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The Volcker Rule: What It Is And Its Impact On Business

The Editor interviews Brett P. Barragate and Antonio (Tony) F. Dias, Partners in the New York City and Washington, DC offices, respectively, of Jones Day.

Editor: Please tell us about your backgrounds and the activities of your practice groups at Jones Day.

Dias: I am a partner in our Washington, DC office and co-leader of the firm's Financial Institutions Litigation and Regulatory practice. Over the last 25 years, I have worked in a number of different areas that relate to regulatory enforcement and litigation. I also am one of the leaders of our states' attorneys general practice and work on a number of joint federal and state enforcement matters and lawsuits brought by the Department of Justice and state attorneys general.

Barragate: I'm one of the two co-leaders of our Banking and Finance Practice. The practice group represents financial institutions and other entities in all aspects of transactional and commercial financing-related matters. We do commercial loan and syndicated loan transactions as well as securitizations and structured finance deals. Our practice group also does derivatives-related work. My personal practice is focused on commercial lending, syndicated loans, corporate loans, leveraged finance and acquisition finance on both the bank and borrower sides.

Editor: What is the Volcker Rule and how is it being implemented?

Barragate: The Volcker Rule is one of the centerpieces of the Dodd-Frank Act. The intended purpose of the Volcker Rule is to prevent banks from engaging in high-risk activities utilizing their own capital. The final rules implementing the Volcker Rule were recently released by the five federal



Brett P. Barragate



Antonio F. Dias

financial regulators. It has two principal components. First, the Volcker Rule generally prohibits banking entities from engaging in what's called "proprietary trading" of securities, derivatives, and commodities. Second, it also prohibits bank ownership of, or investment, in "covered funds" (defined in the Volcker Rule as certain types of entities including private equity and hedge funds).

Editor: Tony, did you have anything to add to that?

Dias: The Volcker Rule is yet another piece of the effort in the Dodd-Frank Act to bring stability to the financial markets and to minimize risk-taking activity by insured banking institutions and their affiliates. During the course of our conversation today we'll talk about that a little bit more.

Editor: Beyond the banks themselves, what implications does the Volcker Rule have for the wider corporate world?

Dias: A corporation that needs to access the capital markets or enter into hedging transactions with banks may find that the cost of capital has increased or at least that access to that capital is going to become a bit tighter. Another impact is that banks will likely shed significant business activities that they previously provided to their corporate customers.

Editor: The Rule covers banks' propri-

etary trading activities. What other sorts of trading are not covered?

Barragate: The Volcker Rule's ban on proprietary trading was designed to prohibit banking entities from using their own capital to speculate in securities markets solely for the purpose of making a profit for themselves and not related to customer business. The Rule has some very important exceptions to the general ban on proprietary trading. I'll just talk about three of them. One is buying or selling securities if it relates to underwriting a securities offering for a customer. The second is purchasing and selling securities pursuant to market-making activity, although this exception is somewhat limited because the market making must not exceed reasonably expected near-term demand. The third exception is they can trade securities to hedge or mitigate their own risk.

Editor: Focusing on proprietary trading, are there gray areas as to the kinds of entities covered?

Barragate: The ban on proprietary trading applies to a "banking entity" and that's pretty easy to determine based on how you're regulated, your affiliates, and your size. However, there is a lot of ambiguity about the exceptions to the general ban on proprietary trading, such as what is permissible market making. This may result in banks taking an overly conservative approach to their proprietary trading generally and to their market-making activities in particular in order to avoid a violation.

Editor: What does the Rule mean for bank investment in "covered funds"?

Dias: At a very simple level, the Volcker Rule was intended to prohibit bank investment in hedge funds and private equity funds. In the Volcker Rule, hedge funds

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and private equity funds were captured as “covered funds” by reference to the exemptions from registration as investment companies under the Investment Company Act that hedge funds and private equity funds typically utilize (those are 3(c)(1) and 3(c)(7)). The result of this approach is that the universe of funds deemed to be “covered funds” by the Volcker Rule is really much broader than just traditional hedge and private equity funds and captures most structured debt issuers, such as collateralized debt obligations (CDOs) and tender option bonds. The final rule does permit banking entities to invest in or sponsor an otherwise covered fund on certain occasions in connection with organizing or offering the fund, including market making, retaining de minimis investments in a covered fund, and some hedging activities that demonstrably hedge risk.

Editor: Can you describe the new compliance obligations that the Rule imposes?

Dias: The compliance rules and requirements in the Volcker Rule vary depending on the banking entity’s asset size and volume of covered activity. In an effort to reduce the burdens on smaller entities that engage in a limited amount of covered activities or investments, the Volcker Rule largely allows smaller and less complex banking entities with assets of less than \$10 billion that engage in covered proprietary trading and/or covered fund activities to implement a simplified compliance program. For banking entities with more than \$10 billion in assets, the Volcker Rule requires them to implement a detailed compliance program that includes written policies and procedures that provide trading and exposure limits, internal controls, assignment of compliance responsibilities to specified members of management, independent testing, audits, training and recordkeeping. Enhanced compliance obligations apply to the very largest bank institutions, which include those with assets in excess of \$50 billion.

Editor: What is the international impact on capital markets of this new U.S. policy?

Barragate: The Volcker Rule itself applies to both the domestic and foreign activities of U.S. banks. A U.S. bank cannot do in Europe or Asia what it’s not permitted to do in the U.S. The Volcker Rule also applies to foreign banks that have branches or agencies in the U.S., but certain activities and investments that are conducted

solely outside the U.S. by foreign banks are exempted. Thus, a foreign bank may have a competitive advantage over U.S. banks, which might give rise to some forum shopping. You may also recall that there was a lot of complaining by foreign governments and foreign banks when the proposed Volcker Rule was released, because it would have prohibited foreign banks from trading in foreign government debt. The final rule now allows foreign banks, and foreign affiliates of U.S. banks, to trade in sovereign debt issued by the government under whose laws they are organized.

Editor: Is any effort being made to change that policy to make U.S. banks more competitive in Europe?

Barragate: The efforts are all being focused on trying to ensure that Europe and London have a rule similar to the Volcker Rule so we’re not at a disadvantage.

Editor: Are there any key regulatory decisions that we should be looking forward to? Are there gaps that are likely to be filled or need to be filled?

Dias: We saw the first volley of regulatory challenges during the first few weeks after the Volcker Rule was announced. There were some lawsuits and a number of bills were offered in Congress to try to deal with perceived issues. The agencies reacted quickly to one particular issue by issuing an Interim Final Rule exempting all CDOs backed by the trust-preferred securities that were issued by banks with less than \$15 billion of assets. However, the way this Interim Final Rule is worded, larger banks that hold trust-preferred securities backed by CDOs would also benefit.

I think you’ll see additional issues being raised in the next few months as people come to appreciate the Volcker Rule’s full impact on different parts of the financial community. There is no question that many of the restrictions, prohibitions, and regulatory controls that were put in place by the Dodd-Frank Act, as well as the continued delays in passing final rules implementing the provisions of the Act, are choking off a lot of the innovation in the financial community. I think we’ll see continuing challenges not only to the Volcker Rule but also to other parts of Dodd-Frank as it continues to have a deep impact on the financial community.

Editor: Do you have any parting advice to our non-bank industry readers on how to adapt to the post-Volcker Rule environment?

Barragate: I tend to deal with clients who operate in the transactional world, so they’re interacting with banks and financial institutions on a day-to-day basis. My advice is to encourage people whose businesses are affected by the Volcker Rule to keep up with it because it’s going to change the way they do business with their banks. Their banks are going to be telling them things or doing certain things that they may not understand unless they understand the Volcker Rule. I think it’s important that they try to keep up with it as best as they can, even though it’s complicated. Banks will be forced to divest certain business lines and services because of the Volcker Rule. While this may cause disruptions or pricing changes for some bank services, it will also present opportunities for others to step in and fill the void.

Dias: The impact of the Volcker Rule runs much broader than just those banks and institutions that are targeted by the application of the Rule. Those involved in capital markets, in private equity, in funds and hedge funds are seeing the impact of it now. What we have done at Jones Day in working with our global clients is to try to anticipate what legal issues there might be for them and to be in a position where we can give them advice that is not limited to an analysis of the Rule but also shows how those clients can benefit from anticipating the changes of the marketplace. Both in Brett’s Banking and Finance practice and in the Financial Institutions Litigation and Regulatory space, we find ourselves not only working with our clients in our own practice group, but also collaborating with lawyers throughout the firm in all of our locations. With our geographic footprint, we find ourselves in every major financial market in the world. We’re now constantly looking at issues from countries outside the U.S. and how it affects their institutions as well as institutions here in the U.S. I think one of the things for your readers to take a look at is how in their businesses these changes in the financial community are affecting them and try to find a way to take advantage of new opportunities.

Editor: Are there any cases or regulatory proceedings that our readers should be following?

Dias: Readers should watch for efforts for the next few months by folks that are going to challenge the Volcker Rule and the restrictions that are put on banks that may affect their interests in a way that threatens their livelihood or their ability to conduct business the way they ought to be able to conduct their business.