CHADBOURNE & PARKE LLP
ClientAlert

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Summary and Analysis of the Volcker Rule in the Dodd-Frank Act - Prohibiting Bank Proprietary Trading and Investing in Hedge Funds, Private Equity Funds and Other Private Funds - It Affects More Than Just Funds

Summary

Prohibited Activities. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted on July 21, 2010, includes a section (§ 619), the "Volcker Rule," that prohibits any banking entity, including affiliates of banks, from:

- (i) sponsoring, or investing in, a hedge fund, private equity fund, and potentially numerous other types of privately offered funds and pooled investment vehicles, including venture capital funds, real estate funds, structured finance vehicles and some types of special purpose vehicles used in project finance transactions,

  except for funds that are organized or offered by the banking entity, subject to:

  - (a) the banking entity owning no more than 3% of the fund;
  - (b) an overall limit of 3% of the banking entity's Tier 1 capital invested in private funds; and
  - (c) other limitations, including as to the name of the fund, and affiliated transactions.

  In addition, the banking entity may make seed investments in a fund, including owning 100% of a fund, for up to one-year; or

- (ii) engaging in "proprietary trading," defined mainly as engaging in short-term trading, subject to a number of exceptions that allow a banking entity significant leeway to engage in some short-term trading, including trading:

  - in U.S. government, state and municipal obligations;
  - in connection with underwriting or market-making related activities;
  - in connection with certain risk-mitigating hedging activities; and
  - of any security or instrument on behalf of customers.

Other Restrictions. Any banking entity that sponsors a private fund, any banking entity that acts solely as an investment adviser to a private fund (even if it does not otherwise sponsor the fund), and any affiliate may not enter into a transaction with such fund that would be a "covered transaction" as defined under Federal Reserve Act Section 23A, and is also subject to Section 23B, except that the Federal Reserve may allow prime brokerage transactions if certain requirements are met.

Effective Date. Banking entities must be in compliance by the end of the Volcker Rule's effective date and transition period.

- The ultimate compliance date is at least 3 years, though more likely to be 4 years, from the bill's enactment date of July 21, 2010; there is the possibility that the Board of Governors of the Federal Reserve will issue up to three 1-year extensions.
- In addition, a banking entity can apply for an additional 5-year extension (in addition to the 3 or 4 year period referenced above) if the banking entity is in a fund that meets the definition of an "illiquid fund," and the banking entity is "contractually obligated " to the fund as of May 1, 2010.

Implementing Rules. A number of significant Volcker Rule provisions are subject to further rulemaking by various regulators, including the Board of Governors of the Federal Reserve (the "Federal Reserve"), other Federal banking agencies, the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"). The rules will determine the breadth of the prohibitions.

I. Affected Institutions

- Both of the Volcker Rule prohibitions affect a "banking entity," which is defined as:
  - any insured depository institution (as defined in §3 of the Federal Deposit Insurance Act);
  - any company that controls an insured depository institution;
  - any company that is treated as a bank holding company for purposes of § 8 of the International Banking Act of 1978;
  - any affiliate of the above ("affiliate" is not defined); and
  - any subsidiary of the above.
- Affiliates or subsidiaries of banks that are asset managers or other investment advisers are included.
- The definition of a "banking entity" excludes an institution that functions solely in a trust or fiduciary capacity and meets a number of other requirements, including one that all or substantially all of the deposits of the institution are in trust funds and received in a bona fide fiduciary capacity.

II. Prohibition on Sponsoring and Investing in Private Funds

A banking entity is prohibited from acquiring or retaining any equity, partnership or other ownership interest in or "sponsoring" a "hedge fund" or "private equity fund" (defined to include all types of private funds), subject to the 3% and one-year seed investment exceptions, and other exceptions.

Definition of "Hedge Fund" and "Private Equity Fund".

- "Hedge fund" and "private equity fund" are both defined as an issuer that would be an investment company as defined in the Investment Company Act of 1940 (the " '40 Act"), but for section 3(c)(1) or 3(c)(7) of the 40 Act, or "such similar funds" as the appropriate regulator may, by rule, determine.
- By way of background, almost all hedge funds and traditional private equity funds rely on the '40 Act exemptions from registration under sections 3(c)(1) (100-investor limit) or 3(c)(7) (all investors must be "qualified purchasers").
- Many other types of privately offered funds and entities also rely on these exemptions, including the following:

- most **venture capital funds** (note that there is no exemption in the Volcker Rule for VC funds, and another provision of the Volcker Rule specifically contemplates that "venture capital investments" are covered by the Rule);
- many **real estate funds** (note that there is no exemption in the Volcker Rule for RE funds, and another provision of the Volcker Rule specifically contemplates that "real estate investments" are covered by the Rule);
- some types of special purpose vehicles used in **project finance transactions**; and
- some **structured finance vehicles** (such as CLOs and CDOs).

- Unless the regulators issue rules that are able to restrict the definition, a number of entities that are not traditionally viewed as hedge funds or private equity funds will be included.
- If the regulators use a broad definition of "such similar funds," even more types of entities could be included, such as any pooled investment vehicle, even one that does not rely on sections 3(c)(1) or 3(c)(7).
- Certain remarks by various members of Congress suggest that the definition should be narrow, but it is unknown what position the regulators will take.

Definition of "Sponsoring" a Fund.

- "Sponsoring" a fund is defined as:
  - serving as a general partner, managing member or trustee of a fund;
  - in any manner selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a fund; or
  - sharing with a fund, for corporate, marketing, promotional or other purposes, the same name or a variant of the same name.
- Solely acting as an investment adviser to a fund, but not otherwise investing in the fund or acting in any other capacity (such as acting as a GP), is allowed as long as the adviser and the fund do not share the same name or a variant of the same name. Merely advising a fund, however, subjects the adviser (if it is a "banking entity") and its affiliates to the Federal Reserve Act Section 23A and 23B restrictions on transactions with the fund (as described below in Section IV).

3% Limitations.

Subject to the further limitations listed below, a banking entity may organize or offer a fund if it invests:

- not more than 3% of the total ownership interests in any single hedge fund or private equity fund; and
- an aggregate amount, in all hedge funds and private equity funds, not exceeding 3% of the banking entity's Tier 1 capital (*i.e.*, the bank's regulatory capital).

Note that the aggregate amount must be "immaterial" (as such term is defined by the regulators) to the banking entity, so it is possible for the regulators to decide upon a lower threshold than 3%.

Seed Investments Permitted for One Year.

Subject to the further limitations listed below, a banking entity may provide a fund with 100% of its initial equity "to permit the fund to attract unaffiliated investors," provided that:

- within one year of the fund's establishment, the banking entity must reduce its ownership to no more than 3% of the total ownership interests in the fund through redemption, sale or dilution; and
- the 1-year limit may be extended for 2 additional years, upon approval by the Federal Reserve of a banking entity's application if the Federal Reserve finds that an extension "would be consistent with safety and soundness and in the public interest."
- (It is unclear under what circumstances an application would be granted; presumably, the banking entity would need to show that it acted in good faith to reduce its holdings to the 3% limit, but have been unable to do so due to factors outside its control.)
- The banking entity must "actively seek" to get its seed investment down to the 3% limit.
- A seed investment must still be "immaterial," as defined by the regulators, to the banking entity.

Other Requirements for Investments in Private Funds.

In order to use the 3% limit and the seed investment exceptions, the banking entity must:

- provide *bona fide* trust, fiduciary or investment advisory services;
- organize and offer the fund only in connection with the provision of such services, and only to persons who are customers of such services of the banking entity (note that it is possible that the regulators will issue rules that define "customer" more expansively to include investors who are not traditionally viewed as customers of the banking entity);
- with its affiliates, comply with the Federal Reserve Act Section 23A and 23B restrictions on transactions with such funds, as described below in Section IV;
- not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the fund or of any fund in which such fund invests;
- not share with the fund, for corporate, marketing, promotional or other purposes, the same name or a variant of the same name;
- prohibit any director or employee of the banking entity from taking or retaining an equity interest, partnership interest or other ownership interest in the fund, *except* for any director or employee who is "directly engaged in providing investment advisory or other services" to the fund;
- disclose, in writing, to prospective and actual investors in the fund that any losses in such fund are borne solely by investors in the fund and not by the banking entity; and
- otherwise comply with any additional rules that the regulators may issue that are designed to ensure that losses are borne solely by the investors.

Further Limitations on "Permitted Activities."

In addition, in order to invest in a private fund or engage in any other "permitted activity" under the Volcker Rule, no transaction, class of transactions or activity may:

- involve or result in a "material" conflict of interest (as will be defined by rule) between the banking entity and its clients, customers, or counterparties;
- result, directly or indirectly, in a "material" exposure to high risk assets or high risk trading strategies (as will be defined by rule);
- pose a threat to the safety and soundness of such banking entity; or
- pose a threat to U.S. financial stability.

The regulators will issue rules implementing these limitations.

Exception for Investments in Certain Non-U.S. Funds.

A banking entity may invest in or sponsor a private fund pursuant to Sections 4(c)(9) or (13) of the Bank Holding Company Act if:

- the acquisition or sponsorship of the fund is "solely outside of the U.S." (which is not defined);
- no ownership interest is offered for sale to, or sold to, a U.S. resident; and
- the banking entity is not directly or indirectly controlled by a banking entity organized in the U.S.

Other Permitted Activities by Rulemaking.

The regulators may, by rule, determine other activities to be permitted if the activities "promote and protect" the safety and soundness of the banking entity and U.S. financial stability.

- (At least in the near future, it seems less likely that the regulators will determine any other activities may be permitted, though it is possible that the regulators will show some flexibility to exclude activities covered by the Volcker Rule that were not intended to have been covered.)

III. Effective Date and Transition Period

The following description applies to all of the Volcker Rule provisions, including the prohibition on sponsoring funds as well as the prohibition on proprietary trading.

Effective Date.

Banking entities must be in compliance by the end of the Volcker Rule's effective date and transition period.

- The Volcker Rule prohibitions do not become effective until the *earlier of*:
  - 12 months after the issuance of final rules implementing the Volcker Rule (which rules must be issued no later than 15 months after enactment of the Volcker Rule); and
  - 2 years after the date of enactment of the Volcker Rule.

- The earliest date upon which the prohibitions could become effective is just over one year after enactment, but that would require that a study be conducted and rules be written immediately, which is extremely unlikely.
- The latest (and more likely) effective date is 2 years from enactment.

Transition Period.

Banking entities have a further period of two years from the effective date to bring their investments and activities in compliance with the Volcker Rule.

- Thus, banking entities will have a total of at least 3 years, though more likely 4 years, to be in compliance (subject to the further extensions set forth below).
- The Federal Reserve has the power to extend the 2-year transition period for up to 3 1-year additional periods if the Board of Governors determines any such extension is "consistent with the purposes of this section" and "not detrimental to the public interest."
- These extensions would apply to all banking entities automatically. As the deadline approaches, if a number of banking entities are unable to comply, then the Board presumably might grant an extension. However, it seems doubtful that many banks would take that risk.

Extended Transition Period for "Illiquid Funds."

The Federal Reserve may, upon application by any banking entity, extend the transition period for that particular banking entity:

- for up to a maximum of 5 years (which is in addition to the 2-year transition period); and
- "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010" to take or retain any equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an "illiquid fund."
- An "illiquid fund" is defined as a hedge fund or private equity fund that:
  - as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in "illiquid assets," such as "portfolio companies, real estate investments and venture capital investments"; and
  - makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.
  - (The Federal Reserve has the power to issue further rules regarding the definition.)
- This extended transition period was presumably designed for traditional private equity funds (which invest in portfolio companies), as well as real estate funds and venture capital funds.
- If an application for a 5-year extension is granted, the banking entity would have a total of at least 8 years (though more likely 9 years or even longer if the 2-year transition period is extended) before the banking entity would have to divest itself of its interest in the illiquid fund.

- Very few hedge funds would fit within the definition of an "illiquid fund," given the investment strategy of most hedge funds is to principally invest in liquid, rather than illiquid, assets.

IV. Prohibition on Proprietary Trading

The Volcker Rule also prohibits any "banking entity" (as defined above) from engaging in "proprietary trading" (further defined by reference to a "trading account"), but the prohibition is subject to numerous "permitted activities."

Definition of "Proprietary Trading."

"Proprietary trading" is defined as:

- engaging as a principal
- for the "trading account" (defined below)
- of a banking entity or systemically important nonbank financial company
- in any transaction to purchase or sell, or otherwise acquire or dispose of,
- any security, derivative, contract of sale of a commodity for future delivery, option on any such security, derivative, or contract, or other security or financial instrument that the regulators may, by rule, determine.

Definition of Trading Account.

"Trading account" is defined as:

- any account used for acquiring or taking positions in securities or other instruments
- principally for the purpose of selling in the near term
- (or otherwise with the intent to resell in order to profit from short-term price movements),
- and any other accounts as the regulators may, by rule, determine.

Prohibition Mainly Covers Short-Term Trading.

Despite the broad prohibition on "proprietary trading," the actual definition of the term in the Volcker Rule narrows the prohibition to proprietary short-term trading. Under the definition, an account is not covered by the prohibition if it is "principally" for a purpose other than selling in the near term, or if there is no intent to profit from short-term price movements.

Permitted Activities.

Subject to the same "Further Limitations on Permitted Activities" as described above in Section II (which include the absence of any material conflict of interest), and any additional restrictions or limitations that the regulators may impose, the following types of transactions are excluded from the ban on proprietary trading:

- Purchases, sales, acquisitions or dispositions of the following instruments:
    - U.S. government or agency obligations;
    - obligations, participations or other instruments of or issued by Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; or

  - state or municipal obligations.
- Purchases, sales, acquisitions or dispositions of any security or other instrument "in connection with underwriting or market-making-related activities" to the extent that any such activities "are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties."
- Risk-mitigating hedging activities "in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings."
- Purchases, sales, acquisitions or dispositions of any security or other instrument "on behalf of customers."
- Investments in small business investment companies and certain "public welfare" investments.
- Purchases, sales, acquisitions or dispositions of any security or other instrument by a regulated insurance company directly engaged in the business of insurance for the general account of the company, or by its affiliates (also for the general account of the company), if:
  - conducted in compliance with insurance company investment laws, regulations and guidance of the jurisdiction in which such insurance company is domiciled; and
  - the appropriate Federal banking agencies, after consulting with the new systemic risk council of regulators and relevant state insurance commissioners, have not jointly determined that a particular law, regulation or item of guidance is insufficient to protect the safety and soundness of the banking entity (*e.g.*, the parent of the insurance company) or of U.S. financial stability.
- Proprietary trading conducted by a banking entity solely outside of the U.S. pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act, unless the banking entity is directly or indirectly controlled by a banking entity organized in the U.S.
- Such other activity as the regulators determine, by rule, would "promote and protect" the safety and soundness of the banking entity and U.S. financial stability.

Brief Analysis of Permitted Activities.

Despite the definition of "proprietary trading" that prohibits short-term trading, a number of the permitted activities allow a banking entity to engage in significant short-term trading.

- Trading in U.S. government, state and municipal obligations is completely excluded, allowing both short-term and long-term trading of those instruments.
- Risk-mitigating hedging activities are not defined, thereby making it possible for a banking entity to interpret the parameters of hedging activities broadly, unless the regulators implement rules that further restrict and define such activities.
- Trading in connection with underwriting and market-making activities could also be used as a basis for more expansive short-term trading.

V. Additional Limitations in the Volcker Rule

Fund Advisers and Sponsors Subject to Section 23A Covered Transactions Prohibition.

In addition to the prohibitions described above, the Volcker Rule prohibits any banking entity that serves, directly or indirectly,

- as the investment manager or investment adviser of a fund (even if it does not otherwise invest in a fund), or
- as the sponsor of a fund, or that organizes and offers a fund as a permitted activity,
- and any affiliate of such banking entity,
- from entering into a covered transaction as defined by Section 23A of the Federal Reserve Act
- with any such fund, or any hedge fund or private equity fund controlled by such fund,
- as if the banking entity and its affiliate were a member bank and the fund were the affiliate.

Under Section 23A, covered transactions include:

- a loan or extension of credit to the fund;
- a purchase of or an investment in securities issued by the fund;
- a purchase of assets, including assets subject to repurchase, from the fund;
- the acceptance of securities issued by the fund as collateral for a loan or extension of credit to any third party; and
- a guarantee, acceptance or letter of credit on behalf of the fund.

Compliance with Section 23B.

In addition, any banking entity that serves, directly or indirectly,

- as the investment manager or investment adviser of a fund (even if it does not otherwise invest in a fund), or
- as the sponsor of a fund, or that organizes and offers a fund as a permitted activity,
- is subject to Section 23B of the Federal Reserve Act,
- as if the banking entity were a member bank and the fund were its affiliate.

Exception for Prime Brokerage Transactions with Funds.

A banking entity may ask the Federal Reserve for an exemption from the 23A covered transactions prohibition, so that a banking entity or systemically important nonbank financial company may be permitted to enter into "prime brokerage transactions" (which term is not defined) with any hedge fund or private equity fund that it manages, sponsors or advises or in which it has taken an equity, partnership or other ownership interest, if:

- the banking entity or systemically important nonbank financial company is in compliance with each of the conditions set forth in the permitted activity exception for sponsoring or making seed or 3% investments in hedge funds or private equity funds described above;
- the CEO (or equivalent officer) annually certifies in writing that the condition that the banking entity will not guarantee or assume the obligations of the fund is satisfied; and

- o the Federal Reserve has determined that such transaction is consistent with the safe and sound operation and condition of the banking entity or systemically important nonbank financial company.

Additional Capital and Other Quantitative Limits on Permitted Activities.

If the regulators determine that additional capital requirements or quantitative limits, including diversification requirements, would be appropriate to protect the safety and soundness of any banking entities engaged in permitted proprietary trading or sponsoring or investing in funds, the regulators are required to impose such additional capital requirements and quantitative limits.

- o For purposes of determining compliance with any of these additional capital requirements, the aggregate amount of outstanding investments by a banking entity under the exception for seed or the 3% investments must be deducted from assets and tangible equity of the banking entity, and the amount of the deduction must increase commensurate to the leverage of the fund in which the investment is made.

Systemically Important Nonbank Financial Companies.

- Although systemically important nonbank financial companies are not subject to the prohibitions on proprietary trading or sponsoring or investing in hedge funds or private equity funds, the Federal Reserve is required to impose additional capital requirements and other quantitative limits on such activities.
- Although systemically important nonbank financial companies are not subject to the 23A and 23B limits described above, the regulators are required to adopt rules imposing additional capital charges or other restrictions to address the same types of risks and conflicts of interest addressed by the 23A and 23B limits applicable to banking entities.

Anti-Evasion Provisions.

- The regulators must issue rules regarding internal controls and recordkeeping to ensure compliance with the Volcker Rule.
- Whenever the appropriate federal regulator has “reasonable cause” to believe that a banking entity or systemically important nonbank financial company has made an investment or engaged in an activity “in a manner that functions as an evasion” of the requirements of the Volcker Rule, whether through abuse of a permitted activity or a violation of the Volcker Rule’s restrictions, the regulator shall order termination of such activity or disposal of such investment.

VI. Rulemaking Authority and Studies

Rulemaking Authority.

The authority to establish the implementing rules depends on the entity being regulated.

- o with respect to insured banks and thrifts, the regulators are the appropriate federal banking agencies (the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS")), jointly;

- with respect to any company that controls an insured bank or thrift or is treated as a bank holding company under § 8 of the International Banking Act of 1978 or any systemically important nonbank financial company and any subsidiary of any of the foregoing (other than a subsidiary for which a different regulator is its primary financial regulatory agency), the regulator is the Federal Reserve;
- with respect to any entity for which the CFTC is the primary financial regulatory agency, the regulator is the CFTC; and
- with respect to any entity for which the SEC is the primary financial regulatory agency, the regulator is the SEC.

Coordination.

The regulators must consult with each other and coordinate their rulemaking, but rules need not be issued jointly. The Chair of the Financial Stability Oversight Council will be responsible for coordination of regulations issued under the Volcker Rule.

Studies and Rulemaking.

- The Financial Stability Oversight Council must conduct a study and issue recommendations for implementation of the Volcker Rule's provisions within 6 months of enactment.
- The regulators are required to issue rules implementing the Volcker Rule within 9 months after completion of the study.
- Within 18 months of enactment, the appropriate Federal banking agencies must jointly review and report on the activities that a banking entity may engage in under federal and state law, including activities authorized by statute, order, interpretation and guidance.
- In the report, the agencies must include recommendations regarding the potential negative effect of such activities on the safety and soundness of banking entities and the U.S. financial system, the "appropriateness" of the conduct of such activities and any additional restrictions as may be necessary to address risks to safety and soundness that arise from such activities.

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