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The Final Volcker Rule's Potential Impact on Securitizations, Repackagings, Covered Bonds and other Structured Products

Key Takeaways for All Banks:

> Final regulations implementing the Volcker Rule's prohibition on sponsoring, investing in and transacting with certain covered funds by banks will significantly impact securitizations and other structured products.

> While certain exceptions from the prohibition will permit banks to sponsor and invest in securitization and structured products vehicles, those banks will not be permitted to (among other things) extend credit to, provide liquidity facilities for or enter into swaps with those vehicles.

> An easier route may be for such vehicles to avoid being covered funds entirely. Banks have free reign to sponsor, invest in and transact with a vehicle that does not satisfy one of the three prongs of the "covered fund" definition.

> Even if a vehicle would be a covered fund under the basic definition, there are carve-outs for vehicles involved in loan securitizations and/or the issuance of asset-backed commercial or covered bonds.

> Alternatively, a bank may also invest in securities issued by a vehicle that do not qualify as "ownership interests," which many such securities should not; however, this will not allow the banking entity to sponsor such a vehicle.

> A bank serving as arranger or underwriter for a vehicle may also not be considered a "sponsor" of that vehicle, which means it would be able to transact with the vehicle freely (provided it is not acting as the vehicle's investment adviser), though its investment options may still be limited.

Key Takeaway for Non-U.S. Banks:

> A non-U.S. bank has broad flexibility to sponsor and invest in vehicles that are not offered or sold in the United States.

Introduction

On December 10, 2013, the Securities and Exchange Commission (the "**SEC**"), the Commodity Futures Trading Commission (the "**CFTC**") and three U.S.

Contents

banking regulators (collectively, the "**Agencies**")[1] issued a final rule (the "**Final Rule**") to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), commonly referred to as the "**Volcker Rule**."[2] The Volcker Rule's prohibitions on investing in or sponsoring certain private funds and its restrictions on banks' transactions with such funds, even when investing or sponsorship is permissible, may prove particularly troublesome for many securitizations and structured products. Although the Final Rule includes certain exceptions for some securitizations and structured products and may be seen as an improvement over the Agencies' original proposal (the "**Proposed Rule**"),[3] it leaves in place many of the Proposed Rule's most problematic restrictions.

This Note addresses the Final Rule's impact on securitizations and other structured products like repackagings and covered bonds.[4] In addition to the tables and charts throughout, we have attached as an Appendix to this Note a high-level flowchart designed to operate as a quick reference guide. We have also reproduced in the Appendix certain of the various tables below.

As a practical matter, the threshold question with respect to a securitization or structured product vehicle (an "**SPV**") is whether it is a "covered fund" subject to the Final Rule's ban (a "**Covered Fund**"). There are some significant carve-outs that may preclude many SPVs from being Covered Funds. Even if an SPV cannot avoid the Covered Fund definition, however, a bank's activity with respect to the SPV may not be considered "sponsorship," which would make its activities permissible. Further, its investments may be limited to interests that do not qualify as "ownership interests," which do not fall within the scope of the Final Rule. Ultimately, however, there are a number of exceptions to the Volcker Rule's prohibition that may permit a bank to sponsor and invest in an SPV that is a Covered Fund, though use of these exceptions may significantly limit the bank's ability to transact with that SPV.

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1 The Agencies include three U.S. bank regulators, the Office of the Comptroller of the Currency, the Federal Reserve Board of Governors (the "**Fed**") and the Federal Deposit Insurance Corporation (the "**FDIC**").

2 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013). A pre-publication version of the Final Rule text (the "**Final Rule Text**") is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf. A pre-publication version of the Supplementary Material released by the Agencies in support of the Final Rule (the "**Final Rule Supp. Mat.**") is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf. Neither the Final Rule Text nor the Final Rule Supp. Mat. has been printed in the Federal Register as of the date hereof.

3 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011).

4 For a more detailed treatment of the Final Rule's impact on non-U.S. banks generally, please see our separate note on that topic. Linklaters LLP, *The Final Volcker Rule and Its Extraterritorial Consequences for Non-U.S. Banks* (Dec. 20, 2013), *available at* http://linklaters.com/pdfs/mkt/newyork/A17489186.pdf.

Overview of banking entities and the Covered Fund ban

The Volcker Rule prohibits "banking entities" from proprietary trading and investing in and sponsoring Covered Funds, which may include a vehicle used in connection with an SPV. It also imposes restrictions on banks' transactions with such entities, which we discuss in greater detail below.

A banking entity includes:
> an FDIC-insured depository institutions; [5]
> a U.S. bank holding companies;
> a foreign bank with a U.S. branch or agency; and
> any affiliate of the foregoing around the globe.

Although there are a number of meaningful exemptions for offshore activity, discussed below, at the threshold, all of a banking entity's global operations are subject to the Volcker Rule, even if the organization, or the activities in question, have limited or no connection with the United States.

Covered Funds and securitizations and structured products

From a securitization and structured products perspective, the Covered Fund ban and the Super 23A Restrictions (as defined below) on transacting with Covered Funds are the most relevant of the Volcker Rule's prohibitions.[6] The Covered Fund ban prohibits a banking entity from sponsoring, or investing in the "ownership interests" of, a Covered Fund, subject to certain exceptions. We discuss the definitions of "sponsor" and "ownership interest" in more detail below. The Final Rule's exceptions to the sponsorship and investment ban allow a banking entity to:

> sponsor or invest in a Covered Fund in connection with, directly or indirectly, organizing and offering the fund, though only if the banking entity's activities are conducted in connection with the provision of *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services (the "**Asset Management Exception**");

[5] Insured depository institutions include U.S. banks, savings associations and industrial loan companies, the deposits of which are insured by the FDIC.

[6] Under the Final Rule, many of a banking entity's transactions with a covered fund which it has sponsored, advises, has organized and offered, or continues to hold an interest in pursuant to certain exceptions, are also subject to Section 23B of the Federal Reserve Act. Section 23B requires transactions between a banking entity and a covered fund to be conducted on terms that are "substantially similar" between unaffiliated parties. We have not gone into detail on Section 23B in this note because we would generally expect transactions with securitization or other structured product issuers to be entered into on an arm's-length basis.

- sponsor or invest in a Covered Fund that issues asset-backed securities,[7] provided that a number of requirements are satisfied (the "**Securitization Sponsorship Exception**");
- underwrite or make a market in the ownership interests of a Covered Fund, provided that the banking entity conducts such activities in accordance with the relevant exceptions to the Final Rule's proprietary trading ban and certain other conditions are met;
- purchase ownership interests of a Covered Fund to mitigate risks arising from compensation to be paid to the employees of the banking entity that advise the Covered Fund; and
- with respect to non-U.S. banks, make investments in and sponsor Covered Funds "solely outside of the United States" (the "**SOTUS Exception**").

In addition to the sponsorship and investment bans, the Final Rule also prohibits a banking entity from extending credit or otherwise entering into a "covered transaction" (as defined in Section 23A of the Federal Reserve Act)[8] with a Covered Fund that it sponsors or to which it serves as investment adviser (the "**Super 23A Restrictions**"). The Super 23A Restrictions apply to all sponsored or advised Covered Funds, even if a banking entity is permitted to sponsor or invest in them under one of the exceptions described above. In the securitization and structured products context, the Super 23A Restrictions could bar a banking entity from entering into a variety of transactions with a sponsored SPV, including swaps, or even bar the banking entity from providing liquidity facilities as well as repurchase covenants, among other things.[9]

The Agencies did emphasize, however, that the Super 23A Restrictions apply only with respect to transactions between the banking entity and a sponsored or advised SPV that is a covered fund, not to transactions with third

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[7] As defined in Section 3(a)(79) of the Securities Exchange Act of 1934.

[8] 12 U.S.C. § 371c. A "covered transaction" under Section 23A includes (1) loans or extensions of credit by a bank to an affiliate, (2) the purchase by a bank of an affiliate's securities, (3) asset purchases by a bank from an affiliate, (4) the acceptance by a bank of an affiliate's securities as collateral, and (5) the issuance by a bank of a guarantee, acceptance or letter of credit on behalf of an affiliate. The Dodd-Frank Act amended Section 23A to include derivative transactions, repurchase transactions, and securities borrowing and lending transactions that create a credit exposure between a member bank and its affiliates. Under the Volcker Rule, a banking entity must treat itself as a member bank and a Covered Fund that it sponsors, advises or is invested in as an affiliate, and is completely barred from any "covered transactions."

[9] The key element to several of these prohibitions is exposure to the credit risk of the sponsored SPV. Accordingly, a banking entity may be permitted to enter into a "fully funded" swap with a sponsored SPV, though it is not likely that it would be able to enter into unfunded swaps, even if subject to daily margining, to the extent that they created intraday exposure to the Covered Fund. Others of these restrictions may prove even more problematic in the securitization context. For example, it is a common feature of virtually all securitizations to require the securitized assets to be repurchased by the depositor if they do not conform to underwriting standards or other eligibility criteria. Although it is the case that many SPVs may qualify for the loan securitization exemption and thus not be Covered Funds, for others, this restriction may prove quite problematic.

parties that may expose the banking entity to such an SPV's credit risk.[10] Thus, for instance, outside indemnities provided by an SPV's sponsor to the SPV's service providers would likely not violate the Super 23A Restrictions. The Agencies emphasized, however, that banking entities could not use this allowance to evade the Super 23A Restrictions on transactions with Covered Funds.[11]

Is the SPV a Covered Fund?

The first and most important question is whether an SPV is a Covered Fund. If not, then the Volcker Rule has no application to it, and any banking entity may sponsor, transact with or invest in it. If it is, then a banking entity must determine whether its investment is in an "ownership interest" in the SPV, whether its arrangement of a securitization makes it a "sponsor" of the SPV, and whether it can avail itself of any one or more of the exceptions to the Volcker Rule's bans discussed below. Even if one or more exceptions to the sponsorship and investment bans are available to the banking entity, it may still have to contend with the Super 23A Restrictions in its dealings with the SPV.

A Covered Fund is:
> an SPV that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "**ICA**");
> an SPV that is a commodity pool the operator of which either (1) is exempt from registration under CFTC Regulation 4.7, or (2) is registered with the CFTC and substantially all of the participation units of the pool were offered[12] to and are owned by "qualified eligible persons" (as defined in Regulation 4.7) (the "**Commodity Pool Prong**");[13] and
> **for U.S. banks only**, an SPV organized or established outside of the United States the ownership interests of which are offered or sold solely outside of the United States and which is, or holds itself out as, an entity that "raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities"

[10] Final Rule Supp. Mat. at 756-57. Under Section 23A of the Federal Reserve Act, as applicable outside of the Volcker Rule context, such a transaction with a third party would be considered a "covered transaction" to the extent that it exposed a Fed-member bank to the credit risk of its affiliate (though it would then only be subject to quantitative limits and certain other requirements, not an outright ban).

[11] Final Rule Supp. Mat. at 757.

[12] Notably, the Agencies emphasized that the use of the term "offer" in the Final Rule was not meant to mean the same thing as the term "offer" in the Securities Act of 1933. Final Rule Supp. Mat. at 502.

[13] The Agencies noted that the Commodity Pool Prong is meant to capture "those commodity pools that are similar to issuers that would be investment companies as defined [in the ICA] but for section 3(c)(1) or 3(c)(7) of [the ICA.]" Final Rule Supp. Mat. at 499. The CFTC has granted no-action relief with respect to many securitization vehicles that takes them out of the definition of "commodity pool." For a discussion of that relief, please see Linklaters LLP, *CFTC Staff Expands Relief for Securitization Vehicles from the Commodity Pool Provisions of the Commodity Exchange Act, Extends CPO Registration Deadline for Securitization Operators to March 31, 2013, and Grants Relief to Certain Legacy Transactions* (Dec. 11, 2012), *available at* http://linklaters.com/pdfs/mkt/newyork/A15956710.pdf.

(a "**Foreign Fund**").[14]

3(c)(1) and 3(c)(7) funds

The Covered Fund definition will pick up many types of SPVs. For example, many collateralized loan obligations ("**CLOs**"), collateralized debt obligations ("**CDOs**") and repackaging vehicles utilize Section 3(c)(7) of the ICA to avoid registration with the SEC as an investment company. The Final Rule makes plain that if an SPV (or other fund) that relies on Section 3(c)(1) or 3(c)(7) could, in fact, rely on another ICA exception, it would not be a Covered Fund. Thus, if an SPV can avail itself of either ICA Section 3(c)(5) or ICA Rule 3a-7, it is not a Covered Fund, even if it purported to rely on Section 3(c)(7) in its offering documents.[15] Likewise, amending existing transactions so that they qualify for another ICA exception is permissible, although in many cases, it may not be practical.

Foreign Funds

While U.S. banking organizations[16] must treat an SPV that is a Foreign Fund as a Covered Fund, a non-U.S. banking organization need not, granting it wide latitude to sponsor, invest in and transact with such Foreign Funds.[17] If any of the Foreign Funds' ownership interests are held by "residents of the United States" (a term defined with reference to the definition of "U.S. person" under the SEC's Regulation S), then that Foreign Fund must be treated as a Covered Fund by all banking entities (assuming it relies on Section 3(c)(1) or 3(c)(7) of the ICA to avoid registration in the United States), even non-U.S. banks. It may be possible, however, for an SPV to retain its Foreign Fund status even if it has some U.S. investors, provided that those investors' stakes are not "ownership interests."

We expect to see an increase in "Reg S for Life" or "Super Reg S" provisions in securitizations and repackaging documentation in order to preclude U.S. persons

[14] As discussed in more detail below, the Foreign Fund prong significantly advantages non-U.S. banking organizations over their U.S. competitors in many respects. From the perspective of a non-U.S. banking organization, a Foreign Fund is not a Covered Fund, and the organization may sponsor, invest in and transact with the Foreign Fund without any Volcker Rule concerns. U.S. banking organizations do not enjoy that flexibility.

[15] To do so, however, the SPV would have to abide by the strict limitations contained in Section 3(c)(5) or Rule 3a-7, which many repackagings and actively managed CLOs, among others, may find difficult to achieve. Among other things, complying with Section 3(c)(5) or Rule 3a-7 would significantly limit the degree to which a repackaging or CLO may utilize derivatives to alter cash flows or purchase and sells pool assets.

[16] Throughout this note, we refer to any banking organization headquartered outside of the United States as a "non-U.S. banking organization" while we refer to a U.S.-headquartered organization, including its non-U.S. banking entity affiliates, as a "U.S. banking organization."

[17] The Foreign Fund prong may grant U.S. banking organizations some relief as well. Only foreign SPVs that "raise[] money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities" are caught by the Foreign Fund prong of the Covered Fund definition. A U.S. banking organization may be able to get comfortable that a foreign SPV that engages in certain limited activities is not investing securities for resale or trading in securities, and thus is not a Covered Fund. How this provision will be interpreted by the market and by the regulators over time remains to be seen.

from owning the securities issued by SPVs.[18] While the SOTUS Exception grants non-U.S. banks the ability to sponsor and invest in SPVs "solely outside the United States," most non-U.S. banks would be more likely to seek to classify an SPV as a Foreign Fund to avoid the consequences of treating it as a Covered Fund subject to the Super 23A Restrictions.

Carve-outs from the Covered Fund definition

Even if an SPV would otherwise be within the definition of Covered Fund, the Final Rule contains a number of carve-outs from the definition that may allow the vehicle to avoid treatment as a Covered Fund. While the Final Rule creates 13 such carve-outs, three of them are of particular interest here.

Loan securitizations

Most prominent among the carve-outs from the Covered Fund definition is the Final Rule's exception for traditional loan securitizations. Under the exception, an SPV will not be a Covered Fund if its assets are limited to the following:

Permissible assets for loan securitization exception
> loans and other receivables (including, among others, credit card receivables, mortgages, student loans, leases, etc., but excluding securities or derivatives);[19]
> servicing rights and other related assets;
> interest rate or foreign exchange swaps that reduce the SPV's risks related to the securities it issues or to its assets, and that meet other criteria; and
> special units of beneficial interest and collateral certificates the issuer of which meets certain criteria and that are used to transfer the economic risks and benefits of assets that are permissible for loan securitizations, that are created to satisfy legal requirements, or that facilitate the structuring of the loan securitization.

This definitional exception permits a banking entity to sponsor, invest in and transact with a number of "plain vanilla" securitization vehicles. Because of the limited categories of permissible assets, however, it will not permit such interactions with anything more exotic, including many repacks (although loan-

[18] Under the normal application of Regulation S, after the distribution compliance period ends, securities may end up in the hands of U.S. investors. Under "Reg S for Life" or "Super Reg S" contractual restrictions are included which go beyond the ordinary restrictions of Regulation S and which operate to completely exclude U.S. person investors. This is one way to ensure contractually that a Foreign Fund has no U.S. person investors.

[19] It is worth noting that the term "loan" is rather broadly defined and sweeps within it a broad variety of receivables that are typically used as pool assets in securitization transactions. The Agencies noted that whether a particular instrument is a security or derivative would be based on a "facts and circumstances" determination under the federal securities laws and the Commodity Exchange Act. Final Rule Supp. Mat. at 540-43.

only repacks would not be precluded), most CLOs (as they typically contain bond buckets) and CDOs, synthetic securitizations and most re-securitizations.

Asset-backed commercial paper conduits

The Final Rule also provides a carve-out from the Covered Fund definition for an asset-backed commercial paper conduit, though only if:

- the conduit's assets are limited to (1) assets permissible for loan securitizations and (2) asset-backed securities issued by an SPV holding only assets that are permissible for loan securitizations, provided that the conduit purchased the securities in the SPV's initial issuance of securities;
- the conduit issues only asset-backed securities comprised of a residual interest and securities with a maturity of 397 days or less; and
- a "regulated liquidity provider" (*e.g.*, a U.S. or non-U.S. bank, a bank holding company, etc.) is legally bound to provide "full and unconditional liquidity coverage" with respect to all of the securities issued by the conduit.

Foreign covered bond programs

For non-U.S. banking organizations that issue covered bonds, the Final Rule also provides a carve-out from the Covered Fund definition for an SPV that holds the cover pool of assets, provided that the covered bonds are backed by an appropriate payment guarantee from the cover pool. The cover pool may only be comprised of assets permissible for loan securitizations, such as mortgage loans. However, the limitation to assets that would eligible for the loan securitization exemption is noteworthy in that it would preclude cover pools comprised of things like residential mortgage-backed securities. This exception is not available to U.S. banking organizations.[20]

The Final Rule provides a number of additional carve-outs from the Covered Fund definition which we do not discuss here because of their limited application in the securitization and structured products context.[21]

What is an ownership interest?

Even if an SPV is a Covered Fund, a banking entity may avoid application of the Volcker Rule if its activities are limited to making investments in securities issued by the SPV that are not "ownership interests." The definition of "ownership interests" is an important one with respect to securitizations and structured

[20] Oddly enough, this seems to vitiate previous efforts to create a product equivalent to covered bonds in the United States.

[21] Specifically, the Final Rule carves-out foreign public funds (e.g., UCITS), wholly-owned subsidiaries, joint ventures, acquisition vehicles, foreign pension or retirement funds, insurance company separate accounts, bank-owned life insurance, small business investment companies and public welfare investment funds, investment companies registered with the SEC, and entities formed in conjunction with an FDIC receivership or conservator ship.

products since some tranches of the notes issued by an SPV may be "ownership interests" even if others are not, thus, making those that are not ownership interests eligible for investment by any banking entity.

An ownership interest is any interest in a Covered Fund that, on a current, future or contingent basis:
> has the right **to participate in**[22] the selection or removal of a general partner, board member, investment manager or similar entity (excluding the rights of a creditor to exercise remedies upon default or acceleration);
> has the right under the interest's terms to receive a share of the Covered Fund's income, gains or profits;
> has the right to receive the Covered Fund's underlying assets after all other interests have been redeemed or paid in full (excluding creditors' default or acceleration rights);
> has the right to receive all or a portion of excess spread;
> provides under the interest's terms that the amounts payable by the Covered Fund could be reduced based on losses arising from the underlying assets of the Covered Fund;[23]
> 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;[24] or
> is a synthetic right to have or receive any of the rights listed above.

The Agencies discussed the application of this definition to securitization interests extensively, indicating that the term "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."[25] This could nevertheless be problematic for many tranches of securitizations, including the traditional equity tranche (e.g., the

[22] Mere participation is enough to trigger this limb even if such participation does not grant control over the process.

[23] The Agencies emphasized that this prong "does not refer to any reduction in the stated claim to principal or interest of a holder of an interest that occurs either as a result of a *bona fide* subsequent renegotiation of the terms of an interest or as a result of a bankruptcy, insolvency, or similar proceeding." While it is not free from doubt, we believe that a fixed income instrument with payments that are in arrears would not be caught by this prong unless the amount of principal or interest owned under the instrument was automatically written down in the event of losses by the SPV in some way beyond the usual extinguishment provisions in limited recourse transactions. Thus, merely because an instrument is PIKable should not make it an ownership interest. Likewise, instruments bearing a stated yield either expressed as a fixed percentage or a floating amount fixed by reference to an external benchmark should not be caught on the basis of the loss-sharing element. Conversely, notes with a yield expressed as a percentage of the profits earned on the underlying assets or with a yield expressed as a sliding scale based upon the underlying may be much more problematic.

[24] The Agencies give as an example of something that would not be caught by this a loan with a step-up coupon on an NAV trigger. Final Rule Supp. Mat. at 611.

[25] Final Rule Supp. Mat. at 608.

subordinated notes or preference shares in CLOs and CDOs) and any other tranches having the right to participate in things like selecting the investment adviser. In some instances, this could mean even senior classes of rated debt in securitizations could, by virtue of having various control rights or loss sharing, be considered ownership interests. This definition could also be problematic for structured products, including repackagings, which are often issued in a single tranche and which often give the holders of beneficial interests the right to receive the issuing vehicle's underlying assets.

To the extent that an SPV issues multiple tranches, banking entities must consider whether the securities of each tranche are "ownership interests." To avoid application of the Volcker Rule, banking entities may be able to ensure that tranches they hold are not ownership interests by amending the terms of the interests they hold before the end of the "conformance period."

What is a sponsor of a Covered Fund?

Sponsorship of a Covered Fund carries a particularly onerous burden with it – a banking entity may not enter into any "covered transactions" with a Covered Fund that it sponsors.

Sponsorship of a Covered Fund means:
> serving as a general partner, managing member or trustee of a Covered Fund, or serving as the commodity pool operator of a Covered Fund caught by the Commodity Pool Prong;
> selecting or controlling, in any manner (or having employees, officers, directors or agents constitute) a majority of the directors, trustees or management of a Covered Fund; or
> sharing with the Covered Fund the same name or a variation thereof for corporate, marketing, promotional or other purposes.

Several commenters on the Proposed Rule had argued that, in light of the many roles that banking entities play with respect to SPVs, the Agencies should adopt a separate definition of "sponsor" for securitizations. The Agencies declined to do this, instead requiring any banking entity arranging, servicing or otherwise involved with a securitization to determine whether its activities come within the definition.

The Agencies did, however, provide some guidance that may help minimize the reach of the "sponsor" definition. First, the definition of "trustee" for purposes of the "sponsor" definition excludes any "trustee that does not exercise investment discretion" with respect to an SPV's assets.[26] In situations in which a banking entity merely executes the decisions of a third party or irrevocably delegates

[26] Final Rule Text § __.10(d)(10).

discretionary authority, its activities would not constitute sponsorship. Although the matter is not free from doubt and will depend on the particular facts and circumstances of any given transaction, in the case of a typical cash CLO, we would not generally expect the underwriter to be considered the sponsor inasmuch as the investment adviser is usually the one making all the relevant decisions. Similarly, certain repackaging and structured product SPVs have a trustee that lacks any investment discretion with respect to the SPV's pool assets; such a trustee would not be considered a sponsor.[27]

Second, the Agencies also stated that a banking entity's status as sponsor may change as its role with respect to an SPV changes. As an example, the Agencies indicated that a banking entity that selects the initial board of directors of a Covered Fund would cease to be a sponsor once its authority to appoint directors terminates, which the Agencies indicated would occur at the point of the first re-selection of a self-perpetuating board or first shareholder election of directors.[28] A banking entity's former position vis-à-vis the Covered Fund ceases to become relevant once its role changes. It is unclear, however, how this may impact a securitization or structured product SPV in which an arranger or underwriter appoints the initial trustee but that authority is subsequently transferred to another party since a trustee's term may be indefinite.

Particular issues under the Final Rule for repackagings

Under the Final Rule, a banking entity's involvement in the arrangement of repackagings could prove particularly problematic. The Super 23A Restrictions could make many repacks virtually impossible to conduct by limiting a banking entity's ability to transact with a repack vehicle, in particular its ability to enter into swaps with the vehicle. However, there are several avenues by which an arranger may be able to avoid the constraints of the Volcker Rule.

Inasmuch as repackaging vehicles typically rely on Section 3(c)(7) of the ICA to avoid registration as an investment company, at least to the extent that they are offered to U.S. investors, many are likely to be Covered Funds. However, non-U.S. banking organizations could sponsor and invest in repack vehicles without U.S. investors (or in which U.S. investors only hold securities that do not qualify as "ownership interests"). As most repack vehicles utilize swaps to some extent, they must also be conscious in structuring not to get caught by the Commodity Pool Prong of the Covered Fund definition, although for most vanilla repacks, this should not be too difficult.[29]

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[27] Thus, a traditional indenture trustee in most securitizations should not be caught by this element. It is unclear whether having the ability to choose cash equivalent investments intra period would rise to the level of being problematic.

[28] Final Rule Supp. Mat. at 631-32.

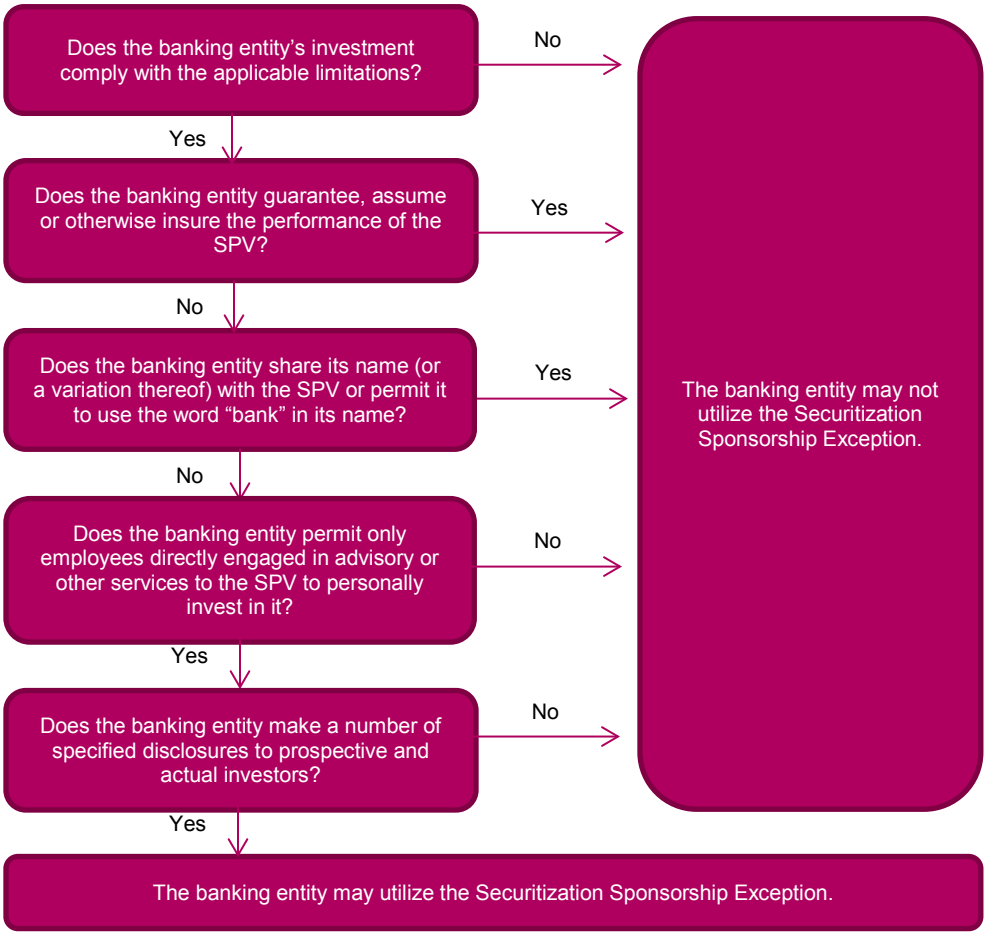
[29] The CFTC has provided relief from the definition of "commodity pool" with respect to certain repack vehicles. *See* discussion in note 13. We note that the Commodity Pool Prong would not capture Foreign Funds because such funds lack U.S. investors and are organized offshore.

Theoretically, a banking entity arranger may also limit its role with respect to a repack vehicle in order to prevent itself from being considered a sponsor. By doing so, and assuming that the banking entity could not separately be considered an investment adviser to the vehicle, it could avoid the Super 23A Restrictions, though it would still have to find an exception if it wishes to invest in the repack vehicle.

Exceptions permitting a banking entity to sponsor or invest in an SPV if it is a Covered Fund

The Final Rule provides a number of exceptions to the prohibition on covered fund sponsorships and investments that are available to a banking entity even if a particular SPV is a covered fund. These exceptions do not, however, permit a banking entity that sponsors (or serves as investment adviser to) such a fund to avoid the application of the Super 23A Restrictions. As a result, while a banking entity may find itself able to sponsor an SPV, it will not be able to extend credit, conduct derivative transactions with, or otherwise enter into "covered transactions" with that SPV. This could prove prohibitive for certain securitization and structured product activities.

Securitization Sponsorship Exception



The Securitization Sponsorship Exception permits a banking entity to sponsor and invest in a Covered Fund that issues asset-backed securities, though it places significant limits on such investments. It does not permit a banking entity to invest at all in an SPV sponsored by a third party, but it is available to U.S. banking entities and, for non-U.S. banking entities, permits sales to U.S. persons.

To utilize the Securitization Sponsorship Exception, a banking entity:

> must limit its investment in the sponsored SPV to seeding and *de minimis* investments, as described below;

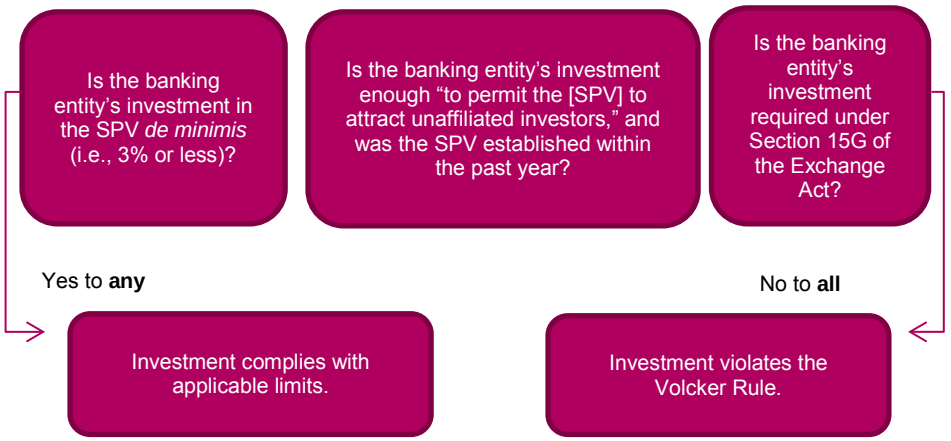
> cannot guarantee, assume or otherwise insure the performance of the SPV;

> for marketing purposes, cannot share its name (or a variation thereof) with the SPV or permit it to use the word "bank" in its name;

> may permit only employees directly engaged in advisory or other services to the SPV to personally invest in it; and

> must make a number of specified disclosures to prospective and actual investors.

Limitations on investments



A banking entity may invest in an SPV sponsored under the Securitization Sponsorship Exception (or, for that matter, the Asset Management Exception) in an amount up to the greater of:[30]

> three percent of the total number or value of the outstanding ownership interests of the SPV;

> the amount that the banking entity is required to retain under risk retention rules established pursuant to Section 15G of the Securities Exchange Act of 1934, though in a lack of recognition of what is occurring

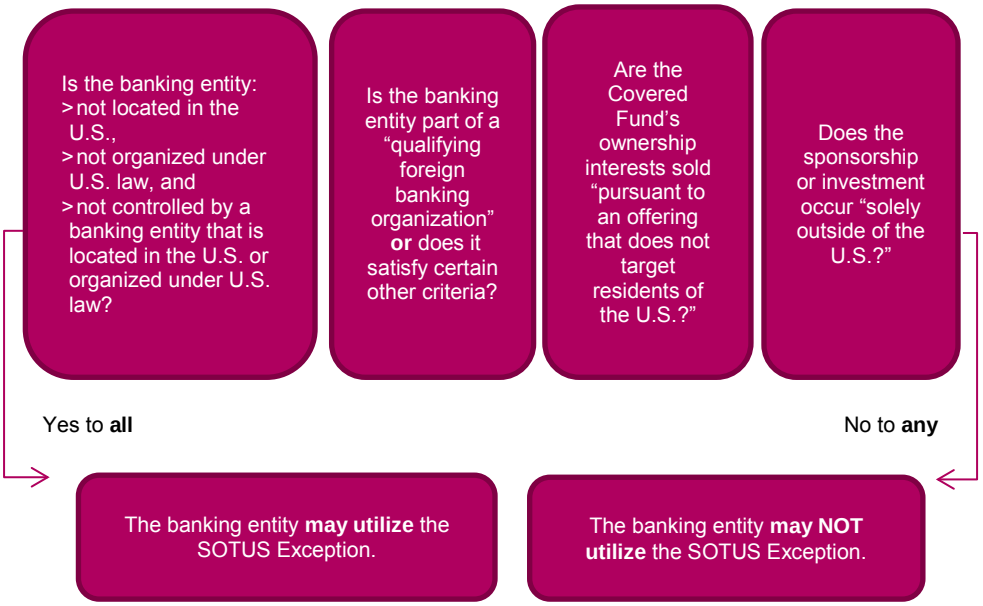
[30] The Final Rule contains extensive guidance on the measurement of investments for purposes of determining whether these thresholds are exceeded.

outside of the United States, there is no similar carve-out for compliance with the requirements of non-U.S. risk retention requirements; or

> an amount sufficient "to permit the [SPV] to attract unaffiliated investors," provided that the banking entity actively seeks such unaffiliated investors and, within one year of the SPV's establishment, reduces its share of the vehicle's ownership interests to either three percent or the amount required under Section 15G.

In addition to these per-fund limitations, banking entities are subject to overall limits on their investment in all Covered Funds. Specifically, a banking entity's aggregate investment in Covered Funds may not exceed three percent of its tier 1 capital, to be measured on the last day of each calendar quarter.

SOTUS Exception for non-U.S. banks



Given the exception to the Covered Fund definition for Foreign Funds, the SOTUS Exception may appear to be largely unnecessary. However, there are certain circumstances in which the SOTUS Exception remains useful, such as when a non-U.S. bank wishes to sponsor or invest in an SPV organized in the United States. Under the SOTUS Exception, a banking entity may sponsor or invest in a securitization vehicle that is a Covered Fund if:

> the banking entity is not located in the United States, is not organized under U.S. law, and is not controlled by a banking entity that is located in the United States or organized under U.S. law;

- the banking entity is part of a "qualifying foreign banking organization"[31] (as defined in the Fed's Regulation K) or satisfies certain other criteria;
- the Covered Fund's ownership interests were sold "pursuant to an offering that does not target residents of the United States" (emphasis added); and
- the sponsorship or investment occurs "solely outside of the United States."

For purposes of the SOTUS Exception, a U.S. branch or affiliate of a non-U.S. bank, along with any non-U.S. subsidiaries of such an affiliate, is considered to be located in the United States, though the home office is not.

Targeted at residents of the United States

The text of the Final Rule does not specify when an offering of an SPV's ownership interests "target[s]" residents of the United States. The Agencies did indicate that the sponsor of an SPV would not be considered to be targeting U.S. residents if:

- it conducts the offering to residents of countries other than the United States;
- the offering materials contain a prominent disclaimer that the securities are not being offered in the United States or to U.S. residents; and
- it implements other reasonable procedures to restrict access to offering materials only to non-U.S. residents.[32]

The Agencies left significant ambiguity concerning whether a banking entity may rely on the SOTUS Exception if such ownership interests end up in the hands of U.S. residents as a result of secondary market transactions. The Agencies indicate that secondary market transactions could be conducted "by the banking entity" in accordance with Regulation S if the ownership interests are listed on a foreign exchange. The Agencies do not provide analogous guidance to non-banking entities. It is, thus, possible that an SPV may initially be targeted outside of the United States, but ultimately, as a result of secondary market transactions, have some of its ownership interests held by U.S. residents without eliminating a non-U.S. bank's ability to invest in the fund under the SOTUS Exception.

The definition of "ownership interest" again comes into play under the SOTUS Exception. A non-U.S. banking entity could market an SPV's securities that are not ownership interests to U.S. residents without stripping it of access to the SOTUS Exception. The relevant question is not where all of the SPV's securities go, but rather where those securities constituting an ownership interest are

[31] A "qualifying foreign banking organization" is a foreign banking organization that meets certain criteria concerning the location of its assets and/or the sources of its revenues and net income.

[32] Final Rule Supp. Mat. at 743-44. The Final Rule specifies that conducting a private placement of securities in the United States would be considered "targeting" U.S. residents. *Id.* at 744 n. 2448.

targeted. Sponsoring banking entities should analyze each tranche of securities to determine to which countries they may be marketed under the Final Rule.

Solely outside of the United States

Under the Final Rule, a sponsorship of or investment in an SPV will occur "solely outside of the United States" if:

> the banking entity (and its relevant personnel) making the decision to sponsor or invest in the SPV is not located in the United States or organized under U.S. law;

> the investment or sponsorship is not accounted for as principal on a consolidated basis by any branch or affiliate located in the United States or organized under U.S. law; and

> no branch or affiliate located in the United States or organized under U.S. law provides financing for the investment or sponsorship.

In the securitization and structured products context, this essentially means that a non-U.S. bank's U.S. operations cannot be involved in any of the decision making in connection with a sponsorship or investment conducted under the SOTUS Exception, although U.S. personnel may provide certain back office support. Nor would a non-U.S. bank be able to rely on its U.S. affiliates or branches to provide financing or a liquidity facility in support of a transaction.

Conflicts of interest

Any sponsorship or investment of an SPV that is a Covered Fund by a banking entity pursuant to the Securities Sponsorship or SOTUS Exceptions must comply with a requirement that "material conflicts of interest" be avoided. Such a conflict occurs under the Final Rule when, as a result of transactions or activity, the banking entity's interest is materially adverse to the interests of its client, customer or counterparty. Given that many securitizations or structured products may result in a sponsor's interests diverging to some extent with those of investors, this prohibition could potentially bar many such transactions.

However, a banking entity can engage in transactions giving rise to a conflict of interest if it provides timely and effective disclosure or establishes information barriers to prevent the conflict of interest. The degree to which this disclosure requirement imposes any greater obligations under existing securities laws remains to be seen. Of course, to the extent the SEC's proposed Rule 127B[33] implementing Section 621 of the Dodd-Frank Act is ultimately adopted as a final rule, the conflicts issue may become a moot point regardless of any disclosure cure.

[33] http://www.sec.gov/rules/proposed/2011/34-65355.pdf. Proposed Rule 127B would, among other things, preclude the sponsor of an asset-backed security from engaging in any transaction within one year from the date of the first closing of the sale of the asset-backed security that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

Compliance timeline

By its statutory terms, the Volcker Rule became effective on July 21, 2012, but is subject to a two-year "conformance period" during which banking entities must bring their activities into line with the Volcker Rule's requirements. On the same day that the Agencies issued the Final Rule, the Fed granted a one-year extension of the conformance period, giving banking entities until July 21, 2015[34] to fully conform their activities, although certain of the Final Rule's reporting requirements commence as early as July 2014.[35]

Documentation requirements

Banking entities that have more than $10 billion in total consolidated assets are also subject to various compliance program requirements, part of which includes new documentation and recordkeeping requirements with respect to a banking entity's fund activities. Specifically, banking organizations that exceed the $10 billion asset threshold must have records evidencing the eligibility for any fund to be excluded or exempted from the Covered Fund definition. The Agencies indicated that these new documentation requirements will be used to prevent evasion of the Volcker Rule, and to facilitate their monitoring of how the various exclusions and exemptions to the Covered Fund ban are utilized and whether they are appropriate.

The path forward

Banking entities around the world have until July 21, 2015 to bring their securitization and structured product activities into conformance with the Final Rule. There is no "grandfathering" of existing deals – to the extent that a banking entity's current sponsorship of, investment in or transactions with an SPV violates the Final Rule, the banking entity must either cease or modify its activity. For U.S. banking organizations, this will likely mean selling positions in many securitizations and structured products, unless the banking organization is comfortable that the securities it holds are not "ownership interests." U.S. banks must also ensure that future sponsorship of such vehicles conforms with either the definitional carve-outs for loan securitizations or asset-backed commercial paper conduits, or abides by the requirements of the Securitization Sponsorship Exception, including its relatively low investment limits.

Non-U.S. banking organizations have significantly more flexibility. Offshore SPVs without U.S. investors (or in which U.S. investors only hold interests that are not "ownership interests") will likely require no modification to comply with the Final Rule since they will not be Covered Funds. In the event that an offshore SPV does have holders of "ownership interests" that are U.S. investors, the terms of those interests could be modified to allow the SPV to escape the Covered Fund

[34] The Fed is empowered to grant two additional extensions of the conformance period of one year each either to individual banking entities or on an industry-wide basis.
[35] Final Rule Text § __.20(d)(2).

definition. Even if an SPV remains a Covered Fund, a non-U.S. banking organization may be able to limit its role such that it does not come within the definition of "sponsor" or may be able to rely on the SOTUS Exception to sponsor and invest in the SPV, though its transactions with such an SPV would then be limited by the Super 23A Restrictions.

Conclusion

The market has already been impacted by the Volcker Rule. For example, in the securitization space, some U.S. regional and community banks have announced that the Final Rule has required or will require them to divest their position in CDOs backed by trust-preferred securities ("**TruPS CDOs**").[36] A banking industry group (along with several banks) has even filed a lawsuit against the Agencies seeking to invalidate the application of the Final Rule to TruPS CDOs,[37] along with a broader appeal seeking to invalidate the entire Final Rule.[38] In response, the Agencies first issued guidance specifying the circumstances under which a banking entity may need to sell out of a TruPS CDO position,[39] and subsequently announced that they were reconsidering the application of the Final Rule to banks' holdings of TruPS CDOs altogether.[40] How this issue is resolved may provide vital clues as to how flexible the Agencies will be in adapting the Final Rule to market realities. In the structured products space, banks are also re-evaluating the economics provided by swaps that may be present in a particular structure, in part to allow the issuing SPV to rely on ICA Rule 3a-7 as their exception from the definition of "investment company" rather than the more traditionally used ICA Section 3(c)(7).

Importantly, there remain a number of ambiguities with respect to how the Final Rule will apply in the securitization and structured products context that may make finding a "crystal clear" answer to some interpretive questions difficult. How the Agencies and the market ultimately interpret the Final Rule will likely take time to work out, and the ultimate implementation may be a product of prevailing market practice and as-yet-unreleased guidance from the Agencies.

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[36] *E.g.,*Matthew Goldstein, *Volcker Rule Quickly Hits Utah Bank*, N.Y. Times (Dec. 16, 2013), *available at* http://dealbook.nytimes.com/2013/12/16/regional-bank-says-it-will-take-charge-because-of-volcker-rule/?_r=0; BusinessWire, *WashingtonFirst Bankshares, Inc. Announces Disposition of Securities in Response to Volcker Rule* (press release) (Dec. 26, 2013), *available at* http://www.businesswire.com/news/home/20131226005150/en/WashingtonFirst-Bankshares-Announces-Disposition-Securities-Response-Volcker.

[37] The lawsuit, filed by the American Bankers Association, is available at http://www.aba.com/Issues/Documents/12-24-13ABAComplaintforDeclaratotryandInjunctiveReliefonVolckerRule.pdf.

[38] The American Bankers Association's petition for review of the Final Rule is available at http://www.aba.com/Issues/Documents/12-24-13ABAComplaintforDeclaratotryandInjunctiveReliefonVolckerRule.pdf.

[39] *See* FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Final Volcker Rule (Dec. 19, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131219d1.pdf.

[40] *See* Statement Regarding Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities under the Rules Implementing Section 619 of the Dodd-Frank Act (Dec. 27, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131227a1.pdf.

There remains more than a year and a half before the end of the conformance period, but banks face a number of challenges in that time, from modifying their trading operations to revamping their asset management businesses and investments to developing a new compliance and reporting regime. With respect to securitizations and structured products, existing approaches may require some modification in order to permit banks to continue sponsoring and investing in SPVs after July 21, 2015. Further, existing SPVs may need to be modified or restructured so that they are not considered Covered Funds, or terms of interests in those SPVs may require change so that they are not considered "ownership interests," so that existing investments may continue.

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If you have any questions, please contact the people on the right or your usual Linklaters contacts.

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A banking entity includes:

FDIC-insured depository institutions;

U.S. bank holding companies;

Foreign banks with a U.S. branch or agency; and

Any affiliates of the foregoing around the globe.

Sponsorship of a Covered Fund means:

serving as a general partner, managing member or trustee of a Covered Fund, or serving as the commodity pool operator of a Covered Fund caught by the Commodity Pool Prong;

selecting or controlling, in any manner (or having employees, officers, directors or agents constitute) a majority of the directors, trustees or management of a Covered Fund; or

sharing with the Covered Fund the same name or a variation thereof for corporate, marketing, promotional or other purposes.

An ownership interest is any interest in a Covered Fund that:

has the right to participate in the selection or removal of a general partner, board member, investment manager or similar entity (excluding the rights of a creditor to exercise remedies upon default or acceleration);

has the right under the interest's terms to receive a share of the Covered Fund's income, gains or profits;

has the right to receive the Covered Fund's underlying assets after all other interests have been redeemed or paid in full (excluding creditors' default or acceleration rights);

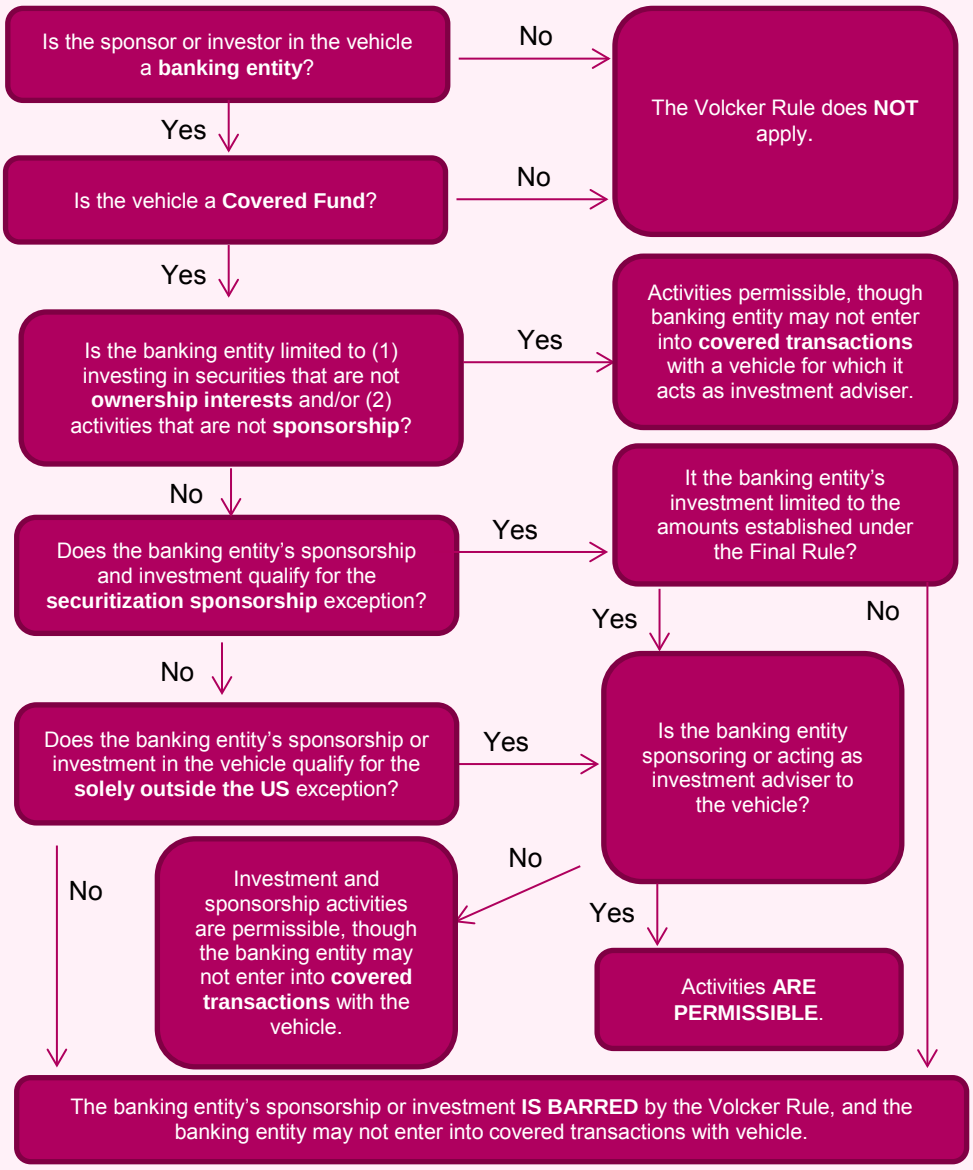
has the right to receive all or a portion of excess spread;

provides under the interest's terms that the amounts payable by the Covered Fund could be reduced based on losses arising from the underlying assets of the Covered Fund;

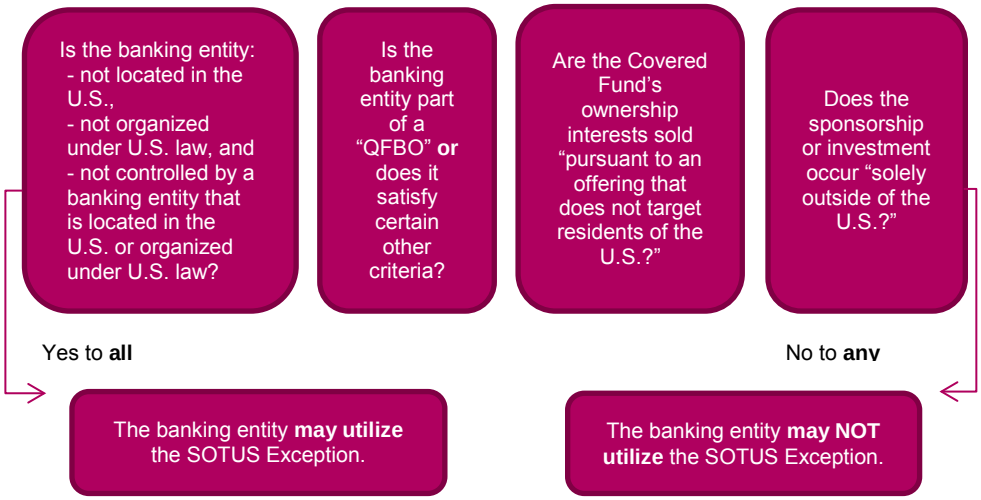
receives income on a pass-through basis from the Covered Fund or has a rate of return that is determined by reference to the performance of the underlying assets of the Covered Fund; or

is a synthetic right to have or receive any of the rights listed above.

Covered Fund Ban Analysis



SOTUS Exception for non-U.S. banks



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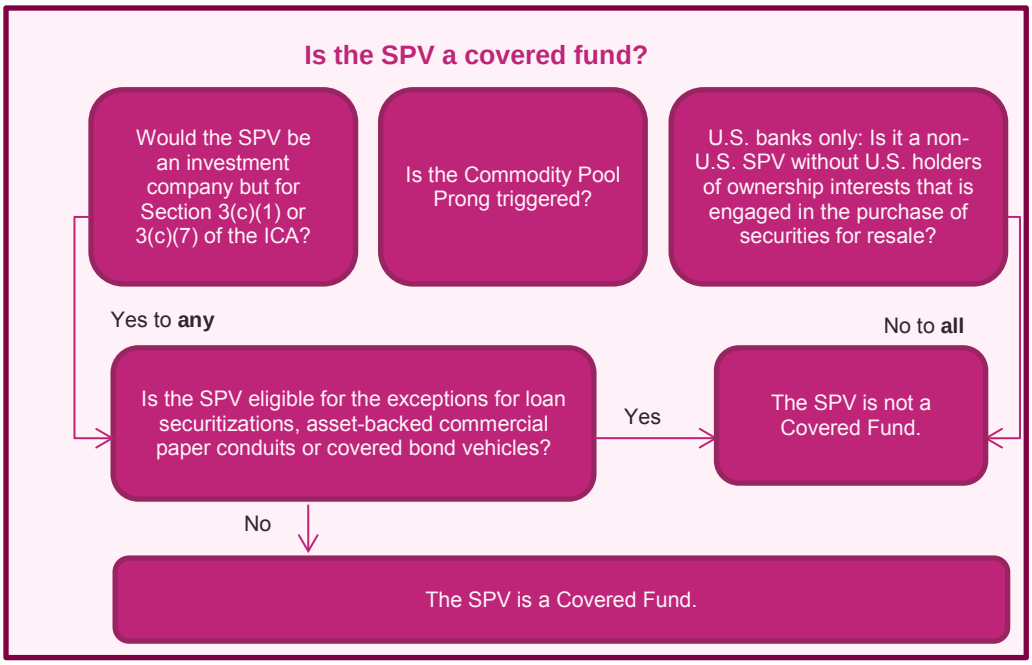
A Covered Fund is …

an SPV that would be an investment company but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "**ICA**");

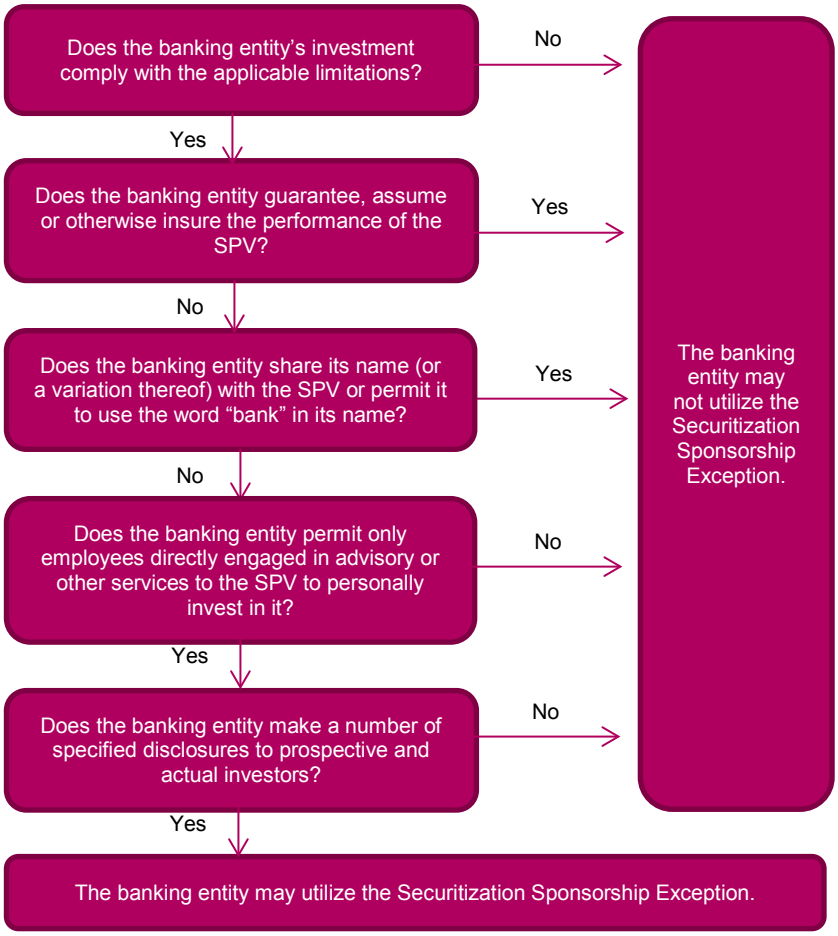
an SPV that is a commodity pool the operator of which either (1) is exempt from registration under CFTC Regulation 4.7, or (2) is registered with the CFTC and substantially all of the participation units of the pool were offered to and are owned by "qualified eligible persons" (as defined in Regulation 4.7) (the "**Commodity Pool Prong**"); and

for U.S. banks only, an SPV organized or established outside of the United States the ownership interests of which are offered or sold solely outside of the United States and which is, or holds itself out as, an entity that "raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities" (a "**Foreign Fund**").

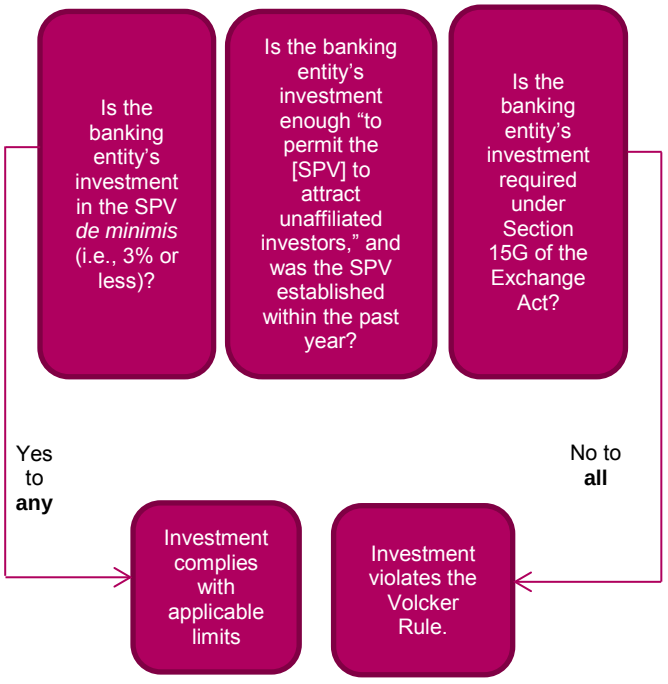
Is the SPV a covered fund?



Securitization Sponsorship Exception



Limitations on Investments



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