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The Volcker Rule, Banking Entities, and Covered Funds Activities

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THE VOLCKER RULE, BANKING ENTITIES, AND COVERED FUNDS ACTIVITIES

Jeffrey Koh & Kyle Gaughan***

ABSTRACT

With the passage of the 2010 Dodd-Frank Act, Congress instituted a host of new laws attempting to protect consumers from the types of risky trading that led to the 2008 economic crisis. However, many of the new rules and regulations, including the Volcker Rule, are yet to fully take effect. Among other restrictions, the Volcker Rule attempts to curtail risky trading by limiting banking entity investments in private equity and venture capital funds. As the Volcker Rule nears its implementation deadline, banking entities are concerned that they will face substantial losses in having to comply with the Volcker Rule by being forced to sell their investments at fire-sale prices.

TABLE OF CONTENTS

I. INTRODUCTION	94
II. BACKGROUND AND TIMELINE OF THE VOLCKER RULE ..	95
III. VOLCKER RULE REQUIREMENTS	96
A. <i>Prohibition on Proprietary Trading</i>	97
B. <i>Compliance and Reporting Requirements</i>	99
C. <i>Covered Funds</i>	100
1. Covered Funds Defined	100
2. Exceptions to Prohibitions on Ownership Interests in Covered Funds	101
i. Issuing; Underwriting and Market Making; Advisory Services	101
ii. New Covered Funds	102
iii. Hedging Compensation Arrangements	104
iv. Covered Funds Outside the United States ...	105
D. <i>Termination of Activities or Investments; Penalties for Violations</i>	105
IV. CONFORMANCE PERIOD	106
V. POTENTIAL IMPACTS & CRITICISMS	107
VI. CONCLUSION	111

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I. INTRODUCTION

In response to the financial crisis of 2007-2008, Congress enacted the Dodd-Frank Wall Street and Consumer Protection Act (“Dodd-Frank”).¹ A variety of factors triggered the financial crisis, including poor safeguards on mortgage lending, excessive packaging and sale of loans to investors, and risky investments into loan-backed securities.² As a result of the crisis, Congress authorized the investment of \$700 billion into the U.S. financial system through the Troubled Asset Relief Program (TARP), via a variety of American banking entities.³ Congress established TARP to stabilize the U.S. banking system, among other purposes.⁴ Together with TARP, Dodd-Frank envisioned numerous new regulations on banking entities to prevent the causes of the crisis from reoccurring in the future, and to better “protect consumers from abusive financial services practices.”⁵

Dodd-Frank includes Section 619, an addition to the Bank Holding Company Act of 1956 (the “BHCA”) entitled “Prohibitions On Proprietary Trading And Certain Relationships With Hedge Funds And Private Equity Funds,” which imposes new regulations on the American banking industry.⁶ Section 619 of Dodd-Frank (and the regulations promulgated thereunder) is commonly known as the Volcker Rule,⁷ and it generally attempts to prohibit banking entities from engaging in proprietary trading and from acquiring, retaining ownership interests in, sponsoring or having certain relationships with private equity funds and hedge funds.⁸ The Volcker Rule restrictions are complex and not ironclad; they cover investments in hedge funds and private equity funds, subject to a variety of qualifications and exemptions.

1. *Wall Street Reform: The Dodd-Frank Act*, WHITEHOUSE.GOV, <http://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform> (last visited Sept. 10, 2014).

2. Sewell Chan, *Financial Crisis Was Avoidable, Inquiry Finds*, N.Y. TIMES (Jan. 25, 2011), available at http://www.nytimes.com/2011/01/26/business/economy/26inquiry.html?_r=0.

3. *TARP Programs*, U.S. DEP’T TREASURY, <http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx> (last updated Sept. 16, 2014); see Matthew Ericson, Elaine He & Amy Schoenfeld, *Tracking the \$700 Billion Bailout*, N.Y. TIMES, http://www.nytimes.com/packages/html/national/200904_CREDITCRISIS/recipients.html (last visited Sept. 11, 2014) (listing which banks received funds and how much from TARP).

4. *TARP Programs*, *supra* note 3.

5. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010) (enacted) (noting the Congressional purpose behind the passage of Dodd-Frank) [hereinafter *Dodd-Frank*].

6. See Responses to Frequently Asked Questions Regarding the Commission’s Rule Under Section 13 of the Bank Holding Company Act (the “Volcker Rule”), U.S. SEC. & EXCH. COMM’N (June 10, 2014), <http://www.sec.gov/divisions/marketreg/faq-volcker-rule-section13.htm>.

7. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, Title VI, § 619, 124 Stat. 1620, 1620-31 (2010) (codified as 12 U.S.C. § 1851 (2012)).

8. *Id.*

II. BACKGROUND AND TIMELINE OF THE VOLCKER RULE

Dodd-Frank has been gradually (but not yet fully) implemented since its passage in 2010.⁹ Drafters completed the Final Volcker Rule on December 10, 2013.¹⁰ This completion date fell well beyond the initial deadline of October 18, 2011 as initially contemplated by Dodd-Frank.¹¹ The complexity behind the Volcker Rule and Congress's desire to ensure that regulators passed a rule that sufficiently carried out Dodd-Frank's aims partially explained the extensive delay.¹² In addition to the Volcker Rule's complexity, much of the delay occurred due to the contentiousness behind the drafting of the Final Volcker Rule.¹³ While many supporters of the Volcker Rule were adamant in their desire to curb risky investments, banking entities were determined to continue to raise capital and make investments without new restrictions.¹⁴ Even before Dodd-Frank's passage in 2010, proponents of the Volcker Rule had begun to worry that the discussed legislation would be watered down.¹⁵ Under the backdrop of these concerns, regulators passed an initial draft in October 2011 that proposed strict restrictions on banking activities.¹⁶ This initial draft caused an uproar on Wall Street, which in turn led to extensive debates between pro-Volcker Rule regulators and the banking industry.¹⁷ The extent of these debates significantly delayed final formulation of the Volcker Rule.

9. See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM, FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, 2 (2013) ("The Dodd-Frank Act has not yet been fully implemented; thus, its impacts have not fully materialized.").

10. *OCC Bulletin 2014-9: Final Regulations Regarding the Volcker Rule*, OFF. CONTROLLER CURRENCY (Mar. 25, 2014), <http://www.occ.gov/news-issuances/bulletins/2014/bulletin-2014-9.html>.

11. See Victoria McGrane & Aaron Lucchetti, *Volcker Rule Delay Likely*, WALL ST. J. (Sept. 12, 2011), <http://online.wsj.com/articles/SB10001424053111904265504576564623589787108>.

12. *Id.* (noting Julie Edwards, spokesperson for Democratic Senator Jeff Merkley as stating "[t]he rule must be written right. If a small delay will help that process, it is acceptable.").

13. Alexander Eichler, *Volcker Rule Deadline Likely Blown, Says Bernanke*, HUFFINGTON POST (Mar. 1, 2012, 11:50 AM), http://www.huffingtonpost.com/2012/03/01/volcker-rule-deadline_n_1313299.html (quoting former Federal Reserve chairman Ben Bernanke as stating regulators would have to resolve "a lot of very difficult issues" and process "about 17,000 comments" before a rule could fully implemented).

14. See *id.*

15. William Alden, *War of Words over the Volcker Rule: A History*, N.Y. TIMES (Dec. 10, 2013, 10:38 AM), http://dealbook.nytimes.com/2013/12/10/war-of-words-over-the-volcker-rule-a-timeline/?_php=true&_type=blogs&_r=0 (noting Paul Volcker's disappointment with the dilution of the Final Rule).

16. See *id.*

17. See *id.* (noting Chief Executive of JPMorgan Chase Jamie Dimon's critique of the rule's complexity, stating "[i]f you want to be trading, you have to have a lawyer and a psychiatrist sitting next to you determining what was your intent every time you did something" and Bart Chilton of the Commodity Futures Trading Commission stating "[w]e should never

For instance, one of the many debates surrounding the Volcker Rule concerned hedging. While hedging is generally permitted, banking entities argued that the Volcker Rule was overly prescriptive in its proposed regulation of hedging.¹⁸ Specifically, banking entities and other critics of the Volcker Rule suggested that institutions covered by the Volcker Rule should be allowed to develop hedging policies and procedures that would be approved by regulators, rather than being bound by the strict hedging procedures required by the Volcker Rule.¹⁹ Critics claimed this would allow banking entities to continue to participate in certain forms of beneficial trading while maintaining the prohibition on proprietary trading.²⁰ In response, proponents of the Volcker Rule argued that its strict requirements would still allow for hedging as a tool for managing risk, while prohibiting hedging that would create “significant new risk exposure.”²¹

Nevertheless, despite these debates, the Federal Reserve’s Board of Governors issued the Volcker Rule in its final form on December 10, 2013 (hereinafter referred to as the “Final Volcker Rule”).²²

III. VOLCKER RULE REQUIREMENTS

The Final Volcker Rule establishes three main areas of “prohibitions and restrictions on proprietary trading by, and investments in or relationships with covered funds by, certain banking entities.”²³ Subject to certain exceptions,²⁴ these three areas include: (1) a “prohibition on proprietary trading,”²⁵ (2) a requirement for banking entities of a certain size to develop “a compliance program . . . to ensure and monitor compliance with [these] prohibitions and restrictions on proprietary trading and covered fund activities and investments” and to report permitted “proprietary trading activity” over a certain threshold to a designated agency,²⁶ and (3)

again be put in a circumstance where too-big-to-fail high-rollers play games of chance with our nation.”).

18. Tim Ryan, *Rebuttal: The True Volcker Rule Debate*, CNBC (June 14, 2012, 7:50 AM), <http://www.cnbc.com/id/47810099#>.

19. *Id.*

20. *Id.*

21. See Steve Liesman, *How Jamie Dimon Whiffed on the Volcker Rule*, CNBC (June 13, 2012, 4:28 PM), <http://www.cnbc.com/id/47803236> (arguing that if the Volcker Rule’s prohibitions were in place, JP Morgan may not have suffered a \$2 billion dollar loss due to hedging transactions).

22. See 17 C.F.R. § 75 (2014); William L. Harvey, *The Volcker Rule: It’s Time to Comply*, A.B.A. BANKING L. COMMITTEE: BUS. L. SEC. ANN. MEETING (2014).

23. 17 C.F.R. § 75.1(b) (2014).

24. See also Memorandum from the Staff of the Bd. of Governors of the Fed. Res. Sys. Seeking Approval of the Volcker Rule Regulations to the Bd. of Governors 2 (Dec. 9, 2013) (on file with author), available at <http://www.federalreserve.gov/aboutthefed/boardmeetings/board-memo-volcker-20131210.pdf> [hereinafter Board of Governors Memo].

25. 17 C.F.R. § 75.3(b) (2014).

26. 17 C.F.R. § 75.10(d) (2014).

a “prohibition on acquiring or retaining an ownership interest and having certain relationships with a covered fund.”²⁷

These prohibitions and restrictions apply to banking entities, which are defined under the Final Volcker Rule to include: “(i) [a]ny insured depository institution, (ii) [a]ny company that controls an insured depository institution, (iii) [a]ny company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3016), and (iv) [a]ny affiliate or subsidiary of any entity described . . . in (i), (ii) or (iii).”²⁸ The definition of banking entities would therefore also include, via 12 U.S.C. 3016, “(1) any foreign bank that maintains a branch or agency in a State, (2) any foreign bank or foreign company controlling a foreign bank that controls a commercial lending company organized under State law, and (3) any company of which any foreign bank or company referred to in (1) and (2) is a subsidiary.”²⁹ Applying the definition of covered fund discussed in Section III.C *infra*, the Final Volcker Rule provides that any “covered fund that is not itself a banking entity,”³⁰ and any “portfolio company” held under the BHCA’s authority³¹ or any “portfolio concern . . . controlled by a small business investment company”³² (as long as these are not themselves banking entities) do not fall within the definition of banking entity under the rule.

A. Prohibition on Proprietary Trading

The Final Volcker Rule generally prohibits banking entities from engaging in proprietary trading,³³ unless such proprietary trading qualifies as a “permitted activity” under the Final Volcker Rule.³⁴ Proprietary trading refers to banking entities “engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.”³⁵

A trading account would be “any account that is used by a banking entity” to “purchase or sell one or more financial instruments” (i) “principally for the purpose of: (A) [s]hort-term resale, (B) [b]enefitting from actual or expected short-term price movements, (C) realizing short-term arbitrage profits, or (D) hedging one or more positions from the purchases

27. 17 C.F.R. § 75.10 (2014).

28. 17 C.F.R. § 75.2(c) (2014).

29. 12 U.S.C. § 3016(a).

30. 17 C.F.R. § 75.2(c)(2)(i) (2014).

31. 17 C.F.R. § 75.2(c)(2)(ii) (2014).

32. 17 C.F.R. § 75.2(c)(2)(ii) (2014).

33. 17 C.F.R. § 75.3(a) (2014).

34. Michael D. Bopp, et. al., *The Final Volcker Rule*, GIBSON, DUNN & CRUTCHER 3 (Dec. 13, 2013), <http://www.gibsondunn.com/publications/Documents/TheFinalVolckerRule.pdf>.

35. 17 C.F.R. § 75.3(a) (2014). *See also* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5535, 5538, (Jan. 31, 2014).

or sales of financial instruments described in . . . (A), (B) or (C),” (ii) covered under the “market risk capital rule,” or (iii) in connection with any licensed or registered business of a dealer, swap dealer, or security-based swap dealer.³⁶

A financial instrument covered under the prohibition on proprietary trading include “(i) [a] security, including an option on a security; (ii) [a] derivative, including an option on a derivative; or (iii) [a] contract for sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery”³⁷ but does not include: “(i) [a] loan; or (ii) [a] commodity that is not: (A) [a]n excluded commodity (other than foreign exchange or currency); (B) [a] derivative; (C) [a] contract for sale of a commodity for future delivery; or (D) [a]n option on a contract of sale of a commodity for future delivery; or (iii) [f]oreign exchange or currency.”³⁸

As part of its prohibition on banking entities engaging in proprietary trading, the Final Volcker Rule further contains a rebuttable presumption that the “purchase (or sale) of a financial instrument by a banking entity” is “presumed to be for the trading account of the banking entity . . . if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase (or sale).”³⁹

Proprietary trading, as defined under the Final Volcker Rule, does not include the purchase or sale of financial instruments by banking entities in connection with: (1) repurchase or reverse repurchase agreements, (2) temporary loans of financial instruments under which the lender retains the underlying economic interests, (3) liquidity management in accordance with a documented liquidity management plan, (4) serving as a derivatives clearing organization or a clearing agency in connection with clearing financial instruments, (5) excluded clearing activities by banking entities that serve as a clearing agency, a member of a derivatives clearing organization, or a designated financial market utility, (6) satisfying existing customer delivery or legal obligations, (7) their capacity as agent, broker or custodian, (8) deferred compensation, stock-bonus, profit-sharing or pension plans, or entities serving as trustee for the benefit of employees, or (9) the ordinary course of collecting a previously contracted debt, providing that the banking entity divests the financial instrument as soon as practicable.⁴⁰

In addition, certain “underwriting and market making-related activities,”⁴¹ certain “risk-mitigating hedging activities,”⁴² and certain “permit-

36. 17 C.F.R. § 75.3(b)(1) (2014).

37. 17 C.F.R. § 75.3(c)(1) (2014).

38. 17 C.F.R. § 75.3(c)(2) (2014).

39. 17 C.F.R. § 75.3(b)(2) (2014).

40. 17 C.F.R. § 75.3(d) (2014).

41. 17 C.F.R. § 75.4 (2014).

42. 17 C.F.R. § 75.5 (2014).

ted proprietary trading activities” involving domestic and foreign government obligations, fiduciary transactions, riskless principal transactions, insurance, and by certain foreign banking entities are permitted under the Final Volcker Rule subject to restrictions.⁴³ These activities must not “(1) [i]nvolve or result in a material conflict of interest between the banking entity and its clients, (2) [r]esult, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (3) [p]ose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.”⁴⁴

A “material conflict of interest” exists if a transaction would lead to the “banking entity’s interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction,”⁴⁵ and the banking entity has not made “timely and effective disclosure” or “established, maintained and enforced information barriers.”⁴⁶ A “high-risk asset” or “high-risk trading strategy” is defined as any assets or trading strategy, which would “significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.”⁴⁷

B. Compliance and Reporting Requirements

The Final Volcker Rule requires each banking entity to “develop and provide for the continuing administration of a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments” set forth in the rule.⁴⁸ The compliance program should at a minimum include: (1) “[w]ritten policies and procedures designed to document, describe, monitor and limit trading activities” subject to the Final Volcker Rule,⁴⁹ (2) a “system of internal controls reasonably designed to monitor compliance,”⁵⁰ (3) a “management framework that clearly delineates responsibility and accountability for compliance,”⁵¹ (4) “independent testing and audit of the compliance program conducted periodically,”⁵² (5) “[t]raining for trading personnel and managers . . . to effectively implement and enforce the compliance program,”⁵³ and (6) “[r]ecords sufficient

43. 17 C.F.R. § 75.6 (2014).

44. 17 C.F.R. § 75.7(a) (2014).

45. 17 C.F.R. § 75.7(b)(1) (2014).

46. 17 C.F.R. § 75.7(b)(2) (2014).

47. 17 C.F.R. § 75.7(c) (2014).

48. *See* 17 C.F.R. § 75.20 (2014).

49. 17 C.F.R. § 75.20(b) (2014).

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

to demonstrate compliance.”⁵⁴ If the banking entity engages in proprietary trading permitted under the Final Volcker Rule, it will also have further “reporting requirements,”⁵⁵ and must regularly provide certain documentation to the Commodity Futures Trading Commissions (“CFTC”) if it has trading assets and liabilities above certain dollar amount thresholds.⁵⁶

C. Covered Funds

Subject to certain exceptions,⁵⁷ the Final Volcker Rule prohibits banking entities from (i) as principal, directly or indirectly, acquiring or retaining any ownership interest in or sponsor a covered fund,⁵⁸ or (ii) entering into certain relationships or transactions with covered funds, described below.⁵⁹ To “sponsor”⁶⁰ means, with respect to a covered fund: (i) to “serve as a general partner, managing member, or trustee of a covered fund, or to serve as a commodity operator,”⁶¹ (ii) to “select or to control (or to have employees, officers, or directors or agents who constitute) a majority of the directors, trustees or management of a covered fund,”⁶² or (iii) to “share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.”⁶³

1. Covered Funds Defined

Under the Final Volcker Rule, the definition of covered fund includes: (i) an issuer that would be an investment company under the Investment

54. *Id.*

55. 17 C.F.R. § 75.20(c) (2014).

56. 17 C.F.R. § 75.20(d)(1) (2014).

57. Notwithstanding any exceptions provided in the Final Volcker Rule to the contrary, banking entities may not engage in any activity relating to a covered fund that would “(1) [i]nvolve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (2) [r]esult, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (3) [p]ose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.” 17 C.F.R. § 75.15(a) (2014). A “material conflict of interest” is defined as an activity “that would involve or result in the banking entity’s interests being materially adverse to the interests of its client, customer, or counterparty” with respect to such activity, 17 C.F.R. § 75.15(b)(1) (2014), which the banking entity has not made timely and effective disclosure or established information barriers. 17 C.F.R. § 75.15(b)(2) (2014). A “high-risk asset” or “high-risk trading strategy” is an asset or trading strategy that would “significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. 17 C.F.R. § 75.15(c) (2014).

58. 17 C.F.R. § 75.10(a)(1) (2014).

59. 17 C.F.R. § 75.14(a)(1) (2014).

60. 17 C.F.R. § 75.14(d)(9) (2014).

61. *Id.*

62. *Id.*

63. *Id.*

Company Act of 1940,⁶⁴ but for section 3(c)(1) or 3(c)(7) of that Act,⁶⁵ (ii) certain commodity pools under section 1a(10) of the Commodity Exchange Act,⁶⁶ and (iii) certain foreign entities, not offering or selling investments in the U.S., that are, or holds themselves out as being, entities or arrangements that raise money from investors primarily for the purpose of investing in or trading securities.⁶⁷

The definition of a covered fund under the Final Volcker Rule does not include: (1) foreign public funds (organized outside the U.S. which offer and sell ownership interests to retail investors in the issuer's home jurisdiction and sell ownership interests predominantly outside the U.S.), (2) wholly-owned subsidiaries (up to 5% of the subsidiary may be owned by employees or directors, and up to 0.5% by a third party if retained by third party for corporate separateness or bankruptcy concerns), (3) joint ventures, if not primarily for the purpose of investing in securities for resale or trading, (4) acquisition vehicles formed solely for the purpose of engaging in a merger or acquisition transaction, (5) foreign pension or retirement funds, if organized and administered outside the U.S., (6) insurance company separate accounts, provided that no banking entity other than the insurance company participates in the account's profits and losses, (7) bank owned life insurance, provided that no banking entity who purchased the policy controls investment decisions regarding underlying assets, (8) certain loan securitizations, (9) qualifying asset-backed commercial paper conduits, (10) certain qualifying covered bonds, (11) small business investment companies and public welfare investment funds, (12) registered investment companies and excluded entities, (13) issuers in conjunction with the FDIC's receivership or conservatorship operations, or (14) any other excluded issuer jointly determined by the appropriate Federal banking agencies, the Securities and Exchange Commission ("SEC"), and the CFTC.⁶⁸

2. Exceptions to Prohibitions on Ownership Interests in Covered Funds

i. *Issuing; Underwriting and Market Making; Advisory Services*

Despite the Final Volcker Rule's prohibition to the contrary, a banking entity is allowed to invest in or sponsor a covered fund "that is an issuing entity of asset-backed securities in connection with . . . organizing and offering that issuing entity"⁶⁹ subject to certain requirements, or in relation

64. 15 U.S.C. § 0a-1 *et seq.*

65. 15 U.S.C. § 80a-3(c)(1) and (7). Sections 3(c)(1) and (7) of the Investment Company Act's exemptions are available to companies that invest in or trade securities that privately offer securities beneficially owned by no more than 100 accredited investors or that are owned exclusively by qualified purchasers.

66. 7 U.S.C. § 1a(10).

67. 17 C.F.R. § 75.10(b) (2014).

68. 17 C.F.R. § 75.10(c) (2014).

69. 17 C.F.R. § 75.11(b) (2014).

to “underwriting and market making in ownership interests of a covered fund,”⁷⁰ subject to certain restrictions.

A banking entity may also invest in or sponsor a covered fund if:⁷¹ (1) the banking entity “provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services,”⁷² (2) the covered fund “is organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services and only to persons that are customers of such services of the banking entity,”⁷³ (3) the banking entity does not otherwise acquire an ownership interest in the covered fund not permitted under the Final Volcker Rule⁷⁴ and (4) complies with the Final Volcker Rule restrictions on covered fund activities,⁷⁵ (5) the banking entity does not insure the obligations or performance of the covered fund,⁷⁶ (6) the covered fund does not share the same name or use the word bank in its promotional materials,⁷⁷ (7) directors or employees of the banking entity do not retain an ownership interest in the covered fund,⁷⁸ and (8) the banking entity clearly discloses that the banking entity will not bear losses relating to the covered fund beyond its ownership in the covered fund.⁷⁹

ii. *New Covered Funds*

Subject to certain limits, a banking entity is also allowed to “acquire and retain an ownership interest in a covered fund”⁸⁰ that it organizes and offers pursuant to the above described exceptions to establish a fund and provide the fund “with sufficient initial equity for investment to permit the fund to attract unaffiliated investors.”⁸¹ When a banking entity makes an investment in these covered funds, the funds will not be considered affiliates of the banking entity.⁸² After providing initial equity financing to such covered funds, the banking entity must “actively seek unaffiliated investors to reduce, through redemption, sale, dilution, or other methods, the aggregate amount of all ownership interests of the banking entity in the covered fund.”⁸³

70. 17 C.F.R. § 75.11(c) (2014).

71. 17 C.F.R. § 75.11(a) (2014).

72. 17 C.F.R. § 75.11(a)(1) (2014).

73. 17 C.F.R. § 75.11(a)(2) (2014).

74. 17 C.F.R. § 75.11(a)(3) (2014).

75. 17 C.F.R. § 75.11(a)(4) (2014).

76. 17 C.F.R. § 75.11(a)(5) (2014).

77. 17 C.F.R. § 75.11(a)(6) (2014).

78. 17 C.F.R. § 75.11(a)(7) (2014).

79. 17 C.F.R. § 75.11(a)(8) (2014).

80. 17 C.F.R. § 75.12(a) (2014).

81. *Id.*

82. 17 C.F.R. § 75.12(b)(1)(iii) (2014).

83. 17 C.F.R. § 75.12(a)(2)(i)(A) (2014).

Within one year of the banking entity providing capital to the covered fund, the banking entity must limit its investment⁸⁴ to no more than 3% of the total ownership interest in the covered fund.⁸⁵ This limitation consists of two particular components: per fund limitations and aggregate limitations. First, a banking entity and its affiliates cannot invest more than 3% in a single covered fund.⁸⁶ For the single covered fund limitation, the investment calculation applies both to the total value of the fund and the total number of ownership interests the banking entity has in a covered fund.⁸⁷ Second, the Final Volcker Rule limits a banking entity's aggregate investment in covered funds at 3% of an entity's Tier 1 capital, which is generally common stock and reserves.⁸⁸

In order to determine whether the 3% ownership limitation has been met, the proper calculation is either:

1. the aggregate amount of total shares owned by the banking entity divided by the total amount of outstanding shares;⁸⁹ or
2. the aggregate fair market value of the banking entities investment in the covered fund divided by the fair market value of all other investments in the covered fund.⁹⁰

Once a selection has been made for calculating the 3% ownership limitation, the banking entity must continue to use the same calculation method.⁹¹

The 3% ownership limitation gave some bite to the Final Volcker Rule, with further restrictions preventing certain potential loopholes. For example, if a "feeder fund" is created to invest substantially all of its assets in a "master fund," then the 3% ownership calculation will be based on the banking entity's investment in the "master fund" and not the "feeder fund."⁹² Additionally, if the banking entity establishes a covered fund for the purpose of investing in other covered funds (a "fund of funds"), the banking entity's calculated interest will include the banking entity's investment in the original fund, as well as the banking entity's pro rata interest in the fund of funds.⁹³

If a banking entity believes that it will not be able to fall into compliance with the 3% ownership interest, a banking entity may request a delay in conformance with the Final Volcker Rule for up to two additional years.⁹⁴ When determining whether to grant an extension on compliance,

84. 17 C.F.R. § 75.12(a)(2)(ii)(A), (B) (2014).

85. Final Volcker Rule, 17 C.F.R. § 255 (2014).

86. Prohibitions and Restrictions, 79 Fed. Reg. 5535, 5725.

87. *Id.*

88. *Id.* at 5728.

89. 17 C.F.R. § 75.12(b)(2)(i) (2014).

90. 17 C.F.R. § 75.12(b)(2)(ii) (2014).

91. 17 C.F.R. § 75.12(b)(2)(iii) (2014).

92. 17 C.F.R. § 75.12(b)(4)(i) (2014).

93. 17 C.F.R. § 75.12(b)(4)(ii) (2014).

94. 17 C.F.R. § 75.12(e)(1) (2014).

the Federal Reserve Board will consider the following factors: (1) whether the investment will materially expose the banking entity to high-risk assets or high-risk trading strategies,⁹⁵ (2) the contractual terms governing the banking entity's interest in the covered fund,⁹⁶ (3) the date on which the covered fund is expected to reduce the banking entity's interest to fall within the Final Volcker Rule's threshold,⁹⁷ (4) potential exposure the banking entity will face upon divestment and the risks this will pose to the banking entity and the financial stability of the U.S.,⁹⁸ (5) the cost to the banking entity of divesting within the applicable timeframe,⁹⁹ (6) whether the divestment would result in a material conflict of interest between the banking entity and an unaffiliated party to which the banking entity owes a duty,¹⁰⁰ (7) the banking entity's prior efforts reduce its stake in the covered fund,¹⁰¹ (8) market conditions, and (9) "[a]ny other factor that the Board believes appropriate."¹⁰²

During any extension period, the Board has discretion to impose any conditions that it "determines are necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the U.S., address material conflicts of interest or other unsound banking practices, or otherwise further the purposes" of the Final Volcker Rule.¹⁰³

iii. *Hedging Compensation Arrangements*

The covered funds prohibition in the Final Volcker Rule also "does not apply with respect to an ownership in a covered fund acquired or retained a banking entity that is defined to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity . . . that directly provides investment advisory, commodity trading advisory or other services to the covered fund."¹⁰⁴ In order to rely on this exemption, the banking entity must demonstrate that: (1) it has an internal compliance program, including (A) reasonable written policies and procedures and (B) internal controls and ongoing oversight;¹⁰⁵ and (2) the ownership interest is (A) made in accordance with the internal controls, (B) directly related to hedging the compensation agreements with the employee offering services to the covered fund, (C) does not give

95. 17 C.F.R. § 75.12(e)(2)(i) (2014).

96. 17 C.F.R. § 75.12(e)(2)(ii) (2014).

97. 17 C.F.R. § 75.12(e)(2)(iii) (2014).

98. 17 C.F.R. § 75.12(e)(2)(iv) (2014).

99. 17 C.F.R. § 75.12(e)(2)(v) (2014).

100. 17 C.F.R. § 75.12(e)(2)(vi) (2014).

101. 17 C.F.R. § 75.12(e)(2)(vii) (2014).

102. 17 C.F.R. § 75.12(e)(2)(ix) (2014).

103. 17 C.F.R. § 75.12(e)(3) (2014).

104. 17 C.F.R. § 75.13(a)(1) (2014).

105. 17 C.F.R. § 75.13(a)(2) (2014).

rise to any significant new risk that is not hedged under this section, and (D) is subject to continuous review, monitoring and management by the banking entity.¹⁰⁶

iv. *Covered Funds Outside the United States*

Non-U.S. banking entities may also acquire ownership interests in, or sponsor, covered funds under the Final Volcker Rule if it occurs solely outside the U.S.¹⁰⁷ The banking entity may not be located in or organized in the U.S. or controlled by a banking entity located in or organized in the U.S.,¹⁰⁸ and the ownership interests in the fund must be sold pursuant to an offering that does not target U.S. persons (as defined in Regulation S under the Securities Act of 1933).¹⁰⁹ Such an offering must include disclaimers and adopt reasonable procedures to restrict access to non-U.S. persons.¹¹⁰ Further, the banking entity and the relevant personnel making sponsorship or investment decisions must not be located in the U.S., the sponsorship or investment must not be accounted for on a consolidated basis by any branch or affiliate of the foreign bank in the U.S., and no financing for the foreign bank's sponsorship of or investment in the fund can be provided by any branch or affiliate located in the U.S. or organized under U.S. law.¹¹¹

D. *Termination of Activities or Investments; Penalties for Violations*

Any banking entity that “engages in an activity or makes an investment in violation of” or “acts in a manner that functions as an evasion of the requirements of” the Final Volcker Rule, including “through an abuse of any activity or investment” permitted by, or “otherwise violates the restrictions and requirements” of the Final Volcker Rule, shall “upon discovery, promptly terminate the activity, and as relevant, dispose of the investment.”¹¹² If the FTC “finds reasonable cause to believe any banking entity has engaged in an activity or made an investment in violation . . . or that functions as an evasion” of the requirements of the Final Volcker Rule, it “may take any action permitted by law to enforce compliance . . . including directing the banking entity to restrict, limit or terminate any or all activities [covered by the Final Volcker Rule] and dispose of any investment.”¹¹³

106. *Id.*

107. 17 C.F.R. § 75.13(b) (2014).

108. 17 C.F.R. § 75.13(b)(1)(i) (2014).

109. 17 C.F.R. § 75.13(b)(1)(ii) (2014).

110. *Id.*

111. 17 C.F.R. § 75.13(b)(2)(B)(4) (2014).

112. 17 C.F.R. § 75.21(a) (2014).

113. 17 C.F.R. § 75.21(b) (2014).

IV. CONFORMANCE PERIOD

The Federal Reserve Board (the “Board”) has delayed full implementation of the Final Volcker Rule by extending its conformance period until July 21, 2015.¹¹⁴ In doing so, the Board has issued a statement of policy in which it clarifies the activities and investments that are permissible for banking entities during the conformance period.¹¹⁵ Unless an exception applies, banking entities are required to ensure that their investments comply with Final Volcker Rule guidelines no later than July 21, 2015.¹¹⁶

As explained in the Board’s Conformance Order, banking entities have until the end of the conformance period to ensure that all of its proprietary trading activities and covered fund activities and investments are in conformance with the Final Volcker Rule.¹¹⁷ During the conformance period, “a banking entity is expected to engage in good-faith efforts and appropriate activities and investments that will result in the conformance of its activities and investments.”¹¹⁸ Banking entities should not further expand covered activities or make investments during the conformance period in expectation of a further extension of the conformance period providing additional time for conformance.¹¹⁹

In determining what constitutes good-faith efforts, the Board has noted that the banking entity must evaluate the extent to which its activities are covered by the Final Volcker Rule and must work towards developing and implementing policies that demonstrate how the banking entity intends to become compliant with the Final Volcker Rule.¹²⁰ In addition, under the Conformance Order, the conformance period does not extend to any stand-alone proprietary trading operations, and banking entities are expected to “promptly” terminate or divest such operations.¹²¹

The Federal Reserve Board is permitted to further extend the two-year conformance period by up to three one-year periods.¹²² In addition to these three one-year periods, the Final Volcker Rule further allows a banking entity to apply for an extension of up to five years for investments

114. See Order Approving Extension of Conformance Period (Dec. 10, 2013) (on file with author), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf> [hereinafter Board Conformance Order].

115. Statement of Policy Regarding the Conformance Period for Entities Engaged in Proprietary Trading or Private Equity Fund and Hedge Fund Activities, 77 Fed. Reg. 33,949 (June 8, 2012), available at <https://www.sec.gov/news/press/2012/2012-70-policystatement.pdf>.

116. Joint Press Release, Bd. Governors Fed. Reserve Sys., *Agencies Issue Final Rules Implementing the Volcker Rule* (Dec. 10, 2013), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm>.

117. Board Conformance Order, *supra* note 114.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. 12 U.S.C. § 1851(c)(2).

in certain illiquid funds.¹²³ It is therefore possible that a banking entity could receive extensions allowing for the maintenance of an investment in an illiquid fund for up to eight more years, or until as late as July 2022.¹²⁴

Illiquid funds include, for example, investments in startups or closely held private companies not traded on a public securities exchange.¹²⁵ In order to qualify for the illiquid fund exception, banking entities must demonstrate that their retention of interest in an investment is a contractual requirement entered into prior to May 1, 2010.¹²⁶ Additionally, banking entities are required to use their best efforts to liquidate these investments notwithstanding. If an investment contract contains a regulatory-out clause allowing for the sale or redemption of interest, the illiquid fund exception will not apply.¹²⁷ This regulatory-out carveout to the illiquid fund exception may prove to be critical for banking entities. Many fund managers would likely consent to banking entities liquidating their shares in these funds, precluding application of the illiquid fund exception and leaving banking entities in a precarious position.¹²⁸ By being forced to sell their investments at an earlier time, banking entities may find themselves locked into liquidating their investments at firesale prices¹²⁹ and forced to take substantial losses.

V. POTENTIAL IMPACTS & CRITICISMS

As currently drafted, the implementation of the Final Volcker Rule may pose serious consequences for the banking industry. One example of an affected banking entity is Goldman Sachs. In the second quarter of 2014, Goldman Sachs beat Wall Street's estimates by \$500 million.¹³⁰ This performance comes with a caveat—about \$1.2 billion of the firm's revenues that quarter came from investment in private and public companies, with a majority of this revenue coming from investments in private equity funds.¹³¹ As such, Goldman Sachs and firms like it may have to forego a substantial portion of their revenues as the Final Volcker Rule becomes

123. 76 Fed. Reg. 8265, 8275 (Feb. 14, 2011) (to be codified at 12 C.F.R. 225).

124. See Jay G. Baris & Henry M. Fields, *The Volcker Rule: Prohibition on Sponsorship and Investment in Covered Funds*, MORRISON FOERSTER (2014), <http://media.mofo.com/files/Uploads/Images/140206-Volcker-Rule-Prohibition-Sponsorship-and-Investment.pdf>.

125. Andrew Ackerman & Ryan Tracy, *Banks Push to Delay Rule on Investments*, WALL ST. J. (Aug. 12, 2014, 6:17 PM), <http://online.wsj.com/articles/banks-push-to-delay-rule-on-investments-1407881847?mg=id-wsj&cb=logged0.36956217349506915>.

126. Baris & Fields, *supra* note 124.

127. *Id.*

128. Ackerman & Tracy, *supra* note 125.

129. *Id.*

130. Stephen Gandel, *Goldman's Private Equity Problem is Getting Bigger*, FORTUNE (July 31, 2014, 5:00 AM), <http://fortune.com/2014/07/31/goldman-sachs-private-equity/>.

131. *Id.*

effective. While Goldman Sachs marks its investments to market¹³² and may not have to lock in additional losses in having to sell them, Goldman Sachs' private equity investment business is one of its most profitable.¹³³ If forced to divest, Goldman Sachs may need to find a new way to earn revenues, especially with its trading earnings continuing to slump.¹³⁴

Other banking entities have already begun to liquidate their shares in covered funds in anticipation of the Final Volcker Rule's implementation. For instance, even prior to the Final Volcker Rule's completion in December 2013, JPMorgan Chase initiated plans to spin off its private equity arm, One Equity Partners.¹³⁵ While there is some question as to whether this preparation was solely in anticipation of having to comply with the Final Volcker Rule, JPMorgan Chase's sale of its private equity arm indicated a change in banking philosophy following the Final Volcker Rule's passage.¹³⁶ Other examples of this shift in banking philosophy include Citigroup, which had sold \$8.5 billion of its private equity fund investments as of January 2014,¹³⁷ and Bank of America Merrill Lynch, which spun off a \$5 billion private equity arm in 2011.¹³⁸

With banking entities already actively preparing for the Final Volcker Rule's implementation, one question is the consequences that will arise if conformance is not further delayed. Indeed, as this Comment previously states, fund managers may be willing to allow banking entities to sell their shares in covered funds, which would prevent banking entities from falling under the illiquid fund exception.¹³⁹ This may be problematic for the banking industry. Given that private equity tends to be a longer-term investment,¹⁴⁰ simply divesting an investment before its planned exit is not optimal. By selling their stakes in advance of their intended maturity,

132. Under mark to market accounting, assets and liabilities are recorded at their market value. Thus, the firm takes gains and losses each quarter as opposed to when it sells. This means assets and liabilities will fluctuate with the market. For more information, see *Fair Value and Mark to Market Accounting*, AM. BANKERS ASS'N, http://www.aba.com/Issues/Index/Pages/Issues_FairValue.aspx (last visited Oct. 18, 2014).

133. Gandel, *supra* note 130.

134. *Id.*

135. Scott Gamm, *JPMorgan to Spin Off Private Equity Business as Volcker Rule Comes to Life*, FORBES (June 14, 2013, 1:28 PM), <http://www.forbes.com/sites/scottgamm/2013/06/14/jpmorgan-to-spin-off-private-equity-business-as-volcker-rule-comes-to-life/>.

136. *Id.*

137. Shayndi Raice, *Citi Considers Selling Private-Equity Stake to Comply with Volcker Rule*, WALL ST. J. BLOG (Jan. 7, 2014, 7:29 PM), <http://blogs.wsj.com/moneybeat/2014/01/07/citi-considers-selling-private-equity-stake-to-comply-with-volcker-rule/>.

138. Chris Nicholson, *Bank of America to Spin Off Buyout Arm*, N.Y. TIMES (April 20, 2011), <http://dealbook.nytimes.com/2011/04/20/bank-of-america-to-spin-off-buyout-arm/>.

139. Ackerman & Tracy, *supra* note 125.

140. Martin Stein, Tony Kiehn & Jennifer Danzi, *How Private Equity Really Works (Part I of 2)*, IMAGING SPECTRUM MAG., Aug. 2007, at 32, available at http://www.blackfordcapital.com/articles/How_Private_Equity_Really_Works_p1.pdf (noting that private equity investment in portfolio companies lasts on average between 3-7 years).

banking entities may lock in substantial losses on their investments or see a very minimal return.

Outside of its impact on banking entities, the Final Volcker Rule also directly affects private equity funds. Because the banking entities implicated by the Final Volcker Rule are large investors in private equity funds, the private equity market risks losing a substantial amount of investors. As noted previously, banking entities such as JP Morgan are already in the process of spinning off their private equity investments.¹⁴¹ One option for private equity funds may be to seek out smaller, non-accredited investors as replacements.¹⁴² The NASDAQ OMX Group recently considered an initiative to bring lower income, non-institutional investors into the private equity space.¹⁴³ Other groups, such as the Carlyle Group and Kohlberg Kravis Roberts, have also considered similar plans.¹⁴⁴

Of course, this strategy does not come without its drawbacks. Private equity funds have consistently sought to minimize the applicability of SEC regulations through a variety of exemptions, including Rule 506 of Regulation D.¹⁴⁵ While appealing to non-institutional, non-accredited investors has the potential to violate the Securities Act as well as the Investment Company Act of 1940,¹⁴⁶ Rule 506 of Regulation D is considered a “safe harbor” under the private offering exemption of Section 4(a)(2) of the Securities Act, allowing private equity funds to raise an unlimited amount of funds without having to make a costly, full-fledged, and public registration with the SEC, subject to certain qualifications.¹⁴⁷

Under Rule 506(c) of Regulation D, a private equity fund may undertake the general solicitation of a private offering if all the investors in the offering are accredited investors and the private equity fund has taken reasonable steps to verify that the inventors are accredited investors.¹⁴⁸ Accredited investors are investors who meet certain criteria, including any

141. Gamm, *supra* note 135.

142. Regulation D defines a natural person as an accredited investor if that person’s “net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000” or if that person “had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.” 17 C.F.R. § 230.501 (2013).

143. William Alden, *Private Equity Takes Steps Toward Wooing Smaller Investors*, N.Y. TIMES (Apr. 25, 2014), <http://dealbook.nytimes.com/2014/04/25/private-equity-takes-steps-toward-wooing-smaller-investors/>.

144. *Id.*

145. *See* 17 C.F.R. § 230.506 (2013).

146. Registration under the Investment Company Act of 1940 is exempted if the purchasers are “qualified.” “Qualified purchasers” are those holding in excess of \$5 million in investments, well above the threshold for an accredited investor. *See* 50 U.S.C. § 80a-2(a)(51).

147. Securities Act of 1933 § 4(a)(2); *see also* *Rule 506 of Regulation D*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/answers/rule506.htm> (last visited Dec. 13, 2014).

148. 17 C.F.R. § 230.506(c) (2013).

natural person whose individual net worth (or joint net worth with that person's spouse) exceeds \$1,000,000 or who had an individual income in excess of \$200,000 (or joint income with that person's spouse in excess of \$300,000) in each of the two most recent years and who has a reasonable expectation of reaching the same income level in the current year.¹⁴⁹

Under Rule 506(b) of Regulation D, if there is no general solicitation, a private equity fund may sell to an unlimited number of accredited investors and up to 35 non-accredited investors whom it considers to be sophisticated, with sufficient "knowledge and experience in financial and business matters [to be] capable of evaluating the merits and risks of the prospective investment."¹⁵⁰ A private equity fund relying on Rule 506(b) must generally provide non-accredited investors with disclosure similar to that used in registered offerings and with any information it provides to accredited investors.¹⁵¹ Many issuers may "avoid the difficulty of determining who is sophisticated" by restricting their offering to accredited investors.¹⁵² Further, an offering to non-accredited investors under Regulation D may implicate the "qualified purchasers" exemption under the Investment Company Act of 1940¹⁵³ upon which private equity funds may rely.

Outside of these regulatory implications, commentators have questioned the investment strategy of opening doors to smaller investors. For example, Josh Lerner, a professor at Harvard Business School has noted that investments involving smaller investors may produce lower returns.¹⁵⁴ Nevertheless, with the restrictions imposed on banking entities under the Final Volcker Rule, private equity funds may have to open their doors to investment by these demographics.

Beyond potential losses by banking entities or private equity funds, other aspects of the Final Volcker Rule have invited criticism. As previously noted, critics of the Final Volcker Rule question its very necessity, with some claiming that the Final Volcker Rule does not really alleviate what they consider to be the main cause of the financial crisis: the overextension of credit and poor federal housing policy.¹⁵⁵ Additionally, critics have argued that the Final Volcker Rule holds too strong on the definition

149. 17 C.F.R. § 230.215 (2012).

150. 17 C.F.R. § 230.506(b) (2013).

151. *Rule 506 of Regulation D*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/rule506.htm> (last visited Dec. 13, 2014).

152. John Washburn & David Brown, *Reg. D – More Popular than Ever?*, GOULD & RATNER (2006), <http://www.gouldratner.com/Assets/News/JAW-Reg%20D.pdf>.

153. Registration under the Investment Company Act of 1940 is exempted if purchasers are "qualified." "Qualified purchasers" are those holding in excess of \$5 million in investments, well above the threshold for an accredited investor. *See* 50 U.S.C. § 80a-2(a)(51).

154. Alden, *supra* note 143.

155. David M. Gallagher, *Public Statement: Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule*, U.S. SEC. & EXCH. COMM'N (Dec. 10, 2013), http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370540477693#.VH4L5GTF_9s.

of covered funds by providing for a rebuttable presumption that a fund is covered until it is proven otherwise, and these critics argue that the burden should instead be on regulators to show that a fund should be covered.¹⁵⁶

As the banking industry prepares for a world post-Final Volcker Rule implementation, these changes may very well attract further attention as members of the banking industry develop new ways to challenge or sidestep the Volcker Rule. Legal challenges are possible, but may not be likely to succeed.¹⁵⁷ Practical challenges to the Final Volcker Rule may take the form of finding loopholes to the restrictions covered in the Final Volcker Rule.¹⁵⁸ How these issues play out will be determined as the Final Volcker Rule is further implemented.

VI. CONCLUSION

After years of debate, the Final Volcker Rule was enacted in December 2013. Among the many regulations included in the Final Volcker Rule is a limitation on banking entities' investments in covered funds. As the Final Volcker Rule is implemented, the heavy investment of banking entities in private equity funds may lead to profound consequences affecting both the banking industry and private equity industry. The current draft of the Final Volcker Rule may force many banking entities to liquidate their investments in private equity funds prematurely. If these investments are considered liquid for the purposes of the Final Volcker Rule (and not subject to its illiquid fund exception), banking entities may face substantial losses as they make efforts to become Final Volcker Rule compliant.

156. *Id.* While Commissioner Gallagher's December 2013 comments take issue with the text of the Final Volcker Rule, it also indicates that the Final Volcker Rule text limits the definition of covered funds as compared with the proposed rule's text.

157. Simon Johnson, *Making the Volcker Rule Work*, N.Y. TIMES (Dec. 10, 2013, 5:22 PM), http://economix.blogs.nytimes.com/2013/12/10/making-the-volcker-rule-work/?_php=true&_type=blogs&_r=0.

158. *See generally id.*

