MAYER | BROWN

Legal Update

Significant Concerns about Credit Risk Transfers (CRTs) under SEC Proposed Rule 192

(Prohibition Against Conflicts of Interest in Certain Securitizations)

Julie A. Gillespie, Christopher B. Horn, Stuart M. Litwin and Michelle M. Stasny

On January 25, 2023, the US Securities and Exchange Commission ("SEC") proposed Rule 192, which prohibits securitization participants from engaging in any transaction that would involve or result in a material conflict of interest with investors.[1] Although not evident from the text of proposed Rule 192 itself, the SEC's commentary in the proposing release[2] (the "Proposing Release") raises significant concerns about whether SPE CRT Transactions (as defined below) are "conflicted transactions" under the rule.[3]

Proposed Rule 192 is likely to have broad coverage. Among many other things:

- Proposed Rule 192 applies not only to "asset backed securities" as defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (the "Exchange Act") ***but also to synthetic asset-backed securities***[4] (a term not separately defined by either proposed Rule 192 or the Exchange Act); and
- Among the types of "conflicted transactions" defined under proposed Rule 192 is a catchall (the "Catchall Provision"): "The purchase or sale of any financial instrument (other than the relevant asset-backed security) or entry into a transaction through which the securitization participant would benefit from the actual, anticipated or potential…[a]dverse performance of the asset pool supporting or referenced by the relevant asset-backed security."[5]

Some CRT transactions are structured as synthetic securitizations that utilize an SPE as the protection seller and provide that:

- A bank enters into either a swap or financial guarantee with the SPE to provide credit protection to the bank with regard to its receivables, loans or other financial exposures;
- The SPE issues credit-linked notes ("CLNs") to investors and deposits the proceeds of the CLNs into a trust account; and
- Payments on the CLNs will be reduced if cash collateral is used to make credit protection payments to the bank.

Central to the design and intent of a transaction such as the above (an "SPE CRT Transaction") is that if the reference assets perform poorly, the bank may be entitled to payments under the swap or financial guarantee issued by the SPE, and, as a result, the investors in the CLNs may incur a loss.

Do CLNs and SPE CRT Transactions constitute "conflicted transaction[s]" between the bank (as a securitization participant) and investors in the CLNs? A passage of potential concern from the Proposing Release indicates that they do:

> "Under the re-proposed rule, the issuance of a synthetic ABS where a securitization participant enters into the short side of the transaction with the issuing entity of the synthetic ABS would be a 'conflicted transaction' because the securitization participant would be entitled to payment if the referenced assets, and thus the ABS, perform poorly."[6]

Fortunately, this passage appears in a request for comment, thus signaling that the SEC remains open to further feedback on the breadth of the Catchall Provision. The SEC asks, "Is this the appropriate result? Please explain why or why not."[7] Unfortunately, the sentences that immediately follow do not provide market participants much comfort about the kinds of answers the SEC may be willing to entertain:

> "Are there examples of synthetic ABS where a securitization participant taking the short position in the referenced assets would not necessarily benefit from the adverse performance of the underlying asset pool, the loss of principal, monetary default, or early amortization event, or decline in the market value of the relevant ABS? If so, should the definition of 'conflicted transaction' exclude the issuance of such synthetic ABS? If so, please explain how such exclusion would be consistent with Section 27B."[8]

Commenters to proposed Rule 192 may be able to provide helpful guidance for the SEC to consider whether the securitization participant would enjoy a net economic benefit from the adverse performance of the underlying asset pool. Indeed, SPE CRT Transactions are essentially a risk-mitigating hedging activity rather than a transaction designed to enable a sponsor to take a net short position in the reference assets.[9]

Moreover, rather than constituting a side bet on the performance of ABS or underlying assets, the swap or financial guarantee between a bank and an SPE is an integral part of an SPE CRT Transaction. In a passage that could benefit from further clarification, the SEC states:

> "**We received comment to the 2011 proposed rule that the scope of prohibited transactions should be limited to transactions other than those that are an integral part of the creation and sale of the relevant ABS. We are not including such a standard in the re-proposed rule.** Under the re-proposed rule, entering into an agreement to serve as a securitization participant with respect to an ABS would not itself be a 'conflicted transaction.' However, any transaction that the securitization participant enters into with respect to the creation or sale of such ABS (e.g., a transaction whereby a securitization participant takes the short position in connection with the creation of a synthetic ABS) would need to be analyzed to determine if it would be a 'conflicted transaction' under the re-proposed rule. [The Catchall Provision] would not capture the purchase or sale of the ABS with respect to which the person is a securitization participant under the re-proposed rule. The short sale of the relevant ABS would be separately covered under proposed Rule 192(a)(3)(i), and the sale of ABS to investors by an underwriter, placement agent, or initial purchaser would not be captured as a conflicted transaction."[10]

From this passage, it is difficult to gauge the SEC's perspective on bank SPE CRT Transactions. However, the SEC's commentary on CRT transactions conducted by Fannie Mae and Freddie Mac (collectively, the "Enterprises") is causing concern among market participants who are studying the Proposing Release for guidance. In its commentary appearing on page 9688 of the Proposing Release, the SEC explains that the Enterprises are excluded from the definition of "sponsor" with respect to ABS that are fully insured or guaranteed by them because "the investors in ABS fully insured or fully guaranteed by an Enterprise would not be subject to credit risk so long as an Enterprise's guarantee is backed by the full faith and credit of the United States. As such, we do not believe that such investors bear significant risk of conflicted transactions."[11]

The commentary proceeds to state that:

> "A security-based CRT transaction typically involves the issuance of unguaranteed ABS by a special purpose trust where the performance of such ABS is linked to the performance of a reference pool of mortgage loans that collateralize Enterprise guaranteed-MBS. As a part of a security-based CRT transaction structure, the relevant Enterprise enters into an agreement with the special purpose trust pursuant to which the trust has a contractual obligation to pay the Enterprise upon the occurrence of certain adverse events with respect to the referenced mortgage loans."[12]
>
> …
>
> "We note, however, that because a CRT security issued in a security-based CRT transaction is not guaranteed by the relevant Enterprise, investors in a CRT security would bear credit risk. Furthermore, because the CRT security is not fully insured or fully guaranteed by an Enterprise, the proposed exclusion from the definition of 'sponsor' for the Enterprises with respect to Enterprise-guaranteed ABS would not apply to a CRT security itself. ***Therefore, the Enterprises would be 'sponsors' of CRT securities for purposes of the re-proposed rule and would be prohibited from engaging in conflicted transactions that would be prohibited by the re-proposed rule with respect to investors in such CRT securities***."[13]

A treatment of SPE CRT Transactions as conflicted transactions would be unexpected by many market participants because investors in CLNs typically are seeking out exposure to a particular tranche of credit risk in a transaction that is transparently structured to mitigate risk to the bank. However, interested parties studying the SEC's commentary on proposed Rule 192 may be uncomfortable with the current ambiguity as to the treatment of SPE CRT Transactions. Therefore, it is expected that many comment letters will address the impact of the proposed rule on SPE CRT Transactions, and CRT transactions generally, and stress the central role that such transactions play in helping banks mitigate their credit risks.

The deadline for comments on proposed Rule 192 is March 27, 2023. Although market participants have requested an extension, there is no assurance that the SEC will grant one.

For more information about this Legal Update, please contact any of the following lawyers.

Julie A. Gillespie
+1 312 701 7132
jgillespie@mayerbrown.com

Stuart M. Litwin
+1 312 701 7373
slitwin@mayerbrown.com

Christopher B. Horn
+1 212 506 2706
cbhorn@mayerbrown.com

Michelle M. Stasny
+1 202 263 3341
mstasny@mayerbrown.com

Endnotes

[1] *See SEC Re-Proposes Conflict of Interest Rule for Asset-Backed Securities*, Mayer Brown Legal Update (January 31, 2023) at https://www.mayerbrown.com/en/perspectives-events/publications/2023/01/sec-re-proposes-conflict-of-interest-rule-for-asset-backed-securities.

[2] *See Prohibition Against Conflicts of Interest in Certain Securitizations*, Release No. 33-11151 (January 25, 2023), as subsequently published in the *Federal Register* at 88 FR 9678 (February 14, 2023).

[3] Although this Legal Update focuses on potential issues with SPE CRT Transactions, we also note that there are potential concerns with respect to any CRT transaction in which the referenced assets are themselves included in a separate securitization. In that case, the CRT transaction could be construed as a "conflicted transaction" on the grounds that it is "a transaction through which the securitization participant would benefit from the actual, anticipated or potential … [a]dverse performance of the asset pool supporting or referenced by the relevant asset-backed security." *See* clause (3)(iii)(A) of proposed Rule 192.

[4] *See* Proposing Release, at 9727.

[5] *Id*., at 9726.

[6] *Id*., at 9698.

[7] *Id*.

[8] *Id*.

[9] Risk-mitigating hedging activities are one of the enumerated exceptions to the prohibition on conflicts of interest set forth in Section 27B. Proposed Rule 192 reflects that exception but provides that "the initial distribution of an asset-backed security is not risk-mitigating hedging activity." *See* Proposed Rule 192(b)(1)(i). Thus, under the SEC's proposal, the risk mitigation that is accomplished by an SPE's issuing a CLN in an SPE CRT Transaction arguably may not be covered by the exception for risk-mitigating hedging activities.

[10] *Id*., at 9695 (emphasis supplied).

[11] *Id*., at 9688.

[12] *Id*.

[13] *Id*. (emphasis supplied).