Milbank

February 6, 2015

CONTACT

Douglas Landy
Partner
+1-212-530-5234
dlandy@milbank.com

Julia Hueckel
Associate
+1-212-530-5539
jhueckel@milbank.com

James Kong
Associate
+1-212-530-5244
jkong@milbank.com

Financial Institutions Regulation Group Client Alert: Things the Media believes the Volcker Rule says … but it actually doesn't

This is a piece in our continuing series exploring the effects of the Volcker Rule; for previous alerts please click here.

BRIEF BACKGROUND

Section 619 of the Dodd-Frank Act[1] (commonly known as the "Volcker Rule") is an extremely complicated piece of legislation and financial regulation. The statutory provision runs to 4,615 words.[2] The proposed rulemaking, released in November 2011, generated over 18,000 comments.[3] The final rulemaking, released in December 2013, included 2,826 footnotes.[4] Banking entities[5] impacted by the Volcker Rule have spent considerable time preparing to comply with its requirements. Even now, more than four and a half years following the adoption of the Dodd-Frank Act, many of the Volcker Rule's provisions remain stubbornly opaque and hard to interpret.

Notwithstanding all of the above, we note that much of the popular discourse surrounding the Volcker Rule misinterprets what it actually says. As evidenced by recent media articles and opinion pieces, many observers and commentators appear to have read into the Volcker Rule a blanket prohibition against a bank making any trade or investment that carries risk. This view is simply not true. The Volcker Rule is a weighty interpretive beast, reflecting value decisions made by Congress concerning the correct manner in which banking entities should conduct their activities. However, as we discuss below, it is far from a total ban on any activities that could

[1] Section 619, *Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1. (2010).
[2] *Id*.
[3] 76 Fed. Reg. 68846 (Nov. 7, 2011).
[4] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014).
[5] The final rule defines covered "banking entities" to include any of the following, unless otherwise exempted:

> (i) Any insured depository institution;
> (ii) Any company that controls an insured depository institution;
> (iii) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and
> (iv) Any affiliate or subsidiary of an entity described above.

12 C.F.R. § 248.2(c).

carry risk. Instead, it is a delicate balance of policies. One may argue that Congress should have adopted a stricter ban on bank activities, but it did not, and nor did the regulatory agencies instructed to implement Congressional intent.

Furthermore, there is a real danger in reading the Volcker Rule as the total ban on risk that many suggest it is. When a bank does make permitted trades or investments, it is liable to be criticized as if it were somehow breaking the law. This fuels a public view of banks as bad actors or morally questionable entities, when in reality they are simply engaged in activities permissible under a complex balance of financial regulatory policies. We would like to help clear up this misconception with a few short examples below.

1. WRONGFUL ASSUMPTION #1: BANKS ARE NOT SUPPOSED TO MAKE MERCHANT BANKING INVESTMENTS IN COMPANIES.

Recently, the New York Times prominently featured an article saying that a large bank was making investments that "Test the Volcker Rule."[6] The investments at issue included apartment buildings, a shopping mall and an ink company. The article noted that "[t]hese are the sorts of investments that many … had assumed would be prohibited by … the Volcker Rule."

That assumption is incorrect. The Volcker Rule, codified as Chapter 13 of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), generally prohibits banking entities from engaging in proprietary trading or in making certain investments in (or having certain relationships with) so-called "covered funds."[7] Since the adoption of the Gramm-Leach-Bliley Act in 1999 (the "GLB Act"), bank holding companies that have elected to become "financial holding companies" ("FHCs") have had the ability to make passive investments, *for profit*, in commercial companies, whether directly or through private equity fund structures. This provision—an FHC's merchant banking authority—is found in Section 4(k) of the BHC Act, as implemented through Subpart J of Federal Reserve Regulation Y.[8]

It is true that the Volcker Rule rolled back a significant component of an FHC's merchant banking authority—namely, its former ability to make merchant banking investments through a private equity fund. What the Volcker Rule did not do, however, is change an FHC's ability to make such investments directly. For example, while a banking entity cannot invest indirectly through a covered fund structure to gain exposure to Company ABC, it can directly acquire and hold up to 100 percent of the

[6] Nathaniel Popper, The New York Times, *Goldman Sachs Investments Test the Volcker Rule*, (Jan. 21, 2015), http://dealbook.nytimes.com/2015/01/21/goldman-investments-are-testing-volcker-rule/.

[7] 12 C.F.R. § 248. The final rulemaking generally defines "covered fund" to include any issuer that would be an Investment Company within the meaning of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act. We note as well that the Volcker Rule prohibits "short-term" proprietary trading (generally speaking, trades of 60 days or less), which then means that longer term trading, or investing, is not prohibited. *See* 12 C.F.R. 248.3(b).

[8] 12 CFR § 225.170-77.

equity interests of Company ABC (so long as it follows the passivity requirements and holding period limitations of the merchant banking rules).[9]

This seeming anomaly makes perfect sense when considered in light of the Volcker Rule's proposed purposes, which were to ban proprietary *trading*, whether done directly by the bank or indirectly through bank investments in covered funds. The Volcker Rule was never intended to ban all bank proprietary *investing*, and any attempt to interpret it as such would be a misreading of both Congressional intent and the ultimate statutory and regulatory language.[10] Again, FHCs have had the ability to directly make merchant banking investments ever since the GLB Act was adopted in 1999; the Volcker Rule did not prohibit such direct investments, and FHCs can continue to make them.

So these types of investments do not actually "test the Volcker Rule" at all, and they are not "a violation of the spirit, if not the letter, of Dodd-Frank."[11] What the New York Times seems to believe is that banks should self-interpret the Volcker Rule as banning such investments, while ignoring the provision in Chapter 4 of the BHC Act that expressly permits them.

2. WRONGFUL ASSUMPTION #2: BANKS CANNOT INVEST IN COLLATERALIZED LOAN OBLIGATIONS ("CLOS") BECAUSE THEY ARE TOO RISKY.

A recent New York Times article discussed a bill that had been introduced into the House of Representatives; among other provisions, the bill would provide an additional two year period for covered banking entities to dispose of certain CLO investments prohibited by the Volcker Rule.[12] The article states that the bill would let banks "hold onto certain risky securities until 2019" and that "C.L.O.s can pose high risk for banks." Adding to the confusion, this bill, meant only to extend the conformance period during which banks would be allowed to hold *legacy* investments in a single type of vehicle prohibited under one part of the Volcker Rule, was alternately painted by politicians as a delay of the Volcker Rule entirely[13] or as a giveaway to Wall Street banks that would allow them to "make more risky bets using taxpayer-backed money."[14]

---

[9] *Id*. The BHC Act contains several provisions that permit banking entities to make and hold investments in non-financial companies. *See, e.g.*, BHC Act § 4(c)(6).

[10] The scope of permissible proprietary bank investments is itself the subject of regulatory consideration; for example, the Federal Reserve issued last year an advance notice of proposed rulemaking related to physical commodity activities conducted by FHCs. *See Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities*, 79 Fed. Reg. 3329 (Jan. 21, 2014). Section 620 of the Dodd-Frank Act also mandated that the Federal banking agencies review and prepare a report on bank investment activities.

[11] The Editorial Board, The New York Times, *An Uncertain Future for Dodd-Frank*, (Jan. 24, 2015), http://www.nytimes.com/2015/01/25/opinion/sunday/an-uncertain-future-for-dodd-frank.html.

[12] Gretchen Morgenson, The New York Times, *Kicking Dodd-Frank in the Teeth*, (Jan. 10, 2015), http://www.nytimes.com/2015/01/11/business/kicking-dodd-frank-in-the-teeth.html.

[13] *Pelosi Statement on Republicans' Latest Wall Street Giveaway*, (Jan. 7, 2015), http://www.democraticleader.gov/newsroom/pelosi-statement-republicans-latest-wall-street-giveaway/.

[14] Zach Carter, The Huffington Post, *Democrats Rail Against GOP Bill to Delay Volcker Rule*, (Jan. 7, 2015), http://www.huffingtonpost.com/2015/01/07/democrats-volcker-rule-revision_n_6431146.html.

It is an opinion whether a CLO, or CLOs in general, are "risky". But the article makes several factual misstatements. It notes the increased issuance of CLOs in 2014 and states that the size of these banks' position in CLOs is the reason for their desire to hold onto them for a longer period. But, of course, this conclusion mixes up the fact that (i) the extended conformance period would only apply to "legacy" CLOs issued prior to January 31, 2014 and (ii) the extended period would not apply to almost all of the issuances whose statistics are cited in the article.[15]

In fact, many CLOs issued since the final rules implementing the Volcker Rule were issued are structured to comply with the Volcker Rule's requirements.[16] Therefore, banks only need an extension to extend conformance with legacy holdings. And the article offers no evidence to back up its assertion that any of these CLOs are "risky"; in fact, the author notes that several of the largest issuers have unrealized gains in their CLO portfolios. This is backed up from statistics from the Loan Syndications & Trading Association ("LSTA"), which find that not only do open market CLOs not have the characteristics of securitizations that ran into difficulties during the financial crisis, but in fact, that their credit performance has been "phenomenal."[17]

In reality, many banks and commentators were caught unaware by the inclusion of CLOs by the Volcker Rule, given the rule's express policy of excluding from its effects loan products.[18] It was only through the broad application of the exclusions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, the broad interpretation of the phrase "ownership interest" and the narrow interpretation of the "loan securitization exemption" that such products were captured by the definition of a covered fund.[19]

The House bill proposal then would have provided an additional two years for banks to hold CLOs in which they had invested prior to January 31, 2014. The banks have argued that being forced to prematurely sell performing CLOs would impose unnecessary losses on them and impair their capital.

3. WRONGFUL ASSUMPTION #3: ELIMINATING THE "PUSH-OUT" PROVISION OF DODD-FRANK WILL PERMIT BANKS TO TRADE RISKY DERIVATIVES SUPPORTED BY INSURED DEPOSITS.

One of the last acts of Congress in 2014 was to pass a bill that eliminated Section 716 of the Dodd-Frank Act, widely known as the "push-out" provision.[20] This provision would have required banking entities to move certain derivatives trading businesses from an insured depository institution to another affiliated entity. Dodd-Frank is an extremely long law, totaling more than 2000 pages. Many experts nominated Section 716 as its most poorly drafted provision. It was almost certainly thrown together in the middle of the night, as evidenced by its poor drafting. It used different

[15] H.R. 37, 114th Cong. (2015).
[16] *See, e.g.*, Tracy Alloway, Financial Times, *Banks Respond to New Rules with Volcker-friendly CLOs*, (Jan. 14, 2014), http://www.ft.com/intl/cms/s/0/057865a6-7c83-11e3-b514-00144feabdc0.html#axzz3QbICdUH2.
[17] *See* comment letter from LSTA to the European Banking Authority regarding the EBA Discussion Paper on simple standard and transparent securitisations, (Jan. 14, 2015).
[18] *See, e.g.*, Victoria Finkle, American Banker, *How Dodd-Frank Might Kill the CLO Market*, (Feb. 24, 2014), http://www.americanbanker.com/issues/179_37/how-dodd-frank-might-kill-the-clo-market-1065802-1.html.
[19] 12 C.F.R. § 248.10.
[20] H.R. 83, 113th Cong. (2014).

terms to refer to the same types of entities, sometimes within a single sentence. And, most importantly, the supposed policy underpinnings failed to take into account the effect of the Volcker Rule.

As noted, the Volcker Rule prohibits any covered banking entity from engaging in the proprietary trading of derivatives, unless the transaction falls into one of the Volcker Rule's exemptions or exclusions. Therefore, the only derivatives a banking entity will be permitted to transact in are those that Congress has not deemed to be risky, proprietary trades. So what is the point of forcing these banks to move existing, safe, client-based trading operations from their insured depository subsidiaries to new derivatives trading subsidiaries? The increased costs associated with such moves would inevitably be passed on to counterparties and clients.

According to the New York Times, this change dismantled a "signature overhaul" from Dodd-Frank.[21] Again, this is not true. Covered banking entities will still be subject to the Volcker Rule's prohibitions, and will only be permitted to engage in derivatives trading of the kind that the Volcker Rule has explicitly deemed safe enough to exclude from its prohibitions. Therefore, the effect of the deletion of Section 716 will only be to permit banks to continue trading safe derivatives in their insured depository subsidiaries.

4. CONCLUSION

As the examples above show, there is much that the popular discourse gets wrong about the Volcker Rule. Beyond simply the media, political rhetoric often—through what are perhaps mischaracterizations calculated to achieve political ends—sensationalizes or caricaturizes key points surrounding financial reform. All of this overheated discourse fuels the perception of banks as bad actors seeking to take inappropriate risks at the expense of taxpayers, and impedes legitimate efforts to effect reasonable legislative and regulatory reform. The conversation surrounding financial regulation is an important one; it should not be held on the basis of exaggerated or erroneous premises. Rather, it should be held with an accurate understanding of the issues and a clear view of what exactly is at stake.

[21] Jonathan Weisman, The New York Times, *A Window Into Washington in an Effort to Undo a Dodd-Frank Rule*, (Dec. 15, 2014), http://dealbook.nytimes.com/2014/12/15/in-push-out-provision-example-of-how-congress-does-its-job/.

FINANCIAL INSTITUTIONS REGULATION GROUP

Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any of the members of our Financial Institutions Regulation Group.

If you would like copies of our other Client Alerts, please visit our website at www.milbank.com and choose "Client Alerts" under "News."

NEW YORK

One Chase Manhattan Plaza, New York, NY 10005

Wayne Aaron	waaron@milbank.com	+1-212-530-5284
Douglas Landy	dlandy@milbank.com	+1-212-530-5234
John Williams	jwilliams@milbank.com	+1-212-530-5537
Dorothy Heyl	dheyl@milbank.com	+1-212-530-5088
Julia Hueckel	jhueckel@milbank.com	+1-212-530-5539
James Kong	jkong@milbank.com	+1-212-530-5244