VOLCKER RULE – QUESTIONS AND ANSWERS FOR PRIVATE EQUITY

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To Our Clients and Friends:

On May 20, the U.S. Senate passed its version of comprehensive financial reform, entitled the Restoring American Financial Stability Act of 2010, which will now be reconciled with parallel legislation passed last December by the U.S. House of Representatives. The Conference process will start this week, reportedly using the Senate bill as a foundation, and with the goal of producing a final bill for President Obama's signature before the July 4th weekend.

The Senate bill (but not the House bill) contains the so-called "Volcker Rule" – a prohibition on banking organizations engaging in proprietary trading and sponsoring/investing in private equity and hedge funds. The questions and answers below outline the potential impact of the Volcker Rule on private equity and hedge funds; this client update does not address the Volcker Rule's ban on proprietary trading.

Numerous amendments were introduced in the Senate to make the Volcker Rule both more and less restrictive, and it is possible – and perhaps likely – that the Rule will be altered in the Conference Committee; this client update is based on the Volcker Rule as passed in the Senate. This client update is divided into two sections: overview of the legislation, and application to specific fact patterns.

OVERVIEW OF THE VOLCKER RULE LEGISLATION

Which organizations would be subject to the Volcker Rule?

The Volcker Rule would apply to an organization that has an FDIC-insured depository institution in the family. This would include bank-centric financial services firms and other organizations, such as investment banks, insurers and asset managers, that have an insured depository institution as a subsidiary. For ease of reference, we call all of these firms "banking organizations" in this client update.

Would non-U.S. banks be subject to the Volcker Rule?

Non-U.S. banking organizations that have a U.S. subsidiary bank or thrift or a U.S. branch, agency or commercial lending subsidiary would be subject to the Volcker Rule, at least to the extent of their U.S. activities.

Importantly, the Volcker Rule would *not* apply to activities of non-U.S. banking organizations that occur "solely outside of" the United States. The Senate bill does not clarify what "solely outside of" means; this will likely be addressed in implementing regulations. Non-U.S.

affiliates of U.S.-based banking organizations (those controlled by an entity organized under U.S. laws) would *not* be able to take advantage of this "solely outside of the United States" exception to the Volcker Rule.

The U.S. Federal Reserve Board has in other contexts allowed banks to deem fund activities to be taking place outside of the United States "if the fund's shares are not sold in the United States or to U.S. residents." At a minimum, it would appear likely that, to avoid the Volcker Rule, non-U.S. banks' funds would need to be structured in this manner. It is not clear whether such funds could be managed from the United States (which we think is not likely to be permitted) or invest in U.S. companies (which also may not be permitted).

Which funds would be subject to the Volcker Rule?
The Volcker Rule would apply to any pooled investment vehicle that is exempt from registration as an investment company under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. The Volcker Rule also would apply to a "similar" fund "as jointly determined by the appropriate Federal banking agencies."

The legislation does not specify how or when the agencies should determine what is a "similar fund." Presumably, they will do so through regulations, which means that "similar funds" may not immediately, or perhaps ever, be affected by the Volcker Rule's prohibitions.

Also, the Senate bill contains certain exemptions. Specifically, the prohibition would not apply to investments in small business investment companies (under the Small Business Investment Act, 15 U.S.C. § 662) or certain public welfare investments (under 12 U.S.C. § 24).

Although not explicit in the legislation, entities controlled by a covered fund may also be treated the same as the fund itself.

Are investments in operating companies (as opposed to funds) prohibited?
It does not appear so. As noted above, the Volcker Rule prohibits investments in private equity and hedge funds and proprietary trading (a term that may be defined further in the regulatory process). Direct investments by banking organizations in operating companies that are not held for trading purposes but for longer-term investment purposes, such as under the merchant banking rule, may be allowed. Regulations may clarify what is permitted.

What are the Volcker Rule private equity and hedge fund restrictions?
In brief, the restrictions fall into two categories:

Prohibition on sponsoring/investing. First, the Senate bill requires the federal banking agencies to issue rules that would prohibit banking organizations from "sponsoring or investing in" a private equity or hedge fund. Under the current Senate bill, this prohibition,

discussed in greater detail below, would not be effective until the agencies issued these regulations.

Restrictions on relationships with advised funds. Second, the Senate bill would ban certain "covered transactions" between a private equity or hedge fund and the banking organization that serves, directly or indirectly, as the fund's investment manager or investment adviser. Also, transactions between such advised funds and the banking organization generally would need to be on market terms – that is, on terms that would be offered to an unaffiliated third party; for example, this rule is intended to prohibit "sweetheart" deals for the fund.

As explained further below, this part of the Volcker Rule (pertaining to advised funds) is unclear in several respects, and there is no consensus on whether the prohibition applies to all parts of the banking organization and when the prohibition takes effect. By its literal terms, this prohibition could be effective immediately upon enactment of the law.

What is prohibited "sponsoring or investing" in a fund?

"Sponsoring" is defined to include three activities: (i) serving as a general partner, managing member or trustee of a fund; (ii) selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of the fund; or (iii) sharing the same name or a variation of the same name with a fund. Sponsoring is *not* defined to include serving an investment adviser.

"Investing" is not defined in the Volcker Rule. We presume it would include taking any investment stake in a private equity or hedge fund.

What are the "covered transaction" restrictions applicable to advised/managed funds?

The Volcker Rule prohibits a banking organization and a fund from entering into a "covered transaction" – as that term is defined in Section 23A of the Federal Reserve Act. Under Section 23A, covered transactions include:

- a loan or extension of credit to the fund;
- a purchase of or an investment in securities issued by the fund;
- a purchase of assets, including assets subject to repurchase, from the fund;
- the acceptance of securities issued by the fund as collateral for a loan or extension of credit to any third party; and
- a guarantee, acceptance, or letter of credit on behalf of the fund.

Thus, it would appear that this term would cover loans, capital contributions to and various types of other transactions with an advised fund. Capital commitments existing as of the time the law is enacted, however, may not be covered, as discussed below.

Also, it should be noted that transactions with third parties that benefit or have their proceeds go to an advised fund would likely be treated as "covered transactions." For example, if a banking organization made a loan to a portfolio company in order to facilitate that company's payment of dividends to a fund advised by the banking organization, the loan could be treated as a loan directly to the fund and, thus, a prohibited covered transaction.

Would "covered transactions" between *all* parts of a banking organization and an advised fund be prohibited?

There is some ambiguity here. Under the literal terms of the Senate bill, the "covered transaction" limit would apply only to transactions between the advised fund, on the one hand, and the insured depository institution, a company that controls it, and any subsidiary of such company or institution that "serves, directly or indirectly, as the investment manager or investment adviser" to the fund.

We believe a sound argument can be made that this language would not capture the other entities within the banking organization that are not (i) depository institutions, (ii) serving as adviser/manager to the fund or (iii) the direct or indirect parent of any such adviser. So, for example, if a broker-dealer were a separate subsidiary of a banking organization and not in the control chain over the adviser to the fund, that broker-dealer could engage in transactions with the fund (*e.g.,* extensions of credit attendant to prime brokerage activity) without regard to this restriction. To be clear, though, the broker-dealer would still be subject to the restriction (once effective) on investing in and sponsoring a fund, as that emanates from the other part of the Volcker Rule.

Some have argued that the "directly or indirectly" language might be interpreted to cover every entity within the banking organization, believing this to be the intent of the drafters. We cannot discount this argument entirely, but believe it is the weaker view of the plain language.

What advisory relationships would trigger the "covered transaction" restriction?

The "covered transactions" restriction would apply to any investment advisory/management relationship by a banking organization with a private equity or hedge fund, where the banking organization "serves, directly or indirectly, as the investment manager or investment adviser" to the fund. The Volcker Rule does not define "investment manager or investment adviser." Because the legislation does not specifically address "sub-advisory" relationships, some have suggested they may not be covered. Based on the plain language of the Senate Bill, it is not clear that any distinction will be drawn between advisory and sub-advisory relationships; regulations may help to clarify this point.

To be clear, if any investment advisory/management relationship exists between the banking organization and the fund, these restrictions would apply — even if the banking organization is not sponsoring or investing in the fund. Conversely, if a banking organization is investing in a fund, but does not have an advisory/management relationship with it, then this set of restrictions would *not* apply.

What is the market terms requirement on advised funds?

In general, the Volcker Rule would require that transactions between banking organizations and advised funds be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the banking organization, as those prevailing at the same time for comparable transactions with non-affiliated funds.

When would these Volcker Rule's restrictions take effect? Would any restrictions become effective immediately on passage of final legislation?

First, if the final legislation follows the Senate bill, it seems clear that the prohibition on sponsoring/investing in private equity and hedge funds will not be immediately effective. The Senate bill, instead, calls for a study to be conducted by a council of regulators (the "Council") and, following that study, rules to be issued. That study and rulemaking process is required to be completed within 15 months of the enactment of the legislation. (It is possible, but seems unlikely, that the process could be completed more quickly; it also is possible that the regulators would miss their deadlines, in which case compliance deadlines presumably would be delayed.)

The Senate bill states that the regulations must have an effective date no later than two years after they are issued. So, if the rules are written on schedule, the prohibition on sponsoring and investing would likely become effective three years and three months after the law is passed.

In addition, the Senate bill would allow banking regulators to grant up to three one-year extensions. Presumably, these extensions would be granted on an institution-by-institution basis. Traditionally, banking regulators have not readily granted statutorily allowed extensions (absent a substantial showing of good cause), so it is not clear how easily firms may obtain extensions.

Second, it is much less clear when the prohibition on "covered transactions" with advised funds (and the market terms requirements for other transactions with such funds) would become effective. On the one hand, this restriction is not expressly predicated on rulemaking, so the plain language of the Senate bill suggests that this restriction would be effective upon enactment of the law. On the other hand, the above-noted Council study process would encompass the "covered transactions" restrictions; so, there is an argument that the "covered transaction" restrictions are not intended to be immediately effective.

It is possible that this timing issue will be clarified in Conference. Unless there is clarification in Conference or subsequently from the regulators, it is prudent to plan for the possibility that these restrictions may be immediately effective.

If the "covered transaction" restriction is immediately effective, would it apply to pre-existing capital commitments by banking organizations to funds?

There is some debate on this point, but there is an argument that at least some pre-existing commitments would not be captured. The Senate bill would prohibit "enter[ing] into" a covered transaction. Therefore, although not free from doubt in the absence of clarifying regulations, we think the better reading is that the prohibition will not apply to the fulfillment of contractual obligations that were entered into before the law is enacted, *e.g.,* draw-downs after enactment of capital commitments made prior to enactment.

We reach this view because the Federal Reserve, in the context of Section 23A, has taken the position that a covered transaction is entered into when a contractual commitment is made. Thus, for example, the entry into a line of credit agreement creates the covered transaction; subsequent draw-downs on the line are not separate or new covered transactions. That said, a renegotiation of, renewal of or increase in the amount of a line of credit would likely be a new covered transaction.

If a similar view is adopted with respect to the Volcker Rule – and we cannot predict whether regulators would take such a view – those contractual commitments that exist at the time the law is enacted would not be covered by this restriction.

What changes could be made in the regulatory process?

This is a question on which there is no clear answer. As noted above, there is a provision in the Senate Bill for the Council to study various aspects of the Volcker Rule. The Council is required to make "recommendations," including "modifications."

Among the "modifications" that the Council may recommend is whether the Volcker Rule's prohibitions should be absolute or apply only above "a specific threshold amount" with additional capital requirements imposed on activities conducted below the threshold. The regulations promulgated by the banking agencies then must reflect the recommendations and modifications from the Council study. In other words, it appears possible that the Volcker Rule might only prohibit sponsoring and investing in funds above certain levels.

There is debate on whether such reasonable steps are likely. Some have taken the view that the term "modification" is meant to allow only minor deviations from the statutory language and not large scale-backs from the prohibitions encompassed in the bill. Moreover, in a charged political climate, it may be difficult for the Council to recommend modifications to prohibitions that some may say were intended to be absolute.

What changes could be made in the legislative process?

Again, there is no clear answer. There is significant speculation that the prohibitions may be modified in the Conference process, for example, by removing or modifying the absolute prohibition on "covered transactions" between an advised fund and the banking organization. An amendment was also proposed in the Senate that would have written into the law a specific level of permitted investments; that approach could be raised again in the Conference. Others have suggested, however, that the prohibitions might be made more restrictive, for example, by proponents of the so-called "Merkley-Levin" amendment in the Senate to limit the regulators' discretion to create exceptions.

SPECIFIC FACT PATTERNS

What does the Volcker Rule require if a banking organization is the general partner or managing member *(only)* of a fund?

The banking organization would have to cease acting as general partner or managing member no later than three years and three months of enactment, unless: (i) the agencies write regulations permitting sponsorship up to a threshold amount, or (ii) the organization obtains extensions of the deadline from its bank regulator. In addition, to the extent that the fund bears the same or similar name to the banking organization, the fund's name would need to be changed.

What does the Volcker Rule require if a banking organization is a general partner or managing member of, *and* adviser to, a fund?

Again, the firm would have to cease acting as general partner or managing member, as discussed above.

If the firm also serves as the investment adviser or investment manager to the fund, then the other limits discussed above also would apply: (i) no "covered transactions" between at least certain parts of (and possibly all of) the banking organization and the fund (*e.g.,* some or all parts of the banking organization would not be able to lend to the fund, purchase its assets or securities issued by it or provide guarantees to the fund), and (ii) other transactions with the fund would need to be on market terms. Unless clarified by the regulators, these limits would appear to apply when the legislation is enacted, though perhaps subject to the ability to fulfill pre-existing commitments.

What does the Volcker Rule require if a banking organization is an adviser *(only)* to a fund but does not serve as the fund's general partner or invest in the fund?

The rules discussed above – *i.e.*, limits on covered transactions and the requirement that other transactions be on market terms – apply if the banking organization serves only as investment adviser or investment manager.

What does the Volcker Rule require if a banking organization is only a lender, has a line of credit with or has other (non-advisory/management) service relationships to a Fund?

The Volcker Rule would not be applicable in this case. The Rule would apply only to sponsorship, investment in and serving as an investment adviser or manager to a fund.

What does the Volcker Rule require if a banking organization has an ownership interest in a fund, and has no other relationships?

The organization would not be able to retain that ownership interest effective within three years and three months after legislation is enacted, unless (as discussed above) the firm obtains a regulatory extension or the regulators write regulations permitting firms to own or retain some investments.

The other part of the Volcker rule (re: "covered transactions") would not apply here because the organization lacks an advisory/management relationship with the fund.

What does the Volcker Rule require if a banking organization is part of a joint venture, which in turn is the general partner/member manager of a fund?

If the joint venture is "controlled" by the banking organization, then the joint venture would be treated as part of that organization and thus subject to all of the Volcker Rule, including the prohibition on serving as general partner or managing member. Bank regulators' view of "control" is generally broader than common usage and includes cases where the regulator determines that an organization may exercise a controlling influence over a GP/managing member based on "all the facts and circumstances." Ownership of as little as 25% of another entity's voting securities is viewed by the bank regulators as control, and even lower amounts (such as 15% or 10%) can be viewed as control, especially if there are other indicia of control, such as overlapping management or representation on the joint venture's board of directors.

Please feel free to contact us with any questions.

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