Clients&FriendsMemo

The Volcker Rule's Impact on Financial Institutions' Ownership and Sponsorship of Structured Finance and Securitization Transactions

November 3, 2011

The three federal banking agencies and the SEC recently approved for comment a proposed regulation implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"),[1] more generally known as the "Volcker Rule." The 298-page proposal has yet to be published in the *Federal Register*, but the agencies have already agreed to an extended comment period for the proposal – running until January 13, 2012 – given the subject matter's significance.

The Volcker Rule, which is scheduled to go into effect July 21, 2012, restricts proprietary trading activities and owning equity interests in or sponsoring of private equity funds by "banking entities." The term "banking entities" is defined by the Act to include (i) FDIC-insured depository institutions, (ii) bank holding companies, (iii) savings and loan holding companies, (iv) other entities that control an FDIC-insured depository institution, and (v) foreign banks that are regulated as if they are bank holding companies under the International Banking Act (*i.e.*, foreign banks that have a U.S. branch or agency office, referred to as a "foreign banking organization"), as well as (vi) any entity that is affiliated with any of the foregoing.

We have previously published memoranda on (i) the general prohibitions of the Volcker Rule as set forth in the statutory provisions of the Act[2] and (ii) the application of the proposed regulation to

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1 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda, please see Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/assets/client_friend/072010_DF1.pdf. Municipal tender option bond programs that rely upon Section 3(c)(1) or 3(c)(7) of the ICA would also be subject to the Volcker Rule and will be addressed in a separate Clients & Friends Memo.

foreign banking organizations.[3] As described in this memorandum, the Volcker Rule as currently proposed would:

- Restrict the ability of banking entities to obtain an "ownership interest" in or "sponsorship" of securitization transactions exempt from the Investment Company Act of 1940 (the "ICA") pursuant to Section 3(c)(1) or Section 3(c)(7), unless such transaction is backed by "loans" (which is defined to include leases, extensions of credit and secured and unsecured receivables);
- Impose onerous compliance requirements on banking institutions obtaining an ownership interest in or sponsorship of securitization transactions backed by loans (as defined above) that are not exempt from the Volcker Rule (such as securitizations exempt from the ICA pursuant to Section 3(c)(5) or securitizations exempt from the ICA pursuant to Rule 3a-7);
- Prohibit banking entities from obtaining ownership interests in or sponsorship of certain other types of securitization transactions or vehicles.

Limitations on Ownership of Covered Funds Under the Proposed Regulation

As a general matter, and subject to certain exceptions, the proposed Volcker Rule would prohibit a banking entity from acquiring, either directly or indirectly, any equity "ownership interest" in a "covered fund."[4] The definition of a "covered fund" combines "hedge funds" and "private equity funds" as defined in Section 13(h)(2) of the Bank Holding Company Act (the "BHCA"),[5] encompassing any issuer or similar fund that would be an investment company under the ICA but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the ICA.[6] Funds that are exempt pursuant to a different exemption under the ICA (e.g., Section 3(c)(5) or Rule 3a-7) are not within the scope of the Volcker Rule.[7]

> *Note: Any securitization that is exempt from the ICA pursuant to Section 3(c)(5) or exempt from the ICA pursuant to Rule 3a-7 is not a "covered fund" for purposes of the Volcker Rule and thus the Volcker Rule does not apply to such entities. Securitizations backed entirely by loans (as defined above), although "covered funds" under the Volcker Rule, are exempt from the Volcker Rule's prohibitions on ownership of equity interests and*

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[3] See *The Volcker Rule's Significant Impact on a Foreign Banking Organization's Proprietary Trading Activities*, October 13, 2011, at http://www.cadwalader.com/assets/client_friend/101311VolckerRuleSignificantImpact.pdf.

[4] § _.10(a).

[5] 12 U.S.C. § 1851(h)(2)

[6] § _.10(b)(1) and 12 U.S.C. § 1851(h)(2) and 15 U.S.C. § 80a-3(c)(1), (c)(7).

[7] Note that a covered fund" that is controlled by a "banking entity" is not itself considered to be a "banking entity." See § _.2(d)(4) of the Volcker Rule."

sponsorship. Note, however, that banking entities' ownership of equity interests in or sponsorship of exempt covered funds are subject to the Volcker Rule's compliance requirements, as discussed below. For securitizations that are covered funds and for which no exemptions are available, banking entities will be prohibited from acquiring any residual or equity interest in the issuer or any class of offered notes that can be characterized as equity and from assuming any sponsorship role of any such covered fund.

Key Definitions

The Volcker Rule would restrict equity participation ("ownership interest") or sponsorship by banking entities of any transaction that meets the definition of "covered fund" as discussed below.

"Ownership interest" is defined in the proposed regulation to mean any equity interest in a covered fund, including warrants, options, trust certificates and similar interests, in each case whether voting or nonvoting, or any derivative of such an interest.[8] The key to the determination of ownership is whether the applicable banking entity has economic exposure to the profits and losses of the covered fund, which makes the definition of ownership interest quite expansive and would include any type of interest (including debt securities) if such interest exhibits substantially the same characteristics (*i.e.,* voting rights, profit-sharing or loss-sharing, or any sort of performance-based return) as equity.

Note: The Volcker Rule offers no specific guidance with respect to the application of the definition of ownership interest for asset-backed securitization transactions. In the context of asset-backed securities, the distinction between debt and equity may be complicated. For example, consider how the Rule may apply to the following types of interests:

- *securities that* are *permitted to defer and capitalize missed interest payments, convertible securities; and*
- *investments that have equity-like features (such as notes that can PIK, convertible debt or notes that do not have adequate levels of subordination to be treated as debt for tax purposes) and that risk being re-classified as equity instead of debt.*

"Sponsorship" of a fund is determined under the proposed regulation primarily by a focus on whether an entity has the ability to control the decision-making and operational functions of the fund. Although the definition includes "trustees" as sponsors, it is unclear whether a traditional

[8] § _.10(b)(3). Similar funds include, under the proposed regulation, commodity pools and foreign equivalents of covered funds, as determined by the applicable agencies.

securitization trustee that acts as a collateral agent and note registrar and can take discretionary action only upon direction of a manager or investor would be covered under the Sponsorship definition.[9]

> *Note: The Volcker Rule indicates that the definition of sponsor does not include a trustee that does not provide discretionary investment services to a covered fund. This exception distinguishes a trustee providing non-discretionary advisory services from trustees that effectively act as a general partner, managing member, commodity pool operator or investment adviser of a covered fund. This seems likely to exclude purely administrative and agent-type trustees from being captured under the "sponsorship" definition such as trustees of CDOs and CLOs. Collateral managers and asset servicers, on the other hand, seem likely to fall under the definition and therefore banking entities with an asset management or servicing business would not be able to participate in a covered fund in such capacity unless one of the exemptions is available. The agencies have requested comment on the economic impact associated with their proposed definition of "sponsor."*[10]

Applicability to Securitizations

As discussed above, securitizations of assets that traditionally rely on the 100 investor limitation exemption in Section 3(c)(1) of the ICA or the qualified purchaser exemption in Section 3(c)(7) of the ICA are "covered funds" and would be subject to regulation under the Volcker Rule. To the extent that a securitization would fall within the covered fund definition of the proposed regulation, even if the securitization is backed entirely by "loans" and hence exempt from the ownership and sponsorship restrictions of the Volcker Rule, any banking entity investing in an ownership interest in such issuer or being a sponsor of such issuer would be subject to the Volcker Rule's compliance and reporting requirements. Ownership and/or sponsorship by banking entities in covered funds not backed by loans are generally prohibited under the Volcker Rule.[11]

> *Note: A securitization issuer that would ordinarily rely on Section 3(c)(7) of the ICA and would therefore be a covered fund under the Volcker Rule could instead opt to maintain its exemption pursuant to Rule 3a-7 to the extent it could be structured to comply with that Rule's requirements. This solution would not work, however, for any actively managed*

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9 § _.10(b)(5). A "sponsor" is an entity that (i) serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund, (ii) in any manner selects or controls (or has employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or (iii) shares with a covered fund, for the corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

10 See page 185-85.

11 Note that there are other exceptions in the Volcker Rule that are not generally applicable to securitization transactions and are beyond the scope of this memorandum.

securitizations that need the flexibility to engage in any discretionary trading of assets for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.[12]

Key Exemptions to the Ownership and Sponsorship Restrictions

An important exemption under the proposed regulation for securitization transactions exempts any securitization issuer whose assets are restricted to "loans" (defined to include leases, extensions of credit and secured and unsecured receivables) and related assets.[13] This exemption covers any acquisition or retention by a banking entity of any ownership interest in, or acting as a sponsor to, a covered fund that issues asset-backed securities backed solely by:

- loans (as defined above);
- contractual rights or assets directly arising from those loans; and
- interest rate or foreign exchange derivatives that materially relate to the terms of such loans or contract rights and are used for hedging purposes.[14]

Thus, ownership or sponsorship by banking entities of securitization issuers obtaining exemption from the ICA pursuant to Section 3(c)(1) or Section 3(c)(7), such as traditional CLO transactions, would not be prohibited under the Volcker Rule but banking entities obtaining ownership interests or sponsorship of such issuers, relying on Section 3(c)(1) or 3(c)(7) of the ICA, will still be subject to the extensive compliance requirements set forth in the Volcker Rule.[15]

Note: Loans are the only asset class exemption from the ownership and sponsorship prohibitions in the Volcker Act. Therefore, other types of traditional securitization

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[12] The key requirements in order for a securitization issuer to avail itself of Rule 3a-7 are: (1) issued debt must be rated no lower than BBB-/Baa3 by each rating agency rating such issuer's debt, unless all investors are either (a) institutional accredit investors under Section 501(a), paragraphs (1), (2), (3) or (7) of Regulation D under the Securities Act or (b) qualified institutional buyers under Rule 144A under the Securities Act (who are also permitted to buy non-fixed income securities under the Rule); and (2) the issuer must comply with certain restrictions on the sale and disposition of collateral, namely that it does not dispose of assets "for the primary purpose of recognizing gains or decreasing losses resulting from market value changes."

[13] Note that the reference to related assets would not cover credit-related hedges such as credit default swaps or a securitization of derivatives. The notional amount of the permitted derivatives must be tied to the outstanding principal balance of the loans supporting the applicable asset-backed securities and such derivatives must be used to hedge risks resulting from a mismatch between the loans and the asset-backed securities.

[14] Interest rate and foreign exchange derivatives must be used only for purposes of hedging specific risks associated with loan assets.

[15] For a discussion of the compliance program created by the Volcker Rule, please see Cadwalader's Clients & Friends Memo: *The Volcker Rule's Significant Impact on a Foreign Banking Organization's Proprietary Trading Activities*, October 13, 2011. The memo can be found at http://www.cadwalader.com/list_client_friend.php?type=159 .

transactions that rely on Section 3(c)(1) or 3(c)(7) would be subject to the prohibitions contained in the proposed regulation. An example of securitizations captured by the Volcker Rule include:

- Synthetic securitizations;
- Re-securitizations;
- CDOs of asset-backed securities such as RMBS, CMBS and other ABS; and
- Certain ABCP conduits.

Note: Traditional CLOs would benefit from this exemption, although sponsors would likely need to consider omitting any proposed bond or derivatives bucket in the underlying asset portfolio of the CLO to ensure compliance.

Note: It is unclear whether the loan exemption would apply to ABCP conduits where the bank-owned or managed conduit makes a loan to a borrower secured by asset backed securities. If the structure were collapsed as if it were a single transaction and the conduit were deemed to hold the asset backed securities instead of the loan, then such transaction could fail to satisfy the requirements for the loan exemption.

Note that the Volcker Rule effectively prohibits securitizations of derivatives and synthetic securities. Application of this prohibition will effectively bar securitization structures such as synthetic or hybrid CDOs, which traditionally sold credit default swap risk exposure to banking entities, unless another types of investors can be found to take on such risk. The Volcker Rule thus limits ownership interests and sponsorships by banking entities to cash assets and effectively prohibits speculation through use of derivatives. These limits may lessen liquidity for all investors by limiting the market to securities backed by cash assets only and depriving investors of access to any assets that cannot be physically obtained.

Permitted Covered Fund Activities for Investments Outside of the United States

The Volcker Rule allows ownership and sponsorship of covered funds outside of the United States by qualifying foreign banking entities.

Note: The proposal does not require that the covered fund itself have no contact whatsoever with the U.S. Thus, a foreign banking entity would be permitted to have an ownership interest in or sponsor a covered fund that itself is located in the U.S., or that contains securitized U.S. assets, provided only that the prescribed criteria are met.[16] *This*

[16] In order to qualify for this exemption, (i) the banking entity must not be directly or indirectly controlled by a banking entity organized under the laws of the United States or any State (i.e., the banking entity must be a non-U.S. subsidiary controlled, directly and indirectly, solely by non-U.S. entities); (ii) no subsidiary, affiliate, or employee of the banking entity that is

would allow offshore banking entities located outside of the U.S. to invest in securitization issuers that hold U.S. assets.

Adoption of a Compliance Program When Relying on Section _.13(d) Exemption

As noted above, although §__.13(d) of the proposed regulation allows banking entities to obtain ownership interests and sponsorships in funds that issue asset-backed securities backed by loans. However, banking entities relying on this exemption will still need to adopt a compliance program meeting the requirements of the proposed regulations.[17] Each "banking entity"[18] will generally be required to develop and provide for the continued administration of a program designed to monitor compliance with the BHCA and this proposed regulation.[19] However, a banking entity will not be required to maintain such a compliance program if it does not engage in activities or investments prohibited or restricted by this proposed regulation, provided its existing compliance policies include measures designed to prevent the banking entity from engaging in any prohibited or restricted activities.[20]

Note: Banking entities that have equity investments in and/or sponsorship of existing securitization transactions in covered funds need to determine if the banking entity needs to divest all or part of its holdings or sponsorship roles to either come into compliance with the prohibitions or, if the applicable issuers are covered by the Volcker Rule but exempt from the prohibitions, how it plans to comply with the reporting and organizational requirements. To the extent banking entities divest, this could result in selling pressure, bank losses and a negative impact on market prices that could impact all investors in the asset class and reduce liquidity in such markets.

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involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the U.S.; and (iii) no ownership interest in such covered fund is offered for sale or sold to a resident of the U.S. In order to avail itself of the exemption, the banking entity must also be a "qualified foreign banking organization" ("QFBO") as defined in the Federal Reserve Board's Regulation K (its worldwide activities must be predominantly banking, and its banking activities must be predominantly outside the United States). Any affiliates of a banking entity that do not meet this QFBO requirement would be unable to rely on the "outside of the United States" exemption to the Volcker Rule's ban on "covered fund" investing and sponsorship. The exemption would be available only to the QFBO's non-U.S. affiliates and could not be used by its U.S. branch or any U.S.-based entity.

[17] For a discussion of the compliance activities required by the Volcker Rule, see Cadwalader's Clients & Friends Memo: *The Volcker Rule's Significant Impact on a Foreign Banking Organization's Proprietary Trading Activities,* October 13, 2011. The memo can be found at http://www.cadwalader.com/list_client_friend.php?type=159 .

[18] See § _.2(j). The term "covered banking entity" is used to describe the specific types of banking entities to which the proposed regulation applies.

[19] § _.20(a).

[20] § _.20(d).

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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