

Volcker Rule Regulations Provide Little Relief for Private Fund Investments

PENpoints

The joint notice of rulemaking implementing the so-called Volcker Rule signals that the regulatory agencies intend to strictly limit banking entities' proprietary investments in private funds.

On October 11, 2011, the federal banking agencies and the Securities Exchange Commission issued a joint notice of rulemaking implementing the so-called Volcker Rule of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which prohibits proprietary trading and private fund investing by banking entities.¹ The Volcker Rule becomes effective on July 21, 2012 and requires (among other things) banking entities to divest their private fund investments by July 21, 2014 (unless they obtain an extension from the Federal Reserve).

The joint notice includes over 300 questions soliciting comments by January 13, 2012 and contemplates that the final regulations will be in place by the July 21, 2012 effective date. While the final regulations could differ substantially from the proposed regulations, the joint notice provides insight into the perspective of the regulatory agencies: namely, that a banking entity's ability to make proprietary investments in private funds should be strictly limited.

Permitted Activities

Although the Volcker Rule generally prohibits a banking entity from investing in a private fund, the joint notice permits the following private fund investments activities:²

- A fund or fund-of-funds maintained by a banking entity on behalf of clients in connection with its bona fide fiduciary or investment advisory activities under the "organized and offered" exemption;
- A private fund investment by a banking entity's retirement plan;
- A private fund investment by a banking entity in a fiduciary capacity, as agent, custodian, broker or trustee for an unrelated party;
- A private fund investment by a banking entity's employees, so long as the banking entity does not facilitate the investment with a loan;

- An investment in a non-U.S. private fund by a non-U.S. banking entity;³
- A private fund interest acquired by a banking entity in satisfaction of a defaulted loan;
- An investment by a banking entity in a joint venture operating company and/or acquisition vehicle that otherwise falls within the definition of a private fund; and
- An investment by a banking entity in a Small Business Investment Company (SBIC).

While these permitted activities would give banking entities flexibility to continue to make some private fund investments, private fund managers should continue to expect significant decreases in investments by banking entities (and requests for broad excuse provisions from those banking entities that continue to invest).

Restrictions Affecting Permitted Activities

The joint notice includes comprehensive restrictions on a banking entity's activities with a private fund in which it holds a permitted investment and requires a banking entity with permitted investments to maintain a compliance program consistent with the size, scope, structure and complexity of the activity and the banking entity.

Additionally, the Volcker Rule prohibits any banking entity (and its affiliates) that serves directly or indirectly as the investment manager, investment advisor, commodity trading advisor or sponsor to a private fund, or that organizes and offers a private fund, from (i) providing a loan to such private fund, or (ii) entering into any non-arms-length transaction with such private fund.

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Further, the proposed regulations would prohibit an otherwise permitted transaction or activity if it would involve a conflict of interest between the banking entity and its clients, customers or counterparties (with some ability to address the conflict of interest issues through disclosure or information walls).

Unanswered Questions

The joint notice does not address a number of significant issues relating to a banking entity's investment in a private fund, such as:

Investments in Non-U.S. Funds: The non-U.S. fund exception applies only to a banking entity organized in a non-U.S. jurisdiction (and not owned by a U.S. bank holding company) investing in a private fund organized outside the U.S., where no U.S. employee of the private fund is involved in any offering of interests in the non-U.S. private fund, and interests in the non-U.S. private fund are only offered and sold outside the U.S. The joint notice, however, does not address whether a non-U.S. private fund that otherwise qualifies for the

exception may (i) invest in U.S. companies, (ii) have a general partner and/or management company with U.S. employees or owners, or (iii) invest in parallel with one or more U.S. funds.

Managed Accounts: The Volcker Rule does not prohibit direct investments in operating companies otherwise permitted under merchant banking and similar investment authority. It is less clear, however, whether a private fund manager could manage an account on behalf of a banking entity in parallel with a private fund it manages, and receive the same (or similar) fee and carried interest arrangements from the managed account that it receives from the private fund.⁴

Merchant Banking Authority: In theory, a fund investment made by a banking entity with merchant banking authority may not be prohibited under the Volcker Rule. If this proposition holds true, most of the large money-center banks could continue to make private fund investments in connection with their investment banking operations.

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- 1 The Volcker Rule also imposes enhanced capital requirements and quantitative limitations on proprietary trading and private fund investing activities of non-bank financial companies that are supervised by the Federal Reserve (including, for example, those financial services companies designated as systemically important under Dodd-Frank).
 - 2 While the proposed regulations do not address investments in venture funds, the staff specifically solicits comments regarding whether such an investment should be a permitted activity.
 - 3 Many non-U.S. financial institutions are considered "banking entities" under to the Volcker Rule by virtue of their activities in the U.S., ranging from owning a full-service bank to branches or representative offices. The Volcker Rule would not restrict an investment in a U.S. private fund by a non-U.S. banking entity that has no U.S. banking nexus.
 - 4 The Financial Stability Oversight Council study released earlier this year urged the regulators to consider whether structures that have the same investing profile and compensation arrangements as a private fund should be considered private funds under the Volcker Rule, but the joint notice does not address managed account structures.
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If you have any questions about the matters addressed in this *KirklandPEN*, please contact the following Kirkland authors or your regular Kirkland contact.

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PENnotes

Kirkland & Ellis Seminar: “Sixth Annual Real Estate Private Equity Symposium”
New York, New York
October 24, 2011

Kirkland will host its Sixth Annual Real Estate Private Equity Symposium and cocktail reception in the New York office on October 24, 2011. Barry Sternlicht, chairman and CEO of Starwood Capital Group, will be the keynote speaker. Click [here](#) for more information about this event.

Terrapin’s “Brazil Investment Summit 2011”
New York, New York
October 25-27, 2011

Kirkland & Ellis is a sponsor of Terrapin’s Brazil Investment Summit 2011, an investment strategy conference for funds, traders and investors focused on Brazilian opportunities. This three-day conference will uncover opportunities across hedge funds, quantitative strategies, private equity, infrastructure, real estate, commodities and more. Kirkland partner Frederick Tanne will participate in a panel discussion on “Private Equity Opportunities.” For more information, or to please visit: <http://www.terrapinn.com/2011/brazil-investment-summit-usa/index.stm>.

2011 11th Annual IVCA CFO Summit
Chicago, Illinois
October 27, 2011

Kirkland & Ellis is a sponsor of the 11th Annual IVCA CFO summit, a private equity conference for finance professionals of venture capital and private equity firms. Topics on the agenda include an Economic Outlook, Tax & Accounting, Healthcare Reform Update, and a CFO roundtable. Kirkland partner Bruce I. Ettelson will present on “Trend and Issues in Fundraising.” Click [here](#) for more information or to register for the event.

PLI’s “Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations, and Restructurings”
Chicago, Illinois
November 15-17, 2011

PLI’s Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings will take place on November 15, 2011, in Chicago. This program will focus on a wide range of corporate transactions, from single-buyer acquisitions of a division or subsidiary to multi-party joint ventures, cross-border mergers and complex acquisitions of public companies with domestic and foreign operations. Kirkland partners Jack S. Levin, P.C., Todd F. Maynes, P.C. and Jeffrey T. Sheffield, P.C. will be speaking at this event. Click [here](#) for more information or to register for this event.

IBA’s “Private Equity Transactions Conference”
London - December 1, 2011
New York - December 6, 2011

The IBA Private Equity Transactions Conference will be held in London and New York, and will feature discussions on the global private equity market; current market issues and predictions for 2012; emerging markets issues; and current issues in financing. Kirkland & Ellis is a sponsor of this event and partner Kirk A. Radke is a co-chair. Additionally, partner David Patrick Eich will be speaking on “Emerging Markets Issues: Themes from Asia and Latin America” and partner Jay Ptashek will speak on “Financing: Current Market Issues and Themes for Next Year.” For more information, or to register for this event, please visit: <http://www.int-bar.org/conferences/conf399/>.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named Best M&A Firm in the United States at World Finance's 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 IFLR Americas Awards. Kirkland was also recognized as "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook." Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2010 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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