Morgan Lewis

FINAL VOLCKER RULE REGULATIONS: SECURITIZATIONS AND OTHER STRUCTURED TRANSACTIONS

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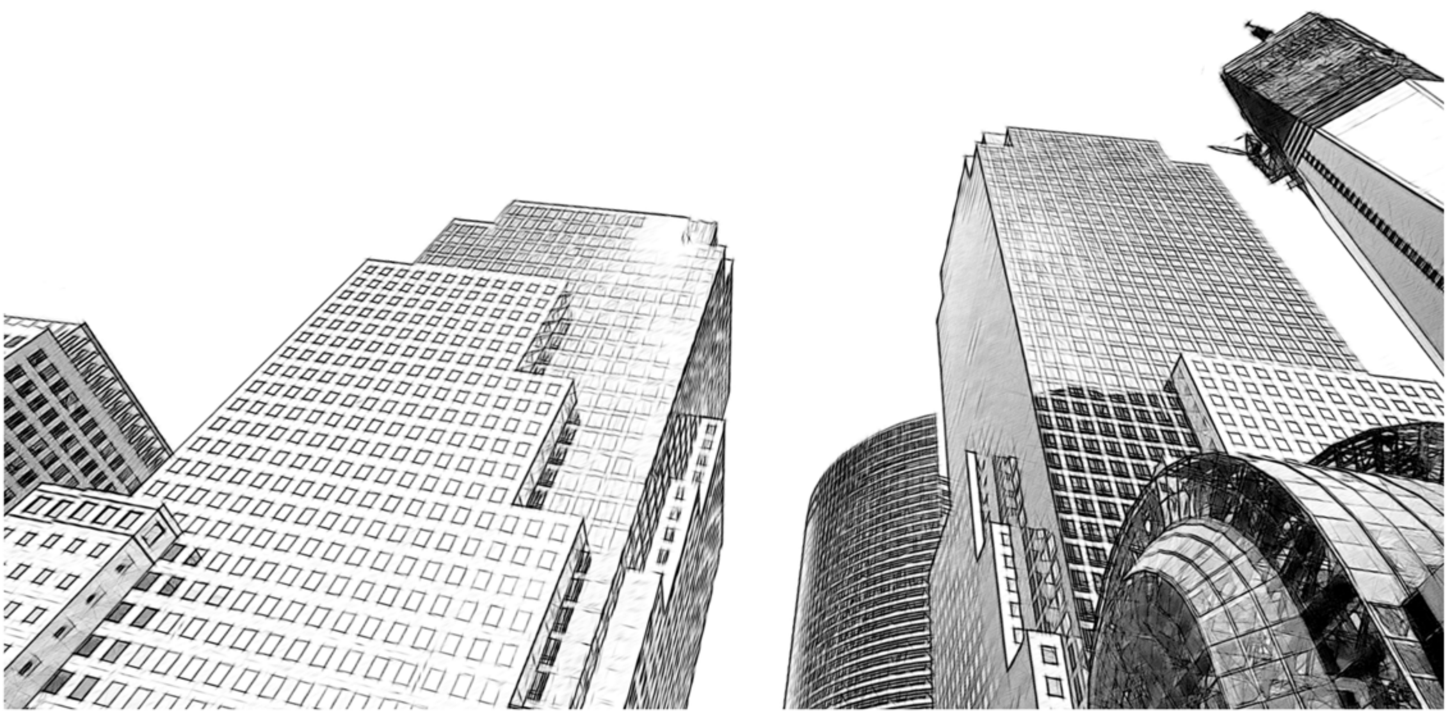

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FINAL VOLCKER RULE REGULATIONS: SECURITIZATIONS AND OTHER STRUCTURED TRANSACTIONS

Introduction

On December 10, 2013, the federal banking agencies,[1] the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission (the "CFTC," and, together with the federal banking agencies and the SEC, the "Agencies") jointly adopted regulations (the "Final Regulations") to implement Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule.[2] The Final Regulations were adopted more than two years after proposed regulations were first published.[3]

The Volcker Rule prohibits any "banking entity" from acquiring and retaining an ownership interest in, sponsoring or having certain relationships with hedge funds, private equity funds and certain other private funds ("covered funds"), and from engaging in proprietary trading, subject to certain exemptions.

In this Alert, we discuss the application of the Volcker Rule to securitizations and other structured transactions.[4]

Highlights of the Volcker Rule for the Securitization Industry

- Banking entities (banks and their affiliates, including broker-dealer affiliates) generally will be prohibited from sponsoring or owning an "ownership interest" in a "covered fund."
    - A securitization entity generally is not a banking entity, but may be a covered fund.
    - A securitization entity that can rely on Rule 3a-7 under the Investment Company Act of 1940, as amended (the "Investment Company Act"), Section 3(c)(1) of the Investment Company Act, or any exemption from registration as an investment company other than Section 3(c)(1) (the "100 holder" exemption) or Section 3(c)(7) (the "qualified purchaser" exemption), is not a covered fund.
    - There is an exemption from the definition of "covered fund" for securitizations of "loans," which include leases and other receivables. However, securities, including other asset-backed securities ("ABS"), generally may not be included in the asset pool, so resecuritizations will not qualify for the loan securitization exemption. Nor may derivatives (other than certain interest rate and foreign exchange rate derivatives) be included in the asset pool, which means that synthetic securitizations will not qualify for the loan securitization exception.
    - There is an exemption from the definition of "covered fund" for certain qualifying asset-backed commercial paper ("ABCP") conduits. An ABCP conduit that finances ABS acquired in the secondary markets, or that has a partially supported liquidity facility, will not meet the requirements of the qualifying ABCP exemption.

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[1] The federal banking agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "FRB"), and the Federal Deposit Insurance Corporation (the "FDIC").

[2] The Final Regulations and accompanying statements, fact sheets, and related documents can be found on the websites of the Agencies. For example, they are available on the FRB's website at **http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm**.

[3] For a summary of the proposed regulations, *see* Proposed Volcker Rule Regulations: A Summary, which is available at **www.bingham.com/Alerts/2011/10/Proposed-Volcker-Rule-Regulations-A-Summary**. The Proposed Regulations can be found in the Federal Register at 76 Fed. Reg. 68,846 (Nov. 7, 2011) and on the FRB's website at **http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm**.

[4] Our client alert on the covered fund restrictions of the Volker Rule, Final Volcker Rule Regulations: Restrictions on Covered Fund Activities and Investments, is available at **http://www.bingham.com/Alerts/2014/01/Final-Volcker-Rule-Regulations**. Our client alert on the proprietary trading restrictions of the Volker Rule, Final Volcker Rule Regulations: Restrictions on Proprietary Trading, is available at **http://www.bingham.com/Alerts/2014/01/Volcker-Rule-Proprietary-Trading**.

    - There is an exemption from the definition of “covered fund” for certain qualifying covered bond transactions.

    - If a securitization entity is a covered fund, any interest held by a banking entity must be analyzed to determine whether it demonstrates one of the seven characteristics that will make it a prohibited “ownership interest.” A residual interest will constitute an ownership interest; other common securitization interests may or may not constitute ownership interests, depending upon the terms of the particular transaction documents.

    - If a securitization entity is a covered fund, and the interests held by a banking entity constitute ownership interests, then the banking entity generally must limit its aggregate ownership interest to three percent of the fair market value of the ownership interests in the securitization (or, if greater, the minimum risk retention required when the final Dodd-Frank credit risk retention rules become effective). There also is an aggregate limit for a banking entity’s ownership of all covered funds equal to three percent of its tier 1 capital.

    - The Agencies have adopted an interim final rule permitting banking entities to retain existing ownership interests in and to continue to sponsor certain legacy covered funds backed by trust preferred securities, or “TruPS” (i.e., TruPS CDOs).

    - There are exemptions that permit a banking entity to sponsor a securitization entity that is a covered fund, underwrite an offering by such a securitization entity, and make markets in ownership interests in such a securitization entity, in each case subject to strict limitations. Among other things, a banking entity’s underwriting and market-maker inventory in ownership interests in a covered fund securitization sponsored by an affiliate will count toward its limit on ownership interests in that particular transaction, and a banking entity’s underwriting and market-maker inventory in ownership interests in any covered fund securitizations will count toward its aggregate limit on ownership interests in covered funds.

    - The so-called “Super 23A” provisions could limit the ability of a banking entity to provide liquidity, servicing advances or other customary extensions of credit to, or repurchase assets from, a securitization vehicle that is a covered fund.

- Banking entities generally will be prohibited from “proprietary trading.”

    - “Proprietary trading” is broadly defined to include engaging as principal in the purchase or sale of any financial instruments, which include ABS. This prohibition applies whether or not the financial instrument in question constitutes an ownership interest in a covered fund.

    - There are exemptions for repurchase financings and securities lending arrangements.

    - There is an exemption for underwriting and private placement activities, subject to strict limitations. Among other things, a banking entity may not purchase more securities than are necessary to meet reasonably expected near-term market demand.

    - There is an exemption for market-making, again subject to strict limitations. Among other things, the market-maker inventory of a banking entity must be designed not to exceed reasonably expected near-term market demand.

- The "conformance period" (*i.e.*, the time by which a banking entity must be compliant with the restrictions of the Volcker Rule) extends until July 21, 2015. During the conformance period, a banking entity must engage in good-faith efforts that will result in its compliance with the requirements of the Volcker Rule by no later than the end of the conformance period.

"Banking Entity"

The prohibitions of the Volcker Rule apply to banking entities. The Final Regulations broadly define a "banking entity" as any of the following:

- Any insured depository institution (other than certain limited purpose trust institutions);
- Any company that controls an insured depository institution;
- Any company treated as a bank holding company;[5] and
- Any affiliate or subsidiary of any of the foregoing.[6]

The Final Regulations provide several exclusions from the definition of banking entity, including an exclusion for a covered fund that is not itself a banking entity under the first three bullets above. Accordingly, a covered fund will not be banking entity solely because it is a subsidiary or affiliate of a banking entity.[7]

According to the Preamble to the Final Regulations (the "Preamble"), while a securitization vehicle may or may not be a covered fund, "most securitization transactions are currently structured so that the issuing entity with respect to the securitization is not an affiliate of a banking entity under the BHC Act."[8] Therefore, most securitization issuers will not themselves be banking entities that need to conform their activities to the requirements of the Volcker Rule.

Prohibition on Covered Fund Activities and Investments

Under the Final Regulations, a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund,[9] subject to certain exemptions. These exemptions include, among other things:

- Certain loan securitizations;
- Certain qualifying asset-backed commercial paper conduits;
- Certain covered bonds;
- Organizing and offering a covered fund, subject to significant restrictions and limitations, or underwriting and market-making in ownership interests of a covered fund; and
- Seeding and *de minimis* investments in a covered fund that the banking entity organizes and offers.

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[5] For purposes of Section 8 of the International Banking Act of 1978 (12 U.S.C. § 3106).

[6] As defined in the Bank Holding Company Act of 1956 (the "BHC Act"). Final Regulations §__.2(c)(1).

[7] Final Regulation §__2(c)(2).

[8] Preamble, at 20 n. 54.

[9] Final Regulations § __.10(a).

The covered fund provisions of the Final Regulations also impose certain other limitations on covered fund activities and investments, including the so-called "Super 23A" restrictions on relationships by banking entities with covered funds and the so-called "back stop" provisions.

"Covered Fund"

The Final Regulations define a "covered fund" to include, among other things and subject to certain exclusions, an issuer that would be an investment company, as defined in the Investment Company Act, *but for* Section 3(c)(1) (the "100 holder" exemption) or Section 3(c)(7) (the "qualified purchaser" exemption) of that Act.[10] In general, a securitization vehicle that can rely on any exemption from requirements of the Investment Company Act other than Section 3(c)(1) or 3(c)(7) will not be a covered fund.

Rule 3a-7 under the Investment Company Act is an exemption designed specifically for issuers of ABS. However, not all securitizations or other structured transactions rely on Rule 3a-7. For example, Rule 3a-7 generally does not permit active management of the asset pool. Many collateralized loan obligations (*i.e.*, CLOs) and collateralized debt obligations (*i.e.*, CDOs) have actively-managed asset pools, so they rely on other exemptions. Other relatively common securitization features that may render Rule 3a-7 unavailable include the issuance of redeemable securities (Rule 3a-7 prohibits the issuance of securities that are redeemable at the option of the holder), and the sale of any class of non-investment grade securities to non-institutional accredited investors (Rule 3a-7 generally limits sales of fixed-income securities to qualified institutional buyers ("QIBs") or institutional accredited investors unless the securities are investment grade, and limits the sales of other securities to QIBs).

Sponsors of securitization transactions that initially relied on Section 3(c)(1) or 3(c)(7), and banking entities that hold ABS issued in those securitizations, may wish to examine those securitizations to determine if any other exemption is available. For example, if Rule 3a-7 (the securitization exemption) was unavailable at issuance because of active pool management, but the asset pool has since become fixed, Rule 3a-7 may now be available.

The definition of "covered fund" also includes any commodity pool,[11] for which:

- The commodity pool operator has claimed exempt pool status;[12] or
- A commodity pool operator is registered with the CFTC in connection with the commodity pool, substantially all participation units are owned by qualified eligible persons[13] and participation units of the commodity pool have not been publicly offered to persons who are not qualified eligible persons.[14]

Most securitization vehicles that include derivative instruments are not commodity pools pursuant to a series of interpretive letters issued by the CFTC's staff, because payments to investors are not be affected by swaps in any way other than as reasonable credit enhancement or an interest rate or

[10] Final Regulations § __.10(b)(1)(i).

[11] Under Section 1(a)(10) of the Commodity Exchange Act.

[12] Under Section 4.7 of the CFTC's regulations.

[13] Under Sections 4.7(a)(2) and 4.7(a)(3) of the CFTC's regulations.

[14] Final Regulations § __.10(b)(1)(ii).

currency swap. Even a securitization vehicle that does not fall within the scope of this exemptive relief (for example, a CDO that has a synthetic bucket) will not be a covered fund if it qualifies for some exemption from the obligation to have a registered commodity pool operator, such as certain securitization-specific no-action advice issued by the CFTC, or the so-called "*de minimis*" exemption.[15]

Loan Securitization Exemption

Generally

A securitization of "loans" that otherwise would be a covered fund (*i.e.*, because it relies solely on Section 3(c)(1) or 3(c)(7) for its exemption from the requirements of the Investment Company Act) may be excluded from the definition of covered fund. To meet the requirements of this exemption, an issuing entity of "asset-backed securities," as defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (the "Exchange Act," and such ABS, "Exchange Act ABS"), must have an asset pool comprised solely of:

- "Loans";
- Certain servicing assets;
- Certain interest rate or foreign exchange derivatives; and
- Certain special units of beneficial interests ("SUBIs") and collateral certificates.

A loan securitization vehicle that satisfies all of these requirements is excluded from the definition of covered fund, so the Volcker Rule does not restrict banking entities' ownership or sponsorship of, or their ongoing relationships with, such an issuer.[16]

Definition of "Loan"

A "loan" includes "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative."[17]

According to the Agencies, "security" and "derivative" generally are defined by reference to the federal securities laws and the Commodity Exchange Act, respectively, because these definitions are generally well-understood by market participants and have been subject to extensive interpretation.[18] Therefore, "security" has the broad definition provided in Section 3(a)(10) of the Exchange Act.[19] "Derivative" is defined in a similarly broad fashion generally to include any "swap" (as defined in the Commodity Exchange Act) and "security-based swap" (as defined in the Exchange Act), in each case as further defined by applicable regulation, interpretation, guidance, or other regulatory action.[20]

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[15] For more information, *see* Bingham McCutchen LLP Legal Alert: CFTC Issues Broader Interpretive Exclusion From Commodity Pool Regulation for Securitizations, and No-Action Advice "Grandfathering" Some Securitizations and Extending Temporary Registration Relief Until March 31, 2013, which is available at **http://www.bingham.com/Alerts/2012/12/CFTC-Issues-Broader-Interpretive-Exclusion-From-Commodity-Pool-Regulation-for-Securitizations**.

[16] Final Regulations § __.10(c)(8).

[17] Final Regulations § __.2(s).

[18] *See* Preamble, at 49.

[19] Final Regulations § __.2(y).

[20] Final Regulations § __.2(h).

Servicing Assets as Pool Assets

Servicing assets that may be included in a loan securitization consist of any other rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders or related or incidental to purchasing or otherwise acquiring, and holding the securitized loans.[21] Servicing assets may be included only to the extent that they arise from the structure of the loan securitization or from the loans supporting a loan securitization. If servicing assets are sold and securitized in a separate transaction, they will not qualify as permissible holdings.[22]

Securities as Pool Assets

Securities, including other ABS, generally may not be included in the collateral pool for an exempt loan securitization.[23] For that reason, resecuritizations generally will not qualify for the loan securitization exclusion.

Only the following three types of securities may be included in an excluded loan securitization:

- Cash equivalents;[24]
- Securities received in lieu of debts previously contracted with respect to the underlying loans;[25] and
- SUBIs and collateral certificates.[26]

The Agencies interpret "cash equivalents" to mean high quality, highly liquid short term investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities. Depending on the context, cash equivalents may include deposits insured by the Federal Deposit Insurance Corporation, certificates of deposit issued by a regulated U.S. financial institution, obligations backed by the full faith and credit of the United States, investments in registered money market funds, and commercial paper.[27]

For a SUBI or collateral certificate to qualify as a permitted asset, four conditions must be met:

- The special purpose entity issuing the SUBI or collateral certificate must meet the conditions of the loan securitization exclusion;
- The SUBI or collateral certificate must be used for the sole purpose of transferring economic risks and benefits of the loans (and other permissible assets) to the issuing entity for the securitization and may not directly or indirectly transfer any interest in any other economic or financial exposures;
- The SUBI or collateral certificate must be created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization; and

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[21] Final Regulations § ___.10(c)(8)(i)(B). This is similar to the types of servicing assets that may be included an asset pool pursuant to the definition of "asset-backed security" in Item 1101(c) of Regulation AB ("any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders"), and pursuant to Rule 3a-7 under the Investment Company Act ("any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders").

[22] *See* Preamble, at 546.

[23] Final Regulations § __.10(c)(8)(ii)(A).

[24] Final Regulations § __.10(c)(8)(iii)(A).

[25] Final Regulations § __.10(c)(8)(iii)(B).

[26] Final Regulations § __.10(c)(8)(v).

[27] *See* Preamble, at 548-49.

- The special purpose vehicle issuing the SUBI or collateral certificate and the issuing entity for the excluded loan securitization transaction must be established under the direction of the same entity that initiated the loan securitization transaction.[28]

Derivatives as Pool Assets

Derivatives and commodity forward contracts generally may not be included in the collateral pool for a loan securitization.[29] For that reason, and because the loan securitization exemption applies only to an issuer of Exchange Act ABS (which does not encompass synthetic securitizations), the loan securitization exemption does not encompass synthetic securitizations.

Only an interest rate or foreign exchange derivative that meets the following conditions may be included in the asset pool:

- The written terms of the derivative must directly relate to either the underlying loans, the issued ABS or any other permitted pool assets; and

- The derivative must reduce interest rate and/or foreign exchange risk with respect to the loans, the issued ABS or any other permitted pool assets.[30]

Qualifying Asset-Backed Commercial Paper Conduit Exemption

A "qualifying asset-backed commercial paper conduit" is excluded from the definition of "covered fund."[31] To be deemed qualifying, an ABCP conduit must hold only loans and other assets that would be permissible in an exempt loan securitization, and ABS that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.[32] Therefore, a qualifying ABCP conduit may not finance ABS acquired in the secondary market.[33]

A qualifying ABCP conduit may issue only ABS consisting of a residual and securities with a maturity of 397 days or less.[34]

A "regulated liquidity provider"[35] must have a legally binding commitment to provide full and unconditional liquidity coverage with respect to all of the outstanding short-term ABS if funds are required to redeem them as they mature.[36] The liquidity coverage may be provided in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement. In the event the qualifying ABCP conduit is unable for any reason to repay its maturing ABS, the total amount for which the liquidity provider may be obligated must be equal to 100 percent of the amount of

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[28] Final Regulations § __.10(c)(8)(v). The latter two conditions are similar to those contained in Rule 190 under the Securities Act, which delineates the circumstances under which the offer and sale of an intermediate security such as a SUBI or collateral certificate need not be registered.

[29] Final Regulations §§ __.10(c)(8)(ii)(B) and (C).

[30] Final Regulations § __.10(c)(8)(iv).

[31] Final Regulations § __.10(c)(9).

[32] Final Regulations § __.10(c)(9)(i)(A).

[33] Preamble, at 567.

[34] Final Regulations § __.10(c)(9)(i)(B).

[35] A regulated liquidity provider is (i) a depository institution as defined in section 3 of the Federal Deposit Insurance Act; (ii) a bank holding company or a subsidiary thereof; (iii) a savings and loan holding company, provided all or substantially all of the holding company's activities are permissible for a financial holding company, or a subsidiary thereof; (iv) a foreign bank whose home country supervisor has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof; or (v) a sovereign nation. Final Regulations § __.10(c)(9)(ii). In order for a sovereign nation to qualify as a regulated liquidity provider, the liquidity provided must be unconditionally guaranteed by the sovereign, which would include its departments and ministries, including the central bank. *See* Preamble, at 565.

[36] Final Regulations § __.10(c)(9)(i)(C).

outstanding ABS, plus accrued and unpaid interest. Amounts due pursuant to the required liquidity coverage may not be subject to the credit performance of the ABS held as pool assets, or reduced by the amount of any credit support.[37]

All ABCP conduits provide 100 percent backstop liquidity facilities covering their outstanding ABCP. In a "fully supported" liquidity facility, the ability to draw on the facility is not conditioned on the performance of the underlying collateral, so the same facility provides both liquidity support and credit enhancement. However, in a "partially supported" liquidity facility, there typically is a borrowing base that is reduced by any excess of non-performing collateral over the customer's credit enhancement. Under the Final Regulations, only a fully supported liquidity facility would meet the requirements of the qualifying ABCP conduit exclusion. A partially supported facility would not, even though both partially and fully supported conduits provide liquidity coverage for 100 percent of their outstanding ABCP.

Qualifying Covered Bond Exemption

Qualifying covered bond structures are excluded from the definition of "covered fund." To qualify for the exemption, an entity must own or hold a dynamic or fixed asset pool consisting solely of loans and other assets (the "cover pool") that would be permissible in an exempt loan securitization, for the benefit of the holders of "covered bonds."[38]

A "covered bond" is defined as a debt obligation issued by a foreign banking organization,[39] if the entity that owns the cover pool fully and unconditionally guarantees its payment obligations, or alternatively, as a debt obligation of the entity that owns the cover pool, if it is a wholly-owned subsidiary of a foreign banking organization that fully guarantees its payment obligations.[40]

Other Key Definitions

"As Principal"

A banking entity is prohibited from acquiring or retaining an ownership interest in a covered fund "as principal."[41] The Final Regulations clarify what it means to act "as principal" by specifying that a banking entity does not hold an ownership interest as principal when the interest is held by the banking entity:

- Acting solely as agent, broker or custodian, so long as the activity is conducted for the account of, or on the behalf or, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;
- Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered under U.S. law or the laws of a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of people who are employees of the banking entity (or an affiliate thereof);

[37] Preamble, at 566.

[38] Final Regulations § __.10(c)(10)(i).

[39] A defined in § 211.21(o) of the FRB's Regulation K (12 C.F.R. § 211.21(o)), but not including a foreign bank, as defined in § 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. § 3101(7)), that is organized under the laws of the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, or the Commonwealth of the Northern Marianas Islands. Final Regulations § ___.2(n).

[40] Final Regulations § __.10(c)(10)(ii).

[41] Final Regulations § __.10(a)(1).

- In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and does not retain such instrument for longer than such period permitted by the appropriate Agency; or

- On behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.[42]

"Ownership Interest"

An "ownership interest" is any equity, partnership, or other similar interest.[43] An "other similar interest" means an interest that exhibits any of the following characteristics on a current, future, or contingent basis:

- Has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or 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);

- Has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund (regardless of whether the right is pro rata with other owners or holders of interests);

- Has the right to receive the underlying assets of the covered fund after all other interests have been redeemed or paid in full (*i.e.*, the residual), excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event;

- Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

- Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could 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;

- Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

- Any synthetic right to have, receive, or be allocated any of the foregoing rights.[44]

There are important interpretive questions regarding the scope of several of these characteristics. For example, would the right of a specified percentage of holders of ABS to remove and replace an indenture trustee constitute the right to participate in the selection or removal of a member of a "board of trustees"? Would a provision stating that when the asset pool is exhausted, the balance of any remaining outstanding ABS is reduced to zero constitute a reduction in amounts payable due to charge-offs of the pool assets? The answers to these questions are not yet clear.

[42] Final Regulations § __.10(a)(2).

[43] Final Regulations § __.10(d)(6).

[44] *Id.*

“Sponsor”

The definition of “sponsor” for purposes of the Volcker Rule’s covered fund provisions is quite different from the definition of “sponsor” that applies to ABS issuers under Regulation AB.[45] A banking entity is a “sponsor” of a covered fund if the banking entity:

- Serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund;
- In any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or
- Shares the same name or a variation of the same name with a covered fund, for corporate, marketing, promotional, or other purposes.[46]

There is no special Volcker Rule definition of “sponsor” for purposes of securitization transactions. Each transaction party must be analyzed in light of the general definition in the Final Regulations.[47] For example, securitization depositors and trusts often bear a name that is a variant of the name of the banking entity that was the Regulation AB sponsor of the transaction. If the securitization is a covered fund, this would result in the banking entity being deemed to be a “sponsor” under the Volcker Rule, which is prohibited by the covered fund restrictions. The names of such depositors and trusts may need to be changed to avoid this result.

“Trustee”

A “trustee” does not include a trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to section 403(a)(1) of the Employee’s Retirement Income Security Act (*i.e.*, ERISA), or a trustee that is subject to fiduciary standards under foreign law that are substantially equivalent to those of such a non-discretionary trustee.[48] However, an entity that directs such a person, or that possesses authority and discretion to manage and control the investment decisions of a covered fund for which such person serves as trustee, is considered to be a trustee of that covered fund.[49]

The Agencies note that a securitization trustee with the right to exercise investment discretion will be a sponsor. However, a trustee that executes decision-making, including the investment of funds before an event of default, only according to written contractual provisions or at the written direction of a non-affiliate, generally is not a sponsor. Similarly, a trustee with investment discretion may avoid characterization as a sponsor by irrevocably delegating all of that discretion to a non-affiliate of the covered fund.[50]

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[45] Regulation AB, Item 1102(l).

[46] Final Regulations § __.10(d)(9).

[47] Preamble, at 635.

[48] Final Regulations § __.10(d)(10).

[49] *Id.*

[50] *See* Preamble, at 636.

Interim Final Rule Regarding TruPS CDOs

On January 14, 2013, the Agencies adopted an interim final rule (the "TruPS Interim Final Rule") regarding the treatment of so-called "TruPS CDOs" – CDOs backed by pools of trust preferred securities or subordinated debt securities, commonly known as "TruPS."[51]

According to the Agencies, community banks typically issued TruPS for capital raising purposes. These securities frequently were acquired by CDOs formed specifically to acquire them.[52] According to market participants, the use of this pooled investment structure was the only practical way for community banking organizations to avail themselves of TruPS for regulatory capital purposes.[53] Congress recognized this structure, as Section 171 of the Dodd Frank Act allowed community banking organizations to continue to hold legacy TruPS CDOs, even though it generally required depository institution holding companies to phase them out of the calculation of regulatory capital for purposes of determining Tier 1 capital.[54] The Agencies adopted the TruPS Interim Final Rule in order to avoid undercutting the grandfathering provision that Congress adopted in Section 171 of the Dodd-Frank Act.[55]

Pursuant to the TruPS Interim Final Rule, the prohibition on a banking entity having an ownership interest in or sponsoring a covered fund will not apply to the ownership or sponsorship of any issuer, if:

- The issuer was established, and the interest issued, before May 19, 2010;
- The banking entity reasonably believes that the offering proceeds received by the issuer were invested primarily in Qualifying TruPS Collateral; and
- The banking entity acquired its interest on or before December 10, 2013 (or in connection with a merger with or acquisition of a banking entity that acquired its interest on or before that date).[56]

"Qualifying TruPS collateral" consists of any trust preferred security or subordinated debt instrument issued prior to May 19, 2010 by a depository institution holding company that, as of the end of any reporting period within 12 months immediately preceding the issuance of such trust preferred security or subordinated debt instrument, had total consolidated assets of less than $15,000,000,000, or issued prior to May 19, 2010 by a mutual holding company.[57]

The Agencies believe that the TruPS Interim Final Rule will cover all TruPS CDOs in the marketplace.[58] Simultaneously with the publication of the TruPS Interim Final Rule, the Agencies also published a non-exclusive list of qualifying TruPS CDOs, which they will recognize as meeting the requirements of the TruPS Interim Final Rule.[59]

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[51] The adopting release (the "TruPS Interim Final Rule Adopting Release"), consisting of the interim final rule and the accompanying summary and supplementary information, entitled 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, can be found on the websites of the Agencies. For example, it is available on the FDIC's website at **http://www.fdic.gov/news/news/press/2014/pr14003a.pdf**.

[52] TruPS Interim Final Rule Adopting Release, at 7.

[53] TruPS Interim Final Rule Adopting Release, at 8.

[54] TruPS Interim Final Rule Adopting Release, at 7.

[55] TruPS Interim Final Rule Adopting Release, at 8.

[56] TruPS Interim Final Rule § __.16(a).

[57] TruPS Interim Final Rule § __.16(b).

[58] TruPS Interim Final Rule Adopting Release, at 9.

[59] This list is available on the websites of the Agencies, e.g., at **http://www.fdic.gov/news/news/press/2014/pr14003b.pdf**.

The TruPS Interim Final Rule is effective on April 1, 2014. Comments are due on or before 30 days after publication in the Federal Register.[60] It was adopted on an expedited basis as an interim final rule, rather than being simply proposed for comment, so that community banks (and their auditors) could take it into account before they are required to file their financial reports for 2013.[61]

Organizing and Offering a Covered Fund, and Underwriting and Market-Making with Respect to a Covered Fund

Organizing and Offering a Covered Fund

A banking entity may retain an ownership interest in, or act as sponsor to, a covered fund in connection with, directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee or commodity pool operator of the covered fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any necessary expenses for the foregoing, if certain conditions are met.[62]

For a covered fund that is an ABS issuer, "organizing and offering an issuing entity of asset-backed securities" means acting as the "securitizer" of the issuing entity, as that term is used in Section 15G(a)(3) of the Exchange Act, or acquiring or retaining an ownership interest in the issuing entity in compliance with the minimum credit risk retention requirements of the Dodd-Frank Act, when they are adopted.[63] The following are the applicable conditions for an ABS issuer:[64]

- The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as described in "Permitted Seeding and *De Minimis* Investments" below;[65]
- The banking entity and its affiliates comply with the requirements described in "Limitations on Relationships Between Banking Entities and Covered Funds" below;[66]
- The banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;[67]
- The covered fund, for corporate, marketing, promotional, or other purposes, does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof), or use the word "bank" in its name;[68]
- No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory or other services

60 TruPS Interim Final Rule Adopting Release, at 2.

61 *Cf.* TruPS Interim Final Rule Adopting Release, at 10-11.

62 Final Regulations § __.11(a).

63 For a summary of the re-proposed credit risk retention rules for securitizations, *see* A Guide to the Re-Proposed Credit Risk Retention Rules for Securitizations, which is available at **http://www.bingham.com/Alerts/2013/09/A-Guide-to-the-Re-Proposed-Credit-Risk-Retention**.

64 Final Regulations § 11(b)(1).

65 Final Regulations § __.11(a)(3).

66 Final Regulations § __.11(a)(4).

67 Final Regulations § __.11(a)(5).

68 Final Regulations § __.11(a)(6).

(such as oversight and risk management, deal origination, due diligence, administrative or other support services) to the covered fund at the time the director or employee takes the ownership interest;[69]

- The banking entity clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):
  - That "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate";
  - That the investor should read the fund offering documents before investing in the covered fund;
  - That the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case); and
  - The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund;[70] and
- The banking entity complies with any additional rules of the appropriate federal banking agencies, the SEC, or the CFTC, that are designed to ensure that losses in the covered fund are borne solely by investors and not by the banking entity and its affiliates.[71]

Underwriting and Market-Making in Ownership Interests of a Covered Fund

A banking entity may engage in underwriting or market making-related activities involving ownership interests in a covered fund, if all of the following conditions are met:[72]

- The activities are conducted in accordance with the underwriting or market making exemptions to Volcker Rule's proprietary trading restrictions, as described below under "Underwriting Exemption" and "Market Making-Related Activities."[73]
- With respect to any banking entity (or an affiliate thereof) that:
  - Acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in the covered fund in reliance on the exemption for organizing and offering a covered fund (see above);

[69] Final Regulations § __.11(a)(7).

[70] Final Regulations § __.11(a)(8)(i).

[71] Final Regulations § __.11(a)(8)(ii).

[72] Final Regulations § __.11(c).

[73] Final Regulations § __.11(c)(1).

- Acquires and retains an ownership interest in the covered fund and is either a securitizer,[74] or is acquiring and retaining an ownership interest in such covered fund in compliance with the minimum credit risk retention requirements of the Dodd-Frank Act (when they are adopted) each as permitted by the exemption for organizing and offering an issuer of asset-backed securities (see above); or

- Directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests: Then any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making-related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the per-fund limits and the capital deductions described in "Permitted Seeding and *De Minimis* Investments" below.[75]

- With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under the exemption for organizing and offering a covered fund (discussed above), including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making-related activities, are included in the calculation of all ownership interests under the aggregate limits and capital deductions described in "Permitted Seeding and *De Minimis* Investments" below.[76]

The inclusion of underwriting and market-maker inventory in ownership interests in covered funds within a banking entity's limits on its permitted ownership interests in covered funds may pose concerns for the securitization markets. For example, if a banking entity sponsors (in the Regulation AB sense) a securitization that is a covered fund, an affiliated broker-dealer's market-maker inventory of ownership interests in that transaction will count towards the banking entity's individual ownership interest limit in that transaction. Because the maximum amount of ownership interests that can be held (at least after the initial one-year seeding period and after the credit risk retention rules become effective) is the required minimum credit risk retention in the securitization, then the broker-dealer may be completely foreclosed from making a market in any ABS issued by that securitization vehicle that constitute ownership interests. Even where a securitization vehicle that is a covered fund is sponsored by an unrelated third party, the inclusion of underwriting and market-maker inventory in ownership interests within a banking entity's aggregate covered fund ownership interest limit may impose capacity limits and difficult corporate compliance issues.

Permitted Seeding and *De Minimis* Investments

A banking entity may acquire and retain an ownership interest in a covered fund that the banking entity or an affiliate thereof organizes and offers pursuant to the exemption for organizing and offering a covered fund (discussed above) for the purposes of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or for purposes of making a *de minimis* investment in the fund,[77] subject to the conditions discussed below.

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[74] As defined in section 15G(a)(3) of the Exchange Act.

[75] Final Regulations § __.11(c)(2).

[76] Final Regulations § __.11(c)(3).

[77] Final Regulations §§ __.12(a).

Seeding Period

With respect to an investment in any covered fund made or held in connection with establishing the fund, the banking entity and its affiliates must:

- Actively seek unaffiliated investors to reduce, through redemption, sale, dilution, or other methods, the aggregate amount of all ownership interests of the banking entity in the covered fund to the per-fund limit (see below and Exhibit A), and
- No later than one year after the date of establishment of the fund (or up to two additional years with FRB approval), conform its ownership interest in the covered fund to the per-fund limits.[78]

The "date of establishment" for a covered fund that is an issuing entity of ABS is the date on which the assets are initially transferred into the issuing entity.[79]

Per-Fund Limits

At the end of the seeding period, an investment by a banking entity and its affiliates in a covered fund that is an issuer of ABS may not exceed three percent of the total fair market value of the ownership interests of the fund, but if any greater percentage is required by the final Dodd-Frank credit risk retention rules, when they become effective, then the investment limit will be the minimum credit risk retention requirement.[80] These limits are described in detail in Exhibit A.

Aggregate Limits

The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under this seeding and *de minimis* investment exemption may not exceed three percent of the tier 1 capital of the banking entity, calculated as of the last day of each calendar quarter.[81] These limits are described in detail in Exhibit A.

Limitations on Relationships Between Banking Entities and Covered Funds

The Final Regulations include the so-called "Super 23A" provisions, which apply to entities (including securitization vehicles) that are covered funds.

"Super 23A" Restriction

A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund pursuant to the exemption for organizing and offering a covered fund, or that continues to hold an ownership interest in reliance on the exemption for organizing and offering a covered fund, is prohibited from entering into a "covered transaction" with the covered fund, or with any other covered fund controlled by such covered fund, that would be a covered transaction as defined in Section 23A of the Federal Reserve Act, as if that banking entity were a member

[78] Final Regulations § __.12(a)(2)(i).

[79] Final Regulations § __.12(a)(2)(iv).

[80] Final Regulations § __.12(a)(2)(ii).

[81] Final Regulations § __.12(a)(2)(iii).

bank and the covered fund were an affiliate thereof.[82] For these purposes, "covered transactions" include, among other things, loans and other extensions of credit; purchases of securities or other assets; and credit exposure from derivatives transactions, securities lending and borrowing transactions, and repurchase agreement transactions.[83]

This restriction is broader than the Section 23A restriction on covered transactions between banks and their affiliates. The Final Regulations prohibit covered transactions between banking entities (including their affiliates) and covered funds subject to the restriction, while Section 23A permits covered transactions between banks and their affiliates provided certain quantitative and qualitative requirements are met.[84] In addition, Section 23A's exemptions for certain types of covered transactions would generally not be applicable (*e.g.*, no exemptions for transactions secured by cash or government securities, or for intra-day extensions of credit).[85] However, the Agencies did clarify that the Section 23A "attribution rule" does not apply in this context.[86] As a result, the "Super" 23A restrictions do not apply to transactions with a third party other than the covered fund.

The Final Regulations provide certain exceptions from these prohibitions. Among other things, a banking entity may acquire and retain any ownership interest in a covered fund in accordance with one of the exemptions discussed above.[87]

Because loans and other extensions of credit are covered transactions, a banking entity that sponsors, manages or provides advisory services to a securitization vehicle that is a covered fund could be limited in its ability to provide liquidity, servicing advances or other customary extensions of credit to the securitization vehicle. Similarly, because a repurchase of assets is a covered transaction, a banking entity that sponsors, manages or provides advisory services to a securitization vehicle that is a covered fund could be limited in its ability to repurchase assets from the securitization vehicle, including in the event of a breach of a representation or warranty.

Market Terms Requirement

A banking entity that is subject to the "Super 23A" restriction with respect to a covered fund is also subject to section 23B of the Federal Reserve Act with respect to that fund, as if the banking entity were a member bank and the covered fund were an affiliate.[88] As a result, most transactions between a banking entity and such a covered fund will be subject the market terms requirement of Section 23B, *i.e.*, that they must be on terms at least as favorable to the banking entity as those of a comparable transaction with an unaffiliated third party.

For a banking entity that sponsors, manages or provides advisory services to a securitization vehicle that is a covered fund, this requirement would apply to any transactions between those entities. For example, transfers of assets to the securitization vehicle would have to be at arms' length, as would any servicing arrangements with the banking entity.

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[82] Final Regulations § __.14(a)(1). Section 23A of the Federal Reserve Act imposes certain qualitative and quantitative restrictions on "covered transactions" between banks and their affiliates, and requires that certain collateral be maintained for certain extensions of credit by a member bank to any of its affiliates.

[83] 12 U.S.C. § 371c(b)(7).

[84] *See* Final Regulations § __.14(a)(1); 12 U.S.C. § 371c(a) and (c).

[85] *See* Preamble, at753-55.

[86] *See* Preamble, at755-56. Under the "attribution" rule, subject to certain exceptions, a transaction between a bank and an unaffiliated third party is treated for purposes of Sections 23A and 23B of the Federal Reserve Act as a transaction between the bank and its affiliate to the extent that the proceeds from the transaction are used for the benefit of, or transferred to, an affiliate. *See, e g.,* 12 C.F.R. § 223.16(a).

[87] Final Regulations § __.14(a)(2).

[88] Final Regulations § __.14(b).

Other Limitations on Covered Fund Activities and Investments

Under the "back stop" provisions of the Final Regulations, no transaction, class of transactions, or activity is permissible if it would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
- Result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy;[89] or
- Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[90]

A material conflict exists between a banking entity and its clients, customers, or counterparties if the banking entity engages in any action that results in the banking entity's interests being materially adverse to the interests of its client, customer or counterparty, unless the banking entity has previously taken at least one of the following two actions to address the conflict:

- Made a clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and such disclosure has been made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or
- Established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.[91]

For a securitization that is a covered fund, these conflict of interest provisions are in addition to any applicable securitization conflict of interest requirements that may be imposed by Section 621 of the Dodd-Frank Act, when final rules are adopted and become effective.[92]

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89 A "high-risk asset" or "high-risk trading strategy" is an asset, group of related assets or trading strategy that would, if held or engage in by a banking entity, increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Final Regulations § __.15(c).

90 Final Regulations § __.15(a).

91 Final Regulations § __.15(b)(2). A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer or counterparty. Final Regulations § __.15(b)(2)(ii).

92 Preamble, at 457. Our client alert on the proposed securitization conflict of interest regulations, SEC Proposed Rule Regarding Prohibition Against Conflicts of Interest in Certain Securitizations, is available at **http://www.bingham.com/Alerts/2011/09/SEC-Proposes-Rule-Regarding-Prohibition-Against-Conflicts-of-Interest-in-Certain-Securitizations**.

Proprietary Trading

In general, the Final Regulations prohibit any banking entity from engaging in proprietary trading. "Proprietary trading" is defined as engaging as principal for a "trading account" in any purchase or sale of any "financial instrument."[93] Despite the extensive guidance in the Preamble, there remain many questions as to whether particular activities are caught in the ban, and whether activities that seemingly are excluded from the ban (*i.e.*, permitted) actually are prohibited.

The proprietary trading restrictions will apply to purchases and sales of ABS by a banking entity, including by a broker-dealer affiliate. However, there are exceptions for several common types of trading activities, including underwriting and market-making. Dealers that are banking entities and that engage in purchases and sales of ABS will need to monitor their activities to ensure that their activities either do not constitute prohibited proprietary trading or fall within the scope of one of the exceptions.

As noted above, a securitization entity generally will not be considered an affiliate of a banking entity, and thus not a banking entity itself, so trading by a securitization entity generally will not be subject to the proprietary trading restrictions. In the unlikely event that a securitization entity is deemed to be a banking entity, the proprietary trading restrictions could have numerous adverse effects, particularly for transactions that have managed asset pools.

"Financial Instrument"

The "financial instruments" that are subject to the prohibition on proprietary trading consist of:

- Any security, including an option on a security;
- Any derivative, including an option on a derivative; or
- Any contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.[94]

However, term "financial instrument" does not include:

- A loan;
- A commodity that is not:
  - An excluded commodity[95] (other than foreign exchange or currency);
  - A derivative;
  - A contract of sale of a commodity for future delivery; of
  - An option on a contract of sale of a commodity for future delivery; or
- Foreign exchange or currency.[96]

[93] Final Regulations § ___.3(a).

[94] Final Regulations § __.3(c)(1).

[95] As defined in Section 1a(19) of the Commodity Exchange Act. Final Regulations § __.2(k).

[96] Final Regulations § __.3(c)(2).

“Trading Account”

“A “trading account” is any account in which a banking entity and/or one of its affiliates engages in one or more of three enumerated types of activities:

- Short-term trading for the banking entity’s account;
- Purchases or sales of financial instruments that are both market risk capital rule covered positions and trading positions (or hedges on the market risk capital rule positions); or
- Purchases or sales of any financial instrument by a licensed, regulated entity that is engaged in the business of dealer, swap dealer or security-based swap dealer.[97]

This three-pronged approach provides the foundation for a rebuttable presumption that trading in a trading account is prohibited if it meets the criteria described below.

Short-Term Trading in a Trading Account

For these purposes, short-term trading in a trading account consists of the purchase or sale of one or more financial instruments principally for the purpose of:

- Short-term resale;
- Benefitting from actual or expected short-term price movements;
- Realizing short-term arbitrage profits; or
- Hedging one or more positions resulting from a purchase or sale of financial instruments that falls within any of the above.[98]

There is a rebuttable presumption that a banking entity is engaging in short-term trading if it holds a financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase or sale. To rebut the presumption, a banking entity must demonstrate, based on all relevant facts and circumstances, that it did not purchase or sell the financial instrument principally for the purpose of prohibited short-term trading.[99] According to the Agencies, facts and circumstances might rebut the presumption when an increase in a financial instrument’s volatility, or a need to liquidate the instrument to meet unexpected liquidity demands, results in a banking entity disposing of a financial instrument intended as a long-term investment within 60 days of its purchase.[100]

Market Risk Capital Rule Trading

The second category of prohibited proprietary trading in a trading account is trading by a banking entity that:

- Is an insured depository institution, bank holding company, or savings and loan holding company (or if an affiliate of a banking entity is such an institution);

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[97] Final Regulations § __.3(b).

[98] Final Regulations § __.3(b)(1)(i).

[99] Final Regulations § __.3(b)(2).

[100] Preamble at 47.

- Trades financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions); and

- Calculates risk-based capital ratios under the market risk capital rule.[101]

Trading by a Dealer

The third category of prohibited proprietary trading is proprietary trading for any purpose by a banking entity that is:

- Licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or

- Engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.[102]

However, there are exceptions for several common types of trading activities, including underwriting and market-making, subject to the detailed requirements described below. Dealers that are banking entities and that engage in purchases and sales of ABS will need to monitor their activities to ensure that they fall within the scope of the permitted exclusions.

Exclusions from the Definition of "Proprietary Trading"

The Final Regulations include several express exclusions from the definition of proprietary trading.

One of the most important of these for the securitization industry is the exemption for repurchase financings and securities lending arrangements. A banking entity may engage in any purchase or sale of one or more financial instruments that arises under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand, with the same counterparty.[103] A banking entity may also engage in any purchase or sale of one or more financial instruments that arises under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed to by the parties.[104] As a result, banking entities may continue to engage in many common types of repurchase and securities lending arrangements involving ABS.

However, the Agencies caution that the exclusion is limited to transactions pursuant to the repurchase agreement, reverse repurchase agreement, or securities lending agreement that the financed position itself is not excluded from the definition of "proprietary trading." Similarly, short positions resulting from securities lending agreements are not excluded.[105]

[101] Final Regulations § __.3(b)(1)(ii).

[102] Final Regulations § __.3(b(1))(iii).

[103] Final Regulations § __.3(d)(1).

[104] Final Regulations § __.3(d)(2).

[105] Preamble, at 59-60.

The other exclusions the definition of proprietary trading consist of the purchase and sale of financial instruments:

- For certain *bona fide* liquidity management purposes;[106]
- In connection with clearing financial instruments, if the banking entity is a derivatives clearing organization or a clearing agency;[107]
- Constituting certain clearing activities, if the banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;[108]
- To satisfy an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity;[109]
- To satisfy an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding;[110]
- If the banking entity is acting solely as agent, broker, or custodian;[111]
- Through a qualifying deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity, if the purchase or sale is made as trustee for the benefit of persons who are (or were) employees;[112] and
- In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable, and in no event retains the instrument for longer than the period permitted by an Agency.[113]

Underwriting Exemption

The prohibition on proprietary trading does not apply to a banking entity's underwriting activities, if certain requirements are met. In general, to engage in permitted underwriting activity, trading desks must satisfy certain requirements with regard to their activities, must make reasonable efforts to sell or otherwise reduce underwritten positions and must be subject to robust risk limit structures.[114]

Exemption Limited to Underwriting Activities

The exemption for underwriting activities applies to a banking entity that acts as an "underwriter" for a "distribution" of securities, so long as a variety of other requirements are satisfied.[115]

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[106] Final Regulations § __.3(d)(3).

[107] Final Regulations § __.3(d)(4).

[108] Final Regulations § __.3(d)(5).

[109] Final Regulations § __.3(d)(6)(i).

[110] Final Regulations § __.3(d)(6)(ii).

[111] Final Regulations § __.3(d)(7).

[112] Final Regulations § __.3(d)(8).

[113] Final Regulations § __.3(d)(9).

[114] Final Regulations § __.4(a)

[115] Final Regulations § __.4(a)(2)(i).

An “underwriter” is as a person who:

- Has agreed with an issuer or selling security holder to purchase securities from the issuer or selling security holders for distribution, to engage in a distribution of securities for or on behalf of the issuer or selling security holder, or to manage a distribution of securities for or on behalf of the issuer or selling security holder; or

- Has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.[116]

“Distribution” is defined as:

- An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

- An offering of securities made pursuant to an effective registration statement under the Securities Act.[117]

The breadth of these definitions means that the exemption for underwriting activities captures not only a full commitment underwriting of registered securities, but other common methods of distributing ABS, including a best efforts public underwriting, acting as an initial purchaser in a Rule 144A placement, and acting as a placement agent in a private placement. However, the exemption still has its limits. For example, with respect to the transfer of financial assets into an intermediate entity in connection with a structured finance product, or the accumulation of financial assets in anticipation of a securitization, the Agencies caution that banking entities may need to adjust their activities or find some other available exemption.[118]

The “underwriting position” of the “trading desk” must be limited to the distribution.[119] “Underwriting position” is defined as the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, across relevant entities, in connection with a particular distribution of securities for which such banking entity or affiliate is acting as an underwriter.[120] The “trading desk” is the organizational level of a banking entity (or across one or more affiliated banking entities) at which the requirements of the underwriting exemption will be assessed.[121]

According to the Agencies, the exemption applies to selling group members as well as members of the underwriting syndicate, and covers a broad scope of activities traditionally associated with underwriting, including stabilization activities.[122]

[116] Final Regulations § __.4(a)(4).

[117] Final Regulations § __.4(a)(3).

[118] Preamble, at 114.

[119] Final Regulations § __.4(a)(2)(i).

[120] Final Regulations § __.4(a)(6).

[121] Final Regulations § __.3(e)(13).

[122] Preamble, at 100.

Limits on the Amount and Type of Securities Underwritten

The underwriting activities of a banking entity are permitted if the amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[123]

Currently, underwriters of ABS sometimes purchase securities that they do not expect to sell in the near term. The Volcker Rule may result in fewer illiquid ABS tranches being held by banking entity underwriters as unsold allotments, and instead being retained by the issuer.

Other Requirements

The compensation arrangements of persons at a banking entity engaged in underwriting activity cannot reward or incentivize prohibited proprietary trading.[124] Rather, a banking entity should provide compensation incentives that primarily reward client revenues and effective client services.[125]

A banking entity can engage in permitted underwriting activities only if it has established, and implements, maintains and enforces, an internal compliance program reasonably designed to ensure compliance with the conditions of Final Regulations, that includes: reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing the types of products that may be purchased and sold; limits on the trading desk's activities; internal controls; and authorization procedures.[126]

Finally, a banking entity must be appropriately licensed or registered to engage in permitted underwriting activity.[127] This provision requires a U.S. banking entity to be an SEC-registered dealer in order to rely on the underwriting exemption in connection with a distribution of securities – other than exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills – unless the banking entity is exempt from registration or excluded from regulation as a dealer.[128]

Market Making-Related Activities

The Final Regulations provides that the prohibition on proprietary trading will not apply to market making-related activities that a banking entity undertakes in order to provide important intermediation and liquidity services to its clients, customers, and counterparties.[129] In order for trading activity to fall within this exemption, several criteria must be satisfied.[130]

Trading Desk Must Stand Ready to Purchase and Sell

The trading desk that establishes and manages the financial exposure must routinely stand ready to purchase and sell.[131]

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123 Final Regulations § __.4(a)(2)(ii).

124 Final Regulations § __.4(a)(2)(iv).

125 Preamble, at 132-33.

126 Final Regulations § __.4(a)(2)(iii).

127 Final Regulations § __.4(a)(2)(v).

128 Preamble, at 135.

129 Final Regulations § __.4(b)(1).

130 Final Regulations § __.4(b)(2).

131 Final Regulations § __.4(b)(2)(i).

"Financial exposure" is defined as "the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities."[132] In order to understand the concept of financial exposure, it is important also to understand the concept of "market-maker inventory," which is defined as "all of the positions in the financial instruments for which the trading desk stands ready to make a market…that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions."[133]

The Agencies, in the Preamble, clarify that:

> [t]he market-maker inventory of a trading desk includes the positions in financial instruments, including derivatives, in which the trading desk acts as a market maker. The financial exposure of the trading desk includes the aggregate risks of financial instruments in the market-maker inventory of the trading desk plus the financial instruments, including derivatives, that are acquired to manage the risks of the positions in financial instruments for which the trading desk acts as a market maker, but in which the trading desk does not itself make a market, as well as any associated loans, commodities, and foreign exchange that are acquired as incident to acting as a market maker.[134]

Simply put, a trading desk's market-maker inventory is the positions in financial instruments that the trading desk stands ready to buy and sell (or otherwise transact in), and the financial exposure of a trading desk is the risk from that inventory, as well as the risk from the positions acquired to manage that risk (and the risk of positions acquired incidentally while doing so).

To qualify as engaged in market making, a trading desk must have inventory and risk limits, as well as escalation procedures for when limits may be or are exceeded, on its financial exposure.[135]

A trading desk must routinely stand ready to transact in financial instruments related to its financial exposure.[136] "Standing ready' includes being willing and available to quote, buy and sell (or otherwise enter into long and short positions in) the financial instruments in commercially reasonable amounts and throughout market cycles. It is not sufficient for a trading desk to provide wide quotations or be only willing to trade on an irregular, intermittent basis. "Routinely" standing ready must be interpreted to account for differences across markets and asset classes.[137] Thus, the requirement to routinely stand ready to transact will differ based on the "liquidity, maturity, and depth of the market" for a given financial instrument."[138] At one extreme, a market maker in liquid equity securities is expected to engage in very regular or continuous quoting and trading activity on both sides of the market; whereas, at the other extreme, a market maker in a highly illiquid market may trade only intermittently or by request from particular customers.[139] Regardless of differences across markets and asset classes, a trading desk

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[132] Final Regulations § __.4(b)(4)

[133] Final Regulations § __.4(b)(5).

[134] Preamble, at 195-96.

[135] Final Regulations § __.4(b)(2)(iii).

[136] Preamble, at 186.

[137] Preamble, at 187.

[138] Preamble, at 208.

[139] *Id.*

should have a pattern of quoting and trading on both sides of the market.[140] Standing ready to transact in "commercially reasonable amounts" requires a trading desk to generally quote and trade in sizes requested by other market participants. A trading desk must make a market through differing market cycles and not just when it is most favorable to do so.[141]

Limits on Type and Amount of Financial Instruments in Market-Maker Inventory

The amount, types, and risks of the financial instruments in the market-maker inventory must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[142]

An analysis of a trading desk's market-maker inventory is needed to determine whether this inventory is related to the reasonably expected near term demands of clients, customers, or counterparties.[143] Based on this analysis, a banking entity must establish risk and inventory limits for each trading desk designed to prevent trading activity unrelated to market-making or managing the risk of specific market-making. The near term customer demand requirement directly applies only to the market-maker inventory; however, limits based on the near term customer demand requirement must be set for not only the market-maker inventory but for the "products, instruments, and exposures" the desk may use for risk management purposes, and the aggregate financial exposure.[144]

There are two factors for assessing whether the "amount, types, and risks of the financial instruments" in the market-maker inventory are designed not to exceed near term customer demand. First, for each financial instrument, the "liquidity, maturity, and depth of the market" must be considered.[145] Very generally, in more liquid markets, customer demand is likely to be more frequent and market-makers should have higher rates of inventory turnover and less aged inventory. When considering a less mature market, banking entities are encouraged to consider their experience with similar products.[146] Second, there must be a demonstrable analysis (generally based on trading desk records and market information) of historical customer demand, current inventory of financial instruments, and market and other factors regarding the risks associated with the financial instruments in which the trading desk makes a market, including through block trades.[147]

According to the Agencies, a trading desk may be able to use the market-making exemption to acquire the risk of complex structured products if that trading desk has evidence of customer demand for each of the associated significant risks, based on prior express interest.[148]

Other Requirements

The banking entity must implement, maintain and enforce an internal compliance program that is reasonably designed to ensure its compliance with the market-making exception. The program must include reasonably designed written policies and procedures, internal controls, analysis, and independent

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[140] Preamble, at 210.

[141] Preamble, at 212.

[142] Final Regulations § __.4(b)(2)(ii).

[143] *Id.*

[144] Preamble, at 239-240.

[145] Final Regulations § __.4(b)(2)(ii)(A).

[146] Preamble, at 254.

[147] Final Regulations § __.4(b)(2)(ii)(B).

[148] Preamble, at 258-59.

testing, which must identify and address: the financial instruments the trading desk may trade; the actions the trading desk will take to reduce or mitigate the risks of its financial exposure; limits on the trading desk's activities; internal controls; and authorization procedures, including escalation procedures that require review and approval of any trade that would exceed any particular limit.[149]

The trading desk must take action to return to compliance as promptly as possible after a limit is exceeded.[150]

The compensation arrangements of persons performing market making-related activities must be designed not to incentivize prohibited proprietary trading.[151] While successful market making involves some risk-taking, a compensation arrangement may not reward speculation in, and appreciation of, the market value of a position held in inventory. Compensation arrangements should primarily reward customer revenues and effective customer service.[152]

Finally, the banking entity must be licensed or registered to engage in market making-related activities in accordance with applicable law.[153]

Permitted Risk-Mitigating Hedging Activities

The prohibition on proprietary trading will not apply to risk-mitigating hedging activities that a banking entity undertakes in order to reduce specific, identifiable risks associated with that entity's (individual or aggregate) positions, contracts, or other holdings.[154] In order for trading activity to fall within this exemption, a variety of specific criteria must be satisfied.[155]

The banking entity must have a compliance program that is reasonably designed to ensure compliance with the restrictions on hedging activities, including: written policies and procedures regarding the positions, techniques, and strategies that may be used for hedging; internal controls and monitoring procedures, including escalation procedures; and analysis designed to ensure that permitted hedging positions, techniques and strategies may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the risks being hedged.[156]

The trading activity must be conducted in accordance with the banking entity's compliance program.[157]

The trading activity must, at the time it is entered into, be tied to one or more specific, identifiable risks and must demonstrably reduce those risks.[158]

The trading activity must not, at the time it is entered into, give rise to any significant new and additional risks unless they are contemporaneously hedged.[159]

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[149] Final Regulations § __.4(b)(2)(iii).

[150] Final Regulations § __.4(b)(2)(iv).

[151] Final Regulations § __.4(b)(2)(v).

[152] Preamble, at 289.

[153] Final Regulations § __.4(b)(2)(vi).

[154] Final Regulations § __.5(a).

[155] Final Regulations § __.5(b).

[156] Final Regulations § __.5(b)(1)

[157] Final Regulations § __.5(b)(2)(i).

[158] Final Regulations § __.5(b)(2)(ii).

[159] Final Regulations § __.5(b)(2)(iii).

Any trading activity that was entered into for the purpose of hedging must be subject to ongoing monitoring and, where necessary, recalibration in order to ensure that it never adds to the banking entity's risk exposure. Ongoing recalibration is required in order to make sure that a position, contract, or holding that was entered into for the purpose of hedging does not later become a source of risk exposure.[160]

The compensation arrangements of people engaged in hedging activities cannot be designed to reward or incentivize proprietary trading.[161]

Finally, if the hedging activity involves multiple trading desks or is undertaken by a trading desk not explicitly permitted to engage in that kind of trading, the banking entity must document several specific aspects of its hedging activity.[162]

Other Permitted Trading Activities

The Final Regulations also permit several other categories of trading activity, including:

- Proprietary trading in obligations of the U.S. government, states and other political entities;[163]
- Propriety trading in foreign government obligations by banking entities with certain specified ties to those foreign nations;[164]
- Proprietary trading on behalf of a customer, including fiduciary transactions and riskless principal transactions;[165] and
- Proprietary trading by banking entities that perform most of their banking activities overseas, so long as the trading occurs outside of the United States and is conducted exclusively between foreign entities.[166]

Limitations on Permitted Proprietary Trading Activities

Regardless of whether there is an otherwise available exemption, proprietary trading will not be permitted in three circumstances.

No proprietary trading will be permitted if the trading activity would involve a material conflict of interest between the banking entity and a client, customer, or counterparty.[167] A material conflict of interest exists when a banking entity engages in a transaction or activity that would involve the banking entity's interests being materially adverse to those of a client, customer, or counterparty.[168] However, a material conflict of interest will not exist if either:

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[160] Final Regulations § __.5(b)(2)(iv)(C).

[161] Final Regulations § __.5(b)(3).

[162] Final Regulations § __.5(c).

[163] Final Regulations § __.6(a).

[164] Final Regulations § __.6(b).

[165] Final Regulations § __.6(c).

[166] Final Regulations § __.6(e).

[167] Final Regulations § __.7(a)(1).

[168] Final Regulations § __.7(b)(1).

- The banking entity makes a timely and effective disclosure of the conflict, so that the affected party has the opportunity to negate or substantially mitigate any adverse effect it might suffer as a result of the conflict;[169] or

- The banking entity has appropriate information barriers in place that are reasonably designed to prevent the conflict of interest from having a materially adverse effect on the client, customer, or counterparty affected by it (unless the banking entity knows or should reasonably know that a conflict of interest which may have such a materially adverse effect, notwithstanding the information barrier).[170]

No proprietary trading will be permitted if the trading activity would result, directly or indirectly, in the banking entity being materially exposed to a high-risk asset or a high-risk trading strategy.[171] "High-risk" assets and strategies are those that would "significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States."[172]

Finally, and similarly, no proprietary trading will be permitted if the trading activity would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[173]

Compliance Program Requirements

Banking entities that engage in proprietary trading or covered fund activity as permitted under the Volcker Rule must implement internal controls and compliance programs reasonably designed to ensure and monitor compliance with the Final Regulations, and to comply with reporting and recordkeeping requirements. The internal controls and compliance program must be appropriate for the size, scope and complexity of the activities and business structure of the banking entity.[174] A banking entity must establish the required internal controls and compliance program as soon as practicable and in no event later than the end of conformance period, which is July 21, 2015.[175]

Enhanced internal control and compliance program standards apply to a banking entity that has significant proprietary trading activities or that has total consolidated assets of $50 billion or more (or, in the case of a foreign banking entity, total U.S. assets of $50 billion or more).[176] The CEO of the banking entity must attest in writing to the appropriate Agency that the banking entity has a compliance program reasonably designed to comply with the Volcker Rule and the Final Regulations.[177]

[169] Final Regulations § __.7(b)(2)(i). A disclosure may be insufficient if it is so generic or made so far in advance of a particular transaction that the affected party is unlikely to take it into account when evaluating the transaction. Preamble, at 452. Simply obtaining the affected party's consent to the conflict will be insufficient unless that party is also offered the opportunity to negate or substantially mitigate any possible adverse effect of the conflict. Preamble, at 449.

[170] Final Regulations § __.7(b)(2)(ii).

[171] Final Regulations § __.7(a)(2).

[172] Final Regulations § __.7(c).

[173] Final Regulations § __.7(b)(2)(iii).

[174] Final Regulations § __.20(a).

[175] Some banking entities will be required to report and record quantitative measurements regarding certain proprietary trading activities beginning as of June 30, 2014.

[176] Final Regulations §§ __.20(c)(1)-(2) and (d).

[177] Final Regulations App. B, § III.

Conformance Period

By statute, a banking entity must bring its activities and investments into compliance with the Volcker Rule and the Final Regulations no later than two years after the statutory effective date, which was July 21, 2012, unless extended by the FRB. The FRB may grant up to three one-year extensions of the compliance transition period if the extension would be consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. For certain "illiquid funds," an additional extension of up to five-years may be available to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.[178]

Concurrently with its adoption of the Final Regulations, the FRB issued an order (the "Order") which granted a one-year extension of the conformance period until July 21, 2015.[179] The Order explains that, during the conformance period, each banking entity will be expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of the Volcker Rule and the Final Regulations by no later than the end of the conformance period. Good faith efforts include evaluating the extent to which the banking entity is engaged in activities and investments that are covered by the Volcker Rule and the Final Regulations, as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the conformance period. Banking entities should not expand activities and make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted.[180]

While the statute and Final Regulations do not require banking entities to conform their activities to the requirements of the Volcker Rule until July 21, 2015, aspects of the rules may have an indirect earlier effect. For example, if a banking entity has an ownership interest in a covered fund that will be prohibited at the end of the conformance period, it would not have to divest that interest until July 21, 2015. However, because of the eventual need to divest that interest, different accounting or capital treatment may be required significantly earlier than the end of the conformance period.

This alert was authored by Charles A. Sweet.

[178] The FRB issued final regulations regarding the conformance period and extended transition period authorities for the Volcker Rule on February 11, 2011.

[179] *See* FRB, Order Approving Extension of Conformance Period, *available at* **http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf**.

[180] *See* Order, at 3.

EXHIBIT A

Calculation of Investment Limits

Under the Final Regulations, the per-fund limits and aggregate limits on investments made under the exemption for seeding and *de minimis* investments must be calculated in accordance with the following framework.

Attribution of Ownership Interests

For purposes of the per-fund and aggregate investment limits, the amount and value of a banking entity's permitted investment in a single covered fund includes any ownership interest held under the seeding and *de minimis* investment exemption by the banking entity, including any affiliate of the banking entity.[181]

Registered Investment Companies, SEC-regulated business development companies, and foreign public funds. For these purposes, a registered investment company, SEC-regulated business development company, or a foreign public fund (as described above) will not be considered to be an affiliate of a banking entity so long as the banking entity meets two conditions:

- The banking entity does not own, control, or hold with the power to vote less than 25 percent of the voting shares of the company or fund; and
- The banking entity provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund only in a manner that complies with other limitations under applicable regulation, order, or other authority.[182]

Covered Funds. The Final Regulations do not generally attribute to a banking entity ownership interests held by a covered fund so long as the banking entity's investment in the covered fund meets the per-fund limitation.[183]

Treatment of Employee and Director Investments. All director or employee investments in a covered fund will be attributed to the banking entity for purposes of the per-fund limitation and the aggregate limitation if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the financing is used to acquire such ownership interest in the covered fund.[184] The Preamble also explains that, as provided in the definition of "ownership interest," the Final Regulations also attribute to the banking entity "any amounts contributed by an employee or director when made in order to receive a restricted profit interest, whether or not funded or guaranteed by the banking entity."[185]

[181] Final Regulations § __.12(b)(1).

[182] Final Regulations § __.12(b)(1)(ii).

[183] Final Regulations § __.12(b)(1)(iii).

[184] Final Regulations § __.12(b)(1)(iv). As provided in the definition of "ownership interest," the Rule also attributes to the banking entity "any amounts contributed by an employee or director when made in order to receive a restricted profit interest, whether or not funded or guaranteed by the banking entity."

[185] Preamble, at 708.

Per-Fund Limits

At the end of the one year period (subject to a limited extension, as discussed above) after the date of establishment of the covered fund (the "seeding period"), an investment by a banking entity and its affiliates in three covered fund may not exceed three percent of the total number or value of the outstanding ownership interests of the fund (except with respect to interests in covered funds that issue asset-backed securities, as described below).[186] For purposes of these calculations:

- The aggregate number of the outstanding ownership interests held by the banking entity is the total number of ownership interests held under the seeding and *de minimis* investment exemption by the banking entity in a covered fund divided by the total number of ownership interests held by all entities in that covered fund, as of the last day of each calendar quarter (both measured without regard to committed funds not yet called for investment);[187]
- The aggregate value of the outstanding ownership interests held by the banking entity is:
    - The aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity, divided by the value of all investments in and capital contributions made to that covered fund by all entities, as of the last day of each calendar quarter (all measured without regard to committed funds not yet called for investment), or
    - If fair market value cannot be determined, the historical cost basis of all investments in and contributions made by the banking entity to the covered fund;[188] and
- Once a valuation methodology is chosen, the banking entity must calculate the value of its investment and the investments of all others in the covered fund in the same manner and according to the same standards.[189]

The Final Regulations clarify how to apply the per fund limits to master-feeder fund investments and fund of funds investments.

- *Master-fund fund investments.* If the principal strategy of a covered fund (the "feeder fund") is to invest substantially all of its assets in another single covered fund (the "master fund"), then for the purpose of the per fund limits, the banking entity's permitted investment in such funds should be measured only by reference to the value of the master fund. The banking entity's permitted investment in the master fund includes any investment by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund.[190]
- *Fund-of-funds investments*. If a banking entity organizes and offers a covered fund pursuant to the exemption for organizing and offering a covered fund for the purpose of investing in other covered funds (a "fund of funds") and that fund of funds itself invests in another covered fund that the banking entity is permitted to own, then the banking entity's permitted investment in that other fund includes any investment by the banking entity in that other fund, as well as the banking entity's pro-rata share

[186] Final Regulations § __.12(a)(2)(ii)(A).

[187] Final Regulations § __.12(b)(2)(i).

[188] Final Regulations § __.12(b)(2)(ii).

[189] Final Regulations § __.12(b)(2)(iii).

[190] Final Regulations § __.12(b)(4)(i).

of any ownership interest of the fund that is held through the fund of funds. The investment of the banking entity in the fund of funds must also not represent more than three percent of the amount or value of any single covered fund.[191]

The Final Regulations provide special rules for investments in a covered fund that is an issuer of ABS.

- The investment limit is three percent of the total fair market value of the ownership interests of the fund, but if any greater percentage is required by the final Dodd-Frank credit risk retention rules, when they become effective, then the investment limit will be the minimum credit risk retention requirement.[192]
- For securitizations that are subject to the Dodd-Frank credit risk retention rules, the calculations will be made as of the date and valuation methodology required by the final credit risk retention rules.[193]
- For securitizations completed prior to the compliance date of the credit risk retention rules (or to which those rules do not apply), the calculations shall be made as of the date of establishment of the securitization vehicle, or such earlier date on which then transferred assets have been valued for purposes of transfer to the securitization vehicle, and thereafter only on a date on which additional ABS are priced for sale to unaffiliated investors.[194]
- For securitizations completed prior to the compliance date of the credit risk retention rules (or to which those rules do not apply), the aggregate value of the outstanding ownership interests in the securitization vehicle shall be the fair market value of the assets transferred to the issuing entity and any other assets held by the issuing entity at that time, determined in a manner consistent with its determination of fair market value for financial statement purposes. The valuation methodology must be the same for all ownership interests in the securitization vehicle, whether held by the banking entity or others.[195]

Aggregate Limits

The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under the seeding and *de minimis* investment exemption may not exceed three percent of the tier 1 capital of the banking entity, calculated as of the last day of each calendar quarter.[196]

- The aggregate value of all ownership interests held by a banking entity is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in covered funds (together with any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining a restricted profit interest, whether or not funded by the banking entity), as measured on a historical cost basis.[197]

[191] Final Regulations § __.12(b)(4)(ii).

[192] Final Regulations § __.12(a)(2)(ii).

[193] Final Regulations § __.12(a)(3)(i).

[194] Final Regulations § __.12(a)(3)(ii).

[195] Final Regulations § __.12(a)(3)(iii-(iv).

[196] Final Regulations § __.12(a)(2)(iii).

[197] Final Regulations § __.12(c)(1).

- The tier 1 capital of the banking entity must be calculated as follows:
    - If a banking entity is required to hold tier 1 capital, the banking entity's tier 1 capital is equal to the amount of tier 1 capital of the banking entity as of the last day of the most recent calendar quarter, as reported to its primary financial regulatory agency.[198]
    - If a banking entity is not required to calculate and report tier 1 capital, but the banking entity is controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital, the banking entity's tier 1 capital is equal to the amount of tier 1 capital reported by such controlling depository institution in the manner described for entities that are required to hold tier 1 capital.[199]
- In the case of a banking entity that is not controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital:
    - If the banking entity is a subsidiary of a bank holding company or company that is treated as a bank holding company, the banking entity's tier 1 capital is equal to the amount of tier 1 capital reported by the top-tier affiliate of such covered banking entity that calculates and reports tier 1 capital in the manner described for entities that are required to hold tier 1 capital.[200]
    - If the banking entity is not a subsidiary of a bank holding company or a company that is treated as a bank holding company, the banking entity's tier 1 capital is equal to the total amount of shareholders' equity of the top-tier affiliate within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.[201]
    - Except as provided below for U.S. affiliates of foreign banking entities, with respect to a banking entity that is not itself, and is not controlled directly or indirectly by, a banking entity that is located or organized under the laws of the United States or of any State, the tier 1 capital of the banking entity is the consolidated tier 1 capital of the entity as calculated under applicable home country standards.[202]
    - With respect to a banking entity that is located or organized under the laws of the United States or of any State and is controlled by a foreign banking entity that is not itself, and is not controlled directly or indirectly by, a banking entity that is located or organized under the laws of the United States or of any State, the banking entity's tier 1 capital shall be as calculated based on the tier 1 capital of the U.S. banking entity.[203]

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[198] Final Regulations § __.12(c)(2)(i).

[199] Final Regulations § __.12(c)(2)(ii)(A).

[200] Final Regulations § __.12(c)(2)(ii)(B)(1).

[201] Final Regulations § __.12(c)(2)(ii)(B)(2).

[202] Final Regulations § __.12(c)(2)(iii)(A).

[203] Final Regulations § __.12(c)(2)(iii)(B).

MORGAN LEWIS' STRUCTURED FINANCE PRACTICE

For assistance, please contact any of the following lawyers:

John Arnholz
Practice Group Co-Leader, Structured Transactions
john.arnholz@morganlewis.com
+1.202.373.6538

Reed D. Auerbach
Practice Group Co-Leader, Structured Transactions
reed.auerbach@morganlewis.com
+1.212.705.7400

Harlyn Bohensky
Partner, Structured Transactions
harlyn.bohensky@morganlewis.com
+1.212.705.7462

Michael P. Braun
Partner, Structured Transactions
michael.braun@morganlewis.com
+1.212.705.7540

Daniel N. Budofsky
Partner, Structured Transactions
daniel.budofsky@morganlewis.com
+1.212.705.7546

Asa J. ("Geordie") Herald
Partner, Structured Transactions
asa.herald@moganlewis.com
+1.202.373.6851

Laurence B. Isaacson
Senior Counsel, Structured Transactions
laurence.isaacson@morganlewis.com
+1.212.705.7297

Jeffrey R. Johnson
Partner, Structured Transactions
jeffrey.johnson@morganlewis.com
+1.202.373.6626

Matthew P. Joseph
Partner, Structured Transactions
matthew.joseph@morganlewis.com
+1.212.705.7333

Steve Levitan
Partner, Structured Transactions
steve.levitan@morganlewis.com
+1.212.705.7325

Edmond Seferi
Partner, Structured Transactions
edmond.seferi@morganlewis.com
+1.212.705.7329

Charles A. Sweet
Managing Director, Shared Legal Services and Practice Development Leader, Structured Transactions
charles.sweet@morganlewis.com
+1.202.373.6777