Interactive Discussion

The Federal Reserve System's Private Equity Merchant Banking Knowledge Center presents

The New World Order of Private Equity

Tenth Annual Private Equity Conference • July 20 – 22, 2010

When Legislation and Private Equity Collide

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Dodd-Frank Act of 2010

Section 619 – "*Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds*"

(Volcker Rule)

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Section 619(a)(1)(B) - Prohibition

- *"A banking entity shall not acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund"*

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(h)(1) Banking entity

- Any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act), any company that controls an insured depository institution, or that is treated as a bank holding company (for purposes of section 8 of the International Banking Act of 1978), and any affiliate or subsidiary of any such entity.

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(h)(2) Hedge fund and Private equity fund

- The terms 'hedge fund' and 'private equity fund' mean an issuer that would be **an investment company, as defined in the Investment Company Act of 1940**, but for section 3(c)(1) or 3(c)(7) of that Act, **or such similar funds as the appropriate Federal banking agencies, SEC, and the Commodity Futures Trading Commission (CFTC) may determine**.

(d)(4)(A) *De minimis* investment

A banking entity may **make and retain an investment in a hedge fund or private equity fund that the banking entity organizes and offers, subject to the limitations and restrictions** for the purposes of—

(i) **establishing the fund and providing the fund with sufficient initial equity for investment** to attract unaffiliated investors; or

(ii) **making a *de minimis* investment**.

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(d)(4)(B) Limitations and restrictions on investments

- Seek unaffiliated investors to reduce or dilute the investment in a hedge fund or private equity fund shall, be reduced through redemption, sale, or dilution
  - Not later than **1** year after the date the fund is established
  - To an amount that is not more than **3%** of the total ownership interests of the fund;
- Upon an application, the Board may extend the period of time to meet the requirements
  - Additional **2** years
  - Consistent with safety and soundness and in the public interest).

(d)(4)(B) Limitations and restrictions on investments

- Must **be immaterial** to the banking entity, as define by rule, but **in no case may the aggregate of all of the interests** of the banking entity **in all such funds exceed <u>3%</u> of the Tier 1 capital** of the banking entity.

Capital— Aggregate amount of the outstanding investments by a banking entity, including retained earnings, shall be deducted from the assets and tangible equity of the banking entity.
  - Amount of the deduction shall increase commensurate with the leverage of the hedge fund or private equity fund.

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Outstanding questions

- Aggregate limitation of foreign banking entities operating and/or making equity investments in hedge funds and PE funds in the US
  - Foreign banking entity is not required to hold tier 1 capital in the same manner as domestic banking entities.
- Direct investments (under merchant banking and traditional noncontrolling BHC Act authorities)
  - Omitted from language, as only investments in indirect third-party and sponsored FUNDS are addressed.
  - Still be subject to existing capital and regulatory restrictions.

(d)(1)(E) Permitted activities

Investments in one or more small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958,

- Historically may invest in third-party SBICs as well as create proprietary (bank/BHC-managed) SBICs.

Investments designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), or

- Clearly refer to Community Development Corporation (CDC)-eligible investments.

Investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

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(d)(1)(G) Permitted activities

- (G) **Organizing and offering a PE or hedge fund, including serving as a general partner, managing member, or trustee** of the fund, only if the banking entity:
  - Provides **bona fide trust, fiduciary or investment advisory services** and the fund is offered only in connection with persons that are customers of such services; and
  - Does not acquire or retain an equity interest, partnership interest or other ownership interest in the funds except for a ***de minimis* investment** (not more than 3% of the total ownership of the fund within 1 year after the fund's establishment, but in no case may the aggregate of all of the interests in all such funds exceed **3%** of the banking entity's tier 1 capital).
  - Complies with **affiliate restrictions** such as Section 23A and 23B of the Federal Reserve Act;
  - **Does not, directly or indirectly, guarantee**, assume, or otherwise insure the obligations or performance of the fund;
  - **Does not share the same or variation of the same name** with the hedge fund or private equity fund;
  - Has **no director or employee that takes or retains an equity interest, partnership interest, or other ownership interest** in the hedge fund or private equity fund, **except for those who are directly engaged in providing investment advisory or other services**; and
  - **Discloses to prospective and actual investors in the fund, in writing, that any losses** in such hedge fund or private equity fund **are borne solely by investors** in the fund and not by the banking entity.

(d)(1)(I) Permitted activities

- The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity pursuant to paragraph (9) or (13) of section 4(c) solely outside of the United States, provided that:
  - No ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States and
  - Banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States.

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Outstanding questions

- It is unclear whether investments in energy vehicles (primarily used to obtain tax credits) would fall under the public welfare umbrella.
- Venture capital industry argument
  - "Contribution to economic growth,"
  - Size/impact exemption similar to advisor registration exemption

(a)(2) Nonbank Financial Companies Supervised by the Board.

- As defined in section 102 of the Financial Stability Act of 2010
  - Systemically relevant
  - Section 117. Treatment of Certain Companies that Cease to be BHCs – will be treated as nonbank financial companies supervised by the Board if:

    (A) Was a BHC having total consolidated assets equal to or greater than $50B as of January 1, 2010; and

    (B) Received financial assistance under or participated in the Capital Purchase Program established under the Troubled Asset Relief Program authorized by the Emergency Economic Stabilization Act of 2008.
- ". . . Shall be subject to **additional capital requirements for and additional quantitative limits** with regards to such proprietary trading and taking or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or a private equity fund.

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(b)(1) – Financial Stability Council Study

Not later than **6** months after the date of enactment

- Study and make recommendations on implementation

  (A) **Promote and enhance the safety and soundness** of banking entities;

  (B) **Protect taxpayers and consumers and enhance financial stability by minimizing the risk** that insured depository institutions and its affiliates will engage in unsafe and unsound activities;

  (C) **Limit the inappropriate transfer of Federal subsidies** from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities;

  (D) **Reduce conflicts of interest** between the self-interest of banking entities and nonbank financial companies supervised by the Board, and the interests their customers;

  (E) **Limit activities that have caused undue risk or loss** in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in them;

  (F) **Appropriately accommodate the business of insurance within an insurance company**, in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the US financial system; and

  (G) **Appropriately time the divestiture of illiquid assets** that are affected by the prohibitions

(b)(2)(A) Coordinated Rulemaking

Not later than 9 months after completion of study, appropriate Federal banking agencies, SEC, and CFTC, shall consider the findings of the study and adopt rules.

- Coordination, Consistency, and Comparability
  - In developing and issuing regulations, the Federal banking agencies, SEC, and CTFC shall **consult and coordinate with each other**,
  - **Assure, that such regulations are comparable and provide for consistent application and implementation** of the applicable provisions,
  - **Avoid providing advantages or imposing disadvantages** to the affected companies, and
  - **Protect the safety and soundness of banking entities and nonbank financial companies** supervised by the Board.
- The **Chairperson of the Financial Stability Oversight Council shall be responsible** for coordination of the regulations issued.

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(c)(1)(A) Effective Date

Shall take effect on the **earlier of**:

(A) **12 months after the date of the issuance of final rules** under subsection (b); **or**

(B) **2 years after the date of enactment** of this section."

(c)(2) Conformance Period for Divestiture

- "A banking entity or nonbank financial company supervised by the Board shall bring its activities and investments into compliance
  - **Not later than 2 years** after the date on which the requirements become effective pursuant to this section or
  - on which the entity or company becomes a nonbank financial 2 years after the date company supervised by the Board.
- The Board may, by rule or order, extend this two-year period for **not more than 1 year at a time**, if, in the judgment of the Board, such an extension is
  - consistent with the purposes of this section and
  - would not be detrimental to the public interest.
  - Extensions may **not exceed an aggregate of 3 years**."

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(c)(3) Extended transition for illiquid funds

- (A) The **Board may, upon the application, extend** the period to the extent necessary to fulfill a **contractual obligation that was in effect on May 1, 2010**, may take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund."
- (B) Time limit on approval.—"The Board may grant **1 extension**, which may **not exceed 5 years**.
- **Special rulemaking**.—"**Not later than 6 months after the date of enactment** of this section (conformance period and extended illiquid transition), the Board shall issue implementation rules.

(h)(7) Illiquid fund

Hedge fund or private equity fund that—

- (i) As of **May 1, 2010**, was principally invested in, or was invested and contractually committed to principally invest in, **illiquid assets, such as portfolio companies, real estate investments, and venture capital investments**; and
- (ii) makes all investments pursuant to, and consistent with, **an investment strategy to principally invest in illiquid assets**.
  - In issuing rules, the Board shall take into consideration the terms of investment for the hedge fund or private equity fund, including contractual obligations,
  - the ability of the fund to divest of assets held by the fund, and
  - any other factors that the Board determines are appropriate.
- (B) Hedge fund—For the purposes of this paragraph, the term 'hedge fund' means any fund identified under subsection (h)(2), and **does not include a private equity fund**, as such term is used in section 203(m) of the Investment Advisers Act of 1940''

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Outstanding questions

"Grace Period" (after enactment)

4 - 7 – 9 or 12?

Are affected banking entities "motivated sellers?"

Other related requirements

- Divestiture required - Banking entity may not engage in any prohibited activity prohibited after the earlier of—
  - (A) Date on which the contractual obligation to invest in the illiquid fund terminates; and
  - (B) Date on which any extensions granted by the Board expire.
- Additional capital during transaction period –Impose **additional capital requirements**, and on any equity, partnership, or ownership interest in or sponsorship of a hedge fund or private equity fund by a banking entity.
- Limitations on relationships with hedge funds and private equity funds – banking affiliate restrictions.

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(e) Anti-Evasion

- (1) Rulemaking – Appropriate Federal banking agencies, SEC, and CFTC shall **issue regulations regarding internal controls and recordkeeping**, in order to insure compliance.
- (2) Termination of activities or investment –whenever an appropriate Federal banking agency, SEC, or CFTC has reasonable cause to believe that a banking entity or nonbank financial company supervised by the Board under the respective agency's jurisdiction has made an investment or engaged in an activity in a manner that functions as an evasion of the requirements of this section (including through an abuse of any permitted activity) or otherwise violates the restrictions under this section, the appropriate Federal banking agency, SEC, or CFTC shall order, after due notice and opportunity for hearing, the banking entity or nonbank financial company supervised by the Board to terminate the activity and, as relevant, dispose of the investment.


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