

# PUBLICATION

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## Volcker Rule Restricts Banks' Activities with Hedge Funds and Private Funds

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On December 10, 2013, the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, the Office of Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission (Agencies) adopted the long-anticipated Volcker Rule, which was required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). Much of the coverage and media attention regarding the Volcker Rule has focused on its prohibition (and exemptions) for banks engaging in proprietary trading (trading for their own accounts, as opposed to trading done for client accounts). However, it also has a substantial impact on the investment management area, particularly for hedge funds and private funds. Dodd-Frank required that the Agencies adopt a rule prohibiting banks from owning an interest in a hedge fund or private fund. Under the Volcker Rule, banks may no longer own an interest in these funds (defined as "Covered Funds" under the Volcker Rule), with the exception of certain permitted activities. This Alert will analyze the definition of a Covered Fund and the permitted activities that banks still may engage in with respect to Covered Funds under the Volcker Rule.

### Covered Funds

Under the Volcker Rule, a Covered Fund includes any fund that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 to be excluded from the definition of an investment company (and thus, excluded from regulation as an investment company).<sup>1</sup> Funds relying on Sections 3(c)(1) or 3(c)(7) are generally considered to be hedge funds or private funds. The definition of a Covered Fund also applies to a commodity pool for which the pool's operator has claimed an exemption under Regulation 4.7 of the Commodity Exchange Act, as well as to a commodity pool that is owned by qualified eligible persons and whose units are not publicly offered. Such commodity pools are generally considered to share characteristics of a 3(c)(1) or 3(c)(7) fund. The definition of Covered Fund with respect to these pools is substantially narrower than under the Volcker Rule proposal issued in 2011, under which the definition of Covered Fund would apply to any commodity pool. Finally, the definition of a Covered Fund, for a bank located or organized in the U.S., includes an investment entity organized and offered solely outside the United States, unless the securities of such a fund are publicly offered (the foreign public fund exclusion).

Other entities excluded from the definition of a covered fund include:

- Wholly-owned subsidiaries;
- Joint ventures that do not engage in investing money for others;
- Acquisition vehicles;
- Foreign pension or retirement funds;
- Business development companies;
- Insurance company separate accounts;
- Small business investment companies and public welfare investment funds;
- Funds that rely on an exclusion from the definition of an investment company other than Sections 3(c)(1) and 3(c)(7) (this includes real estate funds that rely on Section 3(c)(5)(C) and energy funds that rely on Section 3(c)(9)); and
- Registered investment companies.

However, the Volcker Rule permits the Agencies to rescind any of these exclusions if such exclusion is being used to evade the requirements of Dodd-Frank.

Banks, once the Volcker Rule is in effect, banks may no longer own a proprietary interest in a Covered Fund, subject to the exemptions described below.

## Permitted Activities

While generally prohibiting a bank from having any interest in a Covered Fund, the Volcker Rule does provide a number of permitted activities for banks with respect to Covered Funds:

- Investments in a Covered Fund in connection with organizing and offering a Covered Fund for the bank's trust, fiduciary and advisory clients;
- Underwriting and market-making related activities (however, such activity may not exceed the reasonably expected near-term demands of the bank's clients, customers and counterparties – similar to the Volcker Rule's general ban on proprietary trading);
- Risk-mitigating hedging activities;
- Trading for the general account of a registered insurance company;
- Trading on behalf of customers;
- Sponsoring and investing in loan securitizations; and
- Any activity with a Covered Fund by a non-U.S. bank solely outside the U.S.

The restrictions on Covered Fund activities do not apply to trading in U.S. government or agency obligations, obligations of specified government sponsored entities and state and municipal obligations. Foreign governments have opposed the limitation to U.S. government securities.

The Volcker Rule also restricts permitted prime brokerage transactions with Covered Funds. These transactions must be on terms and circumstances the same or at least as favorable as the terms offered to unaffiliated companies. The Volcker Rule requires any bank that engages in Covered Fund activities to develop and maintain a compliance program reasonably designed to ensure compliance with requirements of the Volcker Rule for those activities. For banks with \$10 billion in assets or more, the compliance program must include: (i) written compliance procedures; (ii) internal controls; (iii) a management framework that describes responsibility for compliance; (iv) independent testing and audits; (v) training of employees; and (vi) recordkeeping. The CEO of a bank with assets of \$50 billion or more and significant Covered Fund activities must attest annually in writing that the bank has a compliance program reasonably designed to achieve compliance with the Volcker Rule.

## Conclusion

While much of the coverage of the Volcker Rule has focused on its restrictions on proprietary trading, the rule also has a significant impact on the investment management industry. Banks that have relationships with private funds and private funds that have relationships with banks should examine how the Volcker Rule may impact those relationships. While the effective date of the Volcker Rule is April 1, 2014, the Agencies have extended the compliance deadline until July 21, 2015.

If you have any questions about the Volcker Rule and how it will affect your business, please contact a member of the Firm's Securities and Corporate Governance Group.