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# The Final Volcker Rule: Impact on Securitizations

On December 10, 2013, five U.S. financial regulators (the Agencies) adopted a final rule implementing the Volcker Rule (the Final Rule). The text of the Final Rule and its accompanying lengthy preamble (collectively, the Adopting Release) are available here. Two years ago the Agencies released a proposed rule to implement the Volcker Rule (the Proposed Rule), the text of which is available here.[1]

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) required the Agencies to adopt a rule implementing the so-called Volcker Rule provision in Section 619 prohibiting banking entities from engaging in "proprietary trading" and making investments and conducting certain other activities with "private equity funds and hedge funds," but specifically stated that nothing in Section 619 should be construed to limit or restrict the ability of a banking entity to securitize loans. The Final Rule does not impose restrictions on most traditional consumer asset-backed securities (ABS) transactions and includes specific exclusions for certain securitizations, but it will nonetheless have a significant impact on certain active segments of the securitization market, particularly collateralized loan obligations (CLOs), asset-backed commercial paper (ABCP) conduits and insurance-linked securities (ILS), and on certain legacy transactions. Although sponsors will be able to structure new securitizations of many types of financial assets to take advantage of the exclusions under the Volcker Rule, certain existing securitizations will be considered covered funds under the Final Rule, and banks will generally not be able to hold ownership interests in those securitizations after the extended conformance period ends on July 21, 2015, subject to any further extension.

The definition of covered fund in the Final Rule[2] is broad enough to encompass many securitization transactions even though the Final Rule has exclusions for loan securitizations, qualifying ABCP conduits, qualifying covered bond programs and wholly-owned subsidiaries of banking entities. As discussed below, the broad reach of the covered fund definition means that banks and their affiliates and subsidiaries need to consider whether any securitization entity that they organize or in which they invest will be viewed as a covered fund and, if so, whether they have an ownership interest in the covered fund, act as a sponsor with respect to the covered fund or have other relationships with the covered fund that may now be prohibited. For instance, the so-called Super 23A provision of the Final Rule will generally prohibit a banking entity from repurchasing assets from or entering into an interest rate or currency swap with a covered fund that the banking entity sponsors or in which it holds an ownership interest or that it organizes and offers.

## BASIC FRAMEWORK

Under the Final Rule, a "banking entity" may not, as principal, directly or indirectly acquire or retain any "ownership interest" in or "sponsor" a "covered fund," or have

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1 For up-to-date, detailed discussions on the Volcker Rule, please visit our website.

2 *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (to be codified in various parts of 12 and 17 C.F.R.) § __.10(b) (Dec. 10, 2013), *available at* http://www.sec.gov/rules/final/2013/bhca-1.pdf.

certain relationships with a covered fund.[3] Certain securitization entities will be treated as covered funds because "covered fund" is defined by reference to the exemptions from investment company status under the Investment Company Act of 1940 (the Investment Company Act) provided by Section 3(c)(1) and Section 3(c)(7),[4] which are used by some securitization vehicles in the Rule 144A market, as well as by private equity and hedge funds.

To assess the impact of the Final Rule on securitizations, we begin by examining the definitions of "banking entity" and "covered fund" and the exclusions available to securitizations. We will then consider the particular activities in which banking entities are prohibited or restricted from engaging with covered funds.

## Banking Entity

The Final Rule defines a banking entity as any insured depository institution (IDI), any company that controls an IDI and any company treated as a bank holding company under the International Banking Act of 1978.[5] In addition, affiliates and subsidiaries (each as defined under the Bank Holding Company Act of 1956) of the foregoing, other than covered funds that do not themselves fall into any of the aforementioned categories, are also considered to be banking entities.[6]

Commenters to the Proposed Rule requested clarification regarding the possible inclusion of ABS issuing entities and intermediate special purpose vehicles (SPVs) within the banking entity definition,[7] but the Final Rule and Adopting Release fail to provide such clarification. As a result, it appears that ABS issuers and intermediate SPVs that are affiliates or subsidiaries of banking entities and are not covered funds would be banking entities under the Final Rule and would be subject to the Rule's restrictions on proprietary trading, covered fund activities, risk-mitigating hedging activities and, subject to the applicable thresholds, related reporting and compliance requirements.

## Covered Fund

The Final Rule is of concern for securitization transactions because the Agencies have chosen to define a covered fund, in part, by reference to exemptions from status as an investment company under the Investment Company Act that are used by many securitization transactions, including CLOs, collateralized debt obligations (CDOs) and ABCP conduits. The Final Rule provides no grandfathering exemption for existing securitizations or investments in existing securitizations that predate the Final Rule.

The Final Rule defines a covered fund to include:

- an issuer that would be an investment company as defined in the Investment Company Act but for Section 3(c)(1) or Section 3(c)(7) thereof;
- any commodity pool for which the commodity pool operator has claimed an exemption under U.S. Commodity Futures Trading Commission (CFTC) Rule 4.7 or a commodity pool that is substantively similar; and
- foreign funds sponsored or owned, directly or indirectly, by a U.S. banking entity (except foreign public funds).[8]

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3 *See* Adopting Release at 466.

4 Final Rule § __.10(b)(1)(i).

5 Final Rule § __.2(a)(1).

6 Final Rule § __.2(a)(1).

7 *See, e.g.,* Securities Industry and Financial Markets Association securitization comment letter, Feb. 13, 2012, *available at* http://www.sec.gov/comments/s7-41-11/s74111-204.pdf.

8 Final Rule § __.10(b)(1).

The Final Rule specifically excludes certain categories of entities from the definition of covered fund, including loan securitizations, qualifying ABCP conduits, qualifying covered bond issuing entities, wholly-owned subsidiaries, joint ventures, acquisition vehicles, foreign pension funds, insurance company separate accounts, bank owned life insurance funds, small business investment companies (SBICs) and public welfare investment funds, registered investment companies and business development companies, and funds exempt or excluded from the Investment Company Act that rely on an exemption or exclusion other than Section 3(c)(1) or Section 3(c)(7).[9] We describe and analyze in greater detail below the loan securitization, qualifying ABCP conduit, qualifying covered bond and wholly-owned subsidiary exclusions.

Unlike the Proposed Rule, which categorized all commodity pools as covered funds, the Final Rule limits the definition of covered fund to commodity pools that are offered privately to investors who meet a heightened sophistication standard — much like traditional hedge funds or private equity funds.[10] In 2012, the CFTC provided guidance that excluded certain securitization entities that are party to derivatives from status as commodity pools, but did not provide relief for all securitizations.[11] Banking entities will need to consider whether they hold any ownership interests in or sponsor any securitization entities that would be considered commodity pools that are not exempt under the CFTC's interpretive guidance and therefore could be covered funds, and that would not be excluded from the covered fund definition as loan securitizations, such as synthetic CDOs.

## Loan Securitization Exclusion

The covered fund definition in the Final Rule excludes loan securitization entities that generally hold only loans, servicing assets and interest rate or currency swaps. The Proposed Rule did not have an exclusion for loan securitizations in the covered fund definition, but rather provided limited exemptions for loan securitizations for certain activities and investments. The Final Rule provides a much more useful exclusion: If a securitization qualifies for the loan securitization exclusion, the securitization is excluded from the definition of covered fund and the restrictions on covered fund activities and investments by banking entities.[12]

To qualify for the loan securitization exclusion from the covered fund definition under the Final Rule, a special purpose issuer of ABS must have assets consisting *exclusively* of the following:

- loans;
- rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans;
- interest rate or foreign exchange derivatives that:
  - directly relate to the loans, ABS or contractual rights of other assets; and
  - reduce the interest rate and/or foreign exchange risks related to the loans, ABS or contractual rights of other assets; and
- special units of beneficial interest (SUBIs) and collateral certificates, provided that:
  - the SPV issuing the interests or certificates meets the loan securitization requirements of the Final Rule;
  - the interests or certificates are used for the sole purpose of transferring the economic risks and benefits of the assets;

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9 Final Rule § __.10(c).

10 Final Rule § __.10(b)(1)(ii)(B).

11 *See, e.g.,* CFTC Regulations 3.10(c) and 4.13; 77 FR 11252, 11258 (Feb. 24, 2012) (explaining the need for swaps to be included in the de minimis exclusion and exemption in 17 CFR 4.5 and 4.13); and CFTC Staff Letters Nos. 12-14 (Oct. 11, 2012) and 12-45 (Dec. 7, 2012) (providing interpretative relief that certain securitization vehicles are not commodity pools).

12 *See* Adopting Release at 538.

- the interests or certificates are created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization; and
- the SPV and the issuing entity are established by the same entity that initiated the loan securitization.[13]

The definition of "loans" is intended to be narrow.[14] Most significantly, it explicitly excludes securities (as defined under the Securities Exchange Act of 1934, or the Exchange Act) and derivatives, though a loan securitization issuing entity is permitted to own certain securities and derivatives as described above.[15] The loan securitization exclusion from the covered fund definition will provide relief for CLOs that do not hold any corporate bonds or synthetic exposures. However, because the Final Rule specifies that most securities, derivatives and all commodity forward contracts are impermissible assets for purposes of loan securitizations, a range of transactions — including repackagings and resecuritizations, synthetic transactions, CDOs, ILS, CLOs holding securities and tender option bonds — will not be able to take advantage of the loan securitization exclusion. Banking entities also will need to consider whether certain types of assets, such as participation interests, are loans or securities. Certain fuzzy distinctions could have sharp consequences.

Although the Adopting Release mentions that the provision allowing a loan securitization to hold servicing assets and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans was intended to encompass the type of servicing assets allowed under Rule 3a-7,[16] the Final Rule includes a proviso limiting these assets to cash equivalents and securities received in lieu of debts previously contracted.[17] The Agencies state in the Adopting Release that they interpret "cash equivalents" to mean "high quality, highly liquid short term investments whose maturity corresponds to the securitization's expected or potential need for funds . . . ."[18] For many existing issuers that otherwise would qualify for the loan securitization exclusion, the existing definition of "eligible investments" is broader in scope than the cash equivalents permitted under the Final Rule.

The Agencies did not address whether servicing assets could include pool-wide enhancements.[19] The Adopting Release provides that "mortgage insurance policies supporting the mortgages in a loan securitization are servicing assets permissible for purposes" of this provision,[20] but the Agencies do not address pool-wide credit enhancements, such as letters of credit, guarantees or reserve accounts. While a collection account that would hold the proceeds of loans seems squarely within the terms of the Final Rule,[21] it is less clear whether a reserve account that is funded upfront and/or from excess spread to provide credit enhancement or yield supplement would be permitted.

While the loan securitization exclusion permitting an issuing entity to own SUBIs and collateral certificates is a helpful addition to the Final Rule, no SPV that issues SUBIs can actually satisfy the requirement that the SPV itself must meet the loan securitization requirement. The Adopting Release correctly describes a securitization of equipment leases that involves an SPV titling trust that holds

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13 *See* Final Rule § __.10(c)(8).

14 A loan is defined as "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative." Final Rule §__.2(s).

15 *See* Final Rule § __.10(c)(8).

16 *See* Adopting Release at 547-548.

17 *See* Adopting Release at 547-548.

18 *See* Adopting Release at 548.

19 *See* Adopting Release at 547.

20 Adopting Release at 547, footnote 1889.

21 *See* Adopting Release at 547-549.

ownership of the equipment, and provides that "[t]he Agencies recognize that securitization structures that use these types of intermediate asset-backed securities are essentially loan securitization transactions . . . ."[22] The language in the Final Rule, however, reverts to the requirement that the SPV issuing the SUBI itself must satisfy the requirements of the loan securitization exclusion and not hold assets other than loans and servicing assets.[23] In the foregoing example, the titling trust would own equipment, which is not a permitted asset under the loan securitization exclusion.

## Qualifying ABCP Conduit Exclusion

The Final Rule includes an exclusion for qualifying ABCP conduits, but the exclusion contains some significant limitations, including a limitation on assets to loans permissible for a loan securitization and certain ABS backed solely by assets permissible for a loan securitization that are acquired at issuance. ABCP conduits that buy ABS in the secondary market would not satisfy this requirement, and it is unclear how an ABCP conduit that joined a syndicate providing financing with respect to a borrower after the initial funding to the borrower would be treated. Also, ABCP conduits often hold bonds that are not ABS. Under the Final Rule, a qualifying ABCP conduit must issue only "asset-backed securities" comprised of a residual interest and securities with a legal maturity of 397 days or less.[24] The 397-day maturity requirement is fine for most ABCP conduits and is more generous than the 270-day maximum for qualifying ABCP conduits in the re-proposed rule relating to risk retention released by U.S. financial regulators in October 2013 (the Re-Proposed Risk Retention Rule).[25] The requirement that the conduit issue only "asset-backed securities," however, puts the onus on a banking entity to conclude that the ABCP is an ABS.[26] Certain commenters with respect to the risk retention rules argued that ABCP conduits should not be subject to those rules based on the rationale that ABCP is not an ABS, because, among other things, the ABCP may be repaid in the ordinary course from the proceeds of newly issued commercial paper or from draws on a liquidity facility and, therefore, payments to security holders may not depend primarily on cash flow from the underlying assets.[27]

The further requirement in the Final Rule that a qualifying ABCP conduit have "a regulated liquidity provider" that has committed to "provide full and unconditional liquidity coverage with respect to all outstanding [ABS] issued by the [ABCP conduit]"[28] also runs contrary to the nature of ABS. This liquidity requirement requires an ABCP conduit to have 100 percent liquidity support that will provide funding regardless of the performance of the assets or credit support. This effectively imposes a requirement to provide 100 percent credit enhancement for the assets, which is a feature that is not present in a significant portion of existing ABCP conduits. The rationale for this requirement is unclear, especially given the Final Rule's stated intention of reducing the amount of risk borne by banking entities. It would

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22 Adopting Release at 556.

23 Final Rule § __.10(c)(8)(v).

24 Final Rule § __.10(c)(9)(i)(B).

25 The Re-Proposed Risk Retention Rule is intended to implement the risk retention requirement of Section 941 of the Dodd-Frank Act. The text of the Re-Proposed Risk Retention Rule is *available at* http://www.sec.gov/rules/proposed/2013/34-70277.pdf. The original proposed rule relating to risk retention was released in April 2011.

26 Section 3(a)(77) of the Exchange Act provides that the term "asset-backed security" means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including: a collateralized mortgage obligation; a collateralized debt obligation; a collateralized bond obligation; a collateralized debt obligation of asset-backed securities; a collateralized debt obligation of collateralized debt obligations; and a security that the SEC, by rule, determines to be an asset-backed security for purposes of this section; and does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

27 *See, e.g.,* American Bar Association, Securitization and Structured Finance Committee, Business Law Section comment letter, Jul. 20, 2011, *available at* http://www.sec.gov/comments/s7-14-11/s71411-133.pdf at 38.

28 Final Rule § __.10(c)(9)(C).

require banking entities as liquidity providers to take on more risk than the market currently requires. In addition, the Final Rule refers to "a regulated liquidity provider" and does not clarify whether multiple liquidity providers would be acceptable.

### Covered Bond Exclusion

The Final Rule excludes from the covered fund definition certain qualifying covered bond issuing entities.[29] To be eligible for the exclusion, the covered bonds must be debt obligations issued by a foreign banking organization or a wholly-owned subsidiary of a foreign banking organization, the payment obligations of which are fully and unconditionally guaranteed by the foreign banking organization, or debt obligations of an entity owning a cover pool that is fully and unconditionally guaranteed by its parent foreign banking organization.[30] For purposes of the qualifying covered bond exclusion, a cover pool is a dynamic or fixed pool of loans or other assets, which loans or other assets meet the requirements for loans under the loan securitization exclusion.

### Wholly-Owned Subsidiary Exclusion

The Final Rule also excludes from the covered fund definition wholly-owned subsidiaries of a banking entity. The wholly-owned subsidiary exclusion applies to any entity, the ownership interests of which are wholly-owned, directly or indirectly, by a banking entity or affiliate thereof, except that up to 5 percent of the entity's outstanding ownership interests may be held by its employees or directors and up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the interests are being held for the purpose of establishing corporate separateness or to address bankruptcy or similar concerns.[31] This exclusion addresses market concerns expressed with respect to the Proposed Rule that an intermediate SPV in a multi-step securitization transaction could be a covered fund. This exclusion may also be helpful with respect to ABCP conduits not meeting the qualifying ABCP conduit requirements and corporate repackagings and structured products issued by entities that are wholly-owned subsidiaries of banking entities. Entities that fall under this exclusion, while not covered funds, will be considered banking entities and will themselves be subject to the Final Rule's restrictions on relationships with covered funds and proprietary trading, and, as applicable, requirements regarding recordkeeping and internal controls.

## INVESTMENT IN AND SPONSORING OF COVERED FUNDS AND MARKET MAKING AND COVERED TRANSACTIONS WITH RESPECT TO COVERED FUNDS

### Ownership Interest

The Final Rule prohibits a banking entity from acquiring or retaining an ownership interest in a covered fund subject to limited exceptions described below.[32] It defines an "ownership interest" as "any equity, partnership or other similar interest."[33] The Final Rule adds several clauses listing features of "other similar interests" that would cause them to be an ownership interest.[34]

Most of these listed features are traditional equity characteristics, but, notably, the right to participate in the selection or removal of an investment manager, investment adviser or commodity trading advisor of

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29 Final Rule § __.10(c)(10).

30 Final Rule § __.10(c)(10)(ii).

31 Final Rule § __.10(c)(2).

32 Final Rule § __.10(a)(1).

33 Final Rule § __.10(d)(6)(i).

34 Final Rule §§ __.10(d)(6)(i)(A)-(G).

a covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or acceleration event) is also defined as a characteristic of an ownership interest.[35] Any class of securities that can participate in the selection or removal of a collateral manager, therefore, could be an ownership interest. This language in the Final Rule is troublesome for CLO and CDO transactions because debt classes that do not otherwise have equity-like characteristics generally have voting rights that, while they are the controlling class, allow them to participate in the removal or replacement of a collateral manager upon the occurrence of a "cause" event with respect to the collateral manager or upon resignation. The Adopting Release indicates that rights arising on a contingent or future basis would be relevant to the determination,[36] so a class that will become entitled to participate in the removal of a collateral manager after another class is repaid could be included.

The definition of ownership interest has drawn significant attention since the release of the Final Rule, particularly in the context of CDOs backed by Trust Preferred Securities (TruPS) that are owned by community banks. The Agencies are reportedly contemplating some form of relief for community banks holding TruPS CDOs, which otherwise would be required to reclassify them for accounting purposes, take immediate write-downs and divest prior to maturity if they are considered ownership interests in covered funds. The issue, however, has broad relevance to any security held by a banking entity that may have rights to participate in the selection or removal of an investment manager or investment adviser. Absent either regulatory relief for debt classes with no equity features other than the removal or replacement right or a structural solution to remove that right, banks owning debt tranches in many existing CDOs and CLOs will be required to divest those holdings, to the extent not otherwise paid down, by July 21, 2015 (subject to any extension) and may not acquire additional ownership interests in covered funds with similar rights during the conformance period.

The definition of "other similar interest" in the Final Rule includes an interest that provides that amounts payable can be reduced based on losses arising from the underlying assets of the covered fund.[37] The Agencies provide little guidance with respect to the intended scope of this clause, but it could potentially encompass any security backed by a pool of assets, given the contingent risk of loss with respect to even the most senior securities, and, on a more limited basis, could encompass a security on which interest is not "due and payable" if there is insufficient cash flow due to losses.[38] The language of this clause is similar to the definition of an eligible horizontal residual interest in the Re-Proposed Risk Retention Rule.[39] As discussed below, a banking entity that organizes or offers an ABS transaction will be allowed to retain an ownership interest in a covered fund in an amount up to, but not exceeding, the amount required to satisfy that banking entity's risk retention requirement. But if the banking entity was holding, for instance, the entire junior-most class of a securitization and believed that retention of those securities satisfied the risk retention requirement because that class represented an eligible horizontal residual interest, retention in excess of the minimum risk retention requirement would be prohibited and could require partial divestment.

In the Final Rule, securities typically thought of as residual interests will be "ownership interests," including interests having the right to receive the underlying assets of a covered fund after all other

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35 Final Rule § __.10(d)(6)(i)(A).

36 *See* Adopting Release at 609.

37 Final Rule § __.10(d)(6)(i)(E).

38 *See generally* Adopting Release at 725.

39 Under the Re-Proposed Risk Retention Rule, "Eligible horizontal residual interest" means an ABS interest in the issuing entity ". . . (2) With respect to which on any payment date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) That has the most subordinated claim to payments of both principal and interest by the issuing entity."

interests have been redeemed or paid in full, and interests having the right to receive all or a portion of excess spread.[40] The definition of "other similar interest" also includes any interest receiving income on a pass-through basis from the covered fund, or having a rate of return determined by reference to the performance of the covered fund's underlying assets.

## Sponsor

Under the Final Rule, a banking entity cannot act as a sponsor of a covered fund, subject to limited exceptions described below. Few of the banking entities that securitize will be treated as sponsors under the Final Rule, because the definition is much narrower than the sponsor definition in each of Regulation AB and the Re-Proposed Risk Retention Rule and does not include the securitizer role of organizing and initiating the transaction or transferring assets reflected in each of these regulations.[41] Under the Final Rule, a sponsor is an entity that:

- serves as a general partner, managing member, trustee or commodity pool operator of a covered fund;
- in any manner selects or controls a majority of the directors, trustees or management of a covered fund; or
- shares, for corporate, marketing or other purposes, the same name or variation of the same name with a covered fund.

The Final Rule defines the term sponsor in substantially the same way as did the Proposed Rule. The Adopting Release suggests that concerns raised by commenters with respect to the Proposed Rule's definition of sponsor with respect to securitizations should be largely alleviated because the loan securitization and qualifying ABCP exclusions from the "covered fund" definition result in the sponsor definition applying to a limited set of securitization transactions.[42] As discussed above, however, uncertainty remains as to whether the nuances of the exclusions will cause certain issuing entities to be pulled back into the "covered fund" definition.

The inclusion of "trustees" in the definition of sponsor encompasses investment managers because "trustee" is separately defined to include an entity that has authority and discretion to manage and control the investment decisions of a covered fund for which such person serves as trustee.[43] The definition of "trustee" excludes trustees who do not exercise investment discretion.[44]

## Permitted Investment in a Covered Fund

The Final Rule permits a banking entity to acquire or retain an ownership interest in, or sponsor, a covered fund that is an issuing entity of ABS in connection with organizing and offering that issuing entity, provided that the banking entity complies with certain enumerated requirements.[45] Among other things, the banking entity may not guarantee or assume the obligations or performance of the covered fund; the covered fund may not share the same name or a variation thereof with the banking entity or use the word "bank" in its name; and the banking entity must make certain disclosures to prospective

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40 Final Rule § __.10(d)(6)(i)(C).

41 Under Regulation AB, "Sponsor means the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." Under the Re-Proposed Risk Retention Rule, "Sponsor means a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity."

42 Adopting Release at 637.

43 Final Rule § __.10(d)(10)(ii).

44 Final Rule § __.10(d)(10)(i).

45 Final Rule § __.11(b).

investors in the covered fund.[46] For purposes of this provision, organizing and offering a covered fund that issues ABS means acting as a securitizer as defined in the risk retention provisions in Section 15G of the Exchange Act or acquiring or retaining an ownership interest in the issuing entity as required by the risk retention provisions.[47]

The Final Rule permits a banking entity to acquire and retain an uncapped interest in a covered fund that it organizes and offers for purposes of establishing the fund and providing initial equity for investment to attract outside investors or making a de minimis investment, subject to certain limitations.[48] This initial interest can be held for a one-year seeding period commencing for ABS transactions on the date on which the assets are initially transferred into the ABS issuing entity. Thereafter, the Final Rule puts a cap on a banking entity's permitted investment in a covered fund equal to 3 percent of the total fair value of the ownership interests in the fund. For ABS transactions, however, the Final Rule allows the investment to exceed 3 percent in order to satisfy the risk retention requirements of Section 15G and its implementing regulations. Such investment, however, may not exceed the amount required by the risk retention rules. The Re-Proposed Risk Retention Rule generally requires a sponsor to hold no less than 5 percent of the credit risk in assets it sells into a securitization; the Final Rule, in turn, provides that a banking entity may not hold more than the amount required by the risk retention rules. The conflicting policy objectives of these two sets of rules — one of which is intended to require a securitizer to retain a significant amount of risk, while the other is intended to reduce the amount of risk in the banking system — put banking entities in an uncomfortable position. To satisfy the risk retention requirements, a securitizer might retain an amount somewhat greater than the required amount, due to the timing of the determination, the marketing process for the interests that are not retained and the inherent subjectivity of a fair value calculation. For purposes of the Final Rule, however, no cushion for any amount above the minimum required amount will be permitted. Furthermore, this exemption in the Final Rule does not provide any relief for amounts retained due to foreign risk retention requirements, which could exceed those of U.S. requirements.

The Rule's prohibition on acquiring or retaining an ownership interest in a covered fund does not apply to a banking entity's underwriting activities or market making-related activities in accordance with the requirements of the Final Rule. The Final Rule provides, however, that any ownership interest in a covered fund held for underwriting or market making-related activities must be added to other retained amounts for the purposes of the per-fund limitation.[49] Thus, for any banking entity holding a required risk retention amount of 3 percent or more in the form of ownership interests, any amount of additional ownership interests acquired for underwriting or market making purposes would push the banking entity over the per-fund limit if the additional amount were acquired after the initial seeding period. Effectively, this means that a banking entity holding the required amount of an ownership interest for risk retention purposes cannot engage in market making-related activities with respect to ownership interests in that entity after the initial seeding period. In addition, the aggregate value of the ownership interests of a banking entity and its affiliates may not exceed 3 percent of the Tier 1 capital of the banking entity and any ownership interest held for underwriting or market making-related activities must be added to other retained amounts for purposes of determining compliance with this test. While these limitations on market making activities only apply with respect to ownership interests, to the extent that the definition of ownership interest remains unchanged and encompasses debt classes of ABS with removal or replacement rights, these limitations could apply to market making activities with respect to all classes of a CLO or similar securitization.

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46 Final Rule § __.11(b)(1).

47 Final Rule § __.11(b)(2).

48 Final Rule § __.12(a)(1).

49 Adopting Release at 668.

### Covered Transactions and Super 23A

Under the Super 23A provision of the Final Rule, a banking entity, acting as a sponsor of a covered fund, that organizes and offers a covered fund or that holds an ownership interest in a covered fund as defined in Section 23A of the Federal Reserve Act of 1913 (the Federal Reserve Act) is prohibited from entering into a covered transaction with the covered fund as if the banking entity were a member bank and the covered fund were an affiliate of the banking entity. Prohibited covered transactions would include loans or extensions of credit to the covered fund, entering into derivatives transactions with the covered fund, including interest rate and currency swaps, repurchases of assets from the covered fund — which could prevent a banking entity from repurchasing assets from a covered fund upon a breach of representation or warranty — and issuances of guarantees or letters of credit on behalf of the covered fund.

The Final Rule also provides that any permitted transaction is subject to the requirements of Section 23B of the Federal Reserve Act, as if the banking entity were a member bank and the covered fund were an affiliate of the banking entity. Section 23B requires services and transactions between member banks and affiliates thereof to be on market terms or on terms at least as favorable to the banking entity as those of a comparable transaction by the banking entity with an unaffiliated third party. This would apply to transfers of assets by the banking entity to the ABS issuer, any permitted derivative with the covered fund and servicing functions performed by the banking entity.

### Reporting and Compliance Requirements

IDIs, companies controlling IDIs, bank holding companies and their affiliates and subsidiaries, including those who are ABS issuers or intermediate SPVs that are not themselves covered funds, are required to develop compliance programs designed to ensure and monitor compliance with the proprietary trading and covered fund activities and investment restrictions in the Final Rule. The Final Rule allows a banking entity that does not engage in restricted activities to forego preparation of the compliance program until it becomes engaged in such activities. Some securitization entities that are banking entities will probably not need to develop compliance programs initially, while others that act as sponsor or retain an ownership interest in a covered fund and those that engage in covered transactions with a covered fund will need to develop compliance programs. There are three distinct levels of compliance programs for banking entities that may apply, depending on the amount of consolidated assets of the banking entity. In each case, however, the compliance program includes written policies and procedures to monitor trading activities and investments in covered funds, internal controls to monitor risk-mitigating hedging activities and independent auditing and testing of the compliance program.[50] In addition, the largest banking entities will be required to periodically report certain metrics.[51]

## POTENTIAL FUTURE EFFECTS OF THE FINAL VOLCKER RULE ON SECURITIZATIONS

### Investment Company Act Exemptions

Securitizations of financial assets are structured to avail themselves of one or more exemptions from the requirement to register as an investment company. An "investment company" is defined under Section 3(a)(1) of the Investment Company Act generally to include an issuer of securities that is engaged primarily in the business of investing or trading in securities. The definition of "securities" in the Investment Company Act has been interpreted very broadly and would encompass consumer loans and receivables that generally are not viewed as securities under the Exchange Act. Because its assets may be viewed as "securities" under this Investment Company Act definition, a securitization entity needs an exemption from status as an investment company. Certain securitizations, therefore,

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50 *See* Final Rule § __.20(b)(1).

51 *See* Final Rule § __.20(d).

are brought under the scope of the Volcker Rule because of a broad interpretation of "securities" under the Investment Company Act and will remain subject to the Volcker Rule's restrictions on covered fund activities by banking entities, unless, with respect to the loan securitization exclusion and the qualifying ABCP conduit exclusion, the securitization entity's assets are comprised only of loans and not "securities" under the Exchange Act.

In 2011, the SEC requested public comment on two separate proposals:

- a concept release with respect to Section 3(c)(5)(C) of the Investment Company Act, and
- an advanced notice of proposed rulemaking with respect to Rule 3a-7 and Section 3(c)(5) that could significantly restrict or in some circumstances eliminate the ability of ABS issuers to rely on these exemptions.[52]

In particular, the SEC questioned whether Section 3(c)(5) should be amended to limit the ability of issuers of ABS to rely on Section 3(c)(5) and what the effect would be if issuers of ABS could no longer rely on Section 3(c)(5).[53]

In response to the Dodd-Frank Act directive to review any references to or requirements regarding credit ratings in regulations, the advanced notice of proposed rulemaking included significant new conditions to obtaining the relief provided by Rule 3a-7 that could be added in lieu of the current references to ratings from a nationally recognized statistical rating organization.

If these approaches or similar modifications are adopted, issuers could find that Section 3(c)(5) is no longer available and Rule 3a-7 is subject to new conditions that are undesirable. The remaining option for ABS issuers would be to pursue private transactions that rely solely upon the exemptions provided by Section 3(c)(1) or Section 3(c)(7), which could cause the securitization entity to be a "covered fund" under the Final Rule.

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The Final Rule has addressed many concerns that were raised with respect to the impact of the Proposed Rule on securitizations. While many of the issues for securitizations created by the Final Rule have been identified, undoubtedly more will emerge as banking entities analyze and attempt to comply with the Final Rule, and any interpretive guidance provided thereunder, and other regulations regarding ABS mandated by the Dodd-Frank Act that are yet to be finalized.

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52 *See* SEC Press Release, SEC Seeks Public Comment on Asset-Backed Issuers and Mortgage-Related Pools Under Investment Company Act, Aug. 31, 2011, *available at* http://www.sec.gov/news/press/2011/2011-176.htm. *See also* Concept Release, Request for Comments, *available at* http://www.sec.gov/rules/concept/2011/ic-29778.pdf; Advance Notice of Proposed Rulemaking, *available at* http://www.sec.gov/rules/concept/2011/ic-29779.pdf.

53 *See* Advance Notice of Proposed Rulemaking, *available at* http://www.sec.gov/rules/concept/2011/ic-29779.pdf at 47.