Capital Markets Symposium

2014

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Herrick's 8th Annual Capital Markets Symposium

Banks: The Years of Living Dangerously

September 17, 2014

Speakers

Keynote:	Thomas O'Neill, *Founding Member*, Kimberlite Group and *Co-Chief Executive Officer*, Kimberlite Advisors, LLC
Panelist:	Tony Wilkens, *Senior Vice President*, J.P. Morgan Chase
Panelist:	Christopher K. Wu, *Partner*, Carl Marks Advisors
Moderator:	Richard M. Morris, *Partner*, Herrick, Feinstein LLP
Moderator:	Patrick D. Sweeney, *Partner*, Herrick, Feinstein LLP

Stepped-Up Capital Requirements

Dodd-Frank capital mandate
Basel III: Leverage ratio framework and disclosure requirements
Prospective impact on the banking industry

Consequences of Securities Market Reforms

The Volcker Rules are adopted
Anti-money laundering programs and other significant compliance requirements
Prospective impact of bank departures from the marketplace

Thomas O’Neill

Founding Member, Kimberlite Group and *Co-Chief Executive Officer*, Kimberlite Advisors, LLC

Tom O’Neill is Founding Member of the Kimberlite Group and is Co-CEO of Kimberlite Advisors, a registered broker-dealer that provides advisory and institutional capital raising services. Prior to forming Kimberlite in 2013 Mr. O’Neill served as a Principal of Ranieri Partners. He joined Ranieri Partners in 2010 as the Chairman of Ranieri Partners Financial Services Group, a company formed to acquire and manage financial services companies, including money management and investment management firms. Mr. O’Neill also worked with Ranieri Partners’ investment funds and operating companies. In 2010, Mr. O’Neill retired from Sandler O’Neill & Partners, an investment banking firm he co-founded in 1988 that advises banks, thrifts and other domestic and international financial services firms on a broad range of strategic and transactional matters, including mergers and acquisitions and other strategic transactions, capital formation and financings, asset-liability management and asset purchases and dispositions. Prior to co-founding Sandler O’Neill, Mr. O’Neill was a Managing Director at Bear Stearns and was the Co-Manager of Bear Stearns’ Financial Services Group. Mr. O’Neill began his career at L.F. Rothschild & Co. in 1972, where he served as the Managing Director of the Bank Service Group. Mr. O’Neill currently serves on the Board of Directors of the NASDAQ, the Archer Daniels Midland Company and Misonix, Inc. He is a member of Finance Committee for the NASDAQ and is the former Chairman of the Audit committee and currently a member of the Compensation and Succession Committee for the Archer Daniels Midland Company. Mr. O’Neill has been a director of the Bank Financial since the Company’s 2012 Annual Meeting of Stockholders and has been a member of the Corporate Governance and Nominating Committee and the Human Resources Committee of the Company.

Tony Wilkens

Senior Vice President, J.P. Morgan Chase

Tony Wilkens is a Senior Vice President with the Metro Market, Northeast Middle Market segment of Chase's Commercial Bank. In addition to serving a diversified base of media, financial services and logistic clients, he currently is the National Captain of the Commercial Bank Architecture & Engineering Industry Specialization Group and formerly served as Captain of the Northeast Middle Market Transportation Team. Given his large corporate background, Tony is often called upon to assist deal teams with the structuring of complex capital markets transactions across several industries.

Tony has worked as a relationship manager in the Commercial Bank for his entire 21 year career with JPMorgan Chase; prior to re-joining the Middle Market in 2008, Tony worked in the Corporate Client Banking Group (formerly Mid-Corporate Group) for 14 years where he managed the Commercial Bank's Sports Portfolio Group. Clients of this group included the National Basketball Association, the National Football League, and Major League Baseball.

Prior to joining JPMorgan Chase, Tony was an analyst/account officer at Barclays Bank of New York and a loan officer at Guardian Bank on Long Island. He received a BA in Finance at Hofstra University and an MBA in Finance and International Business from Adelphi University. Tony is Series 79 and Series 63 licensed and lives on Long Island with his wife and two teenage children.

Christopher K. Wu

Partner, Carl Marks Advisors

Christopher Wu is a recognized leader in the mergers and acquisitions, financing and restructuring community, bringing passion, creativity, deep expertise, and smart, innovative solutions to our clients. He has more than 18 years of experience successfully closing over 80 transactions. Mr. Wu works with company owners and management teams, Boards of Directors, private equity groups, lenders, investors, trustees, and official and ad hoc creditors committees.

His experience spans a wide range of industries, with a focus on energy, community banking, real estate, healthcare, consumer products, and financial and business services. He co-leads the firm's energy practice, with a particular focus on renewable energy and biofuels. Mr. Wu's recent notable engagements include representing companies such as DirectBuy, Northern Berkshire Health, Green Field Energy, Metro Fuel Oil, Monitor Consulting, Holley Performance and American Bancorp, as well as significant creditor groups in matters involving General Growth Properties, Innkeepers USA Trust, VeraSun Energy, Rogers Bancshares, PJ Finance, and SunTimes Media Group.

The Global M&A Network, citing his outstanding performance on multiple transactions, recognized Mr. Wu in 2013 and 2014 as Restructuring Banker of the Year. He is consistently ranked as a Top 5 Bankruptcy Investment Banker by The Deal Pipeline and regularly speaks to professional organizations, including the American Bankruptcy Institute, Turnaround Management Association, Urban Land Institute, and Institutional Investor. Mr. Wu also serves as an expert witness on investment banking and valuation topics. He has been recognized by bankruptcy courts nationwide and has testified in numerous contested matters.

Prior to joining Carl Marks Advisors over a decade ago, Mr. Wu worked in J.P. Morgan's Global M&A Group in New York and London as Vice President. He previously served as Special Assistant to the Trade Policy Bureau of Japan's Ministry of International Trade, and as an Assistant Manager in Itochu International's Machinery Group in New York, managing its ceramic refractory and industrial machinery businesses.

Mr. Wu earned a BA in English Language and Literature from the University of Chicago and an MBA in Finance from the Stern School of Business at New York University. He is registered with FINRA as a General Securities Representative. He is also active in the community, serving as Vice Chairman of the Board of Trustees for the Institute for Career Development (ICD), a nonprofit workforce development agency focused on vocational rehabilitation.

Richard M. Morris

Partner, Herrick, Feinstein LLP

Richard M. Morris works closely with the executive management of middle market companies and funds to enhance and implement acquisition, financing, operation and exit strategies and to solve a broad range of commercial and regulatory issues. Financial institutions, investment funds, and investment management professionals have the benefit of Richard's more than 25 years of transactional experience in the following areas:

- Corporate finance, including real estate funds, bank and alternative source financings, venture capital and private equity investments, security offerings, leveraged recapitalizations, workouts and restructurings;
- Corporate regulatory matters, including bank regulatory and compliance matters and bank holding company issues;
- Institutional investment, including formation and acquisition of funds, investments in real estate-related assets, and traditional and alternative source financings and investments;
- Mergers and acquisitions, including strategic alliances, both domestic and cross-border;
- Hedge fund investment, including individual investments and acquisitions of other funds;
- Corporate governance, including company management and regulatory matters, such as securities, banking and investment management and adviser regulations; and
- Executive employment and benefits, including employment and separation agreements.

Richard applies his "Wall Street" certified public accountant and operations experience to our clients' problems, providing practical solutions that improve operations and risk management. He speaks on a variety of subjects, including fiduciary duties of board members and investment professionals, improving company risk management environments and commercial workout and exit strategies. He is a prolific author and is regularly quoted on a variety of investment related topics in notable publications such as *Pension & Investments* and *Law360*. Richard works closely with the New York State Society of CPAs Committee on Anti-Money Laundering and Counter Terrorist Financing, focusing on the Bank Secrecy Act and related issues.

Prior to becoming a lawyer, Richard was a regulatory auditor with the Commodities Exchange in New York and focused on operations and financial management at Kidder Peabody. He also was the U.S. Audit Manager for the financial division of a diversified Australian company.

Patrick D. Sweeney

Partner, Herrick, Feinstein LLP

Patrick D. Sweeney is the chair of Herrick's Investment Management Practice Group. He represents investment managers, investment funds and investment fund fiduciaries in a wide range of corporate, regulatory and transactional matters. Pat also represents major institutional investors in corporate debt restructuring and non-U.S. investors in inbound investments.

Prior to joining Herrick, Pat practiced investment management law in-house for more than 10 years, first as senior investment counsel for Merrill Lynch Asset Management and then as General Counsel to Nomura Corporate Research and Asset Management. He began practicing law in the 1980s in association with Shearman & Sterling where he represented financial institutions in corporate, securities and finance transactions.

Pat is an active member of the New York City Bar Investment Management Committee and the Investment Company and Investment Adviser Subcommittee of the American Bar Association's Business Law Section. In addition, he has participated for many years in committees, conferences and panel presentations of the Investment Company Institute, the Loan Syndications and Trading Association, the Mutual Fund Directors Forum and many other investment management industry organizations.

The FDIC's New Capital Rules and Their Expected Impact on Community Banks

By Richard M. Morris and Monica Reyes Grajales

The Federal Deposit Insurance Corporation (the "FDIC") recently issued its final rules implementing the U.S. version of the international bank capital standards adopted by the Basel III Accords[1] and the bank capital requirements under the Dodd-Frank Act,[2] specifically the Collins Amendment.[3] The Dodd-Frank Act requires federal bank regulators to enhance the minimum risk-based capital requirements and other capital adequacy requirements to "… address the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity." The FDIC's actions will have a significant impact on the U.S. banking industry and a larger impact on community and small banking institutions. These banks may be required to raise additional capital in challenging market conditions and find a more difficult environment for mergers and acquisitions. On the other hand, the new capital rules may provide well capitalized community and small banking institutions with a unique opportunity to consolidate or roll-up other banks.

The FDIC's action was joined by the other U.S. bank regulators as part of a coordinated international effort that has, as the FDIC noted in its final rule, "one of the key objectives of the capital framework, … to mitigate interconnectedness and systemic vulnerabilities within the financial system" primarily through liquidity and capital reforms.

A Historical Perspective

To understand the perspective of the Basel III Accords and the corresponding U.S. regulations requiring an increase in the amount and quality of required minimum capital, it is helpful to first understand the special relationship of the FDIC with commercial banks that accept insured deposits and the history and mission of the FDIC. The relationship of the FDIC and its sister federal and state regulators with banks is unique and similar in large part to a parental relationship. In 1819, the U.S. Supreme Court decided the case of M'Culloch v. Maryland. Justice John Marshall's opinion for the Court equated banks with agents of the government. If a bank is an agent of the government, then for almost 200 years it is the government that has been the parent or principal. Banks are private enterprises. However, a bank's right to effectively borrow money (take in deposits) that are insured by (effectively) the federal government (FDIC) and their access to the Federal Bank window to borrow additional funds has certain consequences (a *quid pro quo*). Banks must operate their franchise subject to complex and unyielding regulatory oversight and control of federal and state regulators. Consistent with this viewpoint, the federal and state banking laws accord the FDIC and other bank regulators a great degree of deference in their ability to prescribe regulations and rules for every aspect of a bank's management, operations, capital structure and business, especially when it comes to "safety and soundness" concerns. This position is expressly stated in the Federal Deposit Insurance Act, which permits the FDIC to establish the required minimum capital for banks. More simply put, if bank regulators want more capital in banks, then banks are required to get the additional capital.

The FDIC was established during the administration of President Franklin D. Roosevelt pursuant to the Banking Act of 1933. One may view the FDIC as the final bastion that was built to prevent the repeat of a horrible financial history. The FDIC was organized during the Great Depression. This was a time with "bank runs" that resulted from a massive liquidity crisis that caused localized bank failures, initially by smaller rural banks. The bank failures quickly spread to more established and (then thought) better capitalized banks that were thought to be "too good to fail." The bank failures in the 1930s and the resulting financial contagion were not stymied until President Roosevelt declared a "national bank holiday" that was orchestrated by President Roosevelt and the Emergency Banking Act of 1933. The environment during the 1930s has some parallels to our more recent "Great Recession."

It is important to remember that the FDIC's fundamental obligation is to maintain a functioning banking system so that consumers have a safe and sound place for their "nest egg" and may conduct the essential retail commerce of our modern society. Directly put, a bank is the one financial institution that provides depositors with a truly risk-free investment option. You put money in, and you get to take it all

out at any time, with a little interest. The FDIC's "official" mission is to, as "an independent agency created by the Congress to maintain stability and public confidence in the nation's financial system by: insuring deposits, examining and supervising financial institutions for safety and soundness and consumer protection, and managing receiverships."

One only needs to look at the photos of the bank runs during the Great Depression and the financial misery that spread from a lack of confidence in the banking system to understand why the FDIC must take appropriate, and, if necessary, tough, action, even if it will likely mean a difficult time for small and community banks and, likely, a further consolidation of the banking industry. The mandate to build a system of well-capitalized commercial banks that do not fail or fall like dominos is the FDIC's absolute priority. There is evidence that our bank regulatory regime has succeeded in this mission. In stark contrast to the pre-FDIC period, there is currently no consumer and financial panic or bank runs associated with the contemporary bank foreclosures. From October 2000 to July 25, 2014, the FDIC has supervised 530 bank failures that had an aggregate of more than $1.87 trillion in deposits and which represented an aggregate of more than $86 billion in estimated losses (measured as of 12/31/13). These failed banks include two community banks located in Manhattan. Even the July 2011 failure of the larger IndyMac Bank (Pasadena, California) did not cause panic as the FDIC took control of this bank, and made sure that the retail depositors had the full benefit of the insurance and that this depository institution was liquidated in a relatively orderly process.

The right to increase capital and require a better quality of regulatory capital is easily rationalized given the relationship of the regulators with banks and the absolute need of the regulators to defend the banking system from systemic risk. The fundamental objectives of the new capital rules are simple: more capital is better and more capital reduces the risk that (i) banks will fail, (ii) the FDIC insurance fund will be used and (iii) retail commerce and the global economy will be disrupted.

Overview of the New Capital Rules

The FDIC has stated that its rules will:

- promote the safety and soundness of the banking industry;
- improve the quality and the quantity of the regulatory capital of banks by, among other provisions, revising the definition of regulatory capital, requiring compliance with a new common equity-only capital ratio, increasing the Tier 1 capital requirements and, for certain institutions, requiring certain supplementary leverage ratios;
- limit capital distributions and certain discretionary bonus payments if a bank does not hold a specified amount of common equity Tier 1 capital in addition to the amount necessary to meet its minimum risk-based capital requirements;
- introduce a higher risk weight for certain past due exposures and acquisition, development, and construction real estate loans;
- provide a more risk-sensitive approach to exposures to non-U.S. sovereigns and non-U.S. public sector entities;
- replace references to credit ratings with new measures of creditworthiness;
- provide more comprehensive recognition of collateral and guarantees; and
- provide a more favorable capital treatment for transactions cleared through qualifying central counterparties.

A full discussion of the capital requirements and measurement of capital ratios, including the risk weighting of assets and deductions and related formulas, would resemble an advanced course in calculus and is not attempted in this article. In general, the FDIC's rules look at the total capital of a banking institution. The capital of a banking institution is divided into (i) Tier 1 capital, which in turn is divided into Common Equity Tier 1 and Additional Tier 1, and (ii)Tier 2 capital.

Tier 1 capital is, generally, the accumulated retained earnings of the bank and the amount of the capital paid to the bank for capital stock and other permitted securities. Common equity capital is the purest form of capital and consists primarily of cash paid in for non-callable or redeemable common stock and additional paid-in-capital and retained earnings, subject to certain FDIC adjustments or deductions. Other permitted securities are defined in the regulations as the Additional Tier 1 capital elements and include fully paid in securities that:

are:

- deeply subordinated;

- treated as capital under generally accepted accounting principles;
- subject to suspension of dividends and other payments without penalty or adverse effect at the FDIC's discretion;

and are not:

- guaranteed by a bank or a bank affiliate, or otherwise credit enhanced;
- subject to any maturity or redemption right or contain an incentive for the bank to redeem the security such as an increasing dividend rate;
- subject to any call right, except to the extent approved by the FDIC, and other specified conditions, including a minimum term of five years;
- subject to redemption or repurchase without the prior approval of the FDIC;
- subject to liquidating dividends or distributions;
- subject to any credit-sensitive feature or other events that require payment; or
- subject to any features, such as anti-dilution provisions, that would limit or discourage additional issuance of capital by the issuer.

Tier 2 capital, in large part, includes the same components as the Additional Tier 1 capital elements described above.

Each of Tier 1 capital and Tier 2 capital are subject to adjustments that are required by the regulations. One of the significant modifications or limits to Tier 1 capital is the limitation on Trust Preferred Securities which are no longer included in Tier 1 capital unless they were issued prior to May 19, 2010 and therefore "grandfathered." The amount of trust preferred securities that may grandfathered and included in Tier 1 is limited to 25% of Tier 1 capital (after specified exclusions and regulatory deductions and adjustments). Trust Preferred Securities are a type of security often used by community banks to increase capital. Generally, the investor received a specified fixed return in the form of a distribution and the bank received capital and a tax deduction for the payment of dividend or distribution to the investors. Accordingly, the security had many of the benefits of a subordinated debt instrument. As this security will often be on a bank's balance sheet, investors and acquirers of community banks need to appreciate the loss or limitations of this regulatory capital.

The new FDIC rules require banking institutions to maintain, among other things, the following minimum capital ratios:

- Tier 1 leverage capital to all assets ratio of 4%;
- common equity Tier 1 capital to risk-weighted assets ratio of 4.5%;
- Tier 1 capital to risk-weighted assets ratio of 6%; and
- total capital to risk-weighted assets ratio of 8%.

The capital ratios are generally calculated by taking the specified amount of the regulatory capital and dividing the value or amount of the assets as adjusted by the risk weight. In this way, the regulators have a method to measure the perceived risk to the bank, both in quality of an asset and the liquidity of an asset.

There are numerous categories of assets and related risk weightings. The risk weighting is based on the regulators' determination of the risk, which is primarily based on the regulatory perceived market, value and/or liquidity risk of the specified asset. This risk weighting process has the advantage of making the capital calculation less complex but resembles a "one size fits all" approach that does not appreciate market changes, transaction structures or other factors that could change the asset's risk profile. For example, one of the provisions of the new capital rules changes the risk weight for unsecured exposures that are past due for 90days or more and that are not sovereign risk exposures. This particular change, and other changes to, and existing provisions of the risk weighting regime, provide certain trip wires that, if activated, would adversely affect a bank's regulatory capital. There may be numerous facts and circumstances that result in a 90-day past-due exposure to pose less risk to a bank than its exposure to a current asset that is about to realize a material adverse financial result. For example, compare: (i) a borrower that is late due to a day's delay in collecting a receivable, or selling an asset and using the net proceeds to pay the loan to the bank (ii) a borrower that made a payment but has aggregate current liabilities in excess of its aggregate current assets or significant, aged or slow-moving inventory that will not be converted to cash. The first credit will be paid but will have a larger risk weight. The second credit satisfies the formula to have a normal risk weight, but clearly presents more credit risk to the bank than the first credit.

Effect of the FDIC's Capital Rules on Community Banks and Small Banking Institutions

While certain commentators and articles criticize the FDIC risk-weighting regime because it is not dynamic and sensitive to current market conditions and risk, one can understand the regulator's position that a standardized formula will yield greater security, safety and soundness than a dynamic approach that could more accurately measure risk, but could prove inaccurate and in any event would be subject to certain judgments. For example, one needs only to look at the recent inaccuracy and degree of judgment that was used in underappreciating the market risk of syndicated residential home mortgage investments. The current risk-weighting regime also provides more certainty to the bank executive managing the bank's portfolio. A dynamic risk-weighting approach could result in a vicious cycle that causes a rush to liquidate assets when market conditions turn adverse, which in turn would decrease values and increase the risk, which in turn would create incentives to liquidate more of the same class of assets, and so on.

Prudent bank executives are required to assess and manage a bank's portfolio within the structure of the risk weighting and capital regimes. The current risk-weighting regime provides greater certainty for such management because each class of assets or investments is treated in a consistent and clear manner. Bank executives must assess their banks' capital position, determine appropriate investments that maintain additional capital as a buffer in case of asset value deterioration or any of the factors under the risk-weighting regime that cause a reduction in the bank's capital ratio. The consistent and clear risk-weighting regime incentivizes a small bank to make investments that limit its business to less risk-weighted assets. The consequence, and the conundrum, for bank executives is that less risk in their portfolio will likely lead to less profits but a more stable bank. However, lower profits will mean a lower ability to provide dividends and would make the less risky bank less valuable. This could cause the bank to be passed over by investors in favor of investments that are perceived to be more profitable. One analogy to this management process is driving a car on a busy highway. The bank executive is required to keep the car in a lane as other cars (risks) come into the lane, sometimes without signaling their lane shift or as a result of erratic driving (business operations). The amount of risk of an accident is reduced by the driver reducing the speed (risky assets) of the vehicle (bank). The balance to be struck is to go fast enough to move the vehicle down the road and be profitable so other vehicles do not pass the bank (which is a requirement for investors seeking a return), but not go so fast as to make it difficult or impracticable to react to erratic drivers (specific asset risks) and inclement weather (general economic risk) and, consequently, get into an accident (fall below its regulatory capital).

The FDIC noted in its release for the final rule that "[a]s a result of the new requirements, some small FDIC-supervised institutions may have to alter their capital structure (including by raising new capital or increasing retention of earnings) in order to achieve compliance." At first glance, this appears to be a significant understatement. The FDIC's position was initially announced in the proposed rules and received many comments, including that the additional capital requirements and compliance burdens applicable to small and community banks would be a difficult burden that would cause many banks to change their asset allocations or investment policies that would have an adverse effect on the U.S. economy, particularly in rural areas. The FDIC did not change its position and the proposed rules were adopted in substantially the same form in the final rules. The comments advocating a change to the proposed rules noted that the new capital rules would:

- "severely" limit the ability of a community bank or small bank to grow;
- reduce returns to shareholders that would reduce investor demand for the equity of banking organizations;
- significantly increase compliance costs;
- diminish a bank's access to the capital markets beause of reduced profit and from dividend restrictions associated with the capital buffers;
- "encourage," if not require, the consolidation of community banks through mergers and acquisitions specifically in rural markets, because such banking organizations would need to spread compliance costs among a larger customer base; and
- confuse market observers of community banks in part because the regulatory capital framework does not allow investors and the market to clearly ascertain regulatory capital from measures of equity derived from a banking organization's balance sheet.

The FDIC's position was similarly not changed by comments that argued that the objectives of the proposal could be achieved through regulatory mechanisms other than the proposed risk-based capital requirements, including enhanced safety and soundness examinations, more stringent underwriting standards, and alternative measures of capital or that the FDIC recognize community banking organizations' limited access to the capital markets and related difficulties raising capital to comply with the new rules.

Some comments to the FDIC argued that the proposed rules also included that the rules would materially and adversely affect the banking industry and the U.S. economy. The simple fact is that if a bank has to hold more capital in less risk-weighted assets (e.g., cash and treasuries), then the bank has less money to deploy to loans to businesses and generate the liquidity for commerce and growth. Comments included that the FDIC capital rules would inevitably lead to:

- restricted job growth and employment;
- reduced lending or increase the cost of lending, including to small businesses and low-income or minority communities;
- limited availability of certain types of financial products; and
- impair the recovery of the U.S. economy because banks would not lend capital but be required to maintain capital to satisfy unnecessary static capital level requirements.

The U.S. bank regulators and the Basel III Accord constituents were not persuaded by these comments and moved forward with the revised capital rules to increase the safety and soundness of the banking industry through increased bank capital levels. It may be that the rules echo a theme to the new vision of bank regulation – that there should be bigger and fewer banks in the industry. Certainly, under the new capital rules, community banks face many challenges.

Community banks will require additional capital to maintain their operations. Even if banks have sufficient capital to satisfy the increased regulatory minimums, additional capital, in particular the newly created Common Equity Capital, will be required to continue the lending to risk weighted assets. The discussion of capital has several parts. The bank must maintain:

- an increased level of regulatory minimum capital;
- a new and further restricted minimum capital ratio that is comprised primarily of the amount paid into capital for common stock in cash and retained earnings;
- a new capital conservation buffer and countercyclical capital buffer amounts;
- additional capital to address, and be an additional buffer for, operating losses resulting from loans, operations or other matters, each of which will reduce retained earnings and therefore reduce all capital amounts and ratios; and
- additional capital to fund improvements and capital expenditures including those to enhance compliance, operational, and financial controls.

The FDIC noted that (i) 74 small FDIC-supervised institutions, or 3% of such supervised banks, with total assets of $500 million or less on the date of the final rule, do not hold sufficient capital to satisfy the requirements of the final rule; and (ii) that these banks must raise an aggregate of $233 million in regulatory capital to meet their increased minimum capital requirements. It should be noted that this data from the FDIC is for banks to meet their minimum capital. As noted earlier, a prudent bank executive would need significantly more capital than the regulatory minimum and would need to manage and allocate the bank's assets/investments to significantly less risky assets (drive their vehicle at such a slower speed). Consequently, these banks, that may be sound and have an excellent portfolio of loans and assets, will be required to exit profitable lines of businesses and face reduced profitability. These banks would find that they are the vehicle that gets passed by as if they were out of gas. It is possible, if not likely, that such vehicles would find it preferable to sell their loan portfolio and deposit base and climb aboard someone else's bigger and more stable vehicle. The FDIC did not attempt to note the difficulty of a community bank that is undercapitalized raising additional equity capital in the current market conditions other than to note that the cost of the capital for equity (as required for the new common equity Tier 1 capital and for total capital requirements) would be somewhat more costly than tier 2 capital, which includes subordinated debt, due to the fact that the subordinated debt would gener-

ate interest deductions. Similarly, the FDIC did not note the dilution that existing investors in such community banks would be required to suffer given their difficult capital position. Such investors (and the bank management) should speak earnestly with seasoned investment bankers to better position the bank and illustrate the bank's earnings potential and value on a *pro forma* basis. Such conversations and capital plan should be developed quickly. Failure to act quickly could result in making it impossible to act at all. The implementation of the new capital rules will cause sound banks that do not raise additional capital to re-allocate their portfolio to less risk weighted assets. The longer the period that a bank maintains its asset base in lower risk (and generally less profitable) assets, the longer the period that the bank will present decreased income performance, which will make the investment case for the bank to be less compelling.

Community and small banks are also challenged by the changes to the risk weightings and operations. In addition to maintaining the capital, a bank will need to address the other part of the algebraic equation – the denominator or their assets (loans and investments). In the FDIC release with respect to the final rules, the FDIC noted that it "… expects that some [banks] may change internal capital allocation policies and practices to accommodate the requirements of the final rule." For example, bank executives may need to make loans and other investments with less risk (a lower risk weight). We may already be seeing the effect of this decision process. The final capital rules codify the FDIC's regulatory capital rules, which have previously resided in various appendices to their respective regulations, into a harmonized integrated regulatory framework. Accordingly, bank executives have had time to develop and implement asset management, investment and allocation strategies to work within the new regime and have already been implementing their revised allocation strategies. This may be one of the reasons that banks have been reducing their commercial real estate and commercial and industrial loans.

Certain of the changes to the capital rules and risk-weighting regime will have a greater impact on community banks.

Increased Capital Requirements

The required minimum capital for banks has increased. One significant change in the regulatory capital requirements is that banks must now have part of their Tier 1 capital as common equity Tier 1 capital, as briefly discussed above. The fact that a minimum of 4.5% of the risk weighted assets of a bank must be the purest form of capital (generally common stock and retained earnings) is expected to significantly impact and limit small and community bank activities. The new common equity Tier 1 capital is the lowest level in the capital stack, making it more expensive to acquire. This requirement will likely:

- require banks to raise additional common stock which, under current market conditions, may result in substantial dilution to the current common stockholders;
- make an acquisition of a bank less attractive, and therefore lower the value of a bank, as the investors or acquirer will be required to use a more expensive type of investment capital that does not permit leverage; and
- increase the due diligence risk in an investment or acquisition because this additional type of capital is another hurdle for banks to conduct operations in full compliance.

Capital Buffer

A new development instituted by the capital rules is that banks are now required to maintain additional capital as a so-called "buffer." This buffer is effectively an additional minimum capital requirement because a bank will be unable to make any distributions or pay certain bonus compensation if its capital buffer is not maintained.

Risk Weighting of Assets

As noted above, the regulatory regime sets forth a formula, the numerator is the amount of a specified capital and the denominator is, generally, the amount of risk weighted assets. Assets of a bank are assigned a risk weight in the regulations, which is expressed as a percentage. The regulatory capital calculus is that assets with more risk are assigned a greater risk weight, which increases the amount of risk weighted assets, which (because this is the denominator) increases the denominator and results in a lower regulatory capital ratio. Accordingly, banks that are near their minimum capital ratios will be required to either (1) get additional capital, as noted above, or (2) man-

age their assets by selling higher risk-weighted assets and shifting the proceeds to lower risk weighted assets or making loans and other investments (acquiring assets) that have a lower risk weight.

Some of the risk-weighting provisions that may disproportionately affect small and community banks include the following:

High Volatility Commercial Real Estate (HVCRE) Exposures

Small and community banks traditionally have a portfolio of real estate loans, although this portfolio allocation has been modified over recent years as regulators have reacted (or overacted) to the real estate investment recession by requiring banks to limit their real estate loans and re-allocate to commercial and industrial loans or assets. The net capital rules continue to discourage real estate loans that are perceived as risky, including High Volatility Commercial Real Estate ("HVCRE") by assigning a 150% risk weight to HVCRE loans. HVCRE is a credit that finances the acquisition, development, or construction ("ADC") of real property where:

- the commercial property loan has a loan-to-value ratio that is less than or equal to the applicable maximum specified ratios established by the FDIC (generally, 80% for commercial, multi-family and other non-residential property; 75% for development properties and 85% for residential properties). The determination of the applicable limits requires further regulatory scrutiny. For example, in determining this loan-to-value ratio, the appropriate limit is the limit applicable to the final phase of the project funded by the loan and loan disbursements cannot exceed actual development or construction outlays. There are other regulations with respect to loans secured by a portfolio or more than one property;
- the borrower has not contributed equity equal to at least 15% of the project, based on the appraised "as completed" value; and
- the borrower contributes capital prior to the first advance of the loan by the bank and the capital is subject to a contractual commitment to stay in the project throughout the life of the project, that is until permanent financing takes out the ADC and actually remains in the project.

There are certain exceptions to HVCRE. HVCRE does not include:

- residential mortgages;
- loans that qualify under the Community Reinvestment Act to a business or farm that is a small business under the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs or have gross annual revenues of $1 million or less; or
- loans secured by agricultural land that is not in any part valued or used for any activity other than farming, and accordingly HVCRE will include loans secured by farm land if the purpose is to develop the land for any commercial, residential or other non-farm purpose.

ADC loans are an important component of community development and generate numerous well-paying jobs in a community. The limitations, noted above, increase the risk weight for a performing loan that is HVCRE to 150%. In addition, the requirement for strict loan to value and for the real estate developer or sponsor to make a 15% equity contribution prior to the first funding of the loan in order for such loan not to be classified as HVCRE will continue to restrict the ability of commercial banks to make profitable loans to develop their communities. The risk-weighting static requirements for HVCRE may require small and community banks to leave a significant amount of ADC to larger banks that may not have the community connections and local knowledge with respect to real estate market conditions and trends and other important local conditions. In addition, the risk- weighting requirements do not accommodate project-specific credit issues. For example, a local developer that land banked a project and needs financing for guaranteed construction costs with a loan-to-value ratio of 60% would still have an HVCRE loan if the developer could not contribute at least 15% of the project costs.

Community banks that have excess regulatory capital may be in an advantageous position to acquire banks with a real estate portfolio that includes HVCREs, as the combined portfolios on a *pro forma* basis may permit expansion into HVCREs that have significant income potential. Similarly, banks faced with the increased capital requirements that are more challenging given their portfolio with HVCREs will need to syndicate their exposures, raise additional capital or combine their portfolios with other banks.

Past-Due Exposures

A bank must assign a 150% risk weight to assets that are unsecured loans (or assign the risk weight to the portion that is under-secured) that are not to a sovereign borrower or a residential mortgage and are past due for 90 days or more. This requirement is a significant change to the risk-weight matrix. The 90-day period may arbitrarily force a bank to liquidate an exposure that has a sound credit profile other than a momentary "hiccup" in payment. For example, the significant increase in a risk weight will require banks to take more prompt action, and perhaps liquidate or sell their exposure, prior to the 90-day mark, even if the delay is due to a good reason, for example a delay in the payment of an asset sale by the borrower or a delay in the payment of escrowed funds or receivables. In addition, any investor or acquirer of a small or community bank needs to continuously monitor and assess these exposures as the closing date approaches. If the target bank falls over this 90-day trip wire at or near the closing date, even if after the closing date, the investor or acquirer will be surprised and find that additional capital will be required to be invested in the bank to implement their business plan.

Sovereign Risks

The FDIC's new rules provide a more risk sensitive approach to non-U.S. sovereign credits, including central banks and credits that may arise from selling or syndicating assets. Under the new rules a risk weight between 0% and 150% is applicable, depending on the country risk classification ("CRC") of the non-U.S. government, as determined by reference to the most recent CRC consensus published by the Organization for Economic Cooperation and Development (or OECD). A credit to a sovereign that has a default in any of its obligations will have a risk weight of 150%. There is a similar risk-weighting regime for exposures to foreign banks and non-U.S. public sector entities ("PSEs"). The practical effect of this risk-weighting regime is that the risk weight for specific CRC is generally greater for foreign banks and PSEs than for sovereigns. As non-U.S. government agencies and foreign banks are increasing their participation in U.S. commerce, there is a greater likelihood that a community bank will have some sovereign credit exposures. The change in the risk weighting may require some small banks to avoid such exposures. This could adversely affect community banks serving immigrant communities or US branches that are established by non-U.S. companies by limiting the exposure that a community bank should prudently have to these institutions.

Repos and Other Derivatives

The new rules significantly modified the risk weighting of collateralized transactions including derivatives and securities financing transactions. Banks must now take into account the fair value of the underlying securities or collateral, which is subject to regulatory discounts or "haircuts." The new rules also significantly changed the risk weighting to cleared derivatives and securities financing transactions to encourage parties to invest in such derivatives through cleared transactions with qualifying central counterparties (e.g., an exchange). These changes reflect a theme in the Dodd-Frank Act to encourage the transparency and lower risk profile of transacting derivatives through exchanges. Community banks will likely make greater use of exchange-traded derivatives.

Securitizations

One of the recurring concerns in the Dodd-Frank Act was to reduce or eliminate the reliance on ratings from credit rating agencies. This concern is reflected in the FDIC's changes to the risk weighting for securitization exposures. Banks previously used credit ratings in part of the calculus of risk weighting securitizations. Banks will continue to use a "gross up" approach so that the risk weight is the aggregate risk of the underlying assets, subject to a specified minimum of 20%. Banks are now required to calculate the risk of the underlying securities based on a matrix of considerations, including the structure, delinquency and loss exposure. Banks are also required to have comprehensive due diligence procedures that appreciate the various risk exposures. Failure to comply with these due diligence obligations to the satisfaction of the primary regulator could lead to a severe result, such as a risk weight of 1,250% for such exposures.

There are numerous other factors in the capital and risk-weighting calculus that challenge bank executives as they attempt to navigate a regulatory environment and provide an attractive return to investors.

Conclusion

The new capital rules implement the core objectives of the FDIC and its sister bank regulators to enhance the safety and soundness of our banking system by making banks maintain more capital and influencing or requiring small and community banks to operate with a lower and more stable risk profile. The regulations continue the static and formulaic approach to determining the risk to a bank and did not take the opportunity to develop a dynamic risk sensitive regime. While an approach that would assess the actual risk profile of bank assets in "real time" would certainly be a great step forward in regulating and monitoring bank capital and operations, such an approach would be subject to substantial discretion by bank executives that would inevitably lead to a difficult and inconsistent regulatory regime. Additionally, given the relative success of the FDIC and its sister regulators in defending the bank system during the Great Recession, in comparison to the unregulated chaos of the early 1930s, it would be difficult to advocate a comprehensive new approach to capital monitoring and risk assessment which would be subject to overly optimistic calculations of underlying risk, as evidenced by the factors that contributed to the need for the Dodd-Frank Act.

The new regulatory capital requirements will likely change the operations, investments and assets of small and community banks and force these banking institutions to avoid HVCRE loans and closely monitor and react to unsecured exposures. The inevitable consequence of these more stringent regulatory capital requirements is that small and community banks will be more stable, generate less profit, have a lower return on capital and find it attractive to merge with larger institutions that have the ability to absorb their assets without materially affecting their capital ratios. The fact that a bank finds its capital ratios deteriorate under the new rules does not necessarily mean that its portfolio is problematic or less profitable. An additional consequence is that certain financings, such as HVCRE and unsecured credits, will be provided by private funds and other financial institutions as small and community banks find it more difficult to maintain these assets. This will lead other financial institutions to, over time, build a portfolio of loans that is perceived by the capital rules to provide greater risk. If such risks are realized and defaults in such loans begin to accumulate, then the contagion scenario will begin again, but this time regulated financial institutions will not be on the front line. While this may be beneficial to the FDIC and bank regulators, the effect may be simply "not at my table" as the risk in banks is shifted to other financial institutions. The next step for the bank regulators will be to assess the exposures of banks to the portfolios of loans made by unregulated financial institutions. It remains to be seen if our next chapter in bank regulatory capital will be written in a proactive or reactive manner. ■

1 Basel Committee on Banking Supervision (BCBS) and described in Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Basel III), as well as subsequent changes to the Basel III framework and recent BCBS consultative papers.

2 Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

3 The amendment proposed by Senator Collins (SA 3879), May 6, 2010, page S3371.

The Federal Reserve has summarized the new Regulatory Capital Requirements at
www.http://www.federalreserve.gov/newsevents/press/bcreg/commbankguide20130702.pdf, which is reprinted below.

Final Rule on Enhanced Regulatory Capital Standards–Implications for Community Banking Organizations

On July 2, 2013, the Federal Reserve Board approved a final rule that implements changes to the regulatory capital framework for all banking organizations.[1] This table highlights the provisions that are most relevant to smaller, non-complex banking organizations and compares the new capital requirements to the current standards.

	Current Treatment	Treatment in Final Rule	Section(s) in Rule Text
Minimum Regulatory Capital Ratios and Capital Buffer			
Common equity tier 1 capital (CET1) ratio	N/A	4.5%	Subpart B, § 10
Tier 1 capital ratio	4%	6%	
Total capital ratio	8%	8% (no change)	
Leverage ratio	4% (or 3%)[2]	4%	
Capital conservation buffer	N/A	Capital conservation buffer (composed of CET1 capital) equivalent to 2.5% of risk-weighted assets in addition to the minimum CET1, tier 1, and total capital ratios	Subpart B, § 11
Definition of Capital			
CET1	No specific definition	Common stock (plus related surplus) and retained earnings less the majority of the regulatory deductions	Subpart C, § 20(b) and § 22
Tier 1 capital	Common stock (plus related surplus) and retained earnings plus preferred stock and trust-preferred securities (for bank holding companies), less regulatory deductions	CET1 plus non-cumulative perpetual preferred stock and grandfathered trust-preferred and other securities, less certain regulatory deductions	Subpart C, § 20(c) and § 22
Mortgage servicing assets (MSAs), certain deferred tax assets (DTAs) arising from temporary differences, and certain significant investments in the stock of unconsolidated financial institutions	MSAs and DTAs that are not deducted are subject to a 100% risk weight	These items are subject to more stringent limits and a 250% risk weight; amounts above the limits are deducted from CET1 capital	Subpart C, § 22(d)
Standardized Approach for Risk-Weighted Assets			
Commercial real estate (CRE) loans	100%	100% for most CRE loans and 150% for high volatility commercial real estate (HVCRE),[3] which is a subset of CRE	Subpart D, § 32(j)
Past due exposures	Risk weight generally does not change when loan is past due (except for residential mortgage exposures)	Generally, 150% risk weight (except for sovereign and residential mortgage exposures)	Subpart D, § 32(k)
Conversion factors for commitments with an original maturity of one year or less	0%	0% if unconditionally cancellable at any time; otherwise 20%	Subpart D, § 33

1 The final rule includes transition periods to help ease potential burden; community banking organizations must begin complying with the rule on January 1, 2015.

2 Currently, banking organizations with the highest supervisory composite rating are subject to a 3% minimum leverage ratio; generally, other community banking organizations are subject to a 4% minimum leverage ratio.

3 HVCRE is a credit facility that, prior to permanent financing, finances or has financed the acquisition, development, or construction of real property, unless the facility finances: (1) one- to four-family residential properties; (2) certain community development projects; (3) the purchase of agricultural land; or (4) commercial real estate projects that meet the criteria in the rule, including criteria regarding the loan-to-value ratio and capital contributions to the project.

The Volcker Rule

By Patrick D. Sweeney and Joshua Lustiger

Background

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Volcker Rule[1] ("the Rule"), was signed into law on July 21, 2010. The Rule adds a new Section 13 to the Bank Holding Company Act of 1956 and it is codified at 12 USC § 1851. Regulators presented proposed regulations regarding the Rule on October 11, 2011 and gave the public until February 13, 2012 to submit comments. Finally, on December 10, 2013, all five regulators approved the final regulations and these were published in the Federal Register in January, 2014 as an interim final regulation. Institutions within the scope of the Rule must now begin finalizing strategies related to further involvement with activities regulated under the Rule.

The premise of the Rule is that banking entities[2] should be prohibited from trading or owning "risky assets." The Rule has two primary components: a prohibition on proprietary trading and a prohibition on sponsoring a "covered fund" or acquiring any ownership interest in the same. Each of these prohibitions contains complex definitions as well as exemptions. The Rule is intended to permit banking entities to continue critical client-oriented financial services, subject to appropriate risk management.

Proprietary Trading

Prohibition on Proprietary Trading

The Rule prohibits any banking entity from engaging in proprietary trading. The main purpose of this prohibition is to limit the risk-taking by banking entities as they try to profit by trading in "risky assets". The broad prohibition against proprietary trading and the various exemptions to it are each the subject of complex definitional provisions. Institutions which determine to avail themselves of exemptions must undertake extensive internal compliance programs and the adoption of detailed policies and procedures at the individual trading desk level. Finally, larger banking entities will be obligated under the regulations to capture and calculate transaction and position data on a variety of quantitative metrics on a daily basis and to report such data to regulators.

Definitions

"Proprietary trading" is defined as "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."

"Financial instruments" generally include any security, derivative, commodity future or option on any of the foregoing. However, the definition excludes loans, most commodities (as opposed to commodity futures) and foreign exchange or currency.

There are three different tests used to determine what constitutes a "trading account." If the account passes any of the tests, it is considered a trading account under the Rule. Trading accounts consist of any one of the following:

- any account used by a banking entity to purchase or sell financial instruments principally for the purpose of short-term resale, benefiting from short-term price movements, realizing short-term arbitrage profits or hedging one or more of the foregoing positions[3],
- any account used by an insured depository institution or bank holding company or savings and loan holding company to purchase or sell financial instruments that are both covered positions and trading positions (or hedges of the foregoing) under the market risk capital requirements imposed on such institutions, and
- any account used by a securities dealer, swap dealer, or security-based swap dealer to purchase or sell financial instruments for any purpose.[4]

Exclusions from the Definition of "Proprietary Trading"

Notwithstanding the scope of the definition of proprietary trading outlined above, there are significant exclusions from the definition. These exclusions refer to purchases and sales of financial instruments: (i) in repurchase or reverse repurchase transactions, (ii) in securities lending transactions, (iii) for liquidity management purposes[5], (iv) by a banking entity which is a derivatives clearing organization or clearing agency in connection with clearing activities, (v) by a banking entity which is a member of a clearing agency,

derivatives clearing organization or designated financial market utility in connection with excluded clearing activities, (vi) in satisfaction of existing delivery obligations or of an obligation in connection with a judicial, administrative, self-regulatory organization or arbitration proceeding, (vii) by a banking entity that is acting solely as agent, broker, or custodian, (viii) in connection with certain employee benefit plans and (ix) in connection with debt collection activities.

Exemptions from the Prohibition on Proprietary Trading

In addition to activities which are excluded from the definition of proprietary trading, the Rule sets forth several exemptions from the general prohibition. These exemptions generally contain significant conditions, including documentation and compliance requirements, and related definitions. Following is a summary of the exemptions:

1. Underwriting activities. A banking entity is permitted to engage in underwriting activities only if (i) the banking entity is acting as an underwriter for a distribution of securities[6] and the trading desk's underwriting position is related to such distribution, (ii) the amount and type of securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable time period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security, (iii) the banking entity maintains compliance policies and procedures directed to compliance at the trading desk level,[7] (iv) the compensation arrangements of underwriting personnel are designed not to reward or incentivize prohibited proprietary trading, and (v) the banking entity is licensed or registered to conduct the underwriting activities.

2. Market-making related activities. A banking entity is permitted to engage in market-making related activities only if (i) the trading desk[8] that manages financial exposure routinely stands ready to purchase and sell financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments, (ii) the amount and type of securities in the trading desk's market-maker inventory are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties, (iii) the banking entity maintains compliance policies and procedures directed to compliance at the trading desk level, (iv) the compensation arrangements of market-making personnel are designed not to reward or incentivize prohibited proprietary trading, and (v) the banking entity is licensed or registered to conduct the market-making activities.

3. Risk-mitigating hedging activities. A banking entity is permitted to engage in hedging activity designed to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, provided that (i) the hedge does not give rise to any significant new or additional risk which is not concurrently hedged and (ii) the hedge is subject to continuing review, monitoring and management by the banking entity. This exemption is also conditioned upon the maintenance of an effective compliance program, and extensive documentation requirements at the trading desk level. Similar limits on compensation arrangements for hedging personnel are required.

4. Other exemptions from the prohibition on proprietary trading. The Rule provides certain other exemptions, each with their own conditions and requirements, which pertain to (i) trading in domestic government obligations, (ii) trading in foreign government obligations, (iii) trading on behalf of customers, (iv) trading by a regulated insurance company and (v) trading by foreign banking entities.

The exemptions to the proprietary trading prohibition are subject to several broad limitations:

- No transaction or activity is permissible if it would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties.
- No transaction or activity is permissible if it would result, directly or indirectly, in a material exposure

by the banking entity to a high-risk asset or a high-risk trading strategy.
- No transaction or activity is permissible if it would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

Covered Funds Activities and Investments

Prohibition on Acquiring or Retaining an Ownership Interest in and Having Certain Relationships with a Covered Fund

The Rule provides that "a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund." As in the case of the proprietary trading rules, there are a host of definitions, exclusions and exceptions to this general rule.

Exclusions

The Rule does not apply to banking entities acting:

- solely as an agent, broker, or custodian for the account of a customer,
- as trustee for an employment benefit plan of the banking entity,
- in good faith debt collection activities, or
- on behalf of customers as trustee or similar fiduciary relationship for the account of a customer which is not a covered fund.

Definitions

A "covered fund" is a private investment company,[9] a private commodity pool,[10] or an offshore entity controlled by a U.S. banking entity.[11] Notwithstanding the broad scope of this definition, the Rule provides exclusions therefrom for (i) foreign public funds,[12] (ii) wholly-owned subsidiaries,[13] (iii) joint ventures,[14] (iv) acquisition vehicles, (v) foreign pension or retirement funds, (vi) insurance company separate accounts, (vii) bank owned life insurance, (viii) loan securitizations,[15] (ix) qualifying asset-backed commercial paper conduits,[16] (x) qualifying covered bonds,[17] (xi) SBICs and public welfare investment funds, (xii) registered investment companies and excluded entities and (xiii) issuers in conjunction with the FDIC's receivership or conservatorship operations.

"Ownership Interest" means any equity, partnership or similar interest.[18] "Ownership Interest" does not include a "restricted profit interest". This exclusion enables investment advisers to collect some forms of carried interests from funds without application of the Rule.

"Sponsoring" a covered fund means to:

- serve as a general partner, managing member, trustee, or commodity pool operator of the fund,
- in any manner select or control (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees, or management of a fund, or
- share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

Exemptions for Organizing and Offering, Underwriting, and Market Making with Respect to Covered Funds

The Rule permits banking entities to organize and offer covered funds only if: (i) the banking entity or its affiliate provides bona fide trust, fiduciary, investment advisory or commodity trading advisory services, (ii) the covered fund is organized and offered only in connection with such services and only to persons who are customers of such services, (iii) the banking entity and its affiliates do not acquire ownership interests in the covered fund, except as otherwise permitted by the Rule, (iv) the banking entity and its affiliates comply with the Rule's limitations on relationships with covered funds (as discussed below), (v) the banking entity and its affiliates do not guarantee, assume or insure the obligations or performance of the covered fund, (vi) the covered fund does not share the same name, or a variation of the same name, of the banking entity or its affiliates and does not include the word "bank" in its name, (vii) no director or employee of the banking entity or its affiliates takes an ownership interest in the covered fund, except for those persons directly engaged in providing services to the covered fund, and (viii) the banking entity includes customary investment risk legends in the offering materials it submits to investors in the covered fund.

A banking entity which securitizes asset-backed securities and is subject to Dodd-Frank's rules on risk retention for securitizers is granted some relief from the foregoing conditions. It is not necessary for the banking entity to be engaged in bona fide trust, fiduciary

investment advisory or commodity trading advisory services and it is not necessary to limit the offering to the banking entity's customers.

A banking entity is also permitted to engage in underwriting and market-making activities involving a covered fund so long as: (i) the activities comply with the underwriting and market-making rules for proprietary trading, (ii) the banking entity is permitted to organize and offer a covered fund under the Rule and includes ownership interests acquired or retained in connection with underwriting or market-making for any particular fund in its calculations of per-fund limits and capital treatment for permitted investments discussed below, and (iii) the aggregate value of all permitted ownership interests are included in a banking entity's calculations of aggregate limits for ownership interests and capital treatment for permitted investments discussed below.

Exemptions for Permitted Investments in Covered Funds

Notwithstanding the Rule's prohibitions on acquiring and retaining ownership interests in covered funds, a banking entity may acquire and retain such ownership interests in a covered fund for the purpose of either (i) establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors or (ii) making *de minimis* investments. Each of these activities is subject to limitations. A *de minimis* investment in a covered fund may not exceed 3% of the value of the outstanding ownership interests of the fund (the "per fund" limit).[19] By contrast, investments made to establish a fund are not subject to per fund limits in the fund's first year, provided that the banking entity actively seeks unaffiliated investors to reduce its position to per fund limits. In addition, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds may not exceed 3% of the Tier 1 capital of the banking entity (the "aggregate" limit). As noted above, ownership interests in connection with underwriting and market-making activities are included in these calculations. Although the per fund and aggregate limits apply to the aggregate holdings of the banking entities and their affiliates, the Rule excludes from the determination of holdings the holdings of certain registered investment companies, business development companies and foreign public funds which might be considered affiliates of the banking entity.[20] Finally, the banking entity's Tier 1 capital is charged in an amount equal to the greater of (i) all amounts paid to acquire the ownership interests and (ii) the fair market value of such ownership interests.

Exemptions for Permitted Risk-Mitigating Hedging Activities

The Rule provides a very narrow exemption for investments in a covered fund which reduce risk to the banking entity arising from an employee compensation arrangement that is tied to the performance of the covered fund. The hedging activity must demonstrably reduce or significantly mitigate one or more specific risks arising in connection with the compensation arrangement with an employee who directly provides investment advisory, commodity trading advisory or other services to the covered fund. The investment may not give rise to any significant new or additional risk which is not itself contemporaneously hedged. The Rule also requires the banking entity to implement and enforce an internal compliance program that includes reasonably designed policies and procedures, internal controls and ongoing monitoring, management and authorization procedures. In addition, the compensation arrangement to which the hedge relates must provide that any losses incurred by the banking entity on the hedge be offset by a reduction in the amounts payable to the employee.

Exemptions for Certain Permitted Covered Fund Activities and Investments Outside of the United States

A banking entity may acquire or retain an ownership interest in, or sponsor, a covered fund if: (i) the banking entity is not organized in the United States or controlled by a banking entity organized in the United States, (ii) the activity or investment is permitted under paragraph 9 or 13 of section 4(c) of the Bank Holding Company Act,[21] (iii) no ownership interest in the covered fund is offered or sold to a United States resident, and (iv) the activity or investment occurs solely outside of the United States.

Exemptions for Permitted Covered Fund Interests and Activities by a Regulated Insurance Company

An insurance company may acquire or retain an

ownership interest in, or sponsor, a covered fund if: (i) the ownership interest is held solely for the general account of the insurance company or for one or more separate accounts established by the insurance company, (ii) the acquisition and retention of the ownership interest is conducted in accordance with applicable insurance company regulations, and (iii) federal banking agencies have not determined that a particular insurance company regulation is insufficient to protect the safety and soundness of the insurance company or the financial stability of the United States.

Limitations on Relationships with a Covered Fund

Generally, no banking entity that serves as the investment manager, investment adviser, commodity trading advisor or sponsor to a covered fund, that organizes and offers a covered fund as permitted by the Rule or that continues to hold an ownership interest as permitted by the Rule, may enter into a transaction with the covered fund that would be a covered transaction[22] under Section 23A of the Federal Reserve Act, assuming that the banking entity were a member bank and the covered fund were an affiliate. However, the Rule provides exceptions for the acquisition and retention of ownership interests as permitted by the Rule and also for certain prime brokerage transactions.

A banking entity which serves as the investment manager, investment adviser, commodity trading advisor or sponsor to a covered fund must comply with the restrictions on transactions between member banks and affiliates imposed under 23B of the Federal Reserve Act, assuming that the banking entity were a member bank and the covered fund were an affiliate.[23]

Other Limitations on Permitted Covered Fund Activities

No exempt transaction may be conducted by a banking entity with a covered fund if the transaction would: (i) involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties, (ii) result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy or (iii) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States. In this context, a banking entity can mitigate a conflict of interest, and proceed with the transaction, through timely and effective disclosure of the conflict, or through established, adequate information barriers.

Compliance

Each banking entity is required to develop a program reasonably designed to ensure and monitor compliance with the prohibitions on proprietary trading and covered fund activities and investments. The terms, scope, and detail of the compliance program must be appropriate for the type, size, scope, and complexity of activities and business structure of the entity. The minimum requirements for all banking entities include:

- written policies and procedures reasonably designed to document, describe, monitor, and limit trading activities and covered fund activities and investments subject to the Rule;
- a system of internal controls reasonably designed to monitor compliance with the Rules and to prevent the occurrence of activities or investments prohibited by the Rule;
- a management framework that clearly delineates responsibility and accountability for compliance, and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters;
- independent testing and audit of the effectiveness of the compliance program conducted by qualified personnel of the banking entity or by a qualified outside party;
- training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
- making and keeping records sufficient to demonstrate compliance, which the banking entity must promptly provide to the appropriate federal agency upon request and retain for at least five years.

Certain large banking entities[24] engaged in proprietary trading are subject to "enhanced compliance" requirements. These entities are required to establish, maintain, and enforce a governance and management framework that is reasonably designed to ensure that appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program, a clear

reporting line with a chain of responsibility, and the periodic review of the compliance program by senior management.

A significantly broader group[25] of banking entities engaged in proprietary trading will be required to report quantitative metrics on their trading activities.

Effective Date and Compliance Dates

The Rule became effective April 1, 2014, but affected banking organizations generally will have until July 21, 2015 to bring their proprietary trading and private fund activities into conformance with the Rule. This new conformance date is an administrative extension of the original statutory conformance date of July 21, 2014. Also, the deadline for conformance by banking entities in connection with loan securitizations will be extended to July 21, 2017 with regard to their ownership interests in, and sponsorship of, any loan securitizations that had been in place as of December 31, 2013.

An important exception to the extension is that banking organizations with significant trading activities will be required to report quantitative metrics on their trading activities beginning in July 2014. In addition, banking organizations are expected to engage in "good faith efforts" to bring all of their covered activities into compliance by the July 2015 conformance date. To this end, the Federal Reserve Board has warned that "banking entities should not expand activities and make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted."

Impact of the Volcker Rule on Capital Markets

In promulgating the Rule, the regulators cited sharply differing views of commenters on the likely impact of the Rule on the capital markets, particularly as a result of the proprietary trading restrictions. Critics of the Rule foresaw a reduction in the efficiency of markets, economic growth and employment as a result of loss of liquidity. Further negative forecasts included high transition costs as non-banking entities assumed trading activities currently performed by banking entities, a reduction in commercial output and resource exploration due to a lack of hedging counterparties, and reduced access to debt markets.

Supporters of the Rule emphasized that restrictions in proprietary trading may reduce systemic risk and lower the probability of another financial crisis.

The regulators contend that the Rule as promulgated achieves a balance between promoting healthy economic activity and reducing regulatory burdens where appropriate. Time will tell whether the right balance has been achieved. ■

This article was authored by Patrick D. Sweeney, a partner at Herrick, Feinstein LLP, and by Joshua Lustiger, a summer associate. This article summarizes in broad outline the principal provisions of the Volcker Rule. The Rule itself is heavily detailed and qualified, and has been nuanced by substantial commentary submitted by the regulatory agencies responsible for the Rule. Application of the Rule to specific circumstances will require a review of pertinent provisions of the Rule in greater detail than that present in this article. We at Herrick, Feinstein LLP are available to assist you with any analysis of the Rule which you may require.

1 These provisions are based on proposals made by Paul A. Volcker, former Federal Reserve Bank (FRB) Chairman and former White House economic advisor.
2 "Banking entities" include (a) any insured depository institution, (b) any company that controls an insured depository institution, (c) any company that is treated as a bank holding company under the International Banking Act of 1978, or (d) any "affiliate" or "subsidiary" of the foregoing. There are exclusions for "covered funds" (as hereinafter defined) and certain portfolio companies and portfolio concerns which might be considered affiliates or subsidiaries of banking entities in any of the first three categories above. There is also an exclusion for the FDIC acting in its corporate capacity or as a conservator or receiver for a banking entity.
3 There is a rebuttable presumption that any purchase or sale of a financial instrument shall be presumed to be for the trading account of the banking entity if the banking entity holds the financial instrument for fewer than 60 days (or substantially transfers the risk of the financial instrument unless the banking entity can demonstrate that it did not purchase or sell the financial instrument for any of the foregoing purposes.
4 The category includes the purchase and sale of financial instruments by any such dealer outside of the United States if the banking entity conducts such business on an unregistered basis.
5 This exclusion applies to purchases and sales of securities only and requires a documented liquidity management plan with mandatory provisions.
6 Distributions include private placements as well as registered offerings.
7 The requirements of the underwriting exemption are thus applied to the aggregate trading activities of a relatively limited group of employees on a single desk.
8 The Rule defines a trading desk as the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof.
9 A private investment company depends upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 for an exemption from registration thereunder.
10 A private commodity pool is one in which the investors are all or substantially all "qualified eligible persons" as defined under the Commodity Exchange Act.
11 In order to fall within the definition, the banking entity must either sponsor or have an ownership interest in the entity.
12 A "foreign public fund" is (i) organized or established outside of the United States, (ii) is authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction and (iii) sells ownership interests predominantly through one or more public offerings outside of the United States. Ownership interests may not be "predominantly owned" by the banking entity or the issuer or their respective affiliates, directors and employees.
13 "Wholly-owned subsidiaries" include subsidiaries with up to 5% ownership by employees or directors and up to 0.5% ownership by third parties for corporate

separateness or insolvency concerns.

14 Joint ventures are limited to 10 unaffiliated joint venturers and must be in a business permissible for banking entities, other than investing in securities for resale or other disposition.

15 A "loan securitization" is an issuing entity for asset-backed securities whose assets consist solely of loans, servicing and distribution rights, interest rate or foreign exchange derivatives and special units of beneficial interest and collateral certificates. A loan securitization generally may not include securities.

16 An asset-backed commercial paper conduit which holds only assets permissible for a loan securitization, issues only short-term asset-backed securities and is supported by a regulated liquidity provider.

17 "Qualifying covered bonds" are bonds issued or guaranteed by a foreign banking organization and secured by a dynamic or fixed pool of assets conforming to the requirements for a loan securitization.

18 "Similar interests" include voting rights, rights to share in income, assets and excess spreads, distribution rights subject to reduction by entity losses, rights to income on a pass-through basis or by reference to asset performance, and synthetic rights to any of the foregoing.

19 However, securitizers of asset-backed securities may hold up to the amount of the required risk retention, if such amount exceeds 3%.

20 By contrast, the Rule includes within the calculation of banking entity holdings the holdings of any director or employee of the banking entity which have been financed by the banking entity.

21 These sections permit ownership interests in and activities with certain non-U.S. entities, as defined in the statute.

22 Section 23A defines "covered transaction" to include loans to affiliates, investments in affiliates, asset purchases from affiliates, acceptance of affiliate obligations as collateral for any loan, issuing a guaranty on behalf of an affiliate, borrowing or lending securities with affiliate if credit exposure to affiliate is created and derivative transactions which create credit exposure to the affiliate.

23 Section 23B essentially requires member banks to deal at arm's length with their affiliates.

24 Large banking entities are generally considered those with reported total assets of $50 billion or more.

25 Ultimately, those banks with $10 billion total consolidated assets.

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