> Final Volcker Rule Regulations: Restrictions on Covered Fund Activities and Investment

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BINGHAM

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On December 10, 2013, the U.S. federal banking agencies,[1] the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission (the "CFTC," and, together with the federal banking agencies and the SEC, the "Agencies") jointly adopted regulations (the "Final Regulations") to implement Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule.[2] The Final Regulations were adopted more than two years after proposed regulations to implement the Volcker Rule (the "Proposed Regulations") were first published.[3]

The Volcker Rule prohibits any "banking entity" from (i) engaging in proprietary trading and (ii) acquiring and retaining an ownership interest in, sponsoring or having certain relationships with hedge funds, private equity funds and certain other private funds ("covered funds"), subject to certain exemptions.

In this Alert, we discuss the Volcker Rule's restrictions with respect to covered funds, as those restrictions will be implemented by the Final Regulations.[4]

Key Changes from the Proposed Regulations

The Final Regulations contain certain important changes from the Proposed Regulations, including the following.

- The Final Regulations' definition of "covered fund" is narrower than the definition in the Proposed Regulations in certain respects.

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[1] The U.S. federal banking agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "FRB"), and the Federal Deposit Insurance Corporation (the "FDIC").

[2] The Final Regulations and accompanying statements, fact sheets, and related documents can be found on the websites of the Agencies. For example, they are available on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm.

[3] For a summary of the Proposed Regulations, *see* Proposed Volcker Rule Regulations: A Summary (Oct. 18, 2011). The Proposed Regulations can be found in the Federal Register at 76 Fed. Reg. 68,846 (Nov. 7, 2011) and on the FRB's website at http://www.federalreserve.gov/newsevents/press/bcreg/20111011a.htm.

[4] For a summary of some of the key highlights of the Final Regulations, *see* Regulators Adopt Final Volcker Rule Regulations (Dec. 11, 2013). For a summary of the Final Regulations' restrictions on proprietary trading, *see* Final Volcker Rule Regulations: Restrictions on Proprietary Trading (Jan. 9, 2014). For a summary of the Final Regulations' application to securitizations and other structured transactions, *see* Final Volcker Rule Regulations: Securitizations and Other Structured Transactions (Updated Jan. 16, 2014).

- A commodity pool is a covered fund only if the commodity pool operator has claimed exempt pool status under section 4.7 of the CFTC's regulations or if the commodity pool could qualify as an exempt pool and has not been publicly offered to persons who are not qualified eligible persons under section 4.7 of the CFTC's regulations.

- A foreign fund which does not rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act")[5] and which is not otherwise a covered fund may be a covered fund only for a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States. Such a foreign fund becomes a covered fund only with respect to the U.S. banking entity (or foreign banking entity that is controlled by a U.S. banking entity) that acts as a sponsor to the foreign fund or has an ownership interest in the foreign fund.

- The Final Regulations exclude from the definition of covered fund a number of entities that are not engaged in the types of investments or activities that the Volcker Rule was designed to address, such as foreign public funds, wholly-owned subsidiaries, joint ventures that do not engage in investing money for others, acquisition vehicles, foreign pension or retirement funds, insurance company separate accounts in which third parties do not participate in profits and losses, small business investment companies and public welfare investment funds, investment companies and business development companies registered under the Investment Company Act and related seeding vehicles, and entities that may rely on an exclusion from the definition of "investment company" in the Investment Company Act other than the exclusions contained in sections 3(c)(1) and 3(c)(7).

- An "ownership interest" in a covered fund continues to be defined as any equity, partnership, or other similar interest, but the Final Regulations provide a list of rights that would constitute an "other similar interest." "Restricted profit interests," characterized as "carried interests" in the Proposed Regulations, continue to be carved out from the definition of "ownership interest."

- The exemption for organizing and offering covered funds for customers of a banking entity has been expanded to include underwriting and market-making activities that are designed not to exceed the reasonably expected near term demands of clients, customers and counterparties.

- The Final Regulations provide greater flexibility for banking entities that hold ownership interests in an asset-backed securities issuer that is a covered fund that the banking entity organizes and offers.

- The exemption for permitted covered fund activities and investments, solely outside the United States, by foreign banking entities has been revised to a "risk-based" approach designed to

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[5] Most hedge funds and private equity funds that are offered in the United States rely on either section 3(c)(1) or 3(c)(7) for exclusion from the definition of "investment company" under the Investment Company Act.

ensure that any foreign banking entity, engaging in activity under the exemption, does so in a manner that ensures the risk and sponsorship of the activity occurs and resides solely outside the United States. Under this approach, the question of whether sponsorship or investment is conducted "solely outside the United States" depends on where the banking entity that acts as a sponsor or invests in the fund is located or organized (or whether it is controlled by a U.S. banking entity); where the banking entity that makes the decision to invest in or act as a sponsor to the fund is located or organized; where the investment or sponsorship is accounted for as principal; and whether financing for the investment or sponsorship by the foreign banking entity is provided by any of the foreign bank's U.S. branches or affiliates.

- The covered fund hedging exemption has been narrowed to allow the use of ownership interests in a covered fund as a hedging instrument only if the hedging activity is directly connected to a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund.

- The Final Regulations include an exemption for an insurance company or its affiliate to acquire or retain an ownership interest in, or act as a sponsor to, a covered fund for the general account or separate account of a regulated insurance company.

- The "Super 23A" requirement (restricting transactions between a banking entity and a covered fund sponsored, managed or advised by the banking entity or its affiliates) is largely unchanged from the Proposed Regulations. However, the impact of this requirement will be altered by the changes to the definition of covered fund in the Final Regulations, since transactions with funds that are not covered funds will not be subject to the "Super 23A" restrictions.

The Agencies declined in the Final Regulations to provide some specific exclusions from the definition of covered fund that were sought by some commenters for certain vehicles including financial market utilities, cash collateral pools, pass-through REITS, municipal securities tender option bond transactions, venture capital funds, credit funds and employee securities companies. However, some of these entities may not fall within the definition of covered fund or may fit within an exclusion from the definition of covered fund, or a banking entity may be permitted to organize, offer, sponsor or retain an ownership interest in such a vehicle pursuant to an exemption from the prohibitions of the Volcker Rule.

Definition of "Banking Entity"

The prohibitions of the Volcker Rule apply to banking entities. The Final Regulations track the statutory definition (and the definition in the Proposed Regulations) closely in broadly defining a "banking entity" as any of the following:

- Any insured depository institution (other than certain limited purpose trust institutions);

- Any company that controls an insured depository institution;

- Any company treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978; and
- Any affiliate or subsidiary of any of the foregoing (as defined in the Bank Holding Company Act of 1956 (the "BHC Act")).[6]

However, the Final Regulations provide exclusions from the definition of banking entity for:

- A covered fund that is not itself a banking entity under the first three bullets above (accordingly, a covered fund will not be a banking entity solely because it is a subsidiary or affiliate of a banking entity);
- A portfolio company held under merchant banking authority or insurance company investment authority of the BHC Act, or a portfolio concern controlled by a small business investment company ("SBIC"), so long as the portfolio company or portfolio concern is not a banking entity under the first three bullets above; or
- The FDIC acting in its corporate capacity as conservator or receiver.[7]

Covered Fund Activities and Investments

Under the Final Regulations, a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund, subject to certain exemptions. These exemptions include:[8]

- Organizing and offering a covered fund which is offered only to customers of the banking entity;
- Underwriting and market making in ownership interests of a covered fund;

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[6] Final Regulations §__.2(c)(1). "Affiliate" and "subsidiary" are defined by reference to the definitions of those terms in Sections 2(k) and 2(d) of the BHC Act, respectively. 12 U.S.C. §§ 1841(k) and (d). A company is a "subsidiary" of a banking entity (and therefore a banking entity itself, except as excluded in the Final Regulations (see above)) if the banking entity owns, controls, or has the power to vote 25% or more of the voting shares of the company, has control over the election of a majority of the company's directors, or otherwise has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the company. 12 U.S.C. § 1841(d). A company is an "affiliate" of a banking entity (and therefore a banking entity itself, except as excluded in the Final Regulations (see above)) if the company controls, is controlled by, or is under common control with the banking entity. 12 U.S.C. § 1841(k).

[7] Final Regulation §__.2(c)(2). These are broader exclusions than were provided in the Proposed Regulations, which would have excluded only an affiliate or subsidiary of a banking entity if the affiliate or subsidiary is a covered fund that is organized, offered and held by a banking entity pursuant to the exemption for organizing and offering a covered fund (see below).

[8] Certain of these exemptions include specific provisions for their application to certain issuers of asset-backed securities. These provisions will be discussed in an upcoming Bingham Alert regarding the applicability of the Final Regulations to securitizations.

- Seeding and de minimis investments in a covered fund that the banking entity organizes and offers to customers of the banking entity (in reliance on the exemption noted above);
- Certain risk-mitigating hedging and insurance company investments; and
- Certain foreign covered fund activities by foreign banking entities.[9]

The covered fund provisions of the Final Regulations also impose other limitations on covered fund activities and investments, including the so-called "Super 23A" restrictions on relationships by banking entities with covered funds and the so-called "back stop" provisions intended to address conflicts of interest and systemic risk. Entities which engage in permitted covered fund activities and investments also must comply with various compliance and internal control requirements.[10]

Definition of Covered Fund

Definition

As explained in the preamble to the Final Regulations (the "Preamble"), the Agencies attempted, in the Final Regulations, to construct a definition of covered funds which focuses on entities and issuers that are formed for the purpose of investing or trading in securities or derivatives that are offered and sold in non-public offerings to institutional investors and high net worth individuals, rather than to retail investors.

The Final Regulations define a "covered fund" to include the following, subject to certain exclusions:

- An issuer that would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act;[11]
- Certain commodity pools;[12] and
- Certain foreign funds, but only with respect to a U.S. banking entity or a banking entity controlled by a U.S. banking entity.[13]

Importantly, issuers which do not rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act (unless they are commodity pools or foreign funds that fall within the other prongs of the Final Regulations' definition of covered fund), or that meet the requirements of another exclusion from the definition of investment company (even if they also choose to rely on section 3(c)(1) or 3(c)(7)),

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[9] Final Regulations § __.11
[10] *See* Final Regulations § __.20
[11] Final Regulations § __.10(b)(1)(i).
[12] Final Regulations § __.10(b)(1)(ii).
[13] Final Regulations § __.10(b)(1)(iii).

are not covered funds.[14] Thus, for example, bank-maintained common trust funds and collective investments funds, which rely on sections 3(c)(3) or 3(c)(11), respectively, of the Investment Company Act, and most REITS, which typically rely on section 3(c)(5) of the Investment Company Act, are not covered funds. Similarly, an employee securities company, which has received an exemption under section 6(b) of the Investment Company Act, would not need to rely on section 3(c)(1) or 3(c)(7) and thus may fall outside the definition of covered fund.

With respect to commodity pools, the covered fund definition includes any commodity pool (under section 1a(10) of the Commodity Exchange Act) for which:

- The commodity pool operator has claimed exempt pool status under section 4.7 of the CFTC's regulations; or
- A commodity pool operator is registered with the CFTC in connection with the commodity pool, substantially all participation units are owned by qualified eligible persons under sections 4.7(a)(2) and 4.7(a)(3) of the CFTC's regulations, and participation units of the commodity pool have not been publicly offered to persons who are not such qualified eligible persons.[15]

Foreign Funds

In the Final Regulations, the Agencies narrowed the categories of foreign funds that are covered funds. The covered fund definition includes, but only for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located or organized under the laws of the United States or of any State,[16] an entity that:

- Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;
- Is, or holds itself out as being, an entity or arrangement that raises money primarily for investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and
- Has as its sponsor that banking entity (or an affiliate thereof) or has issued an ownership interest that is owned directly or indirectly by that banking entity (or an affiliate thereof).[17]

Under this definition, a foreign fund becomes a covered fund only with respect to the U.S. banking entity (or foreign banking entity that is controlled by a U.S. banking entity) that acts as a sponsor

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[14] *See* Final Regulations §__10(b)(2).

[15] Final Regulations § __.10(b)(1)(ii).

[16] For these purposes, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency or subsidiary. *See* Final Regulations § __.10(b)(1)(iii)(C)(3).

[17] Final Regulations § __.10(b)(1)(iii).

to the foreign fund or has an ownership interest in the foreign fund.[18] Thus, a foreign fund may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but the same foreign fund may not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.[19] Also, a foreign banking entity that is not controlled by a U.S. banking entity is not under any Volcker Rule restriction with respect to such a foreign fund, unless the foreign fund would otherwise be a covered fund under another prong of the definition thereof.[20]

The Agencies noted, however, that any foreign fund, including a foreign fund sponsored or owned by a foreign banking entity, that is offered or sold in the United States in reliance on the exclusions in section 3(c)(1) or section 3(c)(7) of the Investment Company Act would be a covered fund, unless it meets the requirements of one of the exclusions discussed below.[21] One of those exclusions covers certain foreign funds that are similar to U.S. registered investment companies. In addition, a foreign banking entity may be able to rely on the Final Regulations' foreign fund exemption to sponsor or invest in a foreign fund which is a covered fund, but only if, among other things, no ownership interest in the fund is offered or sold to a resident of the United States (see "Covered Fund Activities and Investments Outside the United States").[22]

Exclusions from the Definition of Covered Fund

Generally

The Final Regulations exclude certain categories of entities from the definition of covered fund. Sponsorship of or investment in some of these categories of entities would have been allowed under the Proposed Regulations as permitted activities; however, because the Final Regulations provide exclusions for such entities from the definition of covered fund, the Volcker Rule's "Super 23A" restrictions do not apply with respect to transactions between banking entities and such entities. In addition, the Agencies made certain revisions to clarify and, in some cases, broaden the categories of excluded entities.

The following categories of entities are excluded from the definition of covered fund:

- Certain foreign public funds (as discussed further below);[23]
- Wholly-owned subsidiaries;[24]
- Joint ventures between a banking entity or any of its affiliates and one or more non-affiliates, comprised of no more than 10 unaffiliated co-venturers, which are in the

[18] *See* Preamble at 484.
[19] *Id.*
[20] *Id.*
[21] *See* Preamble at 485.
[22] *See* Preamble at 621.
[23] Final Regulations § __.10(c)(1).
[24] Final Regulations § __.10(c)(2).

business of engaging in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or disposition, and do not hold themselves out as being, entities or arrangements that raise money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities;[25]

- Acquisition vehicles formed solely for the purpose of engaging in a bona fide merger transaction and that exist only for such period as necessary to effectuate the transaction;[26]
- Certain foreign pension and retirement funds;[27]
- Insurance company separate accounts, provided that no banking entity other than the insurance company participates in the account's profits and losses;[28]
- Certain bank-owned life insurance separate accounts;[29]
- Certain loan securitizations;[30]
- Certain asset-backed commercial paper conduits;[31]
- Certain qualifying covered bonds;[32]
- SBICs and certain public interest investments;[33]
- Registered investment companies and business development companies, including an entity that will become so registered but, during its seeding period, relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act, subject to certain conditions;[34]
- Entities that may rely on an exclusion or exemption from the definition of "investment company" under the Investment Company Act, other than the exclusions contained in sections 3(c)(1) and 3(c)(7);[35]

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[25] Final Regulations § __.10(c)(3).
[26] Final Regulations § __.10(c)(4).
[27] Final Regulations § __.10(c)(5). This allows such funds to be treated similarly to U.S. pension funds which are not covered funds by virtue of the exclusion for certain broad-based employee benefit plans under section 3(c)(11) of the Investment Company Act.
[28] Final Regulations § __.10(c)(6).
[29] Final Regulations § __.10(c)(7).
[30] Final Regulations § __.10(c)(8).
[31] Final Regulations § __.10(c)(9). The requirements of the exclusions for loan securitizations and asset-backed commercial paper conduits will be discussed in an upcoming Bingham Alert regarding the applicability of the Final Regulations to securitizations.
[32] Final Regulations § __.10(c)(10).
[33] Final Regulations § __.10(c)(11).
[34] Final Regulations § __.10(c)(12).

- Issuers formed in conjunction with the FDIC's receivership or conservatorship operations;[36] and
- Any issuer that the appropriate federal banking agencies, the SEC, and the CFTC jointly determine the exclusion of which is consistent with the purposes of the Volcker Rule.[37]

Notwithstanding these exclusions, an entity may itself be a banking entity, and therefore subject to the Volcker Rule's proprietary trading and other restrictions, if the banking entity is a subsidiary or affiliate of a banking entity.[38]

The Agencies declined to provide exclusions from the definition of covered fund for a number of other categories of entities, such as financial market utilities, cash collateral pools, pass-through REITS, municipal securities tender option bond transactions, venture capital funds, credit funds, and employee securities companies.[39] Such categories of entities will be covered funds if they meet the Final Regulations' definition of covered fund. However, such an entity may still be excluded from the definition of covered fund if, for example, it does not need to rely on section 3(c)(1) or 3(c)(7). As noted above, an employee securities company may rely on an exemptive order under section 6(b) of the Investment Company Act and thus not need to rely on section 3(c)(1) or 3(c)(7). A cash collateral pool may be registered under the Investment Company Act and thus be excluded from the definition of covered fund. Moreover, a banking entity may be permitted to organize these types of entities, even if they are covered funds, and offer ownership interests in them to customers (see "Permitted Organizing and Offering a Covered Fund; Underwriting and Market Making with Respect to a Covered Fund" below).

Foreign Public Funds

The exclusion for foreign public funds in the Final Regulations is intended to address commenters' concerns that the Volcker Rule's prohibitions would be applied to foreign funds that are similar to U.S. registered investment companies.[40] The exclusion applies to any issuer that:

- is organized or established outside of the United States;
- is authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction; and
- sells ownership interests predominantly through one or more public offerings outside of the United States.[41]

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[35] Final Regulations § __.10(b)(2).
[36] Final Regulations § __.10(c)(13).
[37] Final Regulations § __.10(c)(14).
[38] *See* Preamble at 509.
[39] *See* Preamble at 583-604.
[40] *See* Preamble at 486.

For a banking entity that is located in or organized under the laws of the United States or any State (or a banking entity controlled by such a banking entity), this exclusion is available only with respect to a foreign fund sponsored by the U.S. banking entity (or banking entity controlled by a U.S. banking entity) if, in addition to these requirements, the fund's ownership interests are sold predominantly to persons other than the sponsoring banking entity; the issuer; affiliates of such sponsoring banking entity or such issuer; and employees and directors of such entities.[42]

Other Key Definitions

"As Principal"

A banking entity is prohibited from acquiring or retaining an ownership interest in a covered fund "as principal."[43] The Final Regulations clarify the scope of what it means to act "as principal" by specifying that a banking entity does not hold an ownership interest as principal when the interest is held by the banking entity:

- Acting solely as agent, broker or custodian, so long as the activity is conducted for the account of, or on the behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;
- Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered under U.S. law or the laws of a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of people who are or were employees of the banking entity (or an affiliate thereof);
- 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, and does not retain such instrument for longer than such period permitted by the appropriate Agency; or
- On behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, 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.[44]

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[41] Final Regulations § __.10(c)(1). Generally, a public offering is "predominantly outside the United States" if 85 percent or more of fund's interests are sold to investors who are not residents of the United States. *See* Preamble at 505.

[42] *See* Preamble at 504.

[43] Final Regulations § __.10(a)(1).

[44] Final Regulations § __.10(a)(2).

"Ownership Interest"

An "ownership interest" is any equity, partnership, or other similar interest.[45] An "other similar interest" means an interest that exhibits any of the following characteristics on a current, future, or contingent basis:

- Has the 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 adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);
- Has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund (regardless of whether the right is pro rata with other owners or holders of interests);
- Has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (commonly known as the "residual" in securitizations), excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event;
- Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);
- Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;
- Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or
- Any synthetic right to have, receive, or be allocated any of the rights described above.[46]

There is an exclusion from the definition of "ownership interest" for a "restricted profit interest" (characterized as "carried interest" in the Proposed Regulations) held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider, provided:

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[45] Final Regulations § __.10(d)(6).

[46] *Id.*

- The sole purpose and effect of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received;

- All such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in the subsequent investment gains of the covered fund;

- Any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the limits described in "Permitted Seeding and De Minimis Investments" below; and

- The interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy, of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.[47]

"Sponsor"

A banking entity is a "sponsor" of a covered fund if the banking entity:

- Serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund;

- In any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or

- Shares the same name or a variation of the same name with a covered fund, for corporate, marketing, promotional, or other purposes.[48]

[47] Final Regulations § __.10(d)(6)(ii).
[48] Final Regulations § __.10(d)(9).

Note that a banking entity that merely acts as an investment adviser to a covered fund, even pursuant to discretionary authority, does not appear by virtue thereof to be a "sponsor" of that fund.

"Trustee"

A "trustee" does not include 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 the Employee's Retirement Income Security Act, or a trustee that is subject to fiduciary standards under foreign law that are substantially equivalent to those of such a non-discretionary trustee.[49] However, an entity that directs such a person, or that possesses authority and discretion to manage and control the investment decisions of a covered fund for which such person serves as trustee, is considered to be a trustee of such covered fund.[50]

Permitted Organizing and Offering of a Covered Fund; Underwriting and Market Making with Respect to a Covered Fund

Organizing and Offering a Covered Fund

A banking entity may retain an ownership interest in, or act as a sponsor to, a covered fund in connection with, directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee or commodity pool operator of the covered fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including bearing any necessary expenses for the foregoing, provided all of the following conditions are met:[51]

- The banking entity (or an affiliate thereof) provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services;[52]
- The covered fund is organized and offered only in connection with the banking entity providing bona fide trust, fiduciary, investment advisory, or commodity trading advisory services, and the banking entity providing those services offers the covered fund only to persons that are customers of those services of the banking entity ("customers" are not limited to pre-existing customers of the banking entity);[53]

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[49] Final Regulations § __.10(d)(10).

[50] *Id.*

[51] Final Regulations § __.11(a).

[52] Final Regulations § __.11(a)(1).

[53] Final Regulations § __.11(a)(2). The covered fund must be organized and offered pursuant to a written plan or similar documentation outlining how the banking entity (or an affiliate thereof) intends to provide advisory or similar services to its customers through organizing and offering the covered fund.

- The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as described in "Permitted Seeding and De Minimis Investments" below;[54]

- The banking entity and its affiliates comply with the requirements described in "Limitations on Relationships Between Banking Entities and Covered Funds" below;[55]

- 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 of any covered fund in which such covered fund invests;[56]

- The covered fund, for corporate, marketing, promotional, or other purposes, does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof), or use the word "bank" in its name;[57]

- No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services (such as oversight and risk management, deal origination, due diligence, administrative or other support services) to the covered fund at the time the director or employee takes the ownership interest (but note that, importantly, the term "ownership interest" excludes a "restricted profit interest");[58]

- The banking entity clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):

    - That "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate";

    - That such investor should read the fund offering documents before investing in the covered fund;

    - That the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case); and

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[54] Final Regulations § __.11(a)(3).
[55] Final Regulations § __.11(a)(4).
[56] Final Regulations § __.11(a)(5).
[57] Final Regulations § __.11(a)(6).
[58] Final Regulations § __.11(a)(7).

  - The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund;[59] and

- The banking entity complies with any additional rules of the appropriate federal banking agencies, the SEC, or the CFTC, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the covered banking entity and its affiliates.[60]

Organizing and Offering an Issuer of Asset-Backed Securities

The Final Regulations include special rules for banking entities that organize and offer covered funds which are issuers of asset-backed securities.

- A banking entity is not prohibited from acquiring or retaining an ownership interest in, or acting as a sponsor to, a covered fund that is an issuing entity of asset-backed securities in connection with, directly or indirectly, organizing and offering that issuing entity, so long as the banking entity and its affiliates comply with all of the requirements described above except for the requirements that the banking entity (or an affiliate thereof) provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services, and that the covered fund is organized and offered only in connection with the provision of such services to customers.[61]

- In addition, for these purposes, organizing and offering an issuing entity of asset-backed securities means acting as the securitizer of the issuing entity, as that term is used in section 15G(a)(3) of the Securities Exchange Act of 1934, or acquiring or retaining an ownership interest in the issuing entity in compliance with the minimum credit risk retention requirements of the Dodd-Frank Act, when they are adopted.[62]

Underwriting and Market Making in Ownership Interests of a Covered Fund

In response to comments that the statutory exemption for underwriting and market making activities should be applicable to both proprietary trading and covered fund activities, the Final Regulations include a new exemption to permit a banking entity to engage in underwriting or market making-related activities involving a covered fund, provided all of the following conditions are met:[63]

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[59] Final Regulations § __.11(a)(8)(i).
[60] Final Regulations § __.11(a)(8)(ii).
[61] Final Regulations § __.11(b)(1).
[62] Final Regulations § __.11(b)(2).
[63] Final Regulations § __.11(c).

- The banking entity conducts the activities in accordance with the underwriting or market making exemptions to the Volcker Rule's proprietary trading restrictions, as applicable;[64]
- With respect to any banking entity (or an affiliate thereof) that:
    - acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in such covered fund in reliance on the exemption for organizing and offering a covered fund (see above);
    - acquires and retains an ownership interest in such covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or is acquiring and retaining an ownership interest in such covered fund in compliance with the minimum credit risk retention requirements of the Dodd-Frank Act, when they are adopted, each as permitted by the exemption for organizing and offering an issuer of asset-backed securities (see above); or
    - directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests,

  then, in each such case, any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making-related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the per-fund limits and the capital deductions described in "Permitted Seeding and De Minimis Investments" below;[65] and
- With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under the exemption for organizing and offering a covered fund (discussed above), including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making-related activities, are included in the calculation of all ownership interests under the aggregate limits and capital deductions described in "Permitted Seeding and De Minimis Investments" below.[66]

Permitted Seeding and De Minimis Investments

A banking entity may acquire and retain an ownership interest in a covered fund that the banking entity or an affiliate thereof organizes and offers pursuant to the exemption for organizing and offering a covered fund (discussed above) for the purposes of (i) establishing the fund and

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[64] Final Regulations § __.11(c)(1). A discussion of the underwriting and market making exemptions to the Volcker Rule's proprietary trading restrictions will be provided in an upcoming Bingham Alert regarding the proprietary trading provisions of the Final Regulations.

[65] Final Regulations § __.11(c)(2).

[66] Final Regulations § __.11(c)(3).

providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a de minimis investment in the fund, subject to the conditions discussed below.[67]

Seeding Period

With respect to an investment in any covered fund made or held in connection with establishing the fund, the banking entity and its affiliates must:

- actively seek unaffiliated investors to reduce, through redemption, sale, dilution, or other methods, the aggregate amount of all ownership interests of the banking entity in the covered fund to the per-fund limit (see below and Exhibit A),[68] and
- no later than one year after the date of establishment of the fund (or up to two additional years with FRB approval), conform its ownership interest in the covered fund to the per-fund limits.[69]

The "date of establishment" for a covered fund is the date on which an investment adviser or similar party begins to make investments that execute an investment or trading strategy for the covered fund, except that the date of establishment for an issuing entity of asset-backed securities is the date on which the assets are initially transferred into the issuing entity.[70]

Per-Fund Limits

At the end of the one year period (subject to a limited extension, as discussed above) after the date of establishment of the covered fund, an investment by a banking entity and its affiliates in the covered fund may not exceed three (3) percent of the total number or value of the outstanding ownership interests of the fund.[71] These limits are described in detail in Exhibit A hereto.

Aggregate Limits

The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under this seeding and de minimis investment exemption may not exceed three (3) percent of the tier 1 capital of the banking entity, calculated as of the last day of each calendar quarter.[72] These limits are described in detail in Exhibit A hereto.

Capital Treatment

For purposes of determining compliance with applicable regulatory capital requirements, a banking entity must deduct the greater of:

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[67] Final Regulations §§ __.12(a)(1) - (2).
[68] Final Regulations § __.12(a)(2)(i)(A).
[69] Final Regulations § __.12(a)(2)(i)(B).
[70] Final Regulations § __.12(a)(2)(iv)(A).
[71] Final Regulations §§ __.12(a)(2)(ii)(A) - (B)
[72] Final Regulations § __.12(a)(2)(iii).

- The sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest), on a historical cost basis, including earnings;[73] or

- The fair market value of the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.[74]

Risk-Mitigating Hedging

A banking entity may acquire or retain an ownership interest in a covered fund that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund.[75] A banking entity may wish to engage in such hedging if, for example, it maintains a compensation program that rewards portfolio managers of a fund based on the investment performance of that fund or other accounts that utilize a similar investment strategy.

A banking entity may rely on this exemption to hedge employee compensation arrangements only if:

- The banking entity implements a compliance program, as required by the Final Regulations' compliance program provisions, that is reasonably designed to ensure the banking entity's compliance with the requirements of this risk mitigating hedging exemption, including reasonably designed written policies and procedures, and internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures;[76]

- The acquisition or retention of the ownership interest:

  - Is made in accordance with such written policies, procedures, and internal controls;[77]

  - At the inception of the hedge, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with the compensation arrangement with the

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[73] Final Regulations § __.12(d)(1).
[74] Final Regulations § __.12(d)(2).
[75] Final Regulations § __.13(a)(1).
[76] Final Regulations § __.13(a)(2)(i).
[77] Final Regulations § __.13(a)(2)(ii)(A).

employee that directly provides investment advisory, commodity trading advisory, or other services to the covered fund;[78]

- Does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with the requirements of this risk-mitigating hedging exemption;[79] and
- Is subject to continuing review, monitoring and management by the banking entity;[80] and

- The compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate has acquired an ownership interest pursuant to this risk-mitigating hedging exemption and the arrangement provides that any losses incurred by the banking entity on such ownership interest will be offset by corresponding decreases in amounts payable under such compensation arrangement.[81]

The Proposed Regulations would also have allowed a banking entity to hold an ownership interest in a covered fund if the ownership interest is acquired in connection with and related to individual or aggregated obligations of the banking entity that are taken by the banking entity when acting as intermediary on behalf of a customer which is not a banking entity to facilitate exposure by a customer to the profits and losses of the covered fund. However, the Agencies declined to provide an exemption for such activities in the Final Regulations, based on their view that such hedging is a high-risk strategy that could threaten the safety and soundness of the banking entity.[82]

Exemption for Regulated Insurance Companies

The Final Regulations include a new exemption for investment in covered funds through either the general account or a separate account of a regulated insurance company.[83] Under the exemption, a banking entity which is an insurance company, or an affiliate thereof, may acquire or retain an ownership interest in, or sponsor, a covered fund, provided:

- The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company;[84]
- The acquisition and retention of the ownership interest is conducted in accordance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled;[85] and

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[78] Final Regulations § __.13(a)(2)(ii)(B).
[79] Final Regulations § __.13(a)(2)(ii)(C).
[80] Final Regulations § __.13(a)(2)(ii)(D).
[81] Final Regulations § __.13(a)(2)(iii).
[82] *See* Preamble at 719-725.
[83] Final Regulations § __.13(c).
[84] Final Regulations § __.13(c)(1).

- The appropriate federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the states and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular insurance company investment law, regulation, or written guidance of the State or jurisdiction in which such insurance company is domiciled, is insufficient to protect the safety and soundness of the banking entity or financial stability of the United States.[86]

Covered Fund Activities and Investments Outside the United States

Foreign companies with banking operations in the United States are generally subject to the Volcker Rule.

- A "banking entity" for purposes of the Final Regulations includes foreign companies with banking operations in the United States, either because the foreign company controls an insured depository institution in the United States or the foreign company is or controls a foreign bank that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978.[87]

- This means that the Final Regulations apply to any foreign company that is or controls a foreign bank that has a branch or agency in the United States, controls a commercial lending company in the United States, controls a United States bank or bank holding company, or controls any other type of insured depository institution in the United States (*e.g.*, a savings bank or industrial bank).[88]

- The Final Regulations also apply to the subsidiaries and affiliates of such foreign companies.[89]

The Final Regulations provide an exemption that permits foreign banking entities to engage in otherwise prohibited covered fund activity outside the United States. This exemption is available only to foreign banking entities that meet the requirements of the exemption, and not to U.S. banking entities and their affiliates.[90] Foreign banking entities also may rely on any of the exemptions discussed above, provided the applicable requirements are met.

As explained above, the definition of covered fund in the Final Regulations was narrowed from the Proposed Regulations such that certain foreign funds may be covered funds only from the perspective of a U.S. banking entity (or a foreign banking entity controlled by a U.S. banking entity). A foreign banking entity will not need to rely on the exemption for foreign fund activities

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[85] Final Regulations § __.13(c)(2).
[86] Final Regulations § __.13(c)(3).
[87] Final Regulations § __.2(c).
[88] *Id.*; *see* Preamble at 725-33.
[89] Final Regulations § __.2(c)(iv).
[90] Final Regulations § __.13(b).

and investments discussed below (or any other exemption) if the foreign fund is not a covered fund from the foreign banking entity's perspective.

Exemption for Foreign Fund Activities or Investments "Solely Outside the United States"

A foreign banking entity may rely on this exemption to acquire or retain an ownership in, or to sponsor, a covered fund, only if the following conditions are met:

- The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;[91]
- The activity or investment by the banking entity is pursuant to section 4(c)(9) or 4(c)(13) of the BHC Act;[92]
- No ownership interest in the covered fund is offered for sale or sold to a resident of the United States;[93] and
- The activity or investment occurs solely outside the United States.[94]

Activity or Investment Pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act

An activity or investment by the banking entity is pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act only if:

- The activity or investment is conducted in accordance with the requirements of this foreign funds exemption;[95] and
- With respect to a banking entity that is a foreign banking organization, the banking entity meets the requirements to be a qualifying foreign banking organization ("QFBO") under the FRB's Regulation K;[96] or
- With respect to a banking entity that is not a foreign banking organization (*e.g.,* a foreign entity which is a banking entity solely because it controls a U.S. savings bank or industrial bank), the banking entity is not organized under the laws of the United States or one or more States and meets at least two of the following:
    - Total assets of the banking entity held outside the United States exceed total assets of the banking entity held in the United States;[97]

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[91] Final Regulations § __.13(b)(1)(i).
[92] Final Regulations § __.13(b)(1)(ii).
[93] Final Regulations § __.13(b)(1)(iii).
[94] Final Regulations § __.13(b)(1)(iv).
[95] Final Regulations § __.13(b)(2)(i).
[96] Final Regulations § __.13(b)(2)(ii)(C).
[97] Final Regulations § __.13(b)(2)(ii)(B)(1).

- Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States;[98] or
- Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.[99]

No Offer or Sale to a Resident of the United States

An ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of this foreign fund exemption if it is sold or has been sold pursuant to an offering that does not target residents of the United States.[100]

According to the Preamble, the Agencies expect that activities related to certain complex fund structures should be integrated in order to determine whether an ownership interest in a covered fund is offered for sale to a resident of the United States. For example, the Agencies suggest that a banking entity may not be able to rely on the foreign fund exemption to sponsor or invest in a 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 pursuant to an offering that targets U.S. residents) and that is either organized and offered or is advised by that banking entity.[101]

"Resident of the United States"

A "resident of the United States" is defined in the Final Regulations as a "U.S. person" as defined in rule 902(k) of the SEC's Regulation S.[102] However, the Agencies noted in the Preamble that it would not be permissible under the foreign fund exemption for a foreign banking entity to facilitate or participate in the formation of a U.S. investment vehicle that is itself a U.S. person for the specific purpose of investing in a foreign fund.[103]

Activity or Investment "Solely Outside the United States"

In the Final Regulations, the Agencies replaced the transaction-based approach for determining when activity or investment occurs "solely outside the United States" with a risk-based

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[98] Final Regulations § __.13(b)(2)(ii)(B)(2).
[99] Final Regulations § __.13(b)(2)(ii)(B)(3).
[100] Final Regulations § __.13(b)(3).
[101] *See* Preamble at 743-44.
[102] Final Regulations § __.10(d)(8). As proposed, the definition of resident of the United States was similar, but not identical, to the Regulation S definition, but commenters cautioned that any differences would create unnecessary uncertainty and increase compliance burdens associated with monitoring multiple definitions. *See* Preamble at 621-22.
[103] Preamble at 745.

approach.[104] An activity or investment occurs solely outside the U.S. for purposes of this foreign fund exemption only if:

- The banking entity acting as a sponsor, or engaging as principal in the acquisition or retention of the ownership interest in 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 the laws of the United States or of any State;[105]
- The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as a sponsor to the covered fund is not located in or organized under the laws of the United States or of any State;[106]
- 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 branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;[107] and
- No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.[108]

The Agencies explained that these requirements are designed to ensure that any foreign banking entity engaging in activity under the foreign fund exemption does so in a manner that ensures that the risk and sponsorship of the activity occurs and resides solely outside the United States.[109]

The Preamble states that because so-called "back office" activities do not involve sponsoring or acquiring an ownership interest in a covered fund, the Final Regulations do not impose restrictions on U.S. personnel of a foreign banking entity engaging in those activities with one or more covered funds. The Preamble also clarifies that the foreign fund exemption permits the U.S. personnel and operations of a foreign banking entity to act as investment advisor to a covered fund in certain circumstances.[110]

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[104] *See* Preamble at 735.

[105] Final Regulations § __.13(b)(4)(i). For these purposes, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, the foreign bank of which that branch, agency, or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency or subsidiary. *See* Final Regulations § __.13(b)(5).

[106] Final Regulations § __.13(b)(4)(ii).

[107] Final Regulations § __.13(b)(4)(iii).

[108] Final Regulations § __.13(b)(4)(iv).

[109] *See* Preamble at 736.

[110] *See* Preamble at 736-37.

Limitations on Relationships Between Banking Entities and Covered Funds

The Final Regulations include so-called "Super 23A" provisions that largely track the equivalent provisions from the Proposed Regulations.[111] However, by excluding certain categories of entities from the definition of covered fund (see above), the Final Regulations make the "Super 23A" inapplicable to transactions between banking entities and the excluded categories of entities.[112]

"Super 23A" Restriction

A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund pursuant to the exemption for organizing and offering a covered fund (see above), or that continues to hold an ownership interest in reliance on the exemption for organizing and offering an issuer of asset-backed securities, is prohibited from entering into a transaction with the covered fund, or with any other covered fund controlled by such covered fund, that would be a covered transaction as defined in section 23A of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were an affiliate thereof.[113]

- "Covered transactions" include, for example, loans and other extensions of credit; purchases of securities or other assets; and credit exposure from derivatives transactions, securities lending and borrowing transactions, and repurchase agreement transactions.[114]

This restriction is broader than the Section 23A restriction on covered transactions between banks and their affiliates.

- The Final Regulations prohibit covered transactions between banking entities (including their affiliates) and covered funds subject to the restriction, while Section 23A permits covered transactions between banks and their affiliates provided certain quantitative and qualitative requirements are met.[115]

- In addition, Section 23A's exemptions for certain types of covered transactions would generally not be applicable (*e.g.*, no exemptions for transactions secured by cash or government securities, or for intra-day extensions of credit).[116]

- However, the Agencies did clarify in the Preamble that the Section 23A "attribution rule" does not apply in this context.[117] As a result, the "Super" 23A restrictions do not apply to transactions with a third party other than the covered fund.

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[111] Final Regulations § __.14(a) and (b).

[112] *Id.*

[113] Final Regulations § __.14(a)(1). Section 23A of the Federal Reserve Act imposes certain qualitative and quantitative restrictions on "covered transactions" between banks and their affiliates, and requires that certain collateral be maintained for certain extensions of credit by a member bank to any of its affiliates.

[114] *See* 12 U.S.C. § 371c(b)(7).

[115] *See* Final Regulations § __.14(a)(2); 12 U.S.C. § 371c(a) and (c).

[116] *See* Preamble at 753-55; 12 U.S.C. § 371c(d).

The Final Regulations provide exceptions which allow a banking entity to:

- Acquire and retain any ownership interest in a covered fund in accordance with one of the exemptions discussed above;[118] and
- Enter into a prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or affiliate) has taken an ownership interest, if:
  - The banking entity is in compliance with the exemption for organizing and offering a covered fund (see above), as applicable;[119]
  - The banking entity's CEO (or equivalent officer) certifies in writing annually to the appropriate Agency (with a duty to update the certificate if the information in the certification materially changes) that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;[120] and
  - The FRB has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.[121]

Market Terms Requirement

A banking entity which is subject to the "Super 23A" restriction with respect to a covered fund is also subject to section 23B of the Federal Reserve Act with respect to that fund, as if such banking entity were a member bank and the covered fund were an affiliate thereof.[122] Section 23B of the Federal Reserve Act requires that covered transactions and certain other transactions between a member bank and any of its affiliates be conducted on market terms.[123]

Notwithstanding the potential exemption for prime brokerage from the "Super 23A" restriction, a prime brokerage transaction remains subject to this market terms requirement as if the counterparty were an affiliate of the banking entity.[124]

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[117] *See* Preamble at 755-56. Under the "attribution" rule, subject to certain exceptions, a transaction between a bank and an unaffiliated third party is treated for purposes of Sections 23A and 23B of the Federal Reserve Act as a transaction between the bank and its affiliate to the extent that the proceeds from the transaction are used for the benefit of, or transferred to, an affiliate. *See,* 12 U.S.C. § 371c(a)(3); 12 C.F.R. § 223.16(a).
[118] Final Regulations § __.14(a)(2)(i).
[119] Final Regulations § __.14(a)(2)(ii)(A).
[120] Final Regulations § __.14(a)(2)(ii)(B).
[121] Final Regulations § __.14(a)(2)(ii)(C).
[122] Final Regulations § __.14(b).
[123] *See* 12 U.S.C. § 371c-1.
[124] Final Regulations § __.14(c).

Other Limitations on Covered Fund Activities and Investments

Under the "back stop" provisions of the Final Regulations, no transaction, class of transactions, or activity may be deemed permissible under any of the exemptions discussed above if the transaction, class of transactions, or activity would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;[125]
- Result in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy;[126] or
- Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[127]

A material conflict exists between a banking entity and its clients, customers, or counterparties if the banking entity engages in any action that results in the banking entity's interests being materially adverse to the interests of its client, customer or counterparty, unless the banking entity has previously taken at least one of the following two actions to address the conflict:[128]

- Made a clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and such disclosure has been made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest;[129] or
- Established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.[130]

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[125] Final Regulations § __.15(a)(1).

[126] Final Regulations § __.15(a)(2). A "high-risk asset" or "high-risk trading strategy" is an asset, group of related assets or trading strategy that would, if held or engage in by a banking entity, increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Final Regulations § __.15(c).

[127] Final Regulations § __.15(a)(3).

[128] Final Regulations § __.15(b)(1).

[129] Final Regulations § __.15(b)(2)(i).

[130] Final Regulations § __.15(b)(2)(ii). A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the

Compliance Program Requirements

Banking entities that engage in proprietary trading or covered fund activity as permitted under the Volcker Rule must implement internal controls and compliance programs reasonably designed to ensure and monitor compliance with the Final Regulations, and to comply with reporting and recordkeeping requirements.[131] The internal controls and compliance program must be appropriate for the size, scope and complexity of the activities and business structure of the banking entity.[132] A banking entity must establish the required internal controls and compliance program as soon as practicable and in no event later than the end of the conformance period, which is July 21, 2015.[133]

Enhanced internal control and compliance program standards apply to a banking entity that has significant proprietary trading activities or that has 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).[134] The Proposed Regulations would have imposed the enhanced internal control and compliance program requirements on a banking entity if it had significant covered fund activities, but that threshold was replaced by the total consolidated assets threshold in the Final Regulations. One important addition to the enhanced internal control and compliance program standards in the Final Regulations is a requirement that the CEO of the banking entity attest in writing to the appropriate Agency that the banking entity has a compliance program reasonably designed to comply with the Volcker Rule and the Final Regulations.[135]

Conformance Period

By statute, a banking entity must bring its activities and investments into compliance with the Volcker Rule and the Final Regulations no later than two years after the statutory effective date, which effective date was July 21, 2012, unless extended by the FRB. Thus, absent extension, compliance would have been required by July 21, 2014. The FRB may grant up to three one-year extensions of the compliance transition period if the extension would be consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. For certain "illiquid funds," an additional extension of up to five years may be available to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.[136]

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conflict of interest may involve or result in a materially adverse effect on a client, customer or counterparty. *Id.*

[131] Final Regulations §__.20(a).

[132] *Id.*

[133] Some banking entities will be required to report and record quantitative measurements regarding certain proprietary trading activities beginning as of June 30, 2014.

[134] Final Regulations §§__.20(c)(1) and (2) and (d). A banking entity also will be subject to the enhanced compliance program requirements if the appropriate Agency notifies the banking entity that it must comply with those requirements. *See* Final Regulations §__.20(c)(3).

[135] Final Regulations, App. B, § III.

[136] The FRB issued final regulations regarding the conformance period and extended transition period authorities for the Volcker Rule on February 11, 2011 (the "Conformance Period Regulations"). As part of the

Concurrently with its adoption of the Final Regulations, the FRB issued an order (the "Order") which granted a one-year extension of the conformance period until July 21, 2015.[137] The Order explains that, during the conformance period, each banking entity will be expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of the Volcker Rule and the Final Regulations by no later than the end of the conformance period. Good faith efforts include evaluating the extent to which the banking entity is engaged in activities and investments that are covered by the Volcker Rule and the Final Regulations, as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the conformance period. Banking entities should not expand activities and make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted.[138]

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Proposed Regulations, the Agencies proposed to relocate the Conformance Period Regulations from §§ 225.180-182 of the FRB's Regulation Y to Subpart E of the Volcker Rule regulations. Although Subpart E was not included in the Final Regulations published by the Agencies, the Conformance Period Regulations remain effective as adopted by the FRB.

[137] *See* FRB, Order Approving Extension of Conformance Period, *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

[138] *See* Order, at 3.

Exhibit A

Calculation of Investment Limits

Under the Final Regulations, the per-fund limits and aggregate limits on investments made under the exemption for seeding and de minimis investments must be calculated in accordance with the following framework.

Attribution of Ownership Interests

For purposes of the per-fund and aggregate investment limits, the amount and value of a banking entity's permitted investment in a single covered fund includes any ownership interest held under the seeding and de minimis investment exemption by the banking entity, including by any affiliate of the banking entity.[139]

Registered Investment Companies, SEC-regulated Business Development Companies, and Foreign Public Funds. For these purposes, a registered investment company, SEC-regulated business development company, or a foreign public fund (as described above) will not be considered to be an affiliate of a banking entity (and therefore ownership interests of a covered fund held by the company or fund will not be attributed to the banking entity) so long as the banking entity meets two conditions:

- The banking entity does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the company or fund; and
- The banking entity provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund only in a manner that complies with other limitations under applicable regulation, order, or other authority.[140]

Attribution to Banking Entity of Investments by Covered Funds. The Final Regulations do not generally attribute to a banking entity ownership interests held by a covered fund so long as the banking entity's investment in the covered fund meets the per-fund limitation.[141] As a result, assuming adherence to the per-fund limitation, an investment in a portfolio company by a covered fund will not result in the portfolio company being deemed an affiliate of a banking entity that organizes or offers the covered fund.

Treatment of Employee and Director Investments. All director or employee investments in a covered fund will be attributed to the banking entity for purposes of the per-fund limitation and the aggregate limitation if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the

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[139] Final Regulations §__.12(b)(1).
[140] Final Regulations §__.12(b)(1)(ii).
[141] Final Regulations §__.12(b)(1)(iii).

financing is used to acquire such ownership interest in the covered fund.[142] The Preamble also explains that, as provided in the definition of "ownership interest," the Final Regulations also attribute to the banking entity "any amounts contributed by an employee or director when made in order to receive a restricted profit interest, whether or not funded or guaranteed by the banking entity."[143]

Per-Fund Limits

At the end of the one year period (subject to a limited extension, as discussed above) after the date of establishment of the covered fund (the "seeding period"), an investment by a banking entity and its affiliates in three covered fund may not exceed three percent of the total number or value of the outstanding ownership interests of the fund.[144] For purposes of these calculations:

- The aggregate number of the outstanding ownership interests held by the banking entity is the total number of ownership interests held under the seeding and de minimis investment exemption by the banking entity in a covered fund divided by the total number of ownership interests held by all entities in that covered fund, as of the last day of each calendar quarter (both measured without regard to committed funds not yet called for investment);[145]

- The aggregate value of the outstanding ownership interests held by the banking entity is:

    - The aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity, divided by the value of all investments in and capital contributions made to that covered fund by all entities, as of the last day of each calendar quarter (all measured without regard to committed funds not yet called for investment), or

    - If fair market value cannot be determined, the historical cost basis of all investments in and contributions made by the banking entity to the covered fund;[146] and

- Once a valuation methodology is chosen, the banking entity must calculate the value of its investment and the investments of all others in the covered fund in the same manner and according to the same standards.[147]

The Final Regulations clarify how to apply the per fund limits to master-feeder fund investments and fund of funds investments.

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[142] Final Regulations §__.12(b)(1)(iv).
[143] Preamble at 708.
[144] Final Regulations §__.12(a)(2)(ii)(A).
[145] Final Regulations §__.12(b)(2)(i).
[146] Final Regulations §__.12(b)(2)(ii).
[147] Final Regulations §__.12(b)(2)(iii).

- *Master-fund fund investments.* If the principal strategy of a covered fund (the "feeder fund") is to invest substantially all of its assets in another single covered fund (the "master fund"), then for the purpose of the per fund limits, the banking entity's permitted investment in such funds should be measured only by reference to the value of the master fund. The banking entity's permitted investment in the master fund includes any investment by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund.[148]

- *Fund-of-funds investments*. If a banking entity organizes and offers a covered fund pursuant to the exemption for organizing and offering a covered fund for the purpose of investing in other covered funds (a "fund of funds") and that fund of funds itself invests in another covered fund that the banking entity is permitted to own, then the banking entity's permitted investment in that other fund includes any investment by the banking entity in that other fund, as well as the banking entity's pro-rata share of any ownership interest of the fund that is held through the fund of funds. The investment of the banking entity in the fund of funds must also not represent more than three percent of the amount or value of any single covered fund.[149]

The Final Regulations provide special rules for investments in a covered fund that is an issuer of asset-backed securities ("ABS").

- The investment limit is three percent of the total fair market value of the ownership interests of the fund, but if any greater percentage is required by the final Dodd-Frank credit risk retention rules, when they become effective, then the investment limit will be the minimum credit risk retention requirement.[150]

- For securitizations that are subject to the Dodd-Frank credit risk retention rules, the calculations will be made as of the date and valuation methodology required by the final credit risk retention rules.[151]

- For securitizations completed prior to the compliance date of the credit risk retention rules (or to which those rules do not apply), the calculations shall be made as of the date of establishment of the securitization vehicle, or such earlier date on which then transferred assets have been valued for purposes of transfer to the securitization vehicle, and thereafter only on a date on which additional ABS are priced for sale to unaffiliated investors.[152]

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[148] Final Regulations §__.12(b)(4)(i).
[149] Final Regulations §__.12(b)(4)(ii).
[150] Final Regulations § __.12(a)(2)(ii).
[151] Final Regulations § __.12(a)(3)(i).
[152] Final Regulations § __.12(a)(3)(ii).

- For securitizations completed prior to the compliance date of the credit risk retention rules (or to which those rules do not apply), the aggregate value of the outstanding ownership interests in the securitization vehicle shall be the fair market value of the assets transferred to the issuing entity and any other assets held by the issuing entity at that time, determined in a manner consistent with its determination of fair market value for financial statement purposes. The valuation methodology must be the same for all ownership interests in the securitization vehicle, whether held by the banking entity or others.[153]

Aggregate Limits

The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under the seeding and de minimis investment exemption may not exceed three percent of the tier 1 capital of the banking entity, calculated as of the last day of each calendar quarter.[154]

- The aggregate value of all ownership interests held by a banking entity is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in covered funds (together with any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining a restricted profit interest, whether or not funded by the banking entity), as measured on a historical cost basis.[155]

- The tier 1 capital of the banking entity must be calculated as follows:

  - If a banking entity is required to hold tier 1 capital, the banking entity's tier 1 capital is equal to the amount of tier 1 capital of the banking entity as of the last day of the most recent calendar quarter, as reported to its primary financial regulatory agency.[156]

  - If a banking entity is not required to calculate and report tier 1 capital, but the banking entity is controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital, the banking entity's tier 1 capital is equal to the amount of tier 1 capital reported by such controlling depository institution in the manner described for entities that are required to hold tier 1 capital.[157]

  - In the case of a banking entity that is not controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital:

    - If the banking entity is a subsidiary of a bank holding company or company that is treated as a bank holding company, the banking entity's tier 1 capital is equal to

[153] Final Regulations § __.12(a)(3)(iii)-(iv).
[154] Final Regulations §__.12(a)(2)(iii).
[155] Final Regulations §__.12(c)(1).
[156] Final Regulations §__.12(c)(2)(i).
[157] Final Regulations §__.12(c)(2)(ii)(A).

the amount of tier 1 capital reported by the top-tier affiliate of such covered banking entity that calculates and reports tier 1 capital in the manner described for entities that are required to hold tier 1 capital.[158]

- If the banking entity is not a subsidiary of a bank holding company or a company that is treated as a bank holding company, the banking entity's tier 1 capital is equal to the total amount of shareholders' equity of the top-tier affiliate within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.[159]

- Except as provided below for U.S. affiliates of foreign banking entities, with respect to a banking entity that is not itself, and is not controlled directly or indirectly by, a banking entity that is located or organized under the laws of the United States or of any State, the tier 1 capital of the banking entity is the consolidated tier 1 capital of the entity as calculated under applicable home country standards.[160]

- With respect to a banking entity that is located or organized under the laws of the United States or of any State and is controlled by a foreign banking entity that is not itself, and is not controlled directly or indirectly by, a banking entity that is located or organized under the laws of the United States or of any State, the banking entity's tier 1 capital shall be as calculated based on the tier 1 capital of the U.S. banking entity.[161]

[158] Final Regulations §__.12(c)(2)(ii)(B)(1).
[159] Final Regulations §__.12(c)(2)(ii)(B)(2).
[160] Final Regulations §__.12(c)(2)(iii)(A).
[161] Final Regulations §__.12(c)(2)(iii)(B).

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