

## Proposed Volcker Rule and the Effect on Private Fund Sponsors and Investors

The federal banking agencies and the SEC recently proposed regulations to implement Section 13 of the Bank Holding Company Act, also known as the Volcker Rule, adopted as part of the Dodd-Frank Act. The Volcker Rule prohibits proprietary trading and private fund investments and sponsorship by banking entities, subject to certain exceptions. This Alert addresses the restrictions on investments into private funds and the effect they will have on private fund sponsors, highlights certain issues and potential structuring opportunities that are applicable to private fund sponsors, and identifies some issues that require further clarification. This Alert does not discuss the proposed regulations that seek to implement the Volcker Rule's prohibitions on proprietary trading by banking entities.

### General Prohibitions on Private Equity and Hedge Fund Investments or Sponsorship

Subject to certain exceptions discussed below, the Volcker Rule will prohibit a “banking entity”<sup>1</sup> from acquiring or retaining any equity, partnership or other ownership interest in, or otherwise sponsoring or investing in any private fund, which would include most hedge funds or private equity funds, after the Volcker Rule's effective date.<sup>2</sup> The Volcker Rule will have an impact on most private fund investments made and interests held in these funds by banking entities.

### Exceptions

The Volcker Rule will permit banking entities to establish and invest in private funds in certain limited circumstances, unless such investments would (i) involve or create a material conflict of interest between the banking entity and its customers, clients or counterparties, (ii) create a material exposure by the banking entity to high risk assets or strategies, or (iii) pose a threat to the safety and soundness of the financial stability of the United States (all as defined and explained further under the proposed regulations). The most notable exceptions are described below.

#### *De Minimis Exception for Investments in Bank-Sponsored Funds*

Banking entities will be permitted to make certain *de minimis* investments into private funds that the banking entity or its affiliate sponsors. A banking entity is permitted to invest in such a sponsored private fund provided its investment does not exceed 3% of the total outstanding ownership interests of such fund. Under the proposal, typical carried interests would not be an ownership interest.

A banking entity may also exceed the cap on investments in a sponsored private fund to organize such private fund and to provide such private fund with enough equity to attract unaffiliated investors. In the event a banking entity makes a seed investment in excess of the 3% limit, it must actively seek unaffiliated investors for the fund and it must reduce its ownership in the fund to no more than 3% within one year of

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<sup>1</sup> For purposes of the Volcker Rule, “banking entities” include any depository institution insured by the FDIC, as well as any of the institution's parents, affiliates and subsidiaries. This generally includes (i) FDIC-insured national or state banks, (ii) FDIC-insured savings associations, credit card banks and industrial loan companies, (iii) bank-holding companies (“BHCs”), (iv) savings and loan companies and (v) foreign banking institutions regulated as BHCs.

<sup>2</sup> Under the Volcker Rule, a “private fund” is any entity that would be classified as an investment company under the Investment Company Act of 1940, **but for** the exceptions found in Sections 3(c)(1) and 3(c)(7) of that statute, and other “similar funds.”

the fund's establishment. The 3% "*de minimis*" threshold is measured by either capital contributions to or ownership interests in a private fund (aggregating joint-activities and parallel investments).

Investments in all sponsored private funds are subject to a second, overall cap on investments, generally equal to no more than 3% of tier 1 capital.

#### *Foreign Fund Exception*

By taking advantage of a "*Foreign Fund Exception*," foreign banking entities may be able to sponsor private funds outside the United States and make investments in private funds organized outside of the United States. The "*Foreign Fund Exception*" requires non-U.S. banking entities to satisfy four conditions. First, the interests in any such private fund must not be offered for sale in the U.S. or sold to a U.S. resident. Second, the banking entity's activity must be conducted pursuant to paragraph (9) or (13) of Section 4(c) of the Bank Holding Company Act.<sup>3</sup> Third, the activity must occur solely outside of the United States. Fourth, the banking entity must not be directly or indirectly controlled by a banking entity organized under the laws of the United States. Whether or not activity is conducted outside the United States is somewhat nuanced under the proposed regulation. For example, the Volcker Rule does not prohibit administrative or back-office support in the United States from being utilized in foreign transactions, provided such support does not include a client relationship.

#### *Sponsored Fund Exception*

The proposed regulation fleshes out the "*Sponsored Fund Exception*." Banking entities will be permitted to organize a private fund, with no more than a *de minimis* investment, and offer it only to the banking entity's clients who use its investment services. In order to comply with this exception, the banking entity must (among other things) provide *bona fide* fiduciary, trust or advisory services to the fund, comply with certain state regulations and limitations, comply with certain naming restrictions, ensure it has no other interest in the fund, ensure it does not guarantee or insure the performance of the fund, have no director or employee invest in the fund, and make certain disclosures to any prospective or actual investors in the fund. Where a banking entity has a fiduciary duty to a client, this exception would appear to permit certain separate account advisory arrangements. With the right arrangements in place, feeder funds and funds-of-funds would seem to have a home under this exception. Because of the cap on the sponsor's investment, it may be more difficult for a banking entity to establish an actively managed private fund.

#### *Other Exceptions to the Volcker Rule*

While likely to be of little relevance to managers of most private funds, in addition to the exceptions set forth above, the Volcker Rule will permit a banking entity to make certain other investments into entities that may fall within the definition of "private funds," including:

- Investments made in one or more small business investment companies (SBICs);
- Investments in a separate account used solely to purchase a life insurance policy for which the banking entity is the beneficiary (for instance, for a key employee);

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<sup>3</sup> An activity is conducted pursuant to paragraph (9) or (13) or section 4(c) of the Bank Holding Company Act only if (i) with respect to a banking entity that is a foreign banking organization, such banking entity is a qualifying banking organization and is conducting the activity in compliance with subpart B of the Federal Reserve Board's Regulations K, and (ii) with respect to a banking entity that is not a foreign banking organization, the banking entity meets specified conditions relating to the amount of assets, revenues or net income requirements that are derived from business outside of the United States.

- Investments in a joint venture operating company or an acquisition vehicle (the sole purpose to, and the effect of which is to effectuate a merger or acquisition of an entity with or into the banking entity);
- Investments into a wholly-owned subsidiary of such banking entity that performs liquidity management services, where such services are carried out on the books of the banking entity making the investment;
- Investments in a private fund acquired in the ordinary course of collecting a debt previously contracted in good faith, so long as the banking entity divests the ownership interest within applicable time periods; and
- Investments made into a fund that relate to the banking entity's obligations or liabilities resulting from acting as an intermediary for non-banking entity clients, or in connection with compensation for an employee who directly manages or advises the fund, where such investment is designed to mitigate those specific risks.

### Limitations On Relationships between Banking Entities and Private Funds

The proposed regulation does not relax the Volcker Rule's tough prohibition on most transactions between a banking entity (and its affiliates) that advises, sponsors or organizes and offers a private fund and such private fund.

### Considerations for Sponsors of Private Funds

While the exceptions listed above provide for some ability and flexibility by banking entities to invest in their own private funds, the proposed Volcker Rule regulations confirm that the rule will have a profound impact on the ability of banking entities to make direct private direct equity and hedge fund investments.

- In order to qualify for the "*Foreign Fund Exception*" and accept investments from eligible non-U.S. banking entities, a private fund must not offer or sell its interests to U.S. residents. Therefore, it should be possible for a non-U.S. banking entity to invest in a fund that is organized by a third party, so long as the fund interests are offered and sold only outside of the United States. Private fund sponsors may want to consider establishing separate offshore fund entities into which eligible non-U.S. banking entities can invest. The proposed rules do not appear to geographically restrict the activities of such a foreign fund.
- With the effective date of the Volcker Rule approaching in 2012, private fund sponsors and banking entities should take care to review the conformance issues associated with vintage private fund investments, as well as more recent investments and commitments made since the passage of the Dodd-Frank Act. For more information on the conformance period related to the Volcker Rule, please refer to our client alert on the conformance period, which may be found [here](#).
- For feeder funds and funds-of-funds organized by banking entities after the effective date, the proposed regulations restrict transactions between the banking entity and such sponsored funds, they do not expressly prohibit transactions between a banking entity and the investors in such funds.

## Unanswered Questions

The Volcker Rule will have far reaching effects and will continue to spawn difficult interpretive issues. Issues associated with private fund investment in the proposed regulations include:

- *Foreign Fund Exception.* As noted above it should be possible for a non-U.S. banking entity to invest in a fund that is organized by a third party so long as the fund interests are offered and sold only outside of the United States. It is unclear, however, to what extent the “*Foreign Fund Exception*” would be available to a parallel fund (or managed account) for non-U.S. investors that is run in tandem with a private fund sold to U.S. persons.
- *Proprietary Trading and Insurance Company Private Fund Investments.* Under the Volcker Rule’s proprietary trading prohibition, an exception exists (subject to certain prudential limitations) for trading in the general account by insurance companies that are banking entities. However, this exception is not expressly available for general account investments in private funds. The final regulations could clarify that the exception to the proprietary trading prohibition also permits investments in private equity funds and hedge funds.

## Effective Date of the Volcker Rule

Federal regulators are soliciting comments to the Volcker Rule by January 13, 2012, and it is contemplated that the final regulations will be implemented prior to July 21, 2012. Beginning on the effective date, any banking entity engaged in private fund activity under the Volcker Rule must comply with certain internal controls, reporting, and record keeping requirements. For more information on the period during which private funds and banking entities will have to conform to the Volcker Rule following the effective date, please refer to our client alert on the conformance period, which may be found [here](#).

There is little reason to expect any major movements in the private investment fund language in the final regulations. The proposed regulations’ interpretations of the private fund provisions of the Volcker Rule have not deviated significantly from commentators’ prior interpretations of the statutory language. The Volcker Rule and the proposed regulations remain highly controversial.

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For additional information and guidance, a draft of the proposed Volcker Rule may be found at <http://fdic.gov/news/board/2011Octno6.pdf>.

If you have any additional questions about the Volcker Rule, please contact your Ropes & Gray attorney.