

Alert

Regulatory Agencies Request Comments on Proposed Amendments to the Volcker Rule Which Will Affect Collateralized Loan Obligations

January 31, 2020

On Jan. 30, 2020, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission (collectively, “Agencies”) requested comments on proposed amendments to the regulations implementing section 13 of the Bank Holding Company Act (commonly referred to as the “Volcker Rule”)¹. Several of the proposed revisions to the Volcker Rule (“Proposed Amendments”) will affect collateralized loan obligations (“CLOs”). The Proposed Amendments are the follow-up to a notice of proposed revisions to the Volcker Rule originally published by the Agencies in July 2018 (“2018 Notice”)² and address comments received from CLO market participants in response to the 2018 Notice.

In the 2018 Notice, the Agencies solicited feedback on a number of provisions of the Volcker Rule affecting CLOs, including the Volcker Rule’s “covered fund” definition (which limits investments in CLOs by banking entities covered by section 13 of the Bank Holding Company Act), as well as the “loan securitization exclusion” and “ownership interests” in covered funds generally.

Although the Proposed Amendments do not directly address all of the issues on which the Agencies requested comment in the 2018 Notice, they do propose a number of important changes that will affect the application of the Volcker Rule to CLOs:

- The Proposed Amendments would modify the loan securitization exclusion to permit a loan securitization to hold up to 5% of its assets in non-loan assets. This would allow CLOs that rely upon the loan securitization exclusion to invest up to 5% of their assets in bonds, notes, letters of credit and other non-loan assets;
- The Proposed Amendments would also modify the definition of “ownership interest” to make clear that “creditors’ remedies,” upon the occurrence of an event of default or an acceleration event under a debt instrument, include the right to participate in the removal of a CLO’s collateral manager for cause, as well as in the replacement of a CLO’s collateral manager following its resignation or removal, and will not give rise to a banking entity having an ownership interest in a covered fund; and
- The Proposed Amendments would further amend the definition of “ownership interest” to create a safe harbor for “ordinary debt instruments” that were never intended to confer an

¹ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5808 (Jan. 31, 2014).

² Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 137 (July 17, 2018).

ownership interest in the borrower to the holders of such debt instruments. Under the Proposed Amendments, senior loans or other senior debt interests would not be treated as “ownership interests” in a covered fund if:

1. The holders of any such interest does not participate in the profits of the covered fund, but receive only interest payments that are not dependent on the performance of the covered fund and a fixed principal payment on or prior to a stated maturity date;
2. The entitlement to payments on the interest payable to the holders of any such interest is absolute and not contingent (i.e., not subject to write-down or other adjustments arising from losses incurred by the covered fund); and
3. The holders of any such interest are not entitled to receive the underlying assets of the covered fund or any residual assets remaining after the repayment in full of all other interests (excluding creditor rights to exercise remedies upon an event of default or an event giving rise to acceleration).

A copy of the Proposed Amendments is available at:

<https://www.federalreserve.gov/aboutthefed/boardmeetings/files/volcker-rule-fr-notice-20200130.pdf>.

Comments to the Proposed Amendments are required to be submitted to the Agencies by April 1, 2020.

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