Schulte Roth&Zabel

Alert

Summary of Proposed Volcker Rule Regulation — Fund Activities

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Today, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of the Comptroller of the Currency issued a joint Notice of Proposed Rulemaking (the "Notice") to implement the Volcker Rule.[1]

The Volcker Rule is part of the Dodd-Frank Act and restricts the proprietary trading and private investment fund activities of U.S. banks and bank affiliates, as well as foreign banks with banking operations in the United States and their affiliates (collectively, "banking entities"). While the Notice provides far more detail than was contained in the Dodd-Frank Act, many aspects of how the Volcker Rule will be implemented are still open to interpretation. Moreover, in addition to soliciting general comments, the Notice poses nearly 400 explicit questions for consideration. Once the regulation is finalized, banking entities will have until July 21, 2014 to conform their activities, with the Federal Reserve Board empowered to grant a banking entity up to three one-year extensions (with an additional five-year extension potentially available for investments in illiquid funds).

Interested parties will have until Jan. 13, 2012 to submit comments. The Notice is available at: http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm.

This *Alert* summarizes the proposed regulation as it would affect a banking entity's investments in, or sponsorship of, private investment funds.[2] In this regard, the proposed regulation has two parts. First, a banking entity is generally barred from acquiring or retaining an "ownership interest" in a "covered fund," subject to certain exceptions. Second, a banking entity may no longer "sponsor" any covered fund, unless it abides by a series of new requirements.

PROHIBITION ON FUND INVESTMENTS

"Covered Fund"

- A "covered fund" is defined to include any of the following:
    - Any issuer that would be an investment company under the Investment Company Act of 1940 but for the exemptions contained in Sections 3(c)(1) and 3(c)(7) therein.
    - Commodity pools as defined in the Commodity Exchange Act.
    - Any foreign fund that would otherwise be a covered fund were it organized under the laws, or offered to one or more residents, of the United States.

[1] While the Securities and Exchange Commission is also listed on the notice, it is expected to consider it tomorrow. The Commodities Futures Trading Commission is expected to issue a separate, but similar rule at a later date.

[2] An upcoming SRZ *Alert* will summarize the proposed regulation's effect on proprietary trading.

- Any other similar fund as determined by the federal regulators.

"Ownership Interest"

- An "ownership interest" is defined to mean any equity, partnership, or similar interest in a covered fund, whether voting or nonvoting, as well as any derivative of such interest, such as:
  - Shares;
  - Equity securities;
  - Warrants;
  - Options;
  - General partnership interests;
  - Limited partnership interests;
  - Membership interests; or
  - Trust certificates.
- The definition focuses on the attributes of the interest, primarily its economic exposure to the profits and losses of the covered fund, rather than the form or classification of the interest.
  - To the extent that a debt security or other interest exhibits substantially the same characteristics of an ownership interest, regulators could consider it an ownership interest.
  - Characteristics of an interest that are demonstrative of an ownership interest include:
    - Voting rights;
    - Rights to share in the covered fund's profits and losses; or
    - The ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments.
- Carried interest earned by a banking entity in its role as investment adviser to a covered fund will not be deemed to be an ownership interest as long as the following conditions are met:
  - The sole purpose and effect of the interest is to allow the banking entity to share in the profits of the covered fund as performance compensation for services provided to the covered fund, provided that the banking entity may be obligated to return profits previously received;
  - All such profit, once allocated, is distributed to the banking entity promptly after being earned or, if not so distributed, the reinvested profit does not share in the subsequent profits and losses of the covered fund;
  - The banking entity does not provide capital to the covered fund in connection with the acquiring or retaining this carried interest; and
  - The interest is not transferable except to an affiliate.

Exceptions to the Prohibition

- **SBICs and Related Investments**
  - A banking entity may hold an ownership interest in any covered fund that is:
    - A small business investment company under the Small Business Investment Act of 1958;
    - "Designed primarily to promote the public welfare" under Section 24(Eleventh) of the National Bank Act; or

        - A "qualified rehabilitation expenditure" with respect to a qualified rehabilitation building or certified historic structure under Section 47 of the Internal Revenue Code of 1986.

- **Risk-Mitigating Hedging Investments**
    - A banking entity may hold an ownership interest in a covered fund in order to hedge risks in two situations:
        - When acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund; and
        - To cover a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund.

- **Non-U.S. Activity**
    - Certain non-U.S. banking entities are permitted to hold an ownership interest in a covered fund so long as such activity occurs "solely outside the United States."
        - Eligible Banking Entities
            - The banking entity must be organized in a non-U.S. jurisdiction and not directly or indirectly controlled by a banking entity organized in a U.S. jurisdiction.
            - If the entity is a "foreign banking organization" under the Federal Reserve Board's Regulation K, it must be a "qualifying foreign banking organization" and comply with subpart B thereunder.[3]
            - If the entity is not a "foreign banking organization" under Regulation K, it must meet at least two of the following:
                - Its total non-U.S. assets exceed its total U.S. assets;
                - Its total non-U.S. revenues exceed its total U.S. revenues; or
                - Its total non-U.S. net income exceeds its total U.S. net income.
        - In order for a transaction to occur "solely outside the United States":
            - The banking entity must not be organized in a U.S. jurisdiction;
            - None of the banking entity's employees or affiliates involved in the activity may be located or incorporated in the United States (excluding "back office" personnel); and
            - No ownership interest in the covered fund may be offered for sale, or sold, to a U.S. resident.

- **Loan Securitizations**
    - A banking entity may hold an ownership interest in a covered fund that is an issuer of asset-backed securities, the assets of which are solely comprised of:

[3] Under Regulation K, a "foreign banking organization" is a foreign bank that operates a branch office, agency office, commercial lending company, bank subsidiary or Edge corporation in the United States, or any subsidiary of such an institution. To constitute a "qualifying foreign banking organization," it must satisfy three tests. First, more than half of its worldwide business must be banking (disregarding its U.S. banking activity) and more than half of its banking business must be outside the United States. Second, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its total worldwide nonbanking assets; (ii) its revenues derived from the business of banking outside the United States exceed its total revenues derived from its worldwide nonbanking business; or (iii) its net income derived from the business of banking outside the United States exceeds its total net income derived from its worldwide nonbanking businesses. Third, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its banking assets held in the United States; (ii) its revenues derived from the business of banking outside the United States exceed its revenues derived from the business of banking in the United States; or (iii) its net income derived from the business of banking outside the United States exceeds its net income derived from the business of banking in the United States.

        - Loans;
        - Rights or assets directly arising from such loans; or
        - Interest rate or FX derivatives that materially relate to such loans, rights or assets, and are used for hedging purposes.

- **Bank-Owned Life Insurance**
    - A banking entity may hold an ownership interest in a covered fund that is a separate account, used solely for purchasing bank-owned life insurance ("BOLI"), provided that the banking entity:
        - Does not control the investment decisions of the account; and
        - Complies with all supervisory guidance regarding BOLI.
- **Non-Funds**
    - The proposed regulation specifically exempts three additional types of entities that fall within the broad definition of "covered funds," but would not normally be thought of as funds:
        - Joint venture operating companies;
        - Single acquisition vehicles; and
        - Wholly-owned subsidiaries that are principally engaged in providing bona fide liquidity management services (as long as they are carried on the balance sheet of the banking entity).
- **Interests Arising from a DPC**
    - A banking entity is not prohibited from holding an ownership interest in a covered fund, where it acquires such interest in the ordinary course of collecting on a debt previously contracted in good faith.
        - However, the interested must be divested within the normal periods applicable to DPC property.

SPONSORSHIP OF FUNDS

General Rule

- A banking entity may no longer "sponsor" a covered fund, unless:
    - The fund is eligible for the aforementioned investment exceptions for (i) SBIC and related investments; (ii) non-U.S. activity; (iii) loan securitizations; (iv) BOLI; (v) non-funds; and (vi) interests arising from a DPC; or
    - The banking entity abides by a series of new requirements discussed below.
        - This exemption is designed to permit a banking entity to be able to engage in certain traditional, fee-based asset management and advisory services.

"Sponsor"

- A "sponsor" is defined as any entity that:
    - Serves as a general partner, managing member, trustee (excluding trustees that do not exercise investment discretion), or commodity pool operator of a covered fund;
    - In any manner selects or controls a majority of the directors, trustees, or management of a covered fund; or
    - Shares with a covered fund, for corporate, marketing, promotional or other purpose, the same name or a variation of the same name.

Permitted Organizing and Offering of Covered Funds

- A banking entity will be permitted to organize and offer a covered fund, including acting as sponsor, subject to the following:
    - The banking entity must provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services.
        - The covered fund must be organized and offered only to persons that are customers of such services. However, the proposed regulation makes clear that such customer relationship need not be pre-existing or involve more than the relevant fund investment.
    - The banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered find invests.
    - The covered fund may not share the same name, or a variation of the same name, as the banking entity for any purposes, nor can it use the word "bank" in its name.
    - No director or employee of the banking entity may hold an ownership interest in the covered fund, except for a director or employee who is directly engaged in providing investment advisory or other services to the covered fund.
        - However, any ownership interest purchased by a director or employee pursuant to a loan, guarantee or extension of credit by the banking entity will be attributed to the banking entity itself.
    - The banking entity must:
        - Provide written disclosure to prospective and actual investors that all losses of the covered fund are borne solely by investors and not by the banking entity (or the FDIC), and
        - Take any additional steps required by the federal regulators to ensure that it is, in fact, not liable for any fund losses.
    - The banking entity must not hold an ownership interest in the covered fund, except as consistent with the *de minimis* and seeding exceptions discussed below.
    - When engaging in any transactions with the covered fund, the banking entity must comply with certain restrictions detailed below.

Permitted Investments in a Sponsored Fund

- ***De Minimis* Exception**
    - A banking entity may hold an otherwise prohibited ownership interest in a covered fund it organizes and offers, provided the investment:
        - Does not represent more than three percent of the total outstanding ownership interests of such covered fund; and
        - Is not exposed to more than three percent of the losses of the covered fund.
            - Interests held by any entity controlled, directly or indirectly, by the banking entity will be attributed to the banking entity.
            - Interests held by any entity in which the banking entity owns, controls, or holds with the power to vote more than five percent of the voting shares will be attributed to the banking entity on a pro-rata basis.
- **Seeding Exception**

- A banking entity will be permitted to make any investment (i.e., up to 100 percent) in a covered fund that it organizes and offers, for the purpose of establishing the fund and providing it with sufficient capital to attract unaffiliated investors, provided:
    - It actively seeks unaffiliated investors to reduce or dilute its interest; and
    - Such interest complies with the aforementioned *de minimis* exception within a year of the fund's launch (with the possibility of obtaining an extension of up to two additional years).

- **Aggregate Limitation**
    - In the aggregate, all investments under the *de minimis* and seeding exceptions must not exceed three percent of a banking entity's Tier 1 capital.
        - If the investing banking entity does not calculate Tier 1 capital, then:
            - In the case of bank subsidiaries, the limit is measured against the Tier 1 capital of the parent bank;
            - In the case of subsidiaries of banking holding companies (or any company treated as a BHC), the limit is measured against the Tier 1 capital of the top-tier entity that calculates Tier 1 capital; and
            - In all other cases, the limit is measured against the total shareholders' equity of the top-tier affiliate.

Limitations on Transactions with a Sponsored or Managed Fund

- **Market Term Requirement**
    - A banking entity may not provide any services or sell any assets to a covered fund that it organizes and offers (or for which it otherwise serves, directly or indirectly, as investment manager, investment adviser, commodity trading adviser, or sponsor), except on market or better terms.
        - If no market terms exist, then the banking entity may offer terms that are arms-length or better.

- **Prohibited Transactions**
    - A banking entity may not engage in any transaction with a covered fund that it organizes and offers (or for which it otherwise serves, directly or indirectly, as investment manager, investment adviser, commodity trading adviser, or sponsor), if the transaction would be a "covered transaction" as defined in Section 23A of the Federal Reserve Act.
        - "Covered Transactions" include:
            - Loans and other extensions of credit to the fund;
            - Purchases of assets from the fund; and
            - Taking the fund's securities as collateral for an extension of credit to a third party.
    - **Exception for Prime Brokerage Transactions**
        - The foregoing prohibition on "covered transactions" does not apply to prime brokerage transactions with a covered fund in which a covered fund sponsored, managed or advised by the banking entity invests.
            - A "prime brokerage transaction" is defined as "one or more products or services provided by the banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support."

Other Prohibited Activities

- Notwithstanding any of the foregoing, a banking entity may not engage in any activity (including organizing and offering a fund) or transaction that would:
    - Involve a "material conflict of interest" between the banking entity and its clients, customers or counterparties;
        - Unless (i) the other party is given adequate prior disclosure of the conflict and the opportunity to negate or substantially mitigate its impact; or (ii) the banking entity has information barriers that are reasonably designed to prevent a materially adverse effect on the other party (except where the banking entity knows, or should reasonably know, that the barriers are unlikely to prevent a particular materially adverse effect).
    - Materially expose the banking entity to an asset or trading strategy that would significantly increase the likelihood of substantial loss or failure; or
    - Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.
- These are necessarily subjective analyses that a banking entity will have to undertake, but that will ultimately be judged by its primary federal regulator.

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If you have any questions concerning this *Client Alert* or would like assistance in submitting comments to the Notice, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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