VOLCKER RULE: UNINTENDED CONSEQUENCES FOR ABS

Cynthia J. Williams, Partner, Dechert LLP

Dechert LLP

Recently, the OCC, the Federal Reserve Board, the FDIC and the SEC (together with the CFTC, the "Joint Agencies") proposed regulations intended to implement the Volcker rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which seeks to restore safety and soundness to the US banking system. If these regulations are implemented as proposed, there could be serious implications for the ABS markets. Among other things, the proposed Volcker regulations would negatively impact the ability of banking entities to securitize their own assets, sponsor securitizations for others, lend or provide other credit support to ABS issuers and ABCP conduits, purchase assets from ABS issuers, invest in (or continue to own) ABS securities and act as third party service providers to ABS issuers. All of these are necessary for viable ABS markets to continue to provide credit to consumers and businesses.

Here is a closer look at some of the major unintended consequences of the proposed Volcker regulations.

WHAT'S IN A NAME? The Volcker rule generally prohibits banks and their affiliates ("banking entities") from engaging in proprietary trading and from owning interests in hedge funds and private equity funds since Congress was concerned that ownership in such funds would permit banking entities to indirectly engage in prohibited proprietary trading. However, Congress did not define what a hedge fund or private equity fund is. Instead, Congress defined such funds ("covered funds") by reference to the private investment company exceptions (Sections 3(c)(1) and 3(c)(7)) they typically rely on to avoid registration under the Investment Company Act of 1940, as amended (the "Investment Company Act"). Many ABS issuers also rely on these exceptions. As a result, those ABS issuers who cannot rely on another Investment Company Act exception would be treated as covered funds subject to the Volcker rule.

RESTRICTIONS ON "OWNERSHIP INTERESTS". The proposed Volcker regulations restrict banking entities to owning not more than a de minimis amount of ownership interests in the covered funds they sponsor for customers and the amount required to satisfy Dodd Frank credit risk retention requirements. The primary exception is for loan securitizations in which banking entities are permitted to invest (although if such securitizations are covered funds, they remain subject to the proposed Volcker Super 23A and material conflicts of interest restrictions). Although loan is broadly defined to include loans, leases and receivables, the loan securitization carve out does not include the ability to invest in temporary cash equivalent investments or in small buckets of other financial assets. Municipal bond securitizations, certain ABCP conduits and securitizations of other types of financial assets are not included in this exception.

ABS SENIOR DEBT MIGHT CONSTITUTE "OWNERSHIP INTERESTS". Of particular concern is the suggestion in the release accompanying the proposed regulations that if a debt security provides its holder with voting rights, it may be viewed as an ownership interest subject to Volcker restrictions. If that is the case, given the substantial voting rights held by ABS senior debt holders (including the right to remove and replace ABS managers), banking entities may be expected by regulators to sell ABS senior debt as early as July 2012, when the Volcker rule becomes effective whether or not the implementing regulations have been adopted by such date. This could take a significant number of senior debt investors out of the ABS markets.

"SUPER 23A" RESTRICTIONS AND CONFLICTS OF INTEREST RULES WILL MAKE IT EXTREMELY DIFFICULT TO OPERATE AN ABS ISSUER. "Super 23A" under the proposed Volcker regulations would dry up warehouse financing for ABS issuers and the ABCP conduit market. "Super 23A" prohibits any "covered transaction" between a banking entity that is an investment adviser to, or sponsor of, a covered fund and such covered fund including, among other things, any loan, extension of credit or guarantee, any purchase of assets, and any purchase of such covered fund's securities (except as otherwise permitted by the Volcker rule). These types of covered transactions are commonly entered into by banking entities that sponsor ABS securitizations or ABCP conduits, neither of which typically can be done without them. Furthermore, the proposed conflict of interest rules go far beyond the conflict of interest rules for ABS securitizations recently proposed by the SEC. They prohibit any banking entity from relying on an exemption otherwise available under the Volcker rule to hold ownership interests in covered funds, to act as sponsors of covered funds, or to have certain relationships with covered funds, if the permitted activity or investment would result in the banking entity's interests being materially adverse to the interests of its clients, customers or counterparties without either appropriate information barriers or significant disclosure obligations beyond current conflicts of interest disclosure in ABS marketing materials or current registered investment adviser conflicts of interest disclosure.

SO WHAT'S THE SOLUTION? The Joint Agencies should exempt ABS transactions entirely from the Volcker rule. ABS transactions are structured financing transactions that investors require be held by bankruptcy remote special purpose entities so that the cash flow from the entity's financial assets is available to pay its securities. Although many of these entities rely on the private investment company exceptions under the Investment Company Act, they are clearly not hedge funds or private equity funds and should not be subject to the Volcker rule.

We recommend that interested parties comment on the proposed Volcker regulations prior to the end of the comment period on February 13, 2012.

This article was authored by Cynthia J. Williams, a Boston-based partner in Dechert LLP's Finance and Real Estate practice. She can be reached at +1 617 654 8604 or cindy.williams@dechert.com.

This article was published in the January 23rd issue of the 2012 ASF Daily, the conference newspaper reported by the editorial team on Institutional Investor's Securitization Intelligence.
www.SecuritizationIntelligence.com.