Proposed Volcker Rule: Implications for Banking Entities Sponsoring or Investing in Funds and Securitization Issuers

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On Tuesday, October 11, 2011, federal regulators released for comment proposals for implementing the “Volcker Rule,” or Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The proposed rules prohibit insured depository institutions, bank holding companies, and their subsidiaries or affiliates (collectively, “banking entities”) from engaging in many proprietary trading activities and from investing in and sponsoring hedge funds, private equity funds, and similar investment vehicles. Banking entities also would be restricted from engaging in exempted activities that would involve or result in a material conflict of interest with clients, customers, or counterparties, result in a material exposure to specified high-risk assets or trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

Many of the Volcker proposals are highly controversial, portending continued intense debate as the rulemaking process proceeds. Banking industry participants have criticized those proposals concerning proprietary trading, for example, as vague, overbroad, and potentially unworkable in practice given an express but difficult to apply carve-out for permitted market-making activities.

The draft rules generally prohibit any banking entity from sponsoring on its own behalf, or acquiring as a principal, ownership interests in a “covered fund,” which includes any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act. This broadly drafted definition encompasses hedge funds, private equity funds, and securitization issuers *other than* those offering securities collateralized by loans. Generally, however, carried interests in funds do not constitute ownership interests for this purpose, provided that the banking entity or its affiliate, subsidiary, or employee serves as investment adviser to the fund.

An exception permits a banking entity to sponsor and invest in a covered fund if (i) the banking entity’s total investment does not exceed 3% of the covered fund’s invested capital or loss exposure and (ii) the banking entity’s total outstanding investments in all covered funds do not exceed 3% of the banking entity’s Tier 1 capital. Investment limits must be calculated continually to assess compliance.

Certain additional exemptions apply for hedging risks arising from exposure to covered funds through transactions with customers, and for offshore investments by non-U.S. controlled foreign banking entities.

Notably, issuers of collateralized loan obligations (CLOs) and other similar securitizations of loans do not constitute covered funds. As a result, banking entities may sponsor and invest in CLOs and securitize loans without being subject to the investment limits applicable to other covered funds, so long as the issuer’s assets are comprised solely 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, such as interest rate swaps. These criteria exclude certain assets traditionally eligible for investment by CLOs in limited amounts, such as corporate bonds and structured finance securities. Presumably, assets received in exchange for loans during the course of work-outs, such as equity securities, would be covered as assets “arising directly from” loans originally included in an asset pool.

The proposed rules also permit a banking entity to comply with the “risk retention” requirements under Section 15G of the Securities Exchange Act of 1934, added by section 941 of Dodd-Frank, which require a banking entity to maintain a minimum interest in certain sponsored or originated asset-backed securities. The deadline for comment on proposed rules implementing the risk retention requirements expired in August.

Without explanation, the Volcker proposals seem to draw an implicit distinction between investments in issuers of loan securitizations and in funds established for investment in loans. The rationale for such a distinction is not readily apparent, given that investment in loans has always been considered a traditional banking activity.

Regulators have posed hundreds of questions for comment. The deadline for submission of comments on the Volcker proposals is January 13, 2012.

The final rules will become effective on July 21, 2012, by which date banking entities must have in place required compliance programs and record-keeping procedures.