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# Agencies Adopt Final Volcker Rule Regulations

## *Rule Significantly Narrows Scope of Prohibitions Applicable to Bank Securitizations*

*Federal regulators approved final regulations implementing the "Volcker Rule" on December 10, 2013 (the "Final Regulations"). The Final Regulations are a significant and favorable departure from the regulations proposed in October of 2011 (the "Proposed Regulations") with respect to securitization issuers. Issuers of asset-backed securities ("ABS") that hold only loans and related assets and qualifying asset-backed commercial paper conduits are not "covered funds" under the Final Regulations, as they likely would have been under the Proposed Regulations. Therefore, the Volcker Rule's prohibitions against banks and banking affiliates and subsidiaries (collectively, "banking entities") sponsoring or owning covered funds or extending credit to affiliated covered funds will not apply to these types of qualifying entities. In addition, many bank securitizations that may not qualify under these exclusions may nonetheless be excluded from the definition of covered fund under the Final Regulations under separate exclusions for wholly-owned subsidiaries or joint ventures. A copy of the Final Regulations can be found here; the preamble to the Final Regulations can be found here; and the Federal Reserve Board staff memo can be found here.*

## Background

The "Volcker Rule", which was enacted by Congress as part of the Dodd-Frank Act, generally prohibits banking entities from engaging in proprietary trading, sponsoring or holding ownership interests in "hedge funds" and "private equity funds" and from extending credit to any fund that a banking entity sponsors, manages or advises. "Hedge fund" and "private equity fund" are defined under the statute to mean any issuer that would be an investment company under the Investment Company Act of 1940, as amended (the "'40 Act") but for Section 3(c)(1) (exemption for funds with no more than 100 holders) or Section 3(c)(7) (exemption for funds held only by qualified purchasers). The Final Regulations refer to such funds as "covered funds".

Federal banking regulators, the CFTC and the SEC were charged by Congress to adopt rules to implement the Volcker Rule and issued the Proposed Regulations in October 2011. Under the Proposed Regulations, asset-backed commercial paper conduits ("ABCP conduits"), collateralized loan obligation issuers, certain lease and equipment securitization issuers and other issuers who, like hedge funds and private equity funds, rely on the Section 3(c)(1) or 3(c)(7) exemption from registration under the '40 Act, would have been considered "covered funds" subject to the Volcker Rule prohibitions. Accordingly, banking entities would have been prohibited from sponsoring or owning these securitization vehicles unless a specific exemption was available. While the Proposed Regulations contained an exemption for banks owning or sponsoring entities engaged in "loan securitizations", the proposed exemption was too narrow to be workable for many securitization vehicles. In addition, the Proposed Regulations would have prohibited extensions of credit and other transactions between banking entities and the covered funds they sponsored or provided investment advice or management to, even if those funds could be owned or sponsored under the loan securitization exemption. This latter provision, the so-called "Super 23A" rule, would have prohibited, for example, bank sponsors of ABCP conduits from providing to their conduits the credit enhancement and liquidity facilities that commercial paper investors require. It would also have prohibited banking entities from providing to their sponsored or managed entities swap agreements, warehouse financing and other instruments that are necessary structural features for many securitizations.

The Final Regulations remove many of the obstacles to securitization contained in the Proposed Regulations. By excluding qualifying loan securitizations and ABCP conduits from the definition of "covered fund", banking entities will not be subject to the Volcker Rule prohibitions on sponsoring, acquiring ownership interests in and extending credit to these types of securitization entities, even if those entities rely on either Section 3(c)(1) or 3(c)(7) of the '40 Act. The regulators were persuaded by

the multitude of comment letters arguing that the Proposed Regulations ran afoul of the congressional mandate in the Volcker Rule that nothing in the rule be "construed to limit or restrict the ability of banking entities ... to sell or securitize loans....".[1]

The Final Regulations also provide exclusions from the definition of covered fund for direct or indirect wholly owned subsidiaries of a bank and for joint ventures formed by the bank and a third party. These additional exclusions may provide relief for many bank sponsored securitization vehicles that do not otherwise qualify for the loan securitization or qualifying ABCP conduit exclusions.

What seems clear in the Final Regulations is that the regulators intended widespread exemptions for securitizations. Indeed, the preamble states that the regulators "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 loan securitization exclusion, such as time share loans, container leases and servicer advances."

The Volcker Rule, as implemented by the Final Regulations, will be effective on April 1, 2014, but the Federal Reserve Board announced it will delay the end of the conformance period by one year until July 21, 2015 "to provide banking entities with additional time to conform their activities and investments" to the rule. Accordingly, banks will have until the end of the conformance period to either remove non-qualifying assets from any covered fund it sponsors, owns or provides credit enhancement to or otherwise divest ownership in any covered fund.

[1] By contrast, the final rule does not accommodate the request that tender option bond programs and corporate debt repackagings be specifically excluded from the definition of covered fund. The preamble states that because "there is no corresponding rule of construction [in the Volcker Rule] for financial instruments other than loans, the Agencies do not believe that the resecuritization of municipal debt instruments should be treated differently than . . . other types of bond repackaging securitizations" and other securitization vehicles that are not excluded from the definition of covered fund. Note, however, that such securitizations may be excluded from the definition of covered fund under a separate exclusion for wholly owned subsidiaries.

## Loan Securitizations

Under the Final Regulations, a loan securitization issuer that satisfies the requirements described below will not be a covered fund, and banking entities will not be prohibited from owning or sponsoring such vehicles. In order to qualify for the exclusion, an issuing entity, defined as a special purpose vehicle that owns pool assets that support ABS, may hold only assets comprised of:

- **Loans**, defined as "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative;"
- **Rights or Other Assets**, which are any rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) which are related or incidental to purchasing or otherwise acquiring, and holding the loans;
- **Interest rate and foreign exchange derivatives**; and
- **SUBIs and collateral certificates**

A qualifying loan securitization may not hold any security, including any ABS, other than a permitted SUBI or collateral certificate. Cash equivalent securities, including federally insured deposits, bank CDs and money markets that invest collections and whose maturities corresponds to the securitization's payment obligations, are also permitted.

*Discussion:*

*Loans, but not securities*. The Final Regulations modified the Proposed Regulations by adding a requirement that a loan not be a security or a derivative. The regulators reasoned that if these instruments were not excluded from the loan definition, they "could be used to circumvent the restrictions on proprietary trading." "Security" has the meaning set forth in the Securities Exchange Act of 1934, which includes any "note . . . or in general, any instrument commonly known as a 'security.'" This could be an issue for certain securitizations that hold assets that could be construed to be securities. Whether a commercial loan in a collateralized loan obligation constitutes a security, for instance, and therefore would make the issuer ineligible for the covered fund exclusion, "depends on the particular facts and circumstances, including the economic terms of the loan." (Preamble to the Final Regulations). CLO issuers will need to insure that no loans in the pool are structured with features that could render the loan a security under the Securities Exchange Act. In addition, the loan securitization exclusion will not permit CLOs to include corporate bond or synthetic asset buckets. Existing CLOs, therefore, will be required to either divest securities and synthetic assets prior to the end of the compliance period or banks holding ownership interests in or

extensions of credit to such CLOs will need to divest these investments.

*Rights and Other Assets*. The definition of permissible loan does not appear to include guarantees, insurance policies, letters of credit or other contractual commitments supporting a permissible loan. Neither the rule nor the preamble provides any express guidance as to whether such instruments would be related assets and therefore permissible.

*Derivatives*. An issuing entity in a qualifying loan securitization may enter into derivatives "the written terms of [which] . . . directly relate to the loans [or] the asset-backed securities" and "reduce the interest rate and/or foreign exchange risks related to the loans [or] the asset-backed securities." The rule itself doesn't define the meaning of "directly relate", but the preamble provides helpful commentary that should give issuers comfort that interest rate and currency hedges designed to hedge mismatches between an issuer's liabilities and assets will not disqualify a loan securitization issuer. The issuer would not be permitted to hold credit default swaps, total return swaps or other types of derivatives, even if they relate to the loans underlying the ABS. Accordingly, no portion of the securitized assets may be synthetic risk exposures.

*SUBIs and Collateral Certificates*. While the loan securitization exclusion generally prohibits ABS in the asset pool, the Final Regulations permit an issuer to own special units of beneficial interest (SUBI) or collateral certificates, which themselves are backed only by permissible loans, and which "facilitate the structuring of the securitization" and "are established under the direction of the same entity that initiated the loan securitization." As noted by the regulators, loan securitizations that utilize SUBIs or utilize collateral certificates in certain credit card structures "are essentially loan securitizations." In the case of a SUBI, a titling trust owns the leased equipment and the right to receive the related lease stream. The SUBI is issued by the titling trust (directly or indirectly) to the ABS issuer and provides the owner of the SUBI with substantially all of the benefits of owning designated assets in the titling trust. In order to qualify, the SUBI issuer may only hold assets otherwise permitted in a direct loan securitization. While equipment ownership is not one of the permissible enumerated assets, it is clear from the commentary that the regulators intended for permitted SUBI issuers to own the leased equipment.

## Asset-Backed Commercial Paper Conduits

The Final Regulations excluded from the definition of covered fund "qualifying asset-backed commercial paper conduits." Under the Proposed Regulations, ABCP conduits faced two significant barriers to continued viability. First, because many of the assets held by ABCP conduits are loans that are not held directly, but in the form of variable funding notes or other ABS backed by loans, such conduits could not meet the loan securitization exclusion in the Proposed Regulations. Second, the Super 23A rule in the Proposed Regulations would have prohibited banking entities from providing credit enhancement, liquidity facilities and other "covered transactions" to ABCP conduits relying on Sections 3(c)(1) or 3(c)(7) of the '40 Act. The Final Regulations substantially eliminate these two significant challenges.

To qualify for the exclusion:

- an ABCP conduit may only hold:
  - loans and the other permissible assets described above under "Loan Securitizations"; and
  - ABS supported solely by loans and other permissible loan securitization assets which are acquired as part of an initial issuance directly from the issuing entity of the ABS or directly from an underwriter;
- an ABCP conduit may only issue securities with a legal maturity of 397 days or less and residual interests; and
- a regulated liquidity provider must provide "full and unconditional liquidity coverage with respect to all of the outstanding asset-backed securities issued" by the ABCP conduit (other than any residual interest issued by the ABCP conduit).

*Discussion*:

*Loans and Asset-Backed Securities*. The Final Regulations responded to industry concerns by providing that qualifying ABCP conduits may hold asset-backed securities provided that the ABS are acquired at initial issuance and supported by loans and other permissible loan assets. With this change, the loan securitization exclusion would appear to be broad enough to include most of the securitization transactions funded by ABCP conduits in today's market. ABCP conduit sponsors that intend to rely on the qualifying ABCP conduit exclusion will need to examine the portfolios of the ABCP conduits they own or sponsor to determine whether those conduits own or finance assets which would preclude reliance on the ABCP conduit exclusion. If that were the case, arrangements must be made for the ABCP conduit to exit the related transaction by July 21, 2015 (the last day of the extended conformance period).

*Initial Issuance Directly from Issuing Entity*. The requirement that the ABCP conduit acquire ABS directly from the issuing entity (or from the ABS underwriter distributing the ABS), while probably intended to exclude secondary market purchases of ABS, will impose some

limitations on the way in which the ABCP conduit market currently operates. Unless this requirement of the Final Regulations is clarified, ABCP conduits may not be able to accept assignments from other ABCP conduits or banks of ABS supported by permissible loans and other permissible assets.

*Full and Unconditional Liquidity Coverage*. The final rule requires "full and unconditional liquidity coverage" of any outstanding ABCP. At a minimum, this would require ABCP conduits seeking qualifying ABCP conduit status that currently benefit from partially supported liquidity facilities to convert these facilities to fully supported facilities. Currently, most fully supported liquidity facilities have a funding out for bankruptcy of the ABCP conduit. This funding out may be viewed by the joint regulators as inconsistent with the "full and unconditional" requirement.

*Other Options for ABCP Conduits*. As discussed below, wholly-owned subsidiaries of banks and qualifying bank joint ventures are not covered funds under the Final Regulations. It may be possible to restructure some ABCP conduits to qualify for one of these exclusions. Also, it may be possible for certain ABCP conduits to qualify for an exemption from '40 Act registration other than under Section 3(c)(1) or Section 3(c)(7). If other exemptions are available, the ABCP conduit would not be a covered fund subject to the Final Regulations. The most likely alternative exemptions would be provided by Rule 3a-7 or Section 3(c)(5) under the '40 Act. An ABCP conduit sponsor considering such a re-qualification would need to analyze the restrictions imposed on the conduit and sponsor by such exemptions as compared to the restrictions imposed by the qualifying ABCP conduit exclusion. A sponsor should also be aware that both Rule 3a-7 and Section 3(c)(5) are under review by the SEC and could be subject to revision.

## Wholly-owned Subsidiaries; Joint Ventures

Securitization vehicles that are not otherwise excluded from the Volcker Rule under the exclusions for loan securitizations and qualifying ABCP conduits may be able to rely on the exclusion for wholly-owned subsidiaries or joint ventures.

"An entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity" is not a covered fund under the final rule. Ownership interest is defined as an "equity, partnership, or other similar interest." "Other similar interest" includes the right to receive excess spread and what would generally be thought of as a residual interest in an ABS issuer.[2]

The exclusion would permit up to .5% of the entity's ownership interest to be held by a third party "for the purpose of establishing corporate separateness or addressing bankruptcy" or insolvency concerns. Accordingly, if all of the residual or equity interests in a securitization are retained by the sponsoring bank, as they frequently are in securitizations of bank-originated assets, the issuer will not be a covered fund and the bank will not be prohibited from having an ownership interest. This additional exclusion may capture many securitization issuers that otherwise do not meet the loan securitization or qualifying ABCP conduit exclusion. ABCP conduits may be able to avoid divesting assets that do not satisfy the Final Regualtion's definition of loan (e.g. securities purchased on the secondary market) if the conduit is a wholly-owned subsidiary. In addition, collateralized debt obligations, tender option bonds and corporate repackagings that hold ineligible assets under the loan-securitization exclusion may qualify for exclusion from the covered fund definition if they meet the definition of wholly-owned subsidiary.

Some entities may also be exempt from the Volcker Rule under the exclusion from the covered fund definition for joint ventures between a bank or any bank affiliate and one or more unaffiliated persons (not to exceed 10). The joint venture must engage in activities permissible for the bank or its affiliates, other than investing in securities for resale. In addition, the joint venture may not, and may not hold itself out, as an entity that raises money primarily for the purpose of trading in or investing in securities for resale. Accordingly, banks that structure securitizations using joint ventures that satisfy these requirements will not be subject to the prohibition on owning, sponsoring or extending credit to covered funds.

*Conclusion:*

The Volcker Rule, as implemented by the Final Regulations, excludes from its scope many types of securitizations that would have been subject to the rule under the Proposed Regulations. ABS issuers and ABCP conduits that hold only permissible loan collateral and related assets will not be covered funds subject to the prohibitions of the rule. These entities will also be permitted to own certain ABS that facilitate structuring. Moreover, securitizations that do not meet the requirements of the loan securitization or ABCP conduit exclusions may still qualify for exclusion as wholly-owned

[2] In response to a number of comments raising concerns that debt securities with voting rights could have been considered "ownership interests" under the Proposed Regulations, the preamble clarifies that "ownership interest" "would not generally cover typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate." Note, however, that the rule also includes in the definition of "ownership interest" the right to select or remove an investment advisor or manager, unless the right arises upon an event of default or acceleration event.

subsidiaries or as joint ventures. By expanding the exclusions available to securitization entities, the regulators appear to have concluded, consistent with the many comments on the Proposed Regulations, that securitization vehicles are not viewed by the markets as hedge funds or private equity funds.

## For More Information

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