

Clients & Friends Memo

The Volcker Rule's Impact on Banking Entities' Ownership and Sponsorship of Structured Finance and Securitization Transactions

December 17, 2013

On December 10, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the **"Agencies"**) released the long-awaited final regulations¹ (the **"Final Regulations"**) that implement Section 13 of the Bank Holding Company Act (also known as the **"Volcker Rule"**), which was added by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the **"Dodd-Frank Act"**). This memorandum will focus on the Volcker Rule's impact on structured finance and securitization transactions.

The Agencies previously issued a proposed version of the regulations (the **"Proposed Regulations"**) in November 2011, which generated a significant number of comments from participants in the financial markets and the general public. 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 Volcker Rule to: foreign banking organizations; municipal bonds and municipal tender option bond programs; and financial institutions' ownership and sponsorship of structured finance and securitization transactions.³

¹ For the text of the Final Regulations see <http://www.federalreserve.gov/aboutthefed/boardmeetings/final-common-rules-20131210.pdf>.

² See *An Analysis of the Dodd-Frank Act's Volcker Rule*, October 15, 2010, at <http://www.cadwalader.com/resources/clients-friends-memos/an-analysis-of-the-dodd-frank-acts-volcker-rule>.

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/resources/clients-friends-memos/the-volcker-rules-significant-impact-on-a-foreign-banking-organizations-proprietary-trading-activities>; *A Critical Analysis of the Potential Impact of the Volcker Rule on Municipal Bonds*, December 12, 2011, at <http://www.cadwalader.com/resources/clients-friends-memos/a-critical-analysis-of-the-potential-impact-of-the-volcker-rule-on-municipal-bonds>; and *The Volcker Rule's Impact on Financial Institutions' Ownership and Sponsorship of Structured Finance and Securitization Transactions*, November 3, 2011 at <http://www.cadwalader.com/resources/clients-friends-memos/the-volcker-rules-impact-on-financial-institutions-ownership-and-sponsorship-of-structured-finance-and-securitization-transactions>.

Based on the changes that were made by the Agencies in the Final Regulations, the most common types of loan securitizations (such as those backed by residential and commercial mortgages, student loans, credit card receivables, auto loans and leases, and equipment leases, which represent a substantial majority of the current securitization market), as well as securitizations of more esoteric asset classes (such as those backed by time share loans, container leases and servicer advances), will not be subject to the Volcker Rule and, as a result, the activities of banking entities with respect to such securitizations will not become subject to the restrictions and compliance requirements imposed by the Final Regulations.

However, certain other types of structured finance and securitization transactions will be subject to the Volcker Rule, such as: collateralized loan obligations (“**CLOs**”) that are backed in part by bonds or other non-permitted securities; synthetic asset-backed securities; and certain resecuritizations and repackagings of securities. This memorandum will discuss the restrictions and compliance requirements imposed by the Volcker Rule on banking entities with respect to those other types of securitizations.

Volcker Rule Generally

The Volcker Rule, among other things, prohibits any “banking entity” from engaging in proprietary trading and acquiring or retaining an “ownership interest” in, or having certain relationships with, a “covered fund”, subject to certain exemptions.

Conformance Period

Banking entities will have until July 21, 2015 to bring any existing activities and investments into compliance with the Volcker Rule, subject to two 1-year extensions at the discretion of the Agency that oversees the relevant banking entity upon a determination that an extension would not be detrimental to the public interest (the “**Conformance End Date**”).⁴

What is a “Banking Entity”?

The Volcker Rule applies to the activities and investments of “banking entities”. Under the Volcker Rule, a “banking entity” is defined broadly and includes (i) FDIC-insured depository institutions, (ii)

⁴ Although conformance is not required until July 21, 2015, a banking entity is “expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of [the Volcker Rule and the Final Regulations] by no later than the end of the conformance period”. See Board of Governors of the Federal Reserve System, *Order Approving Extension of Conformance Period* (Dec. 10, 2013), at p. 3.

companies that control an FDIC-insured depository institution, (iii) bank holding companies (including a foreign banking organization) and (iv) affiliates or subsidiaries of any of the foregoing.

How Are Structured Finance and Securitization Transactions Affected?

Essential to analyzing the impact of the Volcker Rule with respect to any securitization transaction is determining whether such securitization is a “covered fund” under the Volcker Rule. If the securitization IS NOT a covered fund, then the restrictions in the Volcker Rule on the activities of a banking entity with respect to such securitization will not apply. If the securitization IS a covered fund, and a bank entity sponsored or acts as investment adviser or investment manager to and/or “organized and offered” such covered fund, then such banking entity will be subject to the restrictions and compliance requirements, described below, with respect to such securitization.

What is a “covered fund”?

Under the Volcker Rule, unless an issuer fits within one of the specific exclusions discussed below, such issuer will be a “covered fund” if it (i) would be an investment company but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (“ICA”), (ii) is a commodity pool for which the commodity pool operator has claimed exempt pool status under Section 4.7 of the regulations of the Commodity Futures Trading Commission (“CFTC”) or that could qualify as an exempt pool and the participation units of which have not been publicly offered to persons who are not qualified eligible persons under Section 4.7 of the CFTC’s regulations or (iii) is a foreign issuer that (a) is sponsored, or has an ownership interest held, by a U.S. banking entity (or a foreign affiliate of a U.S. banking entity), (b) is organized primarily for the purpose of trading securities, and (c) would be an investment company but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) of the ICA if such foreign issuer were subject to U.S. securities laws.

Note: Any securitization that is not an investment company pursuant to Section 3(c)(5) of the ICA or Rule 3a-7 under the ICA will not be a “covered fund” for purposes of the Volcker Rule and thus the Volcker Rule’s restrictions on activities of banking entities and required compliance related to covered funds will not apply with respect to such securitization.

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 the requirements of Rule 3a-7. This solution would not work, however, for any actively managed securitizations (e.g., CLOs) 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.⁵

Express exclusions from covered fund definition

In response to the significant number of comments received regarding the covered fund definition in the Proposed Regulations, the Agencies included in the Final Regulations exclusions from the covered fund definition for a number of entities. As a result, any issuer that fits within any of these exclusions will not be a covered fund, notwithstanding that such issuer would otherwise fall within the definition of covered fund described above. The exclusions that are most relevant in the securitization context are the exclusions for loan securitizations, qualifying asset-backed commercial paper (“**ABCP**”) conduits, qualifying covered bonds and wholly-owned subsidiaries.

- Loan securitizations. The loan securitization exclusion will apply to an issuing entity of asset-backed securities⁶ (“**ABS**”) if the underlying assets or holdings are comprised solely of:
 - (1) loans (defined as any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative⁷);
 - (2) any rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans and that satisfy the requirements of clauses (5) and (6) below (“**Permitted Rights and Other Assets**”);
 - (3) certain interest rate or foreign exchange derivatives that (i) “directly relate” to the loans in the issuing entity, the related ABS or Permitted Rights and Other Assets⁸ and (ii) reduce

⁵ 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 accredited investors under Section 501(a)(1), (2), (3) or (7) of Regulation D under the Securities Act of 1933, as amended (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 Rule 3a-7); 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.”

⁶ As defined in Section 3(a)(79) of the Securities Exchange Act of 1934, as amended (the “**Exchange Act**”).

⁷ The Agencies indicated in the preamble (the “**Preamble**”) accompanying the Final Regulations that “the determination of whether an instrument falls outside the definition of loan because it is a security or a derivative is based on the federal securities laws and the Commodity Exchange Act. Whether a loan, lease, extension of credit, or secured or unsecured receivable is a note or evidence of indebtedness that is defined as a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the transaction.”

⁸ The Agencies indicated in the Preamble that they “would expect that neither the total notional amount of directly related interest rate derivatives nor the total notional amount of directly related foreign exchange derivatives would exceed the greater of either the outstanding principal balance of the loans supporting the asset-backed securities or the outstanding

the interest rate and/or foreign exchange risks related to such loans, the related ABS or Permitted Rights and Other Assets;

(4) certain special units of beneficial interest (“**SUBI**”) and collateral certificates (which are issued in certain intermediate securitizations that are created solely for the purpose of facilitating a securitization)⁹;

(5) cash equivalents for purposes of the Permitted Rights and Other Assets; and

(6) securities received in lieu of debts previously contracted with respect to the loans supporting the ABS.

In addition, in order to qualify for the loan securitization exclusion, the issuing entity is not permitted to own or hold any of the following:

(1) a security, including an ABS, or an interest in an equity or debt security other than as permitted above;

(2) a derivative, other than as permitted above; and

(3) a commodity forward contract.

Note: Issuers of synthetic ABS and resecuritizations and repackagings of securities that ordinarily rely on Section 3(c)(7) of the ICA would not qualify for the loan securitization exclusion, and therefore would be covered funds.

Note: In addition, CLOs typically rely on Section 3(c)(7) of the ICA for purposes of the exemption from the registration requirements of the ICA. As result, most CLOs will be covered funds unless they qualify for the loan securitization exclusion. CLOs, whether issued before the recent financial crisis (so-called “CLO 1.0”-era deals) or during the past three years (so-called “CLO 2.0”-era deals), are typically permitted to invest in limited “buckets” (generally expressed as a percentage of the portfolio) of senior secured bonds. Except as noted below, the presence of any bonds in the portfolio of a CLO issuer after the Conformance End Date would disqualify such CLO issuer from the loan securitization

principal balance of the asset-backed securities. . . . (For example, a \$100 million securitization cannot be hedged using an interest rate hedge with a notional amount of \$200 million.)”

⁹ The SUBI and collateral certificates are permitted assets where (i) the special purpose vehicle (“**SPV**”) that issued the SUBI or collateral certificates itself satisfies the conditions of the loan securitization exclusion, (ii) the SUBI or collateral certificates must be used for the sole purpose of transferring economic risks and benefits of the loans to the issuing entity for the securitization and may not directly or indirectly transfer any interest in any other economic or financial exposures, (iii) the SUBI or collateral certificates must be created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization and (iv) the SPV issuing the SUBI or collateral certificates and the issuing entity for the excluded loan securitization transaction must be established under the direction of the same entity that initiated the loan securitization transaction.

exclusion. Even if the collateral manager that is responsible for the management of a CLO issuer's portfolio sold all of the bonds in the portfolio before the Conformance End Date and agreed not to use, after the Conformance End Date, any bond bucket available under the CLO transaction documents, it remains to be seen whether, in the absence of formal amendments to such transaction documents, banking entities could become comfortable that such arrangements ensure a CLO qualifies for the loan securitization exclusion. This issue may be more acute for CLO 2.0-era deals, since most deals from the CLO 1.0-era have entered their amortization phase during which little or no investment in additional assets is permitted and/or may have been optionally redeemed or reached their scheduled final maturity prior to the Conformance End Date.

Note: A securitization vehicle, including a CLO issuer, will not fail to qualify for the loan securitization exclusion solely due to the fact that it owns an asset that does not meet the definition of "loan" so long as it received such asset in connection with a bona fide restructuring, workout, or foreclosure of a loan held by that entity. Specifically, Section __.10(c)(8)(iii) of the Final Regulations permits the ownership of "securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities."

- Qualifying ABCP conduits. The qualifying ABCP conduit exclusion will apply to an issuing entity of ABCP if the underlying assets or holdings are comprised solely of:
 - (1) loans or other assets that would be permissible under the loan securitization exclusion, and
 - (2) ABS that are supported solely by assets permissible under the loan securitization exclusion and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.

In addition, in order to qualify for the qualifying ABCP conduit exclusion, the issuing entity must issue only ABS, comprising of a residual and securities with a term of 397 days or less and a "regulated liquidity provider"¹⁰ must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding short term ABS issued in the event that funds are required to redeem the maturing securities.

¹⁰ A regulated liquidity provider is (i) a depository institution as defined in Section 3 of the Federal Deposit Insurance Act; (ii) a bank holding company or a subsidiary thereof; (iii) a savings and loan holding company, provided all or substantially all of the holding company's activities are permissible for a financial holding company, or a subsidiary thereof; (iv) a foreign bank whose home country supervisor as defined in Section 211.21 of the Federal Reserve Board's Regulation K has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof or (v) a sovereign nation.

Note: This exclusion would not be available to certain ABCP programs, including structured investment vehicles, securities arbitrage programs and other programs that do not satisfy the requirements of this exclusion, most notably the permissible assets limitation, the initial issuance requirement and the 100% liquidity requirement.

Note: Clause (2) of the above exclusion clarifies that the ABS being financed have been issued by and acquired directly from the issuer or acquired directly from the underwriter and not purchased in the secondary market. Under this exclusion, ABCP conduits may no longer purchase ABS interests in the secondary market. This requirement may potentially impact subsequent syndications by underwriters in the ABCP market although regulators most likely did not intend such a result.

Note: Not all ABCP conduits have 100% liquidity coverage and, if they do, it is not clear why a "regulated liquidity provider" is required so long as such provider has a high enough credit standing. Also, it is unclear why the federal banking agencies would require the regulated liquidity provider to provide 100% liquidity coverage when the liquidity provider is typically the bank sponsor of the ABCP conduit. The Volcker Rule's purpose is to protect banks, not investors in ABCP conduits.

- *Qualifying covered bonds.* The qualifying covered bond exclusion will apply to an entity that owns or holds a dynamic or fixed pool of assets that covers the payment obligations of covered bonds only if such assets or holdings meet the requirements of the loan securitization exclusion. In addition, the covered bonds must be debt obligations that are issued either directly (i) by a foreign banking organization¹¹ (in which case, the payment obligations of the covered bonds must be fully and unconditionally guaranteed by the entity that owns the permitted cover pool, as described in the prior sentence) or (ii) by the entity that owns the permitted cover pool (in which case, (a) the payment obligations of the covered bonds are fully and unconditionally guaranteed by a foreign banking organization and (b) the issuer of the covered bond is a wholly-owned subsidiary (as described in the wholly-owned subsidiary exclusion below) of such foreign banking organization.

Due to the requirement that a cover pool can only contain assets that would satisfy the loan securitization exclusion, covered bond programs that include non-loan assets, such as RMBS, would not be able to rely on this exclusion.

¹¹ Foreign banking organization" has the same meaning as in Section 211.21(o) of the Board's Regulation K (12 CFR 211.21(o)), but does not include a foreign bank organized under the laws of certain U.S. territories or possessions.

- Wholly-owned subsidiaries. The wholly-owned subsidiary exclusion will apply to any entity, if all of its outstanding ownership interests are owned directly or indirectly by the banking entity (or an affiliate thereof), except that: (i) up to five percent of the entity's ownership interests may be owned by directors, employees, and certain former directors and employees of the banking entity (or an affiliate thereof); and (ii) within the five percent ownership interests described in clause (i) above, up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

Note: The wholly-owned subsidiary exclusion was included simply to prevent a wholly-owned entity from becoming a covered fund merely because it relies on Section 3(c)(1) or 3(c)(7) of the ICA as the exemption from being regulated as an investment company. A wholly-owned subsidiary of a banking entity, although excluded from the definition of covered fund, still would itself be a banking entity, and therefore remain subject to the prohibitions and other provisions of the Volcker Rule. For example, a wholly-owned subsidiary could not itself acquire an ownership interest in a covered fund, unless an exemption was available.

Impact of Securitization or Structured Finance Transactions Being Covered Funds

If a securitization or structured finance transaction is a covered fund that may not avail itself of one of the exclusions from the covered fund definition, then any banking entity, subject to certain exceptions that will be discussed below, may not, as principal, directly or indirectly, acquire or retain any "ownership interest" in or "sponsor" such covered fund.

In order to make clear that the scope of the above-referenced prohibitions relate to a banking entity acting as principal, the Final Regulations expressly provide that the prohibited activities do not include acquiring or retaining an ownership interest in a covered fund by a banking entity:

- (1) acting solely as agent, broker, or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;
- (2) through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of people who are or were employees of the banking entity (or an affiliate thereof);
- (3) in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no

event may the banking entity retain such instrument for longer than such period permitted by the appropriate agency; or

(4) on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

What is an “ownership interest”?

The Final Regulations define “ownership interest” to mean any equity, partnership, or other similar interest. An “other similar interest” is defined to mean an interest that on a current, future or contingent basis¹²:

- (1) 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 an acceleration event);
- (2) has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;
- (3) has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);
- (4) has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);
- (5) provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;
- (6) receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

¹² Although the phrase “current, future or contingent basis” does not appear in the text of the Final Regulations, it is included in the Preamble’s discussion of the definition of “ownership interest.” See p. 608 of the Preamble.

(7) any synthetic right to have, receive, or be allocated any of the rights in paragraphs (1) through (6) above.

Note: The holder of an interest referred to in clause (1) above need only have the right to “participate in” the selection or removal process of the parties specified above. It is not necessary that such holder be able to control such selection/removal process, or actually participate in the selection or removal process.

In the Preamble, the Agencies made clear that the “definition of ownership interest will apply regardless of the type of legal entity or the name or legal form of the particular interest. The determination of whether an interest is an ownership interest under the final rule will depend on the features and characteristics of the particular interest, including the rights the particular interest provides its holder, including not only voting rights but also the right to receive a share of the income, gains, or profits of a covered fund, the right to receive a residual, the right to receive excess spread, and any synthetic or derivative that would provide similar rights.”

Note: CLOs typically issue multiple tranches of rated, secured debt and a single tranche of unrated, unsecured equity (typically in the form of subordinated notes or preferred shares) with the most senior tranche of debt (which bears the least risk of loss) at the top of the capital structure and the most subordinated equity tranche (which bears the most risk of loss) at the bottom of the capital structure. So long as a CLO is a covered fund, the equity tranche of a CLO is unambiguously captured by the definition of “ownership interest.” Whether any other tranche within a CLO’s capital structure would constitute an “ownership interest” is a function of whether such tranche has on a current, future or contingent basis any of the contractual rights or features specified in the definition of “other similar interest”, above.

In most CLOs, the collateral management agreement provides that the senior-most tranche of debt outstanding (typically referred to in the transaction documents as the “controlling class”) has the right, either by itself or shared with the equity tranche, to remove the collateral manager for “cause” and/or nominate or approve the appointment of a successor collateral manager in connection with the resignation of the collateral manager or its removal for “cause.” As such, the controlling class and any class that could become the controlling class of a CLO (i.e., any debt tranche) would appear to be captured by the language of clause (1) of the “other similar interest” definition above, unless the CLO transaction documents limited such contractual rights of a CLO debt tranche to the exercise of “remedies upon the occurrence of an event of default or an acceleration event.” If a legacy CLO does not qualify for the loan securitization exclusion from the definition of “covered fund”, then treatment of a CLO debt tranche as an “ownership interest” in a covered fund would necessarily result in a banking entity being prohibited on and after the Conformance End Date from holding a position in either a debt

tranche or the equity tranche of such CLO, unless (as discussed below) the banking entity “organized and offered” the covered fund that issued any such tranche. The exemption for “organized and offered” covered funds should not apply to legacy CLO transactions and going forward would only permit a limited amount of such ownership interests to be held by a banking entity.

It is unclear whether the Agencies intend that debt tranches in CLOs be considered ownership interests in CLOs solely as result of the voting rights granted to such debt tranches on a current or contingent basis to participate in the removal of the collateral manager and the selection of the successor collateral manager. Collateral managers typically can only be removed for “cause.” As a result, the right to remove and approve a successor collateral manager is more akin to a creditor’s remedy being exercised as a result of a “default” by the collateral manager under the related collateral management agreement.

If a CLO debt tranche in fact represents an ownership interest in a covered fund as a result of the voting rights described above, then taking away such rights from the holder via an amendment, irrevocable waiver or assignment to a third party prior to the end of Conformance End Date should result in such debt tranche no longer being deemed an ownership interest in a covered fund for purposes of the Volcker Rule. The question exists as to whether an irrevocable waiver or assignment by the debt tranche holder would change the characterization of debt tranche as an ownership interest.

Lastly, as discussed above, if a legacy CLO were able to only hold loans then such legacy CLO would no longer be a covered fund.

Note: Until greater clarity is obtained from the Agencies regarding whether debt tranches constitute ownership interests in a CLO that is a covered fund, it seems advisable to include an amendment provision in CLOs going forward that would permit a holder of a debt tranche that is a banking entity to amend the related indenture in a manner that would alter any voting rights granted to such holder so that such debt tranche would no longer constitute an ownership interest, or to make such other changes as may be necessary to ensure the ability of banking entities to own CLO debt.

What is a “sponsor”?

The Final Regulations define “sponsor” to mean any entity that (i) serves as general partner, managing member, or trustee of a covered fund, or that serves as a commodity pool operator of a covered fund, (ii) in any manner selects or controls (or has employees, officers, or 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 corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

In the context of a securitization, the Agencies indicated in the Preamble that the term “sponsor” would include a trustee that has the right to exercise any investment discretion for the securitization. The Agencies also stated that for issuers of ABS, this would generally not include a trustee that executes decision making, including investment of funds prior to the occurrence of an event of default, solely according to the provisions of a written contract or at the written direction of an unaffiliated party. In addition, the Agencies indicated that a trustee with investment discretion may avoid characterization as a sponsor if it irrevocably delegates all of its investment discretion to another unaffiliated party with respect to the covered fund – although such unaffiliated party that is so delegated would then be considered the “sponsor.”

Note: Based on the definition of “sponsor” in the Final Regulations, a banking entity that structures and offers the securities of a broadly syndicated CLO that is a covered fund in the manner typically done in the market would not be a “sponsor”. The concept of sponsor under the Final Regulations involves a level of control (directly or indirectly) of the CLO issuer by the arranging banking entity that does not exist in a typical broadly syndicated CLO.¹³ The investment manager of a CLO selects the trustee and collateral administrator. In addition, the investment manager selects the corporate service company that will provide the directors of the CLO issuer. Furthermore, other than the name of the banking entity broker-dealer on the CLO’s offering document and related marketing materials (as would be expected as part of a securities offering), the CLO issuer does not typically use the banking entity’s name or variation of such name for any purpose, including in the legal name of the CLO issuer. Lastly, the assets to be included in a broadly syndicated CLO are selected by the investment manager consistent with eligibility and other criteria developed for the transaction documents and acquired from sellers in the market, which may include affiliates of the arranging bank..¹⁴

¹³ See pp. 633-636 of the Preamble.

¹⁴ Based on comments received from the industry, the Agencies acknowledged that banking entities can have different types of relationships with and provide services to a covered fund without being deemed a sponsor of such covered fund. In relation to the final definition of “sponsor,” the Preamble notes that “[i]f the parties that commenters described do not serve in those capacities for a covered fund, do not have those rights with respect to a covered fund or do not share a name with a covered fund, such parties would not be a sponsor for purposes of the final rule, and, therefore, they would not be subject to the restrictions applicable to the sponsor of a covered fund, including the restrictions contained in section 13(f).” See pp. 633-636 of the Preamble.

Exemption for holding an ownership interest in a covered fund that is “organized and offered” by a banking entity

Notwithstanding that a securitization vehicle may be a covered fund, the Final Regulations permit a banking entity to acquire and retain an ownership interest as principal in such securitization vehicle if the banking entity or affiliate thereof “organizes and offers” the securitization so long as certain conditions¹⁵ are satisfied. The conditions include that such “organizing and offering” is for purposes of establishing the securitization and providing the securitization with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, subject to a limit of generally 3% of the total value of the outstanding ownership interests in the securitization (or such greater amount that may be required to be retained by such banking entity or affiliate under the risk retention rule (the “**Risk Retention Rule**”) that will be implemented under Section 15G of the Exchange Act). In addition, the Final Regulations impose an aggregate limit on all such ownership interests in “organized and offered” funds, equal to 3% of the banking entity’s Tier 1 capital. Ownership interests held pursuant to the “organized and offered” exemption must also be deducted from the banking entity’s Tier 1 capital¹⁶ and the banking entity and its affiliates must comply with the restrictions on relationships and transactions described below.

Note: A banking entity must take affirmative steps to “organize and offer” a covered fund under Section __.11(a) of the Final Regulations. Given that very particular conditions must be satisfied, it is extremely unlikely that a banking entity could inadvertently organize and offer a covered fund solely as a result of its activities in relation to such covered fund. Presumably, a banking entity would only seek to satisfy the requirements of “organizing and offering” a covered fund if it intended to hold an ownership interest in, or sponsor, such covered fund.

Exemption for underwriting and market making with respect to a covered fund

In addition, notwithstanding the general prohibition of a banking entity acquiring an “ownership interest” in a covered fund, a banking entity may acquire such an ownership interest if it is in connection with certain underwriting and market making-related activities with respect to a covered fund. Such underwriting and market-making activities must comply with the Volcker Rule’s conditions on underwriting and market-making, found in Section __.4 of the Final Regulations.

Note: If a banking entity has an “ownership interest” in a covered fund that was “organized and offered” by such banking entity or an affiliate thereof, other securities constituting an ownership interest issued by such covered fund that are held by a broker-dealer affiliate of such banking entity as part of its market-making or underwriting activities need to be included for purposes of calculating compliance with the 3% “de minimis”

¹⁵ These conditions are set forth in Section __.11(a) of the Final Regulations.

¹⁶ See Section __.12 of the Final Regulations.

limitation imposed in relation to its permitted ownership of the covered fund and with respect to its ownership in covered funds collectively, as well as the deduction from Tier 1 capital for such ownership.

Exemption for certain permitted foreign covered fund activities

Notwithstanding that a securitization vehicle may be a covered fund, the Final Regulations permit certain qualifying foreign banking organizations to acquire or retain any ownership interest in, or act as sponsor to, a covered fund so long as the activity is¹⁷: (i) 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 States¹⁸. In particular, the following conditions must generally be satisfied:

- (1) the banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;
- (2) the banking entity (including the relevant personnel) that makes the decision to acquire or retain the ownership interest or act as the sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;
- (3) the investment or sponsorship, including any related hedging transactions, is not accounted for as principal by any U.S. branch or affiliate of the banking entity;
- (4) ownership interests in the covered fund are not targeted to residents of the United States; and
- (5) no financing for the banking entity's ownership or sponsorship is provided by a U.S. branch or affiliate of the foreign banking entity.

Note: The Final Regulations do 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. This may allow offshore banking entities located outside of the U.S. to invest in securitization issuers that hold U.S. assets, provided the fund's shares are not targeted to investors who are residents of the U.S.

¹⁷ See Section __.13(b) of the Final Regulations.

¹⁸ “Resident of the United States” is defined as a person that is a “U.S. Person” as defined in Rule 902 of Regulation S under the Securities Act.

Restrictions on relationships and transactions with covered funds

If a securitization or structured finance transaction is a covered fund (i.e., it may not avail itself of one of the exclusions from the covered fund definition), then no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund (including a banking entity that organizes and offers an asset-backed securitization and retains an ownership interest solely due to the Risk Retention Rule), and no affiliate of such entity, may enter into a transaction with the covered fund (or with any other covered fund that is controlled by such covered fund) that would be a covered transaction as defined in Section 23A of the Federal Reserve Act (the “FRA”) and will be subject to Section 23B of the FRA, in each case, as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereto. These two aspects of the Volcker Rule are referred to as “Super 23A” and “Super 23B.”

Generally speaking, under Super 23A, if a banking entity serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund, or that continues to hold an ownership interest due to the Risk Retention Rule, then that banking entity, and any affiliate of that banking entity, is barred from engaging in certain transactions with the covered fund, including:

- (1) a loan or extension of credit to the fund (including a derivative transaction, securities lending / borrowing transaction, or repo or reverse repo transaction that results in credit exposure to the covered fund);
- (2) a purchase of, or an investment in, securities issued by the covered fund (excluding any securities held under the “organized and offered” exemption);
- (3) a purchase of assets from the covered fund; and
- (4) the issuance of a guarantee, acceptance, or letter of credit on behalf of the covered fund.¹⁹

Generally speaking, under Super 23B all transactions between the covered fund and the banking entity (or any affiliate) must be on terms and conditions that are substantially the same as or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving nonaffiliated entities.

Note: Because of these restrictions on relationships and transactions with covered funds described above, banking entities may be prohibited from entering into derivatives transactions with covered funds that they sponsor or have an ownership interest in.

¹⁹ In the Preamble, the Agencies make it clear that banking entities may accept covered fund shares as collateral for loans to third parties (notwithstanding the fact that such transactions are regulated by Section 23A of the FRA).

Note: Even if a banking entity or affiliate thereof is required to retain an ownership interest in a covered fund under the Risk Retention Rule, the restrictions on relationships and transactions with covered funds discussed above under Super 23A and Super 23B would apply.

Note: As noted above, a broker-dealer banking entity that structures and underwrites the securities issued by a typical broadly syndicated CLO that is a covered fund should not be considered a “sponsor” of such CLO for purposes of the Volcker Rule. Assuming that such banking entity and its affiliates do not “organize and offer” such CLO, act as investment manager or investment adviser to such CLO or otherwise own an ownership interest in such CLO (e.g., by virtue of the Risk Retention Rule once finalized), then the restrictions on relationships and transactions with covered funds discussed above under Super 23A and Super 23B would not apply. Accordingly, such banking entity and its affiliate could write an interest rate or hedging swap to such CLO. In addition, such banking entity and its affiliates could provide pre-closing warehouse financing to the CLO issuer. CLO warehousing facilities typically do not permit the lender to remove a collateral manager for “cause” and/or select its replacement (during the period of warehousing financing for a CLO, the occurrence of events that are analogous to, or would be defined in CLO transaction documents as, for “cause” events typically constitute an event of default under the relevant warehouse financing agreement). That said, if the lender in a CLO warehouse financing had any such right to remove and/or select the replacement of the CLO’s collateral manager, then unless such right was drafted as a remedy by the lender following an event of default, the lender might have an impermissible ownership interest in the CLO. Of course, the warehouse facility could be structured to only include loan assets and, as a result, benefit from the loan securitization exclusion from the “covered fund” definition.

Adoption of a Compliance Program With Respect to Covered Funds

Banking entities with assets of \$50 billion or more (and foreign banking organizations with U.S. consolidated assets of \$50 billion or more), as well as any banking entity required to report trading metrics, are subject to certain “enhanced” compliance requirements in Appendix B to the Final Regulations. These enhanced compliance procedures contain a number of obligations relevant to securitization activities, including (i) maintaining documentation regarding all covered funds sponsored, organized and offered, or owned by the banking entity, (ii) adopting a written compliance program describing each business unit’s authority to engage in covered funds activities and (iii) establishing of internal controls with respect to the 3% (or permitted greater percentage pursuant to the Risk Retention Rule) investment limits, Super 23A, and Super 23B.

Note: Banking entities that have investments that may constitute “ownership interests” in existing securitization transactions that are covered funds will need to determine if the banking entity needs to divest all or part of its holdings 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 similar investments and reduce liquidity for such investments.

New Documentation Requirement for Sponsorship of “Funds” (Including Securitization Vehicles)

The Final Regulations added a new documentation requirement with respect to the sponsorship of “funds” (including securitization vehicles) to the extent the sponsoring banking entity (and its affiliates) has consolidated assets in excess of \$10 billion. This provision requires that banking entities that sponsored securitizations that were determined to not be covered funds maintain records for each such securitization that include:

- (1) documentation of the exclusions or exemptions other than Sections 3(c)(1) and 3(c)(7) of the ICA relied on by each fund (securitization) sponsored by the banking entity (including all subsidiaries and affiliates) in determining that such fund (securitization) is not a covered fund; and
- (2) for each fund (securitization) sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions from the definition of covered fund provided for in the Final Regulations and described above, documentation supporting the banking entity’s determination that the fund (securitization) is not a covered fund pursuant to one or more of those exclusions.

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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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