Client Alert

March 10, 2016

Agencies Issue Guidance on Capital Deduction Requirement under the Volcker Rule for Investments in Collateralized Debt Obligations Backed by Trust Preferred Securities Retained Pursuant to 12 CFR 248.16 ("Qualifying TruPS CDOs")

By Henry M. Fields, Jiang Liu and Barbara Mendelson

On Friday, March 4, 2016, the Volcker Inter-Agency Group[1] posted a new frequently asked question (FAQ 21), clarifying the capital deduction requirement under the Volcker Rule for investments in Qualifying TruPS CDOs. FAQ 21 confirms that a banking entity is not required to deduct from its tier 1 capital an investment in a Qualifying TruPS CDO retained pursuant to section 248.16(a) of the interim final rule.

Section 13 of the Bank Holding Company Act of 1956 (also known as the Volcker Rule) generally prohibits a banking entity from sponsoring and investing in private equity funds and hedge funds ("covered funds"), subject to a number of exemptions.[2] In December 2013, the Agencies issued a final rule to implement the Volcker Rule.[3] In January 2014, the Agencies issued an interim final rule to add section 248.16 to the final rules.[4] Section 248.16(a) permits banking entities to retain an interest in, or act as sponsor of, an issuer of TruPS CDOs that would meet the definition of a covered fund, so long as: (i) the issuer was established, and the interest was issued, before May 19, 2010; (ii) the banking entity reasonably believes that the offering proceeds received by the issuer were invested primarily in Qualifying TruPS Collateral;[5] and (iii) the banking entity's interest in the issuer was acquired on or before December 10, 2013 (or acquired in connection with a merger or acquisition of a banking entity that acquired the interest on or before December 10, 2013).[6]

Section 248.11 of the final rule also exempts from the prohibition on investment in covered funds certain *de minimis* investments in specified funds ("Section 11 Exemption"), including private funds sponsored by a banking

[1] The Volcker Inter-Agency Group consists of representatives from the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the "Agencies").

[2] *See* 12 U.S.C. 1851(a)(1)(B); *see also* 12 CFR 248.10(a).

[3] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 FR 5536 (Jan. 31, 2014).

[4] *See* 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, 79 FR 5223 (Jan. 31, 2014).

[5] The term Qualifying TruPS Collateral means any trust preferred security or subordinated debt instrument issued prior to May 19, 2010 by a depository institution holding company that, for any reporting period within the 12 months immediately preceding the issuance of such instrument, had total consolidated assets of less than $15 billion, or issued prior to May 19, 2010 by a mutual holding company. *See* 12 CFR 248.16(b).

[6] *See* 12 C.F.R. § 248.16(a).

entity as a vehicle for investment of customer funds. These exempt funds need to meet certain requirements, including the requirement under Section 248.12 of the final rule that the banking entity, for purposes of determining compliance with applicable regulatory capital requirements, deduct from the banking entity's tier 1 capital the full amount of its investment in covered funds.

FAQ 21 confirms that the capital deduction requirement does not apply to Qualifying TruPS CDOs held in accordance with section 248.16(a) of the final rule. This is because section 248.16(a) provides an additional exemption for Qualifying TruPS CDOs, which is independent from the Section 11 Exemption. The Agencies noted, however, if a banking entity acts as a market maker with respect to interests in a Qualifying TruPS CDO that is a covered fund, then the banking entity would be deemed to be relying on section 248.11(c) of the final rule, which would make the capital deduction provision in section 248.12 applicable to those interests.[7] Moreover, if a banking entity relies on section 248.11 to hold an interest in a TruPS CDO that is a covered fund but is not a Qualifying TruPS CDO, the banking entity would be required to comply with all of the limits and restrictions in section 248.12, including the capital deduction requirement.

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[7] *See* 12 CFR 248.11(c); *see also* 12 CFR 248.16(c).