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Legal Update
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The Volcker Rule—Application to Securitization Transactions

The federal financial agencies on December 10, 2013, approved joint final regulations (the "Final Regulation") implementing section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule. Section 619 added a new section 13 to the Bank Holding Company Act of 1956 (the "BHCA") that generally prohibits any banking entity from engaging in proprietary trading and from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with, a hedge fund or a private equity fund, subject to exemptions for certain permitted activities.

Over 70 pages in rule text and nearly 900 pages of supplementary information (the "Preamble"), the Final Regulation made numerous changes to the proposed regulations (the "Proposal") which had been subject to an unprecedented number of comment letters. These changes address many, but far from all, of the concerns raised in the comment letters. In many respects the Final Regulation is an improvement over the Proposal. For example, the Final Regulation substantially mitigates concerns about its extraterritorial impact and its excessively narrow implementation of the exemptions in the statute. Nevertheless, some changes are more restrictive than the Proposal. Given the complexity of the Final Regulation, this legal update provides a number of initial observations, but additional issues are likely to arise as financial institutions begin to implement compliance with the Final Regulation.

Fortunately, there will be a period of time in which to resolve some of the uncertainty. At the same time that the Final Regulation was approved, the Board of Governors of the Federal Reserve System approved a one-year extension of the conformance period until July 21, 2015. However, banking entities that exceed $50 billion in gross trading assets and liabilities will be required to begin reporting certain metrics on June 30, 2014.

This legal update addresses the impact of the Final Regulation on securitization activities and therefore focuses on the prohibition on covered funds activities and certain of the exceptions thereto.

Prohibition Against Covered Fund Activities

The Final Regulation retains the basic framework of the Proposal as it relates to covered fund activities but makes some significant changes that are important to securitization activities. Like the Proposal, the Final Regulation generally prohibits or restricts a banking entity from investing in, sponsoring, or having certain relationships with, a covered fund. Specifically, the Final Regulation implements the provisions in section 13 of the BHCA that:

- Prohibit a banking entity from sponsoring or acquiring "ownership interests" in a private equity fund or a hedge fund;
- Provide certain exemptions from this prohibition; and

- Prohibit a banking entity from making loans or entering into other “covered transactions” with a covered fund for which a banking entity acts as sponsor, *investment manager* or *investment adviser*, and require that any permitted transactions with covered funds be on “market terms”.

Although securitization transactions generally do not utilize private equity funds or hedge funds and the statutory text of the Volcker Rule expressly required that the Final Regulation not prohibit the securitization of loans, the Final Regulation will impact securitizations in a material way due to the breadth of the definition of “covered funds.”

Covered Funds

The Final Regulation retains the same basic definition of covered fund that was in the Proposal. A “covered fund” is any issuer that relies solely on the section 3(c)(1) or 3(c)(7) exclusion from the definition of “investment company” under the Investment Company Act of 1940 (the “1940 Act”). A securitization issuer that relies on any other exclusion from the definition of investment company under the 1940 Act would not be a covered fund, even if it could also rely on section 3(c)(1) or 3(c)(7). Accordingly, issuers that can rely on exemptions like section 3(c)(5)(C) or Rule 3a-7 under the 1940 Act are not covered funds.

Commodity Pools

The Final Regulation’s inclusion of commodity pools as covered funds is much more narrow than in the Proposal. Only certain commodity pools with CFTC registered commodity pool operators are now covered funds, as are commodity pools if the related commodity pool operator has claimed an exemption under 17 C.F.R. 4.7.

Foreign Issuers

The Final Regulation made a significant change in respect of foreign issuers. Whereas the Proposal included as covered funds issuers organized or offered outside the United States that *would be* investment companies but for section 3(c)(1) or 3(c)(7) of the 1940 Act if the issuer’s securities were offered to one or more residents of the United States, the Final Regulation does not apply to the relationships between non-U.S. banking entities and non U.S. issuers that do not offer or sell their securities to residents of the United States. Specifically, Section ____.10(b)(iii) includes non-U.S. funds as covered funds only in relation to any U.S. banking entity or banking entity controlled by a U.S. banking entity. Consequently, a foreign issuer could be a covered fund with respect to a U.S. banking sponsor or owner while not constituting a covered fund as to its foreign bank sponsor or owner.[1]

Interrelationship of Covered Funds and Super 23A

The Final Regulation provides for 14 separate exclusions from the definition of covered fund in Section ____.10(c). This is a critical change in regulatory structure from the Proposal for two reasons. Although the Proposal permitted for certain activities with respect to loan securitization issuers and foreign issuers, the Proposal nonetheless included those issuers as covered funds. As a result, under the Proposal even permitted securitization issuers were caught under the so-called “Super 23A” restrictions and could also fell under the commodity pool definition and its consequent restrictions. For example, under the Proposal a banking entity could not provide a liquidity facility or simple interest rate hedge to a permitted loan securitization issuer for which the banking entity acted as investment manager. By carving out loan securitizations and foreign funds (as well as other funds) from the definition

of covered fund entirely, the Final Regulation solved these critical problems. Also, because bank relationships with covered funds are subject to other restrictions under the Volcker Rule, including limits on aggregate investments and conflicts of interest, as well as monitoring and reporting requirements, a blanket carve-out from the definition of covered fund reduces the compliance burden much more than permitting only specific activities with a covered fund.

Exclusions Relevant to Securitization

Of the 14 exclusions from the covered fund definition in Section ___.10(c), there are a handful that are likely to be important to many securitization issuers and intermediate special purpose entities.

LOAN SECURITIZATION EXCLUSION

First, not surprisingly, the Final Regulation retained the concept of a loan securitization exclusion ("LSE") in Section ___.10(c)(8). To meet the LSE, an issuer must issue asset-backed securities ("ABS") (as defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (the "1934 Act")) backed solely by (a) loans, (b) rights or other assets designed to assure the servicing or timely distribution of proceeds to ABS holders and rights or other assets related or incidental to purchasing or otherwise acquiring and holding the loans, (c) interest rate or foreign exchange derivatives that directly relate to the permitted assets of the issuer so long as they reduce interest rate and/or foreign exchange risks related to the assets of the issuer, and (d) special units of beneficial interest "SUBIs" and collateral certificates issued by a special purpose vehicle that itself meets the LSE.[2] The LSE specifically excludes as permitted servicing or incidental assets (1) any security other than cash equivalents or securities received in lieu of debts previously contracted with respect to the permitted loans, (2) any derivative (other than interest rate or currency derivatives described above), and (3) any commodity forward contract.

Though more flexible than in the Proposal, the LSE continues to present challenges to many ordinary securitizations in the market today. Perhaps the most significant challenge is the definition of "loan" itself which now expressly excludes all securities and derivatives. As a threshold matter, it is a fair question to ask why a securitization issuer must consider whether it meets any 1940 Act exemption, much less those found in section 3(c)(1) or 3(c)(7), if it does not invest in any securities (as defined in the 1940 Act). That said, in practice, securitization issuers are structured to fall into an exemption under the 1940 Act, even if the pooled assets are primarily ones that would not be considered "securities" under the 1933 Act or 1934 Act. In this regard, section 3(c)(5) of the 1940 Act provides an exemption for certain entities that primarily invest in assets such as notes, loans and mortgages. While the actual text of the definition of "security" in the 1940 Act is virtually identical to that in the 1934 Act, judicial interpretations of that definition over the years has led to a more narrow reading for purposes of the 1934 Act.[3] It is within this interpretive band between the two definitions that issuers seeking to utilize the LSE will need to fall. Issuers should also consider relevant statements in the Preamble.[4] Although this legal update is not the place for a full blown analysis of judicial history in defining "security", it is worth noting that for certain types of pooled assets additional analysis may be needed to determine whether it is a security under the 1934 Act, particularly if in the form of a participation or if it is a "structured loan."[5] Notwithstanding this sobering legal context, there is very helpful commentary around footnote 1970 in the Preamble suggesting the agencies intended a more narrow construction of the term "security": "The Agencies believe that the final rule excludes from the definition of covered fund typical structures used in the most common loan securitizations representing a significant majority of the current securitization market, such as residential mortgages, commercial mortgages, student

loans, credit card receivables, auto loans, auto leases and equipment leases. Additionally, the Agencies believe that esoteric asset classes supported by loans may also be able to rely on the LSE, such as time share loans, container leases and servicer advances." This comment may have been more helpful had it appeared in the LSE discussion rather than in the discussion of qualifying ABCP, but it seems logical to read it as applicable to both since both exclusions include a requirement that the pooled assets be "loans."

Another significant issue in the LSE relates to SUBIs. Although clearly not intended, as evidenced by a straightforward discussion in the Preamble about SUBIs and their use in titled-vehicle lease securitizations to permit centralized ownership of vehicles by a special purpose entity, the LSE requires that the SUBI issuer hold only assets permitted under the LSE. Because the LSE does not permit an entity to hold vehicles, as a technical matter no SUBI issuer could meet this restriction.

QUALIFYING ABCP EXCLUSION

Section __. 10(c)(9) provides a separate exemption for qualifying ABCP conduits ("QABCP"). The QABCP exclusion requires that the ABCP conduit hold only loans and other assets permitted under the LSE, but also permits the conduit to hold ABS supported by LSE permitted assets, provided the ABS is acquired by the conduit in an initial issuance. To satisfy the QABCP exclusion, the conduit's securities must be comprised solely of a residual interest and ABCP with a legal maturity of 397 days or less. In addition, similar to the ABCP safe harbor in the most recent U.S. risk retention proposal, a regulated liquidity provider must enter into a legally binding commitment to provide full and unconditional liquidity coverage with respect to all ABCP issued.

The QABCP exclusion suffers from the same uncertainty around the definition of loan as does the LSE. In addition, the QABCP exclusion serves up another significant hurdle. Any ABCP issuer that utilizes a liquidity facility with an eligible asset test cannot meet the exclusion. This precludes a significant portion of the ABCP industry from availing itself of this exclusion. It is also worth mentioning that the language is not clear that liquidity facilities with no asset tests satisfy the condition if they are provided by more than one regulated liquidity provider or if (consistent within insolvency laws) they provide for funding to stop in the event of an ABCP issuer bankruptcy. However, there is no suggestion in the Preamble that the lack of clarity here was intended to preclude the exclusion applying to conduits with multiple liquidity providers or liquidity facilities with market insolvency events that otherwise have no asset credit tests.

QUALIFYING COVERED BOND EXCLUSION

Qualifying covered bonds that meet the conditions in Section __.10(c)(10) also are exempt from all Volcker Rule restrictions applicable to covered funds. A qualifying covered bond must be either (a) a debt obligation issued by a foreign banking organization the payment obligations of which are fully and unconditionally guaranteed by a cover pool or (b) a debt obligation of a cover pool that is fully and unconditionally guaranteed by its parent foreign banking organization. A "cover pool" for this purpose is an entity owning or holding a dynamic or fixed pool of LSE permitted assets for the benefit of the holders of covered bonds. Because the assets of the covered bond entity all must be LSE permitted assets, the considerations relating to the scope of those discussed above apply equally to this exclusion.

WHOLLY-OWNED SUBSIDIARY EXCLUSION

The exclusion of wholly-owned subsidiaries in Section __.10(c)(2) is very helpful for securitization. This exemption simply requires all ownership interests (discussed below) to be owed by the applicable banking entity, directly or indirectly. It even permits a small percentage

(5%) to be owned by employees or directors and up to 0.5% to be owned by a third party to the extent needed to satisfy legal isolation or similar concerns. This exemption is important for securitization because, among other things, it permits intermediate special purpose entities that hold no assets other than an ownership interest in a securitization issuer (and therefore could not satisfy the LSE) to meet its own covered fund exemption. Banking entities should be mindful, however, that any entity that meets this exemption will itself be a banking entity and therefore subject to all the restrictions under the Final Regulation, including restrictions on proprietary trading and its relationships with covered funds.

Ownership Interest

The Final Regulation defines "ownership interest" to mean any equity, partnership, or other similar interest just as the Proposal did. However, the Final Regulation adds significant detail to the previously undefined text "other similar interest." Although the Preamble indicates that the definition focuses on the attributes of the interest and whether it would provide a banking entity with economic exposure to the profits and losses of a covered fund, the actual text creates additional issues for securitizations.

In particular, the definition now includes any interest that has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or acceleration event). This change has already generated significant concerns in the CLO market where senior debt tranches often have the right to replace a collateral manager in certain circumstances. The definition now also includes an interest the value of which could be reduced as a result of losses in the underlying assets of the covered fund. Because collateral certificates, such as those issued by credit card and other master trusts, typically include this feature, like the CLO concern noted above, this leads to the counterintuitive effect that even the most senior debt class in a securitization could be an ownership interest, making bank investments in those very safe investments prohibited if the issuer is a covered fund that does not have an exclusion.

Definition of Sponsor

Under the Final Regulation (as in the Proposal), the definition of "sponsor" focuses on the ability to control decision-making and operational functions of the fund. A sponsor would include an entity that: (i) acts as a general partner, managing member, trustee, or commodity pool operator of a covered fund, (ii) in any manner selects or controls a majority of the directors, trustees, or management of a covered fund, or (iii) shares the same name, or a variation of the same name, with a covered fund for corporate, marketing, or other purposes.

Separate Asset-Backed Securitization Exemption

As described above, the definition of covered fund excludes certain securitization entities that meet the LSE, QABCP or other covered fund exclusion. However, many securitizations will not meet the strict criteria of an exclusion. Some of those that are not eligible may not be covered funds if they rely on Rule 3a-7 of the 1940 Act or otherwise do not rely on section 3(c)(1) or 3(c)(7) of the 1940 Act. However, recognizing the need for the Volcker Rule to be consistent with the risk-retention mandate in the Dodd-Frank Act, the Final Regulation adds a new exemption for asset-backed securitizations that are not eligible for a complete exclusion from the definition of covered fund. The asset-backed securitization exemption is similar in structure to the asset management exemption.

Section__.11(b) of the Final Regulation provides an exemption from the Volcker Rule that is intended to give effect to the risk retention requirement. It provides that a banking entity is not prohibited from acquiring or retaining an ownership interest in, or sponsoring, a covered fund that is an issuer of asset-backed securities, in connection with organizing and offering such issuer if most of the conditions of the asset management exemption have been met.

The Final Regulation also clarifies that, for purposes of the asset-backed securitization exemption, organizing and offering a covered fund that is an issuer of asset-backed securities means acting as the "securitizer" of the issuer, as that term is used in Section 15G(a)(3) of the 1934 Act, or acquiring an ownership interest in the issuer as required by Section 15G. This is intended to address the activities that would be included as organizing and offering a securitization, which may differ from organizing and offering other covered funds in that the entity that organizes and offers the securitization may not always provide advisory services to the issuer. The Agencies acknowledged this by not requiring those related conditions in the asset management exemption to be satisfied for purposes of the asset-backed securitization exemption.

Importantly, the exemption in Section __.11(b) does not permit a banking entity to have an ownership interest greater than that required by the U.S. risk retention rules (even if preferred by investors or mandated by a non-U.S. regime). Also, the issuer cannot share any variation of its bank sponsor's name or use the word "bank" in its name.

Because the exemption afforded in Section _____.11(b) relates only to the activity of owning or sponsoring a covered fund, this exemption does not permit the banking entity to avoid the Super 23A prohibition on covered transactions with the fund. In addition, the investments in the fund are subject to the aggregate limits on investment and the required deduction of those investments from tier 1 capital.

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Endnotes

[1] For this purpose, a non-U.S. fund is one (a) organized outside the U.S. in which all ownership interests are offered and sold outside the U.S., (b) that raises money primarily for the purpose of investing in securities for resale or other disposition or otherwise trades in securities, and (c) for which the applicable banking entity (or an affiliate) has an ownership interest or acts as sponsor. It is worth noting that the Final Regulation separately excludes a foreign public fund from the definition of covered fund.

[2] A permitted SUBI or collateral certificate must be (a) used for the sole purpose of transferring the economic risks and benefits of the assets permitted under the LSE, (b) created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization, and (c) issued by an entity established under the direction of the same entity that initiated the loan securitization.

[3] Moreover, in the securitization context specifically, Rule 190 under the 1933 Act addresses situations where the assets underlying a securitization are themselves securities and imposes additional requirements on such situations (including that the underlying assets are either registered, exempt from registration, or transferrable without registration) that do not apply where the pooled assets are not "securities". In practice it is generally understood that

these additional requirements do not apply to typical securitized assets such as residential mortgages, commercial mortgages, student loans, credit card receivables, auto loans, auto leases and equipment leases.

4 The Preamble states "[w]hether a loan is a 'note' or 'evidence of indebtedness' and therefore a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the loan" and then includes a string cite at footnote 1831 that includes Reves among other case law.

5 The Preamble described "structured loans" as deserving additional scrutiny under the Volcker Rule, reasoning, "loans that are structured to provide payments or returns based on, or tied to, the performance of an asset, index or commodity or provide synthetic exposure to the credit of an underlying borrower or an underlying security or index may be securities or derivatives depending on their terms and the circumstances of their creation, use, and distribution. Regardless of whether a party characterizes the instrument as a loan, these kinds of instruments, which may be called 'structured loans,' must be evaluated based on the standards associated with evaluating derivatives and securities in order to prevent evasion of the restrictions on proprietary trading and ownership interests in covered funds."

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