

**Davis Polk**

**Volcker Rule Materials  
Hedge and Private Equity  
Funds**

January 19, 2011

**DPW FSOC Study Summary**

## Summary of the Volcker Rule Study – Hedge Funds and Private Equity Funds

Summary as of January 19, 2011

---

The study by the Financial Stability Oversight Council (“**FSOC**”)<sup>1</sup> of the funds portion of the Volcker Rule includes useful findings and recommendations on the definitions of “hedge funds,” “private equity funds” and “banking entities,” but leaves a number of important questions unanswered. To provide an idea of the number and nature of important questions left unanswered, we have attached a chart that maps the recommendations proposed by the Securities Industry and Financial Markets Association (“**SIFMA**”)<sup>2</sup> to the actual recommendations made in the FSOC study.<sup>3</sup>

### Summary of Findings and Recommendations

The FSOC Study made nine sets of findings and recommendations:

- **General Definition of the Terms “Hedge Fund” and “Private Equity Fund”**

- **Findings:**

- In defining the terms “hedge fund” and “private equity fund,” the Volcker Rule “relies on two commonly-used exclusions from the definition of the term ‘investment company’ under section 3 of the Investment Company Act to define hedge funds and private equity funds. Although widely used by *traditional* hedge funds and private equity funds, these statutory exclusions were not designed to apply only to such funds. As such, they do not specifically address or closely relate to the activities or characteristics that are typically associated with hedge funds and private equity funds.” (FSOC Study, p. 7) (Emphasis added.)
- The statutory definition of the terms “hedge fund” and “private equity fund” sweeps in “a wide variety of funds and other legal entities that rely on the exclusions” that are used by the statute to define hedge funds and private equity funds, “including special purpose acquisition vehicles and certain ERISA qualified employee pension funds. Many commenters expressed the opinion that the statutory definition unintentionally includes corporate structures and entities that do not exhibit the characteristics of hedge funds and private equity funds, such as controlled subsidiaries and joint ventures used to hold ordinary course investments, or other investment vehicles. Specifically, a number of commenters suggested that venture capital funds should be excluded from the Volcker Rule’s definition of hedge funds and private equity funds because the nature of venture capital funds is fundamentally different from such other funds and because they promote innovation.” (pp. 61-62)

---

<sup>1</sup> The study was released at the January 18, 2011 FSOC meeting and is now available on the FSOC’s website at <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20org.pdf>.

<sup>2</sup> A copy of the comment letter is available on SIFMA’s website at <http://www.sifma.org/Issues/item.aspx?id=22125>.

<sup>3</sup> This memorandum assumes a basic familiarity with the language of the Volcker Rule, including its defined terms. For a summary of the Volcker Rule, see the Davis Polk client memorandum “[Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act](#)” (July 21, 2010).

- **Recommendations:**
  - “In implementing the Volcker Rule, the Agencies<sup>4</sup> should consider criteria for providing exceptions with respect to certain funds that are technically within the scope of the ‘hedge fund’ and ‘private equity fund’ definition in the Volcker Rule but that Congress may not have intended to capture in enacting the statute.” (p. 7)
  - The Agencies should “carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases.” (p. 62)
- **Similar Funds**
  - **Findings:** “Not all investment vehicles that share the characteristics of *traditional* private equity funds or hedge funds rely on the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, such as commodity pools [that] do not primarily hold or invest in financial instruments. . . . It is possible to create an investment fund pursuing a ‘hedge fund’ or ‘private equity fund’ strategy in reliance on other sections of the Investment Company Act which therefore would not necessarily be captured by the [general] statutory definition of hedge fund and private equity fund.” (p. 62) (Emphasis added.)
  - **Recommendations:** The Agencies should “consider using their authority to expand the definition by rule to funds that do not rely on the section 3(c)(1) and 3(c)(7) exclusions, but that engage in the activities or have the characteristics of a *traditional* private equity fund or hedge fund.” (p. 62) (Emphasis added.) In determining which funds to designate as “similar funds,” the Agencies “should consider the investment vehicles and other characteristics of such funds, including:
    - **Related compensation structure:** Does the fund earn an allocation based on fund performance including both realized and unrealized gains?
    - **Trading/Investment strategy:** What trading or investment strategy does the fund utilize?
    - **Use of leverage:** Does the fund borrow or otherwise utilize material leverage for the purpose of increasing investment performance?
    - **Investor composition:** Is the fund’s capital received from a broad group of unaffiliated investors?” (p. 62)
- **Definition of the Term “Banking Entity”**
  - **Findings:** “The ‘banking entity’ definition contained in the Volcker Rule includes any affiliate or subsidiary of a banking entity which, [because the Volcker Rule incorporates by reference the definitions of the terms “affiliate” and “subsidiary” from Section 2 of the Bank Holding Company Act (the “**BHC Act**”)] arguably, creates a circular definition that would subject an advised fund (which is considered an affiliate) to the . . . hedge fund and private equity fund restrictions of the Volcker Rule, even though setting up an advised fund is an explicitly permitted activity. Commenters argued that unless permitted hedge funds and private equity funds are excluded from the definition of ‘banking entity’ the following would result:

---

<sup>4</sup> These Agencies consist of the Office of the Comptroller of the Currency (“**OCC**”), the Federal Deposit Insurance Corporation (“**FDIC**”), the Board of Governors of the Federal Reserve System (the “**Board**”), the Securities and Exchange Commission (“**SEC**”) and the Commodity Futures Trading Commission (“**CFTC**”). Treasury has a coordination function.

- A banking entity could not operate a fund of funds business where the fund of funds invests in third party funds;
- Hedge funds and private equity funds that are controlled by a banking entity would not be permitted to make investments in other funds;
- Each fund in a family of controlled funds would be treated as a banking entity and an affiliate of each other, therefore requiring each fund to have a unique name;
- Companies (*i.e.*, non-financial companies) controlled by a hedge fund or private equity fund that is controlled by a banking entity would themselves become banking entities subject to the restrictions of the Volcker Rule; and
- SEC-registered investment companies that are controlled by a banking entity, would be subject to the Volcker Rule.” (p. 68)
- **Recommendation:** The Agencies should “carefully consider the impact of certain BHC Act definitions on the Volcker Rule’s definition of ‘banking entity’ and implement that term in a way that avoids results that Congress clearly did not intend in enacting the Volcker Rule.” (p. 69)
- **The “Customer” Requirement in (d)(1)(G) of the Volcker Rule**
  - **Findings:** The Volcker Rule contains an exemption from its general prohibition on investing in and sponsoring hedge funds and private equity funds for funds that are organized and offered subject to certain conditions, including funds that are organized and offered “only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity.’ The Volcker Rule does not, however, define the term ‘customers.’ Historically, banking entities have raised commitments for hedge funds and private equity funds from **existing** customers as well as individuals or entities that have **no pre-existing** customer relationship with the banking entity.” (p. 63) (Emphasis added.) Thus, “under the Volcker Rule, banking entities will generally no longer be allowed to put capital at risk by investing in hedge funds and private equity funds that are **completely divorced** from serving the needs of their customers.” (p. 56) (Emphasis added.)
  - **Recommendations:** The Agencies “should consider developing and issuing regulations to clarify the meaning of ‘customer’ in the context of this permitted activity by banking entities.” (p. 63) Without recommending a specific answer to this question, the FSOC made the following observations and additional recommendations to guide the Agencies in agreeing on the **required nature of the customer relationship**:
    - **Statutory Language.** “The statutory language suggests that there must be a ‘customer’ relationship with a banking entity’s bona fide trust, fiduciary, or investment advisory business.” (p. 63)
    - **Regulatory Analogues.** “There are analogous statutory definitions and regulatory concepts that seek to define a customer relationship in both banking law and securities law; a prescriptive definition such as ‘customer relationship’ has been used in the context of a banking entity [defined in Board regulation 12 C.F.R. 216(3) as a ‘continuing relationship’], while a much more nuanced definition such as ‘substantive and pre-existing relationship’ has been used in the context of private placements.” (pp. 63-64)
    - **Potential Additional Considerations.** “In determining the nature of a customer relationship that may constitute a permitted activity, Agencies should consider these existing authorities and should take into account the following potential considerations:
      - **Continuing relationship versus knowledge of financial needs:**

- A continuing relationship . . . ; or
  - A previous relationship that provided the banking entity with sufficient knowledge of the customer’s financial needs, risk tolerance, and qualifications.
- **Direct versus indirect customer relationships:**
  - A direct and substantive relationship between the banking entity and a prospective customer; or
  - A relationship between the banking entity and the customer’s agent or advisor or investment vehicle.
- **Relationship initiated by the potential customer versus banking entity:**
  - A relationship initiated by the potential customer or its agent to inquire about a product or service offered by the banking entity; or
  - A relationship initiated by the banking entity offering a product or service to the customer or agent.” (p. 64)
- **Whether customers are synonymous with or different from clients:**
  - “[I]n certain instances, the Volcker Rule refers to ‘clients,’ a term which is not defined.
  - Under the federal securities laws, who may be considered a client is a distinct concept from who may be considered a customer of the bank.” (p. 64)
- **Relationships Between a Banking Entity and Third-Party Funds in which a Sponsored Feeder Fund or Fund of Funds Invests**
  - **Findings:** The Volcker Rule permits banking entities to “provide customers with access to third-party private equity funds and hedge funds through the organizing and offering of a hedge fund or private equity fund that makes investments in such third-party funds. . . . However, conflicts of interest may arise where a banking entity directs a feeder fund or fund of fund investment to a third-party hedge fund or private equity fund with which the banking entity has other business relationships.” (p. 65)
  - **Recommendations:** The Agencies should evaluate the appropriateness of those relationships and in doing so, they “should consider:
    - Whether the banking entity’s business relationships with the third-party fund should be subject to the Volcker Rule’s prohibition of ‘covered transactions’”, as well as the “arm’s length” transactions requirements of Section 23B of the Federal Reserve Act; and
    - The extent to which such arrangements could create the opportunity and incentive for banking entities to bail out the third-party funds or expose the banking entity to “outsized risk.” (p. 65)
- **Calculating De Minimis Investments**
  - **Findings:** “The Volcker Rule permits banking entities to take or retain a 3% or lower *de minimis* investment in a hedge fund or private equity fund that such entity organizes and offers, subject to certain conditions and limits.” (p. 65)
  - **Recommendations:** The “Agencies should be careful to ensure that the statutory restrictions be carefully defined to ensure that these [permitted investments] do not place banking entities at undue risk or provide loopholes for proprietary trading or other prohibited transactions. . . . The Agencies should consider defining ‘investment’ in a manner that will best capture the banking

entity's true risk exposure" and avoid understating risk. In order to do so, they need to address the following questions in their implementing regulations:

- **Whether to measure investments on the basis of invested or committed capital.** The Agencies should resolve whether the *de minimis* limit should be measured on the basis of invested or committed capital. (p. 66)
- **Whether *de minimis* limit is a one-time test or continuous requirement.** The Agencies "should consider . . . [w]hether the *de minimis* calculation . . . should reflect changes in the investor base in the fund (e.g., redemptions or other changes in commitment levels) over time or whether a one-time test at the one-year mark or at the inception of a fund would be sufficient." (p. 67) If the test is failed, "in what period of time should banking entities that have failed the test be required to sell down their interest to a compliance level?" (p. 67)
- **Whether and when to include carried interest.** The Agencies "should consider the proper treatment of carried interest for purposes of the *de minimis* calculation, including whether carried interest that remains in the fund, **at the election of the party to whom it is allocated**, should be treated the same or differently than carried interest that is removed from the fund when contractually allocated or earned." (p. 66) (Emphasis added.)
- **Whether to include employee investments.** The "Agencies should consider whether investments by directors and employees engaged in providing services to the fund, together with other investors who may be affiliated with the bank (such as non-ERISA qualified employee deferred compensation plans) should be included in the 3% cap on a banking entity's investment in a hedge fund or private equity fund." (p. 67)
- **Whether to enact certain anti-evasion rules.** "Agencies should consider implementing the 3% *de minimis* investment and seed fund exceptions to prevent banking entities from subverting the intent of the legislation by structuring arrangements that technically comply with the 3% ownership limit while allowing banking entities to retain a synthetic or other interest in a fund, effectively exposing the banking entity to the risks and benefits of ownership otherwise prohibited under the Volcker Rule." (p. 66)
- **Use of Insurance Products to Evade the Volcker Rule**
  - **Recommendations:** The "Agencies should carefully monitor fund flows between banking entities and insurance companies, to guard against 'gaming' the Volcker Rule, whether it is through innovative insurance products and financial instruments, like Bank Owned Life Insurance, or use of separate accounts. Agencies should work with the state insurance agencies in monitoring activity of bank affiliate insurance companies and captive insurers. To the extent such products become vehicles to enable impermissible activity, Agencies should consider procedures for designating such financial instruments [as instruments that are subject to the Volcker Rule]." (p. 75)
- **Monitoring Compliance**
  - **Recommendations:** "[F]irms should be held accountable for compliance with the Volcker Rule's restrictions on investments in and sponsorship of hedge funds and private equity funds. The programmatic compliance regime [should] have the following key attributes, including investment and risk oversight, public attestation of compliance by the CEO, and engagement by the Board of Directors." (p. 69)
  - **Board of Directors.** "The banking entity's Board of Directors should approve the objectives, strategies, and policies governing permissible investments in hedge funds and private equity funds. . . ." (p. 69)

- **Documentation and Communication.** “The banking entity’s approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all personnel involved in their implementation.” (p. 69)
- **Monitoring Program.** “The banking entity should actively monitor the performance and risk profile of private equity and hedge fund investments . . . .” (p. 69)
- **Investment Limits.** “The banking entity’s policies and procedures . . . should identify the aggregate exposure that the institution is willing and able . . . to accept by type and nature of investment. Adherence to such limits should take into consideration unfunded, as well as funded, commitments. Banking entities should have systems in place . . . to ensure that impermissible investments in or transactions with hedge funds and private equity funds are prohibited.” (pp. 69-70)
- **Internal Controls.** “Permitted investments in hedge funds and private equity funds should be subject to active oversight by the banking entity and senior management.” (p. 70)
- **CEO Attestation as to Effectiveness.** “The CEO should be required to attest publicly to the ongoing effectiveness of the internal compliance regime.” (p. 70)
- **Public Disclosure**
  - **Recommendations:** “Agencies should consider requiring banking entities to publicly disclose certain information regarding private equity funds and hedge funds that they are permitted to invest in, organize and offer, or sponsor so that markets and investors can better assess risk profiles and performance. For example, such information could include the type and amount of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital . . . .” (p. 70)

---

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

<b>Randall D. Guynn</b>	212 450 4239	<a href="mailto:randall.guynn@davispolk.com">randall.guynn@davispolk.com</a>
<b>Yukako Kawata</b>	212 450 4896	<a href="mailto:yukako.kawata@davispolk.com">yukako.kawata@davispolk.com</a>
<b>Alex Young-Anglim</b>	212 450 4809	<a href="mailto:alexander.young-anglim@davispolk.com">alexander.young-anglim@davispolk.com</a>

---

---

## Comparison of the Recommendations Proposed in the SIFMA Comment Letter to Actual Recommendations Made in the FSOC Study

- I. **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies clarify that certain entities will not be treated as hedge funds or private equity funds even if they fall within the literal scope of the general definition.
- **FSOC Recommendation:** “In implementing the Volcker Rule, the Agencies should consider criteria for providing exceptions with respect to certain funds that are technically within the scope of the ‘hedge fund’ and ‘private equity fund’ definition in the Volcker Rule but that Congress may not have intended to capture in enacting the statute.” (p. 7) The Agencies should “carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases.” (p. 62)
  - Specific entities relying on 3(c)(1) or 3(c)(7) that the FSOC specifically mentions as candidates for exclusion from the general definition:
    - special purpose acquisition vehicles;
    - certain ERISA qualified employee pension funds;
    - controlled subsidiaries;
    - joint ventures used to hold ordinary course investments;
    - other investment vehicles; and
    - venture capital funds.
- II. **SIFMA proposal:** FSOC should recommend that if the Regulatory Agencies make “similar funds” designations they do so based on whether a fund is similar to a traditional hedge fund or private equity fund, and adopt an appropriate transition period for any funds so designated.
- **FSOC Recommendation:** The Agencies “should consider using their authority to expand the definition [of hedge fund and private equity fund] by rule to funds that do not rely on the section 3(c)(1) and 3(c)(7) exclusions, but that engage in the activities or have the characteristics of a *traditional* private equity fund or hedge fund.” (p. 62) (Emphasis added.) In determining which funds to designate as “similar funds,” the Agencies “should consider the investment activities and other characteristics of such funds, including:
    - **Related compensation structure:** Does the fund earn an allocation based on fund performance including both realized and unrealized gains?
    - **Trading/Investment strategy:** What trading or investment strategy does the fund utilize?
    - **Use of leverage:** Does the fund borrow or otherwise utilize material leverage for the purpose of increasing investment performance?
    - **Investor composition:** Is the fund’s capital received from a broad group of unaffiliated investors?” (p. 62)



- **Note:** *Although these characteristics were included in the proposed definitions for traditional hedge funds and private equity funds in Annex A to the SIFMA letter, SIFMA had proposed that a fund must have **all** of the characteristics included in its proposed definitions in order to qualify as a **traditional** hedge fund or private equity fund.*

- **Not addressed:**

- Appropriate transition periods for funds designated as “similar funds.”
- Confirmation that investments by insurance companies in hedge funds or private equity funds pursuant to BOLI/COLI policies should not be attributed to a banking entity policyholder.
- Regulated foreign investment companies, e.g., UCITS.

**III. SIFMA proposal:** FSOC should recommend that the Regulatory Agencies confirm that credit funds not be treated as hedge funds or private equity funds, if their credit activities are conducted in a safe and sound manner in accordance with sound underwriting and other standards applicable to banking entities.

- **Not addressed.**

**IV. SIFMA proposals:**

- FSOC should effectively recommend that the terms “affiliate” and “subsidiary,” as used in the term “banking entity” for purposes of the Volcker Rule, be construed to exclude hedge funds and private equity funds, portfolio companies of hedge funds or private equity funds, and registered investment companies to avoid internal contradictions, absurd results and unintended consequences in the Volcker Rule.
- **FSOC Recommendation:**
  - The Agencies should “carefully consider the impact of certain BHC Act definitions on the Volcker Rule’s definition of ‘banking entity’ and implement that term in a way that avoids results that Congress clearly did not intend in enacting the Volcker Rule.” (p. 69)
    - Specific affiliates and subsidiaries that the FSOC specifically mentions as candidates for exclusion from the term “banking entity”:
      - a controlled fund of funds that invests in third party funds;
      - hedge funds and private equity funds controlled by a banking entity;
      - funds within a family of controlled funds;
      - companies controlled by a hedge fund or private equity fund that is in turn controlled by a banking entity;
      - SEC-registered investment companies controlled by a banking entity.
  - FSOC should also recommend that solely for purposes the Volcker Rule a banking entity’s employee pension fund be exempted from the provision in the BHC Act that would otherwise attribute the funds’ investments to the banking entity.
- **Not addressed.**

- V. **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies grant an exemption for investments in hedge funds or private equity funds acquired in satisfaction of debts previously contracted.
- **Not addressed.**
- VI. **SIFMA proposal:** FSOC should recommend that the [Federal Reserve] Board construe the term “covered transaction” in Section 23A of the Federal Reserve Act so that it includes all appropriate exemptions for purposes of the Volcker Rule.
- **Not addressed.**
- VII. **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies treat carried interest as incentive compensation, and not an ownership interest, for purposes of the 3% limit on total ownership interests in a fund under the Volcker Rule.
- **FSOC Recommendation:** The Agencies should “consider the proper treatment of carried interest for purposes of the *de minimis* calculation, including whether carried interest that remains in the fund, **at the election of the party to whom it is allocated**, should be treated the same or differently than carried interest that is removed from the fund when contractually allocated or earned.” (p. 66) (Emphasis added.)
- VIII. **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies calculate the 3% ownership limit as of the end of the permitted seeding period.
- **FSOC Recommendation:** The Agencies “should consider . . . [w]hether the *de minimis* calculation . . . should reflect changes in the investor base in the fund (e.g., redemptions or other changes in commitment levels) over time or whether a one-time test at the one-year mark or at the inception of a fund would be sufficient.” (p. 67) If the test is failed, “in what period of time should banking entities that have failed the test be required to sell down their interest to a compliance level?” (p. 67)
- IX. **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies construe the 3% of Tier 1 capital limit to be calculated on a consolidated basis at the ultimate parent company level of any banking entity.

- **Not addressed.**

## Annex A to SIFMA Comment Letter

- **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies exclude directed trustees from the term “trustee” as used in the definition of “sponsor”.
- **Not addressed.**
- **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies permit a banking entity to propose a board of directors upon the formation of a new fund without being deemed to “sponsor” the fund if a majority of such board is comprised of directors that are independent of the banking entity.
- **Not addressed.**

- **SIFMA proposal:** FSOC should recommend that the Regulatory Agencies define **traditional** hedge funds and private equity funds as funds having all of certain specified characteristics.
  - **FSOC Recommendation:** After recommending that the Agencies base their “similar funds” analysis on whether a particular fund engages in the activities or has the characteristics of a **traditional** private equity fund or hedge fund, the FSOC urged the Agencies to consider the following investment activities and other characteristics of traditional hedge funds and private equity funds, without recommending the adoption of SIFMA’s proposed definitions:
    - **Related compensation structure:** Does the fund earn an allocation based on fund performance including both realized and unrealized gains?
    - **Trading/Investment strategy:** What trading or investment strategy does the fund utilize?
    - **Use of leverage:** Does the fund borrow or otherwise utilize material leverage for the purpose of increasing investment performance?
    - **Investor composition:** Is the fund’s capital received from a broad group of unaffiliated investors?” (p. 62)
      - **Note:** *Although these characteristics were included in the proposed definitions, SIFMA had proposed that a fund must have **all** of the characteristics included in its proposed definitions in order to qualify as a **traditional** hedge fund or private equity fund.*
- **SIFMA comment:** FSOC should recommend that the Regulatory Agencies interpret the exemption for investments in “small business investment companies” and certain “public welfare investments” broadly.
  - **Not addressed.**
- **SIFMA comment:** FSOC should encourage the Regulatory Agencies to examine the impact of Basel III and the new generally applicable capital provisions introduced by the Dodd-Frank Act on banking entities and nonbank financial companies prior to determining whether additional capital and quantitative limitations are appropriate for Volcker Rule activities.
  - **Not addressed.**