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The Volcker Rule's Impact on Bridge Loans

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The following Stay Current bulletin represents the first installment in a series of bulletins that will address specific leveraged finance issues stemming from the proposed implementation of the so-called "Volcker Rule" set forth at section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). Specifically, this Stay Current bulletin addresses the potential impact of the Volcker Rule's restriction on "proprietary trading" on the making of non-investment grade bridge loans in the context of committed financings for acquisitions. For a more general discussion of the issues and concerns in implementing the Volcker Rule please see our article titled "The Volcker Rule Proposal – Many Questions, Few Answers."

Overview

Generally, the Volcker Rule bars a "banking entity" from engaging in proprietary trading as well as investing in private equity and hedge funds. As defined by the Act, a "banking entity" includes any insured depository institution ("IDI") and any company controlling an IDI, as well as any company deemed a bank holding company ("BHC") under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity. The Volcker Rule also imposes certain limitations on "nonbank financial companies supervised by the FRB" that engage in proprietary trading and invest in private equity and hedge funds, but these entities are not subject to the ban on proprietary trading and investing in private equity and hedge funds. The Act defines a "nonbank financial company" as an entity predominantly engaged in financial activities. A "nonbank financial company supervised by the FRB" is a nonbank financial company that the FSOC has determined pursuant to section 113 of the Act is systemically significant.

Pursuant to section 3(b)(1) of the proposed rule, "proprietary trading" generally means engaging as principal for the "trading account" of a covered banking entity in the purchase or sale of a "covered financial position." Pursuant to section 3(b)(2), a "trading account" is any account used by a covered banking entity to acquire one or more covered financial positions principally for short-term resale, short-term price movement, or short-term arbitrage profits, hedging a position in one of these. A "trading account" also includes acquiring a covered financial (other than certain foreign exchange and commodity derivatives) position by a banking entity subject to the market risk capital rule, and certain transactions entered into by banking entities that are government securities or swap dealers (and certain other exclusions).[1] Under section 3(b)(3) of the proposal, a "covered financial position" includes any long, short, synthetic or other position in a security or derivative, and option on either, and a commodity sale contract, or an option on the same. Excluded from a "covered financial position" are positions in a loan, commodity, or foreign exchange or currency (although a commodity or foreign exchange derivative would be a covered financial position).

Section 4 of the proposed rule contains exemptions to the ban on proprietary trading for certain underwriting and market making-related activities. Issues with the ban on proprietary trading

generally arise with respect to these exemptions. Section 4(a)(1) of the proposed rule provides that the prohibition on proprietary trading does not apply to the purchase or sale of a covered financial position by a banking entity in connection with its underwriting activities. A covered financial position is deemed to be made in connection with underwriting activities if all of the requirements of section 4(a)(2) of the rule can be satisfied. These include that: (i) the banking entity have an established internal compliance program (as required in the compliance requirements set forth in subpart D of the proposed rule) to ensure, among other things, that the subject activities are underwriting activities; (ii) the covered financial positions is a security; (iii) the purchase or sale is effected solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter; (iv) if the subject underwriting requires the banking entity to be registered as a "securities dealer," the banking entity has the appropriate dealer registration or otherwise be exempt or excluded from registration; (v) the underwriting activities with respect to the covered position are designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties; (vi) the underwriting activities are designed to generate revenues primarily from fees, commissions, or income not attributable to price appreciation or hedging related to such activities; and (vii) compensation arrangements of persons performing the underwriting activities do not reward proprietary risk-taking. The availability of the underwriting exemption requires that the banking entity and subject underwriting satisfy all of the above requirements for the activity not to be deemed "proprietary trading" under the proposed rule.

By examining the Volcker Rule's impact on the making of non-investment grade bridge loans, we will see that the broad reach of the proposed rule (and limited exemptions) may prohibit many activities outside of what market participants and knowledgeable observers think of as "proprietary trading" and could potentially impact how banks acquire debt securities in committed financings for acquisitions with bridge loan components.

Volcker Impact on Bridge Loans

As is customary in committed financings for acquisitions with bridge loan components, banks potentially transact in securities in two ways. First, via the "take out demand," where a bank can require the borrower to issue high yield notes, referred to as "demand notes," to replace or repay the bridge loan. Second, via the issuance of "exchange notes," which are fixed rate, call protected high yield notes held by a bridge lender following the conversion of outstanding bridge loans into exchange notes after a year if the bridge loan is still outstanding. Demand notes are often contemplated to be issued to third parties in a Rule 144A offering underwritten by the banks arranging the bridge loan. However, this is not always the case as bridge loan commitment documentation typically permits a portion (and sometimes all) of the demand notes to be held by the arranger banks and not sold to third parties as part of an underwritten offering, but rather sold from time-to-time in separate, negotiated sale transactions, referred to as "dribble out" sales. This would happen where, after a road show, market demand for the notes replacing the bridge loan commitment is only enough to replace some but not all of the committed amount of the bridge loan. For exchange notes, "dribble out" is a more likely method of sale by a bank than an underwritten offering, as the decision to exchange bridge loans for exchange notes is made by each lender separately. This is in contrast to a take out demand, which is determined by the lead arrangers on behalf of all lenders under the bridge loan, and most bridge loans do not require the borrower to assist in an underwriting process for exchange notes.

As proposed, it appears the Volcker Rule could restrict "dribble out" sales for demand notes or exchange notes in many circumstances where currently permitted and where banks would expect to be able to do so to reduce balance sheet risk. Ironically, this would accomplish precisely the opposite

of the Volcker Rule's intended effect. All "banking entities" (which term includes any affiliate or subsidiary of a bank holding company) are subject to the proposed rule.[2] In addition, all securities (but not loans) are also subject to the proposed rule.[3] As currently proposed, a bank would engage in prohibited proprietary trading if it acquires a security "principally for the purpose of short-term resale."[4] While the proposal includes various exemptions, including an underwriting exemption, it also proposes a rebuttable presumption that the acquisition of a security is for "short-term resale" if the bank holds it for a period of 60 days or less. The presumption can be overcome where a bank can demonstrate, based on all the facts and circumstances, that the security, either individually or as a category, was not acquired principally for short-term resale.[5] The problem is that demand notes and exchange notes to be dribbled out are acquired to be resold as soon as possible, the shorter-term the better, and that's what reduces the bank's risk. Thus, while the substance of the bridge loan transaction would appear not to be a "covered financial position" under the proposed rule, the impact of the rule on securities held by a bank arising from a bridge loan transaction is unclear.

As proposed, the exemption for permitted underwriting activity does not appear to be broad enough to permit a "dribble out" sales strategy for exchange notes or demand notes that were either (i) not acquired in an underwritten offering (i.e., 144A offering) or (ii) acquired in such an offering but represent that portion of the securities underwritten that "exceed the reasonably expected near term demands" of market purchasers. The proposed rule provides that a purchase or sale of a security is a permitted underwriting activity only if (among other conditions) "the purchase or sale is effected solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter".[6] To the extent demand notes to be dribbled out are an "unsold allotment" of an underwritten 144A offering, the exemption would be available so long as the amount of unsold notes does not "exceed the reasonably expected near term demands of clients, customers or counterparties."[7] This creates a potential problem for the dribble out of securities arising from outstanding bridge loans.

The result of all this is that banks could be required to "hold for investment" unsold allotments of underwritten demand notes and demand notes and exchange notes not acquired in an underwritten offering. Under the proposed rule, this could mean that a bank must not intend to sell such notes for at least 60 days (and perhaps longer) after it acquires them. This would clearly create unintended consequences given that 60 days can seem like an eternity when stuck in a hung bridge. While there may well be ways to "work around" certain of these restrictions by changing the customary mechanics of bridge loans (for example, in lieu of call-protected exchange notes, lenders could exchange for call-protected covenant-lite term loans with bond-like covenants), as currently proposed, the rule could make access to the bond market substantially more difficult for banks to replace or refinance bridge commitments and loans. Clearly, this would be a perverse result and, presumably, fall under the category of "unintended consequences."

Conclusion

The October 12, 2011, release by the Securities and Exchange Commission (together with the Federal Reserve, the FDIC and the Treasury Department) of the proposed regulations implementing the Volcker Rule provisions of the Act has brought forth a cascade of opinions ranging from those that question the wisdom of prohibiting proprietary trading by banks to those who think that the proposed restrictions do not go nearly far enough. One criticism echoing from practically all commentators is the complexity of the proposed regulations – a 298-page release that requests input from market participants on hundreds of questions, many of which themselves are multi-part. After reading the release, at least one thing is clear – the Volcker Rule is likely to get a lot more complicated, not less.

As we have discussed above, by looking at the Volcker Rule's impact on a relatively tiny sliver of banking transactions – the making of non-investment grade bridge loans – the broad reach of the proposed rule could prohibit many activities outside of what market participants and knowledgeable observers think of as "proprietary trading." The unavoidable outcome of this will be more complexity, as additions to the rule will be necessary to exempt out non-speculative, ordinary course transactions that actually make banks' balance sheets less risky. It is difficult to imagine that the federal regulatory agencies purposefully intend to make it more difficult for banks to de-risk their balance sheets by selling off bridge loan risk in the form of securities. Accordingly, we expect comments will be generated in response to the potential impact of the proposed rule requesting clarification and/or an exemption from the requirements of the Volcker Rule for customary bank transactions in demand notes and exchange notes. Similarly, it is evident that there are likely numerous other types of "benign" transactions that should be exempted and that will likely generate additional comments, with the end result being further complexity (or, at a minimum, more length).

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[1] See Section 3(b)(2)(i)(B) and (C) of the proposed rules.

[2] See Section 2(e) of the proposed rules. The release for the proposed rules, entitled "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds," File No.: S7-41-11, dated October 12, 2001, is available on the SEC's website, www.sec.gov.

[3] See Section 3(b)(3) of the proposed rules for the definition of "covered financial position."

[4] See Section 3(b)(2)(i)(A)(1) of the proposed rules.

[5] See Section 3(b)(2)(ii) of the proposed rules.

[6] See Section 4(a)(2)(iii) of the proposed rules.

[7] See Section 4(a)(2)(v) of the proposed rules.