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# The Volcker Rule: Key Considerations for Non-U.S. Banks and their Private Funds Teams

In December 2013, U.S. financial regulators published joint final regulations to implement Section 13 of the Bank Holding Company Act, originally enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") and commonly referred to as the "Volcker Rule".

There has since been significant commentary on the application of the Volcker Rule, much of which has understandably focused on the restrictions relating to banks' proprietary trading operations. However, the Volcker Rule also impacts significantly on banks which hold interests in private equity funds (and similar funds such as infrastructure, real estate and debt funds). Its provisions relating to such interests are in some ways more complex than the proprietary trading restrictions.

Although primarily designed to limit the activities of U.S. banks, the Volcker Rule will also affect non-U.S. banks that have a connection to the United States and which hold or intend to acquire interests in private funds which have been or will be marketed in the United States. Many of these banks will be required to divest the private fund portfolios held on their balance sheets by July 2015 and will be restricted in their ability to make new private fund investments.

This paper has been prepared by Campbell Lutyens and Clifford Chance in order to address some of the key issues facing investment professionals within non-U.S. banks who are managing investments in private funds which are held on the bank's balance sheet.

The following questions have been posed by Campbell Lutyens based on its knowledge of the most common commercial issues raised by private equity teams investing from the balance sheet of non-U.S. banks and their affiliated entities. The questions have been answered by Clifford Chance based on its knowledge of the Volcker Rule and the views of the U.S. regulators. This paper is a high level summary of the position only and should not be relied on as legal advice. The actual regulations are lengthy and complex. Both Campbell Lutyens and Clifford Chance would be more than happy to discuss these issues further and contact details are included at the end of this paper.

## SECTION A: SCOPE OF THE VOLCKER RULE

### We are a non-U.S. bank with certain operations in the United States – does the Volcker Rule apply to us?

Most likely yes. In broad terms, the "banking entities" to which the Volcker Rule applies includes non-U.S. banks (and holding companies of non-U.S. banks) that have one or more branches or agencies in the United States or that have a U.S. bank subsidiary. A non-U.S. bank whose U.S. operations are limited to non-banking activities (e.g. a broker-dealer or non-bank finance company subsidiary) generally is not considered a banking entity and would not be caught by the Volcker Rule.

It is worth noting at the outset that even if a non-U.S. bank is a "banking entity" due to its U.S. banking operations, a regulated U.S. or non-U.S. insurance company subsidiary of a non-U.S. bank generally may invest in private funds through its general account or separate accounts.

**We have a portfolio of interests in private funds across the world on our balance sheet – will the Volcker Rule impact on these holdings?**

Yes (assuming you are a banking entity to whom the Volcker Rule applies). As a general matter, banking entities caught by the Volcker Rule may not "acquire or retain any ownership interest in or sponsor" a "covered fund". Banking entities have until 21 July 2015 to adjust their affairs in order to ensure compliance (subject to possible extension in limited circumstances). "Covered fund" is a broad term under the Rule and would catch the large majority of "typical" private equity and other private funds (with the exception of certain real estate funds, and then only in limited circumstances).

There are certain exemptions from the general prohibition, although they are limited in scope and not likely to be relevant to the majority of private funds and their banking entity investors. For example, exemptions may apply in connection with funds that a banking entity itself organizes and offers in connection with its asset management business; covered fund activities and investments by insurance company subsidiaries of a banking entity (as noted above); and covered fund activities and investments by a non-U.S. banking entity that occur "solely outside of the United States" (or "SOTUS") (though the exemption does not apply in circumstances where the non-U.S. banking entity holds interests in a fund in which one or more U.S. investors has also invested).

**We also have significant direct holdings of alternative assets on our balance sheet – how does the Volcker Rule affect these?**

These should not be caught if they are direct, single owner investments. The Volcker Rule prohibition applies to funds, not to their underlying investments, nor to certain wholly owned subsidiaries or joint venture entities formed for the purpose of acquiring such investments. However, care should be taken in the context of any arrangements which are more complicated than a straightforward direct, single-holder investment (see below).

**Many of the investments we make are structured as joint ventures, co-investment arrangements and other similar structures – are these likely to be captured by the Volcker Rule?**

Joint ventures, wholly owned subsidiaries and other corporate structures are generally, but not entirely, excluded from the "covered fund" definition in the Volcker Rule implementing regulations. The exclusion is subject to various detailed conditions. Broadly, the more "fund-like" a product or structure, the higher the risk that an exemption will not be available. So for example, a logical distinction can be drawn between a bona fide dual-party joint venture arrangement, on one hand, and a co-investment club comprised of institutional investors and advised by an external fund manager, on the other. This is an area where it will be important to check the specific facts on a case-by-case basis.

**We have interests in a number of private funds with no U.S. investors – are these caught by the Volcker Rule?**

Probably not, but determining whether a private fund has no U.S. investors for purposes of the legislation may not be a straightforward task. At a minimum, it will require the cooperation of the relevant GP. Input from other investors in the fund could also be required (or confirmation from the GP of various investors' details based on information previously provided by those investors). The incentive for GPs or other investors to accept any legal liability in this regard is low, even if they are minded to cooperate in practice. As a result, banking entity investors may wish to talk to the relevant GPs ahead of time to assess what level of comfort can be provided.

**We also have an insurance business within our bank that holds private equity fund interests – will the Volcker Rule also apply to these holdings?**

Probably not. Interests held by regulated U.S. or non-U.S. insurance companies or by insurance company separate accounts are generally permitted, as long as no banking entity other than the insurance company participates in the relevant profits and losses.

## SECTION B: COMPLIANCE TIMELINE

### What is the timeline within which we need to bring our business into compliance with the Volcker Rule?

30 June 2014 in relation to the various reporting and recordkeeping requirements imposed by the rule.

21 July 2015 in relation to the prohibition on retaining interests in private funds (though please see the paragraph below regarding potential extensions). The prohibition on acquiring new interests in private funds is already in effect.

### Is there any scope to extend this?

Yes, but limited. The 21 July 2015 deadline in respect of interests in private funds represents an extension of the original statutory deadline, which was 21 July 2014. The Federal Reserve only has authority to grant up to two further one-year extensions, and it has warned banking entities that they should not expect that further extensions will be effected.

### What are the penalties for non-compliance?

Varied, and not specific to Volcker. Under the Volcker Rule the authorities may compel the non-compliant banking entity to dispose of any prohibited investments. They may compel the banking entity to limit or terminate its wider fund investment program. The rule itself does not contain specific penalties and focuses more on effecting compliance than on punishment. However, the authorities may rely on their broader powers under other applicable securities, banking and similar laws to bring enforcement actions against banking entities and their personnel and affiliates for violations of those laws. This could involve both civil and criminal penalties. As such, non-compliance is not a viable option.

## SECTION C: SPONSORING PRIVATE FUNDS

### Is there scope in the Volcker Rule for us to continue sponsoring private funds?

Yes, but it will be more difficult if the funds are marketed in the United States. For example, the name of the covered fund cannot include the name of the banking entity sponsor. The sponsor's commitment to the covered fund will be compulsorily capped (see below), which investors may consider unattractive as a commercial matter. Moreover, the sponsor's aggregate commitment to all covered funds will also be capped (at 3% of the banking entity's Tier 1 capital, which must be assessed on a quarterly basis). The sponsor must also be deemed to be providing "bona fide" asset management services, although in most cases this requirement should be straightforward to satisfy.

### If we do sponsor such funds, can we provide seed capital or make house commitments?

Yes, up to 3%. The sponsor is obliged to seek to dilute any interest in excess of 3% from the outset, and must have done so no later than one year from the date of its commitment (which requirement may be extended by the authorities on a case by case basis but, on the face of things, will not necessarily be affected by a commercially-agreed final closing date extension). As a separate but related point, note also that only people who are directly engaged in providing investment advisory or other services to the fund are permitted to participate in any executive co-investment programs (to be assessed at the time he or she takes the ownership interest).

### We often provide banking services or leverage to the funds that we sponsor – can we continue to do this?

Not if the funds are marketed in the United States. This provision attracted extensive criticism and commentary during the public comment phase, but nevertheless was implemented in a substantially similar manner to that originally proposed. A banking entity is not permitted to lend or extend credit to, nor provide guarantees on behalf of, any covered fund it sponsors.

**Can we receive carried interest or other performance incentives in respect of private funds that we continue to sponsor?**

Generally yes. Be aware, though, that interests representing the co-investment portion of a carried interest commitment (including the amount needed to secure the desired tax treatment) are likely to count towards the 3% sponsor commitment cap described above.

## SECTION D: STRUCTURAL SOLUTIONS

**Are there any structural solutions that have been considered to avoid the impact of the Volcker Rule in respect of existing private fund interests – for instance, could we restructure our existing portfolio through non-U.S. feeders without U.S. investors and continue holding our interests in the underlying funds? Similarly, are there potential structural solutions regarding new private funds in which we wish to invest?**

Some possibilities have been, and are being, considered. However, this is an area where it is important to tread with considerable caution. The Volcker Rule includes a general injunction against anything that "functions as an evasion of [its] requirements", and the authorities have various powers to look through "sham, multi-tiered transactions", which may be perceived as a reference to feeder structures. In the context of an existing portfolio, any restructuring would need to factor in the transfer of underlying assets from one vehicle to another, involving potential consent issues as well as potential tax liabilities. Additionally, the relevant GPs may have little incentive (or indeed ability) to implement restructuring programs for the benefit of a limited subset of fund investors, though this may depend upon the number of affected investors and/or size of their commitments. Given the various complexities outlined above, for a number of organisations the focus has been on how, and when, to effect a smooth divestment process. Secondary transfers have been important in this context.

## SECTION E: UTILISING THE SECONDARY MARKET TO ADDRESS THE ISSUE

The private equity secondary market facilitates the sale and restructuring of both limited partnership fund interests and direct portfolios of private equity, infrastructure and other investments. The secondary market, particularly in private equity, is now firmly established as a substantial and sophisticated part of the market which is integral to the wider industry. Since 2007, private equity secondary market volumes have grown by approximately 14 percent on average per annum, peaking at a record level of approximately $26 billion in 2012[1].

A material proportion of secondary sales during this period has been carried out by banks, driven by factors such as the regulatory capital pressure of Basel II and III, the need to improve Tier I capital ratios, the desire to improve balance sheet utilisation, in some cases pressure to shrink or de-risk balance sheets and in others to exit non-core activities. Between 2011 and 2013, bank sales represented over 30 percent of the secondary market by volume[1].

The finalisation of the Volcker Rule has started to contribute to further restructurings of private fund assets from U.S. and non-U.S. banks that are within the scope of the legislation. Both Campbell Lutyens and Clifford Chance are highly experienced in advising banks on solutions to regulatory issues such as the restrictions imposed by the Volcker Rule, whether through restructuring existing portfolios of fund interests to facilitate ongoing compliance, or selling portfolios. Such portfolio sales can either be effected directly to third parties or through structured solutions to allow a degree of involvement in the portfolio by the banks following divestment.

[1] Campbell Lutyens research

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## About Campbell Lutyens

Campbell Lutyens is a leading independent private equity and infrastructure advisory firm founded in 1988. Its secondary advisory practice advises institutions and banks on the secondary sale, or restructuring, of portfolios of private equity, infrastructure and debt fund or direct interests. Its fundraising practice acts as a placement agent to private equity, infrastructure and debt fund managers, raising capital from investors globally. Campbell Lutyens comprises over 80 professionals, advisers and staff across offices in London, New York and Hong Kong.

Since the Dodd-Frank Act came into force, Campbell Lutyens has been a market-leading adviser to non-U.S. banks seeking to review and restructure their private equity portfolios in preparation for the implementation of the Volcker Rule. Campbell Lutyens has acted on secondary transactions of private equity and infrastructure fund interests for an aggregate value in excess of $35 billion, including $7.5 billion for European banks alone since 2010 (representing over 200 fund interests).

www.campbell-lutyens.com

## About Clifford Chance

Clifford Chance is one of the world's premier law firms, with over 3,000 lawyers across 36 offices in 26 countries worldwide. It is ranked as the number one law firm worldwide by Chambers Global Top 30. The firm has market-leading financial regulatory and fund formation teams across its global network, including in London, New York, Hong Kong, Paris, Luxembourg, Beijing and Singapore.

Accordingly, Clifford Chance is ideally placed to provide expert analysis and advice on the details of U.S. regulatory developments and their practical implications for the global asset management industry. The firm routinely advises sponsors and investors (including, on both counts, banking entities) both within and outside the United States, with a prestigious client base spanning not only the Americas but also Europe, Asia and the emerging markets.

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