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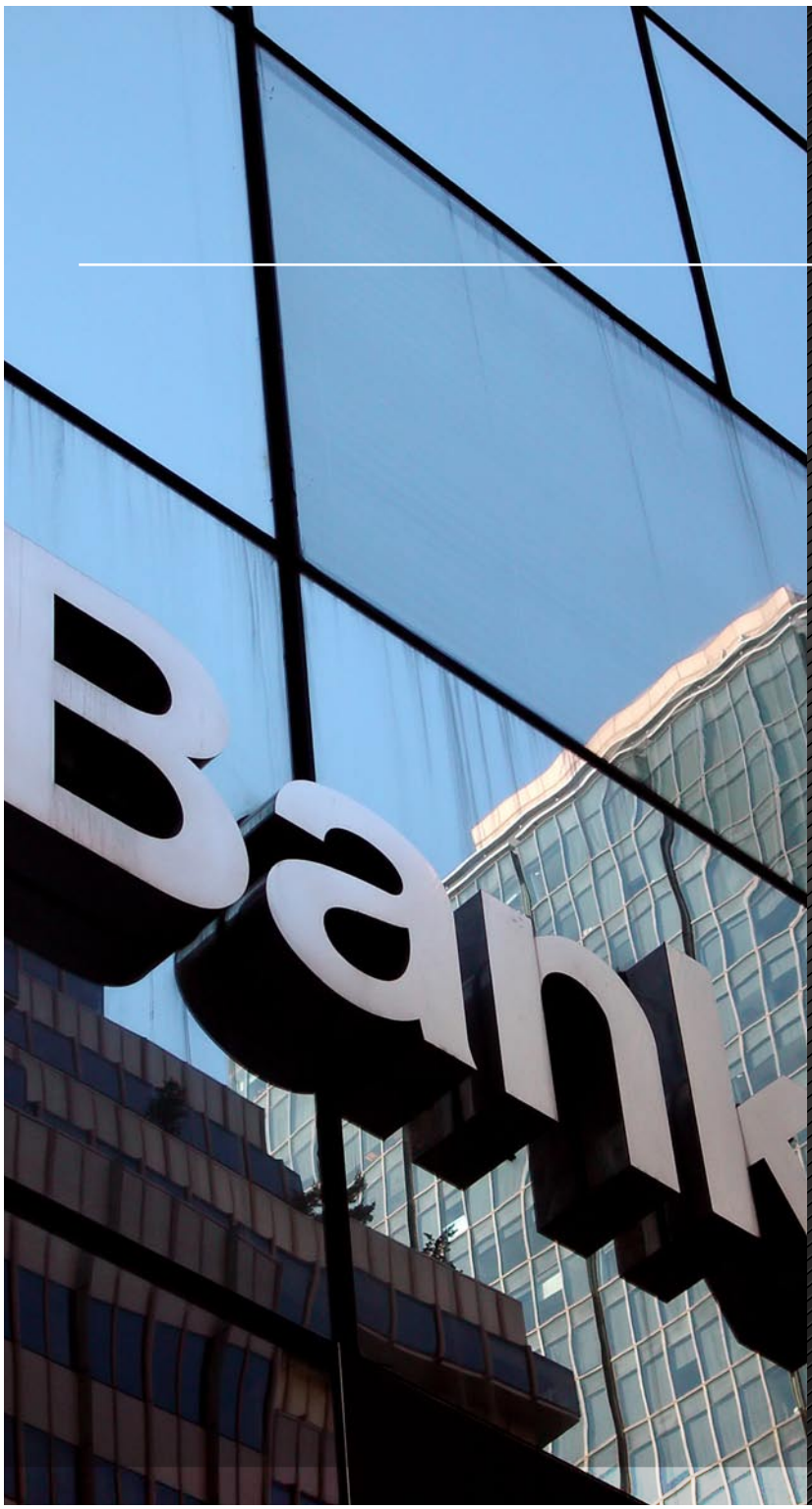

TalkingPoint

IMPACT OF THE VOLCKER RULE

REPRINTED FROM EXCLUSIVE ONLINE CONTENT PUBLISHED IN:
FEBRUARY 2014

FINANCIER WORLDWIDE corporatefinanceintelligence

FW moderates a discussion on the impact of the Volcker Rule between Dwight Smith, a partner at Nelson Mullins, Bradley K. Sabel, of counsel at Shearman & Sterling LLP and Brian D. Christiansen, a partner at Skadden, Arps, Slate, Meagher & Flom LLP.

Dwight Smith
Partner

Nelson Mullins

Dwight Smith is a partner at Nelson Mullins. He focuses his practice on bank regulatory and consumer finance matters. Mr Smith began his banking work during the savings and loan crisis and its resolution during the late 1980s and early 1990s, experience that set the stage for his practice during the recent financial crisis and its aftermath. He has advised on both the institutional and consumer sides of banking. His clients include community, regional, and large banks and thrifts across the country and nonbank consumer finance companies. Mr Smith can be contacted +1 202 545 2885 or by email: dwight.smith@nelsonmullins.com.

Bradley K. Sabel
Of Counsel

Shearman & Sterling LLP

Bradley K. Sabel is of counsel in the global Financial Institutions Advisory & Financial Regulatory Group at Shearman & Sterling LLP. Mr Sabel focuses on advising international banking institutions on US bank regulations, including the impact and consequences of the significant reforms of the recent financial crisis. Prior to joining the firm in 1994, he was an attorney for the Federal Reserve Bank of New York for 18 years, advising on US bank regulation and supervision, including domestic and foreign activities of US and foreign banks, reserve and margin requirements and asset freezes. He can be contacted on +1 (212) 848 8410 or by email: bradley.sabel@shearman.com.

Brian D. Christiansen
Partner

Skadden, Arps, Slate, Meagher & Flom LLP

Brian D. Christiansen is a partner in the Financial Institutions Regulation and Enforcement Group of Skadden, Arps, Slate, Meagher & Flom LLP. Mr Christiansen counsels banks, thrifts, investors and other financial services firms in connection with transactions and regulatory matters. He has helped clients obtain charters, raise capital, develop new products, structure and execute corporate transactions, implement compliance programs, conduct internal investigations and address enforcement actions. Mr Christiansen is active in advising financial institution clients on the Dodd-Frank regulatory reform legislation and related rulemaking. He can be contacted on +1 (202) 371 7852 or by email: brian.christiansen@skadden.com.

FW: Could you explain the importance of the Volcker Rule and why its key provisions represent such a major shift? In your opinion, does it effectively tackle the main underlying causes of the financial crisis?

Smith: The Volcker Rule was designed to take all bank holding companies out of two types of systemically risky activity: certain proprietary trading and equity investments. The immediate importance today of the Volcker Rule, which generally prohibits bank holding companies, and their subsidiaries and affiliates, from engaging in proprietary trading or investing in or sponsoring private equity or hedge funds, is threefold. First, banks and broker-dealers engaged in underwriting or making a market in securities may continue to do so – but need to follow new policies and procedures and to keep new records in order to ensure that they do not run afoul of the ban on proprietary trading. Second, investments in collateralised debt and collateralised loan obligations are largely prohibited. Third, the Rule has an unusually broad scope, particularly in comparison to counterpart concepts in Europe: its prohibitions apply not only to all banks, but also their holding companies and affiliates, and to the US operations of foreign banking organisations. Whether the Rule addresses the financial crisis, which was driven by credit and liquidity risk, rather than market risk, is debatable. However, its roots are in domestic politics and a felt need to reduce bank size, rather than in rigorous economics.

Sabel: The Rule does not address the main underlying causes of the financial crisis. There has been no credible evidence that dealing and private fund activities caused any significant amount of loss to banks. Rather, old-fashioned lending in the form of home mortgages was the primary cause. The Volcker Rule attempts to impose a cultural norm on banks that has always been assumed but not enforced in any substantial way.

Christiansen: The Volcker Rule prohibits banking organisations from doing two things – first, engaging in proprietary trading, and second, investing in or sponsoring hedge funds or private equity funds. Although some banking entities incurred some losses from these activities, few observers would suggest that these particular activities were the main underlying causes of the financial crisis. Nevertheless, the Volcker Rule reflects the broader post-crisis theme that simpler is safer – banking organisations should stick to the 'traditional' functions of taking deposits and making loans. The Volcker Rule marks a shift in another respect. In order to prevent banks and their affiliates from making 'risky bets' or 'gambling' with their capital, the Volcker Ruler prohibits them from engaging in 'proprietary trading'. The Volcker Rule generally defines proprietary trading to mean investment on a short term basis. Thus, the rule would prohibit a banking entity from owning an otherwise permissible asset for 10 days on the policy grounds that doing so would be too risky. Yet the rule would allow the banking entity to own that same asset for 10 months or 10 years. It is unclear how this concept is substantively connected to the actual risk borne by the banking entity.

FW: How have financial institutions responded to the final draft of the Rule, and to what extent is it more lenient than expected? In your opinion, will these regulations drive banks and investors to new financial centres?

Sabel: At this point, institutions are in the process of analysing the final regulation and their own operations to determine how to conform to the Rule. For global institutions with sizable wholesale clienteles, this is a very difficult job. After they determine the locations of activities that are restricted by the Rule, they will have to determine whether the activities are already in conformity, and if not, how to go about 'Volckerising' them – a new term of art. Then they will have to determine how to monitor compliance on an ongoing basis. This is an extremely

burdensome job.

Christiansen: The proposed rule released in October 2011 was formidable in length and complexity. The proposal generated extensive and diverse feedback from industry participants, policymakers and the public. Some argued that it was unduly burdensome, while others argued that it had too many exceptions and carve-outs. Some commentators, including Paul Volcker, encouraged the regulators to scrap the complex proposal in favour of a more streamlined, principles-based approach focused on the 'spirit' of the rule. After more than two years of deliberation, the final rule retained the basic structure and key requirements of the proposal – although the agencies made a number of modifications around the edges. Some of those changes made the rule more lenient – others made it more stringent. No one would regard the final rule as ideal. I would not expect the Volcker Rule to singlehandedly drive banks and investors to new financial centres. But the Volcker Rule must be viewed in the context of the numerous new regulations and heightened supervisory expectations that continue to increase the cost and regulatory uncertainty for banking entities' trading and capital markets activities in the US. As the cumulative weight of these requirements makes it more costly to do business in the US, we can expect that the US activities of international financial institutions will shrink relative to their operations outside the US.

Smith: The banking industry response to the final regulation has been measured, since the fundamental components of the Volcker Rule have been known since July 2010 and since the final regulation may not be the last word. Many large US banks have already wound down the trading desks clearly banned by the Rule. These operations have now entered the shadow banking part of the US financial services industry but have not changed location. Large foreign banks have moved proprietary trading outside the US. The issuance of and investments in collateralised debt, loan, and mortgage obligations are another story, since the final regulation in December seems to end uncertainty about these investments and confirms that they are prohibited. A strong reaction from community banks caused the regulators to grant at least temporary relief for holdings of CDOs backed by bank-issued trust preferred securities. Unless similar relief is given to CLOs and CMOs – the agencies have indicated they will revisit the ban on CLOs – issuers and the parties to the underlying transactions will need to look abroad for new sources of funding.

FW: How will the Volcker Rule affect the investment funds industry, including non-US based funds?

Christiansen: For banking entities that sponsor investment funds, the Volcker Rule raises concerns with respect to both their existing funds and new products in the pipeline. Existing private funds will need to be restructured to be compliance with the Volcker Rule by the end of the conformance period –generally July 2015, subject to possible extensions. This may require the banking entity to divest some or all of its ownership interest in a fund by way of redemption or secondary market transaction. Existing relationships with investors and counterparties may need to be amended, and fund investors may see this as an opportunity to renegotiate for better terms. For new products, banking entities will need to understand the Volcker Rule's exemptions. For example, the Volcker Rule imposes investment limitations, restrictions on affiliated transactions, and naming conventions. There will be a renewed focus on ensuring that non-US funds and offerings are truly and sufficiently outside the US in order to avoid or minimise application of the Volcker Rule to these products.

Smith: The Rule may reduce the participation of US banks in the private equity and hedge fund business. The Rule does not affect the relationships of US bank holding companies with other types of investment vehicles. With respect to

private equity and hedge funds, the Rule contains an important exemption that enables a bank to sponsor such investment funds for the benefit of their customers, subject primarily to the condition that the banking entity reduce its investment in such a fund to less than 3 percent of the interests within one year. From a broader economic perspective, if banking institutions exit the private equity and hedge fund space, there are likely other US market participants able to fill that gap.

Sabel: Global banks constitute a large part of the sponsors of private funds, and living with the Rule's restrictions may pose significant problems for them. Global banks have also been major investors in private funds. In some cases they may have to sell interests in existing funds in order to be in conformity by July 2015. This could pose opportunities for fund managers not affiliated with institutions engaged in banking in the US.

FW: What challenges are likely to surface as the Volcker Rule is rolled out and enforced? What are the penalties for non-compliance?

Smith: The particular challenges for banking entities vary between trading and investments in private equity and hedge funds. The more significant challenge may be divestiture of investments now deemed in the final regulation to be within the prohibition on investments in private equity and hedge funds, notably collateralisations of various types of obligations. Until now, the scope of the prohibition has been unclear. The challenge with respect to trading is ensuring that a bank holding company has the necessary policies, procedures, and record keeping arrangements in place to satisfy the conditions for permissible forms of trading, such as market making, underwriting, and hedging. Most banking entities already have wound down what we might consider their core trading activities. Enforcement will take place through the examination process, and, in the case of banks and bank holding companies, Volcker compliance will be just one of many issues covered in the examination. Enforcement of the Rule will be calibrated to the effect of and intention behind a violation, and the agencies will typically forgo severe penalties for a violation of a new regulation if a company has made a good-faith effort to comply. Each of the five US agencies implementing the Rule has its own set of formal and informal agreements to direct compliance, as well as monetary penalties for compliance failures; there are not Volcker Rule-specific penalties.

Sabel: The interpretive questions are endless. Despite the enormous length of the final regulation and the agencies' explanation, there are a host of points that are still unclear. And the consequences are very unclear, especially for the proprietary trading ban, which might significantly reduce liquidity and prices in the securities market. As to penalties, the agencies said in the explanation that they will use their existing enforcement powers to penalise violations, but the general expectation is that they will be lenient with unintentional violations during the first few months, at least, after effectiveness.

Christiansen: I expect one of the biggest challenges for banking entities will be the difficult task of developing, implementing and maintaining the monitoring and record-keeping programs needed to ensure compliance with rule. For large organisations with multiple business lines, this will require a large investment of management attention and resources. With increased compliance requirements will come more opportunities for banking entities' to make mistakes. As with other types of policies and procedures – such as credit underwriting or anti-money laundering – oversights and weaknesses are often apparent only in hindsight. A banking entity might have a strong compliance system and make a good faith determination that a transaction is permitted under the Volcker Rule. But if that transaction happens to turn out poorly, there may be a natural inclination by regulators, with the benefit of

hindsight, to regard the transaction as a violation or sign of an inadequate compliance system. Perceived weaknesses in risk management and compliance systems can negatively affect a banking entity's confidential supervisory ratings—which in turn can negatively affect the banking entity's ability to expand, enter new business lines, and conduct mergers and acquisitions.

FW: How effectively do you believe regulatory agencies will cope with the task of reviewing each bank's compliance program for completeness, compliance with the final regulation and 'reasonableness'? Which agency, or agencies, are likely to take the lead and on what specific issues?

Sabel: The agencies in the explanation said that they would cooperate with each other in reviewing compliance with the Rule and any enforcement actions, but it is not at all clear how this will work. As a legal matter, each agency has particular types of financial organisations under their jurisdiction and can take enforcement action on that basis. It is likely that the agencies will not identify specific issues that any one of them will take the lead on, but, for example, it is likely that the SEC will have primary jurisdiction over underwriting and market-making activities in the US because of its authority over broker-dealers. The Fed might also be involved because it has 'umbrella' authority over all bank holding company non-bank subsidiaries. Procedures designed to monitor and assess compliance that are satisfactory to each agency's examiners will be extremely important.

Christiansen: This is one of the most important unanswered questions around the Volcker Rule. Despite its length, the final rule relies, in large part, on banking entities implementing policies, procedures and 'frameworks' to avoid engaging in prohibited activities and to manage the risks of permitted activities. Thus, the final rule leaves considerable discretion to examiners and supervisors in their implementation and enforcement of the Volcker Rule. That the rule is to be enforced by five separate agencies, with somewhat different policy objectives, across widely varied types of businesses, will undoubtedly lead to some degree of inconsistency in implementation. Although the agencies recently announced the formation of an inter-agency coordinating committee, significant concern remains that inconsistent interpretation and uneven enforcement of the rule will invite regulatory arbitrage and distort markets.

Smith: The examination and supervision of each banking entity's compliance program will be a work in progress, as the US agencies have acknowledged. As has been the case with other new, multi-agency regulations, the agencies have established an inter-agency working group that will be a source of collective expertise and will review virtually all important interpretations of the Rule. The Federal Reserve Board will have an important role in all issues, since it supervises all bank holding companies and has the legal authority to examine nearly all bank holding company subsidiaries. However, the oversight of activities concentrated in particular segments of the banking industry will be led by the agencies with direct regulatory authority over those segments. For example, most market-making is conducted by broker-dealers or national banks, thus placing the Securities and Exchange Commission (SEC) and the Office of the Comptroller of the Currency, respectively, in the forefront of determining the scope of permissible market making.

FW: With the UK adopting the Vickers proposals and the EU considering the Liikanen proposals, do you believe we are likely to see further fragmentation of financial markets?

Christiansen: The UK, France and Germany are each in various stages of implementing ring-fencing requirements, and the EU has released its own proposal on ring-fencing

and proprietary trading. To differing extents, these measures reflect the principle that proprietary trading should either be kept physically separate from, or not be funded by, retail banking units. Although these measures have some similarities with the Volcker Rule, they will operate in very different ways. When viewed together with the Federal Reserve's recently adopted rule to enhance standards governing non-US banks operating in the US, the effect of these measures will be to reinforce the trend toward 'subsidiarisation' of global banking operations. Rather than operating in multiple jurisdictions through a single legal entity, global financial institutions may increasingly choose to operate through multiple subsidiaries – each separately regulated in its local jurisdiction. Subsidiarisation is often a less efficient means of organisation because capital and liquidity cannot move freely among subsidiaries where it is most needed or most efficiently deployed.

Smith: Yes, further fragmentation is likely to be the result not only of the Volcker Rule but also of the Financial Services (Banking Reform) Act 2013 in the UK and, if adopted, the bank structuring rules recently proposed by the European Commission. Foreign banking organisations have withdrawn or are withdrawing any US subsidiaries that may conduct proprietary trading or hold impermissible investments. US bank holding companies have eliminated most if not all of their proprietary trading, but those operations, now conducted in other institutions, have largely stayed in the US. Borrowers who rely on collateralised obligations and the issuers of those instruments may have to look increasingly abroad for potential investors.

Sabel: It appears that the international trend is toward fragmentation, which would be very unfortunate. The financial system on balance seems to have benefited from relatively free flows of assets and funds across borders. The cost of disrupting that flow, but requiring local capital and liquidity as well as disallowing cross-border transactions, will likely be quite high, and adjustment will take a significant amount of time.

FW: What unexpected opportunities will there be after the Volcker Rule comes into effect? Will there be a surfeit of cheap assets available after the Rule becomes enforceable in July 2015? If banks are forced to liquidate assets in eighteen months time, would this have an adverse effect on the financial system?

Smith: Any opportunities will be a function of the degree to which bank holding companies do not now meet Volcker Rule requirements – they are not in violation today, but will need to be fully compliant by July 2015. The likeliest opportunities today lie in the purchase of certain CDOs, CLOs, and CMOs. Bank holding companies now holding these investments have already begun to sell off their holdings, typically at a loss. For accounting reasons, it is preferable for these investments to be sold off sooner rather than later. For investments in other, more traditional private equity and hedge funds, the Rule provides flexibility for the exiting illiquid investments, and such funds are unlikely to have a strong immediate need to replace these investors. However, banks no longer can invest in such funds, and it is possible that reduced demand could lead to slightly more favourable terms on new funds. The final regulation also is unlikely to generate opportunities for proprietary trading operations since few problematic operations remain.

Sabel: Banks may have to dispose of both some trading assets and some private fund holdings that are non-compliant, but the possibility of 'Volckerising' funds so that they are permissible and of an extension period may reduce the pressure to sell into a fire sale. The final deadline for being in compliance is July 2015, so there is some time to deal with this, but the pace of sales, amount of demand and the like is very hard to predict. The most likely source of harm to the financial system generally would be the use of significant financing for the investments; borrowers might face difficulties honouring their obligations if sales

prices are far below the original price.

Christiansen: Where regulatory directives require institutions to sell assets before they might otherwise do so, the selling institutions will be under pressure to accept less favourable pricing and terms than they might otherwise accept. However, banking entities have been taking steps to adjust their businesses since the Dodd-Frank Act became law in 2010. Banking entities also have the ability to seek additional extensions of the Volcker Rule divestiture period. Banking entities may seek extensions on the basis that more time will allow them to minimise losses on a sale and preserve capital. In most cases, it will be difficult to pinpoint the Volcker Rule as the sole or principal driver of asset transactional activity. This is because banking entities are under a number of other regulatory and economic pressures to sell assets, including increased capital requirements and stress testing. ■