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Volcker Rule Risks Robbing Private Equity Of Players

By **Samuel Howard**

Law360, New York (December 02, 2011, 7:08 PM ET) -- The Volcker Rule, central to the Dodd-Frank Wall Street Reform and Consumer Protection Act, seeks to curb risky proprietary trading by banks, but the limits could make it unfeasible for banks to operate in private equity — an industry that has treated them and their investors so well, attorneys say.

Slated to take effect in July 2012, the rule will bar banking entities from investing in hedge funds and private equity funds, forcing banks to divest hundreds of millions of dollars in assets. While the proposed legislation includes critical exemptions that permit banks to continue investing in private equity funds they sponsor, it comes with strict capital restrictions designed to limit their exposure.

Although the sponsorship provision seems to give banks a lifeline to the private equity market, the capital restrictions are so severe that they might make it more trouble than it's worth for them to maintain private equity arms, attorneys said. In other words, while Volcker seeks to stop banks from putting too much skin in the game, the game soon loses luster if banks are relegated to the margins.

“For the most part, private equity has been a source of profits and diversification, so the banks see the reforms as a loss of opportunity and revenue,” Derrick Cephas ofWeil Gotshal & Manges LLP said. “Even though the banks can continue to sponsor funds, the capital restrictions may make it impossible or at least unwise to be in the private equity business.”

While banks have historically attracted investors and reaped profits by investing heavily in their own funds, Volcker puts an end to the potentially risky practice. The rule requires banks to take no more than a three percent stake in a sponsored fund and bars them from investing more than three percent of their total regulatory capital, or Tier 1 capital, in their private equity and hedge funds.

Importantly, banks will be allowed to provide all the seed capital to get a sponsored fund up and running, but they will have to race to scale back their investment to the acceptable minimum within one year.

The ownership limits do not mean that banks will not be able to succeed in private equity, but they drastically alter the investment dynamics, likely turning off banks as well as investors, attorneys said.

“The question is [whether] banks [will] be successful once they adopt the three percent capital limits," Harvey Eisenberg of Weil Gotshal said. "There are reasons to think not."

Historically, bank-controlled funds have gotten as much as 50 percent of their capital from the bank and its employees, a far cry from the three percent limits under consideration, Eisenberg said.

The hefty ownership position helped attract big investors otherwise hesitant to join bank-sponsored funds due to potential conflicts and the risk of leaguing with one bank over another, possibly harming business, he said.

While the three percent ownership limits mirror the position that private equity firms normally take, Volcker overlooks decisive differences between banks and private equity firms as businesses, attorneys said.

“Congress says if 2 or 3 percent ownership is enough for KKR and Blackstone, why not for banks?" Eisenberg said. "But the truth is [that] the models are different and banks have put much more in their funds in order to retain the management team, attract capital and allay fears of investor conflicts."

The capital restrictions decimate bank profits, but they also repel investors long-attracted to bank-controlled funds precisely because they are anchored by a massive block of bank-affiliated cash, according to Fadi Samman of Akin Gump Strauss Hauer & Feld LLP.

“Investors want banks to have a leading stake in their funds to show an alliance of interests,” he said. “Once banks are restricted to a three percent stake, investors may not find bank-sponsored platforms as attractive as compared to dedicated private equity firms.”

Even though banks have generally preferred to invest in the funds they sponsor rather than outside funds, they have contributed significantly to other private equity firms, often in an effort to build valuable alliances, according to Samman.

“The rule will certainly affect fundraising, as banks have been a source of capital, if not pivotal contributors,” he said.

Major banks have already been spinning off their private equity arms, and while others are waiting to see how fundraising goes under the new regulation, Volcker is bound to squeeze professionals out of the banks into a sector that is already cut-throat, Samman said.

Banks have at least two years to comply with the rule and divest assets in nonsponsored funds, and are entitled to three one-year extensions for illiquid assets, and in rare cases an additional five-year extension. But it remains to be seen whether sufficient buyers crop up for the tide of bank divestitures, Eisenberg said.

“While the rule is designed to give the banks time to divest and prevent a rush to the door, there is still considerable concern about how the secondary market will accommodate the surge and whether it will lead to a bargain hunter’s market, where the abundance of bank-owned equity depresses values,” he said.

While Volcker stands to all but end banks’ plays in private equity except for fund sponsorship, bona fide hedging investments or trades strictly on behalf of customers, all is not lost. Even if the draconian limits go through, the rule permits banks to make private equity-style investments by investing directly in companies and abandoning the fund model entirely, Eisenberg noted.

But the legislation still has immense extraterritorial reach, extending to any banking entity with stateside operations. While it permits foreign banking entities without U.S. operations to invest in private equity funds, they can only do so if the fund does not have investors that are U.S. residents, Eisenberg said.

“Therefore, if a foreign banking entity wants to form a covered fund, it must exclude US residents,” he said. “It’s hard to see why foreign sponsors should be forced to choose between foreign banking entities and U.S. residents.”

Non-U.S. investors remain very uncertain about their exposure to the Volcker prohibitions. As drafted, the rule purports to not only regulate U.S. banks, but also their critical upstream investors like foreign sovereign funds, according to David Goldstein of DLA Piper.

“If a sovereign wealth fund has an interest in a U.S. bank, it is subject to the Volcker Rule and needs to find an exemption to its private equity fund holdings,” Goldstein said. “On the surface, this threatens to bar a staggering amount of foreign investment in private equity firms.”

--Editing by Elizabeth Bowen.