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VOLCKER RULE

Ropes & Gray Attorneys Discuss the Impact on Private Fund Managers of Final Regulations Under the Volcker Rule

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On December 10, 2013, federal agencies issued final regulations for the so-called Volcker Rule (Rule) under the Dodd-Frank Act, which generally prohibits banks from engaging in proprietary trading and from sponsoring or owning interests in certain private funds. See "Key Legal Considerations in Connection with the Movement of Talent from Proprietary Trading Desks to Start-Up or Existing Hedge Fund Managers: The Talent Perspective (Part One of Three)," Vol. 3, No. 49 (Dec. 17, 2010). A recent webinar presented by Ropes & Gray LLP, "The Volcker Rule Final Regulation: The Impact on Private Fund Investment & Sponsorship," provided an overview of key provisions of the Rule, as supplemented by those regulations. The speakers were Ropes & Gray partners Sarah Davidoff and Mark Nuccio, and associate Richard Loewy. Nuccio and other colleagues first addressed the Rule in the HFLR when the Rule was in its proposed form. See "Proposed Volcker Rule and the Effect on Private Fund Sponsors and Investors," The Hedge Fund Law Report, Vol. 4, No. 38 (Oct. 27, 2011).

Key Definitions in the Volcker Rule

Nuccio explained that the "Rule" is actually a law adopted by Congress as Section 619 of the Dodd-Frank Act and now Section 13 of the Bank Holding Company Act. The final regulations under the Rule were issued on December 10, 2013, and full compliance with the Rule is required by July 21, 2015. The Rule prohibits banks from engaging in proprietary trading and from sponsoring or owning interests in certain private funds. The presentation was limited to the fund ownership provisions of the Rule and did not address the bar on proprietary trading. Nuccio observed that the Rule employs a "very specific vocabulary," and highlighted four key terms that form the heart of the Rule: A "*banking entity* is prohibited from *sponsoring*, acquiring or retaining an *ownership interest* in a *covered fund*." The speakers discussed each of those key terms:

Banking Entities

"Banking entities" include FDIC-regulated depository institutions and bank holding companies (BHCs); non-U.S. entities that are regulated as BHCs; and their respective *subsidiaries* and *affiliates*.

- Nuccio said "affiliate" has its customary regulatory meaning: It is a company controlling, controlled by or under common control with another company.
- In contrast, the term "subsidiary" means ownership or control of 25% of a company's voting securities or the ability to elect a majority of a company's board of directors. It also includes any other company over which a company has a "controlling" interest.

Nuccio stressed that only "banking entities" are subject to the Rule and discussed several exceptions to that definition: Most important, a covered fund that is not itself a bank, a BHC or a non-U.S. entity regulated as a BHC is not a "banking entity." This is important because covered funds include entities such as feeder funds that might make investments in other private funds. Bank ownership of a feeder fund would be prohibited by the Rule in the absence of this exception. Nuccio said there are other exceptions to the definition, less relevant to private funds, for certain portfolio companies of small business investment companies and portfolio companies held under merchant banking or insurance company investment authority.

Ownership Interests

As indicated above, banking entities are prohibited from sponsoring or owning covered funds. Nuccio explained that "ownership interest" is broadly defined: It includes any equity interest, partnership interest or "other similar interest," such as an interest in management, profits and losses, or distribution on liquidation. A key exclusion to that definition is a carried interest (retained profit interest) held by a banking entity that provides investment services to a covered fund. See "How Can Hedge Fund Managers Use Profits Interests, Capital Interests, Options and Phantom Income to Incentivize Top Portfolio Management and Other Talent?," The Hedge Fund Law Report, Vol. 6, No. 33 (Aug. 22, 2013). The regulations also exclude investments held by a banking entity that is acting only as an agent or custodian for a customer or in which the bank does not have any beneficial ownership interest.

Sponsoring

Loewy explained that the concept of "sponsoring" is focused on management control. Sponsors include general partners, limited liability company managers, commodity pool operators, persons who have the power to elect directors and others with similar functions. It does not cover custodians, administrators or investment managers or others not acting as principals.

Covered Funds

Loewy said that the term “covered fund” includes (1) any private fund that relies on one of the exemptions to registration contained in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act), (2) commodity pools and (3) certain foreign funds sponsored by U.S. entities. The definition excludes registered investment companies; companies exempt from registration under other provisions of the Investment Company Act, such as mortgage pools; foreign public funds, such as UCITS; foreign private funds (for non-U.S. banking entities); certain commodity pools that look like registered investment companies; joint ventures; acquisition vehicles; regulated development companies; small business investment companies; and certain entities in the asset-backed securities industry. He noted that there is also an exemption for “seeding” vehicles (discussed below) but expects close regulatory scrutiny of banks that rely on that exemption “to make sure they are not trying to do an end run around the Rule.”

“Sponsored Fund” Exception to the Rule

Davidoff explained that under certain conditions, a banking entity may sponsor a covered fund without running afoul of the Rule:

- The banking entity must be providing bona fide asset management services to the fund as a fiduciary, investment adviser or commodity trading adviser. The banking entity must have a written plan regarding the provision of those services.
- A fund may not have the same name as a banking entity, or a variation of that name, and may not use the word “bank” in its name. She said the goal of this requirement is to avoid the perception that a bank is “standing behind” a fund. See “Hedge Fund Names: What a Hedge Fund Manager Should Do Before It Starts Using a Name,” The Hedge Fund Law Report, Vol. 5, No. 11 (Mar. 16, 2012).
- The bank may not have more than a de minimis investment in the fund.
- It may not guarantee the performance of the fund.
- No director or employee of the bank may invest in the fund unless such person is closely involved with fund, such as by providing investment advisory services.
- The bank must advise investors that the bank is not a backstop, that it is only acting in a fiduciary or other permitted capacity, and that there is no FDIC coverage.

Nuccio added that the sponsored fund exception is available to both U.S. and non-U.S.

banking entities.

De Minimis Exception

Davidoff explained that two tests are used to determine whether an investment is de minimis: First, a bank may own up to 3% of an individual covered fund. This is considered "fund-by-fund" and excludes "on-call capital commitments." Second, the aggregate value of all of the bank's ownership interests in covered funds may not exceed 3% of the bank's tier-one capital. Ownership is tested quarterly, using fair market values when available. She added that, in a master-feeder structure, the bank must measure at the master fund level and take "a pro rata snapshot of the bank interest in the feeder." See "Hedge Fund Managers Using 'Mini-Master Funds' to Retain Favorable Tax Treatment of Performance-Based Revenue from Offshore Funds," The Hedge Fund Law Report, Vol. 2, No. 22 (Jun. 3, 2009).

Seeding Exception

Davidoff said the Rule contains an exception for banks that are seeding a covered fund and expect to reduce their investment to a de minimislevel: A bank may provide 100% of seed money at a covered fund's inception so long as the bank is actively looking for capital. The bank has one year from the "establishment" of the fund to reduce its interest below the 3% de minimis limit. She believes that the "establishment" date of a hedge fund will be the date it starts trading and, for a private equity fund, the date of its first investment. Davidoff noted that a bank may seek extensions from the Federal Reserve of up to two additional years to comply with the seeding rule. Nuccio pointed out that the regulations contain a detailed procedure for seeking an extension, which suggests that regulators are anticipating many requests for extensions. See "Ten Issues That Hedge Fund Seed Investors Should Consider When Drafting Seed Investment Agreements," The Hedge Fund Law Report, Vol. 4, No. 12 (Apr. 11, 2011).

"Super 23A"

Loewy explained that, even though banks are able to provide investment management and similar services to covered funds under the "sponsored fund" exception, a banking entity will still be subject to the Rule under certain circumstances under a provision known as "Super 23A." Super 23A prohibits a banking entity that sponsors, manages or advises a covered fund from engaging in certain "covered transactions" with the covered fund, including loans, guarantees and purchases of assets from affiliates. As an example, he said that a bank could not provide a liquidity credit line to a fund that it is otherwise permitted to sponsor. He noted that there are exceptions to Super 23A for certain prime brokerage transactions. See "Prime Brokerage Arrangements from the Hedge Fund Manager Perspective: Financing Structures; Trends in Services; Counterparty Risk; and Negotiating Agreements," The Hedge Fund Law Report, Vol. 6, No. 2 (Jan. 10, 2013).

Foreign Banks May Invest in Covered Funds

Nuccio explained that, under the following conditions, non-U.S. banking entities may invest in covered funds without violating the Rule:

- The exception is not available to a U.S. bank or any foreign affiliate. The banking entity's "center of gravity" must actually be outside of the U.S.
- The foreign banking entity's investment activity must comply with Section 4(c)(9) of the Bank Holding Company Act or pass certain tests to confirm that the entity's business is conducted outside the U.S.
- Funding for an investment in a covered fund must come from a source outside of the U.S.; it may not come from a U.S. branch or affiliate of the foreign banking entity.
- No interest in the covered fund may be sold to U.S. residents. Nuccio believes that this is the most problematic component of the exception.
- The decision-makers of the foreign banking entity that is investing in a covered fund need to be outside the U.S. He said there is "some leeway" with regard to U.S. back office personnel. The non-U.S. banking entity may not be controlled by a U.S. banking entity.

Nuccio said that this exception has created a great deal of interest among financial institutions, both with respect to existing investments that may run afoul of the Rule and with regard to proposed new investments.

Other Exceptions

Nuccio noted that registered insurance companies are not subject to the Rule. Certain employee compensation arrangements that are set up as funds, and risk-mitigating hedging activities with regard to employee compensation arrangements, are also exempt. He said these exceptions are consistent with the basic policy behind the Rule, which is to reduce risk from proprietary trading. For further discussion of exceptions to the Rule, see "Options Under the Volcker Rule for Bank Investment in Unaffiliated Private Equity and Hedge Funds," The Hedge Fund Law Report, Vol. 7, No. 9 (Mar. 7, 2014).

Implementation and Compliance

Loewy said that all banking entities are required to adopt a compliance program to assure their compliance with the Rule. The program must include internal controls and accountability, independent auditing, training and record keeping. He added that banking entities with more than $50 billion in total assets must meet additional compliance requirements, known as "Appendix B," and that the CEO of such entities must attest in writing that the program is effective.

A banking entity with more than $10 billion in assets is also subject to certain additional documentation requirements. First, it must document each determination that a fund is not a covered fund. Second, it must adopt a plan for compliance with regard to any seeding arrangements. Third, if the entity's interests in foreign public funds exceed $50 million in the aggregate, it must document the value of each such fund interest in each jurisdiction.

Treatment of "Legacy" Investments

Loewy said that banking entities are expected to achieve full compliance with the Rule by July 2015. He cautioned that legacy investments are not exempt from the Rule and noted that banks have expressed a great deal of concern about current investments that will not "ripen" by July 2015. In that regard, market participants are starting to restructure their relationships to try and achieve compliance. He noted that it is unclear what types of structures will be acceptable if a current structure is not acceptable. Regulators have made it clear that banks should not be expanding exposure to covered funds now. Loewy said that some illiquid funds might be eligible to apply to the Federal Reserve for extensions of the compliance date for up to five years. However, he said the regulations have very restrictive criteria that many entities will not be able to meet.

Nuccio expects additional guidance from the Federal Reserve for legacy investors and new fund investors. He thinks the "financial dislocation" that the Rule will cause legacy investors is unfair, especially with regard to those who invested prior to the proposal of the Rule in 2010. He thinks the Federal Reserve has shown "a history of understanding and some sensibility," and that, hopefully, it will do the same with regard to legacy investors. Nuccio thinks the hard edges of the Rule are likely to be softened, particularly with respect to non-U.S. banking entities, such as sovereign wealth funds that have interests in banks that may be caught by the Rule. See "Why and How Do Sovereign Wealth Funds Invest in Hedge Funds?," The Hedge Fund Law Report, Vol. 6, No. 13 (Mar. 28, 2013).