KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

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Final Volcker Rule Provides Clarity and Marginally Increases Flexibility With Respect to Private Fund Investments

PENpoints

The Volcker Rule affects a private fund manager that has commitments from, or that markets its private funds to, banking entities and insurance companies.

On December 10, 2013, federal banking agencies, the Securities Exchange Commission and the Commodity Futures Trading Commission jointly issued final regulations and related commentary implementing the so-called Volcker Rule (created under the Dodd-Frank Act),[1] which generally prohibits proprietary trading and private fund investing by banking entities.[2] Concurrently, the Federal Reserve Board issued an order extending until July 21, 2015 the deadline for banking entities to conform their activities to the final regulations, although banking entities are expected to have compliance programs in place by the original July 21, 2014 deadline, and certain large banking entities must begin required reporting by June 30, 2014.[3]

Private fund managers with banking entity investors or who wish to manage investments by banking entities in the future will find the final regulations to be, on the margins, more constructive than the original proposed Volcker Rule regulations, which would have more strictly limited a banking entity's ability to make proprietary investments in private funds.[4]

While the final regulations give banking entities some added flexibility to continue making or to retain some investments in private funds, a private fund manager should still be prepared for an increase in requests from its banking entity investors to transfer, restructure or redeem their private fund interests, and should familiarize itself with the withdrawal, transfer, excuse and other provisions relating to changes in laws and regulations in a private fund's operative documents (including side letters). A private fund manager will not be able to unilaterally determine whether a banking entity may retain an existing private fund interest (or make a new private fund investment), because the analysis will depend on facts and circumstances specific to the banking entity.

Permitted Investments by Banking Entities

Although the Volcker Rule dramatically reduces a private fund manager's pool of available capital from banking entities, the final regulations clarify and marginally improve the possible sources of a banking entity investment in a private fund and now expressly permit the following private fund investment activities:

- a fund or fund-of-funds sponsored by a banking entity and offered to clients in connection with the banking entity's bona fide investment advisory activities, and a *de minimis* investment by the banking entity in such private funds, under the "organized and offered" exemption discussed in the footnote below;[5]
- a private fund investment by a banking entity's retirement plan or deferred compensation plan;
- a private fund investment on behalf of a customer by a banking entity acting as an agent, broker, underwriter, custodian, trustee or other similar fiduciary capacity;[6]
- an investment in a non-U.S. private fund by a non-U.S. banking entity (the "Non-U.S. Fund Exemption"), discussed in the text below;[7]
- an investment by a banking entity in an SBIC;
- an investment by a banking entity in a registered investment company, a regulated business development company or a foreign public fund; and
- an investment by a banking entity in a private fund that may rely on an exclusion or exemption under the Investment Company Act of 1940, other than §3(c)(1) or §3(c)(7).[8]

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Future Investment Opportunities

The final regulations (i) reject the proposal that venture capital fund investing be a permitted activity and (ii) expand the definition of a private fund "ownership interest" (which is generally prohibited or limited) to include a right to receive a share of the profits or assets of a private fund (other than in exchange for services), thus barring the use of debt with equity features or synthetic instruments to evade the private fund investment prohibitions.

A private fund manager may find other opportunities, however, to manage banking entity investments as structures conforming to the requirements of the final regulations evolve. For example:

Banking Entity Co-Investing

Prior to enactment of the Dodd-Frank Act, a banking entity (i) could make passive investments directly in an operating company (generally up to 5% of the voting securities and 25% of the total equity of the company) pursuant to §4(c)(6) of the Bank Holding Company Act and (ii) if qualified as a financial holding company, could make controlling or non-controlling investments directly into an operating company (subject to a 10-year maximum holding period and restrictions on participating in day-to day management) under the merchant banking authority contained in the Gramm-Leach-Bliley Act. The Volcker Rule does not prohibit a banking entity from continuing to make and retain such direct investments.

The commentary to the final regulations (taking a position different from the proposed regulations) states that co-investments by a banking entity directly in an operating company in parallel with a private fund will generally be viewed as legitimate and not made in order to circumvent the Volcker Rule. A private fund manager could therefore establish and manage an account funded and owned by a banking entity (a "managed account") and invest the funds in the managed account (pursuant to the banking entity's 4(c)(6) or merchant banking authority) in parallel with the manager's private fund, with the private fund manager receiving the same fee and carried interest arrangements from the banking entity's managed account as it receives from the private fund.

However, the private fund manager cannot form such a managed account as a limited partnership (or other entity) relying on Investment Company Act §3(c)(1) or §3(c)(7) exemptions.[9] Consequently, while a banking entity's managed account may contractually mirror the economic arrangements of a private fund, the private fund manager's carried interest would not be a limited partnership (or other equity) interest entitled to capital gain flow-through tax treatment, and thus would be taxed as ordinary income.

Non-U.S. Fund Exemption

The Volcker Rule permits a non-U.S. banking entity with a U.S. banking nexus to invest in or sponsor a non-U.S. private fund pursuant to the Non-U.S. Fund Exemption, so long as no ownership interest in the non-U.S. private fund is offered or sold to a U.S. resident. The proposed regulations implementing this provision were very restrictive, but the final regulations are less so.

If a private fund manager wants to form a private fund eligible for the Non-U.S. Fund Exemption (so that a non-U.S. banking entity subject to the Volcker Rule may invest in the private fund), the private fund manager must take reasonable precautions so that the offering of interests in the private fund is not deemed to "target" U.S. residents. Whether or not an offering targets U.S. residents is determined by the facts and circumstances, but the commentary states that a private fund sponsor will not be viewed as targeting U.S. residents if (i) the offering is directed to residents of countries outside of the United States., (ii) the offering materials contain statements that the securities are not offered to U.S. residents, and (iii) there are reasonable precautions in place to restrict access to the offering and subscription materials to non-U.S. residents.[10] Importantly, the acquisition of an interest in a non-U.S. private fund by a U.S. resident in a bona fide secondary market transaction should not void the availability of the Non-U.S. Fund Exemption.

The commentary also concludes that complex private fund structures (such as a limited partnership with multiple feeder entities) should be "integrated" to determine if interests in a non-U.S. private fund have been offered to U.S. residents, and thus fail to meet the requirements of the Non-U.S. Fund Exemption. The commentary does not expressly prohibit, however, a structure whereby a non-U.S. private fund formed by a private fund manager and otherwise qualifying for the Non-U.S. Fund Exemption could invest in parallel with a U.S. private fund formed by the same manager, though at a minimum the parallel private funds should take precautions to avoid integration.

1 The December 10, 2013 release contains approximately 900 pages of commentary and 70 pages of regulations.

2 "Banking entities" includes FDIC-insured depository institutions and their holding companies, non-U.S. companies that are treated as bank holding companies under the International Banking Act of 1978 and most of their subsidiaries and affiliates.

3 In granting the blanket one-year extension, the Federal Reserve used one of the three one-year extensions permitted by the Volcker Rule. Consequently, banking entities may now apply for only two one-year extensions to comply with the Volcker Rule, with an additional five-year extension for illiquid funds committed prior to July 2010.

4 See our prior *KirklandPEN*.

5 Under the Volcker Rule (i) a banking entity can seed an organized and offered private fund with up to 100% of its committed capital, but its interest must be reduced to 3% or less of such private fund's commitments within one year, and (ii) the banking entity's aggregate ownership interests in all of its organized and offered private funds cannot exceed 3% of the banking entity's Tier 1 capital.

6 The banking entity cannot, however, have or retain any beneficial interest in such private fund investment, which may require banking entities to restructure existing compensation arrangements and client vehicles.

7 Many non-U.S. financial institutions are considered "banking entities" under the Volcker Rule by virtue of their U.S. banking nexus, ranging from the ownership of full-service U.S. depository institutions to a non-U.S. bank's U.S. branches or representative offices. The Volcker Rule does not restrict an investment in a U.S. private fund by a non-U.S. bank with no U.S. banking nexus.

8 These issuers would include a bank common trust and collective fund qualifying for the exclusion pursuant to §3(c)(3) or §3(c)(11) of the Investment Company Act and a REIT or other real estate fund qualifying for the §3(c)(5) exclusion. The final regulations also exclude from Volcker Rule prohibitions certain specialized entities such as (i) wholly-owned subsidiaries of a banking entity, (ii) limited types of joint venture and acquisition vehicles, (iii) public welfare funds qualifying for Community Reinvestment Act credit, and (iv) vehicles utilized in structured products (such as loan securitizations) meeting extensive regulatory requirements.

9 In the discussion regarding REIT "pass through" vehicles, the commentary rejects the general proposition that a §3(c)(1) or §3(c)(7) vehicle formed for administrative convenience or tax purposes should be excluded from the Volcker Rule prohibitions to the extent the vehicle holds investments otherwise permitted by the Volcker Rule, citing evasion concerns.

10 The commentary does not directly address whether a U.S. private fund manager (or one of its non-U.S. affiliates) could hold the general partnership interest in a non-U.S. private fund under the Non-U.S. Fund Exemption. The final regulations, however, exclude from the definition of "ownership interest" a profits interest received in connection with providing services to a private fund, which should include a typical private fund manager carried interest or performance fee. If the general partnership interest in a non-U.S. private fund meets the definition of a "profits interest" under the Volcker Rule it should not be considered an ownership interest and thus should not invalidate the Non-U.S. Fund Exemption.

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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PENbriefs

Delaware vs. New York Governing Law - Six of One, Half Dozen of Other?

Acquisition agreements typically include a provision stipulating which state's laws govern the agreement and related disputes, with Delaware and New York the leading jurisdictions. While the laws of those states have a similar approach to most issues, discernable gaps have developed on some recurring transactional issues. To learn more about those gaps and how they might affect a transaction, see our recent *M&A Update*.

PENnotes

ABS Vegas 2014
Las Vegas, Nevada
January 21-24, 2014

The Structured Finance Industry Group (SFIG) and Information Management Network (IMN) are hosting ABS Vegas 2014, which attracts the securitization industry's top professionals. Kirkland & Ellis partner Kenneth Morrison is scheduled to participate in a panel discussion. The program, developed by leaders who represent the most active firms in ABS, will feature coverage of the most pressing issues facing the marketplace. Click here for more information.

20th Annual Harvard Business School Venture Capital & Private Equity Conference
Boston, Massachusetts
February 9, 2014

Kirkland will sponsor Harvard Business School's 20th Annual Venture Capital & Private Equity Conference. More than 100 panelists and moderators will exchange ideas and present their perspectives throughout the conference's 16 panel discussions. Kirkland partners Sean Rodgers, Stephen Tomlinson and Patrick Nash will participate in the "State of the PE Industry," "Real Estate Investing," and "Turnarounds and Restructuring" panels respectively. Click here for more information.

20th Annual Columbia Business School Private Equity & Venture Capital Conference
New York, New York
February 28, 2014

Kirkland is a sponsor of the Columbia Business School's 20th Annual Private Equity & Venture Capital Conference. The goals of the conference are to educate, promote discussion and provide a forum for interaction between academics, professionals and students who are active in the private equity and venture capital communities. Kirkland partners Sean Rodgers and Edward Sassower will participate in the "Creating Value through the LBO" and "Distressed & Restructuring" panels respectively. Click here to register.

9th Annual Stern Private Equity Conference
New York, New York
February 28, 2014

Kirkland is a sponsor of New York University's Stern School of Business 9th Annual Stern Private Equity Conference. This season's conference will provide a forum for industry leaders to discuss the opportunities and risks of today's private equity and venture capital environment. Kirkland partners Jennifer Morgan and Christopher Torrente will participate in the "Real Estate" and "Leveraged Buyout" panels respectively. Click here to register.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 400 private equity attorneys have handled 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 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012 and 2013 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. In addition, Kirkland was awarded "Best M&A Firm" and "Best Private Equity Firm" in the United States at *World Finance*'s 2012 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 *IFLR* Americas Awards.

In 2012 and 2013, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, U.K., Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011 and 2012*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted 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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