Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS OCTOBER 26, 2011

Volcker Rule NPR and Asset-Backed Commercial Paper Conduits

The federal banking regulators and the SEC recently issued a notice of proposed rule-making (the "NPR") setting forth proposed regulations to implement the "Volcker Rule." (See http://www.sec.gov/rules/proposed/2011/34-65545.pdf.) The Volcker Rule is a section in the Dodd-Frank Act that generally prohibits banks and their affiliates from (i) engaging in "proprietary trading", (ii) sponsoring or holding an "ownership interest" in "hedge funds" or "private equity funds", and (iii) entering into certain transactions with any such fund that the bank sponsors, manages, or advises. The Volcker Rule defines "hedge fund" and "private equity fund" (together, "covered funds") very broadly. It therefore appears to cover most asset-backed commercial paper conduits ("ABCP Conduits") and has the potential to significantly restrict conduit operations. The NPR provides an exemption from the Volcker Rule for certain conduit activities, but unfortunately, the exemption may not be adequate to permit bank-administered ABCP conduits to operate in the traditional manner.

How Could the Volcker Rule Apply to ABCP Conduits?

The Volcker Rule defines covered funds to include any company that is exempt from regulation under the Investment Company Act of 1940 (the "'40 Act") pursuant to Section 3(c)(1) or 3(c)(7) thereof. Most ABCP conduits rely upon one of those two '40 Act exemptions. Accordingly, most ABCP conduits will constitute "covered funds", and banks that sponsor, manage, or advise these conduits will be subject to associated Volcker Rule restrictions. It would not be practical for an ABCP conduit to qualify for an exemption from the Volcker Rule by operating as a registered investment company under the '40 Act.

Does This Mean the Volcker Rule Would Prohibit a Bank from Sponsoring or Holding an Ownership Interest in Any ABCP Conduit?

No. The Volcker Rule expressly states that the Rule shall not be construed to limit or restrict the ability of banks to sell or securitize "loans" in a manner otherwise permitted by law. The NPR implements this policy by authorizing banks to sponsor and hold ownership interests in securitization issuers whose assets are comprised solely of "loans" (defined to include loans, leases, extensions of credit, and secured or unsecured receivables) and associated interest rate or foreign exchange hedges. Accordingly, banks could continue to sponsor or hold ownership interests in ABCP conduits that invest only in "loans". However, as described below, the NPR would prohibit banks from extending credit (including liquidity and credit enhancement facilities) to any ABCP conduits constituting "covered funds" that they sponsor, manage, or advise (including conduits that invest only in "loans"). The NPR therefore threatens the continued viability of all such traditional bank-sponsored ABCP conduits.

The NPR specifically provides that a bank's sponsorship or ownership interest in a "covered fund" does not qualify for the "loan securitization" exemption if the covered fund holds credit derivatives such as credit default swaps. This raises the question whether an ABCP conduit that holds guarantees, such as are typically provided by corporate parents for trade receivables owed by subsidiaries, would be covered by the exemption. We expect this issue to be raised with the federal regulators.

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Any ABCP conduit that holds assets other than "loans" will not qualify for the "loan securitization" exemption and banks generally would be prohibited from sponsoring and/or holding an ownership interest in such conduits.[1]

May Banks Continue to Provide Credit and/or Liquidity Support to Traditional Multi-Seller ABCP Conduits that They Sponsor or Manage?

Not under the NPR as drafted. The "loan securitization" exemption would permit a bank to have an ownership interest in or sponsor loan-backed ABCP conduits. Unfortunately, a separate provision of the Volcker Rule (and of the NPR) prohibits a bank and all of its affiliates from entering into any "covered transaction" (as defined in Section 23A of the Federal Reserve Act) with a "covered fund" if the bank sponsors the fund or serves as its investment manager or investment adviser. The Volcker Rule requires the bank to treat any such covered fund as a bank "affiliate" under Section 23A (even if Section 23A itself would not require such treatment) and to treat the bank (and each of its other affiliates) as being the "member bank" subject to Section 23A restrictions. Because a Section 23A "covered transaction" includes any loan or other extension of credit to an "affiliate," this prohibition (the so-called "Super 23A" restriction) would prevent a bank from providing any loans or other extensions of credit (such as liquidity loan facilities, liquidity asset purchase facilities, and/or program enhancement letters of credit) to the ABCP conduit (or to use any bank affiliate to indirectly provide such extensions of credit to the ABCP conduit). As a practical matter, this would prevent a bank from sponsoring, managing, or advising a traditional multi-seller ABCP conduit.[2]

Shouldn't Banks at Least Be Permitted to Continue to Supply Credit and Liquidity Facilities to Loan-Backed ABCP Conduits?

We think so. As previously discussed, the NPR permits banks to sponsor and hold ownership interests in ABCP conduits that qualify for the "loan securitization" exemption. At the same time, the NPR fails to provide an exemption from Super 23A that would permit banks that sponsor, manage, or advise such conduits to provide them with credit enhancement and liquidity facilities. In its report on the Volcker Rule prepared pursuant to the Dodd-Frank Act, the Financial Stability Oversight Council stated that Congress intended to ensure that "the economically essential activity of loan creation [would not be] infringed upon by the Volcker Rule." The failure of the regulators to permit banks to continue to provide credit and liquidity support to ABCP conduits that they sponsor, manage, or advise could significantly reduce loan securitization volumes and appears to be inconsistent with Congressional intent. We expect this issue to be discussed by commenters on the NPR.

Is There Any Other Possible Exemption from the Super 23A Restrictions?

Yes. The NPR proposes to exempt from Super 23A any "ownership interest" that the bank holds in a covered fund under an exemption from the Volcker Rule, such as the "loan securitization" exemption described above. Assuming that the "loan securitization" exemption is broad enough to cover a traditional multi-seller ABCP conduit, a solution might be to convert all of the conduit's liquidity

1 The common equity of an ABCP conduit typically is owned by a trust or corporate services company not affiliated with the bank that manages the conduit. However, the bank's authority to select, negotiate, and manage the conduit's investments would likely make it the conduit's "sponsor" under the Volcker Rule, and its right to receive the conduit's net interest margin as a management fee could be viewed as an "ownership interest."

2 Although Super 23A incorporates its definition of "covered transactions" from Section 23A of the Federal Reserve Act, Super 23A prohibits banks from engaging in any covered transactions with covered funds that they sponsor, manage, or advise and, unlike Section 23A, does not permit banks to engage in covered transactions with their affiliates subject to specified quantitative and qualitative requirements. Also, although there is a technical argument that Super 23A will not apply to a bank in its capacity as the "investment adviser" to a covered fund, any bank that administers the fund's investments could still be characterized as the fund's "investment manager" and thus would remain subject to Super 23A.

and credit facilities into a commitment from the bank to purchase “ownership interests” in the conduit (such interests are defined in the NPR to include any equity, partnership, or other similar interest in a covered fund).

It may also be possible for banks to continue to provide ABCP conduit financing to their customers through a collaborative process with ABCP conduit sponsors that are owned and managed by unrelated third parties. That is, banks might (i) refer customers and related asset financing opportunities to independent companies that organize, administer, and substantively act as sponsors to ABCP conduits and (ii) provide credit and/or liquidity support to support the issuance of commercial paper notes and the related financing by such conduits of such assets. However, this approach would face some practical obstacles (for example, banks may not be comfortable having customer assets financed through an unaffiliated third party), and banks that consider taking this approach to obtain Volcker Rule relief may first want to confirm that regulators will not continue to view the bank as a conduit “sponsor” or “investment manager.”

Given the problems experienced by SIVs and other “arbitrage” ABCP conduits during the recent financial crisis, federal banking regulators have shown a clear preference for traditional multi-seller ABCP conduits as a legitimate banking activity. As discussed, it would appear to be directly contrary to Congressional intent if the regulators applied the Volcker Rule to prevent the operation of traditional multi-seller ABCP conduits (at least to the extent such ABCP conduits limit their investments to “loans”) by requiring the bank that organizes and administers the conduit to either give up control of the ABCP conduit’s investment decisions and funding activities or no longer provide credit or liquidity facilities to the ABCP conduit directly or through an affiliate.

Based on our dialogue with the regulators and with market participants who have themselves talked with the regulators regarding the various Dodd-Frank proposals that could impact the ABCP market, and on the express statement in the Volcker Rule that the Rule shall not be construed to limit loan securitizations, we do not think the regulators intend to shut down traditional multi-seller ABCP conduits. They could permit the continued operation of such conduits either by providing a safe harbor or other clarification that normal bank involvement with a traditional multi-seller ABCP conduit it administers is permitted or by carving out such ABCP conduits from the definition of “covered funds” in the Volcker Rule. Of course, at this time there is no assurance that any such relief will be provided.

Are There Any Other Possible Exemptions from the Volcker Rule?

Yes. As previously discussed, the proposed Volcker Rule defines "covered funds" to include issuers that are exempt from '40 Act registration pursuant to Sections 3(c)(1) or 3(c)(7) of the '40 Act. Most ABCP conduits rely upon one of those two exemptions. However, the Volcker Rule will not apply to bank transactions with issuers that qualify for any other exemption from the ‘40 Act. Many issuers of term asset-backed securities rely upon the exemptions provided by Section 3(c)(5) of the '40 Act or Rule 3a-7 under the '40 Act. Section 3(c)(5)(A) provides an exemption for issuers principally engaged in acquiring notes, accounts receivables, and other obligations representing the sales price of merchandise, insurance, or services, while Section 3(c)(5)(C) similarly exempts issuers principally engaged in purchasing mortgages or other liens on real estate. Rule 3a-7 provides an exemption for asset-backed issuers that meet certain criteria specified in the Rule. ABCP conduits historically have preferred not to rely upon these exemptions or have been ineligible to use them because the exemptions limit the types of assets that the conduits may finance (in the case of Section 3(c)(5)) or restrict asset transfers by the conduit (in the case of Rule 3a-7). However, if the regulators do not otherwise provide workable exemptions from the Volcker Rule for ABCP conduits, certain conduits could consider conforming their investment portfolios and/or operating procedures to the Section 3(c)(5) or Rule 3a-7 restrictions.

The potential availability of these exemptions for certain conduits provides only a partial solution to Volcker Rule issues as widespread reliance by conduits on Section 3(c)(5) and Rule 3a-7 could significantly narrow the categories of assets that conduits finance and significantly restrict conduit operating flexibility. In addition, the SEC recently announced that it may consider major amendments to each of Section 3(c)(5) and Rule 3a-7. The timing and content of any such amendments remain unknown, but in the current regulatory environment, any amendments that are approved are more likely to narrow the exemptions than to broaden them.

Finally, it's also possible that ABCP conduits relying upon Section 3(c)(5) or Rule 3a-7 would themselves constitute "banking entities" for purposes of the Volcker Rule and would be subject to associated restrictions on proprietary trading activities and the ownership or sponsorship of covered funds. We think this should not be the result for the same reason that ABCP conduits have traditionally not

been treated as bank “affiliates” under Section 23A, but the Volcker Rule is a new law, and regulators could reach a contrary conclusion.

When Will the Volcker Rule Become Effective?

The Volcker Rule will become effective on July 21, 2012, whether or not the NPR (or other implementing regulations) are approved by that date; however, banks will be allowed an additional two years (i.e., until July 21, 2014) to bring their existing activities and investments into compliance with the Rule. In addition, the Federal Reserve Board will have discretion to extend the two-year implementation period by not more than three consecutive one-year extensions.

When Are Comments on the NPR Due?

Written comments on the NPR must be submitted to the regulators no later than January 13, 2012.

For more information on any of the issues discussed in this Client Alert, contact any attorney in our Asset Securitization Group or visit us online at chapman.com.

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