Finance

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Clarification of Applicability of the Volcker Rule to Bridge Borrowing and So-Called "Dribble-Out Sales"

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This Client Alert is being sent to our clients and friends to share our views regarding the conclusions set forth in an article published by Bloomberg *on November 2, 2011, that warned that the $63 billion bridge loan market was jeopardized by the proposed regulations recently published by several of the federal financial service agencies. Among other things, the article warned that the functioning of that market segment runs afoul of the proposed Volcker Rule limitations on proprietary trading by covered financial holding companies and their affiliates—including the requirement that a bank hold notes for a minimum of 60 days in order to avoid the proprietary trading prohibition (and thereby incur a host of capital requirements and significantly increase its risk exposure).*

Due to the concern expressed by numerous clients who read the above-referenced article, we believe it to be important to set the record straight that the conclusions in the article are both exaggerated and avoidable.

In regard to the lending segment generally known as bridge borrowing, we note that the Volcker provision of the Dodd-Frank Act adopts a new Section 13(g)(2) of the federal Bank Holding Company Act, which specifically exempts the sale of loans:

> **Section 13(g)(2)—Sale or Securitization of Loans.**—*Nothing in this section shall be construed to limit or restrict the ability of a banking entity* or nonbank financial company supervised by the Board to sell or securitize loans otherwise permitted by law. (Emphasis added.)

Read literally, Section 13(g)(2) appears on its face to be a clear and specific exemption from what would otherwise be a covered transaction under the Volcker Rule limitations.

In addition to the foregoing, we note that another exemption from the limitations imposed by the Volcker provision applies to underwriting of securities—which generally would apply to a bank underwriting of commercial paper commonly employed as part of a bridge loan transaction. More importantly, the supplementary information to the proposed rule addresses the subsequent sale of securities held by an underwriter following an initial distribution of securities:

> There may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. *If the acquisition of such unsold securities were in connection with the underwriting pursuant to the permitted underwriting activities exemption, the underwriter would also be able to dispose of such securities at a later time.* (Emphasis added.)

Finally, while perhaps not precisely applicable, the proposed rule and accompanying supplementary information describes in great detail market-making that is exempt from the proprietary trading prohibitions (provided that the trading activities are that of a market-maker and not typical of a trader). At a minimum, therefore, this discussion supports the view that the actual function being conducted must be closely examined when determining whether it is subject to the proprietary trading prohibitions.

Our conversations with several of the federal regulators responsible for the proposal indicate on their part a clear understanding and appreciation of our view that the exemptions discussed above should be available under the proposed rule. In that regard, staff members with whom we spoke pointed out that while the attempt was made when drafting the proposed regulation not to interfere with financing transactions that do not violate the proscriptions on proprietary trading, the usefulness of the public comment period is to permit affected companies the opportunity to submit comments so that the final rule when issued would eliminate doubt as to the continued permissibility of current market practices.

In conclusion, we trust that this information clarifies the situation. Because of the complexity of today's finance transactions (i.e., which frequently overlap both banking and securities law authorizations), we strongly recommend that our clients use the public comment period to submit comment letters to the various financial regulators—particularly because of the need to educate staff members at those agencies regarding the operation of the market. Specifically, comment letters should focus on the necessity of clarity and the availability of exemptions for specified financial transactions.

Of course, we would be pleased to assist in the comment process, including working with you to analyze other proposed sections of the Volcker rule regulations and its impact on your operations.

If you have questions , contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

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