Volcker Rule Final Regulations: The Effect on Private Fund Sponsors and Investors

In time for the holidays, the long-awaited Volcker Rule final regulations arrived on Tuesday, December 10, 2013. Many of the comments of domestic mutual funds, foreign public funds, insurance companies and foreign banking organizations about the overreaching aspects of the proposed regulations were incorporated. The final rules clean up the proposed regulations in important and obvious ways that will simplify life for those organizations. For organizations in the crosshairs of the Volcker Rule from the outset, the final regulations are as insistent as the Dodd-Frank Act's statutory language intended. The final regulations take a different path than the proposed regulations with respect to implementing the ban on proprietary trading that allows for customized approaches, but the extended lead time provided for full compliance by July 21, 2015, will be needed. There is a monumental task ahead for banking institutions in preparing and implementing systems and compliance procedures that will be required to demonstrate that customary banking activities like market-making and hedging are not disguised efforts to engage in proprietary trading. There are also compliance burdens imposed for fund investment and sponsorship that are significant, but the nature of the regulations focused on fund investment and sponsorship appear to present fewer opportunities for mischief by design or not. The required CEO attestation for the compliance program gives additional teeth to the final regulations. The Federal Reserve Board estimates that the annual burden of Volcker Rule information collection alone for all of the organizations it supervises will be more than 2.3 million hours; and for overall compliance—there's no estimate for the time cost of that. It would be no surprise to see the final regulations subjected to judicial challenge, but the waiting is officially over and it's time to get to work.

Private Fund sponsors that have banking entities as investors should expect the release of the final regulations to spawn a heightened level of inquiry from such investors about their continuing ability to hold such investments. The final regulations do not contain much good news for investors subject to the private fund investment ban set forth in the Volcker Rule, so sponsors may want to assess the impact of the Volcker Rule on their investors if they have not already done so.

Set forth below are the highlights of the Volcker Rule final regulations that affect investment funds and their sponsorship, focusing in particular on aspects of the final regulations that differ from the proposed regulations. Previous alerts that discussed the proposed regulations and the regulations adopted concerning the continuance period can be found here and here.

General Prohibition on Investments and Sponsoring Private ("Covered") Funds

Subject to certain exceptions, the Volcker Rule prohibits a "banking entity"[1] from, as principal, "sponsoring," acquiring or retaining an "ownership interest" in or making certain transactions with "covered funds," which include most hedge funds and private equity funds, after July 21, 2015.[2] The rule will have an impact on most private fund investments made and interests held in these funds by banking entities.

[1] For the 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; (v) foreign banking institutions regulated as BHCs; and (vi) entities controlled by such organizations. A covered fund will not be a banking entity solely because it is an affiliate or subsidiary of a banking entity.
[2] Certain reporting requirements for large banks begin earlier.

Covered Funds

The entities deemed to be "covered funds" by the rule are: (i) any entity that would be an investment company under the Investment Company Act of 1940, but for the statutory exceptions typically used by private funds;[3] (ii) any commodity pool for which the operator has claimed, or could claim, exempt pool status under Section 4.7 of the CFTC's regulations; and (iii) any foreign fund organized, offered and sold solely outside the U.S., but only with respect to a U.S. banking entity that sponsors the foreign fund or has an ownership interest in the foreign fund.[4]

Covered Commodity Pools

The final rule's definition of "commodity pool" differs significantly from the proposed rule. The proposed rule would have included all commodity pools within the definition of covered funds, even if they have few, if any, of the characteristics or risks associated with private equity funds or hedge funds. For example, many non-banking entities that hedge risks using commodity interests would have been treated as covered funds, as would have registered mutual funds, pension funds, and investment companies that rely on exceptions other than 3(c)(1) or 3(c)(7) of the Investment Company Act. The final rule ameliorates this issue to a degree by including as "covered funds" only those commodity pools that are deemed to be similar to private funds.[5]

Foreign Funds Excluded From "Covered Funds"

The final rule significantly narrows the application of covered fund status with respect to certain foreign funds. As proposed, the rule would have covered any foreign fund that would be a covered fund if it were organized in the U.S. As commenters pointed out, this definition provided an awkward fit. For example, foreign funds structured to comply with local regulatory schemes could have been covered even if they are generally similar to U.S. registered investment companies. In addition, the proposed definition could have been read to include foreign funds, even if their securities are never offered or sold to U.S. persons, because the fund could theoretically be offered in the U.S. in reliance on Section 3(c)(1) or 3(c)(7). The final rule generally excludes foreign public funds from the definition of covered funds. To qualify as a foreign public fund, the fund must be an issuer organized or established outside of the U.S., the ownership interests of which are publicly offered and sold to retail investors in the issuer's home jurisdiction predominantly through one or more public offerings. U.S. banking entities may sponsor foreign public funds, provided the fund's ownership interests are sold predominantly (85% or more) to persons other than the banking entity or its insiders and affiliates. Private foreign funds are discussed below under "Permitted Fund Activities and Investments Outside the U.S."

Sponsorship Defined

Under the rule, to "sponsor" a covered fund means: (i) to serve as a general partner, managing member or trustee of that fund, or to serve as a commodity pool operator for a covered commodity pool; (ii) to select or control, or to have employees, officers, directors, or agents who constitute, a majority of the directors, trustees, or management of a covered fund; and (iii) to share the same name or a variation of the same name

[3] Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.
[4] The proposed rule included any foreign fund that would be a covered fund were it organized in the U.S.
[5] The covered commodity pools are similar in that they sell their participation units in unregistered restricted offerings to investors meeting heightened qualification standards. The final rule has fine print on commodity pools that bears close scrutiny.

with a covered fund for corporate, marketing, promotional or other purposes (the name-sharing restrictions are discussed further, below). Custodians and administrators are generally not considered sponsors under the rule. An investment manager is not a "sponsor" for purposes of the new rule.

Ownership Interest Defined

Under the rule, a banking entity may not have any equity, partnership or other similar interest in a covered fund. An interest is "similar" if it has any of certain specified characteristics, including: (i) the ability to participate in the removal of a party with investment discretion; (ii) the right to share in profits or losses; and (iii) the ability to earn a return based on fund performance. Debt securities are not explicitly included or excluded from the definition of ownership interest, and could therefore be deemed an ownership interest if, for example, interest or other payments are calculated by reference to the profits of the fund. Provided certain criteria are met, a restricted profits interest is excluded from the definition of ownership interest when held by a banking entity or its employee providing investment services to the covered fund.

Entities that are not Covered Funds

The rule excludes several entities from the definition of covered funds, thereby allowing banking entities to invest in or sponsor those entities, subject to certain restrictions. Certain significant exclusions are highlighted below.

Registered Investment Companies

The final rule expressly excludes investment companies registered under the Investment Company Act of 1940 and other registered funds from the definition of covered funds. Although the proposed rule did not prohibit a banking entity from holding an ownership interest in a registered investment company, many registered investment companies were inadvertently swallowed by the covered fund definition because they were also commodity pools, and the proposed rule had defined "commodity pool" very broadly. The final rule addresses this issue by expressly excluding SEC-registered investment companies and business development companies from the definition of covered fund, and by narrowing the scope of commodity pools that are covered funds.

Certain Commodity Pools

Unlike the proposed rule, the final rule does not generally classify commodity pools as covered funds. Rather, the rule includes within the definition of covered funds only those commodity pools which are "exempt pools" under Section 4.7(a)(1)(iii) of the CFTC's regulations, or, if the pool's features make the pool substantially similar to exempt pools, a commodity pool which could elect for exempt status under Section 4.7 of the CFTC's regulations.[6]

[6] A commodity pool is a covered fund if it is a commodity pool under Section 1a(10) of the Commodity Exchange Act for which: (i) the commodity pool operator has claimed an exemption under 17 CFR 4.7; or (ii) a commodity pool operator is registered with the CFTC, substantially all participation units are owned by "qualified eligible persons" under 17 CFR 4.7, and participation units have not been publicly offered to non-qualified eligible persons.

Foreign Pension or Retirement Funds

The final rule further narrows the proposed rule's definition of covered fund by excluding foreign pension or retirement funds. In order to provide parallel treatment for foreign pension and retirement funds and U.S. pension and retirement funds, the final rule excludes a foreign pension or retirement fund if it is: (i) organized and administered outside of the U.S.; (ii) regulated as a pension, retirement or similar plan under the foreign jurisdiction's laws and offered broadly to citizens or employees; and (iii) established for the benefit of citizens or residents of a foreign sovereign. The final rule also makes it clear that this exclusion still applies if some of the fund's beneficiaries reside in the U.S. or subsequently become U.S. citizens.

Issuers Excluded in the Agencies' Joint Discretion

In addition to the exclusions above, the final rule reserves the right for the federal banking agencies, the SEC and the CFTC (the "Agencies") to jointly determine that an issuer should be excluded. This ability for the Agencies to grant ad hoc exclusions was not in the proposed rule.

The Agencies will grant an exclusion only if the entity does not engage in investment activities contemplated by the Volcker Rule. Any decision by the Agencies to provide an exclusion for an issuer or entity will be made public promptly after such decision is made.

Other Exclusions

In addition to the exceptions listed above, the final rule excludes from the definition of covered fund: (i) wholly-owned subsidiaries of banking entities, even those not engaged in liquidity management;[7] (ii) certain joint ventures;[8] (iii) acquisition vehicles, provided the vehicle is formed solely for the purpose of engaging in bona fide merger or acquisition transactions; (iv) insurance company separate accounts, provided that no banking entity other than the insurance company participates in the account's profits and losses; (v) bank owned life insurance separate accounts, provided that the separate account is solely used for the purpose of purchasing life insurance policies for which the banking entity is a beneficiary; (vi) loan securitizations that meet certain criteria;[9] (vii) asset-backed commercial paper conduits that are "qualifying asset-backed commercial paper conduits"; (viii) certain covered bonds; (ix) certain public welfare and similar funds (Small Business Investment Companies); and (x) issuers in conjunction with the FDIC's receivership or conservatorship operations.

Permitted Covered Fund Activities

Banking entities may establish and invest in private funds under limited circumstances, unless such investments would: (i) involve or result in a material conflict of interest between the banking entity and its

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[7] To qualify as a wholly-owned subsidiary, the banking entity must own all of the subsidiary's outstanding ownership interests, except that: (i) up to 5% of the ownership interests may be owned by the banking entity's directors, employees and certain former directors and employees; and (ii) within this 5% ownership allowance, up to 0.5% of the ownership interests may be held by a third party who holds the interest for the purpose of establishing corporate separateness or addressing bankruptcy or insolvency.
[8] To qualify, a joint venture must: (i) be between the banking entity (or its affiliates) and no more than 10 unaffiliated co-venturers; (ii) be in the business of engaging in activities that are permissible for the banking entity to engage in, other than investing in securities for resale or other distribution; and (iii) not hold itself out as being an entity that raises money from investors for the purpose of investing in securities for resale or other distribution (i.e., a private fund).
[9] The final rule includes very specific guidance on what types of loan securitizations qualify for the exclusion.

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 banking entity or to the financial stability of the United States. The most notable exceptions are described below.

Sponsored Fund Exception

A banking entity may sponsor a covered fund in connection with organizing and offering a covered fund to clients who use the banking entity's investment or other services, and may acquire an ownership interest in the fund, subject to certain limits discussed below. The final rule clarifies that the required client relationship need not be pre-existing, and that the relationship can instead be established through organizing and offering the fund.

To comply with this sponsored fund exception, the banking entity must, among other things: (i) provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the fund; (ii) comply with certain naming restrictions, discussed below; (iii) ensure it has no interest in the fund except as permitted by the rule; (iv) ensure it does not guarantee or insure the performance of the fund; (v) have no director or employee invest in the fund unless such person is directly engaged in providing investment advisory or other services[10] to the fund; and (vi) make certain disclosures to any prospective or actual investors in the fund.

The name-sharing restriction on sponsored funds received a great deal of attention during the comment period. Commenters argued that it would be unduly burdensome and costly for funds currently affiliated with banking entities to change the names of their affiliated funds, and that doing so would place asset managers and funds affiliated with banks at a competitive disadvantage. Nonetheless, the Agencies included the name-sharing restriction as proposed. The Agencies commented that they believe these concerns have been partially addressed by the final rule's narrowed definition of covered fund and the extended conformance period.

De Minimis Investments in Banking Entity-Sponsored Funds

A banking entity may make certain de minimis investments into covered funds that comply with the sponsorship exception. Such an investment may not exceed 3% of the total number of the outstanding ownership interests or 3% of the total fair market value of the fund, excluding uncalled capital commitments. Under the final rule, a banking entity must calculate the amount and value of its ownership interests in covered funds quarterly, whereas the proposed rule would have required continuous compliance with the per-fund cap.

A banking entity may exceed the 3% per-fund cap in a sponsored covered fund to establish the fund and provide the fund with sufficient seed funding. If it does so, the banking entity must actively seek unaffiliated investors to reduce its ownership interest to no more than 3%, and must reduce its interest to comply with the 3% limitation within one year of the date of establishment of the fund. Upon application by the banking entity, the Board of Governors of the Federal Reserve may extend this period for up to two additional years. The final rule defines the date of establishment as the date when an investment adviser begins to make

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[10] The scope of "other services" is not explicitly defined, but the Agencies have commented that directors or employees who provide "services that enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative or other support services" may also invest in the fund.

investments that execute an investment or trading strategy for the fund; this is not keyed off the date an offering is commended.

Investments in all sponsored covered funds are subject to a second, overall cap on investments, generally equal to no more than 3% of Tier 1 Capital of the applicable banking entity, as calculated on a historical cost basis. Both caps take into account amounts contributed by a banking entity or its employee to obtain a restricted profits interest.

Attribution of Ownership Interests for Master-Feeder and Fund-of-Funds

The final rule clarifies how ownership interests held through master-feeder or fund-of-funds structures will be attributed to a banking entity. Under the final rule, when a banking entity invests through a covered feeder fund that invests substantially all its assets in a covered master fund, the banking entity's ownership interest is measured only by reference to the size of the master fund. Its ownership interest includes any investment held at the master fund level, as well as its pro-rata share of any ownership interest held through the feeder fund. Similarly, when a banking entity invests through a covered fund-of-funds that invests in another covered fund organized and offered by the banking entity, the banking entity's ownership interest includes its pro-rata share of any ownership interest held through the fund-of-funds, in addition to any investment held in that other fund directly.

Permitted Fund Activities and Investments Outside the U.S.

Foreign banking entities are not barred from holding an ownership interest in, or acting as sponsor to, a covered fund provided certain requirements are met. To qualify for this exception, the foreign banking entity must: (i) not be organized under U.S. law or controlled by a U.S. banking entity; (ii) conduct its investment activities in accordance with Section 4(c)(9) of the BHC Act, or pass an alternative test that evaluates the extent to which the entity's business is conducted outside of the U.S.;[11] and (iii) ensure that all investments occur solely outside the U.S. The final rule uses a risk-based approach for determining whether investments occur solely outside of the U.S. This approach requires that: (i) the banking entity acting as sponsor or investor is not itself, and is not controlled by, a U.S. banking entity; (ii) the banking entity (including relevant personnel) that makes relevant investment or control decisions for the covered fund is not located in the U.S.;[12] (iii) a U.S. branch or affiliate does not account for, as principal, the banking entity's investment or sponsorship activity, including any hedging activity;[13] and (iv) a U.S. branch does not finance the banking entity's ownership or sponsorship. Finally, to qualify for this exception, no ownership interest in the covered fund may be offered or sold to U.S. residents.[14]

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[11] The Board has implemented section 4(c)(9) of the BHC Act as part of subpart B of the Board's Regulation K. Regulation K includes many requirements that the foreign banking entity must comply with, including the foreign banking entity demonstrating that a majority of its banking business is outside of the U.S. For banking entities not subject to 4(c)(9), they must pass two out of three tests (assets, revenue, income) evaluating the extent the entity's business is outside the U.S.

[12] Back-office activity is not covered. Therefore, U.S. personnel may provide administrative services to a covered fund, and may act as investment adviser to the fund (provided such activity does not confer control of the covered fund).

[13] Merely having a U.S. subsidiary does not preclude the use of the foreign fund exclusion, as long as the U.S. subsidiary and U.S. personnel do not have control over the covered fund.

[14] An ownership interest is offered or sold to a U.S. resident if it has been sold in an offering that targets U.S. residents. U.S. resident is defined as it is in Regulation S.

Risk-Mitigating Hedging Activities

Unlike the proposed rule, the final rule exempts certain risk-mitigating hedging activities only with respect to employee compensation arrangements. The proposed rule did not bar a banking entity from holding an ownership interest in a covered fund for risk-mitigating hedging activities in two situations: (i) when acting as intermediary for a customer to facilitate the customer's exposure to the covered fund; and (ii) with respect to a compensation arrangement with an employee that directly provides investment advisory services to the covered fund.[15] The final rule permits such hedging activity only in the second scenario, arguing that exempting hedging activities in the first would not be consistent with the safe and sound conduct of banking entities. The Agencies acknowledged that restricting the exemption may disable U.S. banking entities from offering certain customer facilitation products relating to covered funds, but commented that such a result is consistent with the purposes of the rule.

To rely on the above risk-mitigating hedging exemption, the banking entity must establish an internal compliance program (discussed below). Furthermore, the ownership interest: (i) must be acquired in accordance with required policies, procedures and internal controls; (ii) must be designed to reduce specific risks in connection with the compensation arrangement; (iii) must not give rise, at its inception, to any significant new or additional risk; and (iv) must be subject to continuing review, monitoring and management.

Regulated Insurance Companies

The rule does not prohibit regulated insurance companies from holding any ownership interest in a covered fund for its general account or for a separate account.[16] The Agencies reasoned that such an exemption is appropriate because insurance companies are already subject to a robust regulatory regime, including limitations on their investment strategies. The Agencies also noted that such an exemption carries out Congress's intent of accommodating the insurance industry.

Restrictions on Relationships with a Covered Fund

Prohibition on Covered Transactions under Section 23A of the Federal Reserve Act

A banking entity serving as an investment manager, adviser or sponsor to a covered fund may not engage in any transaction with that fund if the transaction would be a "covered transaction" under Section 23A of the Federal Reserve Act. As defined in Section 23A, "covered transactions" include loans to affiliates, purchases of affiliates' assets or investment securities, issuances of guarantees, acceptances or letters of credit on behalf of an affiliate, and others. This prohibition applies even if the banking entity is solely an investment manager or adviser, as sponsorship is not required to trigger the prohibition.

Like the proposed rule, the final rule does not grant exceptions for intraday credit extensions, transactions fully secured by cash or U.S. securities, or riskless principal transactions with covered funds. Further, the

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[15] The compensation arrangement must relate solely to the covered fund, and must provide that losses incurred by the banking entity on its ownership interest will be offset by corresponding decreases in amounts payable under the compensation arrangement.
[16] To qualify for the exemption: (i) the insurance company or its affiliate must hold the ownership interest solely for its general account or for a separate account; (ii) the acquisition and retention of the interest must comply with, and be subject to, applicable insurance company investment regulations; and (iii) the appropriate Federal banking agencies must not have determined that the relevant regulations are insufficient to protect the safety and soundness of the banking entity, or the financial stability of the U.S.

prohibition imposed by the final rule does not incorporate Section 23A's statutory exemptions. Even though the final rule omits these exceptions, fewer transactions should be prohibited than under the proposed rule, due to the narrowed definition of covered fund.

The final rule further clarifies that a banking entity is not barred from engaging in "covered transactions" with third parties, only covered transactions with covered funds. A "covered transaction" under Section 23A can include a transaction between a member bank and a third party, if that transaction is secured by an affiliate's shares or guaranteed by an affiliate. The prohibition on banking entities engaging with covered funds will not apply to third party transactions, however, because the banking entity is not transacting with a covered fund. Therefore, banking entities are not prohibited from extending to a customer credit that is secured by shares of a covered fund.

Exceptions to Section 23A Covered Transaction Prohibition and Additional Limits

A banking entity serving as an investment manager, advisor or sponsor is not barred from having an ownership interest in a covered fund, even though such a relationship would be a "covered transaction" under Section 23A. Further, prime brokerage transactions between the banking entity and a covered fund are exempted if the banking entity has an ownership interest in the covered fund, and if certain other conditions are met. Importantly, one such condition is that the CEO of the banking entity annually certifies in writing that the banking entity does not guarantee, assume or insure the obligations or performance of the covered fund or its covered investments.
Exempted transactions must comply with Section 23B of the Federal Reserve Act, which generally requires that the transactions be on market-rate terms.

Compliance

Compliance Programs

The final rule adopts a tiered approach to mandated compliance programs.
In general, every banking entity must develop a compliance program reasonably designed to ensure and monitor compliance with the prohibitions on covered fund activities and investments. The compliance program must include: (i) written policies and procedures designed to document, describe, monitor and limit activities and investments with respect to covered funds; (ii) a system of internal controls; (iii) a management framework delineating responsibility and accountability for compliance; (iv) periodic independent testing and auditing of the compliance program; (v) training for trading personnel and managers; and (vi) records sufficient to demonstrate compliance.

However, a banking entity that does not engage in covered activities or investments may satisfy its compliance obligations by establishing a compliance program only prior to engaging in covered activities or investments.

A banking entity that engages in covered activities or investments, but which has total consolidated assets of $10 billion or less, may satisfy its compliance obligations by adjusting its existing compliance programs to appropriately address its covered activities or investments.

A banking entity with $50 billion or more in total consolidated assets must, in addition to the general requirements, comply with certain other special requirements contained in Appendix B of the final rule. In general, Appendix B requires a banking entity to: (i) establish a compliance program with certain features;[17] (ii) establish a governance and management framework; (iii) provide for independent testing at intervals appropriate given the banking entity's characteristics; (iv) provide adequate training for personnel and managers engaged in covered activities or investments; and (v) retain records sufficient to demonstrate compliance, for no less than five years. Of particular interest is the requirement that the CEO attest in writing to the relevant agency that the banking entity has a compliance program reasonably designed to achieve compliance.

The final rule also permits authorized regulatory bodies to require their constituent banks to meet the enhanced requirements in Appendix B, even if such entities would not otherwise be required to do so.

Compliance Deadlines

In a separate action, the Board extended the conformance period until July 21, 2015.

Banking entities must bring their non-conforming covered activities and investments into compliance with the final rule by the end of the conformance period.

In addition, banking entities must establish any compliance programs required by the final rule as soon as practicable, and at the latest, by the end of the conformance period.

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For additional information and guidance, the final Volcker Rule may be found here.

Mark Nuccio, Bartholomew Galvin, Jeanna Simeone, and Richard Loewy were responsible for the preparation of this Alert. If you have any additional questions about the Volcker Rule, please contact Mark V.Nuccio at mark.nuccio@ropesgray.com (617.951.7368), or another Ropes & Gray attorney.

[17] The compliance program must include: (i) processes for identifying covered funds and covered fund activities and investments; (ii) an explanation of the compliance program's efficacy; (iii) documentation of covered fund activities and investments; (iv) internal controls; and (v) procedures for identifying and remediating violations.