

Final Volcker Rule Regulation Eases Hedge Fund And Private Equity Fund Restrictions

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On July 9, a final rule was adopted lifting the Volcker Rule's restrictions on community banks from proprietary trading, and hedge funds and private equity funds from using the same name as an affiliated investment adviser, consistent with the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA).

The adoption of the final rule provides important guidance to hedge funds and private equity funds, including:

- Certain community banks are excluded from the Volcker Rule, thereby allowing them to invest in private equity and hedge funds.
- Hedge funds and private equity funds can now use the same name or a variation of the same name as an affiliated investment adviser, subject to certain exceptions.

Background

The Volcker Rule prohibits banks from using customer deposits for short-term proprietary trading of securities, derivatives and commodity futures, as well as options on any of these instruments. Banks cannot own, invest in or sponsor hedge funds, private equity funds or other trading operations (subject to certain exceptions). Banks can underwrite and offer hedge funds and private equity funds only if these activities do not create a material conflict of interest, expose the institution to high-risk assets or trading strategies, or generate instability within the bank or within the overall U.S. financial system. The Volcker Rule aims to discourage banks from taking too much risk by barring them from using their own funds to make these types of investments to increase profits. The Volcker Rule relies on the principle that these speculative trading activities do not benefit banks' customers.

The Volcker Rule, in section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, was introduced in response to the 2007-2008 financial crisis. After the nation's biggest banks accumulated large

losses from their proprietary trading divisions, former Federal Reserve Chair Paul Volcker proposed regulations to reestablish the divide between commercial banking and investment banking, a separation that was extinguished by the Gramm-Leach-Bliley Act in 1999.

In December 2013, five federal agencies — the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission and the Securities and Exchange Commission — approved the final regulations that make up the Volcker Rule.

On May 24, 2018, President Trump signed the EGRRCPA in an effort to ease many of the regulations adopted after the passage of the Dodd-Frank Act, including the Volcker Rule. Shortly thereafter, on December 18, 2018, the agencies proposed a rule consistent with the EGRRCPA that would exclude certain community banks from the Volcker Rule, thereby allowing them to invest in private equity and hedge funds. On July 9, 2019, the agencies adopted the rule without change.

Analysis

Community banks up to a certain size are excluded from the Volcker Rule

The final rule excludes certain institutions from the definition of a “banking entity.” Previously, the definition included any insured depository institution, any company that controls an insured depository, or any bank holding company and any affiliate or subsidiary of such an entity. The final rule excludes from the Volcker Rule banks with:

- \$10 billion or less in total consolidated assets, and
- total trading assets and liabilities that amount to 5 percent or less of their total consolidated assets.

As a result, a bank that meets this statutory exclusion is no longer considered a “banking entity” required to comply with the Volcker Rule.

Hedge funds and private equity funds can have the same name as their affiliated investment advisers under certain circumstances

The final rule also eased the Volcker Rule’s restrictions on affiliations between investment advisers and hedge funds or private equity funds. Investment advisers can have the same name or a variation of the same name as the hedge funds and private equity funds that they sponsor and in which they invest, subject to the following conditions:

- the investment adviser is not an insured depository institution, a company that controls an insured depository institution, or a bank holding company
- the investment adviser does not have the same name or a variation of the same name as an insured depository institution, a company that controls an insured depository institution, or a bank holding company

- the name does not contain the word “bank.”

Takeaways

Community banks and other insured depository institutions that meet the criteria above are no longer subject to the Volcker Rule. While the long-term practical effects remain to be seen, the increased scope and flexibility in trading activities these entities now have will make them attractive partners in private equity funds and hedge funds, spurring financial activity and innovation.

Private equity funds and hedge funds are now able to have the same names and variations of names as the investment advisers that are their sponsors and investors under certain circumstances. This change allows funds whose investment advisers meet the criteria to gain potentially greater market visibility. Funds can now utilize the value of the affiliated investment adviser to more effectively market the fund. The size of this benefit is hard to quantify, as it depends on a number of factors specific to each fund, including business models, the overlap of fund marketing targets and banking entity customers, and customer reaction — but the potential benefits are large.

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