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SPECIAL REPORT

FORUM: Evaluating the Volcker Rule

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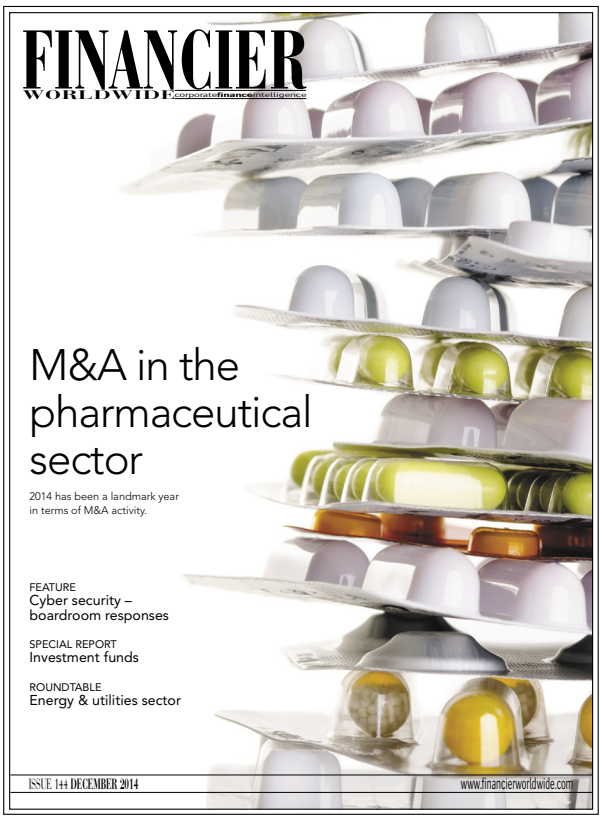

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FORUM

Evaluating the Volcker Rule

FW moderates a discussion on evaluating the Volcker Rule between Mark V. Nuccio, a partner at Ropes & Gray LLP, Rolf Lindsay, a partner at Walkers, and Ernie Patrikis, a partner at White & Case LLP.

THE PANELLISTS

Mark V. Nuccio is a partner at Ropes & Gray LLP. He can be contacted on +1 (617) 951 7368 or by email: mark.nuccio@ropesgray.com.

Mark Nuccio devotes his practice to advancing the business needs of companies. His broad business experience includes acquisitions and dispositions, public offerings and other financing transactions for issuers, underwriters and investors, organising new ventures, intellectual property licensing, and general representation of public and private companies. Mr Nuccio has extensive experience with public company disclosure and reporting, bank holding company regulation, and the organisation and early-stage financing ventures of new entities.

Rolf Lindsay is a partner at Walkers. He can be contacted on +1 (345) 914 6307 or by email: rolf.lindsay@walkersglobal.com.

Rolf Lindsay joined Walkers in 2005 and is a partner in the firm's Global Investment Funds Group. His practice focuses primarily on private equity funds and their activities, and encompasses the structuring of fund sponsor vehicles, the formation of alternative investment funds and the consummation of transactions undertaken by them.

Ernie Patrikis is a partner at White & Case LLP. He can be contacted on +1 (212) 819 7903 or by email: ernest.patrikis@whitecase.com.

Ernest (Ernie) T. Patrikis is a partner in the New York office in the firmwide Bank and Insurance Regulatory Practice. Mr Patrikis is one of the few lawyers in private practice who has extensive experience in both the banking and insurance industries, having served in senior positions for 30 years at the Federal Reserve Bank of New York and for eight years at AIG. Before joining White & Case, he led the regulatory practice at Pillsbury Winthrop Shaw Pittman LLP.

FW: In your opinion, how well do the provisions of the Volcker Rule align with their intended aims? Do you expect the practical effect to be positive?

Lindsay: The apparent purpose of the Volcker Rule was to exclude banks from engaging in high-risk speculative investment practices that expose these institutions to a level of risk beyond ordinary risk to which the day-to-day business of banking exposes them. However, like a lot of legislation adopted in the wake of the GFC, a broad statement of principle has given way to legislative detail that threatens the baby and the bathwater. There are two assumptions inherent in the rhetoric surrounding the adoption of the Volcker Rule. The first is that investing in alternatives is inherently risky, and the second is that the sponsorship of an investment fund necessarily places a bank in conflict with the interests of its banking clients. To dismiss proprietary trading as a matter of principle is concerning. The diversification of risk – hedging if you will – is essential to financial stability. The assumption that all investment funds are inherently high-risk, or even that risk can be assessed in general terms by considering the industry as an homogenous mass, is unfounded. Similarly, the assumption that sponsorship of a private equity fund conflicts with the interests of the bank's separate banking clients does not bear analysis. If the purpose of the Volcker Rule is to reduce high-risk speculative investments, then the regulators may have done better focusing instead on limiting the types of transactions in which banks are permitted to engage, whether directly or indirectly through proprietary investment in funds.

Nuccio: In the Volcker Rule, the President and Congress announced a broadly-worded policy, and left it to a group of regulators to flesh out the details. The final regulations will effectively wean banks

and their affiliates away from some areas of investment involving higher risk. But during the crisis the big money was lost in core banking areas, and bankers deprived of trading and private fund revenue source diversification will double down in other areas where they have demonstrated the ability to lose money in the past. I don't think the effect of the Volcker Rule will be positive – in the fullness of time I worry it might be called Murphy's Rule. In its paint by number approach, the Volcker Rule is contrary to contemporary risk management principles. An outright ban on certain financial activity is a bad idea and will have adverse unintended consequences as the industry looks for revenue sources to replace the ones it lost. The compliance expense will also be titanic, especially when compared to the negligible benefits produced by the law.

Patrikis: The Volcker Rule was not subject to the same extensive debate as were other provisions of the Dodd-Frank Act. It reflects a dislike of proprietary trading. It is not perfectly clear why sponsoring and investing in hedge and private equity funds was prohibited. Indeed, investing in funds was permitted by the Gramm Leach Bliley Act in 1998. The inclusion of a fund prohibition in the Volcker Rule may be grounded on the concern that funds could be used as vehicles for otherwise prohibited trading or that some funds or some of the companies invested in by some funds became too highly leveraged, thereby presenting too risky an investment for banks. Even the US financial authorities seem at a loss to identify a positive practical effect of the Volcker Rule implementation. The short-term effect at least is certainly expected to be a clear net negative. Liquidity provided to the markets by proprietary traders will become more constrained. The availability of fewer fund investors may tighten the availability of investment capital for mergers, acquisitions and alternative investments traditionally provided by private equity and hedge funds. Covered banking entities will have one less source of earning to offset the inherent risk in funding long-term lending through short-term deposits and borrowing. Many, as I, believe that a less draconian Volcker Rule that limited trading and fund activities would have been sufficient to address the potential risks of those activities without triggering the ripple effects of the Volcker Rule prohibitions. That being said, the best way to minimise any negative effect is to look for the opportunities that remain within the fund market as redefined by the Volcker Rule.

FW: How do you expect the restrictions on bank holding companies' investment activities to affect 'covered funds'?

Patrikis: The restrictions apply not only to bank holding companies and foreign banks with US branches that are treated as bank holding companies, but to all of their affiliates, globally. Banking entities are now working on ascertaining whether each existing interest in a covered fund may be retained, whether that interest could be modified so that it can be retained or whether the fund needs to be divested before the 15 July 2015 compliance date, and, if so, whether an extension of time should be sought from the Federal Reserve Board to divest the interest. Sponsors of funds with existing banking entity investors will have to decide how best to accommodate those investors without adversely affecting the interests of other investors and the fund. That may range from doing nothing (and causing the banking entity investor to exercise a right to withdraw due to the change of law or otherwise) to altering the fund's structure to accommodate offshore feeders or parallel funds, or a more limited number of investors. Similarly, for any new funds offered, fund sponsors will have to decide whether a goal will be to attract banking entity investors.

Nuccio: The effect is unlikely to be too significant when measured against what would have happened without it. Those in the US covered by the law were already reducing investment in the asset class, and Basel III is also discouraging those investments by attaching higher risk weights to them. Private investment funds will find other sources of capital from outside the banking system's balance sheet. Because of exceptions written into the law and regulations, non-US banks and their affiliates, investing in a manner that does not jeopardise the safety of the US financial system, will largely be unaffected by the Volcker Rule, a line that was appropriately drawn. There will be some re-engineering of the structures through which they participate.

FW: What considerations will covered funds need to make in relation to the restrictions on banking entity relationships

with covered funds?

Nuccio: Because of Super 23A, banking entities that sponsor covered funds will need to find lenders unaffiliated with their funds. Some funds use leverage and others simply have credit lines to smooth out cash flows. Either way, borrowing from an affiliate is on the 'can't do' list in the Volcker Rule's new world order. Another limitation in the sponsored fund realm is scope of employee investments. Compliance with the asset management exception means that only employees who provide services to the fund can invest, and if they borrow from their employer to fund the investment, the investment counts against the 3 percent ownership position to which the bank is limited.

Patrikis: The so-called Super 23A provision of the Volcker Rule prohibits any transactions between a banking entity and the covered funds it organises and offers, manages or advises. This provision is the super-charged version of a long existing regulation that limits extensions of credit and other covered transactions by a bank to its nonbank affiliates. The Federal Reserve Board has long been concerned about banks bailing out funds sponsored by affiliates. All banking entities will need to establish systems to catch and prevent potential covered transactions with covered funds that are mindful in particular of the broad scope of transactions, besides loans, that would fall within the Super 23A prohibition.

FW: How will the rules and exemptions affect covered funds outside the United States?

Lindsay: For funds formed offshore, it is essentially a structuring and due diligence point. Parallel investment structures that are closely monitored to ensure that restrictions on investor numbers, investor sophistication and the like are not breached, are becoming commonplace. Because of their parallel nature, the formation and management of these entities does not add significantly to the burden of sponsors looking to attract investment capital from investors affected by the rules.

Patrikis: The most shocking aspect of the Volcker Rule is its global application. It seems that the legislators wanted a somewhat level playing field between US banks and non-US banks. Most playing fields are tilted for drainage. The Volcker Rule provides some exceptions for the non-US fund investments of non-US banking entities that are not available to US banking entities. Notably, a non-US banking entity may continue to invest in UCITs and other funds registered outside of the United States and in private funds offered solely outside of the United States that do not target US resident investors. These exceptions give non-US banking entities some latitude in continuing non-US fund investments. Nonetheless, a non-US sponsor desiring to sell an interest in a new unregistered fund to a non-US banking entity subject to the Volcker Rule will need to be in a position to provide some comfort that the fund's structure respects the SOTUS exemption limitations.

Nuccio: If those funds desire to attract investment from non-US banking entities, then they will need to segregate US investors from non-US investors in parallel funds in order to provide the non-US banking entities with a path though the Volcker Rule – either under the SOTUS exception or the non-US, non-covered fund jurisdictional exclusion. A number of firms signed on to an interpretation about the permissibility of parallel fund structures to settle down client concerns, but there remains considerable uncertainty about the structures that will and will not be permissible where some additional official guidance would be useful. In time, custom and practice will take root and provide comfort, but as the full compliance date of 21 July 2015 approaches, there is still confusion out there about what will be acceptable to regulators. Herding all non-US investors, whether or not they are Volcker-challenged, into the same fund will help meet the objective of keeping the ownership of Volcker-challenged investors to less than 25 percent of the fund will avoid control.

FW: Could you outline the general reaction of the alternative asset class to the Volcker Rule?

Patrikis: The understandable initial reaction of global fund managers and banking entities alike has been: What have I done to deserve this? The extraterritorial scope of the Volcker Rule is astounding. It effects the business model of a non-US fund that is offered by a non-US sponsor and managed by a non-US fund manager and limits that fund's ability to market to and attract banking entity investors. But it is the law. Efforts to change or modify it may or may not take hold depending on the configuration and priorities of new Congress in 2015. Banking entities have turned their focus to coming into full compliance by 21 July 2015. Concerns over proving their full compliance to financial authorities and the *de minimis* investment constraints of the Volcker Rule may limit their appetite for sponsoring any new funds, even to the extent permissible under the Volcker Rule. Fund managers and sponsors would do well to focus on how they could benefit from this lessening of competition.

Nuccio: The general reaction is: "What did we do to deserve this?" Alternative asset class fund managers are bewildered that they were black-hatted by the Volcker Rule when there was very little evidence that they had any material responsibility for the financial crisis. There were never legislative hearings to gather evidence of the need for this 'Back to the Future' legal nugget. In my view, the Volcker Rule began as a legislative scare tactic designed to get the banking industry to back off from fighting other reforms, but found a life of its own when stories of bankers behaving badly, one after another, grabbed headlines as Dodd-Frank wound its way through the process on Capitol Hill. When the finger-wagging was over, it was law. If there were excesses in the pursuit of profit from proprietary trading and private fund sponsorship and investment, there were other ways to address them, like the ring-fencing approach under consideration in the EU. By itself, Basel III is a large enough bulwark against excessive risk taking.

Lindsay: Setting aside philosophical objections to the rule itself, and the assumptions upon which it is based, at a practical level the application tends to engender one of two responses from asset management teams within affected banks. People comfortable within the institutional umbrella of a multinational organisation are concerned about having to migrate to businesses where they are responsible for a broader range of operational issues and don't have the benefit of support. The more entrepreneurial personnel are excited to get their hands on the wheel, to restructure and build new businesses. For investors in this industry, individuals and their track records are just as important as the institutional name on the letterhead. And often they are more important. We have seen some significant players jumping ship to start their own funds – sometimes under the wing of a large non-banking fund and other times on a standalone basis with seed investment or personal capital. We have seen managers with specific expertise in particular join existing non-banking in- ▸▸

stitutional funds, operating smaller funds focused on industries or regions under the umbrella of the sponsor. That is a trend that sits particularly well alongside a broader industry trend toward niche funds.

FW: To what extent will fund managers need to assess the nature of their investors with a view toward assisting compliance efforts? How might this play out in practical terms?

Nuccio: Managers need to understand the needs on non-US banking entity investors to be balkanised away from US investors, and to have the fund documentation support the need to demonstrate compliance. While managers are not in a position to provide assurances about regulatory compliance by an investor, they can appreciate the newness of the law and the need for the investor for some flexibility, like an easier exit, in case the worm turns in an unexpected way. Investors need to appreciate that managers may be sympathetic to investor limitations, but managers will only be able to go so far because they have responsibilities to the other investors. Compliance with new laws always seems to follow a pattern that begins with a high, almost obsessive focus. With time, the newness wears off and there will be greater comfort about the do's and don'ts. Dealing with legacy fund compliance is a whole other issue.

Lindsay: We are already in a world of significant due diligence, both on the side of investors investigating funds and fund sponsors understanding the identity of their investors. Fund sponsors now know their investors better than ever before. I do not believe that the Volcker Rule requires significant additional effort in that sense. Internal trading, compliance, accountability and audit policies are nothing new to fund sponsors whose compliance departments continue to grow. What the additional layer of regulation does do is increase barriers to entry for new funds. It is already extremely costly to set up and manage a private equity fund. During the initial few years, these costs are not offset by investment return income; neither does pressure on management fees assist. That is exacerbated when, as here, the effect of regulation is to restrict access to certain types of capital. If we accept the premise that investment is inherently beneficial to relevant economies, and that diversification is an effective risk-mitigation strategy, then the concentration of the industry and the consolidation of service providers seems counterintuitive.

Patrikis: This is already an ongoing process for banking entities, and should be too for fund managers. Non-US sponsors, in particular, should be putting in place changes to their fund investment structures to accommodate continued investment by banking entities subject to the Volcker Rule. We would expect to see more non-US sponsors and managers develop structures that not only permit non-US banking entity investors to retain their existing fund interests but also to invest in that sponsor's new funds in the future.

FW: What is your advice to fund managers on preparing for life in the wake of the Volcker Rule?

Lindsay: It is critical for non-US fund sponsors to understand how to identify and categorise their funds and their investors for purposes of US law, and to understand the impact of permitting certain investors into their funds, and the concerns inherent in undertaking certain investment strategies.

Patrikis: Focus on how you can make a silk purse out of a sow's ear. Fund sponsors need to have a working knowledge not only of the Volcker Rule prohibitions but most importantly of their scope, the structures that are or are not covered, and the exceptions. Those confines are not all encompassing. The ability to structure vehicles that are appealing – and permissible – investments for banking entities still exists.

Nuccio: Develop some understanding about the law and regulation and work with advisers who have a sophisticated understanding of it. For bank-owned fund managers, there is much to do. They are hip deep into it already at this stage. For non-bank fund managers, listen to your clients that are non-US banking entity investors and see how they want to structure investments. Developing a one size fits all solution makes sense, but it needs to account for the sensibilities of those affected and they may not agree with one another on how that is best accomplished. The bottom line is whether it is worth accommodating a special needs investor, which, as it always does, boils down to a commercial decision. ■