

THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 53 No. 17 October 14, 2020

VOLCKER RULE AMENDMENTS: BACK TO THE FUTURE FOR CLOS?

The authors discuss recent amendments to the Volcker Rule and their potential to foster reemergence of a less homogeneous CLO asset class, both in investment capability and performance among CLO managers.

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On June 25, 2020, five federal regulatory agencies (the “Agencies”)¹ released a final rule (the “Modified Rule”) modifying and clarifying the Volcker Rule’s prohibition on banking entities investing in or sponsoring covered funds. The Modified Rule could restore much of the flexibility that advisers to CLOs used to have in managing their portfolios prior to 2013 (the “CLO 1.0 Era”), when the initial regulations implementing the Volcker Rule were adopted. Although the significance of these changes will only become apparent with time as the market digests them, this article summarizes a few preliminary take-aways for CLO industry participants.

BACKGROUND

The Volcker Rule was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the initial regulations implementing which were issued in December 2013 (the “2013 Rules”). The rule prohibits banking entities from having an “ownership

interest” in and certain relationships with any “covered fund”, which it generally defines to include any entity that would be an “investment company” under the Investment Company Act of 1940 but for the exceptions in Section 3(c)(1) or 3(c)(7) thereof. The rule defines an “ownership interest” in a covered fund to mean any equity, partnership, or “other similar interest.” Many CLOs rely on the 3(c)(7) exception and would be “covered funds” under the Volcker Rule absent an exemption or exclusion. Banking entities generally interpret “other similar interest” to include senior CLO notes because their holders generally have rights to remove or replace the collateralized loan obligation (“CLO”) manager, which was a feature described in the 2013 Rules as one indicative of an “other similar interest.”

The 2013 Rules created a loan securitization exclusion (the “LSE”) from the definition of “covered fund” for CLOs comprised solely of loans, servicing rights, and other assets incidental to loan ownership. Many CLOs created after implementation of the 2013 Rules have relied on the LSE and have therefore been restricted from purchasing non-loan assets.

The Modified Rule provides banking entities with incremental relief from the Volcker Rule’s prohibitions

¹ “Agencies” refers to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

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