigating hedging activities, liquidity commitments, and bona fide market-making activities had been met? In what ways (if any) would such a requirement alter the behavior of securitization participants?

**IV. Paperwork Reduction Act**

*A. Summary of the Collection of Information*

Certain provisions of the re-proposed rule would impose a new “collection of information” requirement within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>247</sup> The Commission is submitting the re-proposed rule to the Office of Management and Budget (“OMB”) for review in accordance with the PRA.<sup>248</sup> The title for this proposed new information collection is “Prohibition Against Conflicts of Interest in Certain Securitizations.” OMB has not yet an assigned control number to the collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The re-proposed rule would implement Section 621 of the Dodd-Frank Act, which added Section 27B to the Securities Act, by prohibiting securitization participants from directly or indirectly engaging in any transaction that would involve or result in any material conflict of interest between a securitization participant for such ABS and an investor in such ABS. A more detailed description of the re-proposed rule, including the need for the information and its proposed use, as well as a description of the likely respondents, can be found in Section II above, and a discussion of the economic effects of the re-proposed rule can be found in Section III above.

The collection of information would be mandatory for securitization participants that rely on two exceptions to the re-proposed rule described below. Additionally, the collection of information is not required to be filed with the Commission or otherwise made publicly available but would not be confidential.

*B. Respondents Subject to Rule*

The re-proposed rule would not require a securitization participant to implement, maintain, or enforce written policies and procedures, unless it is relying on the risk-mitigating hedging activities or bona fide market-making activities exceptions of the re-proposed rule. The proposed policies and

procedures requirements are intended to help prevent evasion of the re-proposed rule and the abusive conduct at which Section 27B to the Securities Act is aimed by requiring the implementation, maintenance, and enforcement of frameworks to facilitate compliance with the other conditions of each exception. If a securitization participant were a regulated entity, the collection of such information (*i.e.*, policies and procedures) would be used by the Commission staff in its examination and oversight program, and if such securitization participant were also subject to oversight by a self-regulatory organization, the collection of such information might also be used by the relevant self-regulatory organization in connection with its oversight of the securitization participant.<sup>249</sup>

As stated below in PRA Table 1, we estimate that there are a total of 1,265 securitization participants, all of whom could rely on the risk-mitigating hedging activities exception and 150 of these securitization participants could rely on the bona fide market-making activities exception. For the purposes of this analysis, as described below, we have made assumptions regarding actions respondents might take to manage and memorialize compliance with the re-proposed rule.

The availability of the proposed exceptions would be conditioned on securitization participants implementing, maintaining, and enforcing written policies and procedures reasonably designed to ensure compliance with the requirements of the exceptions, including the identification, documentation, and monitoring of such activities. Accordingly, securitization participants would be required to either prepare new policies and procedures or update existing ones in order to rely on the exception.<sup>250</sup>

<sup>249</sup> We recognize that not all securitization participants that would rely on the risk-mitigating hedging activities exception or the bona fide market-making activities exception (*e.g.*, municipal entities that are sponsors of municipal ABS) would be subject to the Commission’s examination and oversight programs (or, if applicable, those of the relevant self-regulatory organization).

<sup>250</sup> We estimate that only a subset of covered securitization participants (*e.g.*, broker-dealers) would rely on the bona fide market-making activities exception and that, while amending their written policies and procedures to address the more broadly applicable risk-mitigating hedging activities exception, such securitization participants would also amend their written policies and procedures to address the bona fide market-making activities exception.

**PRA TABLE 1—ESTIMATED NUMBER OF SECURITIZATION PARTICIPANTS<sup>1</sup>**

Private-label ABS sponsors .....	455
Municipal ABS sponsors .....	590
Sponsors related to government-backed securities .....	185
Unique underwriters, placement agents, and initial purchasers ...	150
<b>Total .....</b>	<b>1,380</b>

<sup>1</sup> The securitization participant estimates are derived from data in the Green Street Asset-Backed Alert Database, the Green Street Commercial Mortgage Alert Database, the Mergent Municipal Bond Securities Database, and information on [www.ginniemae.gov](http://www.ginniemae.gov) and <https://capitalmarkets.freddiemac.com/mbs/products/dealer-groups>.

We estimate that for each securitization participant relying on the proposed exceptions, it would take approximately 80 hours to initially prepare new written policies and procedures<sup>251</sup> and approximately 10 hours annually to review and update those policies and procedures.<sup>252</sup> As a result, we estimate that the annual burden for each securitization participant would be 33 hours.<sup>253</sup>

<sup>251</sup> While some securitization participants may have policies and procedures in place related to hedging or market-making, we are estimating the same burden hour estimates for all securitization participants. Burden hour estimates for the preparation of new policies and procedures (80 hours) are derived from similar estimates for the documentation of policies and procedures by RIAs as required by Rule 206(4)–7 of the Investment Advisers Act of 1940. *See Compliance Programs of Investment Companies and Investment Advisers*, Release No. 1A–2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] (taking into account industry participant comments specific to the 80-hour estimate). Because the proposed exceptions would require the drafting or updating of reasonably designed written policies and procedures regarding each requirement applicable to such exception, we believe 80 hours is an appropriate burden estimate.

<sup>252</sup> Burden hour estimates for the annual review of policies and procedures (10 hours) are derived from the same estimates for recently proposed Exchange Act Rule 17Ad–25(h). Rule 17Ad–25(h) requires updating current policies and procedures or establishing new policies and procedures to ensure ongoing compliance, which would impose an ongoing annual burden similar to the one imposed by the proposed risk-mitigating hedging activities exception here. *See Clearing Agency Governance and Conflicts of Interest*, Release No. 34–95431 (Aug. 8, 2022) [87 FR 51812 (Aug. 23, 2022)].

<sup>253</sup> These estimates represent the average burden for all issuers, both large and small. In deriving our estimates, we recognize that the burdens will likely vary among individual issuers based on a number of factors, including the size and complexity of their organizations. The OMB PRA filing inventories represent a three-year average. In deriving our estimate, the burden hour estimates for the preparation of new policies and procedures (80 hours) were added to the ongoing estimates for the annual review of policies and procedures (10 hours) for the following two years resulting in a 100 hour burden over three years, or approximately 33 hours per year. Some issuers may experience costs in excess of this average in the first year of compliance with the amendments and some issuers may

<sup>247</sup> 44 U.S.C. 3501 *et seq.*

<sup>248</sup> *See* 44 U.S.C. 3507(d); 5 CFR 1320.11.

Because these estimates are an average, the burden could be more or less for any particular securitization participant, and might vary depending on a variety of

factors, such as the degree to which the participant uses the services of outside professionals or internal staff.

The following table summarizes the estimated paperwork burdens associated with the re-proposed rule.

PRA TABLE 2—ESTIMATED PAPERWORK BURDEN OF PROPOSED RULE 192

Proposed rule 192	Estimated burden increase	Brief explanation of estimated burden increase
Require policies and procedures implementing, maintaining, and enforcing written policies and procedures reasonably designed to ensure compliance with the requirements of the applicable exceptions, including the identification, documentation, and monitoring of such activities.	An increase of 33 burden hours.	This is the estimated effect to initially prepare and subsequently review and update the policies and procedures.

C. Burden and Cost Estimates

Below we estimate the paperwork burden in hours and costs as a result of the new collection of information established by the re-proposed rule. These estimates represent the average burden for all securitization participants, both large and small. In deriving our estimates, we recognize that the burdens would likely vary among individual securitization participants. We estimate the total annual burden of the re-proposed rule to be 45,540 burden hours. We calculated

the burden estimate by multiplying the estimated number of securitization participants by the estimated average amount of time it would take a securitization participant to prepare and review and update the policies and procedures under the re-proposed rule. For purposes of the PRA, the burden is to be allocated between internal burden hours and outside professional cost. PRA Table 3 sets forth the percentage estimate for the burden allocation for the new collection of information. We also estimate that the average cost of

retaining outside professionals is \$600 per hour.<sup>254</sup>

PRA TABLE 3—ESTIMATED BURDEN ALLOCATION FOR THE COLLECTION OF INFORMATION

Collection of information	Internal (%)	Outside professionals (%)
Prohibition Against Conflicts of Interest in Certain Securitizations .....	75	25

PRA TABLE 4—REQUESTED PAPERWORK BURDEN FOR THE NEW COLLECTION OF INFORMATION

Collection of information	Requested paperwork burden		
	Securitization participants	Burden hours	Cost burden (\$)
	(A)	(A) × 33 × (0.75)	(A) × 33 × (0.25) × \$600
Prohibition Against Conflicts of Interest in Certain Securitizations .....	1,380	34,155	\$6,831,000

D. Request for Comment

We are using the above estimates for the purposes of calculating reporting burdens associated with the re-proposed rule. Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comments in order to:

- Evaluate whether the proposed collection of information would be necessary for the performance of the functions of the Commission, including whether the information would have practical utility;
- Evaluate the accuracy of our estimates of the burdens of the proposed collection of information;
- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected;
- Evaluate whether there are ways to minimize the burden of the collection of

information on those who are to respond, including through the use of automated collection techniques or other forms of information technology; and

- Evaluate whether the proposed amendments would have any effects on any other collection of information not previously identified in this section.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing these burdens. Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503; and send a copy to Vanessa Countryman, Secretary, Securities and Exchange

Commission, 100 F Street NE, Washington, DC 20549–1090, with reference to File No. S7–01–23. Requests for materials submitted to OMB by the Commission with regard to the collection of information requirements should be in writing, refer to File No. S7–01–23 and be submitted to the U.S. Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, DC 20549. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

experience less than the average costs. Averages also may not align with the actual number of filings in any given year.

<sup>254</sup> We recognize that the costs of retaining outside professionals (e.g., compliance professionals and outside counsel) might vary depending on the nature of the professional

services, but for purposes of this PRA analysis, we estimate that such costs would be an average of \$600 per hour, consistent with other recent rulemakings.

### V. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 (“SBREFA”),<sup>255</sup> the Commission must advise OMB as to whether the proposed amendments constitute a “major” rule. Under SBREFA, a rule is considered “major” where, if adopted, it results in or is likely to result in:

- An annual effect of the U.S. economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.<sup>256</sup>

We request comment on whether the re-proposed rule would be a “major” rule for purposes of SBREFA. In particular, we request comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment, or innovation.

### VI. Initial Regulatory Flexibility Analysis

The Regulatory Flexibility Act (“RFA”) <sup>257</sup> requires an agency, when issuing a rulemaking proposal, to prepare and make available for public comment an Initial Regulatory Flexibility Analysis (“IRFA”) that describes the impact of the re-proposed rule on small entities.<sup>258</sup> We have prepared the following IRFA in accordance with Section 3(a) of the RFA.<sup>259</sup> It relates to proposed Rule 192 under the Securities Act.

#### A. Reason for and Objections of the Proposed Action

We are proposing Rule 192 to implement Section 27B of the Securities Act. The re-proposed rule seeks to prevent the sale of ABS that are tainted by material conflicts of interest by prohibiting securitization participants from engaging in certain transactions that could incentivize a securitization participant to structure an ABS in a way that would put the securitization participant’s interests ahead of those of ABS investors. The re-proposed rule also provides a standard for determining which types of transactions would be

prohibited so that activities that are routinely undertaken in connection with the securitization process or with respect to the types of financial assets underlying securitizations covered by the re-proposed rule that do not give rise to the risks that Section 27B was intended to address would not be unnecessarily restricted. The requirements of the re-proposed rule are discussed in more detail in Section II above. We discuss the economic impact and potential alternatives to the re-proposed rule in Section III above, and the estimated compliance costs and burdens of the re-proposed rule under the PRA in Section IV above.

#### B. Legal Basis

The re-proposed rule is being proposed under authority set forth in in Sections 10, 17(a), 19(a), 27B, and 28 of the Securities Act.

#### C. Small Entities Subject to Proposed Rule 192

The re-proposed rule would affect some small entities—such as municipal entities, small broker-dealers, and RIAs that advise hedge funds—that would be “sponsors” for purposes of the re-proposed rule.<sup>260</sup> The RFA defines “small entity” to mean “small business,” “small organization,” or “small governmental jurisdiction.”<sup>261</sup>

For purposes of the RFA, under 17 CFR 230.157 and 17 CFR 240.0–10(a), an issuer, other than an investment company, is a “small business” or “small organization” if it had total assets of \$5 million or less on the last day of its most recent fiscal year and is engaged or proposing to engage in an offering of securities not exceeding \$5 million. We estimate that no sponsors of private-label ABS would meet the definition of “small entity” applicable to issuers.

A municipal entity is a small entity for purposes of the RFA (*i.e.*, a “small government jurisdiction”) if it is a city, county, town, township, village, school district, or special district, with a population of less than fifty thousand.<sup>262</sup> We estimate that, of the 478 municipal entities who act as sponsors of ABS, between 75 and 104 would meet the definition of small entity applicable to municipal entities.<sup>263</sup>

<sup>260</sup> We preliminarily believe that the re-proposed rule would not affect small entities other than those that would be a “sponsor” for purposes of the re-proposed rule.

<sup>261</sup> 5 U.S.C. 601(6).

<sup>262</sup> 5 U.S.C. 601(5).

<sup>263</sup> We analyzed calendar year 2021 data from the Mergent Municipal Bond Securities Database to determine the scope and characteristics of the issuers of municipal ABS.

A broker-dealer is a small entity if it has total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to 17 CFR 240.17a–5(d), or, if not required to file such statements, had total capital of less than \$500,000 on the last business day of the preceding fiscal year (or in the time that it has been a business, if shorter); and it is not affiliated with any person (other than a natural person) that is not a small business or small organization.<sup>264</sup> We estimate that one sponsor that is a broker-dealer would meet the applicable definition of small entity.<sup>265</sup>

RIAs other than broker-dealers that advise hedge funds and municipal advisors that advise with respect to municipal securitizations, could also qualify as a “sponsor” under the re-proposed rule. A RIA is a small entity if it: (i) has assets under management having a total value of less than \$25 million; (ii) did not have total assets of \$5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had total assets of \$5 million or more on the last day of its most recent fiscal year.<sup>266</sup> We estimate that, of the RIAs that advise hedge funds, up to 17 would be a small entity as defined for investment advisers.<sup>267</sup>

We estimate that there are 112 municipal advisors who would be sponsors of ABS for purposes of the re-proposed rule.<sup>268</sup> There is no Commission definition regarding when a municipal advisor is a small entity. In adopting rules relating to municipal advisors, the Commission has used the

<sup>264</sup> See 17 CFR 240.0–10.

<sup>265</sup> We evaluated all ABS sponsors for the period of Jan. 2021 through Dec. 2021 to determine whether their characteristics and affiliations (as described in FOCUS data and other disclosures) would result in their being “small entities” for purposes of Section 605 of the RFA.

<sup>266</sup> See 17 CFR 275.0–7(a).

<sup>267</sup> Based on Form ADV data, we estimate that only 17 RIAs that advise hedge funds, representing 0.7% of all RIAs advising hedge funds, would be a small entity as defined by Rule 0–7(a) of the Investment Advisers Act of 1940. See *Definitions of “Small Business” or “Small Organization” Under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933*, Release Nos. 33–7548, 34–40122, IC–23272, and IA–1727 (June 24, 1998) [63 FR 35508 (June 30, 1998)]. Furthermore, we believe that not all 17 of those RIAs act as sponsors of ABS transactions.

<sup>268</sup> Mergent Municipal Bond Securities Database. We note that some municipal advisors are broker-dealers and/or RIAs.

<sup>255</sup> 5 U.S.C. 801 *et seq.*

<sup>256</sup> 5 U.S.C. 804(2).

<sup>257</sup> 5 U.S.C. 601 *et seq.*

<sup>258</sup> 5 U.S.C. 603(a).

<sup>259</sup> 5 U.S.C. 603(a).

Small Business Administration's definition of small business for municipal advisors.<sup>269</sup> The Small Business Administration defines small business for purposes of entities that provide financial investment and related activities as a business that had annual receipts of less than \$7 million during the preceding fiscal year and is not affiliated with any person that is not a small business or small organization.<sup>270</sup> Based on this definition, a majority of municipal advisors would be small businesses. In the MA Adopting Release, the Commission estimated that approximately 62% of municipal advisors would be small entities; therefore, we estimate that 69 would be small entities.

This results in a Commission estimate of 162 to 191 small entities that could be impacted by the re-proposed rule.

#### *D. Projected Reporting, Recordkeeping, and Other Compliance Requirements*

If adopted, the re-proposed rule would apply to small entities to the same extent as other entities, irrespective of size. Therefore, we expect that most of the benefits and costs associated with the re-proposed rule would be similar for large and small entities. Accordingly, we refer to the discussion of the re-proposed rule's economic effects on all affected parties, including small entities, in Section III above. Consistent with that discussion, we anticipate that the economic benefits and costs could vary widely among small entities based on a number of factors, such as the nature and conduct of their businesses, which makes it difficult to project the economic impact on small entities with precision. We note, however, that the similarity of certain proposed exceptions to the re-proposed rule to the Volcker Rule might be more beneficial to larger entity securitization participants (*e.g.*, banking entities and affiliated broker-dealer entities) due to their familiarity with the Volcker Rule. Conversely, as discussed above in Sections II.B.3. and III.D.2., compliance with the re-proposed rule might be more costly for large and diversified securitization participants that have an extensive network of affiliates and subsidiaries. As a general matter, we also recognize that costs of the re-proposed rule potentially could have a proportionally greater effect on small entities, as such costs may be a relatively greater percentage of the total

cost of operations for smaller entities than larger entities, and thus small entities might be less able to bear such costs relative to larger entities.

Compliance with the re-proposed rule might require the use of professional skill, including legal skills. We request comment on how the re-proposed rule would affect small entities.

#### *E. Duplicative, Overlapping, or Conflicting Federal Rules*

We have not identified any Federal rules that currently duplicate, overlap, or conflict with the re-proposed rule. We request comment on whether commenters perceive any such duplication, overlap, or conflict if the re-proposed rule is adopted and, if so, how we should address any such duplication, overlap, or conflict.

#### *F. Significant Alternatives*

The RFA directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the proposed amendments, we considered the following alternatives:

- Establishing different compliance requirements that take into account the resources available to small entities;
- Delaying the implementation of compliance requirements for small entities to take into account the resources available to them;
- Exempting small entities from all or part of the requirements;
- Using performance rather than design standards; and
- Clarifying, consolidating, or simplifying compliance and reporting requirements under the rules for small entities.

The re-proposed rule seeks to prevent the sale of ABS that are tainted by material conflicts of interest by prohibiting securitization participants from engaging in certain transactions that could incentivize a securitization participant to structure an ABS in a way that would put the securitization participant's interests ahead of those of ABS investors. We believe that all ABS investors should be protected from securitization participants entering into conflicted transactions, and exempting small entities from the re-proposed rule's prohibition, establishing different compliance requirements for small entities, or delaying the implementation of the compliance requirements for small entities could frustrate that goal by protecting only ABS investors in transactions with respect to which the relevant securitization participants are larger entities. We do not believe that imposing different standards or

requirements based on the size of the securitization participant would be appropriate, and doing so might result in additional costs associated with ascertaining whether a particular securitization participant may avail itself of such different standards. For these reasons, we are not proposing differing compliance or reporting requirements or timetables, or an exception, for small entities. For the same reasons we do not believe it would be appropriate to impose different standards or requirements based on the size of the securitization participant, we do not believe that the implementation of compliance requirements for small entities should be delayed. We request comment below whether the implementation of compliance requirements for small entities should be delayed. Section II.B. above includes specific requests for comment on whether certain categories of securitization participants should be exempted from the re-proposed rule.

We do not believe that clarifying, consolidating, or simplifying the compliance requirements under the re-proposed rule would permit us to achieve our stated objective. We have sought to create a clear, consolidated, and simple regulatory framework as we believe appropriate under the circumstances. With respect to using performance rather than design standards, the prohibition of the re-proposed rule is a performance standard that would prohibit a securitization participant from entering into a conflicted transaction during the covered time-period. Although the proposed bona fide market-making activities and risk-mitigating hedging activities exceptions do include design standards, we believe that those design standards would promote the objective of the re-proposed rule while still providing flexibility to securitization participants to design compliance programs that are tailored to their specific business models. Sections II.E. and II.G. above include specific requests for comment on whether smaller securitization participants should be exempted from the proposed compliance program requirements applicable to the bona fide market-making activities and risk-mitigating hedging activities exceptions, and if so, how "smaller securitization participant" should be defined for purposes of any such exemption.

#### *G. Request for Comment*

We encourage the submission of comments with respect to any aspect of the IRFA. In particular, we request comment regarding:

<sup>269</sup> See *Registration of Municipal Advisors*, Release No. 34-70462 (Sep. 20, 2013) [78 FR 67468 (Nov. 12, 2013)] ("MA Adopting Release").

<sup>270</sup> See 13 CFR 121.201.

- The number of small entities that may be affected by the re-proposed rule;
- The existence or nature of the potential impact of the re-proposed rule on small entities discussed in the analysis;
- How the re-proposed rule could further lower the burden on small entities by, for example, exempting small entities from compliance requirements applicable to such entities or delaying the implementation of compliance requirements for such entities; and
- How to quantify the impact of the re-proposed rule.

Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the re-proposed rule is adopted, and will be placed in the same public file as comments on the re-proposed rule itself.

#### Statutory Authority

The Commission is proposing new 17 CFR 230.192 under the authority set forth in Sections 10, 17(a), 19(a), 27B, and 28 of the Securities Act.

#### List of Subjects in 17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

#### Text of Proposed Amendments

For the reasons set forth in the preamble, the Commission is proposing to amend title 17, chapter II of the Code of Federal Regulations as follows:

### PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

■ 1. The general authority citation for part 230 continues to read in part as follows:

**Authority:** 15 U.S.C. 77b, 77b note, 77c, 77d, 77f, 77g, 77h, 77j, 77r, 77s, 77z-3, 77sss, 78c, 78d, 78j, 78l, 78m, 78n, 78o, 78o-7 note, 78t, 78w, 78ll(d), 78mm, 80a-8, 80a-24, 80a-28, 80a-29, 80a-30, and 80a-37, and Pub. L. 112-106, sec. 201(a), sec. 401, 126 Stat. 313(2012), unless otherwise noted.

■ 2. Add § 230.192 to read as follows:

#### § 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.

By the Commission.

Dated: January 25, 2023.

**Vanessa A. Countryman,**  
*Secretary.*

[FR Doc. 2023-02003 Filed 2-13-23; 8:45 am]

**BILLING CODE 8011-01-P**