

Davis Polk

**Volcker Rule Materials
Hedge and Private Equity
Funds**

October 7, 2011

DPW Proposed Rule Memo

Summary of Leaked Volcker Release — Funds

Based on staff draft of Sept. 30, 2011 leaked to the *American Banker* on Oct. 5, 2011

- **Draft may have changed since leak.** The leaked draft includes the rulemaking release only, not the proposed rule text or the compliance appendix.
- **Comment Period.** Deadline for comments bracketed as Dec. 16, 2011. Hundreds of questions throughout draft suggest disagreement among agencies.
- **Effective Date.** July 21, 2012. Compliance programs and record-keeping must also be in place and effective on this date.

Scope of General Prohibition:

- **General prohibition:** Prohibits any “banking entity” from sponsoring or acquiring “as principal” “ownership interests” in a “covered fund,” subject to certain exemptions
- **“Covered Funds”**
 - **Included:**
 - Any issuer that relies exclusively on the 3(c)(1) or 3(c)(7) exemptions from the definition of investment company
 - No distinction between covered hedge funds and covered private equity funds despite real-world differences
 - **Similar funds:**
 - Commodity pools
 - “Foreign equivalents” of covered funds
 - **Excluded:**
 - **Joint ventures** that are operating companies and do not engage in any activity prohibited under the Volcker Rule
 - **Acquisition vehicles**
 - **Wholly owned subsidiaries** that are principally engaged in providing liquidity management services and are carried on the balance sheet of the banking entity
 - **Loan securitization vehicles**
- **“As Principal” Limitation**
 - Prohibition only applies to investments “as principal”
 - Thus, prohibition does not apply to investments:
 - In a fiduciary capacity
 - As custodian, broker, agent for unaffiliated third party
 - By qualified employee benefits plan under ERISA

- By a director or employee in his or her personal capacity, but only if directly engaged in providing advisory or “other services” to covered fund, and not made with funds borrowed from banking entity
- **“Ownership Interests”**
 - **Included:**
 - Voting and non-voting equity of covered fund
 - Debt securities of covered fund that have substantially the same characteristics as equity
 - **Excluded:**
 - Carried interest that is not reinvested in the fund (among other conditions)
 - Permitted director/employee investments if not made with funds borrowed from banking entity
- **Financial Stability Exemptions:**
 - Expressly permitted to acquire and retain ownership interests in covered funds, if acquired:
 - Through a BOLI/COLI separate account
 - In satisfaction of debt previously contracted in good faith
 - Before the effective date of the Volcker Rule (but only for the duration of the conformance period)
 - Super 23A still applies (exemption does not extend to Super 23A)
- **Asset Management Exemption**
 - **Customer requirement:** Satisfied for both new and existing customers by organizing and offering a fund to such customers; Reg D and other securities law requirements still apply
 - **Investment Limits** (applicable on an ongoing, not a snapshot, basis)
 - **Per fund limit:** 3% of invested capital or loss exposure
 - **Aggregate Tier 1 limit:** 3% of Tier 1 capital of top-tier BHC (or, if held through a bank ownership chain, the lesser of 3% of bank’s or BHC’s Tier 1 capital)
 - **Invested (not committed) capital:** Calculated using invested (not committed) capital in both numerator and denominator
 - **Timing of calculations:**
 - **Per fund limit:** Must calculate as often as redemptions allowed or valuation calculated (e.g., daily for certain hedge funds), but no less frequently than quarterly (e.g., for most private equity funds)
 - **Aggregate Tier 1 limit:** Quarterly
 - **Carried interest / permitted director/employee investments:** Generally not counted toward 3% limits
 - **Limited to asset management exemption:** Investment limits apply only to asset management exemption, not to hedging, financial stability or other exemptions
 - **Hedging Exemption**

- **Limited to Two Types of Risk:** Permits long positions in covered funds to hedge risks arising out of:
 - **Customer driven derivatives:** Providing non-banking-entity customers exposure to covered funds (e.g., total return swaps or hedge-fund-linked notes)
 - **Employee compensation:** Providing employees with incentive compensation linked to the performance of a covered fund, provided the employee directly provides advisory or “other services” to the covered fund
- **Close match between reference asset and hedge:** Must have a close equivalency between reference asset and the hedge — i.e., no hedging on a portfolio or macro basis
- **Documentation:** Must document risk-mitigating purpose and identify risks that the hedge is designed to reduce
- **Offshore Exemption**
 - **Foreign banking entity.** Limited to foreign banking entities not directly or indirectly controlled by a U.S. company
 - **Solely outside the U.S.** Investment must be acquired and held, and any sponsorship must occur, outside the U.S.
 - **No Employees Located in the U.S.** No employees located in the U.S. can be involved in the offer or sale of a covered fund
 - **No U.S. Incorporated Affiliates.** No affiliates incorporated in the U.S. can be involved in the offer or sale of the covered fund
- **“Banking Entity”** does not include:
 - **Fund of Funds.** Any covered fund of funds or any entity directly or indirectly controlled by such covered fund of funds
- **Directed Trustees.** The term “sponsor” excludes directed trustees and any other trustee that does not exercise investment discretion

Super 23A

- **No Exemptions.** Does not incorporate exemptions from regular 23A (e.g., intraday extensions of credit, extensions of credit backed by government securities)
- **Attribution Rule.** Does not appear to incorporate the attribution rule from regular 23A
- **Does not expand Super 23A** to unaffiliated funds with which banking entity simply has business relationships, as suggested by FSOC study

Compliance

- **Compliance Program.** All banking entities engaging in Volcker covered activities must establish a compliance program “reasonably designed” to ensure and monitor compliance and “suitable for the size, scope, and complexity of activities and business structure of the banking entity”
 - **Minimum Requirements.** Must include internal policies and procedures; internal controls; management responsibility/accountability framework; independent testing of effectiveness; training; and recordkeeping

- **Less complex for smaller institutions:** A banking entity is exempt from certain minimum standards if the banking entity has, together with its affiliates and subsidiaries \$1 billion in aggregate fund investments, or sponsors and advises any covered fund with average total assets of \$1 billion or more

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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