



Volcker Rule and Covered Bonds

The subtler aspects of the Volcker Rule¹ continue to emerge. One of the subtleties is the extraterritorial reach of the Rule in connection with underwriting, investments in, and market making for covered bonds by foreign banks.

Foreign banks that underwrite, invest in, or conduct market making for covered bonds need to review their activity under the Volcker Rule.

Section __.10(a) of the Volcker Rule prohibits the acquiring of ownership interests in covered funds by any banking entity or sponsoring a covered fund.² Foreign banks that are “bank holding companies” under the International Banking Act are included as banking entities under the Volcker Rule definition. The International Banking Act provides that a foreign bank that has a branch or agency in any State or controls a commercial lending company organized under State law is a bank holding company under the International Banking Act and subject to the provisions of the Bank Holding Company Act.

Under the Volcker Rule, a “covered fund” is defined as any issuer that (1) relies on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act for an exemption from the requirement to register under the Act, (2) certain commodity funds, and (3) any entity organized outside the United States for the purpose of investing in securities and in which an ownership interest is owned by a banking entity located in the United States. Covered bond issuers most likely to rely on Section 3(c)(1) or Section 3(c)(7) would be issuers with substantial non-mortgage assets in the cover pool, such as public sector loans.

There is an exemption from the requirement to register under the Investment Company Act under Rule 3a-6 for entities that are “foreign banks” within the meaning of Rule 3a-6. A foreign bank must be regulated as a bank in its home country and engage substantially in commercial banking activity. Some special bank issuers or other non-bank issuers of covered bonds may not qualify as foreign banks under Rule 3a-6. In a two-tier structure, at least one of the entities will not qualify as a foreign bank under the Rule.

Section __.10(c)(10) of the Volcker Rule provides an exemption from the definition of covered fund for issuers of “qualifying covered bonds.” The exemption requires a two-tier structure (so, not a Pfandbrief structure), a “foreign banking organization” as an issuer or guarantor, and a cover pool that consists solely of loans and interest rate and currency swaps (no ABS permitted). A foreign banking organization is defined in Regulation K as a

¹ 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).

² It is likely that organizing the non-bank entity in a two-tier structure would constitute “sponsoring” for purposes of Section __.10(a) if the newly organized entity were a covered fund, although the exemption for a wholly-owned subsidiary in Section __.10(c)(2) could apply.

foreign bank that operates a branch, agency, or commercial lending company subsidiary in the United States, controls a bank in the United States or controls an Edge corporation.³ Many covered bond issuers do not have operations in the United States or do not use a two-tier structure, and therefore would not meet the requirements for this exemption.

If an issuer is a covered fund under the Volcker Rule, its covered bonds must be analyzed to determine whether they constitute “ownership interests” as defined in the Rule. An ownership interest is defined in Section __.10(d)(6) as a security that includes, among other things, certain equity-like features or the right to receive the excess cash flow of the issuer. Covered bonds generally do not have these features, but the provisions of the covered bonds should be examined carefully to ensure that none of the attributes specified in Section __.10(a)(6) is present.

Section __.11 of the Rule provides an exemption from the limitations of Section __.10(a) under certain conditions for organizing or offering, underwriting, and market making with respect to ownership interests in a covered fund. Permitted underwriting and market making of ownership interests in covered funds must be conducted in accordance with Section __.4(a) or Section __.4(b) of the Volcker Rule, which include important compliance and reporting obligations.

Section __.12 of the Volcker Rule provides limited permitted investments in a covered fund, not to exceed 3 percent of the number or value of ownership interest in a covered fund and the aggregate of all ownership interests of the banking entity and its affiliates in all covered funds cannot exceed 3 percent of the tier 1 capital of the banking entity.

Section __.13(b) of the Volcker Rule provides an exemption for a foreign bank from the prohibition in Section __.10(a) for any activity or investment that occurs solely outside the United States. This exemption is available only if no ownership interest in the covered fund is offered for sale or sold to a resident of the United States in an offering that targets residents of the United States and certain other requirements.

The Volcker Rule release⁴ explains that the offer or sale does not have to be made by the foreign bank seeking to rely on the exemption in Section __.13(b). Regardless of who offered or sold an ownership interest to a resident of the United States, if it was a targeted sale to the U.S. resident, the relief in Section __.13(b) is not available.

If the covered bonds constitute ownership interests in a covered fund and a single series of covered bonds of an issuer are sold in an offering to residents of the United States, the exemption provided by Section __.13(b) would be unavailable and the prohibition of Section __.10(a) could apply and the compliance and reporting requirements of Section __.11 could apply to market making activity in any series of covered bonds of the issuer. This is the case even if the series in which the market making is conducted has not been sold to residents of the United States.

In summary, any foreign bank that is a bank holding company under the International Banking Act and invests or conducts market making in covered bonds must review each covered bond issuer that it invests in or makes a market for and determine (i) whether any covered bonds of the issuer have been offered or sold to a resident of the United States and if so (ii) whether the bonds constitute ownership interests in a covered fund under the Volcker Rule. If both conditions are met, the bank may need to determine whether it needs to institute a compliance and reporting regime in accord with Appendices A and B of the Volcker Rule as required by Section __.11 of the Rule. This analysis will need to be conducted even if all of the investment or market making activity takes place in London or elsewhere outside the United States.

³ See 12 CFR 211.21(o).

⁴ 79 FR 5536 at 5742.

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