Legal Insight

K&L GATES

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November 7, 2011

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Proposed Volcker Rule Limitations on Banking Entity Relationships with Hedge Funds and Private Equity Funds

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Four federal regulatory agencies recently proposed regulations to implement the Volcker Rule (the "Proposal").[1] Key elements of the Proposal are summarized below, focusing on how it would significantly limit or affect the relationships that depository institutions and their affiliates have with hedge funds, private equity funds, and other similar funds. Future alerts by K&L Gates will explain how the Proposal would impact proprietary trading by depository institutions and foreign financial institutions.

The Volcker Rule generally prohibits a "banking entity" from: (i) sponsoring, or acquiring or retaining an ownership interest in, a "covered fund"; or (ii) engaging in certain transactions with a "covered fund." The Proposal outlines various exceptions to this general rule, prohibits certain conflicts of interest, and requires banking entities to implement a detailed compliance program. One feature of the Proposal would require investment advisers registered with the SEC to comply with certain federal banking regulations.

The Proposal requests public comment on hundreds of questions relating to all aspects of the Volcker Rule. Comments on the Proposal are due January 13, 2012. Final regulations will presumably be published prior to July 21, 2012, when the Volcker Rule will be effective. New investments in or sponsorship of a covered fund will have to conform to the Volcker Rule after the 2012 effective date; existing investments in covered funds and actions taken with regard to those funds will have to be brought into conformance with the rule generally by July 21, 2014, unless the Federal Reserve Board ("FRB") grants an extension, upon application made to the FRB, which may be granted for up to three one-year periods.[2]

Banking Entity

The term "banking entity" is broadly defined in Section 13 of the Bank Holding Company Act to include insured depository institutions, companies that control insured depository institutions, foreign companies treated as bank holding companies, and any entity controlled by the foregoing.[3] The

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[1] The Proposal was released jointly on October 11, 2011, by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Securities and Exchange Commission ("SEC"). The Commodity Futures Trading Commission is expected to release a similar proposal. The Proposal would implement section 13 of the Bank Holding Company Act, which was enacted into law as part of the Dodd-Frank financial reform package in 2010. This new section 13 is more commonly known as the Volcker Rule because it was championed by former FRB Chairman Paul Volcker. The Proposal would be codified as Rule VV under the FRB regulations.

[2] Final Rule Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity or Hedge Fund Activities, 76 Fed. Reg. 8265 (Feb. 14, 2011).

[3] An insured depository institution includes FDIC-insured commercial banks, savings banks, savings and loan associations and industrial loan companies ("ILCs") and certain limited purpose banks, such as credit card banks. It does not include a non-depository trust company or a trust company that is FDIC-insured but does not take demand deposits or

Proposal would narrow the definition slightly by excluding an affiliate or subsidiary that is also a "covered fund," that is, organized, offered and held by a banking entity and subject to restrictions and conditions described below, or controlled by such a covered fund. This exclusion would prevent the broader prohibitions applicable to all banking entities from being applied to this type of affiliated covered fund and preserve the ability of the covered fund to invest in other hedge funds and private equity funds in, for example, a fund of funds arrangement, as well as to engage in activities that otherwise would be considered impermissible proprietary trading. Affiliated advisers to such covered funds would still be considered banking entities and subject to the Volcker Rule.

Covered Fund

The term "covered fund" would be defined to include most privately offered funds, not solely private equity and hedge funds. More specifically, this definition would include any entity that relies solely on sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 to be excluded from the definition of "investment company." Many entities that are not commonly viewed as hedge funds or private equity funds rely on these two exceptions, however not necessarily exclusively. For example, there are collective investment funds that are organized as 3(c)(7) or 3(c)(1) funds that do not rely solely on those exemptions, also relying on section 3(c)(11), which would not be covered funds under the Proposal. On the other hand, the Proposal recognizes that many pools of asset-backed securities would be covered funds, although it excludes certain securitizations, and specifically requests comment on how to apply the Proposal in that context.[4]

The Proposal goes beyond the express statutory text to designate as covered funds commodity pools and foreign equivalents because they are similar to hedge funds and private equity funds.[5] The Proposal does not address how a managed account functioning similarly to a covered fund would be treated,[6] nor does it clarify how the Volcker Rule might limit, if at all, a banking entity's merchant banking authority.[7]

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use the FRB payment system or a credit union. In addition, all bank and savings and loan holding companies would be covered banking entities, as well as certain non-financial companies that own ILCs or that own a credit card bank. In addition, any foreign bank with a branch or agency office in the United States or an Edge Act or U.S commercial lending company subsidiary would be a covered banking entity. Foreign banks with only a representative office in the United States would not be covered banking entities. In addition, the FRB may prescribe additional capital for and quantitative limits on the acquisition or retention of an ownership interest in or sponsorship of a covered fund by certain non-bank financial companies supervised by the FRB.

[4] *See* Securitization, *infra*.

[5] The Proposal adds a commodity pool as a covered fund but does not have a discussion of the interplay between a fund that meets the definition of a commodity pool and a fund that is exempt, because it is not relying exclusively on 3(c)(1) or 3(c)(7), such as a bank collective investment fund, and whether the commodity pool operations would jeopardize the exempt status of the collective investment fund. In addition, recent changes to the CFTC rules may require registered investment companies to register as commodity pools. This creates the odd situation where a RIC could be treated as a covered fund.

[6] The Proposal does exclude a managed account that is used in connection with the banking entity's BOLI or COLI.

[7] Under merchant banking authority, a financial holding company may take an ownership interest in any company, subject to limitations on the length of time that the investment is held and on its active management of the company. In addition, under merchant banking authority, a financial holding company is permitted to make merchant banking investments through a private equity fund. The Proposal does not address merchant banking authority and the interaction between the Volcker Rule and merchant banking authority.

Proposed Volcker Rule Limitations on Banking Entity Relationships with Hedge Funds and Private Equity Funds

Permissible Investment in Covered Funds

The Proposal includes various exceptions that would permit banking entities to make the following limited investments in covered funds.

Performance Compensation

The Proposal states that carried interest is not an ownership interest. Subject to certain conditions on how the carried interest is structured, the general prohibition on investing in covered funds would not apply to interests held by a banking entity or an employee that provides advisory or other services to the covered fund. These provisions would permit banking entities and their employees to receive performance compensation for services provided to a covered fund.

To qualify, the carried interest would have to be structured so that: (i) the sole purpose and effect is to allow the banking entity to share in the profits of the covered fund, provided that the covered banking entity may be obligated under the terms of such interest to return profits previously received; (ii) either it is distributed promptly after being earned or, if reinvested, does not share in the subsequent profits or losses; (iii) it is not transferrable to a non-affiliate; and (iv) it is not acquired using funds provided by the banking entity.

Agent Versus Principal

The Proposal clarifies that the general prohibition on investing in covered funds would apply only when the banking entity is acting as principal and would not apply when the banking entity is acting as fiduciary, broker, custodian, or agent for its customers. Thus, a banking entity may make whatever investments it deems best or is directed to make in covered funds for its fiduciary, brokerage, custody or agency accounts without violating section 13 of the Bank Holding Company Act.[8] However, the banking entity may not make an investment, even on behalf of its customers, in a covered fund in which the banking entity has an ownership interest except as provided in section 13.

Limited Organizing and Offering of a Covered Fund

The Proposal would permit a banking entity to organize and offer a covered fund, subject to the conditions listed below:

- The covered fund is organized and offered only in connection with *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services. The Proposal indicates that various entities within a banking entity may provide such services. For example, a national bank and its affiliated investment adviser may both provide investment advisory services to the covered fund. The Proposal appears to side-step the question of whether the company within the covered banking entity that offers the *bona fide* trust services has to be the one organizing and offering the covered fund and takes the position that "so long as the banking entity provides trust, fiduciary, investment advisory or commodity trading advisory services in compliance with relevant statutory authority the requirement that the covered fund is offered 'in connection with' such services will be met."
- The covered fund is offered only to customers of the banking entity. The Proposal states that the statute does not require the customer relationship to be pre-existing and would allow new trust, fiduciary, investment advisory or commodity trading advisory customers to be offered covered

[8] In addition, the Proposal permits investment by a banking entity's "qualified plan" (under section 401 of the Internal Revenue Code) in covered funds without regard to the Volcker Rule limitations.

funds. To satisfy this requirement, the banking entity would have to offer the covered fund pursuant to a written plan outlining how the banking entity provides advisory or similar services to its customers through organizing and offering the covered fund.

- The banking entity does not guarantee or otherwise insure the obligations or performance of the covered fund or any covered fund in which such covered fund invests.
- The name of the covered fund is not a variation of the banking entity's name and does not include the work "bank."
- No director or employee of the banking entity has an ownership interest in the covered fund, except for directors or employees directly engaged in providing investment advisory or other services to the covered fund. An ownership interest held by a director or employee is attributed to the banking entity if the banking entity extends credit to enable the investment, guarantees the investment, or guarantees against loss on the investment.
- The banking entity must provide certain required disclosures, which would most likely be included in the covered fund's offering documents.
- The banking entity acquires or maintains an ownership interest in the covered fund for purposes of: (i) establishing the covered fund and providing the covered fund with sufficient capital to attract unaffiliated investors; or (ii) making an investment that does not exceed a per-fund limit of 3% of the covered fund's total outstanding ownership interests. When establishing a covered fund, the banking entity must actively seek unaffiliated investors and, within 1 year of establishing the covered fund, reduce the banking entity's ownership interest in the covered fund to the 3% limit. According to the Proposal, the investment limit also requires that no more than 3% of a covered fund's losses may be allocated to the banking entity's investment. The Proposal specifically requests comment on whether to define when a covered fund is established for purposes of triggering the 1-year period.
- The aggregate value of ownership interests held by the banking entity in all covered funds does not exceed 3% of the banking entity's tier 1 capital.
- For banking entities that calculate tier 1 capital, the total value of all permitted investments in covered funds must be deducted from their tier 1 capital. The Proposal requests comment on how to adjust the deduction according to the covered fund's leverage.

When calculating the percentage limitations described above, the Proposal would require a banking entity to include: (i) all ownership interests held by the banking entity; (ii) all ownership interests held by an entity controlled by the banking entity; (iii) a *pro rata* share of any ownership interest held by a covered fund not controlled by the banking entity but in which the banking entity holds more than 5 percent of the voting shares; and (iv) any committed co-investments or investments by parties acting in concert with the banking entity. Banking entities that do not calculate tier 1 capital for regulatory purposes would instead use the total amount of shareholders' equity. Relevant percentages would have to be calculated at least quarterly.

Public Interest Investments

The Proposal would permit, without limitation, banking entities to invest in certain covered funds designed to promote public welfare, including: (i) small business investment companies; (ii) funds promoting housing, services, or jobs to low- and moderate-income communities; and (iii) investments that qualify as rehabilitation expenditures for certain historic buildings.

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Hedging Activities

The Proposal would permit a banking entity to invest in a covered fund as a hedge against specific risks to the banking entity in connection with positions taken when acting as an intermediary on behalf of a customer (similar to a riskless principal) or when directly connected to compensation of an employee that directly provides investment advisory or other services to the covered fund. A banking entity investing in covered funds as a hedging activity would have to implement the required compliance program discussed below. The hedging activities provision is an exemption to the otherwise applicable limitations on ownership interest in a covered fund.[9]

Foreign Investments by Foreign Banking Entities

The Proposal would permit a foreign banking entity to invest in a covered fund if, among other conditions, the foreign banking entity is not controlled by a U.S. banking entity, no ownership interest in the covered fund is offered to a U.S. resident, and the activity occurs solely outside of the United States. However, such offshore funds may be subject to inclusion as part of the banking entity and thus themselves be subject to restrictions on their investment activities.

Securitization

The Proposal would permit a banking entity to invest in or sponsor securitization vehicles that qualify as covered funds. This provision would align with mandatory risk retention required under the Dodd-Frank Act, which generally requires sponsors of securitizations to retain at least 5% of the credit risk associated with the securitization, ordinarily through an ownership interest in the securitization vehicle itself. To qualify for this exception, the assets of the covered fund would have to be limited to loans, assets directly arising from those loans, and certain interest rate or foreign exchange derivatives.[10] To qualify, the covered fund must not allow the use of a credit default swap, which is consistent with the regulatory aversion to synthetic securitizations evidenced by the Dodd-Frank risk retention rulemaking proposal.[11]

Other Permitted Investments

Although not part of the statutory text, the Proposal would permit investments in certain other covered funds, each subject to certain conditions, including: (i) investments in life insurance policies covering key employees structured as investments in separate accounts; (ii) joint ventures; (iii) acquisition vehicles; (iv) liquidity management subsidiaries of the banking entity;[12] and (v) investments held in the ordinary course of collecting a debt previously contracted in good faith.

Transactions with Covered Funds

Transactions between a covered fund and any banking entity that serves as investment manager, investment or commodities trading advisor, or sponsor of a covered fund would be subjected to additional limitations. These restrictions, known as "Super 23A," rely on concepts familiar to

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[9] Consequently, the hedging exception could not be used if the customer of the banking entity were itself a banking entity.

[10] Loans include loans, leases, extensions of credit and secured and unsecured receivables. Derivatives may not include synthetic securitizations or securitization of derivatives.

[11] Credit Risk Retention, 76 Fed. Reg. 24090 (April 29, 2011).

[12] Liquidity management subsidiaries would have to be wholly-owned subsidiaries.

depository institutions contained in sections 23A and 23B of the Federal Reserve Act ("FRA"). Super 23A differs from the regular Section 23A rules in two ways. First, the prohibition on entering into covered transactions is absolute; it is not subject to the quantitative and qualitative carve outs in the regular rule. Second, the prohibition applies to all members of the banking entity, not just the member bank. Thus, support for a covered fund could not be provided by the bank holding company or its subsidiaries.

Market Terms

All transactions between a banking entity that, directly or indirectly, manages, advises or sponsors a covered fund and such covered fund would be subject to the market terms requirement in section 23B of the FRA. Specifically, all such transactions would have to be on market terms or on terms at least as favorable to the banking entity as the banking entity would receive in a comparable transaction with an unaffiliated third party. Thus, a broker-dealer member of the banking entity could not provide services to the covered fund at cost or provide otherwise preferential terms on services to the covered fund.

Covered Transactions Prohibited

The Proposal would prohibit all transactions between a banking entity that, directly or indirectly, serves as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund and such covered fund that are "covered transactions" under section 23A of the FRA.

In this context, the following are "covered transactions":

- A loan or extension of credit, including a purchase of assets subject to an agreement to repurchase;
- An investment in securities issued by the covered fund;
- A purchase of assets from the covered fund;
- The acceptance of securities or other obligations issued by the covered fund as collateral for credit;
- The issuance of a guarantee or letter of credit on behalf of the covered fund;
- A transaction with the covered fund that involves the borrowing or lending of securities, to the extent such transaction causes the banking entity to have credit exposure to the covered fund; and
- A derivatives transaction with the covered fund, to the extent such transaction causes the banking affiliate to have credit exposure to the covered fund.

An exception to the general prohibition on covered transactions would permit a banking entity to enter into a prime brokerage transaction with a covered fund in which a covered fund managed, organized, or sponsored by the banking entity or an affiliate has taken an ownership interest. The Proposal clarifies that prime brokerage transactions would include providing products or services such as custody, clearance, securities borrowing or lending, trade execution, and other support, such as financing, data, operational or portfolio management support. Although permitted, these prime brokerage transactions would be subject to the market terms requirement discussed above, and the chief executive officer of the banking entity must certify annually that the banking entity does not guarantee the obligations or performance of the covered fund.

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Conflicts of Interest

Any activity that is otherwise permissible under the Proposal, including those permitted by the various exceptions described above, would be prohibited if it would: (i) involve a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result in a material exposure by the banking entity to a high-risk asset or high-risk trading strategy; or (iii) threaten the safety and soundness of the banking entity or U.S. financial stability. A transaction involving a material conflict of interest could proceed if the banking entity gives prior disclosure to the client, customer, or counterparty, thereby providing an opportunity to negate the effect of the conflict.

Compliance Program

All banking entities that engage in activities permitted by the Volcker Rule would be required to develop a program reasonably designed to ensure compliance with the Proposal. At a minimum, the compliance program would have to include written policies and procedures to monitor compliance, internal controls to prevent prohibited activities, clear delineation of management responsible for compliance, independent testing of the compliance program, training, and recordkeeping to demonstrate compliance for at least 5 years. A banking entity would be required to follow standards for more robust compliance programs if, aggregating holdings of any affiliates, the value of: (i) all investments in a covered fund is an average of $1 billion; or (ii) all sponsored or advised covered funds have average total assets of $1 billion. This is measured as of the last day of each of the four prior calendar quarters.

The Proposal's specific requests for comment show that the regulatory agencies may require chief executive officers to certify the compliance program annually or may require that the training be conducted at least once each year. The Proposal permits banking entities to establish compliance programs on an enterprise-wide basis, as opposed to programs at the level of a unit investing in covered funds, but asks whether that option is appropriate.

Advisers Subject to Banking Regulation

In the context of investment in or sponsorship of a covered fund, the SEC's version of the Proposal would require registered investment advisers that are also banking entities to comply with the version of the Proposal issued by the federal banking agency that regulates its affiliate. The SEC would retain enforcement authority, but the federal banking agency's rules and interpretations, including capital determinations, would bind the investment advisers. The Proposal explains that the SEC recommended this approach because the covered fund provisions of the Volcker Rule incorporate or refer to various banking law concepts. The SEC also said this approach would avoid creating incentives for covered fund activities to be moved from a registered adviser to a bank as a means of avoiding SEC jurisdiction.

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