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Client Alert

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VOLCKER RULE – LEAKED DRAFT OF PROPOSED RULE OFFERS A POSSIBLE SHOT IN THE ARM TO THE CLO MARKET

Those closely following the implementation of the Volcker Rule received an advanced look at the proposed regulations likely to be issued by four federal agencies this week, made possible by the circulation last week of a 205-page confidential September 30 staff draft of the proposal (the "Draft Proposal"). The Draft Proposal suggests that the agencies can be expected to adopt a reasonable approach to several difficult issues posed by the Volcker Rule's statutory provisions relating to collateralized loan obligation (CLO) transactions while at the same time remaining faithful to the Volcker Rule's objectives.

In brief, the Volcker Rule prohibits any "banking entity" from (i) sponsoring, (ii) acquiring or retaining an ownership interest in or (iii) having certain relationships with, a hedge fund or private equity fund (referred to in the Proposed Draft as a "covered fund").[1]

Under Dodd-Frank, the Volcker Rule defined a "hedge fund" or "private equity fund" as any entity that is exempt from registration under the Investment Company Act of 1940 (the "1940 Act") under Section 3(c)(1) or Section 3(c)(7) of that Act (known as the "100-holder" and "qualified purchaser" exceptions). The Volcker Rule also authorized the Federal banking agencies, the SEC and the CFTC to expand the types of entities that should be treated as hedge funds or private equity funds for these purposes.

Despite language in Dodd-Frank to the effect that nothing in the Volcker Rule should be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law, the Volcker Rule nevertheless raised the specter of significant new burdens on the CLO activities of banking entities by defining as "hedge funds" and "private equity funds" all entities that rely on Sections 3(c)(1) and 3(c)(7) of the 1940 Act, including CLO issuers that bear little resemblance to typical hedge funds and private equity funds. To date, almost all CLO issuers have relied on Section 3(c)(7).

[1] For a more complete discussion of the prohibition, contained in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, see our Client Alert dated August 13, 2010 available at http://www.milbank.com/images/content/6/4/640/081310_DoddFrank_Act_Limits_Investments.pdf

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Based on what we have seen in the Draft Proposal, we are cautiously optimistic that implementation of the Volcker Rule will not impede basic loan securitization transactions. Among other reasons:

- The Draft Proposal explicitly confirms that funds satisfying all of the requirements of Section 3(a)(5) of, or Rule 3a-7 under, the 1940 Act will not be treated as "covered funds". This will be the case even if the fund's offering documents require that the fund comply with the terms of the exemptions in Section 3(c)(1) or 3(c)(7) of the 1940 Act.

  * Static CLO transactions and other CLO transactions with limited ability to realize market value gains or avoid market value losses (and, as such, which may be able to rely on Rule 3a-7 under the 1940 Act) likely should not constitute "covered funds".

- The Draft Proposal excludes from the definition of "covered fund" any fund that relies on Section 3(c)(1) or 3(c)(7) but the assets of which consist entirely of:

  (i) loans,

  (ii) "contractual rights or assets directly arising from those loans supporting the asset-backed securities," and

  (iii) "interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or contractual rights or assets and (B) are used for hedging purposes with respect to the securitization structure."

  The Draft Proposal defines a "loan" as any loan, lease, extension of credit, or secured or unsecured receivable, and characterizes the proposed definition of loan as "expansive". However, the term "loan" will not include:

  * asset-backed securities that are issued in connection with loan securitizations or otherwise are backed by loans;

  * credit default swaps; and

  * bonds or other securities.

  Thus synthetic securitizations, CLO transactions that include any synthetic assets, such as credit default swaps, CLO transactions that include bond buckets and CLO-squared transactions (among other transaction types) are likely not to fall into this loan securitization exception.

  Left unclear in the Draft Proposal are other, technical details regarding compliant loan securitization transactions, including (A) whether securities received in a distressed exchange or otherwise could be retained by the CLO issuer, (B) whether cash proceeds of loan assets may be invested in short-term cash equivalents, including government bonds, commercial paper and other customary highly-rated short term eligible investments that may not be categorized as "loans" under the rule and (C) whether other de minimis exceptions to cover loan-like situations that arise in the ordinary course will be permitted.

- The Draft Proposal confirms that a carried interest (for example, incentive management fees that a CLO manager may receive after equityholders have realized their agreed IRR hurdle) is not an "ownership interest" and therefore may be held by a banking entity in a covered fund, including in a fund in which the banking entity holds a permissible ownership interest under the three-percent de minimis exemption.

  * As a result, the CLO managers that are, or are affiliated with, "banking entities" should likely be able to continue their CLO management activities, including management of entities that constitute "covered funds".

However, other ownership interests held by the banking entity in a covered fund, including traditional equity stakes, likely will not be protected by this carried interest exception.

To be permissible, however, the Draft Proposal would require carried interest to satisfy several requirements:

* The interest must be held by the banking entity (or an affiliate, subsidiary or employee of a banking entity, in each case) that serves as an investment manager, investment adviser or commodity trading adviser to the covered fund.

* The sole purpose and effect of the interest is to allow the banking entity to share in the profits of the covered fund "as performance compensation for services provided to the covered fund" by the banking entity, provided that the banking entity may be obligated under the terms of the interest to return profits previously received.

* All such profit, once allocated, is distributed to the banking entity promptly after being earned, or, if not so distributed, the reinvested profit of the banking entity would not share in the subsequent profits and losses of the covered fund.

* The banking entity does not provide funds to the covered fund in connection with acquiring or retaining this carried interest.

* The interest is not transferrable by the banking entity except to an affiliate or subsidiary. Whether a CLO manager that is, or is an affiliate of, a banking entity could transfer the rights to accrued carried interest to a third party in connection with the sale or transfer of the CLO manager's management agreement is presently unclear.

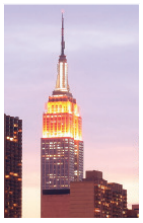
- The Draft Proposal excludes from the definition of "banking entity" any covered fund or an entity controlled by a covered fund. This proposal avoids the possible application of the Volcker Rule prohibitions to a covered fund itself in circumstances in which a banking entity might be a general partner or managing member of such a fund.

- As a result of the definitional measures described above, prohibitions on so-called "covered transactions" between a banking entity and a covered fund would not apply to transactions between a banking entity and a fund that relies on Rule 3a-7 of the 1940 Act or a fund that relies on section 3(c)(1) or section 3(c)(7) but that qualifies for the loan securitization exception as described above.

Perhaps the most onerous features of the Draft Proposal are provisions that would require banking entities to adopt complex and thorough compliance procedures and internal controls to ensure compliance with the Volcker Rule. These measures will need to be studied carefully so that the burden of participating in covered fund investment activities can be adequately assessed.

We note that the Draft Proposal has not yet been adopted by the agencies and is subject to change. Nor does it contain a draft of the proposed regulation itself. Even when adopted, the measure will only be a proposed regulation which might be amended in important ways before it is adopted by the agencies in final form.

WORLDWIDE OFFICES



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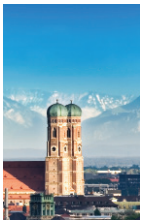

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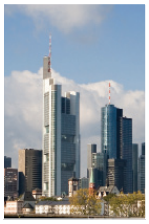

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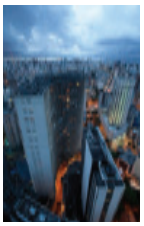

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