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VOLCKER RULE AMENDMENTS: BACK TO THE FUTURE FOR CLOS?

The authors discuss recent amendments to the Volcker Rule and their potential to foster reemergence of a less homogeneous CLO asset class, both in investment capability and performance among CLO managers.

By Deborah Festa and Andrew Keller *

On June 25, 2020, five federal regulatory agencies (the "Agencies")[1] released a final rule (the "Modified Rule") modifying and clarifying the Volcker Rule's prohibition on banking entities investing in or sponsoring covered funds. The Modified Rule could restore much of the flexibility that advisers to CLOs used to have in managing their portfolios prior to 2013 (the "CLO 1.0 Era"), when the initial regulations implementing the Volcker Rule were adopted. Although the significance of these changes will only become apparent with time as the market digests them, this article summarizes a few preliminary take-aways for CLO industry participants.

BACKGROUND

The Volcker Rule was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the initial regulations implementing which were issued in December 2013 (the "2013 Rules"). The rule prohibits banking entities from having an "ownership interest" in and certain relationships with any "covered fund", which it generally defines to include any entity that would be an "investment company" under the Investment Company Act of 1940 but for the exceptions in Section 3(c)(1) or 3(c)(7) thereof. The rule defines an "ownership interest" in a covered fund to mean any equity, partnership, or "other similar interest." Many CLOs rely on the 3(c)(7) exception and would be "covered funds" under the Volcker Rule absent an exemption or exclusion. Banking entities generally interpret "other similar interest" to include senior CLO notes because their holders generally have rights to remove or replace the collateralized loan obligation ("CLO") manager, which was a feature described in the 2013 Rules as one indicative of an "other similar interest."

The 2013 Rules created a loan securitization exclusion (the "LSE") from the definition of "covered fund" for CLOs comprised solely of loans, servicing rights, and other assets incidental to loan ownership. Many CLOs created after implementation of the 2013 Rules have relied on the LSE and have therefore been restricted from purchasing non-loan assets.

The Modified Rule provides banking entities with incremental relief from the Volcker Rule's prohibitions

[1] "Agencies" refers to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

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on investments in CLO securities by (i) introducing a 5% bucket for certain debt securities under the LSE, (ii) providing a safe harbor for certain senior debt interests to not constitute "ownership interests" under the rule, and (iii) clarifying that the rights of a CLO investor to participate in the for-cause removal or replacement of a CLO manager for certain enumerated "cause" event triggers are creditor rights that do not on their own give rise to an "ownership interest".

COMMONLY ASKED QUESTIONS ABOUT THE MODIFIED RULE

1. When will the Modified Rule take effect?

The Modified Rule will become effective on October 1, 2020.

2. Will CLOs be able to invest in bonds?

Two aspects of the Modified Rule are helpful here. Firstly, it permits CLOs relying on the LSE to hold up to 5% of their assets in debt securities, excluding asset-backed securities and convertible securities. Secondly, the Modified Rule provides banking entities independent relief from the Volcker Rule's prohibition on investing in "ownership interests" of covered funds through the introduction of a new safe harbor that carves out at least some senior CLO securities from the definition of "ownership interest" for this purpose.

Existing CLOs with indentures that do not expressly permit investment in bonds, whether currently or through a "springing bond bucket" — a feature that permits investment in debt securities at such future time and to the extent the Volcker Rule is either amended or interpreted by regulators to allow it — will not be permitted to take advantage of this new flexibility without entering into a supplemental indenture, which in most cases will require the consent of holders of one or more classes of notes.

As for new CLOs, investors will determine whether to permit inclusion of a bond bucket, a decision that could well be driven by how experienced the collateral manager's team is perceived to be in investing in such securities.

3. How is the 5% calculated?

This 5% limit is generally par value-based, calculated at the most recent time of acquisition of each such debt security, and must not exceed 5% of the aggregate value of all loans, other debt securities, cash, and cash equivalents held by the CLO.[2]

4. What are the requirements for the safe harbor?

The new safe harbor provides that an "ownership interest" does not include "[a]ny senior loan or senior debt interest that has the following characteristics:

- Under the terms of the interest, the holders of such interest do not have the right to receive a share of the income, gains, or profits of the covered fund, but are entitled to receive only: (*i*) Interest at a stated interest rate, as well as commitment fees or other fees, which are not determined by reference to the performance of the underlying assets of the covered fund and (*ii*) Repayment of a fixed principal amount, on or before a maturity date, in a contractually-determined manner (which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, forgone income resulting from an early prepayment);

- The entitlement to payments under the terms of the interest are absolute and could not be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest; and

- The holders of the interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."[3]

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[2] *See* Preamble at 45-46.

[3] Modified Rule § __.10(d)(6)(ii)(B).

Market participants had requested of the Agencies certain other clarifications, including that the exposures that would benefit from the safe harbor include all "investment-grade" tranches. In staying faithful to a principles-based approach, however, the Agencies stated they believe the final safe harbor, which does not include such a clarification, "will provide additional clarity that the safe harbor is available to senior loan and senior debt interests where contractual principal payments vary over the life of a senior loan or senior debt interest for reasons such as amortization and acceleration provided that the total amount of principal required to be repaid over the life of the instrument does not change."[4] Similarly, the Agencies rejected other securitization-specific clarifying proposals in favor of the above approach, which they stated would "clarify that a debt interest in a covered fund would not be considered an ownership interest solely because the interest is entitled to receive an allocation of collections from the covered fund's underlying financial assets in accordance with a contractual priority of payments."[5] Because typical CLO indentures confer on holders of the most senior class of notes rights that do not extend beyond those described in the final safe harbor, it seems clear the Agencies intended for the safe harbor to cover them.

5. *What are the implications for CLOs investing in securities other than bonds?*

Investors will determine how much flexibility, if any, to provide to collateral managers in light of the Modified Rule's new safe harbor. Now that CLOs need not be structured consistent with the original LSE requirements in order for their senior debt securities to constitute permissible investments for banks, it is possible for CLO indentures to permit certain other investments in non-loan assets without sacrificing a significant portion of their investor base. One category of investments — even if structured to consist of a relatively modest amount of a CLO's aggregate assets — that could be particularly useful for CLO managers as we move further into part of an economic cycle that portends increasing amounts of borrower defaults would be "new money" purchases of assets offered to creditors' committees in a restructuring context. Currently, even though CLOs collectively represent a large and growing segment of broadly syndicated leveraged loans, they are largely constrained in their ability to participate in offerings of warrants and other equity securities in which other debt investors can invest as a means of protecting an existing term loan investment or participating in potential upside beyond such initial loan investments.

6. *What is the import of the "ownership interest" clarification concerning creditors' rights?*

This clarification puts to rest the concern that banking entities previously had that the rights they have as investors in senior CLO notes to remove or replace the CLO manager for certain "cause" events give rise to an "ownership interest." The Modified Rule clarifies that these are customary creditor rights even though they may not be included in CLO documentation as rights arising under events of default or acceleration scenarios.[6] The "for-cause" events listed in the Modified Rule are:

- bankruptcy of investment manager;
- breach by investment manager of material provisions of transaction agreements;
- fraud or criminal activity in the performance of investment manager's obligations;
- indictment of investment manager (or personnel) for criminal offense materially related to investment management activities;
- change in control of investment manager;
- key person event; and
- other similar events that constitute "cause" for removal provided that such events are not solely related to the performance of the covered fund or to the investment manager's exercise of investment discretion.[7]

7. *If CLOs begin to invest in non-loan assets again, what might be the "big picture" results?*

Even though a literal reading of the safe harbor could suggest that CLOs now will have *carte blanche* to invest in large amounts of non-loan assets, the reality is that for many reasons unrelated to the Volcker Rule, most CLOs will likely continue to invest mostly in senior secured leveraged loans. Rating agency criteria, CLO investor appetite, and other securities regulatory and tax considerations will undoubtedly combine to ensure that result. That said, it is easy to envision all the relevant

[4] Preamble at 153-154.

[5] Preamble at 155.

[6] Preamble at 150.

[7] Preamble at 151-152.

stakeholders in a CLO becoming comfortable with small amounts of non-loan assets in the portfolio, such as bonds, common equity, or warrants that do not constitute margin stock[8] that may be offered in a restructuring context, or other assets that from time to time become available to syndicated loan buyers. In the CLO 1.0 Era, the last category included certain types of letters of credit, with which the market became comfortable after significant tax and regulatory analysis, and imposition of a low investment limit for such assets.

Many CLO managers can be expected to advocate strongly for this additional investment flexibility, even within strict limits, which could be used to better protect and enhance value in their portfolios. Some anchor investors in these vehicles may be persuaded of those benefits while others may have concerns about increased risk and resist moving away from all-loan portfolios. We may also see a bifurcation among CLO managers that are able to negotiate with their investors for more flexibility on the basis of capabilities within their broader platforms — such as a bond trading desk or distressed investment business — and those that are not. As a result, CLOs as an asset class may soon regain a lot of the differentiation they enjoyed in the CLO 1.0 Era, which could well produce significantly increased variation across their advisers in portfolio investment performance.

CONCLUSION

The Modified Rule presents interesting opportunities for CLO structurers and managers to explore with potential investors new features that could provide CLOs with additional flexibility to invest in bonds and other non-loan assets. As ever, this market will remain an interesting space to watch as a result. ■

[8] CLOs are generally required to divest within a relatively short time period any margin stock they may receive to facilitate compliance with Regulation U.