CLIENT UPDATE

THE VOLCKER RULE – AN IN-DEPTH Q&A ABOUT THE COVERED FUNDS PROVISIONS

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More than two years after they were originally proposed, on December 10, 2013, the federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "Agencies") adopted final regulations (the "Final Rule") to implement Section 13 of the Bank Holding Company Act ("BHC Act" or "BHCA") (commonly known as the "Volcker Rule").

In a prior Client Update, we provided our initial analysis of this highly complex new regulation.[1] This Update presents a more in-depth analysis of the covered funds aspects of the Final Rule and their implications for affected institutions. For the benefit of clients and friends seeking a way to understand the new regulatory framework and the principal features of the covered funds restrictions, we present in question-and-answer format a discussion of the most prominent components relating to the covered funds aspects of the Final Rule.[2]

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1 *The Volcker Rule: An Overview* (Dec. 13, 2013), *available at* http://www.debevoise.com/publications/pdf/TheVolckerRuleAnOverview.pdf

2 *The Volcker Rule: Proprietary Trading Questions and Answers* (Jan. 6, 2014), *available at* *http://www.debevoise.com/publications/pdf/TheVolckerRuleAnInDepthQAabouttheProprietaryTradingProvisions.pdf*

- Basic prohibitions

Before delving into the specifics, we note that the Volcker Rule contains two general prohibitions regarding fund activities. First, except as otherwise permitted, a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund. Second, a banking entity may not enter into "covered transactions" (as defined in Section 23A of the Federal Reserve Act) with a covered fund for which the banking entity, directly or indirectly, serves as investment manager, investment adviser, or sponsor. We review each aspect of the funds prohibitions and the various exceptions to them below.

- Effective Date

At the outset, it is also worth noting that, in a release accompanying the Final Rule, the Federal Reserve exercised its statutory authority under Section 13 of the BHCA to extend by one year – to July 21, 2015 – the date by which banking entities must come into full conformance with the Volcker Rule's restrictions. The Federal Reserve retains statutory authority to grant additional extensions, and previously adopted regulations explaining how requests for extensions should be made and will be processed. Because of the extension it has already granted, however, the Federal Reserve now only has authority to provide two additional one-year extensions (as it has now used one of the three extensions authorized by Section 13 of the BHCA). In addition, certain "illiquid" funds may be eligible for a further five-year compliance period extension.

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1. *Scope of Covered Fund Prohibitions*

1.1 To whom does the Volcker Rule apply?

Consistent with the proposed rule, the Final Rule applies to "banking entities." The Final Rule defines a "banking entity" as (i) an FDIC-insured depository institution ; (ii) a company that controls an insured depository institution; (iii) a company that is treated as a bank holding company under the International Banking Act of 1978 (generally, a foreign bank with a U.S. banking presence); and (iv) any affiliate or subsidiary of the above. In short, this definition captures any entity that is affiliated with an FDIC-insured depository institution (other than certain limited purpose institutions) and subjects each such an entity to the Final Rule (subject to the Final Rule's exceptions).

Certain entities were excluded from the definition of "banking entity." First, "covered funds" generally are excluded from the definition of banking entity. It is important to note that this exclusion applies only to "covered funds," the definition of which we discuss in Section 1.3 below, but does not apply to other pooled investment vehicles. Accordingly, other fund vehicles, which are not "covered funds," may be considered banking entities if these vehicles are controlled by a banking entity, in which case these vehicles would be subject to the Volcker Rule's prohibitions. The exclusion from the definition of banking entities also applies to portfolio companies that are owned by banking entities pursuant to the merchant banking and other investment authorities available to banking entities.

The Agencies did not address how or whether the Volcker Rule will be applied to nonbank systemically important financial institutions ("Nonbank SIFIs") not affiliated with an insured depository institution, although Section 13 of the BHCA directs the Federal Reserve Agencies to adopt capital requirements and quantitative limits for SIFIs.

1.2 To what fund investment activities does the Volcker Rule apply?

As discussed above, the Volcker Rule has two general prohibitions regarding fund activities. First, it restricts the ability of a banking entity to "sponsor" or to acquire and retain an "ownership interest" in a "covered fund." We discuss these restrictions immediately below. Second, the rule prohibits "covered transactions" between banking entities and "covered funds," which we discuss in Section 3 below.

a. What is a "sponsor" of a covered fund?

A banking entity is a "sponsor" of a covered fund if it (i) serves as a general partner, managing member or trustee with investment discretion of a covered fund or a pool operator of a covered commodity pool; (ii) selects or controls, in any manner, a majority of directors, trustees or management of a covered fund; or (iii) shares the same name, or a variation thereof, with a covered fund for corporate, marketing, promotional or other purposes.

The naming component of the "sponsor" definition may cause issues for a banking entity. For example, a U.S. banking entity that is a subsidiary of a non-U.S. banking entity that sponsors a covered fund pursuant to the exemption in Section _.13(b) for funds that are "solely outside of the United States" could be viewed as "sponsoring" the fund if the fund and the U.S. banking entity share a name, even though the U.S. banking entity may have no involvement in the management, marketing or operations of the fund.

b. When is a "trustee" a sponsor of a covered fund?

In the context of sponsoring covered funds, the term "trustee" excludes (i) a trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to Section 403(a)(1) of ERISA, and (ii) a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those just described. However, an entity that either (i) directs such an excluded trustee or (ii) possesses authority and discretion to manage and control the investment decisions of the covered fund for which the excluded trustee serves, would itself be considered a trustee (*i.e.*, not excluded) of the covered fund.

c. What is an "ownership interest" in a covered fund?

An "ownership interest" generally is defined as any equity, partnership or "other similar interest" in a covered fund. "Other similar interests" include interests where the holder: (i) has a right to select or remove the general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading advisor to the covered fund (except where such a right is exercised by a creditor on an event of default or acceleration); (ii) has a right under the terms of the interest to receive a share of the income, gains or profits from the covered fund; (iii) has a right to receive underlying assets of the fund after other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event); (iv) has a right to receive the "excess spread" of the covered fund (defined as the positive difference between interest payments received on the underlying assets and interest payments made to other interest-holders); (v) has interests that could be reduced based on losses arising from the underlying assets of the fund; (vi) receives income from the covered fund on a pass-through basis or has a rate of return determined by reference to the underlying assets of the covered fund; or (vii) has any synthetic right to have, receive or be allocated any of the above rights.

There still remain a number of technical questions about whether certain interests will be "ownership interests" for purpose of the Volcker Rule. For example, the Agencies declined to adopt a separate definition of ownership interest for securitization transactions, despite noting that the definition of "ownership interest" in the Final Rule may include interests in a covered fund that might not be considered an ownership interest or equity interest in other contexts. The Agencies noted that they chose the definition of "ownership interests" in order to address concerns about possible evasion of the Volcker Rule.

d. Can a debt security be an "ownership interest"?

The Agencies have stated that the term "ownership interest" generally does not include traditional debt securities, including "typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate." However, an "ownership interest" may include a debt security or other interest that "exhibits specified characteristics that are similar to those of equity or other ownership interests." For example, the Agencies noted that interests in preferred stock and lending arrangements with a covered fund that set interest payments by reference to the fund's profits would be ownership interests. In contrast, a loan that provides for an interest rate step-up when a covered fund violates a negotiated covenant would not be an ownership interest.

Since the adoption of the Final Rule, emergency litigation against the Agencies has already been filed to challenge the designation of banks' interests in collateralized debt obligations backed by trust-preferred securities ("TruPS-backed CDOs") as "ownership interests" under the rule. Shortly after this litigation was filed, the Agencies announced that they would review whether it is appropriate to place such CDOs outside the scope of the rule (*i.e.*, to provide an exclusion for TruPS-backed CDOs). Industry groups have requested reviews of similar securitized structures, such as collateral loan obligations ("CLO"). There is concern that because an interest in a CLO often provides for a right of replacement of the collateral manager of the CLO "for cause", although it is otherwise structured to resemble a general debt interest, that the interest may fall within the definition of "ownership interest."

e. Is carried interest or other profit interests an "ownership interest"?

The Final Rule expressly excludes "restricted profit interests" from the definition of an "ownership interest." A "restricted profit interest" is an interest in a covered fund for which the banking entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor or other service provider where the sole purpose and effect of the interest is to share in the profits of the covered fund as performance compensation for such services.

For a restricted profit interest to be excluded from the definition of an ownership interest, it must exhibit specific characteristics: (i) the sole purpose and effect of the interest is to allow the banking entity to share in the profits of the covered fund as performance compensation, (ii) all such profit, once allocated, is distributed to the banking entity (or its employee) promptly after being earned (or retained in a reserve account that does not share in subsequent investment gains), and (iii) the interest generally cannot be transferable to another party, except under certain limited circumstances. The definition is intended to capture the general concept of "carried interest" prevalent in funds-oriented business models.

In the preamble to the Final Rule, the Agencies make clear that the definition of "restricted profit interests" is broad enough to allow (a) an employee or a former employee to retain a restricted profit interest after a change in employment status, so long as the profit interest originally was received as compensation for qualifying services; and (b) so-called "clawback" features, which permit allocated but undistributed profits to be clawed back from a service provider's compensation.

As discussed in III.B below, although excluded from the definition of "ownership interest," any amount invested in a covered fund in order to receive a restricted profit interest must be added to any ownership interests for purposes of determining compliance with the investment limits with respect to "customer funds."

f. What types of investments in "covered funds" are not subject to the prohibition?

The prohibitions and restrictions on fund activities focus on transactions that banking entities conduct "as principal." The Final Rule explicitly excludes the following transactions from the Volcker Rule's covered fund prohibitions.

- *Agent, Broker, Custodian, Trustee or Fiduciary Capacity*. A banking entity may conduct a transaction with a covered fund if it is acting solely as an agent, broker, custodian, trustee or in a similar fiduciary capacity, so long as the activity is on behalf of a customer and no beneficial ownership is acquired or retained by the banking entity.

- *Deferred Compensation and Other Bank Employee Plans*. A banking entity is not subject to the covered fund prohibitions of the Volcker Rule if it is acting as a trustee for a deferred compensation, stock-bonus, profit-sharing or pension plan that is established and administered in accordance with the applicable law for the benefit of employees of the banking entity (or an affiliate).
- *Debt Previously Contracted in Good Faith*. A banking entity is not prohibited from acquiring an ownership interest in a covered fund in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable.

1.3 <u>What types of funds are covered by the Volcker Rule?</u>

The Final Rule restricts banking entity investments and interactions with "covered funds." The definition of "covered fund" in the Final Rule includes principally:

- *Section 3(c)(1) and 3(c)(7) Funds*. As in the statute, the Final Rule's definition of "covered fund" includes entities that would be investment companies under the Investment Company Act of 1940 ("ICA") but for Sections 3(c)(1) or 3(c)(7) of the ICA.
- *Certain Commodity Pools*. A commodity pool under Section 1a(10) of the Commodity Exchange Act is a covered fund if (i) the commodity pool operator has claimed an exemption under 17 CFR 4.7, or (ii) the commodity pool operator is registered with the Commodity Futures Trading Commission as a commodity pool operator in connection with the operation of the commodity pool, substantially all participation units of the commodity pool are owned by "qualified eligible persons" and participation units have not been publicly offered to persons who are not "qualified eligible persons."
- *Certain Foreign Funds (For U.S. Banking Entities Only)*. With respect to U.S. banking entities only, a covered fund includes an entity that (i) is organized or established outside the United States, (ii) the ownership interests of which are offered and sold solely outside the United States, (iii) is, or holds 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, (iv) either has as its sponsor that banking entity or has issued an ownership interest that is owned directly or indirectly by that banking entity, and (v) if the entity was subject to U.S. securities laws, could not rely on an exclusion or exemption from the definition of

"investment company" under the ICA other than the exclusions contained in Sections 3(c)(1) or 3(c)(7) of the ICA.

The Final Rule's definition of "covered fund" represents a significant reduction in scope from the definition in the proposed rule. In addition to adopting a narrower definition of "covered fund," the Agencies expressly excluded several types of funds, as discussed further below.

Also, while sponsorship and investments in non-covered funds are not prohibited, the Volcker Rule may still impact these non-covered funds because they do not have a specific exclusion from the definition of "banking entity." The complications to non-covered pooled investment vehicles are discussed in Section 5 below.

a. What securitization vehicles are excluded from the definition of "covered fund"?

Securitization vehicles are captured by the Final Rule's definition of "covered fund" unless they either (i) do not rely on Section 3(c)(1) or 3(c)(7) of the ICA or (ii) qualify for exclusion in the Final Rule for loan securitization vehicles, asset-backed commercial paper conduits or collateral pools for a covered bond.

- *Entities That Are Not Investment Companies.* A securitization vehicle would not be a covered fund if it is not primarily engaged in the business of investing, reinvesting, owning, holding or trading in "securities" (as defined under the ICA). For example, a securitization vehicle with less than 40% of its assets composed of securities may not be a "covered fund."
- *Entities That Rely on Other Exemptions under the ICA*. A securitization vehicle would not be a covered fund if it is able to rely on Rule 3a-7 under the ICA or Section 3(c)(5) of the ICA (for certain assets relating to sales or financing of goods, services or real estate).
- *Loan securitization vehicles*. The Final Rule includes a limited exclusion for certain loan securitization vehicles. These vehicles are issuing entities for asset-backed securities the assets or holdings of which are comprised solely of (i) loans, (ii) any rights or other assets either that are designed to assure the servicing or timely distribution of proceeds to security holders or that are related or incidental to purchasing or otherwise acquiring and holding the loans, provided that such assets are themselves permitted securities under the rule, (iii) certain interest rate or foreign exchange derivatives directly related to the loans and other assets and (iv) certain interests in intermediate loan securitization vehicles.

Unlike in the proposed rule, the Agencies limited the definition of "loan" to any loan, lease, extension of credit, or secured or unsecured receivable that is not a security (as defined in the Securities Exchange Act of 1934) or a derivative. This limited definition of "loan" excludes a wide range of securitization vehicles that are holding, among other things, debt securities, such as CDOs. The Agencies noted, however, that they believe a wide-range of asset classes would qualify for the loan securitization exclusion, including residential mortgages, commercial mortgages, student loans, credit card receivables, auto loans, auto leases, equipment leases, time share loans, container leases and servicer advances.

- *Asset-backed commercial paper conduits*. The Final Rule defines a "qualifying" asset-backed commercial paper conduit as one that holds only (i) loans or other assets that would be permissible in a loan securitization vehicle (see previous bullet point) and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization vehicle and that are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities. Additionally, the asset-backed securities must be composed of a residual interest and securities with a legal maturity of 397 days or less, and a regulated liquidity provider must provide, under a legally binding commitment, full and unconditional liquidity coverage for all outstanding asset-backed securities issued (other than any residual interest) in the event that funds are required to redeem maturing asset-backed securities.
- *Collateral pools for covered bonds*. A dynamic or fixed pool of assets that covers the payment obligations of covered bonds is excluded from the definition of covered fund if it satisfies the conditions of the loan securitization exclusion (discussed above), except that such a pool is not required to issue asset-backed securities.

The Agencies stated that a wide range of securitization vehicles are not excluded from the definition of "covered fund," including certain loan securitization vehicles and asset-backed commercial paper conduits if they do not satisfy the requirements of the exclusions discussed above. In addition, the Agencies specifically declined to provide an exclusion for municipal securities tender option bond vehicles and acknowledged that the absence of such an exclusion would have an unknown economic impact on the tender option bond market given the prominence of banking entities in that market.

b. What other pooled investment vehicles are excluded from the definition of "covered fund"?

The following pooled investment vehicles (other than securitization vehicles discussed in Section 1.3a above) are excluded from the definition of "covered fund":

- *U.S. Registered Investment Companies*. Investment companies registered under the ICA are specifically excluded from the definition of "covered fund." Additionally, funds established to seed registered investment companies, even if such seeding vehicles rely on Sections 3(c)(1) or 3(c)(7) of the ICA, are excluded, so long as the banking entity operates the seeding vehicle pursuant to a written plan to convert the seeding vehicle to a registered investment company within one year (or such longer period as the Federal Reserve may provide) and complies with the leverage limitations and other requirements of Section 18 of the ICA.
- *U.S. Business Development Companies*. An issuer that elects to be regulated as a business development company pursuant to Section 54(a) of the ICA is excluded from the definition of "covered fund." As with respect to U.S. registered investment companies, the Agencies indicated that seeding vehicles would not be considered to violate the Volcker Rule if they are operated pursuant to a written plan to convert the seeding vehicle to a regulated business development company within one year (or such longer period as the Federal Reserve may provide).
- *Foreign Public Funds*. Foreign public funds are excluded from the definition of "covered fund." To qualify, an issuer must be (i) organized or established outside the U.S., (ii) authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction, and (iii) sell such ownership interests predominantly through public offerings outside the U.S. An important example of such a pooled investment vehicle is an investment fund that complies with the E.U. directive for Undertakings for Collective Investment in Transferable Securities ("UCITS").
- *Foreign Pension or Retirement Plans*. Foreign pension, retirement and others similar benefits plans are excluded from the definition of "covered fund" if the plan is (i) organized and administered outside the U.S.; (ii) a broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the applicable jurisdiction; and (iii) established for the benefit of citizens or residents of one or more non-U.S. jurisdictions.
- *Funds That Rely on Another Exemption Under the ICA*. Pooled investment vehicles that do not rely on Sections 3(c)(1) or 3(c)(7) of the ICA are not covered funds. For example, a real estate fund relying on Section 3(c)(5)(C) of the ICA, a bank common trust fund

relying on Section 3(c)(3) or an oil and gas fund relying on Section 3(c)(9) would not be a covered fund.

- *Public Welfare Funds and SBICs*. The Final Rule specifically excludes certain public welfare funds, including small business investment companies, as defined under Small Business Investment Act of 1958. To qualify as an excluded public welfare fund, the issuer must make investments that are either designed primarily to promote the public welfare (through certain permitted activities) or qualified rehabilitation expenditures for certain buildings and structures.

Although the language of Section 13 of the BHCA focuses specifically on private equity and hedge funds, the definition of "covered fund" in the Final Rule, by referencing Sections 3(c)(1) or 3(c)(7) of the ICA, capture a wider range of private funds, including, among others, real estate funds, infrastructure funds, credit funds and venture capital funds. Furthermore, the Agencies specifically noted that they did not exclude other pooled investment vehicles including cash collateral pools (utilized in securities lending programs) and pass-through REITS (a pass-through trust that holds the preferred securities of the underlying REIT, which may not be a covered fund). In addition, certain employee securities companies ("ESCs") may rely on either Section 3(c)(1) or 3(c)(7) of the ICA, in which case they would be "covered funds"; the Agencies noted that ESCs may also make an exemptive application under Section 6(b) of the ICA to avoid "covered fund" treatment.

c. What corporate structure vehicles are excluded from the definition of "covered fund"?

Three types of corporate structure vehicles have been excluded from the definition of "covered fund."

- *Wholly-owned Subsidiaries*. A subsidiary of a banking entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity, is excluded from the definition of "covered fund." The Final Rule allows (i) up to 5% of the entity's outstanding ownership interests to be held by either employees or directors of the banking entity or (ii) up to 0.5% by a third party if the ownership interest is acquired or retained by that party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns.
- *Joint ventures*. Joint ventures are excluded provided that there are no more than 10 co-venturers, the business of the JV is permissible for banking entities (and is not investing in securities for resale or other disposition) and the JV does not hold itself out as an

arrangement that raises money from investors primarily for the purpose of investing in or otherwise trading in securities.

- *Acquisition Vehicles*. Acquisition vehicles are excluded so long as they are formed solely for the purpose of engaging in a bona fide merger or acquisition transaction.

While these corporate structure vehicles are excluded from the definition of "covered fund," the vehicles may be "banking entities" themselves (and subject to the Volcker Rule) if they are controlled by other banking entities. See Section 5 below for a discussion of the impact of a vehicle being classified as a "banking entity."

d. What other vehicles or entities are excluded from the definition of covered fund?

In addition, to the exclusions discussed above, the Final Rule includes specific exclusions for insurance company separate accounts (that are not for the benefit of a banking entity other than the insurance company), bank-owned life insurance ("BOLI"), and issuers formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's capacity as conservator or receiver.

e. Are there any vehicles that the Agencies specifically did not exclude from the definition of covered fund?

As noted above, the Agencies specifically did not exclude from the covered funds cash collateral pools, pass-through REITs, municipal securities tender option bond vehicles, venture capital funds, credit funds and employee securities companies. The Agencies determined not to grant express exclusions for these vehicles despite requests from commenters to do so. In some cases, most notably with respect to tender option bond vehicles, the Agencies acknowledged that the failure to provide an exclusion could cause a market disruption but still did not act.

In some cases, the Agencies suggested that alternative structures may be available to avoid the definition of "covered fund." Those alternatives, however, present increased costs or other disadvantages when compared to forming a vehicle that relies on Section 3(c)(1) or 3(c)(7) of the ICA. For example, the Agencies suggested that cash collateral pools could be structured as registered investment companies or separate accounts, pass-through REITs could be re-structured so that the securities are issued directly by the REIT, venture capital investments may be made through business development companies or directly using merchant banking authority.

In addition, the Agencies also specifically noted that financial market utilities (such as securities clearing agencies, derivatives clearing organizations, securities exchanges, derivatives boards of trade and alternative trading systems) are not excluded from the definition of covered fund. The Agencies, however, do not believe that financial market utilities would be covered funds because they are not primarily engaged in the business of investing in securities.

2. ***Banking Entities Sponsorship and Investments in Covered Funds***

2.1 How can a banking entity sponsor or acquire and retain an ownership interest in a covered fund?

As noted above, the Volcker Rule contains a general prohibition on the sponsorship of and the acquisition or retention of ownership interests in a covered fund. Both the statute and the Final Rule include various exceptions to this general prohibition for different types of banking entities. The scope and type of exceptions vary based on the type of banking entity involved, as discussed immediately below.

a. U.S. banking entities

U.S. banking entities face only a limited set of options when it comes to sponsoring or investing in covered funds. As discussed in Section 3 below, a banking entity's transactions with these funds would be subject to the so-called "Super 23A" restrictions.

- *Customer Funds*. Under the Final Rule, a U.S. banking entity may sponsor and retain an interest in a so-called "customer fund." Customer funds are funds organized and offered in connection with the banking entity's provision of bona fide trust, fiduciary, investment advisory or commodity trading advisory services and pursuant to a written plan detailing the provision of these services. The banking entity and customer fund generally may not share the same name, or a variant and the customer fund may not use the word "bank" in its name. The banking entity may not guarantee the obligations or performance of the customer fund and must so inform investors through written disclosure statements. Only banking entity directors and employees that provide advisory or other services to a customer fund may invest in that fund. Additionally, the banking entity's investment in the customer fund is restricted to the investment limits discussed in Section 2.2 below.
- *Hedging Related to Compensation Arrangements*. A U.S. banking entity may make investments in covered funds if the investments are designed to reduce demonstrably

or otherwise significantly mitigate the specific, identifiable risks to the banking entity, in very limited circumstances, relating to certain compensation arrangements.

- *Market-Making*. A U.S. banking entity is permitted to engage in underwriting or market-making activities in covered funds provided that such activities conform to requirements on underwriting and market-making in the Final Rule. Any ownership interests a banking entity acquires under this exemption are included in the individual and aggregate investment limits in customer funds discussed in Section 2.2 below.
- *Non-Covered Funds and Direct Investments with Merchant Banking Authority*. In addition, a U.S. banking entity is not subject to the covered fund limitations with respect to its sponsorship of or investment in non-covered funds, including, among others, registered investment companies, foreign public funds, and many securitization vehicles as discussed above. At various points in the preamble, the Agencies specifically suggest re-structuring to avoid the definition of "covered fund." As discussed in Section 5 below, non-covered funds are not specifically excluded from the definition of "banking entity," and a restructuring may raise additional issues where a banking entity "controls" the non-covered fund.

b. Foreign banking entities with U.S. operations

In addition to the options available to U.S. banking entities, non-U.S. banking entities may sponsor and/or invest in a covered fund if that activity occurs solely outside the United States (the "SOTUS fund exemption"). The SOTUS fund exemption includes the following requirements:

- *Non-U.S. Banking Entity*. The banking entity may not be located in or organized in the United States or controlled by a banking entity located in or organized in the United States.
- *Ownership Interests Not Offered to U.S. Persons*. The ownership interests in the fund may not be offered to U.S. persons (as defined in Regulation S under the Securities Act of 1933). The Final Rule clarifies that this restriction means that the ownership interests were sold pursuant to an offering that does not target U.S. persons. A sponsor of a SOTUS fund must include disclaimers and adopt reasonable procedures to restrict access to non-U.S. persons.
- *Risk Criteria*. The Final Rule also introduced three risk criteria: (i) the banking entity and the relevant personnel making sponsorship or investment decisions are not located in the United States, (ii) the sponsorship or investment is not accounted for on a consolidated basis by any branch or affiliate of the foreign bank in the United States,

and (iii) no financing for the foreign bank's sponsorship of or investment in the fund is provided by any branch or affiliate located in the United States or organized under U.S. law.

The narrower definition of "covered fund" to exclude, for example, foreign public funds and other vehicles that do not rely on Section 3(c)(1) or 3(c)(7) of the ICA may make the SOTUS fund exemption less important to non-U.S. banking entities. The interplay of the "covered fund" and "SOTUS" definitions and the practical implications of that interplay are not entirely clear. For example, given the narrower definition of "covered fund," it may be that the SOTUS fund exemption is only available where a non-U.S. fund is required to rely on Section 3(c)(1) or 3(c)(7) of the ICA even though it does not offer its interests to U.S. persons. These circumstances could include, for example, a fund that is organized in the U.S. (but only offered to non-U.S. persons) or a fund that makes an offering of debt securities (that are not ownership interests) to U.S. persons.

Avoiding the definition of "covered fund" (by not relying on Section 3(c)(1) or 3(c)(7) of the ICA) may, depending on the circumstances, have several advantages over the SOTUS fund exemption for a non-U.S. banking entity. For example, none of the risk criteria under the SOTUS fund exemption with respect to the investment decisions, the accounting or the financing would appear to be required to be satisfied, and the "Super 23A" restrictions (discussed in Section IV below) would not apply. There are possible disadvantages as well. For example, the fund that does not rely on Section 3(c)(1) or 3(c)(7) would not be a covered fund so is not excluded from the definition of banking entity, and there may be greater compliance burdens in ensuring that the fund does not rely on Section 3(c)(1) or 3(c)(7) of the ICA in the future.

c. Foreign banking entities with no U.S. operations

A non-U.S. banking entity with no U.S. banking presence is not subject to the Volcker Rule and should be able to sponsor and invest in funds, including covered funds, outside of the rule's restrictions and prohibitions.

d. Insurance companies

The Final Rule is applicable to insurers that control a "banking entity." The Final Rule contains an insurance exception. An insurance company or an affiliate may sponsor or acquire or retain an ownership interest in covered funds if (i) the ownership interest is acquired and retained solely for the general account of the insurance company or for one or more separate accounts established by the insurance company and (ii) the acquisition and retention of the ownership interest is subject to, and in compliance with, applicable state insurance laws on permitted investments (unless the applicable banking agencies jointly determine that the laws are insufficient to protect the safety and soundness of the banking entity or U.S. financial stability). Investments by insurance companies are discussed further in Section 4 below.

2.2 What limits apply to a banking entity's investments in customer funds?

As noted in Section 2.1 above, a banking entity may sponsor and invest in a customer fund in accordance with the requirements of the Final Rule. Among other limits, a banking entity's investment in customer funds is subject an investment limit. There are three main restrictions: a seeding limit (which is applicable during the establishment of a new fund); a per-fund investment limit; and an aggregate investment limit across all customer funds.

- *Seeding*. The Final Rule allows banking entities to seed new customer funds with sufficient initial equity to permit the fund to attract unaffiliated investors. This exemption is available for one year after the date of establishment of the fund or such longer period as the FRB may provide. During this period, the banking entity must actively seek unaffiliated investors to reduce its ownership of the fund. At the expiration of this seeding period, the banking entity is subject to the per-fund limit restrictions on its investment in a customer fund.
- *Per Fund Limit*. After the initial seeding period, the total investment of the banking entity and its affiliates in a single customer fund cannot exceed 3% of the total number or value of the outstanding ownership interests of the fund, except in limited circumstances. In determining the 3% threshold, a banking entity is required to calculate its aggregated exposure to a fund. Thus, for example, where the banking entity has permissible investments in a feeder fund and a master fund, for purposes of the investment limitation, the banking entity's investment in the master fund includes its percentage ownership of the master fund as well as its pro rate share of ownership of the master fund held through the feeder fund. Similar aggregation rules apply for investments in a fund-of-funds. The banking entity calculates its investment in and capital contributions to a customer fund, generally using fair market value, in proportion to the value of all investments in and capital contributions to that fund.

  There is an exception to the 3% threshold for securitization vehicles subject to the risk retention rules found in Section 15B of the Securities Exchange Act. These risk retention rules require issuers of certain securitizations to retain a minimum level of ownership interests that may exceed the 3% threshold. In such a situation, an issuer of securitizations is permitted to retain an ownership interest that does not exceed the amount, number or value of ownership interests that is required by the applicable risk retention rules.

- *Aggregate Investment Limit*. A banking entity's aggregated investment in all customer funds, calculated on a historical cost basis, may not exceed 3% of the tier 1 capital of the banking entity.

  In addition to complying with the investment limits, a banking entity must, whenever it calculates its tier 1 capital, deduct the greater of historical cost or fair market value of all customer fund investments made by the banking entity. The capital deduction does not apply to non-U.S. banking entities.

  In adopting the investment limits, the Agencies chose not to include certain parallel investment language in the Final Rule that had been included in the proposal. In the proposed rule, the Agencies had included a provision that required certain investments alongside a customer fund to be included in the calculation of per-fund and aggregate investment limits. The Agencies dropped this provision from the Final Rule, but the Agencies did state that the co-investments could be integrated with the customer fund if a banking entity makes investments side by side in substantially the same positions as the covered fund.

2.3 <u>Can a covered fund be converted to a non-covered fund or an exempt covered fund?</u>

The Agencies state that they expect such conversions to take place, including in their recent guidance with respect to TruPS CDOs. However, the Agencies did not address questions raised by commenters as to how one should convert, for example, customer funds and SOTUS funds, where the Final Rule includes prohibitions relating to activities in the past (*e.g.*, the requirements relating to disclosures in offering materials with respect to customer funds and the requirements relating to offering to U.S. persons with respect to SOTUS funds).

3. *Super 23A and Backstops to Permitted Activities*

3.1 <u>What is "Super 23A" and how does "Super 23A" differ from Section 23A of the Federal Reserve Act?</u>

The Final Rule prohibits a banking entity that (i) serves, directly or indirectly, as the investment manager, investment adviser, commodity trading adviser or sponsor to a covered fund, (ii) organizes and offers a customer fund, or (iii) continues to hold an ownership interest in a customer fund, and any affiliate of such an entity, from engaging in transactions with the covered fund, and any controlled funds, that would be a covered transaction under Section 23A of the Federal Reserve Act ("FRA").

A "covered transaction" in this context includes, among other transactions, loans and extensions of credit to the fund, repo transactions with the fund, guarantees issued on behalf of the fund, acceptances of the fund's securities as collateral for loans to third parties, securities lending transactions to the extent that the banking entity (or its affiliate) has credit exposure to the fund, and derivatives transactions between the banking entity (or its affiliate) and the fund to the extent that the banking entity has credit exposure to the fund.

This provision has been deemed "Super 23A" because, unlike Section 23A of the FRA, which permits covered transactions subject to certain quantitative and qualitative limits, the Volcker Rule prohibits such transactions. Another difference between the provisions is that "Super 23A" does not incorporate the attribution rule of Section 23A, which treats transactions with third parties as transactions with an affiliate if the proceeds are transferred or benefits accrue to the affiliate.

The prohibition on covered transactions does not apply to certain "prime brokerage transactions" of a banking entity with a covered fund. A "prime brokerage transaction" is defined to mean any transaction that would be a covered transaction that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.

3.2 <u>Are transactions with funds or other vehicles subject to "Super 23A" if (i) the funds are not "covered funds" or (ii) a banking entity has invested in a third-party sponsored covered fund (e.g., pursuant to the SOTUS or insurance company exemption)?</u>

No, the "Super 23A" provision applies only to transactions between banking entities and the covered funds that such banking entities advise or sponsor.

3.3 <u>When are the exemptions (including the customer fund, SOTUS and insurance company exemptions) unavailable?</u>

The exemptions from the covered fund prohibitions discussed above are only available if the permitted activities do not result in a material conflict of interest, a material exposure by the banking entity engaged in the activity to high-risk assets or high-risk trading activities or pose a threat to the safety and soundness of the banking entity or U.S. financial stability.

The Final Rule includes, with certain revisions from the proposal, provisions to implement these statutory "backstops" with respect to permitted fund activities. To begin with, the Final Rule defines a material conflict of interest, which exists if the banking entity engages in any 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. Subject to certain limits, these conflicts may be mitigated through the use of disclosure or the establishment of information barriers.

As noted, another statutory backstop involves material exposures to high-risk assets and high-risk trading strategies. The Final Rule defines high-risk assets and trading strategies as ones that significantly increase the likelihood that the banking entity holding these assets or conducting these strategies would incur a substantial financial loss or would pose a threat to the financial stability of the United States. The Final Rule does not provide much gloss on what assets or activities might fall within these definitions; the Agencies noted in their discussion of these backstops in the proprietary context, and cross-referenced in their discussion of covered fund activities, that "the expansive scope of Section 13 of the BHC Act supports … [an] inclusive approach focusing on the facts and circumstances of each potential conflict or high-risk activity." Thus, it is not yet clear under what circumstances the Agencies will enforce these provisions.

4. ***Insurance Companies***

The Final Rule includes a general exemption that permits an insurance company or an affiliate to sponsor or acquire or retain an ownership interest in covered funds if (i) the ownership interest is acquired and retained solely for the general account of the insurance company or for one or more separate accounts established by the insurance company and (ii) the acquisition and retention of the ownership interest is subject to, and in compliance with, applicable state or foreign insurance company investment laws and regulations (unless the applicable banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners, jointly determine that the laws are insufficient to protect the safety and soundness of the banking entity or the U.S. financial stability). Although there was no similar exemption in the proposed rule, the Agencies decided to include this exemption for insurance activities and investments from the covered fund restrictions in order to appropriately accommodate the business of insurance within an insurance company, in accordance with Congressional intent and the statutory purpose of the Volcker Rule.

4.1 <u>What insurance companies are covered? Does it include both U.S. and non-U.S. insurance companies?</u>

The Final Rule defines an "insurance company" to be a company that is (i) organized as an insurance company, (ii) primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, (iii) subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and (iv) not operated for the purpose of evading the Volcker Rule. This definition is substantially similar to the definition of insurance company in Section 2(a)(17) of the ICA. However, there is little existing guidance as to the meaning of "primarily and predominantly" with respect to the insurance company definitions in the ICA.

4.2 <u>Is a covered fund sponsored by an insurance company or an affiliate under the insurance company exemption subject to "Super 23A"? What about a separate account organized by an insurance company?</u>

It appears that a covered fund sponsored under the insurance company exemption would be subject to the "Super 23A" restrictions, discussed in Section 3 above. However, a separate account is specifically excluded from the definition of "covered fund," and so is not subject to "Super 23A" restrictions.

5. ***Non-Covered Funds That Fall Within the Definition of Banking Entity***

The Volcker Rule and the Final Rule impose no restrictions on banking entities' sponsorship, investment and other transactions with pooled investment vehicles that are not covered funds. Yet, because of the way in which the Agencies have defined the term "banking entity," non-covered funds that are controlled by banking entities may themselves become subject to certain of the Volcker Rule's prohibitions.

5.1 <u>When is a fund or other vehicle a "banking entity"?</u>

A pooled investment vehicle that is "controlled" by a banking entity would itself become a banking entity for purposes of the Volcker Rule, unless it is a covered fund and thereby excluded from the definition of banking entity. Under the BHCA, "control" may exist, for example, if a banking entity (i) owns, controls or has power to vote 25% or more of any class of voting securities of the fund, (ii) controls in any manner the election of a majority of the directors of trustees of the fund, or (iii) exercises a "controlling influence" over the management or policies of the fund. As a general rule, a banking entity that acts as general partner to a fund organized as a limited partnership may be found to control that fund.

It is not clear if the Agencies intended this differential treatment between covered funds and non-covered funds; however, the Agencies acknowledged this treatment with respect to U.S. registered investment companies, as discussed in Section 5.2 below. This differential treatment may create incongruous results in certain scenarios. For example, an insurance company may sponsor, invest in and control a hedge fund that relies on Section 3(c)(7) of the ICA (subject to the restrictions discussed in Section 4 above), in which case the fund will face no restrictions on its investment activities. However, if the insurance company sponsors, invests in and controls a real estate fund relying on Section 3(c)(5)(C) of the ICA, that real estate fund could be a banking entity and subject to the prohibitions of the Volcker Rule. Similar disparate treatment can be seen with respect to (i) non-U.S. funds that are excluded from the definition of "covered fund" (but, then, are not excluded from the definition of "banking entity") and non-U.S. funds that rely on the SOTUS fund exemption (which are "covered funds" excluded from the definition of "banking entity") and (ii) securitization vehicles that are organized as customer funds (which are excluded from the definition of "banking entity") and loan securitization vehicles, asset-backed commercial paper conduits, and securitization vehicles that rely on other exemptions under the ICA (which are not excluded).

5.2 When is a registered investment company a "banking entity"? Does this guidance apply to other pooled investment vehicles?

The BHC Act and the FRB's Regulation Y permit financial holding companies, pursuant to certain limitations, to organize, sponsor and manage registered investment companies, such as a mutual fund, and also to serve as investment advisers to such funds, without being deemed to control the registered investment company for purposes of the BHC Act.

The Agencies note in the preamble that so long as a banking entity subject to the Volcker Rule complies with existing BHC Act limitations, the banking entity would not control the registered investment company and, therefore, the registered investment company would not itself be a banking entity subject to the restrictions and prohibitions of the Volcker Rule. However, if control of the registered investment company is deemed to exist, the registered investment company and its subsidiaries would be banking entities under the Volcker Rule.

The Agencies also stated that a seeding vehicle for a U.S. registered investment company would not be considered banking entities so long as it is operated pursuant to a written plan to become registered investment company within one year (subject to extensions by the Federal Reserve) and complies with the leverage limitations and other requirements of Section 18 of the ICA.

It is unclear whether the Agencies would apply a similar analysis with respect to other pooled investment vehicles, including foreign public funds, which may have substantially different management structures than U.S. registered investment companies. The guidance under the BHCA with respect to registered investment companies generally is limited to U.S. mutual funds and does not on its face extend to, for example, foreign public funds that are structured differently from U.S. mutual funds.

5.3 What types of restrictions would a pooled investment vehicle that is a banking entity face?

A pooled investment vehicle that is a banking entity would appear to be subject to the full force of the Volcker Rule's restrictions and prohibitions, including the restrictions on proprietary trading and investments in covered funds. These restrictions could place real restrictions on the activities of a pooled investment vehicle. For example, a pooled investment vehicle that is a banking entity could not (i) operate as a fund-of-funds or invest in special purpose vehicles where the underlying funds or vehicles are relying on either Section 3(c)(1) or 3(c)(7) of the ICA or (ii) engage in short-term trading of securities. In addition, the substantial compliance burdens of the Volcker Rule would apply to the activities of the pooled investment vehicle.

6. *Compliance Obligations for Investments in Covered Funds*

Now that the Final Rule has been adopted, affected banking entities will need to begin to adapt and implement the specific compliance programs that are required by the Final Rule.

6.1 What policies and procedures are required?

The Final Rule adopts a "tiered" approach to compliance requirements, as described below.

- *Banking entities that do not engage in proprietary trading activities or covered fund activities and investments.* Banking entities that do not engage in proprietary trading activities or covered fund activities and investments are not required to establish a compliance program prior to engaging in such activities and investments.
- *Banking entities with total consolidated assets of $10 billion or less.* Banking entities with total consolidated assets of $10 billion or less that engage in covered trading or covered fund activities or investments may satisfy the compliance requirements by updating existing compliance policies and procedures to reference the Final Rule and Section 13 of the BHCA.

- *Banking entities with total consolidated assets greater than $10 billion.* Banking entities with total consolidated assets greater than $10 billion that engage in covered trading or covered fund activities must establish a new compliance program.
- *Banking entities with total consolidated assets of $50 billion or more.* Banking entities with total consolidated assets of $50 billion or more (or in the case of a foreign banking entity, total U.S. assets of $50 billion or more, including branches and agencies) or that are required to comply with the quantitative metric reporting requirements (based on the trading asset and liability thresholds described above) are subject to heightened compliance requirements, including a CEO attestation.

6.2 Does a banking entity need a compliance program if it does not invest in private funds?

No. Banking entities are permitted to tailor compliance policies and procedures to the size, scope and complexity of their activities. For example, if a banking entity's activities involved only proprietary trading, policies and procedures would need to address those activities but need not address the covered fund prohibitions.

6.3 What is the CEO attestation requirement and how does it apply to investments in private funds?

Only banking entities subject to the heightened compliance requirements triggered by having total consolidated assets of $50 billion or more (or in the case of a foreign banking entity, total U.S. assets of $50 billion or more, including branches and agencies) are subject to the CEO attestation requirement.

Based on a review by the CEO of the banking entity, the CEO of the banking entity must annually attest in writing to the relevant agency that the banking entity has in place a program reasonably designed to achieve compliance with Section 13 of the BHCA and the Final Rule.

In the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations who is located in the United States.

The Final Rule does not contain any explicit exception to the CEO attestation requirement for an industrial company with an insured depository institution subsidiary.

6.4 Is there a standard process for requesting interpretive relief from the Agencies?

The Final Rule does not include a provision for requesting interpretive guidance from the Agencies. Rather, Section 13(e)(2) of the BHCA mandates that each agency enforce compliance with respect to a banking entity under the respective agency's jurisdiction. The Agencies recognized that banking entities may be subject to jurisdiction by more than one agency, but "plan to coordinate their examination and enforcement proceedings under Section 13, to the extent possible and practicable, so as to limit duplicative actions and undue costs and burdens for banking entities."

Thus, it remains to be seen the extent to which the Agencies will coordinate on interpretive, supervisory, and enforcement matters, or whether the Agencies will develop a predetermined process or protocol for coordination.

Certain provisions of the Final Rule contemplate "joint determinations," but it is not clear how any such joint determinations would be made (i.e., the applicable legal authority or administrative process, including an opportunity for public comment).

6.5 What are the consequences of noncompliance?

Any banking entity that engages in an activity or makes an investment in violation of the Final Rule or acts in a manner that functions as an evasion of the Final Rule shall, upon discovery, promptly terminate such activity and, as relevant, dispose of the investment.

The Final Rule provides the Agencies authority to take any action permitted by law to enforce compliance with the Final Rule, "including directing the banking entity to restrict, limit, or terminate any or all activities [under the Final Rule] … and dispose of any investment." Notably, this "termination" provision was revised from the proposed rule to remove an opportunity for a "hearing" and to apply to "any and all activities" under the Final Rule, as opposed to "the activity" that is the subject of a violation.

The Agencies note in the preamble that they may rely on 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 institution-affiliated parties for violations of law.

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Please do not hesitate to contact us with any questions.

January 7, 2014