

December 19, 2013

## FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Final Volcker Rule

The banking agencies have received questions on certain provisions in the final rules implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Final Rules”) relating to banking entities’ investments in entities referred to as “Covered Funds.” Certain banking entities have expressed concerns as to whether their interests in collateralized debt obligations backed by trust preferred securities (“TruPS CDOs”) are ownership interests in Covered Funds under the Final Rules.

### ***Considerations in Determining Whether an Investment Will be an Ownership Interest in a Covered Fund on the Effective Date of the Final Rule***

There are a number of threshold questions that a banking entity should consider in connection with determining whether TruPS CDOs are Covered Funds. Before concluding that an investment in a TruPS CDO is subject to the provisions of the Final Rules, a banking entity should review the structure of each relevant TruPS CDO and the terms of each interest held by the banking entity. The banking agencies understand that this determination will depend in part on information obtained from other parties such as the CDO sponsor. The banking agencies would expect banking entities to undertake good faith efforts to engage in and resolve such analysis in a timely fashion during the conformance period.<sup>1</sup> This document provides an overview of some of the key legal issues banking entities should consider in determining whether holdings of TruPS CDOs are subject to the provisions of the Final Rules.

### ***Is it a Covered Fund Now?***

A threshold issue is whether a TruPS CDO, in its current form, is a Covered Fund under the Final Rule. The Final Rules generally define the term Covered Fund by reference to sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 with some additions.<sup>2</sup> Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions from the definition of an investment company under the Act that are commonly relied on by a wide variety of entities;<sup>3</sup> however, the Final Rules provide a number of express

---

<sup>1</sup> See Federal Reserve Board’s Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities.

<http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b.htm>.

<sup>2</sup> The final rule treats certain foreign funds and commodity pools as covered funds.

<sup>3</sup> Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, in relevant part, provide two exclusions from the definition of “investment company” for: (1) any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities (other than short-term paper); or (2) any issuer, the outstanding securities of which are owned exclusively by persons, who, at the time of the acquisition of such securities, are qualified purchasers, and which is

December 19, 2013

exclusions from the definition of Covered Fund.<sup>4</sup> Among others, the Final Rules provide that an entity that could rely on any exclusion or exemption from the definition of “investment company” under the Investment Company Act other than the exclusions contained in section 3(c)(1) or 3(c)(7) of that Act would not be considered a Covered Fund so long as it satisfies the conditions of another Investment Company Act exclusion or exemption.<sup>5</sup> Thus, if a TruPS CDO is relying on the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act as of the effective date of the Final Rules, it would be excluded from the definition of Covered Fund under the Final Rules if it also satisfies the conditions of another Investment Company Act exclusion. If the TruPS CDO is not a Covered Fund at the end of the conformance period, no further action is necessary, and the banking entity does not need to divest its holdings in the TruPS CDO by July 2015.

***If it is a Covered Fund Now, Can a TruPS CDO Become a Conforming Entity By July 2015?***

If the TruPS CDO, in its current form, is a Covered Fund, the banking entity could also evaluate, as an alternative to disposing of interests in the Covered Fund, whether there is a likelihood that the TruPS CDO could be restructured during the conformance period to avail itself of another exclusion or exemption under the Investment Company Act. If the TruPS CDO vehicle is restructured such that it becomes an entity that is not a Covered Fund during the conformance period, divestiture is not required. As noted above, banking entities and CDO sponsors may undertake an analysis to determine whether a TruPS CDO that currently utilizes the exclusion under section 3(c)(1) or 3(c)(7) of the Investment Company Act would be able to avail itself of other exclusions or exemptions under that Act before making a determination regarding whether divestiture is likely to be required under the Final Rules. As part of its determination, the banking entity should consider the likelihood that the TruPS CDO would ultimately be unable to either utilize a different exclusion or exemption, restructure, or otherwise conform to the requirements of the Final Rules during the conformance period,<sup>6</sup> including based on the banking entity’s evaluation of the operative documents and asset composition and owners of the particular TruPS CDO.

In addition, to the extent that a banking entity initiates actions either to restructure the TruPS CDO or otherwise to conform its interests in and relationships with the TruPS CDO to the requirements of the Final Rules, the banking agencies would expect the banking entity to develop a conformance plan that is

---

not making and does not at that time propose to make a public offering of such securities. See 15 U.S.C. 80a-3(c)(1) and (c)(7).

<sup>4</sup> For example, the agencies excluded certain wholly owned subsidiaries, joint ventures, acquisition vehicles, loan securitizations, and qualifying asset-backed commercial paper conduits.

<sup>5</sup> For example, some issuers of asset-backed securities may qualify for exclusion pursuant to Rule 3a-7 under the Act.

<sup>6</sup> The banking agencies note that, as part of its compliance program, a banking entity will need to establish that the CDO satisfies the conditions of any such other exclusion or exemption and the banking entity is required to maintain documentation regarding the exclusion or exemption being relied upon.

December 19, 2013

appropriately specific regarding the banking entity's plans to bring its holdings in TruPS CDOs in full conformance with the Final Rules.

***Are the Investments by the Banking Entity in a TruPS CDO an Ownership Interest?***

In addition to evaluating whether a TruPS CDO is a Covered Fund, a banking entity should also evaluate whether a security issued by a TruPS CDO is an ownership interest (as defined under the Final Rules). In determining whether the security is an ownership interest, the banking entity would consider, for example, whether the security provides the right to participate in the selection or removal of the CDO's directors or investment adviser, the right to receive a share of the income, gains or profits, the right to receive the underlying assets of the CDO after all other interests have been redeemed or paid in full, the right to receive excess spread, has a rate of return tied to the performance of the CDO, or whether the security provides that amounts payable may be reduced based on losses in the CDO. In addition to evaluating options regarding the status of the TruPS CDO, the banking entity also may consider the likelihood of a modification or change to the rights of the security held so that it no longer is within the definition of ownership interest.

\* \* \*

The banking agencies intend to continue to work together, and with the Securities and Exchange Commission and the Commodity Futures Trading Commission, regarding the implementation of the Final Rules and to provide such further guidance regarding the Final Rules as may be appropriate.