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Capital Relief Trades: Structuring considerations for synthetic securitizations (a three-part series providing a US and UK perspective)

Part two: Volcker Rule and US risk retention considerations

By Julie A. Gillespie and Carol A. Hitselberger

In this series, we highlight a few of the regulatory considerations present in a typical CRT structured as a synthetic securitization. Parts one and two of this series discuss the primary legal considerations that may be encountered in doing a CRT in the United States, but such considerations may not apply to all structures, and a CRT may give rise to additional legal, regulatory and accounting considerations not discussed in this series. We continue our series with a look at issues that may arise under the Volcker Rule[1] and US risk retention rules in connection with structuring CRTs in the United States.

Volcker Rule Implications

If a CRT is structured to use a special purpose entity (SPE) that issues securities, the SPE will need an exemption or exclusion from registration under the Investment Company Act of 1940, as amended (ICA). One potential avenue is reliance on the exclusion provided by Section 3(c)(7) of the ICA, which is available for any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers (i.e., investors that meet certain thresholds for the holding of investment securities), and which is not making and does not at that time propose to make a public offering of such securities.

However, reliance on the exclusion provided by Section 3(c)(7) of the ICA can raise other structuring considerations under the Volcker Rule. The Volcker Rule defines a covered fund as including (i) an issuer that would be an investment company, as defined in the ICA, but for reliance on Section 3(c)(1) or 3(c)(7) of the ICA; and (ii) a commodity pool under Section 1a(10) of the Commodity Exchange Act (CEA) for which the commodity pool operator has claimed an exemption under 17 CFR 4.7 or is registered as a commodity pool operator in connection with the operation of a certain type of commodity pool.[2]

Why might those structuring a CRT need to consider whether the SPE is a covered fund? First, the Volcker Rule prohibits banking entities from engaging in certain transactions with covered funds, including acquiring or retaining any "ownership interest" in the covered fund as principal.[3] If investors in a CRT will include banking entities subject to the Volcker Rule and a transaction makes use of an SPE that is a covered fund, it will be necessary to consider whether the terms of the instrument are such that the investors might be considered to have an ownership interest in the SPE.

Banking entities are also generally prohibited from "sponsoring"[4] covered funds absent an exemption, and Section 13(f) of the Volcker Rule (often referred to as Super 23A), generally prohibits a banking entity, directly or indirectly, from entering into a "covered transaction,"[5] as defined under Section 23A of the Federal Reserve Act, with a covered fund for which the banking entity or any affiliate acts as sponsor, investment manager, or investment adviser. Therefore, a banking entity that enters into a CRT that makes use of an SPE that is a covered fund, needs to consider whether its relationship with such SPE could make it a "sponsor" of the covered fund or give rise to a "covered transaction" covered by Super 23A.

The Volcker Rule excludes from the definition of a covered fund an issuer that may rely on an exclusion or exemption from the definition of "investment company" under the ICA, other than the exceptions contained in Sections 3(c)(1) and 3(c)(7) of the ICA.[6] Accordingly, the lender holding the reference assets may wish to avoid analyzing the Volcker Rule implications of utilizing an SPE that is a covered fund, by relying on an exception to the ICA for such SPE other than the exceptions contained in Sections 3(c)(1) and 3(c)(7) of the ICA. Depending on the structure of a CRT, one potential exclusion from investment company status for an SPE used in a CRT may be Rule 3a-7 under the ICA, which provides an exclusion for certain issuers engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets (and in activities related or incidental thereto). Among other requirements, an issuer relying on Rule 3a-7 must issue fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets. For purposes of Rule 3a-7, eligible assets means "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders." As discussed below under "*Considerations Raised by US Risk Retention Rules—Could a CLN Be 'ABS' Subject to the US Risk Retention Rules,*" whether CRTs, particularly those involving the issuance of collateralized credit-linked notes (CLNs), satisfy the requirement that the issued securities entitle their holders to receive payments that depend primarily on the cash flows from eligible assets, is a question that raises certain interpretive issues.

Considerations Raised by US Risk Retention Rules

CRTs pose two potential issues under the US risk retention rules.[7] First, if the underlying exposures in a CRT include assets that have been previously securitized in a transaction subject to the US Risk Retention Rules, the sponsor of the previous securitization transaction must consider whether the entry into the CRT constitutes a prohibited transfer or pledge of the interest the sponsor was required to retain in connection with the securitization transaction. Second, the entity owning the underlying exposures must consider whether the CRT involves the issuance of an asset-backed security (ABS) in a transaction in which such entity could be considered a "sponsor" subject to the US Risk Retention Rules.

US RISK RETENTION RULES: PROHIBITION ON HEDGING

The US Risk Retention Rules, which were adopted by various US federal agencies in response to the Dodd-Frank Act, generally require the sponsor of a securitization transaction (or one or more majority-owned affiliates—as defined in the US Risk Retention Rules—of the sponsor) to retain a minimum economic interest in the credit risk of the securitized assets in accordance with one of the permissible forms of risk retention described in the US Risk Retention Rules and prohibit a sponsor or any affiliate from hedging or transferring the credit risk that the sponsor is required to retain.[8] Frequently, a bank that is interested in engaging in a CRT will already have securitized a portion of the potential reference pool in a traditional securitization that is subject to the US Risk Retention Rules, or may want the flexibility to include such assets in future securitization transactions. As a result, a bank indirectly holding reference assets subject to an on-balance sheet securitization must consider whether the CRT constitutes an impermissible hedge of its required risk retention interest in connection with the securitization transaction, which will be the case if:

1. Payments on the CRT are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and
2. The CRT in any way reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction.[9]

A sponsor grappling with the above analysis could consider whether the CRT may be designed to include securitized assets in a manner that still ensures that payments on the CRT do not reduce or limit the exposure of the sponsor to the credit risk it is required to retain. One potential method to do so may involve creating one or more synthetic securitization exposures that mirror the terms of the securitization exposures in the sponsor's traditional securitization that are not required to be retained for risk retention purposes and then including only such securitization exposures in the CRT reference pool (specifically excluding the retained risk retention interest).

For potential CRT sponsors that do not currently have traditional securitizations involving the potential reference pool, such sponsors may still wish to preserve flexibility under the terms of the CRT to remove assets from the reference pool for inclusion in future traditional securitizations that are subject to the US Risk Retention Rules. Doing so may raise additional issues—for example, potential prepayment risk for investors—that may need to be considered in structuring a transaction.

COULD A CLN BE "ABS" SUBJECT TO THE US RISK RETENTION RULES?

Only sponsors of asset-backed securities, as defined under the Securities Exchange Act of 1934, as amended (Exchange Act), are subject to the US Risk Retention Rules. CRTs will often involve the issuance of credit-linked notes or other securities, and therefore a bank engaging in a CRT must consider whether such securities are asset-backed securities. An asset-backed security is defined in the Exchange Act as follows:

"The term 'asset-backed security'" —

A. Means 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 cash flow from the asset, including —
   - i. A collateralized mortgage obligation;
   - ii. A collateralized debt obligation;
   - iii. A collateralized bond obligation;
   - iv. A collateralized debt obligation of asset-backed securities;
   - v. A collateralized debt obligation of collateralized debt obligations; and
   - vi. A security that the Commission, by rule, determines to be an asset-

> backed security for purposes of this section; and ...."[10]

CLNs issued in a CRT are often collateralized by the cash proceeds of the issuance of the CLNs, which may be held in a trust account for the benefit of both the CRT sponsor or protection buyer (to satisfy payments on the guaranty or credit derivative) and the investors in the CLNs. As a result, there are potentially two pools of "self-liquidating financial assets" that must be considered when analyzing whether CLNs are asset-backed securities—(1) the "cash" collateral for the CLNs, which may be invested in highly-rated securities and (2) the underlying reference assets for the CRT.

Whether CLNs are collateralized by self-liquidating assets that allow the holders of the CLNs to receive payments that depend primarily on cash flow from the assets (and are therefore potentially asset-backed securities) is a challenging question. On the one hand, the assets that can best be described as "collateralizing" the CLNs are the investment securities that provide security for the CLNs and are the sole source of cash flows for the CLNs. On the other hand, the assets which most directly affect the performance of the securities—that is, which determine the amount and timing of payments of principal in respect of such securities—are the reference assets. In other words, payments on the CLNs are highly dependent on the performance of the reference pool, but the CLNs are not entitled to the cash flow from the reference pool and CLN holders do not have the benefit of a security interest in the reference pool.

Second, one might question whether a bank holding a reference pool of assets in a CRT involving the issuance of CLNs is a "sponsor"—within the meaning of the US Risk Retention Rules—of an asset-backed securities transaction. Under the US Risk Retention Rules, a "sponsor" is defined as an entity that "organizes and initiates a securitization transaction by either selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."[11] Whether a putative sponsor has sold or transferred assets has taken on heightened importance in the analysis after the recent United States Court of Appeals for the District of Columbia Circuit decision holding that the US Risk Retention Rules cannot be applied to managers of open market CLOs, in which the court found that a securitizer must "actually be a transferor, relinquishing ownership or control of assets to an issuer."[12] While a bank that enters into a CRT necessarily must transfer all or a portion of the credit risk of the underlying exposures to third parties,[13] the bank retains ownership of the reference assets, which would support the view that the US Risk Retention Rules are not applicable to synthetic securitizations.

Given the ambiguities discussed above, some bank sponsors may choose to comply with the US Risk Retention Rules rather than grapple with the potential interpretive issues.

For more information about the topics raised in this article, please contact any of the following lawyers:

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

Carol A. Hitselberger
+1 704 444 3522
chitselberger@mayerbrown.com

The authors appreciate the assistance of Paul Forrester, a partner at Mayer Brown, and Harjeet Lall, an associate in the London office of Mayer Brown.

Endnotes

[1] Section 13 of the Bank Holding Company Act of 1956.

[2] 12 CFR 248.10(b)(1).

[3] 12 CFR 248.10(b)(1).

[4] A "sponsor" would include an entity that:

a) Acts as a general partner, managing member, trustee of a covered fund (or serves a CPO of a pool that is a covered fund due to its commodity pool status);

b) In any manner selects or controls a majority of the directors, trustees, or management of a covered fund (including having employees, officers, directors or agents who constitute that majority); or

c) Shares the same name, or a variation of the same name, with a covered fund for corporate, marketing, or other purposes. 12 CFR 248.10(d)(9).

[5] The definition of covered transaction includes (i) loans and other extensions of credit to the covered fund; (ii) purchases of assets from and investments in securities issued by the covered fund; (iii) issuance of financial guarantees on behalf of a covered fund; (iv) securities borrowing or lending that results in a credit exposure to the covered fund; and (v) a derivatives transaction that results in credit exposure to the covered fund.

[6] 12 CFR 248.10(c)(12)(ii).

[7] 79 FR 77601 [hereinafter the "US Risk Retention Rules"]

[8] § __.12(a) of the US Risk Retention Rules. The US Risk Retention Rules contain certain "sunset" provisions for the hedging and transfer restrictions applicable to most ABS and RMBS, after which such restrictions will not apply.

[9] *Id.*

[10] Section 3(a)(79) of the Exchange Act (15 U.S.C. 78c(a)(79)).

[11] § __.2 of the US Risk Retention Rules.

[12] *Loan Syndications & Trading Association v. SEC*, No. 17-5004 (D.C. Cir. Feb. 9, 2018).

[13] §217.41 of Regulation Q.