Client Advisory

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Katten Muchin Rosenman LLP

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Volcker Rule Permits Bank-sponsored Hedge Fund Access Platforms

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (which embodies the so-called Volcker Rule) will impose significant limits on the ability of banks and their affiliates (each, a "banking entity" or "BE") to engage in proprietary trading and to own or sponsor hedge funds when it comes into effect in July of 2012.* Nonetheless, while the headlines about the Volcker Rule have focused consistently on the details of those limitations, there are many current U.S. bank activities with respect to hedge funds that will still be permitted under the Volcker Rule. These permitted activities include offering customers access to third-party hedge funds via dedicated feeder funds (or dedicated stand-alone funds). Under the new regulatory regime, however, it will be more difficult for a BE to organize and seed a hedge fund than it will be to merely act as an advisor, and both activities will be subject to significantly greater compliance burdens and regulatory scrutiny than has previously been the case.

Ownership and Sponsorship Prohibition

If a BE is providing only investment management or other services to a fund, that activity does not violate the primary Section 619 hedge fund-related prohibition, which is triggered only by ownership or sponsorship: "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." Such advisory activity will now, however, give rise to a new compliance requirement (the Covered Transaction Prohibition) whereby neither the BE nor any of its affiliates can enter into any transaction with the feeder fund (or any fund controlled by the feeder fund) that would be a "covered transaction" for a bank under Section 23A of the Federal Reserve Act (i.e., a transaction involving an extension of credit) if the fund was an affiliate of the bank. (The only exception to the Covered Transaction Prohibition is a narrow one for prime brokerage services offered to an underlying hedge fund.) Transactions that would not be "covered transactions" are permitted, but only subject to compliance with Section 23B (even if the relevant BE is not itself a bank).

Permitted Activity Exception

Typically, however, offering an access platform requires the BE to have some degree of ownership or sponsorship of the funds taking customer investments. That additional factor implicates the primary prohibition, but that is not problematic if the activity is structured to fall within the "permitted activity" exception to the Volcker Rule that allows a BE to "organize and offer" any fund, including a feeder fund, subject to meeting certain conditions:

1. The BE must be providing bona fide trust, fiduciary, investment advisory or commodity trading advisory service to the fund;
2. The fund must be "organized and offered" (a) only in connection with the provision of the "bona fide" service, and (b) only to persons that are customers of such services of the BE (with this condition being met in part by the creation of a "credible plan" outlining how the BE intends to provide approved services to its customer by means of the fund);
3. The banking entity's ownership interest in the fund (a) will be reduced to 3% of the fund within one year of establishment of the fund, and (b) is immaterial and, in any event, when combined with all of the BE's other ownership stakes in funds will not exceed 3% of its Tier 1 capital;
4. The BE must not, directly or indirectly, guarantee, assume or otherwise insure the obligations of the fund or any fund in which the first fund invests;
5. The covered fund may not (a) share the same name (or a variation thereof) with the banking entity, or (b) use the word "bank" in its name;

* Under the Volcker Rule, both (1) a non-U.S. bank with a U.S. branch, and (2) a non-bank affiliate of a bank, can be a "covered banking entity."

6. No director or employee of the BE may take or retain an ownership interest in the fund (except for one who is directly engaged in providing permitted services to the fund); and
7. The BE must make certain prescribed written warning disclosures to prospective investors in the feeder fund covering the risks of the fund.

Even if all of these conditions are met, however, the activity cannot take place (a) if it will give rise to certain impermissible consequences, or (b) if the BE will not be able to meet two relatively onerous compliance requirements in conducting the activity.

Impermissible Consequences

The impermissible consequences are few in number but significant in impact—offering a feeder fund in a manner that satisfies all seven of the primary conditions is still not permissible if the activity (1) involves or results in a "material conflict of interest" between the banking entity and its "clients, customers, or counterparties"; (2) results in the banking entity having a "material exposure to a high-risk asset or a high-risk trading strategy"; or (3) poses a threat to the safety and soundness of the banking entity or to the financial stability of the United States. The second and third consequences are relatively easy to spot (and likely to be rare), but unfortunately the term "material conflict of interest" is defined in a way that is more circular than illuminating: "a material conflict of interest . . . exists if the covered banking entity engages in any . . . activity that would involve or result in the covered banking entity's interests being materially adverse to the interests of its client, customer or counterparty with respect to such . . . activity." The rule does provide, however, that a material conflict of interest can be negated or substantially mitigated by certain type of disclosures or the creation of appropriate information barriers.

Compliance Requirements

Of the two compliance requirements, one is specific and one is general. The specific requirement is the Covered Transaction Prohibition described above. The general requirement is that any banking entity engaging in activities subject to the Volcker Rule must "develop and provide for the continued administration of a [compliance] program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions" in Section 619 and the implementing rule. That program must include, at a minimum, (1) internal written policies and procedures; (2) a system of internal controls; (3) a management framework; (4) independent testing for effectiveness; (5) training; and (6) recordkeeping. The implementing rule also includes an Appendix C that provides 13 single-spaced pages of guidance concerning "Minimum Standards for Programmatic Compliance." Any financial institution will already have in place a compliance framework with the necessary basic elements, but many Volcker Rule-specific components will have to be added and tested before the effective date occurs in order to avoid violations for an insufficient program.

We have prepared a chart illustrating the elements necessary to allow a BE to provide a hedge fund access platform involving ownership or sponsorship of the feeder fund.

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of Katten's **Financial Services Practice**.

Guy C. Dempsey, Jr.
212.940.8593 / guy.dempsey@kattenlaw.com

Henry Bregstein
212.940.6615 / henry.bregstein@kattenlaw.com

Jeffrey M. Werthan
202.625.3569 / jeff.werthan@kattenlaw.com

Katten
Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK OAKLAND WASHINGTON, DC

Exhibit 1

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A Banking Entity can organize/sponsor a fund if A) it can answer "Yes" to each question below:

CONDITIONS

1. Is the BE providing only permitted, bona fide services to the fund?
2. Is the fund "organized and offered" only in connection with the bona fide services and only to BE customers?
3. Will the BE's ownership interest in the fund meet the "3 and 3" test?
4. Is the fund structured so that its obligations are not guaranteed or insured by the BE?
5. Is the name of the fund different than that of the BE and does it omit the word "bank"?
6. Will BE directors and employees be excluded from owning interests in the fund (except if directly involved with providing services)?
7. Will fund investors be given required written disclosures?

B) the activity will not cause any of the consequences below:

IMPERMISSIBLE CONSEQUENCES

8.
- a. Material conflict of interest with clients
- b. Material exposure to high-risk assets or trading strategy
- c. Threat to safety and soundness of entity or U.S. financial stability

and C) the activity will be conducted in accordance with the compliance requirements below:

COMPLIANCE REQUIREMENTS

9.
- a. "Super" Covered Transaction prohibition
- b. Comprehensive compliance program