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DODD-FRANK ACT LIMITS INVESTMENTS BY BANK HOLDING COMPANIES IN HEDGE AND PRIVATE EQUITY FUNDS

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). Section 619 of the Act — an element of the so-called "Volcker Rule" — amends the Bank Holding Company Act of 1956 (the "BHCA") to add a new section 13(a) that provides in relevant part that:

> [u]nless otherwise provided in this section, 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.

This provision is likely to force significant changes in the current and future private equity business of major banking institutions. As with so many other provisions of the Act, its precise application will not be clear until interpretive regulations are issued, in this case by the Board of Governors of the Federal Reserve System (the "FRB"), other federal banking agencies, the Securities and Exchange Commission (the "SEC"), and the Commodity Futures Trading Commission (the "CFTC").

1. To What Institutions Does the Prohibition Apply?

The prohibition applies to any "banking entity." "Banking entity" is defined to include any insured bank or thrift, any company that controls an insured bank or thrift, any company that is treated as a bank holding company, and any affiliate or subsidiary of any such entity. It thus reaches any bank holding company, any non-U.S. bank that maintains a branch or agency in the United States, and any U.S. or non-U.S. bank or non-bank subsidiary of a bank holding company or foreign banking organization.

2. What Private Funds Are Affected?

The prohibition prevents a banking entity from taking certain actions with respect to a "hedge fund" or a "private equity fund." These terms are defined to 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 section 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the [SEC] and the [CFTC] may, by rule, as provided in subsection (b)(2), determine.

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The provision thus affects any company (i) that meets the definition of "investment company" under the Investment Company Act of 1940 (the "1940 Act") and (ii) qualifies for an exemption from that definition under either section 3(a)(1) (generally, issuers the securities of which are held by fewer than 100 investors) or section 3(a)(7) (generally, issuers the securities of which are held by investors that meet the definition of "qualified purchasers"). It could also affect any other fund that various regulatory agencies define as "similar" to a section 3(c)(1) or section 3(c)(7) fund.

Most hedge funds and private equity funds would thus fall within this definition. Regulations to be issued by the SEC and the CFTC can be expected to clarify whether investment funds that invest in loans, leases and other instruments will fall within the definition. A fund that meets the definition of investment company but that relies on an exception from the definition or an exemption from registration other than section 3(a)(1) or section 3(a)(7), *e.g.*, bank-sponsored collective funds, should not be affected.

3. **What Is Prohibited?**

New BHCA section 13(a) contains two prohibitions: a banking entity may not (i) "sponsor" a hedge or private equity fund, and (ii) "acquire or retain any equity, partnership, or other ownership interest in" a hedge or private equity fund.

a. Sponsorship

"Sponsor" is defined to mean: (i) "to serve as a general partner, managing member or trustee" of a fund, (ii) "in any manner to select or control (or to have employees, officers, or directors or agents who constitute) a majority of the directors, trustees or management" of the fund, or (iii) "to share with the fund, for corporate, marketing, promotional, or other purposes, the name or a variation of the same name" of the fund.

Banking entities should therefore be free to advise, manage and administer a hedge or private equity fund. They should also be free to "organize" and "offer" these funds, including acting as a placement agent for their securities. Transactions deemed "covered transactions" under section 23A of the Federal Reserve Act between a banking entity and a fund that it advises would be prohibited.

b. Investments

To be prohibited, an investment must be (i) an equity interest, (ii) a partnership interest, or (iii) an ownership interest. Managing or non-managing membership interests and general or limited partnership interests in funds organized as limited liability companies or limited partnerships would be covered. Depending on regulations yet to be issued, other interests in hedge or private equity funds that do not constitute "ownership" interests should not be prohibited.

4. **What Are the Exceptions to the Prohibition?**

New BHCA section 13(a) contains exceptions to its prohibitions of which the following are likely to prove most significant.

a. Seed and *De Minimis* Investments

Notwithstanding the prohibition, a banking entity may make and retain an investment in, and may sponsor, a hedge fund or private equity fund "that the banking entity organizes and offers," subject to the following limitations and restrictions:

(i) The banking entity must provide *bona fide* trust, fiduciary or investment banking services;

(ii) The fund must be organized and offered only in connection with the provision of these services; and

(iii) The banking entity may not acquire or retain an equity interest in the fund unless (a) the investment is for the purpose of establishing the fund and attracting investors, (b) the banking entity "must actively seek third party investors," (c) the investment must "not later than 1 year after the date of establishment of the fund, be reduced . . . to an amount that is not more than 3 percent of the total ownership interests of the fund" (subject to a two-year extension), and (d) the investment must be "immaterial to the banking entity" as defined by regulation and in no case may interests in all such funds exceed three percent of the Tier 1 capital of the banking entity.

A banking entity should therefore be able to acquire a greater-than-three-percent interest in a hedge or private equity fund but only in a fund that it organizes and only temporarily.

b. Investments in Non-U.S. Funds

Notwithstanding the prohibition, a banking entity may acquire or retain any equity, partnership, or other ownership interest in, or may sponsor, a hedge fund or a private equity fund

> 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 that the 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.

To qualify for this exception, the investment must be made by a banking entity pursuant either to section 4(c)(13) or section 4(c)(9) of the BHCA. These sections permit a U.S. or non-U.S. bank holding company, respectively, to make certain investments in a non-U.S. company engaged in non-banking activities outside the United States. Because the exception is not available to a company controlled by a U.S. parent of an insured depository institution, it is unclear how the exception would apply to an investment by a non-U.S. non-bank subsidiary of a U.S. bank holding company that would otherwise be permitted to make the investment under section 4(c)(13) of the BHCA.

5. **Evasions of the Prohibitions**

Considerable attention is likely to be paid to ways in which to structure investments by banking entities in private funds in a manner that escapes the terms of new section 13(a) of the BHCA. Overhanging these efforts are the provisions of a new section 13(e) of the BHCA that grants the FRB and other agencies' authority to prevent efforts to evade the prohibition. These agencies are authorized to order a banking entity "to terminate [an] activity or dispose of [an] investment" whenever they "have reasonable cause to believe that a banking entity . . . has made an investment . . . in a manner that functions as an evasion of the requirements of this section." Forthcoming regulations may provide much-needed guidance on the question whether otherwise permissible investments by a banking entity will be judged to "function as evasion" of the section 13(a) prohibitions.

6. **Transitional Provisions**

The prohibitions of section 13(a) of the BHCA became effective on the earlier of (i) 12 months after the issuance of the final regulations implementing the prohibition or (ii) two years from enactment of the Act, *i.e.,* by July 22, 2012. Thereafter, banking entities have two years to conform their activities to the prohibition.

The federal banking agencies would have the authority to grant extensions to individual banking entities — including extensions of up to five years for a hedge fund or private equity fund that as of May 1, 2010 was principally invested in, or was involved in and contractually committed to principally invest in, "illiquid assets" such as "portfolio companies, real estate investments and venture capital investments" — to the extent necessary to enable the banking entity to fulfill a contractual obligation that was in effect on May 1, 2010.

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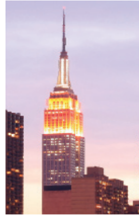

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