The Volcker Rule

Q&A with Joseph P. Vitale

IN CONVERSATION WITH ROD SPARKS

The Volcker Rule, which implements restrictions and requirements on sponsorship of, or investment in, hedge funds by banks, took effect in late July 2015. We spoke to Schulte Roth & Zabel LLP (SRZ) bank regulatory partner Joseph P. Vitale, who is one of the foremost experts on the Rule.

THFJ: What is the scope of the Volcker Rule and who does it apply to?

Joseph Vitale: The Volcker Rule is part of the Dodd-Frank Act and it adds a new section to a long-standing statute in the US called the Bank Holding Company Act of 1956. The Rule applies to all US FDIC-insured banking institutions, as well as any foreign banks that have a certain type of banking presence in the US, including foreign banks that operate a branch office or agency office in the US or have a subsidiary banking entity in the US, and all of their affiliates. Thus, all affiliates of US banks (regardless of where they are domiciled or operate) and all affiliates of foreign banks that have a sufficient nexus to the US and their worldwide affiliates (regardless of where those affiliates are domiciled or operate) are subject to the Rule. The Rule refers to all such entities as "banking entities."

So, the scope of the Volcker Rule is quite broad, and many would argue that it's extra-territorial, since it applies to entities that normally would not be subject to US law.

THFJ: What does the Rule do?

JV: Basically, there are two sides to the Rule. On one side, there is a prohibition on proprietary trading, commonly referred to "prop trading." The second side of the Volcker Rule is a ban on the sponsorship of, and investment in, most hedge funds and private equity funds – although with regard to sponsorship it's not really a ban, it's more like a set of new requirements.

THFJ: When you refer to "most" hedge funds and private equity funds, what do you mean?

Joseph P. Vitale

JV: Specifically, the Rule covers funds that would have to register with the SEC but for the fact that they are exempt from registration under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "'40 Act"). In other words, if a fund is exempt from registration solely because of one or both of those sections, then it's a "covered fund" under the Rule. There are certain other types of vehicles beyond 3(c)(1) and 3(c)(7) funds that are also treated as covered funds – essentially, funds that the regulators have deemed to be equivalent to 3(c)(1) and 3(c)(7) funds. These include commodity pools that are similar to 3(c)(1) and 3(c)(7) funds, as well as non-US funds that would constitute 3(c)(1) and 3(c)(7) funds if they were subject to the '40 Act. In this way, the Volcker Rule is much broader than the '40 Act. Moreover, it's somewhat extraterritorial because it can apply to certain situations involving funds domiciled and managed outside the US.

THFJ: So, can banks still sponsor such funds?

JV: Definitely. It is a misunderstanding to believe that the Volcker Rule will cause banks to get out of the fund business. Although the Rule starts out by saying that they can't sponsor covered funds anymore, it later includes an exception that swallows the rule. Essentially, the Rule just imposes certain new requirements affecting limited aspects of how such funds are sponsored. Most of these new requirements are easy to deal with. However, a few are more material.

Most notably, beyond a limited seeding period, the sponsor and all of its affiliates may not own more than 3% of the fund. In addition, employees of the sponsor and its affiliates are prohibited from investing in the fund, unless they provide services to the fund. Finally, the fund can't share the name of the sponsor or any of its affiliates, or any variation of the same name. However, with those few, albeit significant, changes, banking entities are able to sponsor covered funds, including hedge funds, in very similar ways to how they did prior to the Rule. Moreover, under certain circumstances, non-US banks won't even have to abide by the few restrictions I just mentioned.

THFJ: How will those requirements affect the marketability of bank-sponsored covered funds?

JV: It really remains to be seen. But, there are some concerns. First, because of the 3% cap I mentioned, the bank's ability to put skin in the game – to invest in its own funds – is now significantly restricted. It remains to be seen whether being unable to put more skin in the game will affect the sponsor's ability to raise outside money.

Moreover, under the Rule, the seeding period normally ends on the one-year anniversary of the fund's first investment. Many banking institutions believe that one year is not long enough. In many cases, a longer timeline may be needed to build up a track record to help attract sufficient outside capital to reduce the sponsor's seed investment to no more than 3%

of the fund. Although the sponsor can apply to the Federal Reserve Board to extend the seeding period for up to two years, it's not clear how easy such extensions will be to get.

Another issue, which is not as material, is that the requirement for banking entities to take their name off of all of their funds may initially create some confusion and make marketing a little bit more difficult. However, this effect will only be temporary – until the market gets used to the new names employed by different bank-affiliated funds.

THFJ: So that's the situation with sponsoring covered hedge funds. What about investing in them?

JV: With regard to investing in covered funds, the ban is dramatically more restrictive – at least for US banks and their affiliates. In general, US banks, and their worldwide affiliates, are no longer able to invest at all in covered funds managed by third parties. They are limited to investing in their own funds, except for certain very limited exceptions that largely are not expected to have any material impact on the market. For domestic banks, it's basically game-over as far as investing in third-party funds (and, as I mentioned a moment ago, largely capped at owning no more than 3% of their own funds).

Non-US banks have more latitude and, in many ways, they will be able to make investments in third-party funds just as before the Volcker Rule. Essentially, so long as they make their investments through non-US arms and are not involved in marketing the third-party fund's ownership interest to US investors, it will be business as usual. In other words, as long as the non-US bank and its affiliates are not serving as a distributor, adviser or sub-adviser, or otherwise involved in the management and marketing of the fund, then non-US arms of the bank will be able to invest in third-party funds to a similar extent as they did prior to the Volcker Rule.

THFJ: What is "proprietary trading" and how does the Volcker Rule's ban on proprietary trading affect hedge funds?

JV: First, in order for activity to constitute proprietary trading, it has to involve the banking entity acting as principal – so we are only talking about transactions the entity does with its own money for its own purposes, as opposed to investments on behalf of, or as an agent for, a client. Second, it has to involve the purchase or sale of "financial instruments" for a "trading account."

The Rule defines "financial instruments" to broadly cover all securities, most derivatives, commodities futures and options on any of the foregoing. Whether a trade is done for a "trading account" is a complicated issue, but at the very least, includes all transactions entered into principally for short-term resale, to take advantage of short-term price fluctuations, to realize short-term arbitrage profits, or to hedge any of the foregoing. There is a reverse safe harbour that says any trading that occurs in less than 60 days is presumed to be prop trading. There are a number of exceptions to the Rule's ban on prop trading, most importantly for market-making and underwriting activities. Non-US banks also have additional exemptions for activity deemed to occur solely outside the US.

The prop trading side of the Volcker Rule does not directly affect hedge funds, since it's unlikely that a banking entity would be engaging in short-term trading of hedge fund instruments. However, the ban may affect hedge funds in at least three potential ways. First, hedge funds that previously engaged in short-term trading with banking entities have now lost those trading partners. Second, and similarly, the ban may create liquidity problems for certain instruments, which, in turn, could affect the value of such instruments and any hedge funds that hold them. Finally, some hedge funds may see a competitive advantage arise as they are able to take over activity that banking entities must now cede.

As I noted earlier, there are exceptions to the prop trading ban for underwriting and market-making activities. These exceptions were designed to take care of any potential impact on liquidity. However, many industry observers and banking entities believe that because of the ambiguity as to where the lines are drawn on those exceptions, the Volcker Rule will have a chilling effect on certain underwriting and market-making. So, the Volcker Rule is likely, notwithstanding those exceptions, to have an impact on liquidity.

THFJ: Does the Volcker Rule affect prime brokerage or other relationships between banks and hedge funds?

JV: Under the Rule, the types of transactions that a banking entity may enter into with a covered fund sponsored by it or its affiliates are now significantly restricted. A banking entity can no longer lend money to any affiliated fund or guarantee any obligations of such fund. A banking entity also cannot purchase assets from such fund, and any transactions that it does engage in with such fund have to be conducted at an arm's-length market-term basis that's at least as favourable to the banking entity as it would be if the banking entity were engaging in a transaction with an unaffiliated third party.

In contrast, the Volcker Rule does not generally affect the prime brokerage relationship or other transactions between a covered hedge fund and any unaffiliated banking entity. Thus, for covered funds that are sponsored by managers that are not banking entities, those funds should see no change in their prime brokerage relationships, and no change in their ability to buy and sell assets from banking entities, other than, potentially, the impact of the prop trading ban that I mentioned a moment ago.

The one exception to the foregoing is where the fund has a significant investment from a bank-sponsored covered fund. For example, if a banking entity sponsors a covered feeder fund that invests in the third-party covered fund, and that investment exceeds certain control thresholds under the Bank Holding Company Act – which are generally set as low as 5% of the voting securities of the fund, or 25% of its total capital – then certain transaction restrictions would kick-in. In such a case, the fund will still be able to engage in prime brokerage transactions with the banking entity, but outside prime brokerage the banking entity

transactions in between the banking entity and the fund will be restricted in the same manner as transactions between the banking entity and any affiliated funds, as I described a moment ago.

THFJ: Is the Volcker Rule now fully effective? And, if not, what is still to come?

JV: The Rule largely went into effect on 21 July 2015, after a five-year wait. The Dodd-Frank Act was enacted on 21 July 2010 and, in the statute, the Rule was originally meant to be effective on 21 July 2012, subject to a two-year conformance period ending in 2014. However, that two-year conformance period was eventually extended another year, which is why the Rule generally took effect this year.

The one exception is with regard to what are called, "legacy covered funds." On 18 December 2014, the Federal Reserve Board granted a limited extension of the Rule, given banking entities another two years to conform any investment, sponsorship or relationship with a covered fund, where the investment or the relationship was in place by 31 December 2013. Technically, they granted a one-year extension, but said they would grant the second one-year extension when the first extension expired. So banking entities have until 21 July 2016 to cease, or divest of, any prohibited fund activity that occurred during 2013 or earlier. With regard to anything that occurred in 2014 or later, the Rule has taken full effect.

THFJ: What significant changes have hedge fund firms made per the Volcker Rule?

JV: Investment management firms that are affiliated with banks have had to make significant changes to the way they do business in order to comply with the Volcker Rule. For example, as I mentioned earlier, any new covered fund that was sponsored in 2014 (or going forward) can't share the same name as any banking entity, and since a manager that is affiliated with a bank is, itself a banking entity, that means the fund can't even share the name of its manager. Obviously, this a change from the typical industry practice.

Even more importantly, those managers that are banking entities have had to reduce their interests, and those of their affiliates, in order to comply with the 3% cap. Similarly, employees that are not engaged in providing services to a fund have had to transfer or redeem their interests.

THFJ: What about managers that aren't affiliated with a bank, how has the Rule impacted them so far?

JV: With regard to managers that are not banking entities, the impact of the Volcker Rule differs depending on the extent of the firm's existing client or other relationships with banking entities. If the manager doesn't have significant investors that are banking entities, then the impact has probably been minimal or even non-existent. Such managers may see the Rule as a potential positive, as it takes a competitor out of the market or at least places additional restrictions on certain competitors.

Conversely, those managers with covered funds that have large investments from banking entities, especially from US banking entities, have had to, in some cases, give back that money, or restructure the investment in order to enable it to take advantage of an exemption. Where this has had a particularly strong impact is on banking entities acting as seed investors for third-party funds – a role they typically played in past. In some cases, even where managers have only distribution or feeder fund arrangements with banking entities – in other words, the money coming in is not from the bank, but from its clients – such arrangements have had to be tweaked to comply with the Rule.

As I mentioned before, however, non-US banks can generally continue to invest in third-party covered funds with very few restrictions. Thus, the impact is far greater on those managers that had strong relationships with US banking entities, than those whose relationships are primarily outside the US.

With regard to taking investments from non-US banks, originally, the way the Rule was interpreted, it would have required managers to set up a new, or perhaps parallel, fund for the non-US banks and their non-US affiliates, so that such investments were completely segregated from those of US investors. So, the typical offshore fund which combined non-US investors with tax-exempt US investors would not have worked. Nor would segregating the US money at a feeder level only to comingle it in a master fund. However, fortunately, that interpretation was changed at the last minute and now it is clear that non-US banks can invest alongside US investors as usual, provided the requirements I mentioned earlier are satisfied.

THFJ: Do you believe that there's more clarity or more confusion, now that the dust is settling on Volcker/Dodd-Frank?

JV: I think with regard to the broader brush-strokes, we have somewhat more clarity, especially than we did before the final Rule was promulgated. However, with regard to the finer points, there remains a great deal of uncertainty. And, when you are actually applying a regulation in the real world, the finer points become quite important. Thus, there is still quite a lot to be answered, and the full impact of the Volcker Rule remains yet to be seen.

THFJ: When regulators start conducting their first audits this year, what will they be looking for?

JV: In general, they'll be looking for a good-faith attempt to comply with the Rule. The regulators, I believe, understand that this is going to be a work in progress, that no one is going to be able to get it perfect right out of the gate, especially because many of the details still need to be worked out. Therefore, I think that the regulators are going to be working with their regulatees to help them understand the Rule and fill in those finer points. But it's going to take some time.

It is difficult to advise clients in these kinds of "work in progress" situations, because clients, understandably, just want to know what they need to do to not run afoul of the law. Telling them "it is uncertain" is not helpful, it's just frustrating and stress-inducing. However, on

many issues that's the best we can do right now. So, ultimately, I advise my clients on what I believe to be reasonable approaches and tell them to document their decision-making, to be able to demonstrate to their regulator that they acted reasonably and in good faith.

THFJ: Almost 1,500 new hedge funds were launched from 2011 to 2014. Many created by former bankers. Is that a Volcker impact?

JV: I think the Rule has had some impact on the number of managers and other personnel from banks spinning out of their banks in order to form their own hedge funds. In particular, many bank traders who used to engage in activity that is now prohibited under the prop trading ban, have left to form funds, rather than conform their activities within the bank or move to an overseas arm if they work for a non-US bank.

However, some of those banking entities are now setting up funds for their former traders, so that they can move from trading prop money (which is now prohibited) to trading client money (which is not).

Ultimately, I think that the impact of the Volcker Rule is probably a bit overblown, compared to other parts of Dodd-Frank, which I believe have had a larger impact. For instance, due to Dodd-Frank and Basel III, banks are now subject to heightened capital requirements, and as a result, many banking entities are looking to shore-up their balance sheets by selling-off or spinning-off non-core businesses, including hedge fund managers. As a bank looks to increase its capital, it may decide that certain activities are no longer essential to its business plan, and as a result, we've seen numerous banks spin-off some of their fund activities.

Moreover, under Dodd-Frank, there are new restrictions on incentive compensation. So the way in which banks can now pay certain personnel is changing from the way in which they were able to in the past, where banks were able to somewhat mirror the compensation structures and the bonus-potential of employees of managers that were not affiliated with banks. So I think that many bank employees believe that they may be able to make more money on the outside, and that's driven certain people to leave banks.

These two aspects have probably played as large, if not a larger role, than the Volcker Rule, in the movement we've seen. **THFJ**

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