Hunton & Williams

Private Investment Fund Update

July 2010 Analysis of the Dodd-Frank Wall Street Reform Act

Volcker Rule Will Impact Private Fund Industry

On July 15, 2010, the Senate approved the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), previously passed by the House on June 30, 2010. President Obama is scheduled to sign the Act into law on July 21, 2010. The Act includes expansive financial industry regulatory reforms, including new restrictions on the private investment fund activities of banking entities and their affiliates, known as the "Volcker Rule."[1] This analysis discusses the Volcker Rule's impact on the private investment fund industry.

The Volcker Rule

Who is covered?

The Volcker Rule 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 engaging in the prohibited activities may also be subject to certain limitations, including additional capital requirements. Since smaller banking entities generally have not focused on private investment funds as a business strategy, such smaller banking entities generally will be less affected by the Volcker Rule than larger banking entities.

What is prohibited?

The Volcker Rule imposes several restrictions on these entities: (1) banking entities are prohibited from engaging in proprietary trading; and (2) 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. Most notably, 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 terms "hedge fund" and "private equity fund" are loosely defined in a manner similar to the new "private fund" definition under the Private Fund Investment Advisers Registration Act (included in Title IV of the Act), 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, as amended.

Is any private fund sponsorship or investment permitted?

The Volcker Rule permits certain de minimis investments in hedge funds and private equity funds, defined as investments that (i) do not exceed 3 percent of the total ownership interests of the fund and (ii) do not represent in aggregate more than 3 percent of the Tier 1 capital of the banking entity. This exception also permits organizing, offering, serving as a general partner or managing member and controlling the management of the fund, provided the banking entity complies with certain conditions, including:

- the banking entity must provide bona fide trust, fiduciary or investment advisory services;
- the fund may be offered only to the banking entity's customers of such services;
- the banking entity must comply with the prohibition on covered transactions;
- the banking entity (including its subsidiaries and affiliates) sponsoring or advising the fund will be subject to Section 23B of the Federal Reserve Act (which requires arm's-length terms in transactions with affiliates) as if

1 The Volcker Rule is found in Section 619 of the Act.

it were a member bank and such fund its affiliate;

- the banking entity may not guarantee, assume or insure the obligations of the fund;
- the banking entity may not share with the fund the same name or variation of its name;
- only those employees of the banking entity who are directly engaged in providing investment advisory or other services to the fund may take or retain an ownership interest in the fund;
- the banking entity must make certain disclosures to investors regarding fund losses;
- the sponsorship or investment must not (i) involve or result in a material "conflict of interest" (yet to be defined) between the banking entity and its clients, customers or counterparties; (ii) result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (yet to be defined); or (iii) pose a threat to the safety and soundness of such banking entity or a threat to the financial stability of the United States; and
- the banking entity must comply with additional capital requirements and quantitative limitations, including diversification requirements, that may be adopted by federal banking regulators, the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC").

While this 3 percent exemption may initially appear helpful to the industry, it raises a number of questions. For example, what happens 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? Presumably, these and other important questions will be addressed in the rulemaking process as mandated by the rule.

What is the prohibition on covered transactions?

Compliance with the new prohibition on a banking entity that serves as the investment adviser or sponsor to a hedge fund or private equity fund entering into a "covered transaction" with the fund may be challenging. As a practical matter, "covered transactions" include a number of related party transactions between the fund and affiliated banking entities involving leverage. The Federal Reserve Board may permit an exception for a banking entity to engage in prime brokerage transactions with any hedge fund or private equity 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 determined that the transaction is consistent with safe and sound operation and condition of the banking entity.

What is the timing of implementation?

While the impacts on certain regulated financial institutions may be severe, Congress has allowed substantial time for delayed implementation. The Act requires the new Financial Stability Oversight Council to conduct a study of the Volcker Rule, to be completed within six months of the enactment of the Act. Within nine months of the completion of this study, the appropriate federal banking agencies, the SEC and the CFTC must jointly issue final regulations implementing the Volcker Rule. The Volcker Rule is effective on the earlier of (i) 12 months after the date of issuance of final rules or (ii) two years after the date of enactment, which would be July 2012. The Volcker Rule contemplates a two-year divestiture period for prohibited businesses and investments, which period may be extended one year at a time for not more than an aggregate of three years, provided the divesting party is using good faith to expedite its disposition.

The Act acknowledges that some banking entities may have commitments to continue fund investments at increased ownership levels. Thus it has expressly allowed 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.

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 their portfolios will fall under the de minimis exemption prior to the compliance dates. They should also examine the underlying fund documents for transfer requirements. The markets have seen an increasing volume of secondary sales in 2009 and 2010, and the Volcker Rule should facilitate a continuation of that trend. Other banking entities have become active in the sponsorship of private funds. Each of those entities should undertake a similar assessment. 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 Fund 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 huntonfinancialindustryrecovery.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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