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Alternative Investments Practice Client Alert: CLO 3.0 – Volcker's Impact on CLOs

I. INTRODUCTION

On December 10, 2013, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Securities and Exchange Commission (collectively, the "Agencies") adopted the final Volcker Rule,[1] which has impacted the U.S. collateralized loan obligation ("CLO") marketplace in unanticipated ways. In this alert we (i) provide a brief overview of the Volcker Rule as applicable to CLOs, (ii) explore ways in which new CLOs are being structured to avoid the impact of the Volcker Rule, which some have dubbed "CLO 3.0" and (iii) discuss the impact of the Volcker Rule on existing CLOs.

II. THE VOLCKER RULE

The Volcker Rule prohibits a "banking entity" from acquiring or retaining an "ownership interest" in a "covered fund." Therefore, only "banking entities" (including insured depositary institutions, bank holding companies, foreign banks with U.S. branches and agencies, as well as any of their respective affiliates and subsidiaries) are subject to the Volcker Rule. Moreover, only CLOs that are "covered funds" are within the scope of this prohibition. Pursuant to the definition of covered fund, any CLO that would be an "investment company" but for the exceptions set forth in section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") is a covered fund, subject to several exceptions.

The Agencies define the term "ownership interest" quite broadly for Volcker Rule purposes, such that even a holder of a debt tranche may be considered to have an ownership interest in a CLO. Most troubling for holders of CLO debt tranches is that the definition of ownership interest includes an interest that:

> has the right to participate in the selection or removal of a[n]…investment manager, investment adviser, or

[1] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5535 (Jan. 31, 2014). The Commodity Futures Trading Commission also issued a final rule that is substantively the same, 79 Fed. Reg. 5807 (Jan. 31, 2014). (the "Volcker Rule")

commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).[2]

In a typical CLO structure, either the holders of a majority of the outstanding notes voting collectively or the holders of a majority of the controlling class (i.e., the highest rated notes) may remove the CLO manager for "cause." As a result, the holders of each class of notes may be deemed to have an ownership interest in the CLO for purposes of the Volcker Rule.[3]

A banking entity's ownership interests in all covered funds must not exceed three percent of its Tier 1 capital. Therefore, a banking entity that has an ownership interest in a CLO covered fund must either count such investment toward the three percent limit or divest of its ownership interest in such CLO.

III. VOLCKER EXEMPT CLO STRUCTURES

Currently, most CLOs rely on section 3(c)(7) of the Investment Company Act to avoid registration as an investment company under the Investment Company Act by issuing securities in a private offering solely to qualified purchasers[4] and certain employees of the CLO manager. Under the Volcker Rule, such CLOs would, absent an exemption, be regulated as "covered funds."

Loan Securitization Exemption

In an effort to provide some relief for CLOs, the Agencies explicitly provide an exemption from the definition of covered funds for any "loan securitization."[5] In order to qualify as a loan securitization, the assets of the CLO must consist solely of loans[6], rights designed to

[2] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5535,5790.

[3] In a recent letter to the Agencies, various industry groups requested that the Agencies grant relief to the effect that the right to remove a CLO manager for "cause" does not constitute an ownership interest because it is equivalent to exercising remedies upon the occurrence of an event of default. Letter from Loan Syndication and Trading Association, Securities Industry and Financial Markets Association, Structured Finance Industry Group and Financial Services Roundtable to the Agencies, *Re: "Ownership Interests" in Connection with Certain CLO Debt Securities* (January 10, 2013 [*sic*.] January 10, 2014).

[4] §2(a)(51) of the Investment Company Act defines "qualified purchaser" to include (i) any natural person who owns not less than $5,000,000 in investments; (ii) certain family owned companies that own not less than $5,000,000 in investments; (iii) any trust that is not covered by clause (ii) and that was not formed to acquire securities, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis not less than $25,000,000 in investment.

[5] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds , 79 Fed. Reg. at 5535,5788.

[6] The Volcker Rule defines a "loan" as "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or a derivative;" however, the Volcker Rule fails to respond to requests received by the

assure servicing or timely distribution of proceeds of loans or incidental to the purchase and holding of loans, certain interest rate and foreign exchange derivatives that reduce interest rate or foreign exchange risk related to the loans or other permitted assets and certain special units of beneficial interest and collateral certificates. Critically, the definition of "loan" generally excludes securities.[7] The majority of CLOs that closed prior to issuance of the Volcker Rule allow the CLO manager to invest a portion of note issuance proceeds and asset sale proceeds, subject to certain concentration limits, in securities, including senior secured bonds and high-yield bonds. Therefore, many existing CLOs would not qualify for the loan securitization exemption.[8]

One solution for managers of new CLOs seeking to qualify for the loan securitization exemption is simply to prohibit the CLO from acquiring bonds or other securities. Although bonds comprise only a small portion of a typical CLO's assets, given a CLO's highly leveraged structure, restricting such investments may cause a reduction in returns for the CLO's equity holders, and may cause interest rate "mismatch" issues for CLOs with fixed rate tranches of notes. Therefore, in this scenario a CLO manager is essentially given a choice between potentially decreasing returns for equity holders and driving away banking entity investors that have historically invested in the most senior tranche. In an effort to increase returns for the equity holders while not investing in bonds, some CLO managers are turning to an increased bucket for second lien loans.

Some recent CLO issuances are taking a middle-of-the-road approach by allowing a "springing securities basket," whereby the CLO documentation would permit investments in securities and other non-loan assets only upon receipt of an opinion of counsel that the investment does not cause the CLO to be a covered fund under the Volcker Rule or that no class of secured notes issued by the CLO constitutes an "ownership interest" in a covered fund under the Volcker Rule. This approach allows for flexibility in the event that the Agencies subsequently provide helpful guidance on the loan securitization exemption. Absent such clarification, CLO managers may be limited in their ability to provide the highest possible return for equity investors while still being able to qualify for the loan securitization exemption.

Agencies from market participants for clarification as to whether a loan participation constitutes a loan for purposes of the loan securitization exemption. Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5535,5780. In addition, the text of the exemption is silent as to the treatment of letters of credit. Absent guidance from the Agencies, banking entities are currently formulating their own positions regarding these and other assets.

[7] A qualified loan securitization may hold securities only if they fall into one of the following categories: (i) cash equivalents, (ii) securities received in lieu of debts previously contracted with respect to loans and (iii) certain special units of beneficial interest (SUBIs) or collateral certificates. Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5535,5788.

[8] One report indicates that over eighty percent of outstanding CLOs would not qualify for the loan securitization exemption. *S&P: 80% of US CLOs Run Afoul of Volcker*, Asset Securitization Rep., Feb. 6, 2014.

Rule 3a-7 of the Investment Company Act

Another option for a CLO manager to ensure the CLO is not deemed to be a "covered fund" is to structure the CLO as compliant with Rule 3a-7, which is promulgated under the Investment Company Act ("Rule 3a-7").[9] If a CLO satisfies the characteristics in Rule 3a-7 it will not be a "covered fund" subject to the Volcker Rule, and it will therefore also be outside the scope of the "Super 23A" restrictions.[10] Rule 3a-7 provides an exemption from the definition of investment company for certain issuers of asset backed securities; provided that, among other things,

(i) the securities issued by the issuer are rated in one of the four highest ratings categories by at least one rating agency (except securities sold to certain institutional accredited investors and qualified institutional buyers);

(ii) assets acquired or disposed of by the issuer are not acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes;

(iii) the acquisition or disposition by the issuer of assets does not result in a ratings downgrade of the securities issued by the CLO; and

(iv) the issuer appoints a trustee that is unaffiliated with the issuer, has a perfected security interest in the issuer's assets and maintains the segregated accounts into which cash flows of the issuer's assets are deposited periodically (i.e., the securities are issued pursuant to an Indenture).[11]

Some CLO managers find that the requirements in Rule 3a-7 would not impact the economics of a typical cash flow CLO. For example, a typical CLO issues securities only to qualified investors in accordance with the first requirement above. Also, CLO managers do not typically purchase or sell portfolio assets primarily to capture market value changes. Rather, CLO managers often dispose of an asset based on characteristics such as deterioration of credit quality. Unlike hedge fund managers, for example, CLO managers neither have incentives nor compensation based on the current market value of the assets managed. A CLO manager relying on this exemption from the definition of covered fund should have sound policies and procedures in place in order to ensure compliance with the trading requirements in Rule 3a-7.

[9] Many CLOs that are Rule 3a-7 compliant have the ability to rely on section 3(c)(7) of the Investment Company Act as a "back up" exemption from registration as an investment company under the Investment Company Act.

[10] The section of the Volcker Rule known as "Super 23A" results from the interplay between the Volcker Rule and section 23A of the Federal Reserve Act. Super 23A would prohibit a banking entity that (directly or indirectly) either (i) is the CLO manager of a covered fund or (ii) has an ownership interest in a CLO covered fund from engaging in certain transactions with such CLO. Prohibited transactions include entering into a derivative arrangement or liquidity facility with such CLO. Since a CLO that is compliant with Rule 3a-7 is not a covered fund, Super 23A would not apply.

[11] On September 7, 2011, the Securities and Exchange Commission issued an advance notice of proposed rulemaking indicating that it may amend Rule 3a-7. Treatment of Asset-Backed Issuers Under the Investment Company Act, 76 Fed. Reg. 55308 (Sept. 7, 2011) (the "Proposal"). The Proposal requests comments on various alternatives to the current ratings-based criteria in Rule 3a-7, such as requiring that the CLO's assets be selected and valued in a specified manner. At this point it is unclear what form a new Rule 3a-7 would take, if it is revised at all.

Wholly-Owned Subsidiary Exemption

A CLO that is a "wholly-owned subsidiary" of a banking entity is excluded from the definition of a covered fund. Although the banking entity or one of its affiliates generally must own all of the outstanding ownership interests of the subsidiary in order for it to qualify for this exclusion, an unaffiliated third party may hold up to 0.5 percent of the CLO's equity under certain circumstances. Therefore, if an affiliate of a banking entity is a CLO manager that holds the minimum required amount of the equity of the CLO (which would typically be the case in a bank-sponsored balance sheet CLO), such CLO would not be a covered fund subject to the Volcker Rule.

IV. LEGACY CLO TRANSACTIONS

Banking entities must "engage in good faith efforts" to conform their CLO investments, including any current investments, to the covered funds provisions of the Volcker Rule by July 21, 2015, at which point the investments must be fully conformed. There are no grandfathering provisions for current investments in CLOs. While Senator Mark Kirk (R-IL) has recently sponsored legislation[12] providing that a banking entity would not be required to divest an investment in a non-compliant CLO that was issued before December 10, 2013, such legislation has yet to gain traction. Interestingly, as a response to concerns raised by community banks that they would be forced to liquidate collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs), the Agencies provided certain exemptions from the Volcker Rule for certain TruPS CDOs established before May 19, 2010, provided certain conditions were satisfied.[13] This relief was granted despite TruPS CDOs' poor performance during the financial crisis, which was strongly correlated with the poor performance of the real estate market and the financial crisis.[14] On the other hand, CLOs, which have not been granted such relief, performed relatively well during the financial crisis with cumulative impairments since 1996 of less than 1.5%.[15]

Recently the Agencies announced the formation of an interagency working group to discuss a unified approach to the implementation of the Volcker Rule, with Federal Reserve Governor Tarullo indicating that the treatment of CLOs is at the top of the

[12] S. 1907, 113th Cong. (2014).

[13] Interim Final Rule, Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5535 (Jan. 31, 2014).

[14] L. Cordell, M. Hopkins, Y. Huang, Federal Reserve Bank of Philadelphia, Working Paper No. 11-22, *The Trust Preferred CDO Market: From Start to (Expected) Finish* (June 2011), *available at* http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-22.pdf, which also provides that "poor performance existed across all issuers" of TruPS CDOs with a default/deferral rate for the entire TruPS CDO market at 32%, as of March 2011.

[15] *Impact of the Volcker Rule on Job Creators Before the House Comm. on Financial Services* (Jan. 15, 2014) (statement of Elliot Ganz, Executive Vice President and General Counsel, Loan Syndication and Trading Association).

agenda.[16] Some market participants believe that, given the Agencies' treatment of TruPS CDOs and the recent formation of the working group, relief may be in sight for CLOs. In the meantime, banking entities that are invested in CLOs continue to wait, in limbo, for guidance from the Agencies.

Legacy CLOs, nevertheless, may be amended or managed in such a way as to no longer be considered covered funds. As discussed, one approach would be through compliance with the loan securitization exemption, i.e., not investing in securities. Banking entities may put pressure on CLO managers to divest of bonds and other securities in order to be able to retain their investments in the CLO. Complying with this request, however, could pose certain challenges for the CLO manager. In particular, divesting of bonds may diminish the return for equity holders. Moreover, from a practical point of view, such an amendment may be difficult to obtain, given the various parties whose consents may be required and any applicable rating agency confirmations.[17] The CLO manager's fiduciary duties to its client may also be implicated, especially if any such bonds would be sold at a loss.

Other banking entity investors are attempting to shift the burden of compliance with the Volcker Rule to the CLO manager, by requiring the CLO manager to undertake to effect such sales (or cease such purchases) as may be required to comply with the Volcker Rule by the implementation deadline. Requiring the CLO manager to make judgments as to which assets must be sold (or not acquired) in order to comply with the Volcker Rule may result in an increased exposure to liability that CLO managers may not be willing to accept.

Assuming that the Agencies fail to clarify that the ability of a holder of a CLO's secured notes to remove a CLO manager for cause is not indicative of an ownership interest, or to provide alternative relief, another option for a banking entity holding an interest in a covered fund CLO is to request an amendment to the relevant CLO management agreement voiding the banking entity's voting rights (except in the case of the exercise of remedies following an event of default). A banking entity may also attempt to unilaterally abdicate such voting rights. Both options would leave the investing banking entity without a voice in the removal and replacement of the CLO manager (absent an event of default), which may not be palatable to such investor.

V. CONCLUSION

Some market observers anticipate that the Agencies will recognize the negative impact that the Volcker Rule will have on the CLO market and take the appropriate actions to provide

[16] *Impact of the Volcker Rule of Job Creators, Part II Before the House Comm. on Financial Services* (Feb. 5, 2014) (statement of Gov. Daniel K. Tarullo, Federal Reserve).

[17] Some AAA investors in new CLOs are requesting that amendments to the CLO documents that are made for the purpose of causing the CLO not to be a covered fund or to alter the rights of an investor so as not to have an "ownership interest" be permitted to be made without investor consent. Such "no-consent" amendments should be considered carefully, as in theory, they could permit sales of assets otherwise prohibited or amendments that otherwise have a negative impact on certain classes of investors.

relief to banking entities that invest in CLOs. In the meantime, CLO managers would be wise to take steps to print new CLOs that comply with the Volcker Rule. Milbank has recently advised CLO managers on a number of new CLOs that comply with the Volcker Rule, including CLOs that comply with Rule 3a-7. If you would like to discuss any concerns regarding how to structure a CLO in the new marketplace, please feel free to contact any member of our Alternative Investments Practice.

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