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CLO Group Client Alert:
Non-U.S. Bank CLO Investors Benefit from Standalone "SOTUS" Volcker Rule Exemption

This is a piece in our continuing series exploring the effects of the Volcker Rule. For previous alerts, please click here.

The agencies charged with implementing the Volcker Rule[1] (the "Agencies") posted the most important addition to date to their "Frequently Asked Questions" when they released their thirteenth FAQ ("FAQ 13") on February 27, 2015.[2] Unlike prior FAQs, which, for the most part, addressed more limited or technical issues, FAQ 13 clarified a major ambiguity regarding the ability of foreign banks to invest in covered funds, including non-Volcker-exempt CLOs.[3]

The Final Rule restricts a "banking entity" from acquiring or retaining an "ownership interest" in or sponsoring a "covered fund," unless an exemption applies.[4] The "SOTUS" exemption permits foreign banking entities to engage in certain otherwise-prohibited activities occurring "solely outside the United States."[5] Under one of the conditions of the SOTUS exemption, the so-called "marketing restriction," "[n]o ownership interest in the covered fund may be offered for sale or sold to a resident of the United States."[6]

Before FAQ 13, a common reading of the marketing restriction was that it caused the SOTUS exemption to be unavailable with respect to any covered fund that had been offered to U.S. residents at all, regardless of whether the bank seeking to rely on the exemption had any involvement in the offering of the fund. FAQ 13 clarifies that, in the view of the Agencies' staffs, the marketing restriction applies *only to the activities of the foreign banking entity seeking to rely on the SOTUS exemption*. In other words, according to FAQ 13, so long as a foreign banking entity (including its affiliates) is not itself deemed to have "participate[d] in an offer or sale of covered fund interests to a resident of the United States," it may rely on the SOTUS exemption to invest in the covered fund, provided it meets the other conditions of the exemption. Notably, FAQ 13 also states that if a foreign banking entity or any of its affiliates sponsors a covered

fund, or "serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund," then the Agency staffs will view that banking entity as having participated in *any* offer or sale by the covered fund of its ownership interests. In citing the preamble of the Final Rule, FAQ 13 indicates that this interpretation of the marketing restriction is consistent with the Agencies' intent to "not advantage foreign banking entities relative to U.S. banking entities with respect to providing *their* covered fund services in the United States by prohibiting the offer or sale of ownership interests in *related* covered funds to residents of the United States."[7]

As a result of FAQ 13, foreign banking entities investing in CLOs that are covered funds and are sponsored and managed by third parties can rely on the SOTUS exemption exclusively as a means of Volcker compliance for those investments, irrespective of the source of the CLO collateral and regardless of whether the CLOs or their managers are domiciled or operating abroad or in the U.S. Nor do the conditions of the SOTUS exemption preclude a relying bank from making a purchase within the U.S., although in any case the decision to invest cannot be made by U.S.-located personnel, and no U.S. branch or affiliate can provide funding for the investment, among other conditions.[8]

Of course, CLOs simultaneously marketed to U.S. banking entities, which are unable to take advantage of the SOTUS exemption, will require another compliance strategy to accommodate those investors. This means, as a practical matter in the existing market, the subset of CLOs for which the SOTUS exemption will be meaningful is limited to (i) European CLOs not marketed to U.S. banks and (ii) U.S. CLOs that are not marketed to U.S. banks and that, if targeting European banking entities and other EU regulated investors, are compliant with European risk retention requirements. Until now, sponsors of European CLOs included within this subset have relied on other, more restrictive, compliance strategies, including (i) ensuring a CLO complies with the Final Rule's loan securitization exemption, which prohibits investments in bonds and other securities, (ii) structuring a CLO to permit reliance on Rule 3a-7 for its Investment Company Act exemption, which contemplates certain trading restrictions, or (iii) most common of all, attempting to achieve exclusion from the Final Rule's definition of "ownership interest" by creating for investment by banks one or more special classes of the CLO's notes that do not have the right to vote on removal or replacement of the CLO manager (the "Dual Class Strategy").[9] Some U.S. banks have been loathe to rely on the Dual Class Strategy for their own Volcker compliance purposes due to the reduced influence it would afford them over the CLO manager, and as a result, reduced control over their investment. Some CLO managers likewise have rejected the Dual Class Strategy over concerns about potential unintended consequences in the context of a CLO manager removal scenario, wherein a small number of investors or investors

with a relatively small economic stake in the CLO, or both, could act on their own to remove and replace the CLO manager.

Some have questioned the utility of the SOTUS exemption on the grounds that, in the absence of another exemption, liquidity for a foreign bank's investment in a CLO would be limited, as U.S. banking entities would not be natural secondary market buyers; however, for CLOs that rely on the Dual Class Method, liquidity for their notes may already be limited given certain U.S. banking entities' predisposition against that strategy.

On balance, the SOTUS exemption offers non-U.S. banks a viable option for investing in at least some third party-managed CLOs. It may also result in reduced pressure on some CLO managers by non-U.S. bank investors to pursue amendments to transaction documents for older CLOs to render them Volcker compliant, as it is now clear that foreign banks can retain their non-compliant investments provided they otherwise meet the SOTUS conditions.

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[1] "Volcker Rule" refers to Section 13 of the Bank Holding Company Act of 1956, added by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final regulations implementing the Volcker 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)) are referred to herein as the "Final Rule."

[2] The Frequently Asked Questions, as updated from time to time, are posted on each Agency's website. See (for example) www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm .

[3] Under the Final Rule, only a 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. For example, CLOs that can rely on Rule 3a-7 for their Investment Company Act exemption are not covered funds.

[4] See Milbank Alternative Investments Practice Client Alert: CLO 3.0 – Volcker's Impact on CLOs.

[5] Final Rule §_.13(b).

[6] Final Rule §_.13(b)(1)(iii). §_.13(b)(3) amplifies the marketing restriction: "An ownership interest is not offered for sale or sold to a resident of the United States for purposes of paragraph (b)(1)(iii) of this section only if it is sold or has been sold pursuant to an offering that does not target residents of the United States."

[7] Citing the Final Rule at 5742 (emphasis added).

[8] See Final Rule §_.13(b). Banks investing in dollar-denominated CLO securities in reliance on the SOTUS exemption would therefore generally need a source of dollar funding other than a U.S. branch or affiliate.

[9] The Final Rule's definition of "ownership interest" includes an interest that has the right to participate in the selection or removal of an investment manager. In a typical CLO, either the holders of a majority of the outstanding notes of the CLO or the holders of a majority of the CLO's controlling class of notes may remove the CLO manager for "cause."

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