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Securities and Derivatives Briefing

# Final Volcker Rule – Impact on CLOs

On December 10, 2013, five U.S. financial regulatory agencies (the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "**Agencies**")) adopted a final rule (the "**final rule**") implementing the provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act commonly referred to as the Volcker Rule.

This briefing outlines the impact of the final rule on CLO transactions, both within the U.S. and elsewhere. There are two main restrictions in the final rule – firstly the holding by banking entities of ownership interests in "covered funds" and secondly the entering into "covered transactions" by banking entities which sponsor, act as investment manager or advisor to, or organize and offer a covered fund.

**Covered Funds**

The final rule prohibits banking entities from acquiring, as principal, "ownership interests" in or sponsoring covered funds, subject to limited exceptions (see below).

The definition of covered fund includes issuers of the type that would be investment companies but for the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act. The "qualified purchaser" exclusion provided by section 3(c)(7) is widely relied upon by the CLO market. Thus CLOs relying on section 3(c)(7) are brought within the definition of covered fund, and banks cannot hold ownership interests in or sponsor such CLOs unless an exclusion or exemption applies.

**Loan Securitization Exclusion**

There is an exclusion from the definition of covered fund for "loan securitizations". However, this is limited to CLOs that only hold loans (and limited derivatives that directly hedge interest rate and currency risks that relate to loans), which are defined narrowly and exclude securities or interests in securities. Thus any CLO with a bond bucket will be unable to use this exclusion, and permitted investments in loan CLOs will have to be drafted so as to ensure the exclusion remains available.

**Ownership Interests in a Covered Fund**

In the proposed rule, the definition of "ownership interest" included equity interests and "equity-like" interests that participate in profit and loss, such as subordinated debt tranches. However, the final rule has significantly broadened the definition of ownership interest so as to include any interest that has the right to participate in the selection or removal of certain entities such as investment advisors and managers and members of the board of directors, other than as a creditor exercising its remedies on an event of default or acceleration event.

This raises the concern that the securities that comprise the controlling class in a CLO, which typically has the right to remove a Collateral Manager for cause and to select a new manager, may constitute an "ownership interest" according to the definition in the final rule, even if such controlling class is a senior debt class that does not participate in the profits or losses of the CLO (other than interest on its senior debt). If this were the case, then banking entities would be prohibited from owning those securities.

As discussed below ("*What's next?*"), clarification is being sought from the regulators on this issue.

**"Sponsorship" of a Covered Fund**

"Sponsoring" a covered fund essentially means having direct or indirect control of the Issuer e.g. by acting as or having any power over selection of the board of directors, the trustee or management of the covered fund, or sharing a name or marketing material with the fund, or having any investment discretion on behalf of the fund. In a typical CLO it will be the investment manager and not the arranging bank which has these powers, and thus this prohibition should not be problematic.

**Exemptions from the Prohibition on Ownership of a Covered Fund:**

There are limited exceptions to the prohibition. Those relevant to CLOs include i) reasonable underwriting and market making-related activities for clients and counterparties and ii) any activity with a covered fund by a foreign banking entity which is conducted solely outside of the United States (see "*Non-U.S. banking entities*", below).

The underwriting and market-making exemptions are available for an offering of securities carried out to meet the reasonable demands of clients, customers and counterparties, and are subject to various other restrictions, including an aggregate limit of 3 per cent of tier 1 capital and a 100 per cent capital charge with respect to such ownership interests.

There is a further exemption for banks holding ownership interests in a covered fund in connection with an offering of asset-backed securities which it "organizes and offers" and in which it also acts as risk-retainer as required by section 15G of the Securities Exchange Act of 1934 (the "Exchange Act"). In those circumstances, the bank can provide the fund with sufficient initial equity to attract unaffiliated investors, provided that within a year after the transfer of assets into the fund, the bank's ownership interest is reduced to no more than 3 per cent of the value of outstanding interests in the fund, or such higher percentage as is required in order to comply with the retention requirements in section 15G of the Exchange Act (although no similar exemption is provided to comply with other non-U.S. retention regimes). The proposed risk retention requirement under section 15G is 5 per cent. The overall of 3 per cent of tier 1 capital limit and the 100 per cent capital charge discussed above will also apply.

**Restriction on Covered Transactions with Covered Funds by sponsors and managers**

The final rule also prevents a banking entity from entering into "covered transactions" with covered funds for which the bank acts as sponsor, investment manager or advisor, or if the bank "organizes and offers" that covered fund or holds the required risk retention under section 15G of the Exchange Act. This is the so-called "Super 23A Provision" of the final rule.

"Organizing and offering" an issuing entity of asset-backed securities such as a CLO means acting as the securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or acquiring or retaining an ownership interest in the issuer to comply with the retention requirements in section 15G of the Exchange Act. "Securitizer" is defined in section 15G(a)(3) of the Exchange Act to mean an issuer of an asset backed security or a person who organizes and initiates an asset-backed securities transaction by directly or indirectly selling or transferring assets to the issuer, including through an affiliate. Thus if a bank is not the investment manager or advisor, sponsor or "securitizer", or the retaining party, it can enter covered transactions with the covered fund (although will remain subject to the restrictions on holding ownership interests and will have to rely on the exemptions described above).

The covered transaction provisions are taken from section 23A of the Federal Reserve Act and include:

- Extending loans to the fund
- Purchasing or investing in the fund's securities or purchasing assets from the fund
- Accepting the fund's securities as collateral for loans
- Issuing guarantees for the fund's obligations
- Taking any credit exposure to the fund by way of securities lending or repo transactions
- Entering any derivative transaction with the fund, to the extent the bank takes credit exposure to the fund.

Excluded covered funds, such as loan securitizations, are not subject to the restrictions in the section 23A Provision.

**Non U.S. banking entities**

The final rule permits a non U.S. banking entity to acquire or retain any ownership interest in, or act as sponsor to, a covered fund so long as i) the activity is conducted "solely outside of the United States", and ii) no ownership interest in the covered fund is offered for sale or sold to a resident of the United States. This exemption is not available to U.S. banking entities or their foreign subsidiaries and affiliates, and is only available to non U.S. banks if:

- The banking entity (including relevant personnel) that makes the decision to invest or act as sponsor is not located in the United States;
- the investment or sponsorship, including any related hedging transaction, is not accounted for as principal in the United States;
- ownership interests in the covered fund are not offered to residents of the United States; and
- no financing for the banking entity's ownership or sponsorship of the covered fund is provided by a U.S. affiliate.

As most European CLOs will offer a Rule 144a tranche, the use of this exemption by CLOs outside the U.S. may be limited.

**No Grandfathering**

As there is no grandfathering provision in the final rule, CLOs will have to ensure they comply by 21 July 2015. This may mean banks divesting themselves of their CLO notes, or agreeing to modifications of the transaction documents to allow their continued holding of those notes.

**What's next?**

The industry had been expecting that the Agencies might give further guidance by 15 January to clarify the ownership interest provisions with the effect that CLOs might fall outside the restrictions. However, although the Agencies did release further guidance on 14 January, the relief provided was limited to CDOs backed primarily by depository institution-issued Trust Preferred Securities ("TruPS"). No further guidance has yet been given in relation to CLOs.

We observe that funds that rely on other exemptions from registration as an Investment Company are not covered funds, even if those in sections 3(c)(1) and 3(c)(7) could be available. Asset-backed security issuers that rely on rule 3a-7 of the Investment Company Act are explicitly exempted from the definition of covered fund in the final rule. There is some scope for modification of CLO transaction documents so that the CLO issuer may meet the requirements of rule 3a-7, although at the cost of additional limitations and requirements as compared to deals that rely on sections 3(c)(1) and 3(c)(7). Nevertheless, it may be that some portion of the European market will migrate in response to the final rule. Certain U.S. structures that require a bond bucket may also avail themselves of rule 3a-7, subject to the same limitations and restrictions.

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