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Federal Agencies' Proposals to Implement the Volcker Rule Will Impact Private Fund Industry

SEC Implementation of the Dodd-Frank Wall Street Reform Act

In early October 2011, the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC") proposed rules to implement the restrictions on the private investment fund activities of banking entities and their affiliates found in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), more commonly known as the "Volcker Rule."

The Volcker Rule and the related proposed rules to implement it generally prohibit a banking entity from owning or sponsoring a covered fund. However, both the Volcker Rule and the related proposed rules include certain exceptions from this general prohibition for activities that comply with a number of specific conditions and as long as any investments satisfy both a per fund de minimis ownership limit and an aggregate fund de minimis ownership limit. As a result of these exceptions, banking entities may be able to structure their private fund operations in a manner to comply with these conditions and de minimis ownership limits. This analysis discusses the impact of the Volcker Rule proposals on banking entities with an ownership interest in, or sponsoring, private investment funds.

Background

The Volcker Rule added a new section 13 to the Bank Holding Company Act (the "BHC Act") and applies to any "banking entity," including any insured bank or thrift, a company that controls an insured bank or thrift, a company that is treated as a bank holding company and their affiliates and subsidiaries. Nonbank financial companies supervised by the Federal Reserve also may be subject to certain limitations, including additional capital requirements.

The Volcker Rule imposes two key restrictions on these entities:

- banking entities are prohibited from engaging in proprietary trading; and
- banking entities are prohibited from acquiring or retaining any interest in, or sponsoring, a "hedge fund" or "private equity fund," subject to certain limited exemptions.

In addition, banking entities that sponsor or act as investment advisers to hedge funds or private equity funds are prohibited from entering into a "covered transaction" (including loans, purchases of assets or securities and guarantees) with those funds.

The Volcker Rule called for a study and recommendations on the implementation of the Volcker Rule and for certain federal regulatory agencies, including the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System ("Board"); the FDIC; the SEC; and the Commodity Futures Trading Commission ("CFTC"), to adopt rules to carry out the Volcker Rule. Banking entities that are registered investment advisers fall under the SEC's regulatory authority. The Financial Stability

Oversight Council issued its study and recommendations on January 18, 2011. After a comment period expiring on January 13, 2012, the regulators will adopt final rules.

General Prohibition Relating to Private Funds

Subpart C of the proposed new rules implements the Act's prohibition on fund activities. The proposed rules prohibit, except as otherwise permitted in Subpart C, any banking entity from, as principal, directly or indirectly, acquiring or retaining an "ownership interest" in, or "sponsoring," a "covered fund."

While the Act prohibits a banking entity's activities with respect to "hedge funds" and "private equity funds," the proposed rules prohibit activities with respect to "covered funds." A "covered fund" is defined as any investment fund that relies on the exceptions from investment company status found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act"), and also identifies "such similar funds" that are also subject to the general prohibition. The proposed rules consider a commodity pool as well as foreign equivalents to be "similar funds" subject to the Volcker Rule's prohibitions. Covered funds also would include venture capital funds.

The proposed rules also define the types of interest that constitute an "ownership interest" and thus would be subject to the general prohibition. An "ownership interest" includes any equity, partnership or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate or other similar interest) in a covered fund, whether voting or nonvoting, as well as any derivative of such interest. The proposed rules consider an ownership interest to include a debt security or other security that provides economic exposure to the profits and losses of the covered fund or exhibits substantially the same characteristics as an equity interest.

An ownership interest does not include "carried interest" or an interest held in a covered fund for which the banking entity serves as investment manager, investment adviser or commodity trading advisor, so long as:

- the sole purpose and effect of the interest is to allow the banking entity to share in the profits of the covered fund as performance compensation for services provided to the covered fund, provided that the banking entity may be obligated under the terms of such interest to return profits previously received;
- all such profit, once allocated, is distributed promptly after being earned or, if not so distributed, the reinvested profit does not share in the subsequent profits and losses of the covered fund;
- the banking entity does not provide funds to the covered fund in connection with acquiring or retaining this carried interest; and
- the interest is not transferable except to an affiliate or subsidiary.

The proposed rules define "sponsor" to mean:

- serving as a general partner, managing member, trustee or commodity pool operator of a covered fund;
- selecting or controlling in any manner a majority of the directors, trustees or management of a covered fund; or
- sharing with a covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.

The general prohibition also covers activities of the banking entity's affiliates, subsidiaries and employees.

Permitted Organizing and Offering of a Covered Fund

The proposed rules permit a banking entity to, directly or indirectly, organize and offer a covered fund, including by serving as its general partner, subject to the following conditions:

(a) The banking entity provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services;

(b) The covered fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, investment advisory or commodity trading advisory services and only to persons who are customers of such services of the banking entity, pursuant to a credible plan or similar documentation outlining how the covered banking entity intends to provide advisory or similar services to its customers through organizing and offering such fund;

(c) The banking entity does not acquire or retain an ownership interest in the covered fund except in compliance with Subpart C;

(d) The banking entity complies with the restrictions relating to covered transactions in section 23A of the Federal Reserve Act and section 23B of the Federal Reserve Act (which requires arm's-length terms in transactions with affiliates);

(e) The banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;

(f) The covered fund, for corporate, marketing, promotional or other purposes: (1) does not share the same name or a variation of the same name with the covered banking entity; and (2) does not use the word "bank" in its name;

(g) No director or employee of the banking entity takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; and

(h) The banking entity:

(1) Clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's private placement memorandum):

- That "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity and its affiliates or subsidiaries]; therefore, [the banking entity's and its affiliates' or subsidiaries'] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by the [banking entity and its affiliates or subsidiaries] in their capacity as investors in the [covered fund]";
- That such investor should read the fund offering documents before investing in the covered fund;
- That the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case);

- The role of the banking entity and its affiliates, subsidiaries and employees in sponsoring or providing any services to the covered fund; and

(2) Complies with any additional rules of the appropriate federal banking agencies, the SEC or the CFTC designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity and its affiliates or subsidiaries.

Permitted Investment in a Covered Fund

Establishment/De Minimis Exception: The general prohibition also does not apply with respect to a banking entity acquiring and retaining any ownership interest in a covered fund that the banking entity organizes and offers, for the purposes of:

- establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors; or

- making and retaining an investment in the covered fund that does not exceed 3 percent of the total outstanding ownership interests in the fund.

Per Fund Limit: With respect to any investment to establish a covered fund that does not comply with the 3 percent per fund ownership limit initially, (A) the banking entity must actively seek unaffiliated investors to reduce through redemption, sale, dilution or other methods the aggregate amount of all ownership interests of the banking entity in any covered fund to the per fund de minimis limit (described in the next clause); and (B) the banking entity may not exceed 3 percent of the total amount or value of outstanding ownership interests of the fund not later than one year after the date of establishment of the fund (or such longer period as may be permitted by the Board). In addition, the investment in a covered fund may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment.

Aggregate Fund Limit: Investments in covered funds are also subject to an aggregate fund ownership limit. The aggregate value of all ownership interests of a banking entity in all covered funds may not exceed 3 percent of the Tier 1 capital of the banking entity.

Calculations: The proposed rules include special attribution and other rules for calculating amounts and determining compliance with these de minimis limits, including in the event a banking entity is not required to calculate and report Tier 1 capital. Notably, the calculation rules require the deduction of a banking entity's aggregate investment in a covered fund from the assets and tangible equity of the banking entity and the amount of that deduction increases with the leverage of the underlying fund. The per fund limit applies at all times, and thus must be calculated at least as often as the fund issues or redeems interests or calculates its value. Or if the fund does not determine its value daily and does not allow frequent redemptions, the per fund limitations must be made no less frequently than at the end of every quarter. The aggregate de minimis ownership limit for investments in all covered funds is to be calculated as of the last day of each calendar quarter. As a result, if a banking entity relying on this exemption experiences appreciation of fund investments or depreciation of other assets resulting in an over-allocation to hedge and private equity funds, the entity may inadvertently fall out of compliance.

Extensions: The Board may extend the compliance deadline for a particular banking entity to satisfy the per fund ownership limit (but not the aggregate fund limit) up to two additional years if the banking entity satisfies certain requirements and the Board, after considering a number of factors outlined in the proposals, finds an extension would be consistent with safety and soundness and not detrimental to the public interest. In addition, the Board may impose conditions on any such extension.

Certain Other Permitted Covered Fund Activities and Investments

Permitted Investments in Community Welfare and Tax Credit Funds: The proposed rules do not prohibit acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund by a banking entity or an affiliate or subsidiary thereof: (i) that is designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services or jobs); or (ii) that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar state historic tax credit program.

Permitted Investments in SBICs: The proposed rules do not prohibit acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund by a banking entity in one or more small business investment companies.

Certain Permitted Risk-Mitigating Hedging Activities: In addition, the proposed rules do not prohibit an ownership interest in a covered fund by a banking entity, as long as (among other conditions) the acquisition or retention of the ownership interest is: (i) made in connection with and related to individual or aggregated obligations or liabilities of the banking entity that are: (A) taken by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or (B) directly connected to a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund; and (ii) designed to reduce the specific risks to the banking entity in connection with and related to such obligations or liabilities.

Permitted Activities and Investments Outside the U.S.: Certain foreign banking entities are eligible for exemption. The proposals permit the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity if: (i) the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states; (ii) the activity is conducted pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; (iii) no ownership interest in such covered fund is offered for sale or sold to a resident of the United States; and (iv) the activity occurs solely outside of the United States. The proposals discuss when such activity would be considered to be in compliance with the BHC Act and to have occurred solely outside the United States.

Loan Securitizations: Under the proposals, a banking entity would be able to acquire or retain an interest or security of an issuer of asset-backed securities that is a covered fund if: (i) the interest or security of the issuer does not qualify as an "ownership interest"; (ii) the issuer of asset-backed securities is comprised solely of loans, contractual rights or assets directly arising from those loans, and certain specified interest rate or foreign exchange derivatives used for hedging purposes, as permitted under the proposed rules; (iii) the banking entity is a "securitizer" or "originator" and acquires and retains such interest in compliance with the minimum requirements of section 15G of the Securities Exchange Act of 1934 and any implementing regulations issued thereunder; or (iv) the banking entity organizes and offers the issuer and the ownership interest is a permitted investment under the de minimis ownership limits of the proposed rule.

Bank-Owned Life Insurance: Subject to certain conditions, a separate account that is used solely for the purpose of allowing a covered banking entity to purchase an insurance policy for which the banking entity is the beneficiary also is permitted activity.

Joint Ventures and Acquisition Vehicles: The proposals also permit a joint venture between the banking entity or one of its affiliates and any other person if the joint venture is an operating company and does not engage in any activity or make any investment that is prohibited under the rules. In addition, certain types of acquisition vehicles are permitted.

Liquidity Management Vehicles: The proposed rules do not prohibit a wholly owned subsidiary of the banking entity that is engaged principally in performing bona fide liquidity management activities permitted elsewhere in the rule proposals, and carried on the balance sheet of the banking entity.

Debt Collection: The prohibition does not apply to the acquisition or retention by a banking entity of any ownership interest in, or acting as sponsor to, a covered fund, if acquired or retained by a banking entity in the ordinary course of collecting a debt previously contracted in good faith, if the banking entity divests the ownership interest within applicable time periods required by the applicable oversight agency.

Internal Controls, Reporting and Recordkeeping

Each banking entity engaged in any permitted covered fund activities or investments must comply with the internal controls, reporting and recordkeeping requirements specified in the proposed rules as well as any other reporting and recordkeeping requirements as the agencies deem necessary or appropriate.

Additional Limitations/Prohibition on Covered Transactions

The proposed rules prohibit banking entities that serve, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor or sponsor to a covered fund, or that organize and offer a covered fund from entering into a transaction with the covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were its affiliate. The proposed rules are more restrictive than those in section 23A because the proposed rules reflect a complete prohibition while section 23A permits covered transactions subject to certain limitations. As a practical matter, "covered transactions" include a number of related party transactions between the fund and affiliated banking entities involving leverage.

The Board may permit an exception for a banking entity to engage in prime brokerage transactions with any covered fund in which it has taken an ownership interest if it is otherwise in compliance with the conditions described above, its CEO certifies annually as to its compliance and the Board has not determined that the transaction is inconsistent with safe and sound operation and condition of the banking entity. The proposed rules define a "prime brokerage transaction" to mean one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution or financing, data, operational and portfolio management support.

Timing of Implementation

The Volcker Rule provision of the Act will be effective on July 21, 2012. In addition, the rule proposals specify an effective date of July 21, 2012, for the rule's prohibitions as well as the reporting, recordkeeping and compliance program requirements of the rule, but the agencies have solicited comment on the proposed effective date and compliance periods. Comments are due by January 13, 2012.

The Volcker Rule contemplates a two-year divestiture period for prohibited businesses and investments, which may be extended by the Federal Reserve Board on a case-by-case basis one year at a time for not more than an aggregate of three years (for a total of five years), subject to certain conditions. In a separate rulemaking focused only on the compliance period, the Board adopted final rules effective April 1, 2011 to confirm that this two-year divestiture period would commence on July 21, 2012. These final rules also permit a new banking entity a two-year compliance period from the date it becomes a banking entity and set forth the procedures for a banking entity to seek extensions of the divestiture period.

The Act acknowledges that some banking entities may have capital commitments to existing funds and expressly allows the Federal Reserve Board to extend for up to five years the period in which a banking entity may take or retain an ownership interest in or provide additional capital to an "illiquid fund" (which is defined as any fund that as of May 1, 2010, was invested or committed to invest principally in illiquid assets such as portfolio companies, real estate investments and venture capital investments) to the

extent necessary to fulfill a contractual obligation in effect on May 1, 2010. In each case the extensions will be subject to the banking entity's complying with additional capital requirements and other conditions. The Board's final rules also address the divestiture period for illiquid funds and clarify that any extensions may not exceed five years beyond the compliance period described in the prior paragraph.

Impact

The private equity industry is already planning for compliance with the Volcker Rule. Several banking entities are active limited partners in all variety of funds, in some cases building large portfolios of fund interests. Each of those investors will want to assess whether to sell some investments or whether its portfolio will fall under the 3 percent exemption prior to the compliance dates. The markets have seen an increasing volume of secondary sales, and the Volcker Rule should facilitate a continuation of that trend. Obviously, planning to dispose of a fund management business will be more involved than a sale of limited partner interests. Further, general partners of private funds will want to understand the impact of the Volcker Rule on their LP base and LP plans to transfer LP interests and/or cease investing in subsequent funds. Finally, other limited partners may see attractive secondary purchase opportunities, whether through rights of first refusal in fund documents or in marketed transactions. These transactions often require prompt action on the part of the buyer, and such LPs would be well advised to plan in advance for these purchase opportunities.

Further Information

The Hunton & Williams Private Investment Funds practice group regularly represents funds, sponsors and a variety of investors, including regulated financial institutions, in all types of private investment fund matters, including structuring, formation, offerings, secondary sales and compliance. We will continue to monitor the study and various regulations implementing the Volcker Rule and other relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on www.huntonfinancialindustryresourcecenter.com. For additional information on recent proposals relating to regulation of private investment funds and their advisers, see our prior memoranda available on our website at www.hunton.com.

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