Market Guide to the Implementation of SEC Rule 192

Conflicts of Interest in Securitization Transactions

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INTRODUCTION

The purpose of this market guide is to assist market participants in interpreting the terms and provisions of Rule 192 and designing compliance programs with respect thereto. This market guide is the result of a careful analysis of the Adopting Release and a series of group discussions involving many SIFMA members.

On November 27, 2023, the Securities and Exchange Commission (the "SEC") adopted Rule 192 (Conflicts of Interest Relating to Certain Securitizations) ("Rule 192") pursuant to Section 27B of the Securities Act of 1933 (the "Securities Act"). The adopting release (the "Adopting Release") was published in the Federal Register on December 7, 2023.[1] Rule 192 is codified at 17 C.F.R. §230.192. The text of Rule 192 is set forth in Appendix A.

Rule 192 became effective on February 5, 2024.[2] Compliance with Rule 192 is required with respect to any ABS the first closing of the sale of which occurs on or after June 9, 2025.[3]

We wish to emphasize the following with respect to this market guide:

- ✓ *This market guide is limited to interpretive matters relating to the scope and terms of Rule 192 and is not intended to address all implementation issues, particularly those involving facts and circumstances determinations, which would require further discussion of the relevant facts with appropriate counsel.*
- ✓ *This market guide addresses only the interpretation of SEC Rule 192 and not any other federal securities laws or rules, any SRO rules, any state securities laws or rules, or any other legal schemes (including but not limited to tax and ERISA) not expressly addressed here.*
- ✓ *This market guide does not preclude any reader from adopting its own interpretation of Rule 192. Each reader must decide for itself, independently, whether or to what extent it will adopt or implement any of the views expressed in this market guide.*
- ✓ *In preparing this market guide, Mayer Brown LLP ("Mayer Brown") acted as counsel to SIFMA. The views expressed in this market guide do not constitute legal advice, and this market guide is not a legal opinion of Mayer Brown to any party, including SIFMA. Each reader of this market guide should seek legal advice with respect to such reader's compliance with Rule 192.*
- ✓ *The views expressed in this market guide do not necessarily reflect the authors' views, but rather represent general consensus positions of working group members on the topics discussed herein. These consensus positions were developed based on group discussions and careful review of the Adopting Release.*
- ✓ *SIFMA and Mayer Brown have not previewed the positions in this market guide with SEC staff, and there can be no assurance that the SEC or its staff would agree with the views expressed in this memorandum.*

[1] *See* Prohibition Against Conflicts of Interest in Certain Securitizations, 88 Fed. Reg. 85396 (Dec. 7, 2023). https://www.govinfo.gov/content/pkg/FR-2023-12-07/pdf/2023-26430.pdf
[2] *See* Adopting Release, at 85443.
[3] *Id*.

- ✓ *The views expressed in this market guide are subject to change as market practices evolve or new guidance from the SEC or its staff becomes available.*

Rule 192 as adopted reflects significant changes from the proposed version that was issued by the SEC in January 2023. SIFMA, together with SIFMA AMG and the Bank Policy Institute, filed two substantial comment letters on the proposed rule[4] and had numerous meetings with the SEC and its staff. We appreciate their careful consideration of SIFMA's comments on the proposed rule and are grateful that many of SIFMA's recommendations were reflected in the final rule.

[4] SIFMA's first comment letter was filed on March 27, 2023, and is available at https://www.sec.gov/comments/s7-01-23/s70123-20161806-330705.pdf. SIFMA's second comment letter was filed on June 27, 2023, and is available at https://www.sec.gov/comments/s7-01-23/s70123-213659-436182.pdf. The SIFMA comment letters were cited 185 times in the 70-page Adopting Release.

OVERVIEW OF RULE 192

General Prohibition. Under Rule 192, a ***securitization participant*** with respect to an ***asset-backed security*** shall not during the ***prohibition timeframe*** directly or indirectly engage in any ***conflicted transaction*** with respect to that ***asset-backed security***.

Exceptions. Rule 192 provides exceptions for (1) ***risk-mitigating hedging activities***, (2) ***liquidity commitments***, and (3) ***bona-fide market-making activities***. These exceptions are subject to an ***anti-evasion provision***.

Extraterritorial Application. Rule 192 provides a ***safe harbor for certain foreign transactions***. The application of Rule 192 to a foreign transaction that does not qualify for the safe harbor will depend on ***extraterritoriality principles*** set forth in applicable caselaw.

Rule 192 involves an analysis of whether a transaction (the "**Subject Transaction**") entered into by a "securitization participant" with respect to an asset-backed security (as defined under Rule 192) ("**ABS**") is a "conflicted transaction" with respect to that ABS.

For ease of reference, this market guide utilizes the following defined terms:

- "**ABS**" has the meaning specified above.
- "**Subject Transaction**" has the meaning specified above.
- "**Conflicted Transaction (IM)**" means a Subject Transaction that would be a Conflicted Transaction if the materiality condition set forth in Rule 192 is satisfied.
- "**Conflicted Transaction**" means a "conflicted transaction" as defined in Rule 192.
- "**Prohibited Transaction**" means a Conflicted Transaction for which there is no available exception under Rule 192.

Much of the content in this market guide is derived from Parts I through VI of the Adopting Release. This market guide refers to those parts collectively as the "**Preamble".**

This market guide will focus primarily on interpretive, implementation, and compliance matters and frequently-asked questions with respect to the following ten topics:

Topic 1:	What is an "asset-backed security" for purposes of Rule 192?
Topic 2:	What is a "conflicted transaction"?
Topic 3:	How are CRTs treated under Rule 192?
Topic 4:	Who is a "securitization participant"?
Topic 5:	What is the "prohibition timeframe"?
Topic 6:	What are the terms and conditions of the "risk mitigating hedging activities" exception?
Topic 7:	What are the terms and conditions of the "bona fide market making activities" exception?
Topic 8:	What are the terms and conditions of the "liquidity commitments" exception?
Topic 9:	What is the extraterritorial application of Rule 192?
Topic 10:	Who steps can securitization participants take to prepare for Rule 192?

TOPIC 1:
WHAT IS AN "ASSET-BACKED SECURITY" FOR PURPOSES OF RULE 192"?

Under Rule 192, the term "asset-backed security" means (1) an "asset-backed security" as defined under Section 3(a)(79) of the Securities Exchange Act of 1934,[5] and (2) a synthetic asset-backed security or hybrid cash and synthetic asset-backed security.

Q.1.1
How does Rule 192 define "synthetic asset-backed security"?

Rule 192 does not provide a separate definition of "synthetic asset-backed security" or "hybrid cash and synthetic asset-backed security."

The Preamble does provide the following helpful guidance, which makes clear that a synthetic ABS is a security issued by a special purpose entity:[1]

- "[W]hile a synthetic ABS may be structured or designed in a variety of ways, we generally view a synthetic asset-backed security as a fixed income or other security *issued by a special purpose entity* that allows the holder of the security to receive payments that depend primarily on the performance of a reference self-liquidating financial asset or a reference pool of self-liquidating financial assets."
- "[W]hether a transaction is a 'synthetic ABS' subject to Rule 192 will depend on the nature of the transaction's structure and characteristics of the underlying or referenced assets."

The Preamble acknowledges that commenters' suggestions are consistent with the characteristics that the SEC has previously identified as features of synthetic ABS.[2]

Notes to Q.1.1:

[1] Guidance. See p. 85402 of the Adopting Release (emphasis added).

[2] Acknowledgement of commenters suggestions. From the Preamble: "[C]ommenters' suggestions are consistent with the characteristics that we have previously identified as features of synthetic ABS."[6]

SIFMA suggested the following definition: "Synthetic asset-backed security means a fixed-income or other security (a) issued by a special purpose entity, and (b) secured by (i) one or more credit

[5] Section 3(a)(79) of the Securities Exchange Act of 1934 defines asset-backed security, in relevant part, as "a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on the cash flow from the asset." This is the same definition that applies to ABS covered by Regulation RR and many other securitization regulations. It covers both publicly-offered and privately-offered ABS.
[6] Adopting Release, at 85402.

derivatives or similar instruments that reference self-liquidating financial assets (including bonds, loans, leases, mortgages, secured or unsecured receivables, or asset-backed securities) ("reference pool") and (ii) financial collateral held by the SPV where performance on the note is primarily linked to the performance of the reference pool and the repayment of principal is dependent on the financial collateral held by the SPV. The term "synthetic asset-backed security" shall not include any insurance or reinsurance policy, corporate debt, or swap or security-based swap where the counterparty is not a special purpose entity that issues a security to investors, whether or not payments thereunder are contingent on the performance of referenced financial assets. For avoidance of doubt, the term "self-liquidating financial asset" (as used in this definition) shall not include any insurance or reinsurance contracts (or insurance or reinsurance risks)."[7] SFA proposed a substantially similar definition.[8]

Q.1.2
If an "asset-backed security" as defined by Rule 192 is never actually sold to an investor, does Rule 192 apply?

No. Rule 192 does not apply if the ABS is never actually sold to an investor.[1]

Notes to Q.1.2:

[1] From the Preamble: "While the prohibition against entering into conflicted transactions will commence on the date on which a person has reached an agreement to become a securitization participant with respect to an ABS, if such ABS is never sold to investors, Rule 192 will not apply. As noted above, the rule is designed to prevent the sale of ABS that are tainted by material conflicts of interest by specifically prohibiting securitization participants from engaging in conflicted transactions that could incentivize a securitization participant to structure an ABS in a way that puts the securitization participant's interests ahead of ABS investors. In the event that the sale of an ABS is not completed, there will be no investors with respect to which a transaction could involve or result in a material conflict of interest. Therefore, as adopted, the Rule 192 prohibition on material conflicts of interest will not apply if the ABS is never actually sold to an investor."[9]

[7] *See* Sec. Indus. and Fin. Mkts. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interest in Certain Securitizations, 10–11 (June 27, 2023).
[8] *See* Structured Fin. Ass'n, Comment Letter on Proposed Rule on Prohibition Against Conflicts of Interests in Certain Securitizations, A-8 (July 13, 2023).
[9] Adopting Release, at 85419.

Q.1.3
Does the term "synthetic asset-backed security" include corporate debt obligations, including CLNs issued directly by a bank?

No. The Preamble makes clear that a corporate debt obligation is not a synthetic asset-backed security under Rule 192. As noted in Q.1.1, security must be issued by a special-purpose entity to be a synthetic asset-backed security under Rule 192.[1]

See Topic 3 for a further discussion of synthetic ABS.

Notes to Q.1.3:

[1] From the Preamble: "[A] corporate debt obligation is issued by, and offers investors recourse to, an operating entity that is not a special purpose entity. Therefore, a corporate debt obligation is not a synthetic ABS for purposes of Rule 192."[10]

Q.1.4
Does the term "synthetic asset-backed security" include equity-linked or commodity-linked products?

No. Such products do not reference self-liquidating financial assets and therefore are not synthetic ABS under Rule 192.[1]

Notes to Q.1.4:

[1] From the Preamble: "Some commenters also requested confirmation that synthetic ABS does not include equity-linked or commodity-linked products. Because such products do not involve self-liquidating financial assets, they are not synthetic ABS subject to Rule 192's prohibition."[11]

Q.1.5
Does the term "synthetic asset-backed security" include a security-based swap, credit-default swap, or other financial contract between two counterparties?

No. A synthetic ABS refers to a security issued by a special purpose entity, not a financial contract between two counterparties.[1] While a swap can represent a component of an ABS transaction, the stand alone swap is not itself a synthetic ABS.[2]

[10] Adopting Release, at 85402.
[11] Adopting Release, at 85402.

Notes to Q.1.5:

[1] Bilateral financial contracts not synthetic ABS. From the Preamble: "[A] security-based swap is also not a synthetic ABS for purposes of Rule 192 because it is a financial contract between two counterparties without the issuance of a security from a special purpose entity."[12] In several places throughout the preamble of the Preamble, the SEC specifies that a synthetic ABS is a "security issued by a special-purpose entity."[13]

[2] Swap as a component of synthetic ABS. From the Preamble: "A security-based swap can represent a component of a synthetic ABS transaction where, for example, the relevant special purpose entity that issues the synthetic ABS enters into a security-based swap that collateralizes the synthetic ABS that it is issuing. However, the standalone security-based swap in such example is not a synthetic ABS; it is only one component of the broader synthetic ABS transaction."[14]

Q.1.6
Are mortgage insurance linked-notes ("MILNs") considered "asset-backed securities" under Rule 192?

No. The collateral for MILNs are private mortgage reinsurance contracts, which are not self-liquidating financial assets. Thus, they do not meet the definition of "asset-backed security" under Rule 192.[1][2]

Notes to Q.1.6:

[1] MILNs not Exchange Act ABS. From the Preamble: "Insurance policies and contracts, such as private mortgage insurance contracts, are not securities, and therefore are not Exchange Act ABS subject to Rule 192. MILNs are reinsurance products used by insurance companies to obtain reinsurance coverage for a portion of their risk related to private mortgage insurance policies, which assist homebuyers in obtaining low-down payment mortgages. The collateral for the MILN are the private mortgage insurance contracts, which are not self-liquidating financial assets. … In each of these cases, the securities do not meet the definition of Exchange Act ABS and, therefore, are not asset-backed securities as defined in Rule 192(c)."[15]

[2] MILNs not synthetic ABS. From the Preamble: "Accordingly, MILNs are not synthetic ABS subject to the prohibition in Rule 192(a)(1), and consequently, neither would the reinsurance agreements executed between the mortgage insurer and the special purpose insurer be conflicted transactions under Rule 192(a)(3)."[16]

[12] Adopting Release, at 85402.
[13] Adopting Release, at 85401-85402.
[14] Adopting Release at 85402.
[15] Adopting Release, at 85401.
[16] Adopting Release, at 85402.

Q.1.7
Are municipal securities carved out of the definition of "asset-backed security" under Rule 192?

No. Municipal securities that meet the definition of "asset-backed security" under the Exchange Act are ABS for purposes of Rule 192.[1]

Notes to Q.1.7:

[1] From the Preamble: "[S]everal commenters requested that the rule exempt certain municipal securities from being ABS subject to the prohibition in 17 CFR 230.192(a)… Municipal securitizations that are collateralized by any type of self-liquidating financial asset and that allow 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. … We see no reason, therefore, why municipal securities that meet the definition of Exchange Act ABS (and are consequently subject to other federal securities laws), and which, like other Exchange Act ABS, involve securitization participants, such as an underwriter, that would have an opportunity to engage in conflicted transactions, should be exempted from the definition of ABS—and, thus, the prohibition against conflicts of interest—for purposes of this rule."[17]

Q.1.8
Are ABS that are privately placed with investors in direct private placements under Section 4(a)(2) of the Securities Act or under Rule 144A carved out of the definition of "asset-backed security" under Rule 192?

No. Rule 192 applies to any security that meets the definition of "asset-backed security" regardless of whether it is issued registered in a registered public offering or privately placed. [1]

Notes to Q.1.8:

[1] From the Preamble: "[A]ny securities that meet the definition of "asset-backed security," as adopted for purposes of Rule 192, will be subject to the prohibition in Rule 192(a), whether registered or unregistered."[18]

[17] Adopting Release, at 85399-85400.
[18] Adopting Release, at 85401.

Q.1.9
For purposes of the definition of "asset-backed security" under Rule 192, can market participants continue to look to SEC guidance and staff positions regarding the definition of "Exchange Act ABS"?

Yes. Market participants may continue to look to SEC guidance and staff positions regarding the definition of Exchange Act ABS for purposes of construing the definition of "asset-backed security" under Rule 192.[1]

Notes to Q.1.9:

[1] From the Preamble: "The definition of asset-backed security we are adopting in Rule 192(c) does not change the Exchange Act ABS definition, nor does it impact existing Commission guidance or staff positions regarding that definition. Market participants may, therefore, continue to look to such guidance or staff positions unless and until they are changed, withdrawn, or otherwise superseded, as applicable."[19]

[19] Adopting Release, at 85401.

TOPIC 2:
WHAT IS A "CONFLICTED TRANSACTION"?

Overview

As noted above, Rule 192 involves an analysis of whether a Subject Transaction entered into by securitization participant is a "conflicted transaction." Rule 192 defines "conflicted transaction" as follows:

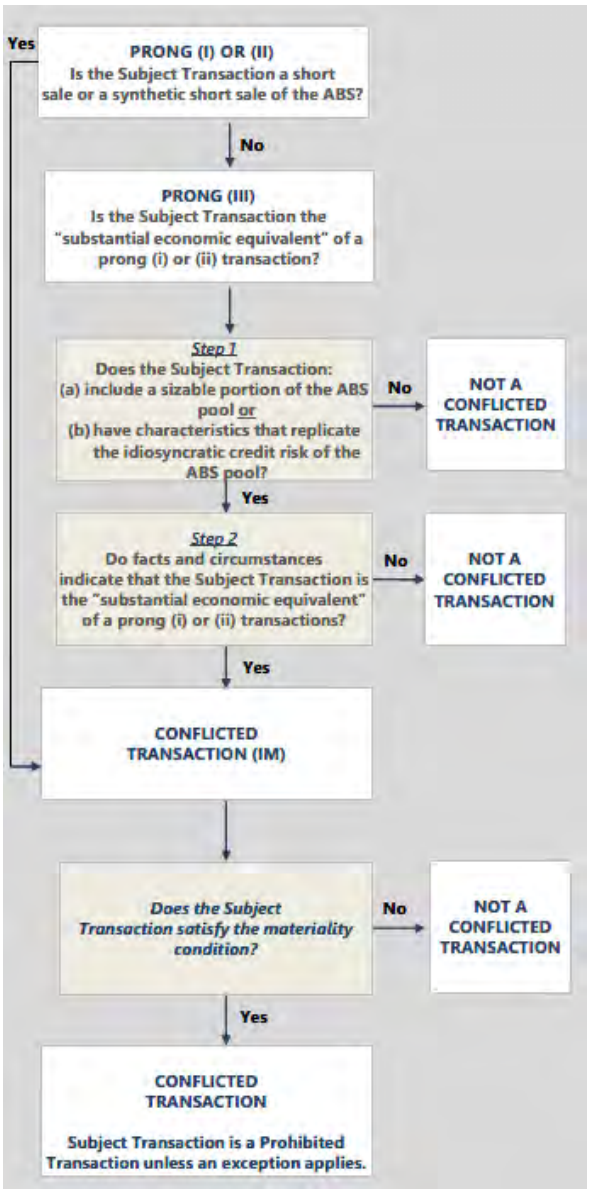
For purposes of this section, a conflicted transaction means any of the following transactions with respect to which there is *a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision whether to retain the asset-backed security* [the ***"materiality condition"***]:

(i) A short sale of the relevant asset-backed security ["***short sale of ABS***" prong];

(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 ["***synthetic short sale of ABS***" prong]; or

(iii) The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction that is *substantially the economic equivalent of a transaction described in paragraph (a)(3)(i) or (a)(3)(ii) of this section* other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk ["***substantial economic equivalent***" prong].

The flowchart on the right previews the step-by-step analysis that follows.



Prong (i) (Short Sale of ABS)

Prong (i) captures a "short sale of the relevant asset-backed security."

Q.2.1
How does Rule 192 define "short sale"?

Rule 192 does not define "short sale," but the Preamble states that "A short sale occurs when a securitization participant sells an ABS when it does not own it (or that it borrows for purposes of delivery)."[20][1]

Notes to Q.2.1:

[1] The Adopting Release states that "A short sale of an ABS by a securitization participant is a bet against the relevant ABS regardless of whether the bet is successful, and this is the exact type of transaction that the rule is intended to prohibit in order to remove the incentive for securitization participants to place their own interests ahead of those of investors."[21]

Q.2.2
What if, due to human or systems errors, a securitization participant's sell order is executed with respect to an ABS that the securitization participant does not own?

Occasionally, due to human or system errors, a sell order might be executed where the seller does not own the security. This is typically followed by a corrective trade or a buy order to cover the unintentional short position. Such sale would not constitute a "short sale" under prong (i).

An errant sell order is not a "bet against the relevant ABS"[1] nor does it create an incentive for the securitization participant to place its own interests ahead of those of investors.[2]

Notes to Q.2.2:

[1] Bet against the relevant ABS. From the Preamble: "Rule 192(a)(3)(iii) is intended to 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."[22]

[20] Adopting Release, at 85421.
[21] Adopting Release, at 85421.
[22] Adopting Release, at 85421.

[2] Incentive. From the Preamble: Prong (iii) seeks to "remove the incentive for securitization participants to place their own interests ahead of those of ABS investors, as contemplated by the statute."[23]

Prong (ii) (Synthetic Short Sale of ABS)

Prong (ii) captures a "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."

Q.2.3
Does prong (ii) apply to credit default swaps or other credit derivatives that reference assets in the securitization pool?

No. Prong (ii) applies solely to a direct bet against the ABS itself in the form of "a credit default swap or other credit derivative that references such ABS and entitles the securitization participant to receive a payment upon the occurrence of a specified credit event with respect to the ABS such as a failure to pay, restructuring or any other specified credit event that would trigger a payment on the derivative contract."[1]

Prong (iii) governs the question of whether a credit default swap or other credit derivative that references assets in the securitization pool is a Conflicted Transaction (IM). As explained below, such a credit default swap or other credit derivative would be a Conflicted Transaction (IM) if it is the substantial economic equivalent of a prong (i) transaction or a prong (ii) transaction.

Notes to Q.2.3:

[1] Adopting Release, at 85421.

Prong (iii) (Substantial Economic Equivalent)

Prong (iii) captures "the purchase or sale of any financial instrument (other than the relevant [ABS]) or entry into a transaction that is *substantially the economic equivalent of a transaction described in paragraph (a)(3)(i) or (a)(3)(ii) of this section* other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk."

[23] Adopting Release, at 85422.

Q.2.4
How does Rule 192 define "substantial economic equivalent"?

Rule 192 does not define "substantial economic equivalent." However, the Preamble provides extensive guidance that this market guide organizes into a two-step test:

- **Step 1(a)**: Does the Subject Transaction include a sizeable portion of the ABS asset pool?

- **Step 1(b):** Does the Subject Transaction have characteristics that replicate the idiosyncratic credit risk of the ABS pool?

  - *If the answer is "no" under both Step 1(a) and Step 1(b), the Subject Transaction is not a Conflicted Transaction. If the answer is "yes" under either Step 1(a) or Step 1(b), move to Step 2.*

- **Step 2**: Do the facts and circumstances indicate that the Subject Transaction is the "substantial economic equivalent" of a prong (i) or prong (ii) transaction? If no, it is not a Conflicted Transaction. If yes, it is a Conflicted Transaction (IM).

Prong (iii), Step 1(a): Does the Subject Transaction include a sizeable portion of the ABS pool?

Q.2.5
Under Step 1(a), if the Subject Transaction includes a sizeable portion of the ABS pool, does that automatically make the Subject Transaction a Conflicted Transaction (IM)?

No.

- If the Subject Transaction does not include or reference a sizeable portion, it generally would not be a Conflicted Transaction under Step 1(a).[1]
- On the other hand, if the Subject Transaction does include or reference a sizeable portion, then it is a facts and circumstances determination as to whether the Subject Transaction is a Conflicted Transaction (IM).[2]

Notes to Q.2.5:

[1] Not a conflicted transaction if does not include sizeable portion. From the Preamble: "In the context of an ABS with an asset pool consisting of a large number of different and distinct obligations, we recognize that a short transaction with respect to a single asset or some non-sizeable portion of the assets in that pool would generally *not* result in a short position with respect to such asset or

assets being substantially the economic equivalent of a short sale of the relevant ABS itself or a CDS or 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."[24]

[2] Facts and circumstances otherwise. From the Preamble: "However, if the relevant assets do represent a sizeable portion of the asset pool supporting or referenced by the relevant ABS, then entering into a transaction with respect to such assets can present the same investor protection concerns that Section 27B was intended to address. Under the final rule, such a transaction can be a conflicted transaction *based on the facts and circumstances*."[25]

Q.2.6
Under Step 1(a), what constitutes as "sizeable portion" of the ABS pool?

A reasonable interpretation of "sizeable portion" is a portion of the asset pool that is sufficiently large such that a bet against that portion is tantamount to a bet against the relevant ABS.[1]

- Facts and Circumstances. The facts and circumstances of the relevant ABS and the Subject Transaction are the first consideration in any analysis. It is our consensus view that the relevant inquiry is whether a bet against the portion in question is tantamount to a bet against the relevant ABS. Relevant factors include, but are not limited to:

  (a) The homogeneity of the ABS pool: Are the assets in the ABS pool homogenous, or is the ABS pool heterogenous or lumpy?
  (b) The degree of overlap between the Subject Transaction and the ABS pool: Does the putative "sizeable portion" of the ABS pool constitute a sizeable portion of the Subject Transaction?[2]
  (c) What are the reasons for the overlap of assets in the relevant ABS and the Subject Transaction? Was the Subject Transaction designed with the relevant ABS in mind?

Note that a Subject Transaction captured by Step 1(a) is a Conflicted Transaction (IM) only if the facts and circumstances indicate a Conflicted Transaction.

Notes to Q.2.6:

[1] Tantamount to bet against the ABS itself. From the Preamble: "In our view, … a bet against the asset pool supporting or referenced by an ABS should be captured as a conflicted transaction. ABS are cash-flow vehicles that distribute cash to investors based on the performance of the relevant asset pool for such ABS. Therefore, a bet against the relevant asset pool is a bet against the ABS itself, which presents the same type of material conflict of interest raised by a short sale of the relevant ABS or a CDS entered into with respect to the relevant ABS as addressed in [prong (i) and

[24] Adopting Release, at 85424 (emphasis added).
[25] Adopting Release, at 85424 (emphasis added).

prong (ii)], respectively. Accordingly, it would not be appropriate to allow a securitization participant to bet against the performance of the relevant asset pool."[26]

[2] Threshold. Depending on the facts and circumstances of the relevant ABS and the Subject Transaction, including the relevant factors listed above, it is our consensus view that a sizeable portion will typically be in excess of 50%. Our consensus view is informed, in part, by analogous securities law principles. We note that the SEC does not reference these principles in the Preamble or Rule 192 itself, and we are citing them here as illustrative of reasonable thresholds in other contexts. Such thresholds would need to be considered in light of the specific facts and circumstances for any relevant ABS and Subject Transaction. For example:

- Under Item 1101(c)(2)(iv) of Regulation AB, if delinquent assets constitute less than 50% of the ABS pool, the portion of delinquent assets is not sizeable enough to prevent the ABS from meeting Regulation AB's definition of "asset-backed security." That is, a portion less than 50% is not sizeable enough to cause the SEC concern that the performance of the ABS depends more on the ability of the servicer than on the self-liquidating nature of the securitized assets. *See* Asset-Backed Securities; Final Rule, 70 Fed. Reg. 1506 (Jan. 7, 205) (the "Regulation AB Adopting Release"), at 1518.
- Under Item 1101(c)(2)(v) of Regulation AB, if the residual value of the motor vehicles relating to motor vehicle leases constitutes less than 65% of the securitized pool balance, that portion is not sizeable enough to prevent the ABS from meeting Regulation AB's definition of "asset-backed security." That is, a portion less than 65% is not sizeable enough to cause the SEC concern that the transaction does not resemble a traditional securitization of self-liquidating financial assets for which the SEC's regime for asset-backed securities is designed. *See* Regulation AB Adopting Release, at 1519.

Q.2.7
Under Step 1(a), what if there is a sizeable overlap in obligors between the Subject Transaction and the ABS pool?

Step 1(a) focuses on the overlap of the securitized assets themselves, not the overlap of obligors. See Q.2.11 for a discussion of overlap of obligors under Step 1(b).

Q.2.8
Under Step 1(a), what if there is a sizeable overlap in comparable assets between the Subject Transaction and the ABS pool?

Step 1(a) focuses on the overlap of the actual assets, not comparable assets. See Q.2.12 for a discussion of the overlap of comparable assets under Step 1(b).

[26] Adopting Release, at 8524.

Prong (iii), Step 1(b): Does the Subject Transaction have characteristics that replicate the idiosyncratic credit risk of the ABS pool?

Q.2.9
Under Step 1(b), if the Subject Transaction includes or references assets that replicate the idiosyncratic credit risk of the ABS pool, does that automatically make the Subject Transaction a Conflicted Transaction (IM)?

No.

- If the Subject Transaction does not include or reference assets that replicate the idiosyncratic credit risk of the ABS pool, it is not a Conflicted Transaction under Step 1(b).[1]

- On the other hand, if the Subject Transaction does include or reference assets that replicate the idiosyncratic credit risk of the ABS pool, then it is a facts and circumstances determination as to whether the Subject Transaction is a Conflicted Transaction (IM).[2]

Notes to Q.2.9:

[1] Not a conflicted transaction if sufficiently distinct. From the Preamble: Prong (iii) is "designed to *not* capture transactions entered into by a securitization participant with respect to an asset pool that has characteristics that are sufficiently distinct from the idiosyncratic credit risk of the asset pool that supports or is referenced by the relevant ABS. Such transactions do not give rise to the investor protection concerns that Section 27B is designed to address."[27]

[2] Facts and circumstances otherwise. From the Preamble: "However, as discussed in detail above, if the transaction is with respect to a pool of assets with characteristics that replicate the idiosyncratic credit performance of pool of assets that is already underlying or referenced by the relevant ABS, then whether such transaction is a conflicted transaction under the final rule will be a *facts and circumstances determination*."[28]

[27] Adopting Release, at 85423.
[28] Adopting Release, at 85426.

Q.2.10

Under Step 1(b), what does it mean for the assets in a Subject Transaction to have characteristics that replicate the idiosyncratic credit risk of the ABS pool?

It is our consensus view that the "replication of idiosyncratic credit risk" standard should be narrowly construed. To create a pool of assets that are not included in the ABS pool but that replicate the idiosyncratic credit risk of the ABS pool generally would require deliberate effort[1] and careful structuring[2]. For this reason, it would be unlikely for a securitization participant to inadvertently create a pool of assets that are not included in the ABS pool but that replicate the idiosyncratic credit risk of the ABS pool.

- Overlap of Obligors. It is generally reasonable for securitization participants to conclude that the subject assets do not replicate the idiosyncratic credit risk of the ABS pool if there is not a substantial overlap of obligors between the subject assets and the ABS pool.[3]
    - Absent a substantial overlap in obligors, it is generally reasonable to expect the subject assets to have different prepayment, delinquency and default patterns than those of the ABS pool due to idiosyncratic obligor behaviors, characteristics or circumstances.
    - An analogous consideration is the SEC's adoption of loan-level disclosure requirements, which highlights the importance of obligor-specific information in assessing the credit risk of the ABS pool.[4]

- Overlap of Asset Type and Other Material Characteristics. Although it depends on the specific facts and circumstances, it is generally reasonable for securitization participants to conclude that the subject assets do not replicate the idiosyncratic credit risk of the ABS pool if there is not a substantial overlap of asset type and other material characteristics between the subject assets and the ABS pool.
    - *Asset type*. The subject assets will generally not replicate the idiosyncratic credit risk of the ABS pool if the subject assets and the ABS pool are not of the same asset type. The idiosyncratic credit risk of any financial asset is a function not only of the idiosyncratic characteristics of the obligor, but also the idiosyncratic characteristics of the obligation. See Q.2.11.
    - *Eligibility criteria and concentration limits*. The subject assets will generally not replicate the idiosyncratic credit risk of the ABS pool if the subject assets do not meet the material eligibility criteria[5] and concentration limits[6] applicable to the ABS pool.
    - *Pool stratification*. The subject assets will generally not replicate the idiosyncratic credit risk of the ABS pool if the subject assets do not substantially match the pool stratification (geographic concentration, distribution of ABS pool by weighted average FICO score, etc.) characteristics of the ABS pool. If any material pool characteristic of the subject assets differs by 5% or more from the ABS pool, that would be a strong indication of a material difference in idiosyncratic credit risk.

- *Consistency with certain other attributes*. The subject assets will generally not replicate the idiosyncratic credit risk of the ABS pool if the subject assets do not match the ABS pool with respect to other material attributes. Although not dispositive, criteria identified by Regulation AB could be informative, such as:
  - Item 1108 of Regulation AB: Identity of the servicer and the terms of the servicing agreement and servicing policies.
  - Item 1110 of Regulation AB: Identity of the originator and features of its origination program and the credit granting process/underwriting criteria it used to originate the ABS pool.
  - Item 1112 of Regulation AB: Presence of significant obligors.

Notes to Q.2.10:

[1] Deliberate effort. A potentially analogous example is when the SEC noted the difficulty of assembling a representative pool when it decided not to include the proposed representative sample option in the final version of Regulation RR. The proposed representative sample option involved randomly selecting the ABS pool and the representative sample from the *same* designated pool of assets. Even that method of assembling a representative pool was deemed unreliable by the SEC and the other agencies: "In order to allow sponsors to hold a representative sample, a number of material factors would need to be considered for the sample to be truly representative. However, even if many factors are considered, a factor could potentially be missed, and as a result, sponsors would end up holding a sample that differed in a material way from the pool assets. This could lead to ineffective alignment of incentives and therefore fail to realize one of the intended benefits of the rule. Due to these concerns, the agencies have decided not to include a representative sample option in the final rule."[29]

[2] Careful structuring. For example, for a pool of financial assets to replicate the idiosyncratic credit risk of a separate pool of financial assets over time, it may be necessary to utilize mechanisms to add, remove, or other otherwise adjust the reference assets in the Subject Transaction to correct for any divergence in credit performance between such assets and the ABS pool.

[3] Substantial Overlap. Determination of what constitutes a "substantial overlap" of obligors should be made for each Relevant ABS and Subject Transaction based on their particular facts and circumstances. For example, a Securitization Participant could engage in a similar analysis as that set forth for a "sizeable portion" in Q.2.6 and come to a determination that a "substantial overlap" will typically be in excess of 50%.[30]

[29] *See* Credit Risk Retention, 79 Fed. Reg. 77602 (Dec. 24, 2014) (the "Regulation RR Adopting Release"), at 77722.
[30] Other Securities Act and Exchange Act rules, regulations and forms rely on other standards. For example, 5% is the standard applied in Item 6.05 of Form 8-K (Securities Act Updating Disclosure). Item 6.05 requires updated disclosure "if any material pool characteristic of the actual asset pool at the time of issuance of the asset-backed securities differs by 5% or more (other than as a result of the pool assets converting into cash in accordance with their terms) from the description of the asset pool in the prospectus".

[4] Obligor-specific and loan-specific attributes to credit risk of ABS pool. In adopting loan-level disclosure requirements for various asset types, including relatively homogenous consumer loans, the SEC stated that:

"We continue to believe that the disclosure of data that relates to the credit risk of the obligor, such as an obligor's credit score, income, or employment history, would strengthen investors' risk analysis of ABS involving consumer assets. We believe these disclosures, combined with other asset- level disclosures, such as the terms and performance of the underlying loan and information about the property, will enable investors to conduct their own due diligence for ABS involving consumer assets, and thus facilitate capital formation in the ABS market. Consequently, it is critically important that the manner in which such information is disseminated enables all investors to receive access to the required asset-level disclosures."[31]

[5] Eligibility criteria. Eligibility criteria typically include the identity of the originator, the credit underwriting policies used to originate the receivables, and the material granular characteristics of the pool assets. An analogous consideration can be found in the Adopting Release for Regulation RR, where the SEC and the other agencies stated that they were "not persuaded that the sponsor's interest in [ineligible receivables that remain in a revolving ABS pool as collateral for the benefit of ABS investors] should be included as eligible risk retention. By their terms, these are assets that *are not representative of the assets that stand as the principal repayment source for investor ABS issued by the revolving pool securitization*."[32]

[6] Concentration limits. Concentration limits may include limits relating to interest rates, principal amounts, FICO scores, and other attributes of the ABS pool.

Q.2.11
Under Step 1(b), if the obligors referenced in the Subject Transaction are the same as the obligors under the ABS pool, does that mean the assets in the Subject Transaction replicate the idiosyncratic credit risk of the assets in the ABS pool?

Not necessarily. Step 1(b) focuses on the idiosyncratic credit risk of the specific financial assets that comprise the ABS pool. The idiosyncratic credit risk of any financial asset is a function not only of the idiosyncratic characteristics of the obligor, but also the idiosyncratic characteristics of the obligation.[1] For example, an unsecured consumer loan to particular obligor would have a different idiosyncratic credit risk profile than an 80% LTV first-lien residential mortgage loan to that same obligor.

Notes to Q.2.11:

[1] Form of obligation. Although not dispositive, it could be helpful to consider the requirements under Item 1111 of Regulation AB. In describing the material characteristics of the pool assets, Item 1111

[31] *See* Asset-Backed Securities Disclosure and Registration, 79 Fed. Reg. 57184 (Sept. 24, 2014), at 57236.
[32] *See* Regulation RR Adopting Release, at 77628.

refers not only to obligor-specific information, such as "standardized credit scores of obligors and other information regarding obligor credit quality" (Item 1111(b)(11), but also on the characteristics of the pool assets themselves, including "[w]hether the pool asset is secured or unsecured, and if secured, the type(s) of collateral" (Item 1111 (b)(10)).

Note also that the regulatory capital approach for calculating a bank's total risk-weighted assets for general credit risk assigns risk weights based on the obligation type. For example, under current rules, a qualifying first lien residential mortgage loan has a 50% credit risk weight, whereas a consumer loan has a 100% risk weight, even if each loan is made to the same obligor.[33] Indeed, the U.S. banking regulators are currently proposing to make credit risk weights more sensitive to idiosyncratic differences in risk by, for example, assigning risk weights to residential mortgages loans based on LTV.

Q.2.12
Under Step 1(b), if the assets referenced in the Subject Transaction are originated by the same entity and under the same origination platform as the assets in the ABS pool, does that mean the assets in the Subject Transaction replicate the idiosyncratic credit risk of the assets in the ABS pool?

Not necessarily. See Q.2.10 for a discussion of the relevant considerations for the replication of idiosyncratic credit risk analysis.

Prong (iii), Steps 1(a) and 1(b): Shorting index; interest rate and currency hedges; routine activities; pre-securitization activities

Q.2.13
Is a CDS index that includes the relevant ABS or the ABS pool the substantial economic equivalent of a prong (i) or prong (ii) transaction?

No, if the relevant ABS or the ABS pool does not represent a sizeable portion of the index.[1]

If the relevant ABS or the ABS pool does present a sizeable portion of the index, then it is a facts and circumstances determination as to whether it is the substantial economic equivalent of a prong (i) or prong (ii) transaction.[2]

The Adopting Release does not provide extensive commentary on what a sizeable portion means in the context of a CDS index.[3] The guidance in Q.2.6 with respect to sizeable/non-sizeable portion of the ABS pool is also generally applicable with respect to sizeable/non-sizeable portion of the index.

[33] *See* Subpart D of Regulation Q, at 12 CFR 217.32.

Notes to Q.2.13:

[1] Not a sizeable portion of index. From the Preamble: "If the relevant ABS or the asset pool supporting or referenced by such ABS does not represent a sizeable portion of the index, then entering into a transaction with respect to such index will not present the same investor protection concerns that Section 27B addresses. In such a scenario, the adverse performance of the asset pool supporting or referenced by such ABS would not have enough of an economic impact on the performance of the relevant index for a short position with respect to that index to be substantially the economic equivalent of a transaction described in Rule 192(a)(3)(i) or Rule 192(a)(3)(ii)."[34]

[2] Facts and circumstances. "From the Preamble: However, if the relevant ABS or the asset pool does represent a sizeable portion of the index, then entering into a transaction with respect to such index presents the same investor protection concerns that Section 27B addresses. Under the final rule, such a transaction could be a conflicted transaction based on the facts and circumstances."[35]

[3] Reference to index standard under Regulation RR. Footnote 386 of the Preamble makes clear that "a transaction with respect to an index that includes a class of the relevant ABS and that is permissible under 12 CFR 373.12(d) will not be a conflicted transaction for purposes of the final rule[.]"[36]

Q.2.14
Are hedges of interest rate or foreign exchange risk the substantial economic equivalent of a prong (i) or prong (ii) transaction?

No.

As a general principle, transactions unrelated to the idiosyncratic credit performance of the ABS are not captured by prong (iii).[1]

Consistent with this general principle, prong (iii) states that "for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk" is not captured by prong (iii). As the Preamble explains:

- "[H]edges that are unrelated to the credit performance of the relevant ABS or the asset pool supporting or referenced by the relevant ABS will not be conflicted transactions as they are not substantially the economic equivalent of a transaction described in Rule 192(a)(3)(i) or Rule 192(a)(3)(ii)."[2]

- "The qualifier 'general' has been included to specify that the relevant transaction must relate to overall market movements and not the idiosyncratic credit risk of the relevant

[34] Adopting Release, at 85424.
[35] Adopting Release, at 85424-85425.
[36] Adopting Release, at 85424, fn. 386.

ABS. … As adopted, Rule 192(a)(iii) will permit any transaction that only hedges general interest rate or currency exchange risk."[3]

Notes to Q.2.14:

[1] General principle. From the Preamble: "Other transactions unrelated to the idiosyncratic credit performance of the ABS, such as hedging of general market risk, are not conflicted transactions, and thus are not subject to the prohibition in Rule 192(a)(1)."[37]

[2] Hedges unrelated to credit performance. *See* Adopting Release, at 85431.

[3] "General" qualifier. *See* Adopting Release, at 85425.

Q.2.15
Does prong (iii) prohibit warehouse financing or the transfer or sale of assets into the relevant securitization SPE?

No. Prong (iii) does not prohibit these ordinary course activities.[1]

Notes to Q.2.15:

[1] From the Preamble: "Commenters expressed concerns that the rule as proposed would prohibit the ordinary course pre-securitization and issuance activities of market participants, such as the provision of warehouse financing or the transfer of assets into a securitization vehicle. As stated in the Proposing Release, the rule is not designed to hinder routine securitization activities that do not give rise to the risks that Section 27B addresses. This includes the provision of warehouse financing and the transfer or sale of assets into the relevant securitization vehicle, which are standard activities in connection with the issuance of ABS. Such normal course activities are not prohibited by final Rule 192(a)(3)(iii) as they are not transactions that are substantially the economic equivalent of a transaction described in final Rule 192(a)(3)(i) or final Rule 192(a)(3)(ii). As described in further detail below, the customary mechanics of secured loans, such as warehouse financing facilities, do not render that financing facility a conflicted transaction under Rule 192(a)(3)(iii) because they do not provide a mechanism for the financing provider to benefit from the adverse performance of the asset pool supporting or referenced by the relevant ABS. Similarly, the transfer or sale of assets to a securitization vehicle does not provide the transferor or seller a mechanism for such entity to benefit from the adverse performance of the asset pool supporting or referenced by the relevant ABS as, absent some other transaction that may need to be separately analyzed, such entity no longer has exposure to the performance of such assets."[38]

[37] Adopting Release, at 85425.
[38] Adopting Release, at 85425.

Q.2.16
Other than general interest rate and exchange rate hedging (which are addressed by Q.2.14) and warehouse financing and pre-securitization transfers (which are addressed by Q.2.15), how are pre-securitization activities treated under Rule 192?

Rule 192 does not contain an express carveout for a Subject Transaction that terminates prior to the issuance of the relevant ABS, and the Adopting Release expresses concern about bets against the asset pool while the ABS is being marketed to investors.[1] However, the Adopting Release states that a Subject Transaction with respect to a pool of assets that, during the duration of the Subject Transaction, neither underlies the relevant ABS nor is referenced by the relevant ABS, then that transaction will not be substantially the economic equivalent of a prong (i) or (ii) transaction.[2]

From a practical perspective, the carveouts referenced above for general interest rate and exchange rate hedging, warehouse financing, and pre-securitization transfers probably alleviate most concerns about pre-securitization activities. Moreover, if a Subject Transaction closes out prior to the ABS being marketed or sold to investors, there may not be a substantial likelihood that a reasonable investor would consider the Subject Transaction important to its investment decision.

Notes to Q.2.16:

[1] No express carveout. From the Preamble: "The Commission received a comment that the prohibition should not apply to transactions that terminate prior to the issuance of the relevant ABS. … We do not believe that it would be appropriate to allow a securitization participant to bet against the performance of an asset pool while, for example, after reaching an agreement to become a securitization participant, simultaneously marketing an ABS to investors that references or is collateralized by that same asset pool even if the relevant bet is closed out prior to the issuance of the relevant ABS."[39]

[2] ABS does not include or reference assets in the ABS pool. "The Commission also received a comment that the prohibition should not apply to any transaction relating to all or a portion of the pool of assets underlying the ABS that terminates on or prior to the date on which such assets are included in the securitization. … ABS are cash-flow vehicles that distribute cash to investors based on the performance of the relevant asset pool for such ABS, and, therefore, a bet against the relevant asset pool is a bet against the ABS itself. In response to the comment, if a securitization participant engages in a transaction with respect to a pool of assets that, during the duration of the transaction, neither underlies the relevant ABS nor is referenced by the relevant ABS, then that transaction will not be substantially the economic equivalent of a transactions described in Rule 192(a)(3)(i) or Rule 192(a)(3)(ii)."[40]

Q.2.17
Does prong (iii) capture servicing activity?

[39] Adopting Release, at 85425-85426.
[40] Adopting Release, at 85426.

No. Servicing activity in accordance with the servicing covenants in the ABS transaction documents is not considered the substantial economic equivalent of a prong (i) or (ii) transaction.[1]

Notes to Q.2.17:

[1] From the Preamble: "Certain commenters also expressed concern that the proposed rule could prohibit the normal-course servicing activity of a securitization participant pursuant to its contractual rights and obligations under the transaction documents for the relevant ABS, particularly with respect to the servicing of distressed assets supporting the relevant ABS. We recognize the role played by servicers over the life cycle of an ABS to help minimize losses for ABS investors with respect to distressed assets and understand that servicers may be entitled to additional income or expense reimbursement when servicing distressed assets that require the servicer to expend more of its time and resources or require specialized skills. Accordingly, the final rule is designed not to impede the ability of servicers to service the assets supporting an ABS in accordance with the contractual covenants applicable to the servicer in the transaction agreements for such ABS. We understand that these covenants are subject to the negotiation of investors prior to the closing of the relevant ABS and that such covenants typically set forth a servicing standard that is designed to direct the servicer to realize the value of the assets through collections and recoveries and, by extension, support the overall performance of the ABS for the benefit of the investors in such ABS. Restricting servicing activity that is conducted in accordance with such servicing standards could, in some cases, not only harm the ABS investors that the rule is intended to protect but also impede the ability of the relevant underlying obligors to avoid foreclosure or insolvency. As adopted, the final rule will not prohibit such servicing activity as it is not substantially the economic equivalent of a transaction described in final Rule 192(a)(3)(i) or final Rule 192(a)(3)(ii)."[41]

Q.2.18
If a Securitization Participant finances a long investor's long position of an ABS, could such a transaction be a Conflicted Transaction? Could a hedge of such a financing arrangement be a Conflicted Transaction?

Providing financing to a long purchaser of an ABS (*e.g.*, margin lending, securities lending, and repo transactions) is not a Conflicted Transaction.[1] Collateral posting requirements are permissible and other customary mechanics of secured loans are permissible.[2]

However, if the Securitization Participant obtains a hedge with respect to the financing exposure, that hedge could constitute a Conflicted Transaction unless the risk-mitigating hedging activities exception is satisfied.[3]

Notes to Q.2.18:

[41] Adopting Release, at 85427.

[1] Long financing not a Conflicted Transaction. From the Preamble: "Other commenters requested an exception for hedging related to intermediation and financing services provided by a securitization participant. As discussed above in Section II.D.3., providing financing to a long purchaser of an ABS is not a conflicted transaction under Rule 192(a)(3)."[42] For the sake of completeness, a securitization participant's obtaining financing for its own long position in an ABS (e.g., margin lending, securities lending, and reverse repo transactions) is not a Conflicted Transaction.

[2] Collateral posting requirements permissible. From the Preamble: "A number of commenters expressed concern that a securitization participant financing an investor's long purchase of an ABS could be a conflicted transaction under the proposed rule. We understand that it is customary for financing arrangements of ABS to include borrowing base mechanics, which are collateral arrangements that require the long purchaser (borrower) to post cash or other collateral in order to maintain a required collateralization level if the value of the financed ABS declines. Customary transactions that are designed to protect the financing provider from a decline in the value of the collateral for its loan would not give rise to the investor protection concerns addressed by Section 27B. In the event of a default by the borrower, any additional collateral posted by the borrower would customarily be available to the lender exercising its rights as a secured creditor but would not provide an additional net benefit to the lender. These types of customary mechanics of secured loans do not render a financing facility a conflicted transaction under Rule 192(a)(3)(iii) because they do not provide a mechanism for the financing provider to benefit from the adverse performance of the asset pool supporting or referenced by the relevant ABS and are therefore not substantially the economic equivalent of a transaction described in final Rule 192(a)(3)(i) or final Rule192(a)(3)(ii)."[43]

[3] Hedging could be a Conflicted Transaction. "If the person providing such financing is a securitization participant with respect to the relevant ABS and desires to enter into a hedge with respect to its financing exposure that would constitute a conflicted transaction under the rule, then such person can enter into that hedge so long as such hedge satisfies the requirements of the risk-mitigating hedging activities exception. The risk-mitigating hedging activities exception applies to the individual or aggregated positions, contracts, or other holdings of the securitization participant, and this risk mitigating hedging activity will be covered by the exception. Therefore, creating an expanded or separate exception for such hedging activity would be redundant."[44]

[42] Adopting Release, at 85431.
[43] Adopting Release, at 85427.
[44] Adopting Release, at 85431-85432.

Prong (iii), Step 2: What facts and circumstances are relevant under the prong (iii) analysis?

As noted above, if the Subject Transaction does not include a sizeable portion of the ABS pool (Step 1(a)) and does not have characteristics that replicate the idiosyncratic credit risk of the ABS pool (Step 1(b)), then the Subject Transaction is not a Conflicted Transaction.

If, however, the Subject Transaction does include a sizeable portion of the ABS pool or if it replicates the idiosyncratic credit risk of the ABS pool, then the next step is to determine whether the facts and circumstances indicate that the Subject Transaction is the substantial economic equivalent of a prong (i) or (ii) transaction.

Q.2.19
What facts and circumstances are most relevant to whether a Subject Transaction is a Conflicted Transaction (IM) under prong (iii)?

The facts and circumstances determination should focus on whether the Subject Transaction is the "substantial economic equivalent" of a prong (i) or prong (ii) transaction.

The Preamble provides two major interpretive principles to help securitization participants identify relevant facts and circumstances.

- Replication of Economic Mechanics. The Preamble states that prong (iii) seeks to capture transactions that "replicate the economic mechanics" of a short sale, or synthetic short sale, of the ABS through alternative or novel means.[1] We understand that prong (iii) is generally not intended to capture transactions of the type that regularly occur in the market at the time of the rulemaking; rather, it is intended to capture transactions that might be developed in the future that "in the same way" replicate a prong (i) or prong (ii) transaction, but in altered or re-structured form.[2]

- Incentive to Select Poor Credit Quality Assets. Neither intent nor knowledge is required under prong (iii).[3] Rather, the stated purpose of prong (iii) is to capture transactions that create an incentive for the securitization participant to select poor credit quality assets to support the ABS.[4] If the Subject Transaction does not create an economic incentive for the securitization participant to select poor credit quality assets to support the ABS, the Subject Transaction is unlikely to be the substantial economic equivalent of a prong (i) or prong (ii) transaction, each of which does create such an economic incentive.

In addition to the major interpretive principles described above, the characteristics of the ABS itself may be relevant in a facts and circumstances determination. Subordination, overcollateralization and other forms of credit enhancement generally seek to break the economic equivalency between (i) the relevant ABS and (ii) the assets in the ABS pool.[5]

Although neither knowledge nor intent are elements under Rule 192, it generally would require deliberate effort to design a transaction that utilizes a short position in the assets to create the substantial economic equivalent of a short position in a particular ABS. For this reason, it is unlikely that a securitization participant would inadvertently enter into a prong (iii) transaction.

Finally, with respect to Step 1(b) (sizeable portion of ABS pool), a facts and circumstances consideration is whether the ABS pool assets that are included in the Subject Transaction are not only a sizeable portion of the ABS pool, but also a sizeable portion of the Subject Transaction itself. This dilution consideration is effectively the same as an index that includes the relevant ABS.[6]

Notes to Q.2.19:

[1] Replication. From the Preamble: "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 Rule 192(a)(3)(i) and (ii) without triggering those prongs, final Rule 192(a)(3)(iii) is designed to alleviate the risk that securitization participants could avoid Section 27B's prohibition premised on the form of the transaction rather than its substance[.]"[45]

[2] Essentially same; different form. From the Preamble: "As adopted, final Rule 192(a)(3)(iii) will capture the types of transactions through which the securitization participant could, in economic substance, bet against the ABS or the asset pool supporting or referenced by the relevant ABS *in the same way* as a short sale of the ABS or a CDS referencing the ABS but without regard to the particular form of the relevant transaction. This will help ensure that the rule protects investors from purchasing ABS tainted by material conflicts of interests as markets evolve and new forms of betting against an ABS or its relevant asset pool that are distinct from a short sale or CDS, but which are substantially the economic equivalent of such transactions, may emerge."[46]

[3] Intent or knowledge not required. From the Preamble: "We believe that narrowing the scope of the final rule to add an element of intent or knowledge is not appropriate because the statute is clear in mandating the prohibition of material conflicts of interest in ABS transactions."[47]

[4] Incentive created by Subject Transaction. From the Preamble: "Rule 192(a)(3)(iii) is focused on prohibiting a securitization participant from entering into a bet against the ABS or the asset pool supporting or referenced by the relevant ABS. This approach is intended to remove the incentive for a securitization participant to select poor credit quality assets for the asset pool supporting or referenced by the ABS."[48] That prong seeks to "remove the incentive for securitization participants to place their own interests ahead of those of ABS investors, as contemplated by the statute."[49]

"As discussed above, final Rule 192(a)(3)(iii) is focused on prohibiting a securitization participant from entering into a bet against the ABS or the asset pool supporting or referenced by the relevant

[45] Adopting Release, at 85421-85422 (emphasis added).
[46] Adopting Release, at 85424 (emphasis added).
[47] Adopting Release, at 85428.
[48] Adopting Release, at 85428.
[49] Adopting Release, at 85422.

ABS. This approach is intended to remove the incentive for a securitization participant to select poor credit quality assets for the asset pool supporting or referenced by the ABS."[50]

[5] ABS and ABS pool assets not economically equivalent. A securitization transaction could feature a AAA-rated senior ABS whose credit quality is much better than that of the overall pool of underlying assets, and an unrated deeply subordinated ABS whose credit quality is much worse than that of the overall pool of underlying assets. Thus, for example, in a subprime auto loan securitization featuring only AAA-rated senior ABS, shorting subprime auto loan assets may not be economically equivalent to shorting the ABS.

The bank regulatory capital rules recognize this distinction as well. Under the credit risk rule's standardized approach,[51] a bank would be required to hold:

- 8% capital[52] against a pool of unsecuritized auto loans on its balance sheet;
- 1.6% capital[53] against a senior ABS backed by that same pool of auto loans; and
- Up to 100% capital[54] against a deeply subordinated ABS backed by that same pool of auto loans.

[6] Dilution. If the ABS (and by extension the entire ABS pool) is in an index, dilution is an important factor in determining whether shorting that index is a Conflicted Transaction (IM). Thus, even if the entire ABS pool is included in a Subject Transaction, dilution of those assets within the Subject Transaction will be an important factor in determining whether the Subject Transaction is a Conflicted Transaction (IM).

[50] Adopting Release, at 85428.
[51] *See* Subpart D of Regulation Q, at 12 CFR 217.30 *et seq*.
[52] The 8% capital figure is calculated by multiplying the capital requirement (8%) by the credit risk weight for auto loans (100%).
[53] The 1.6% capital figure is calculated by multiplying the capital requirement (8%) by the minimum credit risk weight (20%) specified by the credit risk rule. The 20% minimum credit risk weight would apply to a sufficiently senior auto loan ABS.
[54] The 100% capital figure is calculated by multiplying the capital requirement (8%) by the maximum credit risk weight (1250%) specified by the credit risk rule. The 1250% maximum credit risk weight would apply to a sufficiently subordinated auto loan ABS.

Questions regarding the materiality condition

Under Rule 192, a Subject Transaction is not a Conflicted Transaction unless "there is a substantial likelihood that a reasonable investor would consider the transaction important to the investor's investment decision, including a decision to retain the asset-backed security."

Q.2.20
What are some considerations in determining whether the materiality condition under Rule 192 is satisfied with respect to a Subject Transaction?

Whether a reasonable investor would consider the Subject Transaction important to its investment decision presupposes that the investor is fully informed about the Subject Transaction. That is, the question is whether a reasonable investor would consider the Subject Transaction important to its investment decision after having been fully informed of pertinent facts and circumstances of or with respect to the Subject Transaction, which may include, without limitation:

- The business purpose of the Subject Transaction.
- The involvement, if any, of the personnel or business unit that engaged in the Subject Transaction with the structure, design, or assembly of the ABS or the composition of the related asset pool.
- The timing of the Subject Transaction.
    - Was the Subject Transaction entered into far in advance of the ABS being marketed or sold to investors?
    - Was the Subject Transaction entered into well after the structure, design, and assembly of the ABS or the selection of the related asset pool?
    - Was the Subject Transaction substantially concluded prior to the marketing and sale of the ABS to investors?

Another relevant consideration may be whether the Subject Transaction is sufficiently material to be routinely disclosed to investors.

In making the materiality determination with respect to a prong (iii) transaction, it is reasonable for market participants to focus attention on the extent to which a reasonable investor would consider the conflict of interest associated with the transaction to be important to its investment decision. Such an approach is consistent with the stated purpose of Section 27B of the Securities Act, which is to prohibit transactions "that would involve or result in any *material conflict of interest* with respect to any investor."

Notes:

- As in the context of disclosure, the materiality condition under Rule 192 is a fact-specific judgment call and there is considerable risk of hindsight bias. But note that the standard is whether there is a "substantial likelihood that a reasonable investor would consider the

transaction important," not whether there is a mere possibility that a reasonable investor would consider the transaction important.

- Under Rule 192, if the materiality condition is not satisfied with respect to the Subject Transaction, then the Subject Transaction is not a Conflicted Transaction and no exception under Rule 192 is required. However, a Securitization Participant may choose to treat a Subject Transaction as a Conflicted Transaction even if it does not believe the materiality condition is satisfied. Thus, a Securitization Participant's decision to treat a Subject Transaction as a Conflicted Transaction does not imply that the Securitization Participant has concluded that disclosure of the Subject Transaction is required under applicable disclosure principles.
- Similarly, a Securitization Participant's decision to disclose a Subject Transaction does not imply that the Securitization Participant has concluded that the Subject Transaction is a Conflicted Transaction.

Q.2.21

Does the use of the reasonable investor disclosure standard for materiality under Rule 192 imply that a Subject Transaction that is otherwise a Conflicted Transaction would be permitted if disclosure of the Subject Transaction is made to investors?

No. Disclosure does not render an otherwise Conflicted Transaction permissible.[1]

Notes to Q.2.21:

[1] From the Preamble: "As stated in the Proposing Release, the use of the reasonable investor standard in this context does not imply that a transaction otherwise prohibited under the final rule would be permitted if disclosure of the conflicted transaction is made by the securitization participant to the relevant investor. The prohibition will apply to transactions that are bets against the relevant ABS whether or not such transactions are disclosed to investors in the ABS."[55]

Q.2.22

Does the use of the reasonable investor disclosure standard for materiality under Rule 192 imply that a Subject Transaction that is otherwise a Conflicted Transaction would be permitted if an investor selected or approved the assets underlying the relevant ABS?

No. Permitting an investor to select or approve the assets underlying the relevant ABS does not render an otherwise Conflicted Transaction permissible.[1]

Notes to Q.2.22:

[55] Adopting Release, at 85429.

[1] From the Preamble: “Similarly, as stated in the Proposing Release, the use of the reasonable investor standard does not imply that a transaction otherwise prohibited by the final rule will be permitted if an investor selected or approved the assets underlying the ABS. We are not persuaded, as suggested by some commenters, that the prohibition should not apply with respect to an ABS where the investor selects or approves the asset underlying the relevant ABS.”[56]

[56] Adopting Release, at 85429.

Other questions regarding conflicted transactions

Q.2.23
How should "directly or indirectly" engage in a conflicted transaction be interpreted?

The prohibition set forth in Rule 192(a) refers to a Securitization Participant "directly or indirectly" engaging in a Conflicted Transaction. The Adopting Release explains that the purpose of the "directly or indirectly" language is to stop a Securitization Participant from evading the prohibition by routing portions of the Subject Transaction through legal entities deliberately structured to not be affiliates or subsidiaries of the Securitization Participant.[1]

The Adopting Release makes clear, however, that the "directly or indirectly" provision does not prohibit a Securitization Participant from effecting permissible transactions through an affiliate or subsidiary.[2]

Notes to Q.2.23:

[1] Anti-evasion purpose. From the Preamble: "As noted above, several commenters suggested that the phrase 'directly or indirectly' should be removed from proposed Rule 192(a)(1) with one commenter specifically stating that the rule, as proposed, would already apply directly to the affiliates and subsidiaries of a securitization participant. The final rule will apply to certain affiliates and subsidiaries of a securitization participant, but, as explained in the Proposing Release, a securitization participant could design a transaction structure to route the various payment legs of a short transaction through a variety of different legal entities that are deliberately structured to not be affiliates or subsidiaries of the securitization participant in an effort to obscure the ultimate economics of the relevant transaction. Therefore, we are retaining the phrase ''directly or indirectly'' in the adopted rule to address this issue, minimize the risk of evasion, and, by extension, achieve the investor protection goals of Section 27B."[57]

[2] Transacting through affiliates and subsidiaries. "At the same time, we recognize the separate concern of the same commenter that using the phrase ''directly or indirectly'' in Rule 192(a)(1) could be potentially interpreted to create a misalignment between the scope of the entities subject to the prohibition and the scope of the exceptions to the rule that apply to the activities of a securitization participant. However, as discussed in detail below in Sections II.E. through II.G., the final rule does not prohibit a securitization participant from using an affiliate or subsidiary as an intermediary, for example, to effect risk-mitigating hedging activity or fulfill a liquidity commitment obligation of the securitization participant consistent with the conditions enumerated in the exceptions to the rule."[58]

[57] Adopting Release, at 85420.
[58] Adopting Release, at 85420.

Q.2.24
If the Subject Transaction is entered into pursuant to a fiduciary duty, is it carved out from the definition of Conflicted Transaction?

No, Rule 192 contains no carveout for transactions entered into pursuant to a fiduciary duty.[1] The Adopting Release is clear that Securitization Participants who enter into an agreement to participate in the securitization will need to consider the impact on their affiliates or subsidiaries who are investment advisers.[2] Note that coordination or information sharing is necessary to cause an affiliate or subsidiary to be considered a Securitization Participant.[3]

Notes to Q.2.24:

[1] No carveout for fiduciary duty. From the Preamble: "We do not believe that a carve-out for conflicted transactions entered into pursuant to a fiduciary duty would be appropriate or necessary. As discussed above in Section II.B.3., Rule 192 will complement the existing Federal fiduciary duties. Final Rule 192(a)(3)(iii) is focused on prohibiting a securitization participant from entering into a bet against the ABS or the asset pool supporting or referenced by an ABS. This approach is designed to remove the incentive for a securitization participant to select poor credit quality assets for the asset pool supporting or referenced by an ABS. The final rule, therefore, prohibits an investment adviser from entering into a conflicted transaction to allow a fiduciary client to profit from the adverse performance of an ABS with respect to which the investment adviser structured and selected the asset pool in order to sell such ABS to long investors."[59]

[2] Consider impact on affiliates and subsidiaries. From the Preamble: "We recognize that securitization participants, when entering into an agreement to participate in the securitization, will need to consider potential impacts related to their affiliates or subsidiaries (that meet the definition of securitization participant in Rule 192(c)), as the prohibition will restrict those affiliates and subsidiaries from entering into conflicted transactions. A conflicted transaction entered into by such an affiliate or subsidiary may fall within an available exception, but, in any case, will still be covered by this rule."[60]

[3] Coordination and information sharing. From the Preamble: "In response to the concerns of commenters, the revised approach to affiliates and subsidiaries described above in Section II.B.3.c. should help address situations that do not involve these same investor protection concerns, such as where there is no coordination or information sharing between the relevant personnel of the investment adviser entering into the relevant client transaction and the relevant investment personnel responsible for the design and composition of the ABS."[61]

[59] Adopting Release, at 85427.
[60] Adopting Release, at 85427.
[61] Adopting Release, at 85428.

TOPIC 3:

HOW ARE CRTS TREATED UNDER RULE 192?

Note: Readers of the guide should be aware that a CRT with respect to a reference pool included in an ABS transaction may raise issues under Regulation RR (the credit risk retention rule). This guide does not address issues under Regulation RR.

Scenario 1 – SPV Issued

Issuer:	SPV
Security Issued:	Synthetic ABS under Rule 192
Subject Transaction:	Credit default swap or similar credit derivative on Reference Pool ("CDS"). CDS is between SPV, as protection seller, and the Rule 192 "sponsor" of the synthetic ABS (the "Securitization Participant-Sponsor"), as protection buyer.
Reference Pool:	Type 1: Financial assets not included in or referenced by a separate ABS.
	Type 2: Separate ABS or financial assets included in or referenced by a separate ABS.

Q.3.1
Is the Subject Transaction (the CDS) a Conflicted Transaction for the Securitization Participant-Sponsor?

Yes, for both reference pool types. Although the Subject Transaction (the CDS) is an inherent component of the synthetic ABS transaction, the SEC considers the Subject Transaction to be the substantial economic equivalent of a bet by the Securitization Participant-Sponsor against the Synthetic ABS itself.[1]

In addition, with respect to Reference Pool Type 2, if the Securitization Participant-Sponsor is also a securitization participant with respect to the separate ABS, the SEC considers the Subject Transaction to be the substantial economic equivalent of a bet by the Securitization Participant-Sponsor against the separate ABS.[2] Note that the Securitization Participant-Sponsor may be considered a securitization participant with respect to that separate ABS if it is an affiliate or subsidiary of a sponsor, underwriter, initial purchaser or placement agent with respect to that separate ABS.[3]

In either of the above cases, the Subject Transaction would be a Prohibited Transaction unless it qualifies for the risk-mitigating hedging activities exception. The Preamble expressly acknowledges the valid use of synthetic ABS for hedging purposes.[4]

Notes to Q.3.1:

[1] Conflicted transaction with respect to synthetic ABS. From the Preamble: "As discussed in the Proposing Release, the relevant material conflict of interest in the context of the issuance of a new synthetic ABS arises when the securitization participant engages in a transaction (such as CDS contract(s) with the synthetic ABS issuer) where cash paid by investors to acquire the newly created synthetic ABS will fund the relevant contract(s) and be available to make a payment to the securitization participant upon the occurrence of an adverse event with respect to the assets included in the reference pool. In economic substance, if the reference pool for the synthetic ABS performs adversely, then the securitization participant benefits at the expense of the investors in the synthetic ABS. Pursuant to the final rule, this arrangement will result in a conflicted transaction with respect to the investors in the synthetic ABS because it is substantially the economic equivalent of a bet against such ABS itself."[62]

[2] Conflicted transaction with respect to separate ABS. From the Preamble: "Additionally, if the reference pool for the synthetic ABS collateralizes a separate ABS with respect to which the relevant securitization participant is a securitization participant under the final rule, this arrangement will result in a conflicted transaction with respect to the investors in the ABS collateralized by such reference pool as being substantially the economic equivalent of a bet against such ABS itself. Such transaction, in economic substance, is the same as the securitization participant entering into a bilateral CDS on the ABS that is collateralized by such reference pool."[63]

[3] Affiliate or subsidiary of securitization participant with respect to separate ABS. As explained below in Topic 4, a securitization participant with respect to an ABS includes not only the sponsor, underwriter, initial purchaser or placement agent with respect to that ABS, but also certain of their affiliates and subsidiaries.

[4] Use of synthetic ABS for hedging purposes. From the Preamble: "However, we also understand, as commenters stated, that securitization participants may utilize synthetic ABS structures for hedging purposes. Therefore, as discussed in detail in Section II.E. below, we are adopting a change to the proposed risk-mitigating hedging exception so that the issuance of synthetic ABS that are entered into and maintained for hedging purposes are eligible for the risk-mitigating hedging activities exception. To help ensure that these types of transactions cannot be utilized as a bet by a securitization participant against the credit performance of the reference assets, any such transaction will need to satisfy each of the conditions to the risk-mitigating hedging activities exception described in Section II.E. If such transaction is not entered into for purposes of hedging an existing long exposure of the securitization participant to the assets included in the reference

[62] Adopting Release, at 85426.
[63] Adopting Release, at 85426.

pool in accordance with the requirements of the risk-mitigating hedging activities exception, then such activity will not qualify for the exception and will be prohibited by the final rule."[64]

Scenario 2 – Directly Issued

Issuer:	Bank or other corporate entity
Security Issued / Subject Transaction:	Credit-linked note or other corporate debt obligation[65]
Reference Pool:	Type 1: Financial assets not included in or referenced by a separate ABS.
	Type 2: Separate ABS or financial assets included in or referenced by a separate ABS.

Q.3.2
Is the Subject Transaction a Conflicted Transaction for the bank or corporate entity?

No, for the Type 1 Reference Pool. Rule 192 applies to material conflicts of interests with investors in an ABS. Since neither the Security Issued nor the Reference Pool involves an ABS, Rule 192 would not apply.

For the Type 2 Reference Pool, the Subject Transaction would be the substantial economic equivalent of a bet by the bank or corporate issuer against the separate ABS. Thus, if the bank or corporate issuer is a securitization participant, the Subject Transaction would be a Prohibited Transaction unless it qualifies for the risk-mitigating hedging activities exception. However, if the bank or corporate issuer is not a securitization participant, the Subject Transaction would not be a Conflicted Transaction and, therefore, not a Prohibited Transaction.

[64] Adopting Release, at 85426-85427.
[65] Note that a security issued directly by a bank or corporate issuer is not a synthetic ABS under Rule 192.

TOPIC 4:

WHO IS A "SECURITIZATION PARTICIPANT"?

Overview

Final Rule 192 applies to transactions involving any "securitization participant." The term "securitization participant" is defined to mean:

(i) An underwriter, placement agent, initial purchaser, or sponsor of an asset-backed security [each, a "**named securitization participant**"]; or

(ii) Any affiliate (as defined in 17 CFR 230.405) or subsidiary (as defined in 17 CFR 230.405) of a [named securitization participant] if the affiliate or subsidiary:

(A) Acts in coordination with a [named securitization participant]; or

(B) Has access to information or receives information about the relevant asset-backed security or the asset pool underlying or referenced by the relevant asset-backed security prior to the first closing of the sale of the relevant asset-backed security.

Underwriters, Placement Agents, and Initial Purchasers

Q.4.1
How are "underwriter" and "placement agent" defined?

Each is defined as "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."

Q.4.2
How is "initial purchaser" defined?

An "initial purchaser" is "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."

Q.4.3
Are underwriting syndicate co-managers or selling group members considered underwriters, placement agents or initial purchasers?

Underwriting syndicate co-managers are considered underwriters, placement agents, or initial purchasers, as applicable, if they have entered into an agreement with the issuer or selling security holder to become one, even if they have no direct involvement in structuring the ABS or selecting the ABS pool.[1][2][3]

On the other hand, selling group members (underwriters, placement agents, and initial purchasers with no such agreement with the issuer or the selling security holder) are not underwriters, placement agents, or initial purchasers under Rule 192.[4]

Notes to Q.4.3:

[1] Underwriting syndicate co-managers. From the Preamble: "Some commenters requested that we limit the definition of 'underwriter,' 'placement agent,' and 'initial purchaser' to capture only those persons who are directly involved in structuring the relevant ABS or selecting the assets underlying the ABS, stating as an example that underwriting syndicate co-managers generally rely on lead managers and have little direct involvement with the aforementioned securitization activities. While it may be the case that underwriters, placement agents, or initial purchasers are involved in the issuance of an ABS in varying degrees, the prohibition in Rule 192(a)(1) only applies to such persons if they have entered into an agreement with an issuer (or, with respect to underwriters and placement agents, a selling security holder) because those persons would likely be privy to certain information about the ABS or underlying assets."[66]

[2] Co-managers entering into agreement. It is often the case that the lead managing underwriters sign the underwriting agreement, placement agency agreement or note purchase agreement, as applicable, on behalf of themselves and on behalf of the co-managers pursuant to an "agreement among underwriters" ("AAU"). The AAU authorizes the managing underwriters to act on behalf of all the underwriters, including executing the underwriting agreement, placement agency agreement or note purchase agreement. Absent unusual circumstances, this mechanism constitutes the co-managers' entering into an agreement with the issuer. Note, however, that co-managers may be added to the syndicate at different times and therefore the prohibition timeframe for each co-manager may begin at different times. See Topic 5 (Prohibition Timeframe).

[3] Agreement with issuer or selling security holder. Note that the text of Rule 192(a)(1) does not specify with whom an agreement must be reached in order for a person to become a securitization participant. The Preamble states that agreement must be reached "with the issuer or selling security holder." In this context, "issuer" should be read to include not only the issuing entity, but also the sponsor.

[66] Adopting Release, at 85405.

[4] Selling group members. Adopting Release, at 85405.

Sponsors

Q.4.4
How does Rule 192 define the term "sponsor"?

For purposes of Rule 192, the term "sponsor" means:

- A "traditional" sponsor: "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

- A "contractual rights" sponsor: "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 or referenced by the asset-backed security, other than":

    - "a person who acts solely pursuant to such person's contractual rights as a holder of a long position in the asset-backed security (the "**long-only investor exclusion**") or

    - "a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design assembly, or ongoing administration of an asset-backed security or the composition of the pool of assets underlying or referenced by the asset-backed security" (the "**service provider exclusion**").

U.S. / U.S. agency exclusion. The term "sponsor" does not include "the United States or an agency of the United States … 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."

Q.4.5
Is an investor a potential "sponsor" under Rule 192?

Generally no.

Rule 192, as adopted, does not contain the "directing sponsor" concept that was in the proposed version of the rule. The directing sponsor concept was very broad and could have captured investors who express preferences about the ABS or the ABS pool.[1]

Under final Rule 192, an investor in an ABS is not considered a "sponsor" of that ABS if the investor does not have the contractual right to direct or cause the direction of the structure, design, or assembly of the ABS or the composition of the ABS pool. Investors do not typically have the contractual right to direct or cause the direction of the structure, design, or assembly of the ABS or the composition of the ABS pool.

Once the ABS deal closes, the related transaction documents often give investors contractual rights as holders of the ABS. Examples of contractual rights that an investor has a holder of a long position in the ABS are: "consent rights over major decisions such as initiating foreclosure proceedings with respect to assets underlying the ABS, the right to replace the special servicer of the ABS, or the right to direct or cause the direction of an optional redemption of outstanding interests in the ABS."[2]

The text of Rule 192, as well as the Preamble, make clear that actions that an investor takes solely pursuant to such contractual rights qualify for the long-only investor exclusion.[3] However, an investor's right to take actions pursuant to other contractual rights that it, or an affiliate, has (e.g., the rights that it may have as special servicer) are not covered by the long-only investor exclusion. Therefore, such other contractual rights may render the long-only investor exclusion unavailable. However, an investor is not a contractual rights sponsor simply because it does not qualify for the long-only investor exclusion. In that case, the investor would be contractual rights sponsor only if it has the contractual right to direct or cause the direction of the structure, design, or assembly of the ABS or the composition of the ABS pool.

Note that:

- The application of the long-only investor exclusion with respect to B-piece buyers in CMBS transactions and directing noteholders in CRE CLO transactions is discussed in Q.4.7 below.
- If the long investor is an affiliate or subsidiary of any named securitization participant, it may be a securitization participant if it acts in coordination with that named securitization participant or if it has access to information about the ABS or the ABS pool. The treatment of affiliates and subsidiaries is discussed in more detail below.

Notes to Q.4.5:

[1] Directing sponsor concept not included in final rule. The proposed version of Rule 192 defined sponsor to include any person "that directs or causes the direction of the structure, design, or assembly of an asset-backed security or the composition of the pool assets underlying the asset-backed security." Market participants expressed concern about whether, and the extent to which, this "directing sponsor" concept could capture investors and other parties who might influence the structure, design, or assembly of the ABS or the composition of the ABS pool. From the Preamble:

"In current market practice, investors in ABS transactions may receive information about collateral (including, for example, specific loan data and due diligence results) and may specify preferences or requirements for a given deal structure or terms of the security. Commenters stated, and we agree, that these negotiations are important and beneficial market functions. Consequently, as requested by commenters and to help ensure that Rule 192 is not an impediment to an investor's negotiating power, we are not adopting paragraph (ii)(B) (Directing Sponsor) of the proposed definition of 'sponsor.'"[67]

[67] Adopting Release, at 85409.

[2] Examples of contractual rights granted under transaction documents. Adopting Release, at 85409.

[3] Long-only investor exclusion. From the preamble: "Rule 192 is not designed to impair an ABS investor's ability to negotiate for such contractual rights as a holder of a long position in the ABS. Nor is it designed to discourage investors from exercising such rights as a holder of a long position in the ABS. Therefore, we are adopting paragraph (ii) of the definition of 'sponsor' to exclude from the definition of Contractual Rights Sponsor any person who acts solely pursuant to such person's contractual rights as a holder of a long position in the ABS."[68]

Q.4.6
Are servicers and other service providers potential "sponsors" under Rule 192?

Generally no.

As noted above, under the service provider exclusion, a contractual rights sponsor does not include a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design assembly, or ongoing administration of the ABS or the composition of the ABS pool.

Activities customarily performed by servicers are the types of activities described in the service provider exclusion.[1] The Preamble indicated that changing "only" to "primarily" as requested by commenters wasn't necessary because customary servicer activities "include the drafting and negotiation of the operating and disclosure documents with respect to an ABS, setting fees to be paid to certain transaction parties, reviewing the asset pool, negotiating the priority of payments within an ABS transaction, potentially advising on how to structure an ABS to meet the objectives of the deal parties, collecting payments on underlying assets, and making distributions to bondholders."[2] In order to be a sponsor under Rule 192, a servicer would typically have to engage in pre-closing activities relating to structure, design, or assembly of the ABS or the composition the ABS pool, that go materially beyond the customary servicing activities referenced above.

Notes to Q.4.6:

[1] Customary servicer activities excluded. From the Preamble: "[W]e agree with commenters that the activities customarily performed by accountants, attorneys, and credit rating agencies with respect to the creation and sale of an ABS, as well as the activities customarily performed by trustees, custodians, paying agents, calculation agents, and servicers, relating to the ongoing management and administration of the entity that issues the ABS and its related assets, are the types of activities described in the Servicer Provider Exclusion."[69]

[2] Scope of servicing activities. Adopting Release, at 85412. The Preamble goes on to state: "While we agree that such activities could be understood to be consistent with the activities described in

[68] Adopting Release, at 85407.
[69] Adopting Release, at 85412.

the Contractual Rights Sponsor definition, we also agree that they are consistent with the administrative, legal, due diligence, custodial, and ministerial activities covered by the Service Provider Exclusion. As the Commission stated in the Proposing Release, the Service Provider Exclusion is intended to avoid inadvertently including certain parties to securitization transactions whose contractual rights could be interpreted as consistent with the activities described in paragraph (ii) of the definition of ''sponsor'' but who are otherwise not the parties that Section 27B was intended to cover. For this reason, so long as a person's activities with respect to the relevant ABS are only administrative, legal, due diligence, custodial, or ministerial in nature, the Service Provider Exclusion is available ''notwithstanding'' the fact that such a person's contractual rights could also be understood to be captured by paragraph (ii) of the definition of sponsor. Accordingly, we do not believe that changing 'only' to 'primarily' is necessary."[70]

Q.4.7
How do the long-only investor exclusion and the service provider exclusion apply in the case of CMBS B-piece buyers (or CRE CLO directing holders) and special servicers?

B-piece buyer/long-only investor exclusion.

- For what are typically referred to as "major decisions" (such as releasing a commercial property from the lien of the mortgage or entering into a lease with a significant tenant), the borrower's request would typically be processed by the special servicer, subject to the B-piece buyer's contractual right to approve pursuant to the related transaction documents. Without the long-only investor exclusion, these contractual rights with the respect to major decisions concerning the ABS pool would otherwise cause a B-piece buyer to be a contractual rights sponsor.[1]
- However, because the B-piece buyer exercises such major decision rights solely pursuant to its contractual rights under the transaction documents as a long investor, it will qualify for the long-only investor exclusion.[2]

Special servicer/service provider exclusion.

- Whether a special servicer's activities satisfy the service provider exclusion "will depend on the nature of the special servicer's activities."[3] The Preamble states that:

> "a special servicer can potentially have a significant role in the servicing and disposition of troubled assets in an asset pool, such as the ability to determine whether (and when) to negotiate a workout of a loan, take possession of the property collateralizing a loan, and purchase the loan out of the securitization at a discount and, therefore, the special servicer's activities may not be limited to the types of administrative or ministerial functions eligible for the exclusion. As such, whether a special servicer qualifies for the exclusion will depend on the facts and circumstances of the ABS and the activities performed by the special servicer."[4]

[70] Adopting Release, at 85412.

- The failure of a special servicer to qualify for the service provider exclusion does not mean that the special servicer is a contractual rights sponsor. That will require a separate facts and circumstances determination as to whether the special servicer has the contractual right to direct or cause the direction of the structure, design, or assembly of the ABS or the composition of the ABS pool.

- It is our consensus view that it would be a rare case for a servicer to be appropriately considered a contractual rights sponsor simply by virtue of exercising its contractual obligations as servicer pursuant to the terms and conditions of the servicing agreement.

    - A servicer acting in its capacity should not be considered to be "directing" or "causing the direction" of the composition of the ABS pool simply because its actions may influence the composition of the ABS pool after closing. The influence of servicing activities on the composition of the ABS pool (e.g., through modifications or enforcement actions) is determined by, and limited by, the instructions, directions, covenants and limitations set forth in the servicing agreement.
    - As noted in Q.4.6, in order to be a sponsor under Rule 192, a servicer would typically have to engage in pre-closing activities relating to structure, design, or assembly of the ABS or the composition the ABS pool, that go materially beyond the customary servicing activities referenced in Q.4.6.

Where the B-piece buyer is also the special servicer.

According to the Preamble, if the B-piece buyer is also the special servicer (or an affiliate thereof), then the B-piece buyer may not qualify for the long-only investor exclusion[5] and the special servicer may not qualify for the service provider exclusion[6]. However, the lack of availability of an exclusion does not necessarily mean that the B-piece buyer/special servicer is a contractual rights sponsor. Rather, it would remain a facts and circumstances determination as to whether the B-piece buyer/special servicer has a contractual right to direct or cause the direction of the structure, design, or assembly of the ABS or the composition of the ABS pool.

While the Preamble discussion focuses primarily on CMBS transactions, the Preamble states that "[t]he same analysis applies for the directing noteholder in a commercial real estate collateralized loan obligation ("CRE CLO"), which functions similarly to the B-piece buyer in CMBS transactions."[7]

Notes to Q.4.7:

[1] B-piece buyer – potential contractual rights sponsor. From the Preamble: "As a holder of a long position in the relevant ABS, a B-piece buyer will generally have additional ongoing rights in an ABS transaction. For example, transaction agreements may dictate that certain actions with respect to the asset pool underlying the ABS (such as releasing a property from a lien) are subject to the approval of the B-piece buyer, giving the B-piece buyer a contractual right to direct or cause the direction of the composition of the pool. As such, absent the exclusion we are adopting for Long-

only Investors, a B-piece buyer could be subject to the prohibition of Rule 192(a)(1) as a Contractual Rights Sponsor."[71]

[2] B-piece buyer – long only investor exclusion. From the Preamble: "Under the final rule, if the B-piece buyer exercises such rights solely pursuant to its contractual rights as a holder of a long position in the ABS, then the B-piece buyer will satisfy the conditions for the Long-only Investor carve-out from the definition of Contractual Rights Sponsor as adopted and, therefore, will not be subject to the prohibition in Rule 192(a)(1)."[72]

[3] Special servicer's activities. Adopting Release, at 85409.

[4] Special servicer's impact. Adopting Release, at 85412.

[5] B-piece buyer / special servicer may not qualify for the long-only investor exclusion. From the Preamble: "[I]f a B-piece buyer is also a special servicer for an ABS transaction, the B-piece buyer will not be acting ''solely'' pursuant to its rights as a holder of a long position in the relevant ABS and will need to then consider whether the performance of its contractual obligations as special servicer will be sufficiently administrative or custodial in nature to be excluded from the definition [of sponsor]."[73]

[6] B-piece buyer / special servicer may not qualify for the service provider exclusion. From the Preamble: "For example, if the special servicer for a CMBS transaction is also the B-piece buyer (or an affiliate or subsidiary of the B-piece buyer) and can exercise such contractual rights with respect to the asset pool without needing to obtain the consent of any unaffiliated investor or transaction party in the CMBS transaction, then the special servicer's activities are not only administrative, legal, due diligence, custodial, or ministerial in nature with respect to such CMBS transaction."

[7] Same analysis for CRE CLO directing noteholder. *See* Adopting Release, at 85409 (fn. 197). Footnote 197 is appended to the Preamble text stating that "Whether a B-piece buyer in a CMBS transaction is a 'sponsor' for purposes of Rule 192 or satisfies the condition of the exclusion for Long-only Investors will depend on the facts and circumstances of a given transaction and B-piece buyer." *See* Adopting Release, at 85409.

[71] Adopting Release, at 85409.
[72] Adopting Release, at 85409.
[73] Adopting Release, at 85409-85410.

Q.4.8
Is a third-party asset originator or third-party seller a potential "sponsor" under Rule 192?

Generally no.

The purchase of assets from an unaffiliated asset originator or seller is a routine capital market function through which the seller would not have the contractual right to direct or cause the direction of the structure, design, or assembly of the ABS or the composition of the ABS pool.[1]

Unrelated to the origination and sale activity, note that an asset originator/seller that is an affiliate or subsidiary of a named securitization participant may be a securitization participant for purposes of Rule 192 because the definition of "securitization participant" includes affiliates or subsidiaries of named securitization participants under certain circumstances.[2]

Notes to Q.4.8:

[1] Third-party originator/seller not a sponsor. From the Preamble: "The purchase of assets from unaffiliated originators to be later transferred into a securitization is a routine capital market function through which the seller would not have the contractual right to direct or cause the direction of the structure, design, or assembly of an ABS or the composition of the underlying or referenced pool of assets. Such persons' activities are limited to merely originating assets that are then transferred to the ABS sponsor in a true sale; they do not have ongoing roles or contractual rights or duties with respect to the assets or the ultimate ABS. Therefore, while we do not believe that the function performed by these third-party asset sellers is consistent with the types of activities enumerated in the Service Provider Exclusion, we do agree that such persons are not 'sponsors' under the rule."[74]

[2] Affiliated originator/seller may be a securitization participant. From the Preamble: "An originator that is affiliated with an underwriter, placement agent, initial purchaser, or sponsor of a covered transaction, however, may be a securitization participant subject to the rule's prohibition against engaging in conflicted transactions."[75]

[74] Adopting Release, at 85413.
[75] Adopting Release, at 85413 (fn. 247).

Q.4.9
Is a warehouse lender a potential "sponsor" under Rule 192?

Generally no. Warehouse lending is a routine activity to finance the purchase of assets by a securitization participant in anticipation of an ABS issuance. A warehouse lender whose role is to engage in such routine lending activity is not a sponsor under Rule 192.[1]

However, if the warehouse lender is an affiliate or subsidiary of a named securitization participant, the warehouse lender may also be a securitization participant.[2] The inclusion of affiliates or subsidiaries of named securitization participants is addressed below. Note that even if a warehouse lender is a securitization participant due to its affiliation with a named securitization participant, warehouse lending is not a conflicted transaction.[3]

Notes to Q.4.9:

[1] Warehouse lender not a sponsor. From the Preamble: "As stated in the Proposing Release, the rule is not designed to hinder routine securitization activities that do not give rise to the risks that Section 27B was intended to address. Warehouse financing is a routine activity to finance the purchase of assets by a securitization participant in furtherance of the issuance of an ABS. A warehouse lender whose role is to engage in such routine lending activity with respect to the ABS, including the lender's right to determine which assets it is or is not willing to finance pursuant to its underwriting standards, does not meet the definition of 'sponsor' under the final rule."[76]

[2] Affiliated warehouse lender may be a securitization participant. From the Preamble: "However, if a securitization participant has an affiliate or subsidiary that is a warehouse lender, and such affiliate or subsidiary meets the definition of securitization participant in Rule 192(c), such person will be subject to the prohibition in Rule 192(a)."[77]

[3] Warehouse lending not a conflicted transaction. See [Q.2.14].

Q.4.10
Are market participants acting subject to a fiduciary duty to a client or customer, such as an open-market CLO collateral manager, municipal advisor, or other investment adviser excluded from the definition of "sponsor"?

No. The SEC declined to adopt a fiduciary-duty based exclusion from Rule 192.[1]

[76] Adopting Release, at 85411.
[77] Adopting Release, at 85411.

Notes to Q.4.10:

[1] From the Preamble: "Some commenters requested that market participants acting subject to a fiduciary duty to a client or customer, such as open-market CLO collateral managers, municipal advisors, or other investment advisers be excluded from the definition of 'sponsor' because such participants are already subject to various laws and regulations that regulate their conduct and address conflict management. … As discussed earlier, the fact that an entity is subject to other rules, laws, or regulatory policies pertaining to its conduct, including the existence and management of conflicts of interest, does not preclude such entity from satisfying the conditions of other regulatory requirements. … Although the application of an adviser's Federal fiduciary duty, which requires the adviser to serve the best interests of its clients, and the Antifraud Provisions provide protections relating to conflicts of interest that act in harmony with Rule 192, these duties and provisions do not necessarily require elimination of conflicted transactions. Accordingly, a fiduciary duty-based exclusion from Rule 192 would frustrate Section 27B's prophylactic investor protection objectives to eliminate certain conflicted transactions."[78]

Q.4.11
Are the GSEs excluded from the definition of "sponsor"?

No. The Preamble states that Fannie Mae and Freddie Mac "are sponsors under the final rule with respect to any ABS that they issue, whether or not it is fully guaranteed."[1]

Notes to Q.4.11:

[1] Adopting Release, at 85414. From the Preamble: "Although we still believe that, while the Enterprises are in conservatorship, investors in their guaranteed ABS are not exposed to the same types of risk that existed in certain ABS transactions leading up the financial crisis of 2007–2009,that would not be the case once the Enterprises exit conservatorship. In light of the concerns that the cumulative effect of the proposed exclusion from the ''sponsor'' definition and the proposed exception for risk-mitigating hedging activities was unclear, we have concluded that including the Enterprises as sponsors and permitting Enterprise CRT transactions so long as they meet the conditions enumerated in the risk-mitigating hedging exception, would provide more certainty for the Enterprises and the market. Further, we believe that the revisions to the definition of ''conflicted transactions,'' together with the revised exception for risk-mitigating hedging activities discussed below, sufficiently address commenter concerns with respect to the ability of the Enterprises to continue to engage in CRT transactions for purposes of managing their credit risk. As sponsors—and, thus, securitization participants— subject to the prohibition in Rule 192(a) against engaging in conflicted transactions, the Enterprises are subject to the same limitations on such behavior as private market participants."[79]

[78] Adopting Release, at 85410.
[79] Adopting Release, at 85414.

Q.4.12
If an ABS is issued by the U.S. or an agency of the U.S., are the underwriters, placement agents, or initial purchasers considered "securitization participants" under Rule 192?

Yes. While Rule 192 excludes the U.S. and any agency of the U.S. from the definition of "sponsor" and thus from the definition of "securitization participant," the underwriters, placement agents, or initial purchasers are still securitization participants and subject to Rule 192.[1]

Notes to Q.4.12:

[1] From the Preamble: "For purposes of the final rule, and as noted in the Proposing Release, the exclusion in paragraph (iv) of the definition of 'sponsor' applies only to the specified entities (i.e., the United States or an agency of the United States). Any other securitization participant involved with an ABS issued or guaranteed by a specified entity (e.g., an underwriter or a non-governmental sponsor) is subject to the prohibition in Rule 192 against engaging in transactions that effectively represent a bet against the relevant ABS."[80]

Q.4.13
If the ABS are fully guaranteed by the U.S. but the sponsor is not the U.S. or an agency of the U.S., is the sponsor carved out of the definition of "securitization participant"?

No. A non-governmental sponsor of ABS fully guaranteed by the U.S. (for example mortgage-backed securities guaranteed by Ginnie Mae) is still a securitization participant and is subject to Rule 192.[1]

Notes to Q.4.13:

[1] From the Preamble: "If, therefore, the issuer of a fully-guaranteed Ginnie Mae ABS meets the definition of ''sponsor'' as adopted, such issuer is prohibited from engaging in conflicted transactions."[81] See, also, the notes to Q.4.12.

[80] Adopting Release, at 85413.
[81] Adopting Release, at 85413.

Affiliates and Subsidiaries of Named Securitization Participants

As noted above, an affiliate or subsidiary of a named securitization participant is not itself a securitization participant unless it (i) acts in coordination with the named securitization participant (the "**coordination prong**") or (ii) has access to information or receives information about the relevant ABS or ABS pool prior to the first closing of the sale of the relevant asset-backed security (the "**information prong**").

Q.4.14
Why did the SEC add the coordination prong and the access to information prong?

As initially proposed, Rule 192 would have applied to all affiliates and subsidiaries of each underwriter, placement agent, initial purchaser, and sponsor, no matter how remotely related, distinct in operation or uninvolved in the ABS transaction, and without regard to the use of information barriers or other indicia of separateness.

The Preamble acknowledges these concerns, and indicates the addition of the coordination prong and the access to information prong is consistent with commenter suggestions that:

- "affiliates and subsidiaries should only be subject to the prohibition if they have direct involvement in, or access to information about, the relevant ABS or are otherwise acting in coordination with the named securitization participant"[1]; and

- "the final rule permits securitization participants to demonstrate lack of involvement or control through the presence of information barriers or other indicia of separateness."[2]

Notes to Q.4.14:

[1] Direct involvement; access to information; acting in coordination. Adopting Release, at 85416.

[2] Information barriers and other indicia of separateness. Adopting Release, at 85416.

Q.4.15
What does it mean for an affiliate or subsidiary to "act in coordination" with the named securitization participant?

The Preamble states that "an affiliate or subsidiary would be acting in coordination with a named securitization participant if it (i) directly engages in the structuring of or asset selection for the securitization, (ii) directly engages in other activities in support of the issuance and distribution of the ABS, or (iii) otherwise acts in concert with its affiliated securitization participant through, e.g., coordination of trading activities."[1]

The phrases "directly engages" and "acts in concert" indicate that there must be more than incidental or unrelated joint activities. It is our consensus view that substantive coordination with respect to the ABS is required.

Notes to Q.4.15:

[1] Adopting Release, at 85414 (fn. 276).

Q.4.16

If an affiliate or subsidiary of a named securitization participant receives, or has access to, publicly-available information, or non-public but irrelevant information, about the ABS or the ABS pool, does that, by itself, make the affiliate or subsidiary a securitization participant under the information prong?

No.

In most ABS offerings, information about the ABS or the ABS pool is publicly available prior to the marketing and sale of the ABS. For example:

- In a registered public offering of ABS, (i) the shelf registration statement on Form SF-3 is available on EDGAR well in advance of the marketing and sale of the ABS and (ii) the preliminary prospectus and, when applicable, asset-level data are available on EDGAR at least three business days before the first sale in the offering of the ABS.

- In both registered public offerings and private offerings of rated ABS:
  - due diligence reports are required to be filed on Form ABS-15G at least five business days before the first sale in the offing of the ABS; and
  - rating agency pre-sale reports are typically publicly available before the first sale in the offering of the ABS for both registered public offerings and private offerings of ABS.

- Other information about an ABS or the asset pool may be available to subscribers to paid services such as Bloomberg or Intex.

On July 31, 2024, SEC staff posted a Compliance and Disclosure Interpretation stating that having access to or receiving information that is publicly available on EDGAR about a relevant ABS or the asset pool underlying or referenced by a relevant ABS prior to the first closing of the sale of the relevant ABS does not, by itself, result in the affiliate or subsidiary being a securitization participant under paragraph (ii)(B) of the "securitization participant" definition in Rule 192(c).[82]

Although Bloomberg and similar information is not "public" in the same sense as EDGAR, it is our consensus view that having access to or receiving information about a relevant ABS or the asset pool

[82] See Compliance and Disclosure Interpretations for Asset-Backed Securities, Question 103.01.

underlying or referenced by a relevant ABS prior to the first closing of the sale of the relevant ABS because such information is generally available in the market, including via a subscription service or rating agency pre-sale report, also does not, by itself, result in the affiliate or subsidiary being a securitization participant under paragraph (ii)(B) of the "securitization participant" definition in Rule 192(c).

In addition, even if information about an ABS or an ABS pool is *not* publicly available prior to the marketing and sale of the ABS, such information may be irrelevant to the structure, design, and assembly of the ABS or the composition of the ABS pool, and would not incentivize or enable the affiliate or subsidiary to influence the assets included in the ABS.

While the Rule 192 text itself does not elaborate on the meaning of "information," the Preamble refers to facts and circumstances that help to define its scope. In general, these facts and circumstances capture information that is:

- non-public and relevant to the structure, design, and assembly of the ABS or the composition of the ABS pool[1] and
- susceptible to control by information barriers (*i.e.*, information that could, in the absence of information barriers, flow between, or be shared by, the named securitization participant and its affiliates and subsidiaries).[2]

Even if an affiliate or subsidiary receives or has access to non-public and relevant information, facts and circumstances may warrant the conclusion that such affiliate or subsidiary is not a securitization participant.[3]

The Preamble also stresses that the information prong is intended to provide securitization participants with "sufficiently clear boundaries to establish effective compliance programs" [4] and permit the use of "information barriers to support a claim that the affiliates and subsidiaries are not involved in conflicted transactions, reducing the compliance costs."[5] Interpreting the information prong to refer to publicly-available and/or irrelevant information about ABS or the ABS pool would be contrary to this stated intent.

Finally, an entity (such as a warehouse lender) may receive non-public and relevant information from a source that is not an affiliated securitization participant (such as the warehouse borrower). Absent unusual facts and circumstances, if that entity is not otherwise acting in coordination with, or sharing (or receiving) non-public and relevant information with (or from), its affiliated securitization participant, that entity should not be considered a securitization participant.

Notes to Q.4.16:

[1] Non-public and relevant information. The Preamble contains various indications that the information prong refers to non-public and relevant information.

- Under the Preamble, one of the facts and circumstances as to whether an affiliate or subsidiary had access to, or received information about the ABS or the ABS pool is whether the named

securitization participant has "effective information barriers… including written policies and procedures designed to prevent the flow of *information* between relevant entities."[83] The reference to "information" in this guidance clearly refers to non-public information, as no information barrier would be effective to prevent the flow of publicly-available information.

- The Preamble also referred to commenters' concerns "that, without recognizing information barriers …, the prohibition could apply to foreign affiliates and subsidiaries of U.S.-based securitization participants regardless of their participation in the transaction. … We believe that … the definition of "securitization participant with respect to affiliates and subsidiaries … will appropriately limit such application only to those affiliates and subsidiaries who have direct involvement in, or *access to information about*, a covered ABS, which should mitigate these concerns."[84] The reference to "access to information" in this guidance clearly refers to non-public information that is relevant to the structure, design, and assembly of the ABS or the composition of the ABS pool.
- The Preamble states that the "revisions we are adopting to the definition of 'securitization participant' … are aimed at alleviating commenter's concerns with respect to the scope of the rule's prohibition, while also obviating the need for a prescriptive information barrier exception, avoiding potential additional costs associated with establishing policies and procedures to satisfy conditions imposed by such an exception. … This approach is also consistent with commenter recommendations that the final rule permit securitization participants to demonstrate lack of involvement or control through the presence and effectiveness of information barriers and other indicia of separateness."[85] This characterization would be rendered untrue if access to publicly-available information, or non-public but irrelevant information, makes an affiliate or subsidiary a securitization participant.
- The Preamble's discussion about selling group members is also instructive as to the type of information that is relevant under Rule 192. Selling group members "are not underwriters, placement agents, or initial purchasers as defined in Rule 192(c)" as they are "unlikely to have the same ability to influence the design of the relevant ABS."[86] On the other hand:

  "For purposes of Rule 192, therefore, it is sufficient that a person who otherwise meets the definitions of 'underwriter,' 'placement agent,' or 'initial purchaser' in Rule 192(c) has an agreement with the issuer or selling security holder, as applicable, to perform the enumerated functions because, as stated above, such persons would likely be *privy to information about the ABS or underlying assets, giving them the opportunity to influence the structure of the relevant ABS and engage in a bet against it*. No factual determination of whether such person actually had ''direct involvement'' in the structure or design of the ABS is required."[87]

[2] Information flowing between or shared by named securitization participant and its affiliates and subsidiaries. The Preamble repeatedly indicates that the information referred to in the information prong refers to information that flows between, or is shared by, the named securitization participant and its affiliates and subsidiaries. From the Preamble:

[83] Adopting Release, at 85416 (emphasis added).
[84] Adopting Release at 85415 (fn. 280) (emphasis added).
[85] Adopting Release, at 85416.
[86] Adopting Release, at 85405.
[87] Adoption Release, at 85405 (emphasis added).

- "Our changes to the scope of the affiliates and subsidiaries covered by the rule, including permitting securitization participants and their affiliates and subsidiaries to employ various mechanisms (such as information barriers) to prevent coordination or *sharing of information* tailored to their organization, will help address commenters' concerns about the rule's applicability to affiliates and subsidiaries."[88]
- One of the facts and circumstances as to whether an affiliate or subsidiary had access to, or received information about the ABS or the ABS pool is whether the named securitization participant has "effective information barriers… including written policies and procedures designed to prevent the *flow of information between relevant entities*."[89]
- "We expect these [compliance] costs to be lower because securitization participants are not required to establish a customized information barrier compliance program for Rule 192, but can instead rely on existing information barriers or other mechanisms that would effectively prevent coordination or *flow of information between named securitization participants and their affiliates and subsidiaries*."[90]

[3] Facts and circumstances. From the Preamble: "If, for example, a securitization participant employs an information barrier, and the barrier fails, whether the affiliate or subsidiary is a securitization participant under Rule 192 will depend on the facts and circumstances. On one hand, if the failure was accidental, was quickly remedied upon discovery, and the affiliate did not use the information to influence the assets included in the ABS, then the affiliate would likely not be a securitization participant under Rule 192. On the other hand, even if the failure was accidental, but the access to information led to the affiliate using the information to influence the assets included in the ABS, then that affiliate would likely be a securitization participant for purposes of Rule 192."

[4] Clear boundaries. Adopting Release, at 85417.

[5] Reduction of compliance costs. Adopting Release, at 85453.

Q.4.17
How can compliance programs demonstrate that an affiliate or subsidiary has not acted in coordination with a named securitization participant and did not have access to, or receive, information about an ABS or the ABS pool prior to the closing date?

This acting in coordination/access to information determination is a based on the facts and circumstances of a particular transaction.[1]

The Preamble provides an illustrative list of such facts as circumstances, which strongly resembles the SEC's guidance as to indicia of separateness under Rule 105 of Regulation M.[2] According to the

[88] Adopting Release, at 85410 (emphasis added).
[89] Adopting Release, at 85416 (emphasis added).
[90] Adopting Release, at 85458 (emphasis added).

Preamble,[3] "[A]n affiliate or subsidiary may not be a "securitization participant" if the named securitization participant, for example:

- "Has effective information barriers between it and the relevant affiliate or subsidiary (including written policies and procedures designed to prevent the flow of information between relevant entities, internal controls, physical separation of personnel, etc.),
- Maintains separate trading accounts for the named securitization participant and the relevant affiliate or subsidiary,
- Does not have common officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) between the named securitization participant and the relevant affiliate or subsidiary,
- Is engaged in an unrelated business from the relevant affiliated entity and does not, in fact, communicate with such relevant affiliated entity, or
- Has personnel with oversight or managerial responsibility over accounts of both the named securitization participant and the affiliate or subsidiary, but such persons do not have authority to (and do not) execute trading in individual securities in the accounts or authority to (and do not) pre-approve trading decisions for the accounts."

  It is our consensus view that the presence of overlapping personnel with authority to establish trading policies (exposure limits, desk limits, general trading policies and parameters, etc.) would not be inconsistent with the foregoing indicia of separateness as set forth in the Preamble.

The Preamble makes clear that the list above is illustrative and not exhaustive.[4]

Notes to Q.4.17:

[1] Facts and circumstances. Adopting Release, at 85416.

[2] Resemblance to guidance under Rule 105 of Regulation M. The SEC's guidance under Rule 105 includes that (1) the accounts have separate and distinct investment and trading strategies and objectives, (2) personnel for each account do not coordinate trading among or between the accounts, (3) information barriers separate the accounts, (4) information about securities positions or investment decisions is not shared between accounts, and (5) each account maintains a separate profit and loss statement. The guidance notes that "[d]epending on the facts and circumstances, accounts not satisfying each of these conditions may nonetheless fall within the exception." Short Selling in Connection with a Public Offering: Amendments to Rule 105 of Regulation M, U.S. SEC. AND EXCH. COMM'N, https://www.sec.gov/divisionsmarketregtmcomplianceregmrule105-secg.htm#foot1 (last modified May 21, 2008).

[3] List of facts and circumstances. Adopting Release, at 85416.

[4] Illustrative and not exhaustive. From the Preamble: "This list is not exhaustive and simply includes examples of the types of barriers that could be used by securitization participants and their affiliates and subsidiaries. We are not endorsing any one of these methods over another mechanism that may be used to prevent the flow of information between the relevant entities. While it is possible that one of these methods (or another method not listed here) may be sufficient for compliance with the final rule, securitization participants may find that they need to utilize a combination of methods to establish an effective compliance program."[91]

Q.4.18
If an affiliate or subsidiary shares employees or officers with a named securitization participant, does that mean that such affiliate or subsidiary is a securitization participant?

Not necessarily.

As noted in Q.4.17 above, a lack of common officers (or persons performing similar functions) or employees (other than clerical, ministerial, or support personnel) between the named securitization participant and the relevant affiliate or subsidiary is one of the (non-exclusive) indicia of separateness. However, it is our consensus view that the mere presence of common officers or employees is generally not sufficient to cause an affiliate or subsidiary to be acting in coordination with, or sharing information with, a named securitization participant. Other relevant facts and circumstances, such as the role of the officer or employee and the presence of information barriers, should also be considered.

Q.4.19
If an affiliate or subsidiary and a named securitization participant both utilize the same "shared services" department or company, does that means that such affiliate or subsidiary, or such shared services department or company, is a securitization participant?

Not necessarily.

Just as the presence of common officers or employees is generally not in itself sufficient cause an affiliate or subsidiary to be a securitization participant (see Q.4.18), the presence of a shared services department or company is not dispositive. Other relevant facts and circumstances, such as the nature of the shared services and the presence of information barriers, must be considered.

Q.4.20
What are the key considerations in evaluating the effectiveness of a compliance program to prevent affiliates and subsidiaries from acting in coordination with a named securitization

[91] Adopting Release, at 85416-85417 (fn. 306).

participant or having access to, or receiving, information about an ABS or the ABS pool prior to the closing date?

In general, the compliance program "must effectively prevent an affiliate or subsidiary from acting in coordination with the named securitization participant or from accessing or receiving information about the ABS or the ABS pool."[1]

Note, however, that the purpose of the coordination and information prongs is a substantive one; namely, "to capture the range of affiliates and subsidiaries with the opportunity and incentive to engage in conflicted transaction."[2] Thus, facts and circumstances are important. For example:

- If there is an accidental failure of the compliance program (e.g., failure of an information barrier), whether or not an affiliate or subsidiary is a securitization participant will be a facts and circumstances determination (e.g., whether the affiliate or subsidiary took advantage of the failure of an information barrier to influence the assets included in the ABS pool).[3]

- If, at the time it engaged in the Subject Transaction, an affiliate or subsidiary did not act in coordination with the named securitization participant and did not have information (or access to information) about the ABS or the ABS pool prior to closing, that affiliate or subsidiary would not retroactively become a securitization participant upon the subsequent receipt of such information.[4]

Notes to Q.4.20:

[1] Must be generally effective. Adopting Release, at 85417.

[2] Substantive purpose. Adopting Release, at 85417.

[3] Accidental failure. From the Preamble: "If, for example, a securitization participant employs an information barrier, and the barrier fails, whether the affiliate or subsidiary is a securitization participant under Rule 192 will depend on the facts and circumstances. On one hand, if the failure was accidental, was quickly remedied upon discovery, and the affiliate did not use the information to influence the assets included in the ABS, then the affiliate would likely not be a securitization participant under Rule 192. On the other hand, even if the failure was accidental, but the access to information led to the affiliate using the information to influence the assets included in the ABS, then that affiliate would likely be a securitization participant for purposes of Rule 192."[92]

[4] No retroactive effect. From the Preamble: "Additionally, if the affiliated entity did not meet the terms of the definition of affiliate and subsidiary, as adopted, at the time that it enters into the conflicted transaction (i.e., it did not act in coordination with the named securitization participant and did not have information (or access to information) about the ABS or the asset pool prior to closing), such affiliated entity would not then retroactively become a securitization participant upon the

[92] Adopting Release, at 85417 (fn. 307).

subsequent receipt of such information. For example, if an affiliate or subsidiary receives information—or has access to information—after having previously engaged in a conflicted transaction, whether the affiliate or subsidiary would then be a securitization participant under the final definition depends on the facts and circumstances as they existed leading up to and at the time of the entry into the conflicted transaction."[93]

[93] Adopting Release, at 85417 (fn. 307).

TOPIC 5:

WHAT IS THE PROHIBITION TIMEFRAME?

Overview

Under Rule 192, the prohibition timeframe with respect to a securitization participant:

- Begins on the date on which a person has reached an agreement that such person will become a securitization participant with respect to an ABS; and

- Ends on the date that is one year after the date of the first closing of the sale of such ABS.

Q.5.1
At what point in time does a person reach an agreement to become a securitization participant?

The Preamble sets forth four guidelines:

1. Agreement in principle. The prohibition timeframe begins when a securitization participant reaches "an agreement in principle (including oral agreements and facts and circumstances constituting an agreement) as to the material terms of the arrangement by which such person will become a securitization participant."[1]

2. Written agreement not required. "An executed written agreement, such as an engagement letter, is not required; whether there has been an agreement to become a securitization participant will depend on the facts and circumstances of the transaction and the parties involved."[2]

   > "For example, once a person agrees with the issuer or selling security holder to be the underwriter for the relevant ABS transaction, that underwriter is a securitization participant subject to the prohibition in Rule 192, even if a written agreement has not yet been executed."[3]

3. Written agreement generally sufficient. "While a written agreement (such as [an] engagement letter) is not necessary to establish an ''agreement'' for purposes of final Rule 192, it will be sufficient, regardless of whether such written agreement includes all material terms of the contractual arrangement."[4]

4. Market practice and understanding. "[M]arket participants are able to identify and understand when an agreement has been reached in their ordinary business operations and, therefore, they will be able to establish effective procedures for determining when they have triggered the prohibition against engaging in conflicted transactions."[5]

Notes to Q.5.1:

[1] Agreement in principle. Adopting Release, at 85418.

[2] Written agreement not required. Adopting Release, at 85418. From the Preamble: "This is because, even in the absence of such material terms, the written agreement will be consistent with an agreement in principle to perform as a securitization participant for purposes of Rule 192."[94]

[3] Agreement to become underwriter. Adopting Release, at 85418 (fn. 331).

[4] Written agreement generally sufficient. Adopting Release, at 85418 (fn. 330).

[5] Market practice and understanding. Adopting Release, at 85418-85419.

Q.5.2
What facts and circumstances should be considered as to whether an agreement in principle has been reached to as to the material terms of the arrangement by which such person will become a securitization participant?

The "agreement in principle" concept is designed to generally correspond with the facts and circumstances market participants rely on to identify and understand when an agreement has been reached in their ordinary business operations. This allows market participants to establish effective procedures for determining when they have triggered the prohibition against engaging in conflicted transactions.[1]

Relevant facts and circumstances with respect to an "agreement in principle" include:

- Agreement on material terms; affirmative steps. While an agreement on all material terms is not required to have an agreement in principle, market practice is that an agreement in principle involves agreement with respect to some fundamental material terms of the engagement, as well as affirmative steps indicating that an agreement has been reached. An agreement in principle is more than a negotiation, preliminary discussion, or general understanding.[2]
- Written agreement. While a written agreement is not required in order for there to be an agreement in principle, market practice is that an agreement in principle is typically memorialized in writing.
- Sharing of non-public information. Sharing of non-public information about the ABS or ABS pool typically does not occur prior to an agreement in principle.[3]

Notes to Q.5.2:

[94] Adopting Release, at 85418 (fn. 330).

[1] Market practice and understanding. See Q.5.1.

[2] Agreement on material terms; affirmative steps. For example, the pre-filing period in an IPO begins once the company and its underwriters have reached an agreement in principle to proceed with the IPO and continues up through the public filing of the registration statement with the SEC. The agreement in principle is generally made at an organizational meeting attended by representatives of the company and its accountants and counsel, and the underwriters and their counsel. The meeting generally includes discussion of the timeline for the offering, the general terms of the offering and the responsibilities of the various parties. The organizational meeting often includes presentations by the company's management, as well as initial due diligence questions from the underwriters.

[3] Sharing of information. Rule 192(a) applies only to underwriters, placement agents, and initial purchasers who have reached an agreement with the issuer "because those persons would likely be privy to certain information about the ABS or underlying assets."[95]

Q.5.3
Does the prohibition timeframe start for a warehouse lender when a warehouse facility is established in anticipation of a term ABS transaction?

Not necessarily.

It is often the case that an affiliate of the warehouse lender is an underwriter, initial purchaser or placement agent of a subsequent securitization, when and if that subsequent securitization occurs. However, merely entering into a warehouse lending facility is not, in itself, sufficient to indicate that there is an agreement in principle for an affiliate of the warehouse lender to become a securitization participant.

There must be an agreement in principle as to the material terms of the arrangement by which such affiliate will become a securitization participant, although (1) not all material terms are required to be stated in such an agreement and (2) a written agreement (*e.g.*, engagement letter) memorializing the arrangement by which such affiliate will become a securitization participant will generally be sufficient. *See* Q.5.2.

Q.5.4
When does the prohibition timeframe begin for the sponsor?

Under prong (i) of the definition of "sponsor," an entity becomes a sponsor if it "organizes and initiates an asset-backed securities transaction by selling or transferring assets … to the entity that issues the asset-backed securities."

[95] Adopting Release, at 85405.

Under prong (ii) of the definition of "sponsor," an entity becomes a sponsor if it has the "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 or referenced by the asset-backed security."

Neither of these prongs should be considered to apply if the entity has merely (1) entered into a warehouse lending arrangement in anticipation of a possible future securitization, (2) originated assets with the intent to securitize them in the future, (3) adopted a funding plan that contemplates future asset-backed securities transactions, or (4) internally approved a future asset-backed securities transaction. The Preamble contemplates a more definitive commencement point.[1]

It is our consensus view that, at a minimum, an entity does not become a sponsor with respect to any asset-backed securities transaction before it has:

- Entered into an agreement in principle with an underwriter, placement agent or initial purchaser with respect to that asset-backed securities transaction, or

- Otherwise engaged other key transaction participants (such as a rating agency or a third-party due diligence provider) with respect to that asset-backed securities transaction.

Notes to Q.5.4:

[1] More definitive commencement point. While the Proposing Release contemplated a "substantial steps" test, the Preamble acknowledges commenters' concerns about the ambiguity created by that standard. From the Preamble: "In response to comments received, we are revising the prohibition timeframe to begin at a ***more definitive commencement point*** and are adopting the end point of the prohibition timeframe as proposed. Under Rule 192(a)(1), the prohibition against entering into conflicted transactions will commence on the date on which such person has reached an agreement to become a securitization participant with respect to an asset-backed security and will end one year after the date of the first closing of the sale of the relevant ABS. ***By omitting the proposed language about taking ''substantial steps'' to reach an agreement, the final rule will avoid many of the concerns that commenters raised with respect to the scope of the proposed rule***. The prohibition timeframe, as revised, together with the changes we are making to the final rule's applicability to affiliates and subsidiaries of named securitization participants, should help to mitigate commenters' concerns about their ability to determine when a person is subject to the rule's prohibition." Adopting Release, at 85418 (emphasis added).

TOPIC 6:

WHAT ARE THE TERMS AND CONDITIONS OF THE "RISK MITIGATING HEDGING ACTIVITIES" EXCEPTION?

Overview

A Conflicted Transaction is not prohibited under Rule 192 if it qualifies for the risk-mitigating hedging activities exception. The risk-mitigating hedging activities exception is subject to three conditions; namely, that:

(1) the hedging activity relate to specific, identifiable risks of the securitization participant (the "**specific identifiable risks condition**"),

(2) the hedging activity is subject to ongoing recalibration (the "**recalibration condition**"), and

(3) the securitization participant has established and implements, maintains, and enforces an internal compliance program (the "**compliance program condition**").

The Rule 192 exception for risk mitigating hedging activities is a modified and simplified version of that exception as it appears in the Volcker Rule. Below is the Rule 192 exception marked to show differences from the corresponding provision in the Volcker Rule.

	Rule 192, marked to show differences from Volcker Rule
Exception	~~The prohibition contained in § 255.3(a) does not apply to the~~ The following activities are not prohibited by paragraph (a) of this section: risk-mitigating hedging activities of a ~~banking entity~~ 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 ~~banking entity and designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings~~ securitization participant, including those arising out of its securitization activities, such as the origination or acquisition of assets that it securitizes. *Rule 192(b)(1)(i) vs. 17 C.F.R. 255.5(a)*
Condition 1: Specific identifiable risk condition	At the inception of the hedging activity, including, without limitation, 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~~, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks,~~ arising in connection with and related to identified positions, contracts, or other holdings of the ~~banking entity~~ 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. *Rule 192(b)(1)(ii)(A) vs. 17 C.F.R. 255.5(b)(2)(i)*
Condition 2: Recalibration condition	~~Is~~ The risk-mitigating hedging activity is subject, as appropriate, to ongoing recalibration by the ~~banking entity~~ securitization participant to ensure that the hedging activity satisfies the requirements set out in paragraph (b)~~(2)~~(1) of this section and ~~is not prohibited proprietary trading~~ does not facilitate or create an opportunity to materially benefit from a conflicted transaction other than through risk-reduction. *Rule 192(b)(1)(ii)(B) vs. 17 C.F.R. 255.5(b)(2)(ii)*
Condition 3: Compliance program condition	The ~~banking entity~~ securitization participant has established and implements, maintains and enforces an internal compliance program ~~required by subpart D of this part~~ that is reasonably designed to ensure the ~~banking entity's~~ securitization participant's compliance with the requirements set out in paragraph (b)(1) of this section, including~~:~~ ~~(A)~~ Reasonably designed written policies and procedures regarding the ~~positions, techniques and strategies that may be used for hedging, including documentation indicating what positions, contracts or other holdings a particular trading desk may use in its risk-mitigating hedging activities, as well as position and aging limits with respect to such positions, contracts or other holdings;~~ risk-mitigating hedging activities that provide for the specific risk and risk-mitigating hedging activity to be identified, documented, and monitored. ~~(B) Internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures; and~~ ~~(C) The conduct of analysis and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged.~~ *Rule 192(b)(1)(ii)(C) vs. 17 C.F.R. 255.5(b)(1)(i)*

	Note that under the Volcker Rule, the compliance program is required only with respect to banking entities that have significant trading assets and liabilities.

Q.6.1

To what extent does a securitization participant's compliance with the Volcker Rule's risk mitigating hedging activities exception ("VR-RMH") constitute compliance with Rule 192's risk mitigating hedging activities exception ("Rule 192-RMH")?

There is substantial overlap between the conditions applicable to VR-RMH and Rule 192-RMH. Thus trading desks within a securitization participant that are set up to be VR-RMH compliant will be well-positioned to comply with Rule 192-RMH, with some modifications as described below.

- Specific identifiable risk condition. The specific identifiable risk condition in Rule 192(b)(1)(ii)(A) is nearly identical to the analogous condition under the VR-RMH. Thus a hedge that satisfies the specific identifiable risk condition under VR-RMH will also satisfy the same condition under Rule 192-RMH.

- Recalibration condition. The recalibration condition in Rule 192(b)(1)(ii)(B) is worded somewhat differently than the analogous condition under the VR-RMH, but addresses substantially the same concern.

    - Under VR-RMH, recalibration is required to ensure that a hedge doesn't become proprietary trading; that is, recalibration must ensure that the hedge is designed to reduce or otherwise substantially mitigate one or more specific, identifiable risks.[1]

    - Under Rule 192-RMH, recalibration is required to ensure that a hedge doesn't allow the securitization participant to materially benefit from that hedge, other than through risk reduction.

      Absent unusual circumstances, recalibration under VR-RMH should suffice under Rule 192-RMH. See Q.6.2 for further guidance on recalibration.

- Compliance program condition.

    - A banking entity that has significant trading assets and liabilities is required to have a compliance program in order to take advantage of the VR-RMH.[2] The Rule 192-RMH compliance program requirement is based on the VR-RMH requirement, and therefore securitization participants that already have a VR-RMH compliance program may leverage their existing VR-RMH compliance program to meet the requirements of Rule 192-RMH.[3]

- The compliance program condition in Rule 192(b)(1)(ii)(C) 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." That language is similar to the Volcker Rule requirement that the compliance program include "internal controls and ongoing monitoring, management and authorization procedures, including relevant escalation procedures."

- In general, the VR-RMH compliance program is more exacting and rigorous than the Rule 192 requirement.[4] Thus, many existing VR-RMH compliance programs should also work for Rule 192-RMH purposes.

There are, however, two important mismatches securitization participants will need to address to ensure compliance with Rule 192-RMH.

1. Instrument mismatch. The Volcker Rule applies to "proprietary trading," which is defined as "engaging as a principal for the trading account of the bank in any transaction to purchase or sell any security, derivative, commodities future, or any option on any of the foregoing." On the other hand, Rule 192 applies to "conflicted transactions," which may occur in either the banking book or the trading book, and, through prong (iii), potentially includes loans and other financial assets that are not securities, derivatives or commodities futures. Thus, existing VR-RMH compliance programs would have to be modified to ensure that they are capturing the full range of potential transactions under Rule 192.

2. TOTUS. For some banks, some trades or trading desks may rely on the Volcker Rule's exemption for trading outside the United States (TOTUS), and not on the Volcker Rule's risk mitigating hedging activities exception. As Rule 192 does not provide an exemption for conflicted transactions that occur outside the United States, existing reliance on TOTUS under the Volcker Rule would not suffice.

Notes to Q.6.1:

[1] Volcker Rule recalibration. According to the Volcker Rule adopting release, the Volcker Rule requirements "seek to prohibit banks from taking large proprietary positions through action or inaction relating to an otherwise permissible hedge." See p. 5636.

[2] Volcker Rule's compliance program requirement. See 17 C.F.R. 255.5(b)(1)(i).

[3] Banking entities may leverage existing compliance programs. The SEC anticipates that larger banking entities will be able to leverage their existing Volcker Rule compliance programs when establishing their Rule 192 compliance programs. From the Preamble: "[C]ertain requirements of the final rule that apply to the risk-mitigating hedging activities exception and bona fide market-making activities exception are similar to those under the Volcker Rule …. Such similarity will be more beneficial to securitization participants that are already familiar with the Volcker Rule compliance requirements and already have relevant programs in place, because these

securitization participants will incur lower marginal costs of compliance, especially in the short run. Securitization participants of this type tend to be larger entities (e.g., bank holding companies)."[96]

[4] Volcker Rule more rigorous and exacting. Note that under the Volcker Rule, the compliance program condition for RMH is required only for banks that have significant trading assets and liabilities. The Preamble to Rule 192 states that the compliance program condition is intended to be flexible and does not suggest that large banks must have Rule 192 compliance programs that are more rigorous and exacting than those required under the Volcker Rule. According to the Preamble, "to avoid imposing a one-size-fits-all requirement that may unduly burden securitization participants that are different in size or that make markets in different financial instruments, this condition recognizes that a securitization participant that engages in risk-mitigating hedging activity is well positioned to design its own individual internal compliance program to reflect the size, complexity, and activities of the securitization participant. This should help ease compliance costs as the relevant securitization participant can tailor its compliance program to its particular business model." See Preamble, at 85435.

Q.6.2
Does a hedge need to be a "perfect" hedge in order to qualify for the risk-mitigating hedging activities exception?

No. Rule 192 requires that "[a]t the inception of the hedging activity and at the time of any adjustments to the hedging activity, the risk-mitigating hedging activity [must be] designed to *reduce or otherwise significantly mitigate* one or more specific identifiable risks" of the securitization participant.[1] Whether a hedge is so designed is "based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof."[2]

The Preamble makes clear that Rule 192 does not impose an exact negative correlation standard.[3]

The exception requires that the hedge "be subject, as appropriate, to ongoing recalibration by the securitization participant to ensure that the hedging activity … does not facilitate or create an opportunity to *materially* benefit from a conflicted transaction other than through risk reduction."[4]

The Preamble makes clear that the materiality qualifier is intended to relieve securitization participants of the impractical obligation to immediately recalibrate a risk-reducing hedge that turns into a net short due to events such as the unexpected prepayment of a hedged position.[5]

Notes to Q.6.2:

[1] Reduction or significant mitigation. See Rule 192(b)(1)(ii)(A) (emphasis added).

[2] Facts and circumstances. See Rule 192(b)(1)(ii)(A).

[96] Adopting Release, at 85456.

[3] Exact negative correlation not required. From the Preamble: "[T]he final rule does not include an exact negative correlation standard in the 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 circumstances at the time of the transaction that would make a hedge with exact negative correlation impractical or unworkable."[97]

[4] Recalibration required; no material benefit. See Rule 192(b)(1)(ii)(B) (emphasis added). The SEC rejected a suggestion that the exception specify that the "primary benefit" of the hedge must be risk reduction, on that grounds that it "implies that a securitization participant could as a 'secondary benefit' to the activity, materially profit from a net short position with respect to the relevant ABS."[98]

[5] Immediate recalibration not required. From the Preamble: "We recognize that it may not be possible for a securitization participant to immediately recalibrate its hedging positions given the liquidity, maturity, and depth of the relevant market for such hedging positions. For example, if there is an unexpected early prepayment of the relevant positions being hedged, a securitization participant may be unable to immediately reduce its related hedge. The addition of the word 'materially' is designed to address this concern and not unduly disrupt normal course hedging activities that do not present material conflicts of interest with ABS investors."[99]

Q.6.3
If a securitization participant's market making desk conducts its hedging activities pursuant to the Volcker Rule's exception for market making activities rather than the Volcker Rule's exception for risk-mitigating hedging activities, does that create a compliance mismatch under Rule 192?

No. The market making activities exception under both the Volcker Rule and Rule 192 contemplate hedging activity with respect to risks arising from market making.

In most cases, a market making desk that engages in hedging activity will be relying on the market-making activities exception, rather than the risk-mitigating hedging activities exception, under both Rule 192 and the Volcker Rule.

Q.6.4
Does the exception for risk mitigating hedging activities require hedging on a trade-by-trade basis?

No. As noted below, the hedging activity must address "one or more specific identifiable risks," but it need not be implemented on a trade-by-trade basis.

[97] Adopting Release, at 85434.
[98] Adopting Release, at 85434.
[99] Adopting Release, at 85434.

Rule 192(b)(1)(i) provides that the risk-mitigating hedging activities exception extends to "individual or aggregated positions, contracts, or other holdings of the securitization participant, including those arising out of its securitization activities."

Note that regardless of whether the hedging activity is on an individual or aggregated basis, Rule 192(b)(1)(ii)(A) requires that the hedging activity 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."[1]

Notes to Q.6.4:

[1] The Preamble states that this condition is designed to "prohibit 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 ABS exposure where the notional amount of the CDS exceeds the amount of the securitization participant's relevant exposure to that ABS, and any other aggregated exposures, that are 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."[100]

Q.6.5
Must a general interest rate or currency exchange rate hedge, or a hedge that is otherwise unrelated to the credit performance of the ABS or the ABS pool, satisfy the exception for risk-mitigating hedging activities?

No. General interest rate and currency exchange rate hedges, and other hedges that are otherwise unrelated to the credit performance of the ABS or the ABS pool, are not conflicted transactions.[1] Thus no exception is required for such hedges.

Notes to Q.6.5:

[1] From the Preamble: "As described in Section II.D.3., general interest rate hedges and currency exchange hedges entered into by a securitization participant are not conflicted transactions. Furthermore, hedges that are unrelated to the credit performance of the relevant ABS or the asset pool supporting or referenced by the relevant ABS will not be conflicted transactions as they are not substantially the economic equivalent of a transaction described in Rule 192(a)(3)(i) or Rule 192(a)(3)(ii). Therefore, we are not including such activities in the risk- mitigating hedging exception because securitization participants engaging in such transactions will not need to rely on any exception to the rule."[101]

[100] Adopting Release, at 85433.
[101] Adopting Release, at 85431.

Q.6.6
Is the risk-mitigating hedging activities exception available for a synthetic ABS that a securitization participant enters into and maintains as a hedge?

Yes. For example, a bank CRT transaction that utilizes an SPE can qualify for the risk-mitigating hedging activities exception so long as the CDS between the SPE and the bank hedges the bank's exposure to the assets included in the reference pool.[1]

Notes to Q.6.6:

[1] From the Preamble: "In a change from the proposal, the initial issuance of a synthetic ABS will be eligible for the risk-mitigating hedging activities exception set forth in the final rule. This change is intended to allow for the initial issuance of a synthetic ABS that the relevant securitization participant enters into and maintains as a hedge. This change is also consistent with the requests of certain commenters. As discussed above in Section II.D.3., the relevant material conflict of interest in the context of the issuance of a new synthetic ABS arises when the securitization participant engages in a transaction (such as CDS contract(s) with the synthetic ABS issuer) where cash paid by investors to acquire the newly created synthetic ABS would fund the relevant contract(s) and be available to make a payment to the securitization participant upon the occurrence of an adverse event with respect to the assets included in the reference pool. If such activity is not entered into for purposes of hedging an exposure of the securitization participant to the assets included in the reference pool, then such activity will not qualify for the risk-mitigating hedging exception. However, we understand that the Enterprises and other market participants utilize synthetic ABS structures for hedging purposes. To the extent that such transactions mitigate a specific and identifiable risk exposure of the securitization participant, we agree that such transactions should be permitted under the risk-mitigating hedging exception. Section 27B specifically applies to synthetic ABS transactions and provides an exception for risk-mitigating hedging activity; therefore, we believe that it is consistent with Section 27B to allow a synthetic ABS as described above to be eligible for the risk-mitigating hedging activities exception if it is entered into and maintained for risk-mitigating hedging purposes."[102]

Q.6.7
If a securitization participant does not maintain the compliance program required by the risk-mitigating hedging exception, does that mean that the securitization participant is in violation of Rule 192?

Not necessarily. If a securitization participant does not maintain the compliance program required by the exception, then the exception is unavailable. However, Rule 192 does not require any securitization participant to maintain the compliance program required by the exception if that securitization participant is not utilizing the exception.[1]

[102] Adopting Release, at 85430-85431.

Notes to Q.6.7:

[1] From the Preamble: "In response to comments that the compliance program requirement should specify that it would only apply to any securitization participant utilizing the exception, adding that language would be redundant. Rule 192(b)(1)(ii)(C) sets forth a condition to utilizing the exception in Rule 192(b)(1)(i) and does not separately require that a securitization participant satisfy the compliance program requirement if it is not utilizing the exception."[103]

Q.6.8

If a securitization participant's hedging activity does not satisfy the requirements of the risk-mitigating hedging activities exception, does that mean that such activity is a Conflicted Transaction that is prohibited by Rule 192?

Not necessarily. If a securitization participant's hedging activity does not satisfy the risk-mitigating hedging activities exception, that means that the exception is not available in the event that the hedging activity otherwise constitutes a Conflicted Transaction. Whether hedging activity constitutes a Conflicted Transaction turns on whether it involves a short sale, or synthetic short sale, of the relevant ABS, or the substantial economic equivalent thereof. See Topic 2 (What is a "Conflicted Transaction"?).

[103] Adopting Release, at 85436.

TOPIC 7:

WHAT ARE THE TERMS AND CONDITIONS OF THE "BONA FIDE MARKET-MAKING ACTIVITIES" EXCEPTION?

A Conflicted Transaction is not prohibited under Rule 192 if it qualifies for the bona fide market-making activities exception. The market-making activities exception is subject to five conditions; namely, that:

(1) the securitization participant routinely stands ready to purchase and sell (the "**routinely stands ready condition**"),

(2) the market-making activity is limited to reasonably expected client, customer, or counterparty demand (the **"limited to demand condition"**),

(3) the compensation arrangements do not reward or incentivize conflicted transactions (the **"compensation condition"**),

(4) the securitization participant is licensed or registered, if required, to engage in market-making activity (the **"registration condition"**), and

(5) the securitization participant has established and implements, maintains, and enforces an internal compliance program (the "**compliance program condition**").

The Rule 192 exception for bona fide market-making activities is a modified and simplified version of that exception as it appears in the Volcker Rule. Below is the Rule 192 exception marked to show differences from the corresponding provision in the Volcker Rule.

	Rule 192, marked to show differences from Volcker Rule
Exception	~~The prohibition contained in § 255.3(a) does not apply to a banking entity's market making related activities conducted in accordance with this paragraph (b)~~. The following activities are not prohibited by paragraph (a) of this section: … 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 or with respect to which the prohibition in paragraph (a)(1) of this section otherwise applies, 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. *Rule 192(b)(3)(i) vs. 17 C.F.R. 255.4(b)(1)*

Condition 1: Routinely stands ready condition	The ~~trading desk that establishes and manages the financial exposure,~~ securitization participant routinely stands ready to purchase and sell one or more types of financial instruments ~~related to its financial exposure~~ described in paragraph (b)(3)(i) of this section[104] as part of its market-making 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 ~~for its own account~~, 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. *Rule 192(b)(3)(ii)(A) vs. 17 C.F.R. 255.4(b)(2)(i)*
Condition 2: Limited to demand condition	The ~~trading desk's~~ 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. *Rule 192(b)(3)(ii)(B) vs. 17 C.F.R. 255.4(b)(2)(ii)*
Condition 3: Compensation condition	The compensation arrangements of persons performing the foregoing activities ~~described in this paragraph (b)~~ are designed not to reward or incentivize prohibited ~~proprietary trading~~ conflicted transactions. *Rule 192(b)(3)(ii)(C) vs. 17 C.F.R. 255.4(b)(2)(v)*
Condition 4: Registration condition	The ~~banking entity~~ securitization participant is licensed or registered, if required, to engage in activity described in ~~this~~ paragraph (b)(3) of this section in accordance with applicable law and self-regulatory organization rules. *Rule 192(b)(3)(ii)(D) vs. 17 C.F.R. 255.4(b)(2)(vi)*
Condition 5: Compliance program condition	~~In the case of a banking entity with significant trading assets and liabilities, the banking entity~~ The securitization participant has established and implements, maintains, and enforces an internal compliance program ~~required by subpart D of this part~~ that is reasonably designed to ensure the ~~banking entity's~~ securitization participant's compliance with the requirements of paragraph (b)(3) of this section, including reasonably designed written

[104] The financial instruments referred to in paragraph (b)(3)(i) are "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 or with respect to which the prohibition in paragraph (a)(1) of this section otherwise applies."

	policies and procedures that demonstrate a process for prompt mitigation of the risks of its market-making positions and holdings.~~, internal controls, analysis and independent testing identifying and addressing:~~ ~~(A) The financial instruments each trading desk stands ready to purchase and sell in accordance with paragraph (b)(2)(i) of this section;~~ ~~(B) The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the limits required under paragraph (b)(2)(iii)(C) of this section; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and positions; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;~~ ~~(C) Limits for each trading desk, in accordance with paragraph (b)(2)(ii) of this section;~~ ~~(D) Written authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval; and~~ ~~(E) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits.~~ *Rule 192(b)(3)(ii)(E) vs. 17 C.F.R. 255.4(b)(2)(iii)* *Note that under the Volcker Rule, the compliance program is required only with respect to banking entities that have significant trading assets and liabilities.*

Q.7.1

To what extent does a securitization participant's compliance with the Volcker Rule's risk bona fide market-making activities exception ("VR-MM") constitute compliance with Rule 192's bona fide market-making activities exception ("Rule 192-MM")?

There is substantial overlap between the conditions applicable to VR-MM and Rule 192-MM. Thus market making desks within a securitization participant that are set up to be VR-MM compliant will be well-positioned to comply with Rule 192-MM, with some modifications as described below.

- Routinely stands ready condition. The routinely stands ready condition in Rule 192(b)(3)(ii)(A) is nearly identical to the analogous condition under VR-MM. Thus, market making activity that satisfies the routinely stands ready condition under VR-MM will also satisfy the same condition under Rule 192-MM.

- Limited to demand condition. The limited to demand condition in Rule 192(b)(3)(ii)(B) is nearly identical to the analogous condition under VR-MM. Thus, market making activity that satisfies the limited to demand condition under VR-MM will also satisfy the same condition under Rule 192-MM.

- Compensation condition. The compensation condition in Rule 192(b)(3)(ii)(C) is somewhat different than the analogous condition under VR-MM. Under VR-MM, compensation may not reward or incentivize proprietary trading, whereas under Rule 192-MM, compensation may not reward or incentivize conflicted transactions. In practice, a compensation system that does not reward or incentivize proprietary trading may be unlikely to reward or incentive conflicted transactions. Thus, in many cases, a VR-MM compensation policy may require only minimal changes.

- Registration condition. The registration condition in Rule 192(b)(3)(ii)(D) is substantially the same as that under VR-MM. Thus, market making activity for which a securitization participant satisfies the registration condition under VR-MM will also satisfy the same condition under Rule 192-MM.

- Compliance program condition.

    - A banking entity that has significant trading assets and liabilities is required to have a compliance program in order to take advantage of the VR-MM. The Rule 192-MM compliance program requirement is based on the VR-MM requirement, and therefore securitization participants that already have a VR-MM compliance program may leverage their existing VR-MM compliance program to meet the requirements of Rule 192-MM.

    - In general, the VR-MM compliance program is more exacting and rigorous than the Rule 192-MM requirement. Thus, existing VR-MM compliance programs should work well for Rule 192-MM purposes.

As noted in Q.6.1, securitization participants will need to address the instrument mismatch and TOTUS mismatch to ensure compliance with Rule 192-MM.

Q.7.2
Does the routinely stands ready condition take into account the fact that ABS and related financial instruments may be trade infrequently?

Yes. The routinely stands ready standard takes into account that the market for ABS and related financial instruments may be relatively illiquid and that such instruments may trade only intermittently or at the request of customers.[1]

However, merely providing liquidity is not necessarily sufficient.[2] Other factors outlined in the Preamble are:

- Establishing a consistent pattern of offering price quotations and trading with customers on both sides of the market.[3]
- Willingness to support customer needs in varying market conditions.[4]
- Engaging in transactions of commercially reasonable size.[5]

Notes to Q.7.2:

[1] Standard takes into account illiquidity. From the Preamble: "This 'routinely stands ready' standard takes into account the actual liquidity and depth of the relevant market for ABS and financial instruments related to ABS described in 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,' is designed to avoid having a chilling effect on a person's ability to act as a market maker in a less liquid market. The 'routinely stands ready' standard is appropriate for bona fide market-making activities in ABS and related financial instruments described in 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."[105]

[2] But providing liquidity not necessarily sufficient. From the Preamble: "However, the mere provision of liquidity is not necessarily sufficient for a securitization participant to satisfy this condition. This condition is designed to help ensure that activity that will qualify for the exception in the final rule will 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."[106]

[3] Consistent pattern. From the Preamble: "[T]he securitization participant needs 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."[107]

[105] Adopting Release, at 85440.
[106] Adopting Release, at 85440.
[107] Adopting Release, at 85440.

[4] Willing to facilitate customer needs. From the Preamble: "[A] securitization participant needs 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."[108]

[5] Transactions of commercially reasonable size. From the Preamble: "[I]n this context, 'commercially reasonable' amounts means that the securitization participant must be willing to quote and trade in sizes requested by market participants in the relevant market. This is 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."[109]

Q.7.3
What standards apply in satisfying the condition that market-making related activities are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties?

This is a facts and circumstances determination – there is no bright-line test. Securitization participants should consider the following, taking into account the liquidity, depth and maturity of the market in the relevant ABS:

- Historical customer demand;
- Current customer demand; and
- Current market conditions and reasonably-anticipated near-term market conditions.[1]

Notes to Q.7.3:

[1] Facts and circumstances test. From the Preamble: "this is a facts and circumstances determination that is focused on an analysis of the reasonably expected 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 condition should avoid unduly impeding a market maker's ability to build or retain inventory in less liquid instruments. The facts and circumstances that will be relevant to determine compliance with this condition include, but are not 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, inter-dealer demand."[110]

[108] Adopting Release, at 85440.
[109] Adopting Release, at 85440.
[110] Adopting Release, at 85440.

Q.7.4
What factors apply in considering whether the compensation condition is satisfied?

A compensation arrangement that is "designed to reward effective and timely intermediation and liquidity to customers" is consistent with the compensation condition.[1]

A compensation arrangement that is "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" would not be consistent with the compensation condition.[2]

The Preamble states that this approach is "similar to that taken for purposes of the Volcker Rule."[3]

Notes to Q.7.4:

[1] Designed to reward effective and timely intermediation. Adopting Release, at 85440.

[2] Designed to reward speculation. Adopting Release, at 85440.

[3] Similarity to Volcker Rule. Adopting Release, at 85440.

Q.7.5
If a securitization participant does not maintain the compliance program required by the bona fide market making exception, does that mean that the securitization participant is in violation of Rule 192?

Not necessarily. If a securitization participant does not maintain the compliance program required by the exception, then the exception is unavailable. However, Rule 192 does not require any securitization participant to maintain the compliance program required by the exception if that securitization participant is not utilizing the exception.

Q.7.6

If a securitization participant's market making activity does not satisfy the requirements of the bona fide market-making activities exception, does that mean that such activity is a Conflicted Transaction that is prohibited by Rule 192?

Not necessarily. If a securitization participant's market making activity does not satisfy the bona fide market making activities exception, that means that the exception is not available in the event that the market making activity otherwise constitutes a Conflicted Transaction. Whether market making activity constitutes a Conflicted Transaction turns on whether it involves a short sale, or synthetic short sale, of the relevant ABS, or the substantial economic equivalent thereof. See Topic 2 (What is a "Conflicted Transaction"?).

TOPIC 8:

WHAT ARE THE TERMS AND CONDITIONS OF THE "LIQUIDITY COMMITMENTS" EXCEPTION?

Overview

Rule 192 provides securitization participants with an exception for "liquidity commitments." Under paragraph (b)(2), securitization participants may make "[p]urchases or sales of the asset-backed security [that are] made pursuant to, and consistent with, commitments . . . to provide liquidity for the asset-backed security."

Q.8.1
If a securitization participant provides liquidity to a securitization to support the performance of the securitization, does that activity require compliance with the liquidity commitments exception?

No. Liquidity commitments to support the performance of the securitization, 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" are not Conflicted Transactions in the first instance. Thus, a securitization participant would not need to rely on the liquidity commitments exception for such activities.[1]

Notes to Q.8.1:

[1] Liquidity commitments to support securitization performance. From the Preamble: "As discussed above in Section II.D.3., such as an extension of credit by a securitization participant that functions to support the performance of the securitization rather than to benefit from its adverse performance will not be a conflicted transaction under the final rule. Therefore, a securitization participant will not need to rely on any exception to the rule to enter into such extension of credit."[111]

Q.8.2
Must the securitization participant directly engage in the purchase and sale of the ABS to qualify under the liquidity commitments exception?

No. Rule 192 does not prohibit a securitization participant from utilizing an affiliate or subsidiary as an intermediary for the purpose of fulfilling its liquidity commitment obligations with respect to an ABS.[1]

Notes to Q.8.2:

[111] Adopting Release, at 85436.

[1] Use of affiliate or subsidiary as intermediary. From the Preamble: “The final rule does not prohibit a securitization participant from utilizing an affiliate or subsidiary as an intermediary for the purpose of fulfilling its liquidity commitment obligations with respect to the relevant ABS. This is because the liquidity commitments exception is available to a ‘‘securitization participant,’’ which is defined to include not only the underwriter, placement agent, initial purchaser, or sponsor of an ABS but also any affiliate or subsidiary who is acting in coordination with such person or who has access to or receives information about the relevant ABS or the asset pool underlying or referenced by the relevant ABS. For example, it is not inconsistent with the exception for liquidity commitments in Rule 192(b)(2) for an entity that it is an underwriter, placement agent, initial purchaser, or sponsor with respect to an ABS under the final rule to provide liquidity for the ABS by causing one of its subsidiaries to engage in purchases and sales of the relevant ABS.”[112]

[112] Adopting Release, at 85437.

TOPIC 9:

WHAT IS THE EXTRATERRITORIAL APPLICATION OF RULE 192?

Overview

In the Preamble, the SEC provides guidance as to the cross-border scope of Rule 192. In the SEC's view:

- "As a threshold matter, Rule 192's cross-border scope is co-extensive with the cross-border scope of Securities Act Section 27B(a), which this rule implements pursuant to the mandate in Section 27B(b)."[113]
- "Our understanding of Section 27B(a)'s cross-border scope is based on the territorial approach that the Commission has applied when adopting rules to implement other provisions of the securities laws."[114]
- "Consistent with that territorial approach, which is based on Supreme Court precedent,… the Commission understands the relevant domestic conduct that triggers the application of Section 27(B)(a)'s prohibition to be the sale in the United States of the ABS. *If there are ABS sales in the United States to investors, the prohibition of Section 27B(a) – as implemented through the provisions of Rule 192 – applies*."[115]

In order to provide additional certainty, Rule 192 includes a safe harbor provision for certain foreign transactions. The safe harbor provision in Rule 192 is modeled on that under Rule 15Ga-2 (Findings and Conclusions of Third-Party Due Diligence Reports).[116]

Under the Rule 192 safe harbor for certain foreign transactions, the prohibition against Conflicted Transactions does not apply to an ABS if:

- the ABS is not issued by a U.S. person (as defined in 17 CFR 230.902(k)); and
- the offer and sale of the ABS is in compliance with Regulation S (17 CFR 230.901 through 905).

Q.9.1
Does Rule 192 apply to ABS sold outside of the United States?

The Rule 192 safe harbor is not available for ABS sold outside of the United States if either (a) the ABS is issued by a U.S. person or (b) the offer and sale outside the United States does not comply with Regulation S.

[113] Adopting Release, at 85402.
[114] Adopting Release, at 85402.
[115] Adopting Release, at 85402-85403.
[116] *See* 17 CFR 240.15Ga-2. Under clause (e) of that rule: "The requirements of this rule would not apply to an offering of an asset-backed security if certain conditions are met, including: (1) The offering is not required to be, and is not, registered under the Securities Act of 1933; (2) The issuer of the rated security is not a U.S. person (as defined in § 230.902(k)); and (3) All offers and sales of the security by any issuer, sponsor, or underwriter linked to the security will occur outside the United States (as that phrase is used in §§ 230.901 through 230.905 (Regulation S))." The Preamble states that "it is appropriate to model the safe harbor provision in Rule 192 on existing Rule 15Ga-2(e)." *See* Adopting Release, at 85403.

Note, however, that even if the safe harbor is not available, Rule 192 would likely not apply to any ABS sold exclusively outside of the United States. As noted above, under the territorial approach applied by the SEC, "the relevant domestic conduct that triggers the application of Section 27(B)(a)'s prohibition [is] the sale in the United States of the ABS."[1]

The Preamble cautions that the SEC retains broad cross-border antifraud authority:

- "even if there is no domestic sale to an investor that would trigger Rule 192's regulatory prohibition"[2] and
- "even if the safe harbor conditions are met."[3]

Notes to Q.9.1:

[1] Sale of ABS outside the United States. *See* Adopting Release, at 85402.

[2] Broad cross-border antifraud authority even if no domestic sale. *See* Adopting Release, at 85403 (fn. 99).

[3] Broad cross-border antifraud authority even if safe harbor conditions met. *See* Adopting Release, at 85403 (fn. 115).

Q.9.2
Does the Rule 192 safe harbor require that the ABS always be held by a non-U.S. person ("Super Reg S")?

No. Under Regulation S, securities can be offered or sold to a U.S. person after the end of the distribution compliance period. For ABS, the distribution compliance period is 40 days.[1]

Some transactions include a contractual provision (colloquially referred to as "Super Reg S") to the effect that so long as the security is outstanding, it cannot be offered or sold to a U.S. person. That contractual provision is not required by Regulation S and the Rule 192 safe harbor does not separately impose such a requirement.

Notes to Q.9.2:

[1] 40-day distribution compliance period. *See* 17 CFR 230.903(b)(3)(ii).

Q.9.3
Does the Rule 192 safe harbor require that the ABS pool consist of assets that are non-U.S. dollar denominated?

No, neither Regulations S nor the Rule 192 safe harbor contains such a requirement.

Q.9.4
In a synthetic ABS transaction, does the Rule 192 safe harbor require that the credit protection buyer (e.g., the bank in a CRT transaction) be a non-U.S. person?

No. The Rule 192 safe harbor requires that the issuer of the synthetic ABS (the SPE) be a non-U.S. person. Whether the credit protection buyer is a U.S. person is not relevant to the availability of the safe harbor.

If an ABS or ABS pool is not exempt under the Rule 192 safe harbor, a CRT transaction which references that ABS or ABS pool would also not be exempt under the safe harbor.

Q.9.5
Is the location of the trustee, custodian, underwriter, placement agent or initial purchaser relevant to the question of whether the Rule 192 safe harbor is available?

No. The Rule 192 safe harbor requires that the issuer of the synthetic ABS (the SPE) be a non-U.S. person. Whether the trustee, custodian, underwriter, placement agent, initial purchaser or other transaction party is a U.S. person is not relevant to the availability of the safe harbor.

Q.9.6
If an ABS offering qualifies for the safe harbor for foreign transactions under Rule 15Ga-2 (Findings and Conclusions of Third-Party Due Diligence Reports), will it also qualify for the safe harbor for foreign transactions under Rule 192?

Generally yes. As noted above, the SEC acknowledged that the Rule 192 safe harbor is modeled on the safe harbor under Rule 15Ga-2(e). Although the language of the two safe harbor requirements is slightly different, compliance with the Rule 15Ga-2(e) safe harbor will constitute compliance with the Rule 192 safe harbor absent very unusual facts or circumstances.

TOPIC 10:

WHAT STEPS CAN SECURITIZATION PARTICIPANTS TAKE TO PREPARE FOR RULE 192?

Securitization participants should begin to take affirmative steps to ensure that they are ready to comply with Rule 192. These steps should include:

- Reviewing Rule 192 with counsel.
- Identifying all of the potential entities within the enterprise that could be securitization participants.
- Identifying the potential types of transactions across the securitization participant's enterprise that could be conflicted transactions.

Every securitization participant will need a general compliance program for Rule 192, as well as the specific compliance programs required by Rule 192 if the securitization participant intends to utilize the exceptions for risk mitigating hedging activities and bona fide market-making activities.

For compliance program planning purposes, many securitization participants (particularly those subject to the Volcker Rule) will find it most convenient to apply a "filtering" approach; that is, an approach that scopes out certain transactions without the need to consider whether the transactions meet the definition of "conflicted transaction" (which, in the case of prong (iii), is a facts-and-circumstances intensive inquiry). Such filters include:

- Subject Transactions relating to ABS that satisfy the requirements for the safe harbor for certain foreign transactions as set forth in Rule 192(e).

- Subject Transactions for which the exception for risk mitigating hedging, bona fide market-making or liquidity commitments applies. As discussed in this market guide, securitization participants who have existing Volcker Rule compliance programs are well-situated to utilize these exceptions.

- Subject Transactions entered into by affiliates or subsidiaries of a named securitization participant, where the requisite indicia of separateness are satisfied (i.e., no acting in coordination and no sharing of information).

These filters will capture many, but not all, Subject Transactions.

With respect to prong (i) (short sale of the ABS) or prong (ii) (synthetic short sale of the ABS), many securitization participants may find it most convenient and reliable to adopt (or utilize existing) CUSIP tracking systems to prevent prong (i) or prong (ii) transactions from occurring within the enterprise.

As discussed in this market implementation guide, prong (iii) transactions are facts-and-circumstances intensive. As a result, most securitization participants will necessarily rely on compliance/trading policies and training programs, rather than CUSIP tracking or other forms of active monitoring, to ensure compliance.

In developing compliance/trading policies and training programs, securitization participants should consider:

- Designing executive and employee training to reinforce legal requirements and company policies, including the principles of anti-evasion and avoidance of reputational harm.

- Identifying transaction types that are disallowed.

- Identifying transaction types that require an internal process to review and approve such transactions.

- Identifying transaction types that are allowed (*e.g.*, interest rate or currency hedges or broad-based index hedging).

Finally, in the event that interpretive questions arise that are not addressed by this market guide, securitization participants are encouraged to raise those questions with their counsel and, if appropriate, SIFMA so that they can be discussed with a broad range of industry participants.

In some cases, it may be advisable to seek guidance from the SEC's Office of Structured Finance. In order to ensure efficiency and consistency, market participants are encouraged to work with SIFMA in seeking such guidance.

This market guide may be updated from time to time to answer additional questions or refine answers to existing questions based on feedback from market participants or the SEC.

APPENDIX A:

TEXT OF RULE 192

§ 230.192 Conflicts of interest relating to certain securitizations.

(a) Unlawful activity.

(1) ***Prohibition***. A securitization participant shall not, for a period commencing on the date on which such person has reached 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 that is substantially the economic equivalent of a transaction described in paragraph (a)(3)(i) or (a)(3)(ii) of this section, other than, for the avoidance of doubt, any transaction that only hedges general interest rate or currency exchange risk.

(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,

including those arising out of its securitization activities, such as the origination or acquisition of assets that it securitizes.

(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 materially 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 or with respect to which the prohibition in paragraph (a)(1) of this section otherwise applies, 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, if required, 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 a synthetic asset-backed security and a hybrid cash and synthetic asset-backed security.

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 if the affiliate or subsidiary:

(A) Acts in coordination with a person described in paragraph (i) of this definition; or

(B) Has access to or receives information about the relevant asset-backed security or the asset pool underlying or referenced by the relevant asset-backed security prior to the first closing of the sale of the relevant asset-backed security.

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 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 or referenced by the asset-backed security, other than a person who acts solely pursuant to such person's contractual rights as a holder of a long position in the asset-backed security.

(iii) Notwithstanding paragraph (ii) of this definition, a person that performs only administrative, legal, due diligence, custodial, or ministerial acts related to the structure, design assembly, or ongoing administration of an asset-backed security or the composition of the pool of assets underlying or referenced by the asset-backed security will not be a sponsor for purposes of this rule.

(iv) Notwithstanding paragraphs (i) and (ii) of this definition, 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.

(d) **Anti-evasion**. If a securitization participant engages in a transaction or a series of related transactions that, although in technical compliance with paragraph (b) of this section, is part of a plan or scheme to evade the prohibition in paragraph (a)(1) of this section, that

transaction or series of related transactions will be deemed to violate paragraph (a)(1) of this section.

(e) **Safe harbor for certain foreign transactions.** The prohibition in paragraph (a)(1) of this section shall not apply to any asset-backed security for which all of the following conditions are met:

(1) The asset-backed security (as defined in this section) is not issued by a U.S. person (as defined in 17 CFR 230.902(k)); and

(2) The offer and sale of the asset-backed security (as defined by this section) is in compliance with 17 CFR 230.901 through 905 (Regulation S).