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Community Bank TruPS CDOs Exempted from the Volcker Rule Re: Trust Preferred Securities and Collateralized Debt Obligation

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Interim final rule exempts collateralized debt obligation vehicles that hold qualifying community bank trust preferred securities from the private fund sponsorship and investment prohibitions.

On January 14, the five federal financial regulatory agencies (Agencies)[1] approved an interim final rule (Interim Final Rule) that may resolve a brewing regulatory and legal controversy over the scope and application of the **Volcker Rule** under the new final regulations (Regulations) that were adopted in December 2013.[2] The Interim Final Rule permits banking entities to retain interests in certain collateralized debt obligations (CDOs) backed primarily by trust preferred securities (TruPS).[3]

Background

Section 619 of the **Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)**—more commonly known as the Volcker Rule—generally prohibits a banking entity from acquiring or retaining any ownership in, or acting as sponsor to, a hedge fund or private equity fund. The Regulations define a "hedge fund" or "private equity fund" (a "covered fund") to be any issuer that would be an investment company under the Investment Company Act of 1940 (the Investment Company Act), but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, with certain exceptions and additions. The "covered fund" definition therefore would include pooled investment vehicles, such as many TruPS CDOs, that rely on the section 3(c)(1) or 3(c)(7) exemption but that do not qualify for another exclusion under the Investment Company Act or the Regulations.

After the issuance of the Regulations, the Agencies released an FAQ document strongly suggesting that banking organizations owning interests in TruPS CDOs would have to treat such interests as covered fund ownership interests that are subject to the Volcker Rule and the Regulations.[4] In the wake of that document, several banking organizations that have held TruPS CDO interests decided to treat such interests as impaired under generally accepted accounting principles and wrote down their values or sold their TruPS CDO holdings. Shortly thereafter, the American Bankers Association filed suit in U.S. district court and the U.S. Court of Appeals, challenging the legality of the Agencies' apparent application of the Volcker Rule to TruPS CDOs; the Agencies thereafter determined to

review their Volcker Rule treatment of TruPS CDOs.[5]

Section 171 of the Dodd-Frank Act—commonly known at the Collins amendment—requires, among other things, that the appropriate federal banking agencies establish minimum leverage and risk-based capital requirements for insured depository institutions and depository institution holding companies that are not less than the generally applicable capital requirements that were in effect for insured depository institutions as of the date of the enactment of the Dodd-Frank Act. Although section 171 generally disqualifies TruPS from counting as Tier 1 regulatory capital, it permits any banking organization with total assets of less than $15 billion to continue treating TruPS issued before May 19, 2010 as Tier 1 regulatory capital.

The Agencies stated that they approved the Interim Final Rule in response to concerns expressed by a number of community banks that the Regulations conflict with section 171 of the Dodd-Frank Act, which sought to grandfather TruPS issued by smaller banks as of May 19, 2010. Community banks used the TruPS CDO structure prior to the enactment of the Dodd-Frank Act as an alternative means to access the capital markets and avail themselves of TruPS to increase their regulatory capital.

The Interim Final Rule

The Interim Final Rule permits a banking entity to retain an interest in, or to act as the sponsor (including as trustee) of, an issuer that is backed by TruPS so long as

- the issuer was established before May 19, 2010;
- the banking entity "reasonably believes" that the offering proceeds received by the issuer were invested "primarily" in Qualifying TruPS Collateral;[6] and
- the banking entity's interest in the vehicle was acquired on or before December 10, 2013 (unless acquired pursuant to a merger or acquisition).

In addition, the Agencies require that an issuer must have invested primarily in Qualifying TruPS Collateral to meet the requirements of the Interim Final Rule, which covers only those securitization vehicles that have invested a majority of their offering proceeds in Qualifying TruPS Collateral. The Interim Final Rule provides clarification that the relief relating to these TruPS CDOs also extends to the activities of a banking entity acting as a sponsor for these securitization vehicles because acting as a sponsor may otherwise be subject to the prohibitions or requirements of the Volcker Rule and the Regulations.

Notwithstanding the requirement that the banking entity's interest in the TruPS CDO must have been acquired on or before December 10, 2013, a banking entity may act as a market maker with respect to the interests of an issuer that qualifies for the exemption, in accordance with the applicable provisions of sections ___.4 and ___.11 of the Regulations. Consistent with the Regulations, the Interim Final Rule does not limit or restrict the ability of the appropriate Agency to place limits on any activity conducted or investment held pursuant to the exemption in a manner consistent with their safety and soundness or other authority, to the extent the agency has such authority. The Agencies have also included a "reasonable belief" standard to accommodate CDOs that were structured and made their investments many years ago and for which all relevant documentation may not be readily available.

The Interim Final Rule should be viewed as welcome relief by those eligible banking organizations that either issued qualifying TruPS to TruPS CDOs or that invested in TruPS CDO interests. That being said, the fact that the Agencies decided to address the TruPS CDO controversy through the adoption of a regulation, rather than through interpretation, indicates that the Agencies will continue to liberally apply the Volcker Rule to fund structures that are not expressly excluded or exempted under the Regulations. In addition, the TruPS CDO controversy serves as a cautionary note for both the banking industry and the Agencies about the potential impact of the Volcker Rule, whether intended or not. Given the scope and complexity of the Volcker Rule and the Regulations, other instances of "unintended effects" very possibly may arise, and it will be interesting to see how the Agencies address those situations.

The Interim Final Rule is effective on April 1, 2014 (the effective date of the Regulations) and is open for public comment for a period of 30 days.

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[1]. The Agencies are the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

[2]. For more information about the Regulations, see our January 2014 White Paper, "A Review of, and Insights into, the Volcker Rule Regulations," available here.

[3]. View the Interim Final Rule here.

[4]. View the FAQ here.

[5]. View the press release here.

[6]. Under the Interim Final Rule, "Qualifying TruPS Collateral" is defined by reference to the standards in section 171(b)(4)(C) of the Dodd-Frank Act to mean 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 during 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.

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