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The Volcker Rule's Impact on CLO Issuances and other Securities Offerings

Section 619 of the Dodd-Frank Wall Street Reform Act of 2010[1] (the "Dodd-Frank Act") – commonly known as the "Volcker Rule" – adds a new section 13 to the Bank Holding Company Act of 1956, as amended, and prohibits "banking entities" (including US banking organizations and foreign banking organizations with a branch or agency in the United States and their US and non US subsidiaries and affiliates) from engaging in proprietary trading financial instruments, or from acquiring or retaining "ownership interests", in "covered funds", subject to certain exceptions.

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The Volcker Rule is a key component of the US financial reform program under the Dodd-Frank Act, and represents a significant change in US financial regulation. In the context of capital markets transactions, the Volcker Rule's requirements have given rise to certain restrictions on trading, particularly in connection with issuers relying on certain exemptions under the Investment Company Act of 1940[2] (the "IC Act").

This Insight offers an overview of the key provisions of the Volcker Rule that relate to capital markets issuers that may fall within the definition of an "investment company" for purposes of the IC Act. The overview is presented in a question-and-answer format to provide easy access to the issues of most interest to issuers subject to the Volcker Rule.

What entities are subject to the Volcker Rule?

The Volcker Rule governs "banking entities", which include (i) any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company ("BHC") under Section 8 of the International Banking Act of 1978[3] (the "IB Act"); and (iv) any affiliate or subsidiary of any such company.

Notably, the Volcker Rule excludes certain subsidiaries and affiliates that would otherwise fall within the definition of "banking entity". In particular, a banking entity does not include any portfolio company held by a BHC under the merchant banking authority of the BHC Act[4] and any portfolio concern controlled by a small business investment company, so long as the portfolio company or portfolio concern is not a banking entity other than as a result of its subsidiary relationship with the BHC or small business investment company[5]. Additionally, any "covered fund" is excluded from the definition of banking entity, if such covered fund would not fall within the definition but for its affiliate/subsidiary relationship with another banking entity.

1 Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).
2 15 U.S.C. 80a-1 et seq.
3 12 U.S.C. 3106.
4 12 U.S.C. 1843(k)(4)(H), (I).
5 As defined in the Small Business Investment Act of 1958 (15 U.S.C. 662).

What is the relationship between a "Covered Fund" and the IC Act?

The Volcker Rule's definition of "covered fund" includes any issuers that would otherwise fall within the definition of an "investment company" under the IC Act but for reliance on the exemptions provided in Sections 3(c)(1) and 3(c)(7) thereof. The IC Act (and rules enacted thereunder) have established criteria for the determination of whether an issuer qualifies as an "investment company", including the proportion of its total assets that is derived from investment securities (other than US government securities).

Section 3(c)(1) of the IC Act exempt from the definition of "investment company" any issuer whose outstanding securities are beneficially owned by no more than 100 persons. Section 3(c)(7) provides an exemption for issuers whose outstanding securities are owned exclusively by persons who, at the time of the acquisition of such securities, are "qualified purchasers" (as defined in the IC Act). These exemptions are commonly referred to as the private fund exemptions.

In other words, an issuer that is exempted from the definition of "investment company" for purposes of the IC Act's registration requirements because it limited fund shareholders as required by sections 3(c)(1) or 3(c)(7) is a private equity or hedge fund that is a "covered fund" under the Volcker Rule. However, if an issuer that would rely on either section 3(c)(1) or 3(c)(7) and is able to rely on any other IC Act exemption (e.g., the IC Act's exemptions for commercial banks and insurance companies[6], asset backed securitizations, or pension and profit-sharing plans[7]), then the issuer is deemed not to fall within the definition of "covered fund".

Further, with respect to US banking entities[8], the Volcker Rule's definition of "covered fund" includes any issuer that:

- Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;
- Holds itself out as an entity that raises money from investors primarily for the purpose of investing in securities for resale, disposition or trading; and
- Has that banking entity (or its affiliate) as its sponsor, or has issued an ownership interest owned directly or indirectly by that banking entity (or its affiliate).

A US branch or agency of a foreign bank is treated as a US entity for this purpose, but the foreign bank is not. The Volcker rule definition of covered fund also includes a commodity pool operated by a CFTC-registered commodity pool operator or under an exemption from CFTC regulation.

What securities qualify as Ownership Interests in a Covered Fund?

Under the Volcker Rule, "ownership interests" are defined as any equity, partnership, or other similar interest in a covered fund. The definition is meant to be broadly applied. Criteria to determine whether the terms of a security qualify as "other similar interests" include (i) rights to participate in the selection or removal of management or board members; (ii) rights to receive a share of income, gains or profits of the covered fund; (iii) rights to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full; (iv) rights to receive all or a portion of excess spread between interest received on the covered fund's underlying assets and interest paid to security holders; (v) provisions to reduce the interest payable under the security based on losses arising from the underlying assets of the covered fund; (vi) receiving income on a pass-through basis or determined by the performance of the covered fund's underlying assets; and (vii) any synthetic right to have, receive, or be allocated any such rights above.

A security issued by a covered fund is excluded from the definition of "ownership interest" if it qualifies as a restricted profit interest. The security holder will be deemed not hold an ownership interest in the covered fund if (i) the sole purpose of the interest is to allow the holder to share in the profits of the covered fund as performance compensation for an advisory service; (ii) all such profit is either distributed to the security holder promptly after being earned or retained for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses (and such undistributed profit does not share in the covered fund's subsequent investment gains); (iii) any amounts invested or paid by the security holder into the covered fund in connection with the profit interest are "permitted investment" in the covered fund[9]; and (iv) the interest is not transferable by the security holder to related parties (except to an affiliate of the security holder, or to an employee of the security holder or such affiliate) or to other unrelated parties that provide advisory services to the covered fund.

6 IC Act Section 3(c)(3).

7 IC Act Section 3(c)(11).

8 *I.e.*, a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State.

9 Within the meaning of Section 12 of the Volcker Rule.

What implications does the Volcker Rule have on offers made in reliance on Sections 3(c)(1) and 3(c)(7) of the IC Act?

In fund share offerings conducted by issuers in reliance on the section 3(c)(1) or section 3(c)(7) exemptions, the issuer would fall within the definition of a "covered fund" under the Volcker Rule. In these cases, the sponsor of the fund and any prospective investors in the fund must then consider whether they (or their affiliates) are banking entities under the Volcker Rule, and if so, whether an acquisition of fund shares would represent an ownership interest in the issuer.

If the fund shares qualify as ownership interests and no exemption is applicable, banking entities would be unable invest in the fund shares absent compliance with the requirements of the Volcker Rule for excluded or permitted activities. However, it is important to note that many "vanilla" debt securities are not ownership interests for purposes of the Volcker Rule. For instance, the terms of many senior or subordinated bond issuances do not provide voting rights to participate in the selection or removal of persons related to the issuer; payments of principal and fixed or floating rate interest would also not generally be considered a share of the income, gains or profits of the issuer. In such instances where the terms of the security would not be considered an ownership interest, banking entities would be able to participate in the offering as well. Any right to remove the fund manager other than in connection with creditor rights following an event of default would make the note an ownership interest.

How does the Volcker Rule apply to Collateralized Loan Obligations ("CLOs")?

Typically a CLO issuer relies on section 3(c)(7) of the Act to offer CLO interests without registering under that IC Act, and, therefore, the CLO issuer would be a "covered fund." As noted above, a CLO noteholder's exposure to the CLO's profits and losses or through the right of a CLO noteholder to vote on the removal or selection of the collateral manager would make the CLO notes ownership interests of a covered fund.

How do European CLOs address the Volcker Rule?

The European CLO market has sought to address the application of the Volcker Rule in the following manner. Each class of CLO notes is divided into 3 notes: a voting note; a non-voting exchangeable note; and a non-voting note (all of which rank pari passu with each other). A voting note allows the CLO noteholder to vote on the appointment or removal of the collateral manager (a "CM Appointment/Removal Matter") and allows the transferee of such note to elect to hold such note as a voting note, a non voting exchangeable note or a non voting note. A non-voting exchangeable note prohibits the CLO noteholder from voting on a CM Appointment/Removal Matter but allows the transferee of such note to elect to hold such note as a voting note, a non-voting exchangeable note or a non-voting note. A non-voting note prohibits the CLO noteholder from voting on a CM Appointment/Removal Matter and allows a transferee of such note to only hold such note as a non voting note. Once a note is in the form of a non-voting note it may not be exchanged for any other type of note.

Holders of non-voting notes and non-voting exchangeable notes may vote on all other matters that holders of such CLO notes would be entitled to vote on. Many market participants have concluded that a non-voting note or a non-voting exchangeable note would not constitute an ownership interest in a covered fund. However, even if such notes would not constitute ownership interests in a covered fund, some investors (whether subject to the Volcker Rule or not) are reluctant to invest in CLOs using the structure described above because the entitlement to vote on a CM Appointment/Removal Matter may end up being concentrated in the hands of a small subset of CLO noteholders holding the voting notes only. **The Federal Reserve has in the past determined that a non voting share that can at the option of the holder be converted into a voting share is to be treated as a voting share.**

What is the "solely outside the United States" ("SOTUS") Exemption in the context of CLOs?

The Volcker Rule provides an exemption for certain activities by non-US banking entities investing in or sponsoring a covered fund solely outside the United States (the "SOTUS Covered Fund Exemption") if certain conditions are met. One condition is that no ownership interest in such covered fund is offered for sale or sold to a resident of the United States (the "Marketing Restriction"). Market participants questioned whether the Marketing Restriction could be satisfied if a non-US banking entity invested in a covered fund which was offered for sale or sold to a resident of the United States by the fund's sponsor or an unaffiliated third party.

The Federal Reserve Board and other federal financial agencies on 27 February 2015 issued guidance with respect to the Marketing Restriction in the form of Frequently Asked Questions (the "FAQ"). The FAQ makes it clear that the Marketing Restriction applies only to the activities of the non-US banking entity seeking to rely on the SOTUS Covered Fund Exemption and not more generally to the activities of any unaffiliated person offering for sale or selling interests in a covered fund. The practical consequence of this guidance is that any marketing activities to US residents by parties that are unaffiliated with a non-US banking entity seeking to rely on the SOTUS Covered Fund Exemption, including the CLO's sponsor, will not cause the non-US banking entity to fail to satisfy the Marketing Restriction. Consequently, if each of the other requirements of the SOTUS Covered Fund Exemption is satisfied, the non-US banking entity will not be prohibited from investing in any CLO other covered fund under the Volcker Rule. The banking entity sponsoring the CLO cannot rely on the SOTUS exemption if sales target US residents.

What is the timeframe for implementation of the Volcker Rule?

The Volcker Rule will become effective on 21 July 2015 with respect to covered fund ownership interests acquired and sponsorships of covered funds occurring on or after 1 January 2014, and on 21 July 2016 with respect to covered fund ownership interests acquired or sponsorships of covered funds occurring prior to 1 January 2014 ("Legacy Covered Funds"). The Federal Reserve Board announced its intention to grant an additional one-year extension with respect to ownership interests in and sponsorships of Legacy Covered Funds, which would extend the period for covered banking entities to conform their ownership interests in and sponsorship of CLOs constituting Legacy Covered Funds to the Volcker Rule until 21 July 2017.

The above is intended only to form an outline of the basic elements of the Volcker Rule, which will vary on a case-by-case basis. If you are concerned about your particular exposure under this rule, your regular White & Case contact will be pleased to provide you with more information.