

Alert

Volcker Rule 2.0 — Impact of Final Rule on CLOs

June 29, 2020

On June 25, 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, the “Agencies”) approved a new final rule (“Final Rule”) to amend the regulations implementing section 13 of the Bank Holding Company Act (commonly known as the “Volcker Rule”). A number of the Agencies’ revisions to the Volcker Rule (“Amendments”) will affect collateralized loan obligations (“CLOs”), their managers and their investors. A copy of the Final Rule is available at <https://www.sec.gov/rules/final/2020/bhca-9.pdf>. The Final Rule goes into effect on Oct. 1, 2020.¹

The Final Rule makes a number of important changes to the application of the Volcker Rule to CLOs and banking entities that invest in CLOs:

- The Final Rule amends the “loan securitization exclusion” to permit a loan securitization to hold up to 5% of its assets in debt securities (excluding asset-backed securities and convertible securities), calculated at par value at the time a debt security is purchased.² The Final Rule is narrower on this issue than the Proposed Amendments, which would have permitted a loan securitization to hold up to 5% of its assets in *any* non-loan assets, rather than limiting the non-loan bucket to non-convertible debt securities. Additionally, the Final Rule also codifies clarifications made by the staffs of the Agencies regarding “servicing assets”³ and “cash equivalents”⁴ that may be permissibly held by loan securitizations.
- The Final Rule modifies the definition of “ownership interest” to allow for certain additional rights of creditors under a debt instrument (that are not triggered exclusively by an event of default under, or acceleration of, the debt instrument) with respect to the right to participate in the removal of a CLO’s investment manager “for cause,” as well as in the replacement of a CLO’s investment manager following its resignation or removal, that will not give rise to a banking entity having an ownership interest in a covered fund. In addition to such rights arising under events of default or acceleration, the Final Rule expands the scope of such “for cause” removals or replacements of a CLO investment manager to include (1) the bankruptcy, insolvency, conservatorship or receivership of the investment manager; (2) breaches of material provisions of a covered fund’s transaction agreements applicable to the investment manager; (3) breaches

¹ On Jan. 30, 2020, the Agencies requested comments on proposed amendments to the Volcker Rule (“Proposed Amendments”). Several of the Proposed Amendments affected CLOs, as we described in our [Alert](#) published on Jan. 31, 2020.

² Final rule § __.10(c)(8)(i)(E).

³ Final rule § __.10(c)(8)(i)(B).

⁴ Final rule § __.10(c)(8)(iii)(A).

of material representations and warranties by the investment manager; (4) the occurrence of an act that constitutes fraud or criminal activity in the performance of the investment manager's obligations under the covered fund's transaction agreements; (5) the indictment of the investment manager for a criminal offense or any officer, member, partner or other principal of the investment manager for a criminal offense materially related to his or her investment management activities; (6) a change in control with respect to the investment manager; (7) the loss, separation or incapacitation of an individual critical to the operation of the investment manager or primarily responsible for the management of the covered fund's assets; or (8) other similar events that constitute "cause" for removal of the investment manager, provided that such events are not solely related to the performance of the covered fund or the investment manager's exercise of investment discretion under the covered fund's transaction documents⁵; and

- The Final Rule further amends the definition of "ownership interest" to create a safe harbor for "ordinary debt instruments" that were never intended to confer an ownership interest in the borrower to the holders of such debt instruments. Under the Final Rule, senior loans or other senior debt interests would not be treated as "ownership interests" in a covered fund if:
 - The holders of any such interest do 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. The repayment of the fixed principal payment on or prior to a stated maturity date must be required by contract (and such terms may include prepayment premiums to compensate holders of the interest for forgone income from an early prepayment);
 - The amount of interest payable to the holders of any such interest is not contingent (i.e., subject to write-down or other adjustment arising from losses incurred by the covered fund); and
 - The holders of any such interest are not entitled to receive the underlying assets of the covered fund or any 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).⁶

The Agencies declined to clarify whether "senior loans or other senior debt interests" include all investment grade loans, so it is not clear that the Final Rule covers interests other than AAA-rated notes.

The 5% non-loan asset bucket for the "loan securitization exclusion" was expected to be included in the Final Rule following the Proposed Amendments. While the non-loan asset bucket does provide some flexibility for CLOs, the amendments to the "ownership interest" definition in the Final Rule provide significantly more flexibility for CLOs. As long as the "for cause" removal provisions of a CLO's collateral management agreement conform to the Volcker Rule's parameters, the new definition of "ownership interest" will allow a CLO to avoid relying on the "loan securitization exclusion" because CLO notes will not constitute an "ownership interest" for purposes of the Final Rule's covered fund provisions. We also

⁵ See the exclusions under Final Rule § __.10(d)(6)(i)(A)

⁶ Final Rule § __.10(d)(6)(ii)(B)

expect that new CLOs issued prior to Oct. 1, 2020 (the effective date of the rule) will include a springing bond bucket that will take effect without the requirement of any amendment or consents.

Authored by [Phillip J. Azzollini](#), [Daniel Oshinsky](#), [Craig Stein](#), [Adam M. Singer](#), [James V. Williams, III](#) and [Sanjana V. Nafday](#).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

This communication is issued by Schulte Roth & Zabel LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising. ©2020 Schulte Roth & Zabel LLP. All rights reserved. SCHULTE ROTH & ZABEL is the registered trademark of Schulte Roth & Zabel LLP.