The Volcker Rule: Prohibition on Sponsorship and Investment in Covered Funds

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The Volcker Rule

• The “Volcker Rule” is the popular name of Section 619 of the Dodd-Frank Act (DFA), enacted in July 2010
  • Codified as Section 13 of the Bank Holding Company Act
• Section 619 of the DFA prohibits (with exceptions) banking entities from
  • Engaging in proprietary trading
  • Sponsoring or investing (or retaining an interest in) private equity and hedge funds
The Volcker Rule

- The statute is broad
  - Congress left regulators to construe it without much specific direction
- October 2011: First proposed rules
  - Rule proposals drew comments, including from international banking community
- December 10, 2013: Final Rule
  - Effective April 1, 2014
  - 71 pages
  - 900-page preamble
Conformance Period

- The Volcker Rule took effect by statute on July 21, 2012
- Provides for a two-year conformance period, ending July 21, 2014
  - Conformance period recently extended one year by Federal Reserve to July 21, 2015
- Each banking entity expected to make good faith efforts to conform by end of conformance period
  - New capital commitments likely prohibited
  - Develop plan for disposition or restructuring of existing prohibited investments
  - Capital calls under existing commitments
Conformance Period

- Two one-year extensions possible, upon application
- Further extension of up to five years available, upon application, for continued investment/activity with respect to an “illiquid fund”
- To qualify for “illiquid fund” extension, must demonstrate that retention of interest necessary to fulfill a contractual commitment in effect on May 1, 2010
  - Condition not met if a “regulatory-out” allows sale or redemption of interest
  - Banking entity required to make reasonable best efforts to get consent for sale or redemption, and to have that consent denied
- No expansion of impermissible activities or investments during the conformance period with expectation of extensions
What the Volcker Rule Covers

Banking entities include
- US banks and thrifts
- Bank and thrift holding companies
- Foreign banking organizations (FBOs) that operate a branch or agency or commercial lending company in the US
- Affiliates of these entities

Banking entities do not include
- A covered fund (unless it is a banking entity included in one of the first three categories above)
- A portfolio company held by a financial holding company under merchant banking authority or insurance company authority, and a portfolio company held by a Small Business Investment Company (SBIC) (unless it is a banking entity included in one of the first three categories above)
Covered Funds Prohibition

- General prohibition
  - A banking entity, as principal, may not directly or indirectly acquire or retain an ownership interest in, or sponsor, a covered fund
- The prohibition on acquiring or retaining ownership interests does not apply if
  - The banking entity acts solely as agent, broker or custodian for the account of, or on behalf, of a customer and does not have its own ownership interest
  - The banking entity’s ownership interest is held/controlled by it as trustee in connection with a deferred compensation or similar plan
  - The ownership interest is acquired and held in the ordinary course of collecting a debt
  - The banking entity holds the interest as a trustee or in a similar capacity solely for a customer that is not itself a covered fund
Scope of Prohibition

- A banking entity may not **sponsor** a covered fund, subject to certain exceptions
- Sponsorship means
  - To serve as a general partner, managing member, trustee or commodity pool operator (CPO) of a covered fund
  - To select or control selection of a majority of directors, trustees or management of a covered fund
  - To share with the covered fund the same name or a variation of the name
Scope of Prohibition

• A banking entity may not acquire/retain an **ownership interest** in a covered fund, subject to certain exceptions

  • Ownership interest
    • Means any equity, partnership or “other similar interest”
    • “Other similar interest” is broadly defined to include
      • An interest in or security issued by a covered fund that exhibits certain characteristics on a current, future or contingency basis
      • The right to participate in the selection/removal of general partner, or managing member, director, investment manager or adviser (but not including typical creditor’s rights in the event of a default or acceleration)
      • The right to receive a share of income, gains or profits, or the underlying assets (*e.g.*, the “residual” in a securitization)
    • Does not include “restricted profit interest” (carried interest)

• Ownership interest may include interests in a covered fund not considered an ownership or equity interest in other contexts
Scope of Prohibition

• Ownership interests in securitization vehicles
  • Many collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs) provide rights to a “controlling class” of senior debt security holders to participate in the designation of investment managers or advisers
  • As a result, holders of even the most senior, highly rated debt securities may be considered to hold ownership interests
  • If the securitization vehicle is a covered fund, a debt holder may inadvertently be covered by the Volcker Rule
  • CDOs holding trust preferred securities (TruPS) issued by certain issuers recently have been specially exempted
    • The exemption is narrow
    • Review of this issue is at the “top of the list” for the Agencies

What Is a Covered Fund?

• Statute prohibits investment in and sponsorship of private equity and hedge funds (not defined)

• Under the Final Rule, a “covered fund” includes an issuer that would be an “investment company” under the Investment Company Act of 1940 (1940 Act) but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act
  - Section 3(c)(1) exempts from the definition of “investment company” funds whose securities are sold privately to less than 100 purchasers
  - Section 3(c)(7) exempts from the definition of “investment company” funds whose securities are sold privately only to “qualified purchasers”

• These two exemptions are the principal ones relied upon by private equity and hedge funds, but many other investment companies rely on these exemptions

• Concept imported from Title IV of the Dodd Frank Act, requiring registration of investment advisers to private funds
What Is a Covered Fund?

• Commodity pools
  • A commodity pool is a covered pool when the CPO has claimed an exemption under Rule 4.7 under the Commodity Exchange Act (CEA)
  • The CPO is registered in connection with the operation of a pool that limits investors to qualified eligible persons (QEPs)
  • “Exempt” commodity pools are covered funds because they have characteristics similar to those of hedge funds or private equity funds
    • They are restricted to investors that meet heightened qualification standards
What Is a Covered Fund?

- Foreign covered funds
  - For a banking entity that is, or is controlled by, a US banking entity (which would include a US branch/agency of a foreign bank), a covered fund includes a foreign fund with the following characteristics
    - The fund is organized outside the US
    - The fund’s interests are offered and sold only to non-US persons
    - The fund is sponsored by the US banking entity (or an affiliate)
  - However, a foreign covered fund does not include a foreign fund that, if organized or offered in the US, would not rely on Section 3(c)(1) or 3(c)(7) for an exemption from the definition of an “investment company”
What Is Not a Covered Fund?

- Companies that do not meet the general definition of an “investment company”
  - For example, a fund may not be an investment company if it is not engaged or proposes to engage in the business of investing in securities that have a value exceeding 40% of the value of the company’s total assets (excluding cash and government securities)
- Funds that rely on an exception other than those found in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act
What Is Not a Covered Fund

• For a foreign banking entity (not controlled by a US banking entity), a foreign private fund may not be a covered fund if
  • The fund is organized under the laws of a foreign country; and
  • The fund is offered and sold solely to non-US persons

• However, the breadth of this exclusion is not entirely clear
  • Certain US connections to the fund may make the exclusion unavailable

• For this reason, it may be preferable for a foreign banking entity to rely on the foreign fund exemption, which we discuss below
What Is Not a Covered Fund?

• A foreign public fund is not a covered fund if
  • The fund is organized outside the US
  • The fund is authorized to offer and sell its interests to retail investors in the fund’s home jurisdiction (no investor suitability qualification)
  • The fund sells its interests predominantly through one or more public offerings outside the US (85% or more to non-US Persons)
  • If a US banking entity sponsors the fund, the interests must be sold predominantly to persons other than the sponsoring banking entity, its affiliates and their employees and directors

• Foreign funds that do not meet the specific conditions of this exclusion may not be covered funds for other reasons
  • For example, they may qualify for the foreign fund exemption (discussed below), or they may rely on exemptions other than those found in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act
What Is Not a Covered Fund?

- Loan securitization vehicles
  - Loan securitization issuers may meet the definition of a covered fund if they rely on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act
  - But the Volcker Rule was not intended to limit the ability of banking entities to sell or securitize loans
  - Thus, the definition of a “covered fund” explicitly excludes issuers of collateralized obligations secured by loans (e.g., mortgage loans, auto loans, student loans and credit card receivables), including commercial paper conduits backed by loans
  - However, there are detailed requirements for this exclusion, and securitization vehicles with assets that include securities or derivatives may not qualify for the exclusion and therefore are covered funds
  - The treatment of securitization vehicles is complex

What Is Not a Covered Fund?

- Entities excluded from the definition of covered fund
  - Wholly owned subsidiaries
  - Joint ventures
  - Acquisition vehicles
  - Registered investment companies (including seeding vehicles)
  - Qualifying covered bonds
  - Other excluded entities
    - Foreign pension or retirement funds
    - Insurance company separate accounts
    - Bank-owned life insurance company separate accounts
    - SBICs and certain permissible public welfare and similar funds
    - Entities used by the Federal Deposit Insurance Corporation (FDIC) to dispose of assets as receiver or conservator
- Federal agencies will evaluate requests for more exclusions
What May or May Not Be a Covered Fund

• The federal agencies declined to exclude certain entities from the definition of covered fund despite requests to do so
• In some cases, these are likely covered funds and in others not
• These entities include
  • Financial market utilities
  • Collateral cash pools
  • Pass-through real estate investment trusts (REITs)
  • Municipal securities tender option bond transactions
  • Venture capital funds
  • Credit funds
  • Employee securities companies
Implications of Not Being a Covered Fund

• Why does it matter if a fund is a covered fund?
  • If a fund is not a covered fund under these exclusions, the prohibitions on
    sponsorship and investment do not apply and prudential backstops and the need
    for a compliance program are not triggered, as discussed below
Permitted Activities and Investments

- Customer funds
  - A banking entity may acquire ownership interests in, and/or sponsor, a covered fund as a means of offering investment opportunities to its existing or future customers
  - This customer fund activity must be in connection with the banking entity’s trust, fiduciary or investment management services for customers pursuant to a written plan
  - Detailed conditions apply
    - Among other things, the banking entity
      - Cannot guarantee performance of customer funds
      - Cannot share the same name as a customer fund
      - Must make clear and conspicuous specified disclosures in writing to prospective investors
Permitted Activities and Investments

• Asset-backed securities
  • A banking entity may acquire ownership interests in an issuing entity of asset-backed securities* that is a covered fund, but only in connection with the banking entity’s organization and offering of the covered fund’s ownership interests, subject, generally, to the same conditions that apply to customer funds
    • This exemption does not permit a banking entity to invest, as a passive investor, in ownership interests in securitization vehicles that are covered funds

• Underwriting and market-making activities
  • A banking entity may acquire an ownership interest in a covered fund in connection with the banking entity’s underwriting or market making of the covered fund’s ownership interests, as long as those activities conform to the Volcker Rule's requirements for permissible underwriting and market making-related activities

*See Securities and Exchange Act of 1934, §3(a)(79)
Investment Limitations

• Per-fund limits
  • A banking entity’s and its affiliates’ investment in covered funds, as a general rule cannot exceed 3% of the value of, or the number of ownership interests in, the covered fund
    • During a seeding period of up to one year, the investment may exceed the 3% limit while unaffiliated investors are actively solicited
  • Special rules apply for calculating the per-fund investment limits for ownership interests held in
    • asset-backed securities issuers in connection with a banking entity’s organization and offering of that entity’s ownership interests and
    • covered funds whose ownership interests are underwritten by a banking entity or in which a banking entity makes a market
Investment Limitations

• Aggregate investment limits
  • The aggregate value of all ownership interests in such permitted covered fund investments cannot exceed 3% of the banking entity’s Tier 1 capital

• Capital deduction
  • A US banking entity (but not an FBO) is required to deduct from Tier 1 capital its investment in such funds
  • The Volcker Rule treatment does not correspond to Basel III risk weights and deductions for fund investments
  • The Agencies intend to review the interaction between the Volcker Rule and Basel III and propose steps to reconcile them
"Super 23A" and 23B Restrictions

- No banking entity that (i) advises or sponsors a covered fund, (ii) organizes and offers a customer fund or an issuer of ABS, or (iii) holds an ownership interest in an ABS issuer, and no affiliate of any of these, may enter into any of the following transactions with the fund*
  - A loan or extension of credit to the fund (including repos)
  - The purchase of securities issued by the fund (except for permitted ownership interests)
  - The purchase of assets from the fund
  - The issuance of guarantees, acceptances or letters of credit on behalf of the fund
  - Securities borrowing or lending or derivative transactions that result in the banking entity having a credit exposure to the fund

*Section 23A also prohibits the acceptance of securities issued by an affiliate as collateral for a loan, but as such a transaction would not be with the covered fund, it is not subject to Super 23A
“Super 23A” and 23B Restrictions

• These restrictions are called “Super 23A” because, unlike Section 23A itself, which allows affiliated transactions within limits, these prohibitions are absolute

• However, the following transactions are permitted
  • Acquisitions of ownership interests in a covered fund to the extent permitted elsewhere in the Final Rule
  • Subject to certain conditions, prime brokerage transactions (transactions that would be subject to Super 23A but are provided in connection with custody, clearance and settlement, securities borrowing and lending, trade execution, etc.) with a covered fund in which a covered fund that is managed, sponsored or advised by the banking entity or its affiliates has taken an ownership interest (a “second-tier fund”)

• The “market terms” requirement of Section 23B of the Federal Reserve Act also applies, as if the banking entity were a bank and the fund it sponsors or advises, its affiliate
Other Permitted Activities and Investments

• Risk-mitigating hedging activities
  • Sponsorship of, and investment in, covered funds engaged in permitted risk-mitigating hedging activities, subject to extensive conditions, including a specific internal compliance program

• Insurance companies
  • Investment and sponsorship by regulated foreign and domestic insurance companies of any covered funds, if conducted in compliance with applicable insurance investment laws
Other Permitted Activities and Investments

• Foreign fund exemption
  • In addition to the *exclusion* from the definition of covered fund for certain foreign funds, the Volcker Rule contains an *exemption* for a foreign covered fund
  • To qualify for the foreign fund exemption, the investor/sponsor
    • May not be a US banking entity or controlled by a US banking entity
    • If an FBO, must be a qualified foreign banking organization (QFBO)
    • If not an FBO, must be organized outside the US and have a majority of its business outside the US
    • Must make investment/sponsorship decisions outside the US—i.e., decision-making personnel must be outside the US (back office and administrative functions can be in the US, and investment advice can be given from the US)
Other Permitted Activities and Investments

- Additional conditions for foreign fund exemption
  - Fund interests may be offered and sold only in an offering that does not target US Persons (basically, compliant with SEC Regulation S, with appropriate disclosures)
    - Secondary trades?
  - Fund investment/sponsorship (including any related hedging) cannot be booked or accounted for in a US entity (including in any US branch/agency)
  - No financing of any fund investment/sponsorship may be provided by a US affiliate (including any US branch/agency)
  - Prudential backstops apply

Prudential Backstops

• No permitted fund investments and activities are permissible if
  • The investment/activity involves or results in a material conflict of interest between the banking entity and its clients, customers or counterparties, unless
    • The banking entity makes clear and timely disclosure of the conflict, or
    • The banking entity uses information barriers, such as physical separation of personnel or functions, that address the conflict
  • The investment/activity results in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy
  • The investment/activity poses a safety and soundness threat to the institution or a threat to US financial stability
Other Regulations Not Pre-empted

- None of the activities or investments permitted under the Volcker Rule pre-empt other applicable investment or activity limitations that apply to banking entities and their affiliates
  - A banking entity must evaluate any such investment/activity under both the Volcker Rule and other regulations of the Board of Governors of the Federal Reserve applicable to investments and activities by banking entities and their affiliates
  - For example, a bank holding company may be able to hold 10% of a real estate fund under the Volcker Rule
    - However, the bank holding company may not be able to invest in more than 4.9% of the ownership interests of such a fund under other applicable provisions of the Bank Holding Company Act
Compliance Programs

- The compliance program requirement applies to all banking entities (including FBOs) engaged in proprietary trading or permitted covered fund investment/activity
  - If a banking entity is not engaged in proprietary trading (other than trading in US government obligations) or covered fund investment/activity, it is not required to establish a Volcker Rule-specific compliance program
    - However, it will need to determine whether it is engaging in such activities
  - Banking entities with such activities/investments that have total consolidated assets of $10 billion or less need only refer to the requirements of the Volcker Rule in their compliance policies and procedures and make “adjustments as appropriate given the activities, size, scope and complexity of the [banking entity]”
Compliance Programs

• All other banking entities engaged in covered fund activity must implement a compliance program that meets the following six criteria
  • Written policies and procedures reasonably designed to document, describe, monitor and limit proprietary trading activities, and activities and investments with respect to covered fund activities, to ensure compliance with the Volcker Rule
  • A system of internal controls reasonably designed to monitor compliance with the Volcker Rule, and to prevent the occurrence of activities or investments that are prohibited by the Rule
  • A management framework that delineates responsibility and accountability for compliance with the Volcker Rule and includes management review of trading limits, strategies, etc.
  • Independent testing and audits of the effectiveness of the compliance program
  • Training for trading personnel and managers, as well as other “appropriate” personnel, to appropriately implement and enforce the compliance program
  • Records sufficient to demonstrate compliance with the Volcker Rule
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