THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

Volcker 2.0 Published: Let The Comment Period Begin!

July 18, 2018 - Last month the federal bank regulatory agencies and the SEC approved a sweeping 373 page proposal to revise the 2013 Volcker Rule. This week, the proposal was formally published in the Federal Register, thereby starting the 60 day period for stakeholders to comment. The proposal would materially loosen restrictions on the ability of banks to engage in proprietary trading. Importantly for the loan and CLO markets the proposal puts into play the issue of whether banks should be able to own the debt securities of CLOs that own bonds. While not taking a position, the agencies request comments on a myriad of issues, such as the definitions of "covered fund", "ownership interest" and "loan securitization", changes to any of which could result in the end of the current prohibition.

Background. The Volcker Rule was intended to restrict the ability of banks to engage in proprietary trading and limit banks' investments in the equity of PE and hedge funds ("covered funds"). While loans were carved out from the prop trading restrictions, because the definition of covered funds was very broadly drafted, securitizations, including CLOs that hold any amount of bonds were included. (CLOs that are "loan-only" (loan securitizations") are specifically carved out of the Volcker Rule). Moreover, the agencies oddly ruled that even the most senior debt securities of such "non-compliant CLOs" are considered "ownership interests" equivalent to equity and thereby forbidden to banks, because holders have the contingent right to remove and replace CLO managers for cause. The LSTA has long and consistently argued that non-compliant CLOs should not be considered covered funds and that CLO notes are not ownership interests. It has also supported the view that the definition of "loan securitization" should be broadened to include CLOs with small buckets for debt securities.

What issues does the proposal raise that could impact CLO bond buckets?

Covered Funds. If all securitizations were excluded from the definition of "covered funds", it follows that non-compliant CLOs would fall outside Volcker. In the proposal the agencies ask a series of questions about that definition. Should covered funds be limited to hedge funds and private equity funds (the ostensible target of Congress, from most accounts)? Should the definition be a "characteristics"-based test, i.e., limited to the types of funds that have the characteristics of a PE or hedge funds?

Loan Securitizations. The agencies then directly ask whether they "should consider permitting an exempt loan securitization vehicle to hold 5 percent or 10 percent of assets that are considered debt securities rather than "loans"'.

Ownership Interests. The current Volcker Rule provides that an ownership interest includes an interest that has "the right to participate in the selection or removal" of an investment manager or investment adviser "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)". The agencies ask whether the parenthetical should be expanded to include "the right to participate in the removal of an investment manager for cause, or to nominate or vote on a nominated replacement of a manager upon an investment manager's resignation or removal." Further, they ask, would these limited rights more closely resemble a creditor's rights upon default to protect its interest, as opposed to the right to vote on matters affecting management of an issuer that may be more typically associated with equity interest? The LSTA, reflecting market sentiment, has always taken exactly that position. If the agencies were to accept this view, CLO notes, which have these limited rights, would no longer be considered ownership interests so banks could once again purchase and hold notes of non-compliant CLOs.

Summary. While the agencies do not take a position on any of the pertinent issues, they have identified three different avenues that could result in the end of the prohibition against banks owning the debt of non-compliant CLOs. The LSTA has organized a member working group to review the proposal and expects to weigh in with its own comment letter. For more information please contact LSTA general counsel Elliot Ganz at eganz@lsta.org.