

February 11, 2010

President Obama Calls for Prohibitions on Banks Sponsoring or Investing in Hedge Funds and Private Equity Funds

On January 21, 2010, President Obama called for new restrictions that would limit the size and scope of banks and other financial institutions, including the following restriction on private funds: "Banks will no longer be allowed to own, invest [in], or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers." President Obama named these restrictions the "Volcker Rule," after Paul Volcker, former Federal Reserve chairman and current chairman of the President's Economic Recovery Advisory Board.

This Alert refers to "proposed restrictions," but note that the restrictions have not yet been incorporated into any proposed bill. The Alert is based on the remarks of President Obama and various members of his administration. President Obama suggested that the proposed restrictions be added to the "comprehensive financial reform package that is already moving through Congress." This Alert examines the potential reach of the proposed restrictions as they relate to private funds. It is too early, however, to predict the exact scope of the restrictions, or the likelihood that any restrictions will be adopted.

Affected Institutions. President Obama said the proposed restrictions would apply to banks, thrifts, and bank holding companies, as well as to financial institutions that contain banks that use federal deposit insurance and the Federal Reserve's discount window.¹ At a February 2nd Congressional hearing, Deputy Treasury Secretary Neal S. Wolin said that the proposals would apply to any company, foreign or domestic, that owned a bank with federally insured deposits. Accordingly, it would seem that the restrictions would apply to foreign entities with U.S. bank subsidiaries, though the extent of U.S. jurisdiction over the activities of foreign parents of U.S. banks is unclear. As currently stated, the proposed restrictions would seem to apply to all subsidiaries of a U.S. bank, including foreign subsidiaries, though it is unclear whether there will be any carve-out for affiliated entities that are separately capitalized and that do not use federal deposit insurance or the Fed's discount window. The proposed restrictions appear to apply to all covered financial institutions regardless of their size.

Scope of the Terms "Sponsor" and "Invest." The proposed restrictions would prevent a bank or financial institution that contains a bank from "sponsoring" or "investing" in a hedge fund or private equity fund but do not define the term "sponsor." It is unclear if President Obama's use of the term "sponsor" only extends to acting as the general partner or managing member of a fund, or instead more broadly includes acting as the investment manager or investment advisor of a fund. Larry Summers, the head of the National Economic Council, stated that the proposal would limit a bank's ability to "operate" a private

¹ The Bank Holding Company Act currently places certain percentage restrictions on bank holding companies' ownership of private funds.

fund, but offered no definition of the term "operate." Theoretically, the scope of the term "investing in" private funds could be read to include a ban on banks offering margin lending to hedge funds, or otherwise lending to private equity funds, but as a practical matter it seems very unlikely that the proposed restrictions would extend that far.

Definition of "Hedge Fund" and "Private Equity Fund." During his testimony at the Congressional hearing, Volcker said that the definitions of hedge funds and private equity funds need to be "carefully specified" but also "broad enough to encompass efforts sure to come to circumvent the intent of the law." Based on other Congressional bills, it is likely that Congress will leave it to the SEC to define the terms. It is unclear whether similar funds, such as venture capital funds and real estate funds, would also be included.

Purpose of the Restrictions. President Obama stated that the purpose of the proposed restrictions is to "rein in excessive risk taking and to protect taxpayers." Owning and sponsoring private funds is apparently being grouped with bank proprietary trading generally, which Volcker has defined as "placing bank capital at risk in the search of speculative profit rather than in response to customer needs." In his Congressional testimony, Volcker explained that proprietary trading creates inherent conflicts of interest because the bank will almost inevitably act at cross purposes to the interests of unrelated commercial customers. If the purpose of the proposed restrictions is to prevent excessive risk taking by banks, then it would seem that a ban should not extend to a bank that solely serves as an advisor to a private fund, where the bank does not otherwise invest its own capital in the fund, as the bank in that situation is not putting any of its capital at risk. It is unclear, however, whether the restrictions, if adopted, will be consistent with their stated purpose.

Timing of Adoption. Representative Barney Frank, Chairman of the House Committee on Financial Services, has said that the new proposals could be incorporated into Congressional legislation and be passed within months, well before November's mid-term elections. The House passed a financial regulatory reform bill in December 2009, and the Senate Banking Committee has been working on its own version of a reform bill. Senator Christopher Dodd, chairman of the Senate Banking Committee, said the Volcker Rule has "great merit," but expressed concern that the President's proposal might be too ambitious because it runs the risk of derailing months of delicate negotiations that have already taken place (though Senator Dodd subsequently suggested that negotiations had reached an impasse and the Democrats in the Senate would forge ahead on their own financial regulatory reform bill).

Timing of Implementation. President Obama did not address the timing of implementation of the proposed restrictions, if a bill is adopted. Representative Frank stated that he supports a transition period of at least three years to prevent the fire sale of assets. Any final bill might either grandfather or include a period of several years to allow financial institutions to divest themselves of fund investments and sponsorships.

Our client alerts are for general informational purposes and should not be regarded as legal advice. The author of this Alert is Adam D. Gale, with the assistance of James Berger. If you would like additional information or have any questions, please contact Adam Gale or any of the following:

Adam D. Gale
+1 (212) 408-5196
agale@chadbourne.com

Charez X. Golvala
+44 (0) 20-7337-8020
cgolvala@chadbourne.com

William Greason
+1 (212) 408-5527
wgreason@chadbourne.com

Morton E. Grosz
+1 (212) 408-5592
mgrosz@chadbourne.com

Thomas J. Hall
+1 (212) 408-5487
thall@chadbourne.com

Peter K. Ingerman
+1 (212) 408-5422
pingerman@chadbourne.com

Jonathan M.A. Melmed
+1 (212) 408-1002
jmelmed@chadbourne.com

J. Allen Miller
+1 (212) 408-5454
amiller@chadbourne.com

Scott W. Naidech
+1 (212) 408-5440
snaidech@chadbourne.com

Talbert I. Navia
+1 (212) 408-5316
tnavia@chadbourne.com

Ayse Yüksel
+44 (0) 20-7337-8060
ayuksel@chadbourne.com