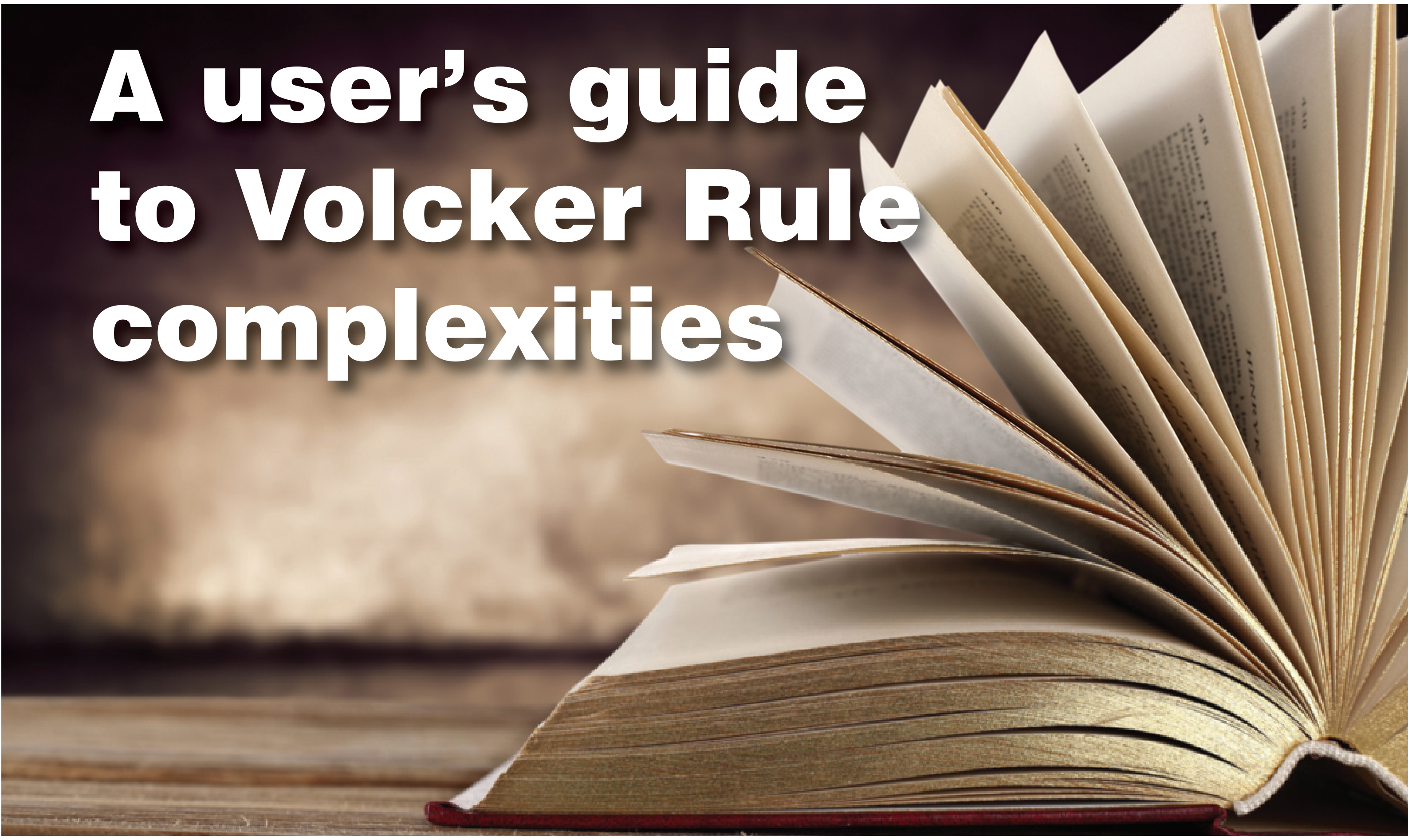
A user's guide to Volcker Rule complexities



Jerry Marlatt and **Melissa Beck** of **Morrison & Foerster** offer a practical guide to Volcker Rule considerations for covered bond investors

Increasingly, we receive questions from prospective investors in covered bonds on whether an investment is prohibited or limited under the Volcker Rule, which was adopted by the various agencies under section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The answer is relevant to US bank investors in covered bonds as Volcker Rule restrictions apply directly to US banks, including US branches and agencies of foreign banks. However, the answer may also be relevant to other investors in covered bonds, particularly in dollar-denominated covered bonds, because the answer will affect the secondary market liquidity in the bonds.

The best response to this market concern is for issuers of covered bonds to develop a practice of expressly stating in their prospectuses whether an investment in their covered bonds is restricted under the Volcker Rule. Until including such a statement becomes a widespread practice, an analysis of the status of the issuer under the Investment Company Act of 1940, as amended (Investment Company Act) and the terms of the covered bonds will be necessary.

The Volcker Rule was designed to prevent or limit bank investments in hedge funds and private equity funds. By its terms, the Volcker Rule prohibits or limits a bank from holding an ownership interest in a covered fund. A covered fund is defined under the Volcker Rule as any entity that relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act for an exemption from the requirement to register as an investment company under the Investment Company Act because those are exemptions commonly used by hedge funds and private equity funds. Unfortunately, those exemptions are also used by many other types of entities, including some covered bond issuers and many asset-backed issuers.

Therefore, in technical terms, the question is whether an investment in a covered bond constitutes an 'ownership interest' in a non-exempt 'covered fund' as such terms are defined in the Volcker Rule.

Covered bonds may be issued in a one-tier structure, such as Pfandbriefe, or a two-tier structure, such as UK or Canadian covered bonds. The analysis is similar for both structures, except that in a two-tier structure, both the bond and the guarantee are considered securities for US securities law purposes and therefore the status of both entities under the Investment Company Act must be analysed.

Generally, an entity that doesn't declare itself to be primarily engaged in the business of investing, reinvesting or trading in securities is not subject to the Investment Company Act unless more than 40% of its assets consist of investment securities and the entity issues securities. The Investment Company Act definition of an investment security is quite broad and includes essentially all securities (except US government securities and securities of majority-owned subsidiaries), loans, mortgage loans, leases, and various other receivables. If an issuer held more than 40% of its assets in investment securities, it could look to one of several exemptions from the requirement to register under the Investment Company. The following are some relevant exemptions from registration under the Investment

Company Act:

- Section 3(c)(1) – which limits holders of the securities (other than short-term securities) to not more than 100 persons;
- Section 3(c)(5) – which is limited to an issuer that is not engaged in the business of issuing securities redeemable at the discretion of the holders and which is engaged in the business of purchasing, acquiring or making specified types of loans (including, in some cases, real-estate loans);
- Section 3(c)(7) – which requires all of the holders of the securities of the issuer to be qualified purchasers (as defined under the Act);
- Rule 3a-6 – which exempts from the requirement to register under the Investment Company Act any foreign bank or foreign insurance company that is regulated as such by its home jurisdiction; or
- Rule 3a-7 – which is limited to issuers that do not issue redeemable securities, that issue securities rated in one of the four highest categories by a rating agency, that is engaged in the business of holding financial assets, and that does not acquire or dispose of financial assets for the primary purpose of recognising gains or decreasing losses resulting from market value changes.

If an issuer of covered bonds is deemed to be a covered fund because section 3(c)(1) or 3(c)(7) is the only exemption available to it, then investment in the covered bonds by a US bank would be prohibited or limited under the Volcker Rule unless: (a) the covered fund fell within one of the Volcker Rule covered fund exclusions; or (b) the investment in the covered bonds did not represent an 'ownership interest' in the covered fund as defined in the Volcker Rule.

While the Volcker Rule analysis by an issuer of securities can be a relatively straightforward process, for a prospective investor, particularly in the secondary market, the analysis can be complex and may not lead to a clear conclusion. The investor's analysis is typically limited to the information in the prospectus, and the prospectus may not provide enough information to make a clear determination of the status of the issuer and the covered bonds under the Volcker Rule. The task can be more difficult with non-US issuers because if they were not contemplating issuing securities into the US, they may have given no consideration to their status under the Investment Company Act and the prospectus may be devoid of helpful clues.

The analysis of a covered bond under the Volcker Rule may take several different routes. We suggest the following three-step approach as we think it may be the most efficient.

Initial covered fund review

The first step would be to determine whether the issuer is a covered fund or an exempt covered fund. Trying to determine which Investment Company Act exemption an issuer relied upon can be a time-consuming process, but there are a few facts that can be quickly determined that could eliminate the possibility that section 3(c)(1) or 3(c)(7) was the only exemption available for the issuer to rely upon.

Publicly-registered or public issuer

If the covered bonds were issued in a public offering (an offering registered with the SEC) or by an issuer with outstanding SEC-registered securities, the covered bonds could not have been issued by an entity relying on sections 3(c)(1) or 3(c)(7) as those sections are applicable only for issuers of securities who are not making and do not at that time propose to make a public offering of its securities. Accordingly, if the covered bonds were issued in a public offering or by an issuer with SEC-registered securities outstanding, no further analysis is required as the issuer must have relied on another exemption and that would take the issuer and the covered bonds outside the scope of the Volcker Rule. If the issuer has issued SEC registered securities, the issuer must be: (i) a registered investment company; (ii) a company not subject to registration under the Investment Company Act; or (iii) exempt from registration other than under section 3(c)(1) or 3(c)(7).

Express exemption

If the covered bonds were not issued in a US public offering (issued in a private offering or non-US offering), sometimes the prospectus will specify what section of the Investment Company Act the issuer relied upon for an exemption. If a section other than sections 3(c)(1) or 3(c)(7) is specified, no further analysis is required, as the covered bonds will be outside the scope of the Volcker Rule and investment in the covered bonds will not be subject to restriction under the Volcker Rule.

> **The Volcker Rule was designed to prevent or limit bank investments in hedge funds or private equity funds**

Section 3(c)(5) exemption

If there is no specific reference to the section of the Investment Company Act relied upon by the issuer, it may be possible to determine whether section 3(c)(5) of the Investment Company Act may be available in order to rule out the need to rely on sections 3(c)(1) or 3(c)(7). If the offering documents for the covered bonds list the assets held by the issuer, you may be able to determine if section 3(c)(5) is an available exemption. As described above, section 3(c)(5) provides an exemption from registration requirements of the Investment Company Act for an issuer that is not engaged in the business of issuing redeemable securities, and that is primarily engaged in the business of purchasing or making various types of specified loans. Section 3(c)(5)(C) is most often the exemption available to covered bond issuers because it provides an exemption for an issuer who has at least 55% of its assets consisting of interests in real estate, including residential or commercial mortgage loans. At least 25% of the remaining assets must be real estate-related assets. Note that securitised mortgage loans would not be qualifying interests in real estate for section 3(c)(5)(C). A periodic investor report may be helpful in determining the issuer's assets.

If the issuer's assets satisfy the section 3(c)(5)(C) requirement, the issuer would not be a covered fund under the Volcker Rule and an investment in its covered bonds would not be subject to restriction under the Volcker Rule.

Rule 3a-6 exemption

Rule 3a-6 provides that a foreign bank or foreign insurance company is not an investment company if it is regulated as such in its home jurisdiction and is engaged substantially in commercial banking activity or writing insurance agreements or reinsurance of such agreements.

An issuer that qualified to rely on Rule 3a-6 would not be a covered fund under the Volcker Rule and its covered bonds would not be subject to restriction under the Volcker Rule.

Loan securitisation exclusion

In the event the issuer does not qualify for an exclusion from the definition of a covered fund, the loan securitisation exclusion provided in the Volcker Rule should be examined to determine if it would be applicable to the issuer

Our long experience with covered bonds and our knowledge of bank regulatory issues, financial institutions and financing techniques makes us a first call for covered bonds issuances.

We share information on regulatory and market developments on our covered bond dedicated blog, **www.us-covered-bonds.com/**

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of the covered bonds. To qualify under the loan securitisation exclusion, an issuer must issue covered bonds backed solely by: (i) loans; (ii) rights or other assets designed to assure the servicing or timely distribution of proceeds to covered bondholders and rights or other assets related or incidental to purchasing or otherwise acquiring and holding the loans; and (iii) interest rate or foreign exchange derivatives that directly relate to the permitted assets of the issuer so long as they reduce interest rate or foreign exchange risks related to the assets of the issuer. The following are expressly prohibited as permitted servicing or incidental assets: (a) any security other than cash equivalents or securities received in lieu of debts previously contracted with respect to the permitted loans; (b) any derivative (other than interest rate or currency derivatives described above); and (iii) any commodity forward contract.

If the issuer of covered bonds satisfied the loan securitisation exclusion, the issuer would not be a covered fund under the Volcker Rule even if it expressly relied on section 3(c)(1) or 3(c)(7) and investment in the covered bonds would not be restricted under the Volcker Rule.

The qualified covered bond exclusion

The Volcker Rule excludes from the definition of covered fund an issuer and a guarantor of covered bonds if one of the entities is a foreign banking organisation (as defined in the Volcker Rule) and the cover pool consists solely of assets that qualify under the loan securitisation exclusion. This exclusion expressly requires a two-tier structure.

> **The Volcker Rule analysis can be complex and may not lead to a clear conclusion**

If the qualifying covered bond exclusion applies, neither of the issuer nor the guarantor would be a covered fund under the Volcker Rule even if one of them expressly relied on section 3(c)(1) or 3(c)(7), and the covered bonds of such an issuer would not be restricted under the Volcker Rule.

Review of restrictive legends

Finally, you may review the offering or transferring restriction in the prospectus to determine if section 3(c)(1) or 3(c)(7) were relied upon by the issuer when the covered bonds were issued. If an issuer relied on section 3(c)(1) or section 3(c)(7), the restrictive legends will restrict initial offers and transfers in unique ways. Offers and transfer will be limited so that at no time will there be more than 100 holders if section 3(c)(1) was relied on. Offers and transfers will be limited to qualified purchasers (QPs) as defined in the Investment Company Act if section 3(c)(7) was relied on. If neither of these two restrictions appears in the legend, then the issuer may not be a covered fund. If the legends, for example, include typical Rule 144A offering and transfer restriction it is fair to conclude that the issuer contemplated a US offering and did not include the restrictions required by section 3(c)(1) or 3(c)(7) because it did not need to rely on one of those exemptions. However, if a non-US issuer did not contemplate offering covered bonds in the US, it may not have conducted an Investment Company Act analysis.

If there are express indications that the issuer contemplated a US offering or otherwise expressly contemplated transfers to US person and did not include the restrictions required by section 3(c)(1) or 3(c)(7), it may be reasonable to conclude that the issuer is not a covered fund under the Volcker Rule, and an investment in the covered bonds is not subject to the Volcker Rule.

If, after this initial review, it is still not clear whether the issuer is exempt from the covered fund definition, we suggest switching to an analysis to determine whether the covered bonds may constitute an ownership interest.

Ownership interest

An ownership interest is defined in the Volcker Rule as any equity, partnership or similar interest. The Volcker Rule provides that a similar interest means an interest that: (i) has the right (other than in an event of default) to select or remove a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading adviser; (ii) has a right to receive a share of the income or profits; (iii) has the right (other than in an event of default) to receive the underlying assets when senior interests have been paid; (iv) has the right to receive all or a portion of the excess spread; (v) provides that interest to be paid on the securities may be reduced based on losses on the underlying assets; (vi) receives income on a pass-through basis or has a rate of return that is based on the performance of the underlying assets; or (vii) has any synthetic right to any of the foregoing. If the securities have none of the rights listed above, the securities will not constitute ownership interests for purposes of the Volcker Rule.

For most covered bonds, the covered bonds will not have any of the seven enumerated rights that meet any of the criteria of ownership interest. Care must be taken, however, to evaluate both the terms and conditions of the bonds and any rights available to bondholders under agreements related to the issuance of the bonds and, in particular, in a trust deed or bond indenture. Although the complete terms of the agreements may not be readily available to investors, if any of the seven enumerated rights were made available to investors, it seems very unlikely that the issuer would fail to disclose such significant rights in the prospectus.

Covered bonds that meet any of the seven elements in the second preceding paragraph should be examined in detail for a determination of whether they constitute an ownership interest in a covered fund. With respect to the covered bondholders' right to select or remove a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading adviser, the analysis should focus on the type of role such entity plays with respect to the cover pool, and under what circumstances the covered bondholders can exercise such control. Management changes as a result of events of default are treated differently from management changes at the option of the holders. Removal of an asset manager that controls assets of the issuer and whose actions and decisions impact the financial health of the issuer are viewed differently from removal of a covered bond indenture trustee whose role is limited to administrative functions enumerated in a trust agreement or similar document.

With respect to interest payments reduced based on losses of underlying assets, it is unclear if the mere inclusion of that provision in the covered bond is enough to constitute a 'similar interest'. For example, the holders of covered bonds will usually not have their interest payments reduced as a result of realised losses in the cover pool as described in (v) above because, first, the bonds are obligations of the issuer and, second, there is significant over-collateralisation to address that risk. Only if the issuer becomes insolvent and there are significant losses in the cover pool would the conditions arise where interest payments might be reduced. But when those conditions arise, typically all outstanding covered bonds are accelerated and paid out *pari passu*. If they sustain losses, it is due to the same risk of loss that any secured senior debt holder is subject to and not similar to the risks taken by an equity holder. While the Volcker Rule does not address a covered bond in this context, the losses that a covered bond may be exposed to should not be viewed as the type of loss contemplated by (v) above.

Only if covered bonds are issued by an entity with no capitalisation other than the cover pool assets should losses on the bonds qualify as the losses contemplated by (v) above. Given the breadth of the definition of ownership interest, only covered bonds that exhibit specific characteristics of equity (such as participation in profits or losses or the right to select or remove a person with investment discretion) should qualify such covered bonds as an ownership interest. Although the regulators promulgating the Volcker Rule used some general examples in an attempt to provide clarity with respect to certain securitisation structures and provisions in the final rule and related release, it is not clear how much weight should be given to each characteristic in the absence of regulatory or judicial guidance. As such, if it is determined that the covered bonds are ownership interests (or it cannot be determined with certainty that they do not constitute ownership interests) the analysis should shift back to the nature of the issuer and whether the issuer constitutes a covered fund.

Rule 3a-7 review

If an initial covered fund review is not dispositive and the covered bonds in question have (or may have) one or more characteristics of an ownership interest, then, in the event that the covered bonds in question are: (i) rated one of the four highest categories assigned to long-term debt; or (ii) the sales of such covered bonds are limited to accredited investors or qualified institutional buyers (each as defined under the Securities Act of 1933, as amended), then such covered bonds should be analysed to determine if the issuer may qualify for a Rule 3a-7 exemption. This section provides an outline of Rule 3a-7 requirements. The definitive Rule 3a-7 may be found at 17 CFR 270.3a-7.

In the event of the insolvency of a covered bond issuer, the covered pool assets are the only source of cash flow available to make payments to holders, similar to a securitisation, which would satisfy the first prong of the Rule 3a-7 test. The covered bonds are reliant on the cash flows from the cover pool to make such payments on the covered bonds, and the cover pool assets are assets that automatically convert to cash within a finite period of time, satisfying the definition of financial asset under Rule 3a-7.

With respect to the ratings requirement at the time of initial offering, a review of the prospectus may confirm if such requirement is met. If the covered bonds are not rated in one of the four highest rating categories assigned to long-term debt, the exemption under Rule 3a-7 could still be available if sales of the covered bonds are limited to accredited investors or qualified institutional buyers. This limitation should be apparent in the sale and transfer restriction legend in the prospectus.

Rule 3a-7 places restrictions on the purchase and disposal of issuer assets. Such actions may only be taken in if the following conditions are met: (i) the action is taken in accordance with transaction terms or conditions set out in applicable transaction documents; (ii) the action does not result in a ratings downgrade of the issuer's securities; and (iii) the assets are not purchased or sold for the primary purpose of realising a gain or decreasing a loss in market value. A review of the prospectus and transaction agreements should disclose whether assets may be purchased or sold to realise a gain or decrease a loss in market value. Usually the trustee or asset manager is restricted in its ability to purchase or sell assets except as expressly set out in the applicable transaction agreements.

With respect to the requirement relating to the appointment of a trustee, the identity of the trustee should be disclosed in the prospectus. Note that under Rule 3a-7 the trustee must be a US bank and meet certain minimum financial requirements. Unfortunately, many non-US issuers may not use a US bank as trustee.

Most covered bonds are issued under a trust deed, bond indenture or similar instrument that provides that the entity holding the cover pool assets has a fiduciary relationship with bondholders. The trustee must have a perfected security interest in the cover pool assets or a similar interest in the assets under the laws of the home jurisdiction of the issuer.

If the Rule 3a-7 exemption is applicable, then the covered bond issuer will not be a covered fund under the Volcker Rule and therefore an investment in the covered bonds of the issuer will not be restricted under the Volcker Rule.

If the Rule 3a-7 exemption is not applicable, then the covered bond issuer in question may be a covered fund under the Volcker Rule, and the covered bonds may constitute an ownership interest in a covered fund under the Volcker Rule, and be prohibited or limited investments under the Volcker Rule. In this case, a prospective investor can only resort to contacting the dealer for the covered bonds or contacting the issuer directly for assistance in determining whether the covered bonds are impermissible ownership interests in a covered fund.

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Jerry Marlatt is senior of counsel in the capital markets group of Morrison & Foerster. He represents issuers, underwriters and placement agents in public and private offerings of debt, covered bonds, surplus notes, securities of structured investment and specialised operating vehicles, and securities re-packagings.

Marlatt is co-author of Considerations for Foreign Banks Financing in the US, published by International Financial Law Review (2012, updated 2014), a contributor to Covered Bonds Handbook, published by Practising Law Institute (2010, updated 2012-2014) and a charter member of the United States Covered Bonds Council. He was named Dealmaker of the Year in 2013 by The American Lawyer for his work as issuer's counsel on the first covered bond deal ever registered with the Securities and Exchange Commission.