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MEMORANDUM

The Volcker Rule and Private Funds: Final Regulations Are Out

December 16, 2013

On December 10, the five federal agencies responsible for writing regulations implementing the Volcker Rule (the "Agencies") approved final rules (the "Final Rules") that restrict banking entities from engaging in proprietary trading and from investing in or sponsoring private equity funds and hedge funds. The Final Rules differ in significant respects from the rules initially proposed in October 2011 (the "Proposed Rules").[1]

The text of the Final Rules, together with explanatory background from the Agencies, is nearly 1,000 pages, which is reflective of the complexity inherent in implementing the Volcker Rule and addressing the largest number of public comments received on any Dodd-Frank proposal to date. Despite their length, the Final Rules leave a number of questions unanswered and the Agencies may need to issue formal or informal interpretations or clarifications as banking entities face the deadline to comply.

This memorandum focuses on the portion of the Final Rules relating to banking entities' activities with private funds. Key provisions and changes from the Proposed Rules include:

- *More Time to Comply*—Banking entities will generally have until July 21, 2015 to comply with the Volcker Rule, a delay of one year. The Federal Reserve has authority to grant only two more one-year extensions.
- *Scope of Banking Entities Covered*—The Final Rules largely track the statute and the Proposed Rules on what constitutes a "banking entity," with only a few carve-outs for entities the inclusion of which would have clearly created unintended consequences.
- *Scope of Funds Covered*—The definition of a "covered fund" is more circumscribed under the Final Rules. In contrast to the Proposed Rules, the Final Rules explicitly exclude a number of entities from coverage, such as foreign public funds, joint ventures, insurance companies' separate accounts, business development companies and loan securitization vehicles. However, the Agencies were unpersuaded by industry comments that employee security companies (or ESCs) not subject to an SEC order, venture capital funds, pass-through entities holding shares of REITs and credit funds (which are generally formed as partnerships with third-party capital that invest in loans or make loans or otherwise extend the type of credit that banks are authorized to undertake on their own balance sheet) should also be excluded.

[1] 76 Fed. Reg. 68846 (Nov. 7, 2011).

- *Foreign Banks and Offshore Parallel Funds*—The Final Rules appear to provide more flexibility with respect to the use of offshore parallel funds. Among other things, the Final Rules more consistently make clear that they cover foreign bank investments in as well as sponsorship of funds, clarify that only the entity (and its personnel) of a foreign banking entity that makes the decision to invest in a fund must be located outside the United States, and require only that ownership interests in a covered fund not be sold in an offering "targeted" to U.S. residents. Secondary trading in offshore markets would be permitted.
- *Sponsored Funds Exemption*—The Final Rules continue to provide banking entities with leeway to sponsor private funds (as long as they are primarily a way to provide investment management and certain other services to others) and to invest in such sponsored funds, subject to a 3% per-fund limit (based on a single fund's total outstanding ownership interests) and a 3% aggregate limit (based on the banking entity's Tier 1 capital).
- *CEO Attestation*—Unlike the Proposed Rules, the Final Rules specifically require a banking entity's CEO to make a written attestation, on an annual basis, that the banking entity has processes to review and enforce its Volcker-related compliance program.

A. A NEW DEADLINE FOR COMPLIANCE

By statute, banking entities must conform their activities and investments to the Volcker Rule by July 21, 2014,[2] a deadline the Federal Reserve affirmed in a policy statement it issued in April 2012.[3] However, in recognition of the substantial delay in issuing the Final Rules, the Federal Reserve has ordered a blanket, industry-wide one-year extension to the statutory deadline. Accordingly, banking entities now have until July 21, 2015 to conform their activities and investments to the Volcker Rule. The extension, however, does not apply to the various data reporting and recordkeeping requirements applicable to certain banking entities with "significant trading activities."

The Federal Reserve, which has sole authority to grant extensions,[4] cautioned that banking entities "should not expand activities and make investments" during the extended conformance period "with an expectation that additional time to conform those activities or investments will be granted."

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2 12 U.S.C. § 1851(c)(2).

3 77 Fed. Reg. 33949 (June 8, 2012).

4 The Final Rules did not amend the rules regarding the extension process that were issued in 2011. *See* 76 Fed. Reg. 8265 (Feb. 14, 2011)(12 C.F.R. § 225.181). The Federal Reserve is authorized to grant up to three one-year extensions and a single five-year extension for funds that qualify as illiquid funds. Because the number of one-year extensions cannot exceed an aggregate of three years, the extension granted in conjunction with the release of the Final Rules counts toward the statutorily imposed limit.

B. THE PROHIBITION ON INVESTING IN AND SPONSORING PRIVATE FUNDS

The Volcker Rule, as enacted in Dodd-Frank, was intended to generally prohibit a banking entity from sponsoring or investing in private equity funds and hedge funds.[5] The Final Rules implement this prohibition by generally prohibiting a "banking entity," "as principal," from directly or indirectly acquiring or retaining an equity, partnership or other "ownership interest" in, or acting as "sponsor" to, a "covered fund."

1. *"Banking Entity"*

Consistent with the statute and the Proposed Rules, the Final Rules define a "banking entity" as including: (i) any insured depository institution; (ii) any company that controls an insured depository institution (*i.e.*, bank holding companies and thrift holding companies, but also any company that directly or indirectly controls a "nonbank bank," such as a credit card bank or industrial loan company); (iii) any foreign bank or other company that is treated as a banking holding company under the International Banking Act of 1978 (*i.e.*, foreign banks that have a U.S. branch, agency or commercial lending subsidiary); and (iv) any affiliate or subsidiary of any of the foregoing entities.

The Final Rules expressly provide that the following entities *do not* constitute banking entities:

- *Permitted Covered Funds*—any covered fund that is not itself a banking entity (*i.e.*, insured depository institution, insured depository institution holding company or foreign bank subject to the Bank Holding Company Act of 1956 (the "BHC Act")), which would include fund entities, such as a "fund-of-funds," that a banking entity controls and invests through to make permitted investments pursuant to a specified exemption; and
- *Merchant Banking and Insurance Related Portfolio Companies*—any portfolio company of a banking entity that is held pursuant to the merchant banking authority of Section 4(k)(4)(H) of the BHC Act or the insurance company investment authority of Section 4(k)(4)(I) of the BHC Act.

2. *"Covered Fund"*

As a general matter, a "covered fund" includes any issuer that would be an investment company *but for* the exemptions provided by Section 3(c)(1) (funds with 100 or fewer holders) or Section 3(c)(7) (funds sold only to "qualified purchasers") of the Investment Company Act of 1940 (the "ICA"). It also includes any (i) "commodity pool" under the Commodity Exchange Act that shares characteristics of an entity excluded from the ICA under Sections 3(c)(1) or 3(c)(7); and (ii) certain foreign funds which a U.S. banking entity has sponsored or invested in and which, if they were subject to U.S. securities laws, could not rely on any exemption or exclusion from the ICA other than Sections 3(c)(1) or 3(c)(7).

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5 12 U.S.C. § 1851(a)(1).

The Final Rules expressly exclude from the definition of a covered fund various types of entities, including the following:

- *Foreign Public Funds*—that are organized or established outside the United States, authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction, and sell ownership interests predominantly through public offerings outside the United States (such as retail Undertakings for Collective Investments in Transferable Securities, or UCITS).
- *Joint Ventures*—between a banking entity or any of its affiliates and one or more unaffiliated persons, provided that the joint venture is comprised of no more than 10 unaffiliated co-venturers, engages only in activities that are permissible for the banking entity or affiliate (other than investing in securities for resale or other disposition) and does not hold itself out as being an "entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities" (the Proposed Rules, which did not contain such conditions, instead required that the joint venture be an operating company and not engaged in any activity or investments prohibited by the Volcker Rule). [6]
- *Acquisition vehicles*—formed solely for the purpose of engaging in a bona fide merger or acquisition and that exist only for such period as necessary to effectuate that transaction (or if it exists thereafter, if it falls under another exemption).
- *Foreign pension or retirement funds*—that are organized and administered outside the United States, established for the benefit of non-U.S. citizens or residents and constitute broad-based plans subject to applicable local regulation. [7]
- *Insurance company separate accounts*—that are only used by the insurance company and do not involve any other banking entity participating in the account's profits or losses.
- *Bank owned life insurance (BOLI) separate accounts*—that are used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which the banking entity is a beneficiary, provided that no banking entity that purchases the policy has control over investment decisions or participates in the accounts' profits or losses.

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6 Although joint ventures that meet such criteria will not be treated as a covered fund, based on the preamble, the Federal Reserve would not permit a banking entity that is a financial holding company to use a joint venture (at least one defined under the Final Rules) to engage in activities under the merchant banking authority. By definition, the merchant banking authority is premised on a financial holding company acquiring ownership interests in a portfolio company and selling its investment after a period of time to realize a profit, rather than as a means for the financial holding company to engage in the nonfinancial activities in which the portfolio company is engaged.

7 By definition, U.S. pension and retirement funds that are ERISA-qualified funds that rely on Section 3(c)(11) of the ICA are not covered funds because they do not rely on Sections 3(c)(1) or 3(c)(7).

- Wholly-owned subsidiaries—of a banking entity or its affiliate, except that up to 5% of any subsidiary's outstanding ownership interests may be held by employees or directors and up to 0.5% may be held by a third party if the ownership interest is acquired or retained by the third party for the purpose of establishing corporate separateness or addressing other bankruptcy, insolvency or similar concerns (note that, unlike under the Proposed Rules, there is no requirement that the subsidiary be principally engaged in performing *bona fide* liquidity management activities or be carried on the balance sheet of the banking entity).
- Loan securitization vehicles—certain issuers of securitized loans (including residential, commercial, auto and credit card loans) that meet specified criteria. Generally, issuers of other securitized obligations, including collateralized loan obligations (CLOs), insurance-linked securities and corporate debt re-packagings, will not qualify for this exemption. Because of the broad definition of "ownership interest" (discussed below), interests in some asset securitization vehicles held by banks for investment purposes may in fact be prohibited by the Volcker Rule.
- Registered investment companies and excluded entities under the ICA—issuers that are registered investment companies under the ICA, such as many mutual funds, and issuers that are exempt from the definition of an "investment company" under the ICA *other than* pursuant to Sections 3(c)(1) and 3(c)(7). These exempt entities would include, for example, REITs (which are exempt pursuant to Section 3(c)(5)(C) of the ICA).
- Business development companies (BDCs), small business investment companies (SBICs) and public welfare investments—that qualify under applicable provisions of federal law.

The Final Rules also exclude certain other entities, such as qualifying asset-backed commercial paper conduits and other issuers of securities that the Agencies jointly determine to exclude. The Agencies are working to establish a process within which to evaluate requests for additional exclusions from the "covered fund" definition, and expect to provide additional guidance on this matter as the Agencies gain experience with the Final Rules.

3. "As Principal"

The general prohibition on a banking entity investing in covered funds applies only when the banking entity is investing "as principal," either directly or indirectly. While this term is undefined, the Final Rules explicitly clarify that the prohibition on investing or retaining an ownership interest in a covered fund does *not* apply to investments made or held by a banking entity (i) acting solely as agent, broker or custodian (so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest); (ii) on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund (same as previous parenthetical); (iii) through a deferred compensation, stock-bonus, profit-sharing or pension plan where the banking entity is acting as trustee for the benefit of participants of such plans; or (iv) in the ordinary course of collecting a debt previously contracted (DPC) in good faith, provided that the banking entity divests the ownership interest as soon as practicable. However, the Agencies cautioned that they intend to monitor these activities and investments for efforts to evade the Volcker Rule's restrictions on banking entities' investments in and relationships with covered funds.

4. "Ownership Interest"

An "ownership interest" in a covered fund is defined broadly to include any equity, partnership or "other similar interest" in a covered fund. The "other similar interest" concept includes the following types of interests in covered funds:

- *Participation in Management Selection*—interests that carry a right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment advisor, or commodity trading advisor of the covered fund, excluding interests of creditors that carry such rights upon the occurrence of an event of default or an acceleration event;
- *Profit Sharing*—interests that carry a right to receive a share of the income, gains or profits of the covered fund;
- *Excess Spread Sharing*—interests that have the right to receive all or a portion of the positive difference, if any, between the aggregate interest payments received from the covered fund's underlying assets and the aggregate interest paid to the holders of other outstanding interests in the covered fund;
- *Loss Sharing*—interests whose terms provide that the amounts payable by the covered fund to such interest could be reduced based on losses arising from the underlying assets of the covered fund;
- *Residual Claimant*—interests that have the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full, excluding interests of creditors that carry such rights upon the occurrence of an event of default or an acceleration event;
- *Pass-Through or Structured Products*—interests that receive income on a pass-through basis from the covered fund, or have a rate of return that is determined by reference to the performance of the covered fund's underlying assets; and
- *Synthetic Interests*—interests that carry any synthetic rights to receive any of the rights listed above.

The Final Rules generally provide that profits or carried interests[8] do not constitute "ownership interests" (and therefore are not subject to, among other restrictions, the 3% limits described below). These exempted interests are defined as interests held by a banking entity (or by an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment advisor, or other service provider, provided that:

8 Carried interests are referred to as "restricted profit" interests in the Final Rules.

- the sole purpose of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as compensation for investment management, investment advisory, commodity trading advisory or other services[9] provided to the fund;
- such profits are distributed to the entity (or employee or former employee of the entity) promptly after being earned or otherwise are retained by the covered fund for the sole purpose of covering subsequent losses pursuant to contractual obligations, and such profits do not share in the subsequent investment gains of the covered fund;
- any amounts invested in the covered fund, including amounts paid in connection with acquiring the interest, are within the Volcker Rule's 3% limits addressed in Section C.2 below; and
- the interest is not generally transferrable by the entity (or employee or former employee thereof).

5. *"Sponsor"*

The definition of sponsorship under the Final Rules is substantially the same as the definition used in the Proposed Rules and the statute. An entity will be the "sponsor" of a covered fund if it: (i) serves as a general partner, managing member, or trustee (unless such trustee does not exercise investment discretion) of a covered fund, or serves as a commodity pool operator with respect to a covered fund; (ii) in any manner, selects or controls (or has employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a covered fund; or (iii) shares with a covered fund the same name or a variation of the same name for corporate, marketing, promotional or other purposes.

C. THE EXEMPTIONS

Following is a summary of the main exemptions from the Volcker Rule's general prohibition on banking entities sponsoring or investing in covered funds.

1. *The Foreign Fund Exemption*

The Volcker Rule contains a so-called "foreign fund" exemption to allow foreign banking organizations ("FBOs"), including certain sovereign wealth funds, to acquire or retain an ownership interest in, or act as sponsor to, a covered fund provided certain requirements are met. As a threshold matter, this exemption is only available to foreign banking entities that are not directly or indirectly controlled by a banking entity that is organized under U.S. law and

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[9] The Final Rules do not specify what "other services" would make a service provider eligible to receive a restricted profit interest, but seem to adopt a broad understanding of the "other services" concept. For example, the Final Rules note that a service provider serving in a capacity as sub-adviser or placement agent would be eligible receive or hold a restricted profit interest.

that meet certain tests of "foreignness," which the Final Rules adopted with only minor, technical changes from the Proposed Rules.[10]

For foreign banking entities that seek to invest in or sponsor a covered fund, the two requirements that must be satisfied for this exemption to apply relate to (i) whether the investment or sponsorship activity occurs "solely outside of the United States" and (ii) whether ownership interests in the covered fund are offered and sold only to non-U.S. residents.

The Final Rules significantly refine the conditions that the Proposed Rules had contained for a foreign banking entity to invest in or sponsor a fund offshore. A covered fund investment or sponsorship will be considered to occur solely outside of the United States if:

- the banking entity making an investment as principal in or sponsoring the covered fund is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or organized under U.S. law;
- the banking entity and its "relevant personnel" that make the decision to acquire or retain the ownership interest in or act as sponsor to the covered fund are not located in the United States;
- the investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any U.S. branch or U.S. affiliate of the banking entity; and
- no financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any U.S. branch or U.S. affiliate of the banking entity.

As for determining whether interests are offered and sold to U.S. residents, the Final Rules go beyond the Proposed Rules, which had merely repeated the statutory language on this particular requirement. Under the Final Rules, this requirement will be considered met if interests in the fund are sold pursuant to an offering that does not "target" residents of the United States. For this purpose, a U.S. resident means a "U.S. person" as defined in the SEC's Regulation S.

There are a number of other key observations on how the Agencies have implemented this exemption. First, the Final Rules do not make the exemption dependent on the location of the assets in which the covered fund invests or on where the investment manager for those assets is

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10 For FBOs, the relevant test is whether they meet the so-called "qualifying foreign banking organization" ("QFBO") requirements of the Federal Reserve's Regulation K, which requires that more than half of their worldwide business is banking and more than half of their banking business is outside the United States. For foreign companies that are not FBOs (because they control a thrift or "nonbank bank," such as an industrial loan company, and therefore are not bank holding companies for BHC Act purposes, but are "banking entities" under the Volcker Rule), a modified QFBO test applies. This modified test is generally satisfied if a majority of the foreign company's business (whether banking or nonbanking) is outside the United States.

located. And technically, the Final Rules do not explicitly require that the fund which the foreign banking entity sponsors or invests in pursuant to this exemption be organized in a non-U.S. jurisdiction.

Second, the Final Rules do not include the Proposed Rules' requirement that no subsidiary, affiliate or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund be incorporated or physically located in the United States. Instead, the issue is whether the foreign banking entity's "relevant personnel"—the personnel that *make* investment decisions with respect to a covered fund investment—are offshore. The exemption does not restrict U.S. personnel of the foreign banking entity from providing investment advice or making investment recommendations to the fund. Also, there are no restrictions on "back office" personnel who provide various administrative services or similar functions, such as recordkeeping, clerical support, clearing/settlement or the furnishing of statistical and research data, all of which may be conducted in the United States.

Third, the Agencies have provided some relief to foreign banking entities that had concerns regarding whether the exemption could continue to be relied upon in cases where another non-U.S. investor in the fund subsequently sold or transferred its interest to an unaffiliated U.S. investor, such as in a secondary market transaction. In the preamble to the Final Rules, the Agencies note that, "[a]bsent circumstances otherwise indicating a nexus with residents of the United States," an offering of a foreign fund's interests targeted to non-U.S. residents would not be viewed as targeting U.S. residents if (i) the relevant offering materials contain prominent disclaimers that the interests are not being offered or sold to U.S. residents and (ii) there are other reasonable procedures in place to restrict access to offering and subscription materials to persons that are not U.S. residents. If ownership interests that are issued in foreign offerings are listed on a foreign exchange, secondary market transactions in fund interests will not cause the fund to lose its "foreign fund" exemption.

Finally, the Agencies indicated that certain "complex fund structures," such as multi-tiered fund structures, will be integrated when determining whether the ownership interest in a covered fund is offered or sold to a U.S. resident. According to the Agencies, "a banking entity may not be able to rely on the foreign fund exemption to sponsor or invest in an initial covered fund (that is offered for sale only overseas and not to residents of the United States) that is itself organized or operated for the purpose of investing in another covered fund (that is sold or pursuant to an offering that targets U.S. residents) *and* that is either organized and offered or is advised by that banking entity" (emphasis added). Significantly, the Agencies did not indicate that attribution would apply to a structure in which the fund that targets U.S. investors is neither organized/offered nor advised by the foreign banking entity, or to offshore parallel funds that invest in tandem with U.S. funds.

2. *Exemption for Sponsoring Covered Funds and for Certain Underwriting and Market Making Activities*

a. Sponsoring Covered Funds

The so-called "sponsored funds" exemption permits banking entities to organize and offer or sponsor a covered fund and to acquire and retain an ownership interest in such a fund, subject to significant limitations. The exemption does, however, generally allow banking entities to continue to sponsor "feeder" funds with private equity and hedge funds sponsored and managed by others.

The following requirements must be satisfied for this exemption to apply:

- 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 or any of its affiliates, pursuant to a written plan by the banking entity outlining how the banking entity intends to provide such services to its customers (as such, no pre-existing customer relationship is required);
- the investment by the banking entity and its affiliates in the covered fund does not exceed 3% of the total amount or value of the outstanding ownership interests of such fund at any time after one year from the date of the fund's establishment (the "per-fund limit") and the aggregate investment of the banking entity and its affiliates in all covered funds does not exceed 3% of its Tier 1 capital, as calculated on a quarterly basis (the "aggregate limit"); however:
    - the Federal Reserve may grant up to a two-year extension to the one-year "seeding" exemption from the 3% per-fund limit; and
    - the per-fund limit is increased to 5% for funds subject to the risk-retention requirements in Section 15G of the Securities Exchange Act;
- the banking entity and the covered fund do not share the same name (or any variant) for corporate, marketing, promotional or other purposes;
- the covered fund does not use the word "bank" in its name;
- the banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund (or any other covered fund in which the first covered fund invests);
- the banking entity ensures that the relevant offering documents contain specified written disclosures regarding, among other things, that any losses will not be borne by the banking entity or any of its affiliates and on the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the fund;
- no director or employee of the banking entity or any affiliate thereof takes or retains an ownership interest in the covered fund, excluding directors and employees who are directly engaged in providing investment advisory, commodity trading

advisory, or other services[11] (the "Covered Services") to the fund at the time the director or employee takes the ownership interest (subject to attribution to the banking entity if it or any affiliate extends credit or a guarantee against loss to the director or employee); and

- the banking entity (including its affiliates) and the covered fund may not engage in any "covered transactions" (as defined by reference to Section 23A of the Federal Reserve Act) with each other, and all transactions that do not constitute covered transactions must satisfy the qualitative "market" terms requirements of Section 23B of the Federal Reserve Act.

In addition, a banking entity relying on this exemption will need to deduct from its Tier 1 capital, on a dollar-for-dollar basis, the greater of (i) the fair market value of its ownership interests (including any amounts paid for restricted profit interests) in covered funds under this exemption; and (ii) the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining such interests, on a historical cost basis, plus any earnings received.

These requirements generally track what the Agencies had initially proposed, but below are some observations:

- The calculation of the 3% per-fund limit is based on investments made and the outstanding ownership interests held, without regard to committed funds not yet called for investment. In determining the aggregate value of outstanding ownership interests held by a banking entity, the Agencies will look to the aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity, divided by the fair market value of all investments in and capital contributions made to that fund.[12]

- The Final Rules do not automatically count toward the 3% per-fund limit any investment by a banking entity in the same target company as a fund it sponsors (unlike the Proposed Rules, which required such aggregation if, among other things, the banking entity was found to be "acting in concert" with the sponsored fund). Under the Final Rules, however, aggregation may still be required if the banking entity co-invests to supplement the capital of the fund (for example, when the investment opportunity exceeds the investment capacity of the fund and the banking entity is invited to co-invest to fill the deficit) or where there is a pattern of the banking entity regularly co-investing with the fund.

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11 The Final Rules do not define "other services" but the preamble states that directors or employees who provide services that "enable the provision of" investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative and other support services, may invest in the fund.

12 If the fair market value of such investments and capital contributions cannot be determined, then historical cost basis should be used for valuation purposes.

- The Final Rules contain language on how the 3% per-fund limit will be calculated for "master-feeder" fund investments and "fund-of-fund" investments. In the case of master-feeder funds, a banking entity's permitted investment will be measured only by reference to the value of the master fund. For "fund-of-funds" investments, a banking entity's permitted investment will be measured by looking both at the investment it has in the underlying fund and at the *pro rata* share it has in such underlying fund when looking through the fund-of-funds.
- While the 3% per-fund limit will be based on the *fair market* value of the interests in a single covered fund, the 3% aggregate limit, which is calculated by reference to the banking entity's Tier 1 capital, is based on the *historical cost* of all covered fund investments.
- With respect to the participation of directors and employees of a banking entity or any of its affiliates in covered fund investments, the Final Rules specify that these individuals must be directly engaged in providing Covered Services *at the time they take an ownership interest in the fund* (former directors and employees may retain interests they received while serving in such capacities and providing such services). Based on the preamble, the scope of Covered Services also includes services that "enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative or other support services."

b. Underwriting and Market Making in Covered Fund Interests

The Final Rules include an exemption for engaging in underwriting and market making activities related to the ownership interests of a covered fund, provided that certain conditions are met to ensure that these activities do not exceed the reasonably expected near term demand of clients, customers and counterparties. Any ownership interests that a banking entity acquires or retains pursuant to such activities, however, will be attributed to the banking entity for purposes of calculating the 3% per-fund and 3% aggregate limits.

3. Hedging-Related Exemption

The Final Rules provide a very narrow exemption for a banking entity to hold an ownership interest in a covered fund in order to reduce risks arising when a banking entity offers an incentive-compensation that is tied to the performance of a particular covered fund to an employee of the banking entity or an affiliate that directly provides investment advisory, commodity trading advisory or other services to the covered fund. The hedging activity must demonstrably reduce or significantly mitigate one or more specific risks of the incentive-compensation scheme that are identifiable at the inception of the hedge, and may not give rise to any significant new or additional risk. Consistent with the Proposed Rules, the Final Rules also require the banking entity establishing such a hedge to implement and enforce an internal compliance program that includes reasonably designed policies and procedures, internal controls and ongoing monitoring, management and authorization procedures, and the hedge must be made in accordance with that program. In addition, the incentive-compensation arrangement to which the hedge relates must provide that any losses incurred by the banking entity on the ownership interest be offset by a reduction in the amounts payable to the employee.

The Final Rules eliminate an exemption from the Proposed Rules that would have allowed a banking entity to hold an ownership interest in a covered fund when acting as intermediary on behalf of a non-banking entity customer to facilitate exposure by the customer to the profits and losses of the covered fund. In eliminating this exception, the Agencies noted that such transactions expose the banking entity to the risk that the customer will fail to perform, a risk that is particularly acute when the value of the covered fund declines, thus exposing the banking entity to the risks of the covered fund. The Agencies recognized that without this exemption, U.S. banking entities may no longer be able to offer certain innovative financial products, such as fund-linked swaps and shares of covered funds referenced by fund-linked products.

4. *Insurance Company Exemption*

While a significant number of insurance companies have de-registered as savings and loan holding companies or bank holding companies in the past year, insurance companies still affiliated with depository institutions are "banking entities" subject to the Volcker Rule. However, the statute allows a banking entity that is a regulated insurance company or an affiliate of an insurance company to purchase and sell covered financial instruments for the general account of the insurance company. The Proposed Rules included this exemption with respect to proprietary trading but did not address investments in private funds by insurance companies (arguably due to the statutory silence on whether an exemption was available for fund investments).

The Final Rules clarify this point by permitting an insurance company or its affiliate to acquire or retain an ownership interest in, or act as sponsor to, a covered fund solely for the general account of the insurance company or one or more separate accounts established by the insurance company. Such an investment is permissible if made in compliance with insurance regulations of the state or jurisdiction in which the insurance company is domiciled, unless the Financial Stability Oversight Council determines such regulations pose safety and soundness concerns.

D. LIMITATIONS ON TRANSACTIONS WITH ADVISED COVERED FUNDS

Consistent with the statute and the Proposed Rules, the Final Rules flatly prohibit a banking entity that serves as an investment manager, advisor or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to an exemption), including any of the banking entity's affiliates, from entering into any "covered transaction" with the covered fund or any covered fund that is controlled by the first-tier covered fund. The Final Rules also apply this prohibition to a banking entity acting as originator or securitizer that retains an ownership interest in a covered fund that is an issuer of asset-backed securities, and any affiliates of such banking entity.

The term "covered transaction" comes from Section 23A of the Federal Reserve Act and includes loans, extensions of credit, purchases of assets and affiliate securities, issuances of guarantees by an insured depository institution and credit exposures from derivatives transactions. Unlike Section 23A, which permits covered transactions between a bank and its affiliate so long as such transactions meet specified quantitative and other requirements, the Volcker Rule prohibits such covered transactions outright. Accordingly, none of the exemptions contained in Section 23A or the Federal Reserve's Regulation W are incorporated into the Final Rules.

The prohibition on covered transactions does not extend to a covered fund's transactions with other covered funds in which it invests, nor does it extend to transactions between a banking entity and portfolio companies of a covered fund (assuming that such portfolio companies are not themselves covered funds).[13] The prohibition also does not apply to prime brokerage transactions with a covered fund that is controlled by a first-tier covered fund, subject to certain conditions, including an attestation by the CEO of the banking entity that the banking entity does not directly or indirectly guarantee, assume or insure the obligations of the covered fund. Prime brokerage transactions include any transaction that would be a covered transaction under Section 23A that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, data, operational and administrative support. Investments and ownership interests in covered funds expressly permitted by the Volcker Rule (for example, the acquisition of up to 3% of a sponsored fund's total ownership) are also not prohibited, even though they might otherwise fall within the boundaries of Section 23A.

The Final Rules also require that all transactions between a covered fund and a banking entity that serves as its investment manager, advisor or sponsor (or that organizes and offers such covered fund pursuant to an exemption) and all transactions between a covered fund issuer of asset-backed securities and a banking entity that serves as the originator or securitizer of such asset-backed securities satisfy the qualitative standard set forth in Section 23B of the Federal Reserve Act. Section 23B generally provides that transactions between a bank and an affiliate be on "market" terms and under circumstances that are substantially the same or at least as favorable to the bank as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies broadly to most commercial transactions with an affiliate, including prime brokerage transactions and any transaction in which an affiliate is receiving a fee for providing services.

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13 The statutory text of the Volcker Rule does not clearly prohibit transactions between a banking entity and portfolio companies controlled by the private fund. The prohibition by its terms applies to transactions by a banking entity with "the fund, or with any other hedge fund or private equity fund that is controlled by such fund." 12 U.S.C. § 1851(f)(1). Also, the prohibition on covered transactions specifically mentions affiliates of the banking entity in several places but not affiliates of the private funds, which suggests that it was not intended to cover transactions between a banking entity, on the one hand, and portfolio companies of private funds that are advised or sponsored by the banking entity, on the other.

E. CONFLICTS OF INTEREST AND HIGH-RISK TRANSACTIONS

The Volcker Rule prohibits any transaction that would otherwise be permissible under an exemption to its prohibitions on proprietary trading and investing in or sponsoring private funds that would (i) involve a material conflict of interest between the banking entity and its clients, customers, or counterparties, (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or high-risk trading strategy, or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States. Consistent with the Proposed Rules, the Final Rules allow a banking entity to resolve a material conflict of interest by (A) providing clear, timely and effective disclosure to the client, customer or counterparty in reasonable detail and in a manner sufficient for the client, customer or counterparty to understand and mitigate adverse effects, or (B) establishing an information barrier that is reasonably designed to prevent the conflict of interest from materially adversely affecting the client, customer or counterparty, provided that the banking entity may not rely on an information barrier if it knows or should reasonably know that any given transaction may materially adversely affect the client, customer or counterparty notwithstanding such barrier. "High-risk" assets and trading strategies are those that, if held or employed by a banking entity, would significantly increase the likelihood of the banking entity incurring a substantial financial loss or would pose a threat to the financial stability of the United States.

F. COMPLIANCE AND REPORTING MATTERS

1. Minimum Compliance Requirements

Under the Final Rules, banking entities engaged in proprietary trading or covered fund activities and investments will need to establish a compliance program reasonably designed to ensure and monitor compliance with the Volcker Rule and related regulations. The compliance program must be appropriate for the types, size, scope and complexity of the banking entity's activities and business structure. At a minimum, the compliance program must include the following elements:

- Written policies and procedures designed to document, describe, monitor and limit proprietary trading and covered fund activities and investments;
- Internal controls to monitor compliance with the Volcker Rule;
- A management framework that delineates responsibility and accountability for compliance with the Volcker Rule, and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the Final Rules or by management as requiring attention;
- Independent testing and audits of the compliance program's effectiveness, which may be conducted either by qualified personnel of the banking entity or by a qualified outside party;

- Training for trading personnel, managers and other appropriate personnel to effectively implement and enforce the compliance program; and
- Records sufficient to demonstrate compliance, which a banking entity must retain for at least five years. The Final Rules allow the Agencies to require a banking entity to retain its compliance records for a period of more than five years.

2. *Simplified Compliance for Smaller, Less Complex Banking Entities*

The Final Rules include modifications that reduce the compliance burden on small banking entities. While the Proposed Rules required a banking entity not engaged in any proprietary trading or private fund activity to establish compliance policies and procedures designed to prevent the entity from becoming engaged in such activities, the Final Rules do not require any change to the compliance program of a banking entity not engaged in any covered activities or investments other than investing in government obligations. Additionally, the Final Rules allow a banking entity with total consolidated assets of $10 billion or less at the end of the previous two calendar years that does engage in covered activities to satisfy its compliance obligations by including in its existing compliance policies and procedures appropriate references to the Volcker Rule.

3. *Enhanced Compliance Requirements*

The Final Rules maintain the requirement from the Proposed Rules that certain banking entities meeting minimum thresholds must satisfy additional minimum standards for each element of the compliance program. However, the Final Rules revise the minimum triggering thresholds such that a banking entity will be subject to the enhanced compliance requirements if it has an average gross sum of trading assets and liabilities of at least $10 billion or total consolidated assets of at least $50 billion (or total U.S. assets of at least $50 billion in the case of foreign banking entities). Compared to the Proposed Rule, the Final Rules increase the threshold level of trading assets and liabilities that will trigger the enhanced compliance requirements from $1 billion or 10% of total assets to $10 billion, and substitute the total consolidated assets test for the Proposed Rules' threshold of $1 billion in covered fund investments or sponsorships. The Final Rules further reserve for the Agencies the authority to notify a banking entity that it must satisfy the enhanced compliance requirements even if the banking entity does not otherwise meet the triggering thresholds.

Among other requirements, a banking entity subject to the Final Rules' enhanced compliance requirements must adopt a written compliance program approved by the board of directors and senior management, and must ensure that its compliance program is periodically reviewed by senior management. Based on a review of the banking entity, the CEO of the banking entity must provide an annual written attestation to the relevant agency that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program in a manner reasonably designed to achieve compliance. In the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided by the senior management officer of the U.S. operations of the foreign banking entity who is located in the United States, and may relate only to the U.S. operations of the foreign banking entity. Significantly, however, this attestation requirement does not require the banking entity's CEO to certify that the banking entity is actually in compliance.

4. Documentation for Covered Funds

The Final Rules add the requirement that banking entities that sponsor one or more funds and that have more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years must document the exclusions or exemptions on which the banking entity and the sponsored fund have relied in determining that such fund is not a covered fund under the Volcker Rule.

G. VIOLATIONS AND ANTI-EVASION AUTHORITY

If a banking entity were to engage in any activity or make any investment in violation of the Volcker Rule, or act in a manner that functions as an evasion of the Volcker Rule's requirements, the Final Rules require that the banking entity terminate the activity or dispose of the investment promptly upon discovery of the violation. The Final Rules authorize the relevant Agencies to take any action permitted by law to enforce compliance whenever the agency finds reasonable cause to believe that a banking entity has violated the Volcker Rule, including ordering the banking entity to limit or terminate any or all proprietary trading activities or covered fund investments.

The Agencies' anti-evasion authority under the Volcker Rule is in addition to their inherent authorities under otherwise applicable provisions of banking, securities, and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other affiliated parties for violations of law. For example, a banking entity that violates the Volcker Rule may be subject to criminal and civil penalties under Section 8 of the BHC Act, formal enforcement actions under Section 8 of the FDI Act, or safety and soundness orders under Section 39 of the FDI Act.

H. TREATMENT OF NONBANK FINANCIAL COMPANIES SUPERVISED BY THE FEDERAL RESERVE

The Volcker Rule does not apply to nonbank financial institutions that are designated as systemically important by the Financial Stability Oversight Council and, as a result, are subject to supervision by the Federal Reserve. However, Dodd-Frank requires the Federal Reserve to impose on such companies that engage in activities prohibited by the Volcker Rule additional capital requirements, quantitative limits, or other restrictions. The Final Rules do not address such restrictions, which the Agencies believed would be premature in light of the fact that, to date, the Council has designated as systemically significant only three nonbank financial institutions, two of which are affiliated with insured depository institutions and are therefore "banking entities" subject to the Volcker Rule.

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For more information about the Final Rules and how they may impact your organization, please contact any of the members of our Financial Institutions or Private Funds groups, as listed below.

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