A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act

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Part of an ongoing series

The Volcker Rule Proposal: Regulators Propose Restrictions on "Covered Funds"

December 2011

"Fools ignore complexity. Pragmatists suffer it. Some can avoid it. Geniuses remove it."

— *Alan Perlis*

In October 2011, the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and Securities and Exchange Commission (SEC) (collectively "the Agencies") issued a Proposed Rule to implement the Volcker Rule provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "the Act"), which prohibits proprietary trading by banking entities and restricts those entities from sponsoring, investing in, or having certain relationships with hedge funds and private equity funds.

Following our earlier *A Closer Look* titled *The Volcker Rule Proposal: A Focus on Proprietary Trading,*[1] this *A Closer Look* describes the proposed prohibition on banking entities' sponsoring, investing in, or having certain relationships with hedge funds or private equity funds. As proposed, the prohibition would extend to "covered funds," including traditional hedge and private equity funds, as well as other funds, including certain foreign funds and commodity pools. The comment period ends on January 13, 2012, and the effective date is July 21, 2012. If adopted, these proposed restrictions will have significant impacts on banks and their affiliates. This *A Closer Look* describes the Proposed Rule and the significant definitional, interpretive, and compliance challenges they present.

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[1] http://www.pwc.com/us/en/financial-services/regulatory-services/publications/closer-look-volcker-rule-proposal.jhtml.

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Background

The proprietary trading prohibition in the Volcker Rule has received the lion's share of attention as it addresses the key goal articulated by former FRB chairman Paul Volcker in the wake of the recent financial crisis: reducing the risk of trading by banks. What complicates the prohibition is that trading as principal — the proposal's essential description of proprietary activity — occurs as part of other financial activities critical to the functioning of markets (market-making) and to the management of risk (hedging), among other activities. The ultimate challenge posed by the ban on proprietary trading is whether any rule that is based on the intent of the trader at the time a transaction is effected can work in dynamic trading environments.

The less-noted "covered funds" provisions of the Volcker Rule are intended to prohibit a banking entity from doing indirectly or even inadvertently what the proprietary trading provision prohibits it from doing directly: trading as principal in financial instruments. The legislative authors of the Volcker Rule were concerned that banks, in response to a ban on proprietary trading, would simply shift these activities to hedge or private equity funds that they would own or sponsor, in order to continue to reap the rewards of proprietary trading while being exposed to the same level of risk that the Volcker rule is intended to mitigate. In addition to closing a potential loophole, the covered funds provisions also intend to protect banks from assuming financial exposures, risks, and conflicts that may arise from having certain relationships with hedge or private equity funds.

While the legislative purposes behind the covered funds provisions may seem relatively straightforward, translating policy goals into rulemaking language is an inherently complex process. This is especially so given that the Volcker Rule implicates elements of federal banking, securities, commodities, investment management, and other laws that have their own internal logic in the form of definitions, structure, history, and enforcement.

What does the Volcker "funds" proposal actually prohibit?

The Volcker proposal prohibits a banking entity, as principal, from directly or indirectly acquiring or retaining equity, partnership, or other ownership interests in or sponsoring a covered fund, except as may be permitted under the proposal. The proposal also prohibits a banking entity from conducting certain transactions with a hedge or private equity fund that it owns, sponsors, advises, or manages.

Which institutions are subject to these prohibitions?

- **The prohibitions apply to a "banking entity."** This includes any insured depository institution (IDI); any company that controls an IDI (e.g., a bank holding company); any foreign banking organization (FBO) that has US banking operations,[2] including any parent thereof; and any affiliate or subsidiary of the preceding legal entities. These are the same institutions that are subject to the Volcker Rule proposal regarding proprietary trading, with one exception: in regard to the covered fund prohibitions, a banking entity does not include any affiliate or subsidiary of a banking entity that is a covered hedge fund or private equity fund. The Preamble notes this

[2] A foreign bank that owns a savings association or other IDI exempt from the Bank Holding Company Act definition of "bank" and that does not have a US branch or agency is not an FBO but is a banking entity.

exclusion is necessary because the definition of "affiliate" and "subsidiary" in the Bank Holding Company Act (BHC Act) is broad and could include a covered fund that a banking entity has permissibly sponsored or made an investment in because, for example, the banking entity acts as general partner or managing member of the covered fund as part of its permitted sponsorship activities.

This latter exclusion is important, as without it, a covered fund could be considered a banking entity and would not be able to invest in other funds. However, the scope of this exclusion is subject to differing interpretations. Is the exclusion limited solely to "de minimis covered funds" specifically authorized under the Volcker Rule, or does it include other covered funds permissibly held by a banking entity? Does it extend to investment vehicles controlled by a banking entity that are not covered funds?

- **Registered investment companies are not "banking entities."** While the Proposed Rule does not explicitly exclude US-registered investment companies from the definition of "banking entity," the proposal does indicate that the regulators believe that banking entities currently structure their advisory relationships with US-registered investment companies so that they are not viewed as affiliates for purposes of the BHC Act and thus are not a banking entity.

What is a covered hedge or private equity fund?

A covered fund is any issuer that would be an investment company under the Investment Company Act of 1940 ("Investment Company Act") but for the exclusion provided in Investment Company Act Section 3(c)(1) or Section 3(c)(7). These sections provide exclusions from the definition of investment company for private funds — i.e., a fund that is not making and does not presently propose to make a public offering of its securities and either (i) has outstanding securities that are beneficially owned by not more than 100 persons, or (ii) has outstanding securities that are owned exclusively by qualified purchasers. This definition would include most hedge and private equity funds that explicitly rely on one of these exclusions from the definition of an investment company (and are thus not required to register with the SEC as investment companies). As noted in the Financial Stability Oversight Council's (FSOC's) *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds ("FSOC Report"),* many hedge and private equity funds rely on Sections 3(c)(1) and 3(c)(7). However, these exclusions are also used by a "wide variety of funds and other legal entities."

If a fund relies on another exclusion from the Investment Company Act, it is not a covered fund. Therefore, certain mortgage pools (Section 3(c)(5)), certain asset-backed securities pools (Section 3(a)(7)), and bank common and collective trust funds (Section 3(c)(3)) would likely not be deemed covered funds, even if their organizing documents also made reference to Section 3(c)(1) or Section 3(c)(7).

As was noted in the FSOC Report, not all investment vehicles that share the characteristics of hedge or private equity funds rely on the exclusions contained in Sections 3(c)(1) and 3(c)(7), such as commodity pools that do not primarily hold or invest in financial instruments. The FSOC thus recommended that the Agencies use their authority to expand the definition by rule to include "similar funds."

Similar funds. The Proposed Rule thus includes as covered funds two types of "similar funds": commodity pools as defined in the Commodity Exchange Act and so-called "foreign equivalent funds." Each is described below.

- **Commodity pools.** The term "commodity pool" means any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in "commodity interests." With the enactment of Dodd-Frank, the term "commodity interests" includes swaps and certain other instruments in addition to futures, and may cover a number of fund vehicles not intended to be within the scope of Volcker.
- **Foreign equivalent funds.** Foreign equivalent funds are funds organized and offered outside the United States that would be a covered fund if organized or offered under US law or to one or more US residents.

These "similar" funds" proposals have generated a number of industry concerns. With respect to commodity pools, the definition could include any fund that makes even small investments in futures, options, swaps, and other instruments subject to the jurisdiction of the Commodity Futures Trading Commission (CFTC). In particular, it appears possible that the definition could even include public funds or exchange-traded funds. Including these types of funds in the prohibition would expand the scope of what is considered a covered fund to include significantly more funds. Contributing to uncertainty surrounding the inclusion of commodity pools as covered funds is the fact that the CFTC has not yet issued its proposed implementing rules and did not join the other Agencies in issuing the Proposed Rule. Including "foreign equivalent funds" as covered funds also raises a number of questions. Construed broadly, this would appear to prohibit a US banking entity (and any of its US or non-US subsidiaries) from investing in any non-US fund that to qualify for sales into the United States would rely on Sections 3(c)(1) or 3(c)(7). This appears to be true regardless of whether the non-US fund is, for example, a private hedge fund organized in the Cayman Islands or a highly regulated (and registered) undertaking for collective investment in transferable securities (UCITS) fund organized and sold publicly across the EU. The fact that US banking entities will be able to invest in US mutual funds but not in foreign mutual funds appears to be an unintended consequence and is sure to raise concerns of unfair competition from UCITS sponsors and others.

What is an "ownership interest" in a covered fund? What does it mean to "sponsor" a covered fund?

An "ownership interest" is defined very broadly to go beyond "equity, partnership or similar interests" as indicated in the Act. The Agencies note that they will focus on whether an interest, however structured, results in a banking entity having similar exposure as an owner to the profits and losses of a fund. In this regard, the proposal includes any "derivative" of an ownership interest, which appears intended to capture a total return swap or other derivative that mirrors the economic benefits of a traditional ownership interest. The proposal does clarify that "carried interest" is not treated as an ownership interest, subject to certain conditions.

A banking entity is a "sponsor" if it serves as general partner, managing member, trustee or commodity pool advisor or in any manner selects or controls directly or indirectly a majority of the directors, trustees, or management of a covered fund, or for marketing or other purposes shares the same name or a variant thereof. A banking entity would not be deemed a "sponsor" of a covered fund if it selects or controls, or has employees, officers, or agents who serve as, a trustee that does not have investment discretion (including a directed trustee under the Employee Retirement Income Security Act). A banking entity would be a sponsor if it "directs" such a trustee.

The Proposed Rule does not prohibit the acquisition or retention of an ownership interest (including a general partner or membership interest) in a covered fund (i) by a banking entity in good faith in a fiduciary capacity or in its capacity as a custodian, broker, or agent for an unaffiliated third party; (ii) by a "qualified plan" if the ownership interest is attributed to the banking entity solely because of interests held for the benefit of shareholders, members, or employees of a company; or (iii) by a director or employee of a banking entity who acquires the interest in a personal capacity and who is directly engaged in providing services to the covered fund, unless the banking entity, directly or indirectly, extended credit for the acquisition of such ownership interest.

Which covered fund activities or investments are permitted?

The Proposed Rule includes a number of specific exemptions. Some are based on exemptions in Dodd-Frank; others are based on the Agencies' use of authority provided by Dodd-Frank, allowing them to exempt activities that would promote the safety and soundness of a banking entity. These are referred to as permissible covered fund activities or investments, and are described below.

Exemption for organizing and offering of a covered fund

A banking entity may organize, offer, and invest in a covered fund subject to a number of requirements intended to mitigate the risks of such activities. Among these restrictions are *de minimis* limits on amounts that can be invested by a banking entity in any fund or in all such funds in the aggregate. These permitted fund activities and investments thus tend to be referred to as being made in "*de minimis* funds."

A *de minimis* fund must be organized and offered only (i) in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services; and (ii) to customers of such services. These permitted fund activities are thus viewed as part of the asset management services a banking entity provides to its customers.

The *de minimis* limits. Under the Proposed Rule, a banking entity generally could invest:

1. Less than 3% of the total amount or value of each *de minimis* covered fund's outstanding ownership interests (the "single-fund limits"); and
2. An aggregate amount in all *de minimis* covered funds at a level that is less than 3% of the banking entity's tier 1 capital (the "aggregate limit").

Single-fund limit. The single-fund limit would be the greater of (i) the value of all investments or capital contributions in a *de minimis* covered fund, divided by the value or capital contributions made by all persons in the fund; and (ii) the total number of ownership interests held by the banking entity in the *de minimis* covered fund, divided by the total number of ownership interests held by all persons in the fund.

Exemption for seed investment. The Proposed Rule provides an exemption to the single-fund limit for an initial "seeding" period that allows a banking entity to hold more than 3% of a fund's interests for the first year following the establishment of a *de minimis* covered fund. Absent an FRB-approved extension, a banking entity would need to come into compliance with the single-fund limit within one year of the fund's establishment.

Aggregate limit. The aggregate limit would be the ratio, calculated at least quarterly, of (i) the aggregate value of the banking entity's *de minimis* covered fund investments; and (ii) the banking entity's tier 1 capital. The aggregate customer fund investment amount in the numerator would be required to be calculated on an ongoing basis according to the applicable accounting standards. The tier 1 capital amount in the denominator generally would be either the tier 1 capital reported to the relevant regulator or, if not available, the shareholders' equity.

Banking entities will have to assess whether this effective limit on "skin in the game" will force them to alter the way in which they sponsor, structure, and promote de minimis covered funds and whether the market will perceive this as a significant disadvantage vis-a-vis other competing funds managed by non-banking entities. In addition, the proposed language suggests that any parallel investments by a banking entity acting in concert with a de minimis covered fund to achieve a common goal will likely be counted toward the 3% single-fund de minimis limits. However, the Proposed Rule appears to be silent on parallel investments alongside third-party covered funds.

Deduction from capital. The Proposed Rule would require a banking entity to deduct the aggregate value of its interests in *de minimis* funds from its tier 1 capital for purposes of determining compliance of the relevant entity with the applicable federal bank regulatory capital rules.

No pre-existing customer relationship is required. While there had been industry concern that a banking entity would need to have a pre-existing fiduciary or advisory relationship with an investor prior to that investor acquiring an interest in a *de minimis* covered fund, the Proposed Rule focuses instead on whether the *de minimis* covered fund is being created as part of the asset management services provided by the banking entity. *De minimis* covered funds could be offered to any third-party investor regardless of any pre-existing relationship between the banking entity and such investor. However, the *de minimis* covered funds would have to be organized and offered "pursuant to a credible plan" outlining how the banking entity intends to provide asset management services via the *de minimis* funds. There is no specific guidance on what would have to be included in such a plan.

Marketing restrictions. A *de minimis* covered fund is prohibited from using the same name as the banking entity or any affiliate or subsidiary, or any variation of those names. Thus a *de minimis* covered fund could not share the same name as an investment adviser subsidiary of a banking entity. A *de minimis* fund also cannot use the word "bank" in its name. The covered banking entity also must disclose, in writing, to any prospective investor that any losses in such covered fund will be borne solely by the investors and not by the covered banking entity and its affiliate, and that ownership interests are not FDIC-insured or guaranteed in any way by a banking entity.

Exemption for covered fund activities outside the United States

The Proposed Rule permits foreign banking entities subject to the Volcker Rule to sponsor and invest in covered funds outside the United States, subject to certain requirements. (Foreign banks with no IDI subsidiary in the United States and with no US branch, agency, or Edge Act subsidiary are not covered by the Proposed Rule.) While acknowledging the need to limit the extraterritorial impact of the Volcker Rule covered fund prohibition — a prohibition that is unique to the US market — the interpretations of the exemption in the Proposed Rule appear to be very narrow in scope and driven more by a desire to ensure competitive equity between US and foreign banks in the United States, rather than by any focus on where the foreign covered fund is located.

Foreign organized and controlled. To qualify for the exemption, the foreign banking entity must not be controlled by a US banking entity or be organized under US law.

Meet QFBO requirements. For an FBO to be eligible for the foreign trading exemption, the Proposed Rule requires that the FBO must be a qualifying foreign banking organization (QFBO) — i.e., be considered as principally conducting a banking business outside the United States — and conduct the activity in compliance with the FRB's Regulation K. A foreign banking entity that is not currently subject to the BHC Act and does not have a US branch or agency (e.g., a company that owns a US thrift) must meet requirements similar to the QFBO test.

No marketing or sales to a US resident. A condition of the exemption is that no ownership interest in the covered fund is offered for sale or sold to a resident of the United States. The eight-paragraph definition of "resident of the United States" includes a natural person resident in the United States, business entities organized under US law, any agency or branch of a foreign entity located in the United States, and other definitions relating to estates, trusts, and discretionary or non-discretionary accounts with a US nexus.

The scope of this requirement is unclear in several respects. For example, would it apply to secondary market sales into the United States? Does the banking entity have to be involved for the prohibition to apply, i.e., would sales by a third-party sponsor not be prohibited? Could a covered fund continue marketing activities into the United States until the end of the transition period in 2014, or would it need to cease engaging in any US sales activity as of the effective date in 2012?

In addition, the Proposed Rule's definition of US resident is similar to the SEC's definition of "US person" under SEC Regulation S, which governs securities offerings and sales outside of the United States that are not registered with the SEC. However, the differences that exist between these two definitions are not explained — which creates uncertainty around a number of specific exemptions from the Regulation S definition of US person that are not adopted in the US resident definition.

The Proposed Rule would appear to permit foreign banks to sell foreign covered fund interests to a foreign subsidiary of a US company, provided that the foreign subsidiary was not established for purposes of evading the restrictions and the other terms of the exemption are met. On the other hand, the Proposed Rule would appear to define US resident to include the foreign branches of US residents (thus prohibiting sale to a foreign branch of a US bank) and would also include as a US resident any US dealer or fiduciary, regardless of whether the dealer or fiduciary is acting on behalf of a foreign client.

Solely outside the United States. As a final condition, the activity must occur solely outside the United States, which includes a requirement that no subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is organized or physically located in the United States. This would appear to permit the foreign fund to use a US adviser since there would be no involvement of US personnel in the offering or sale of an ownership interest.

Extraterritorial impact. *The Proposed Rule appears to result in a covered foreign banking entity being subject to the Super 23A restrictions (discussed below) in its dealings outside the United States with covered foreign funds and funds which the foreign bank manages or advises. Unless clarified, the application of such restrictions to transactions outside the United States between foreign firms raises significant issues of extraterritorial application of US law and regulation.*

Other exemptions for permitted fund activities or investments

- **Investments in Small Business Investment Companies (SBICs).** The Proposed Rule does not prohibit a banking entity from investing in SBICs, in making public welfare investments and qualified rehabilitation expenditures.
- **Acquisition of an ownership interest in a covered fund for hedging purposes.** The Proposed Rule provides that any banking entity relying on this exemption may only hedge or otherwise mitigate one or more specific risks arising in connection with and related to two situations:
  - Risks taken by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or
  - Risks connected directly to its compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund.
- **Sale and securitization of loans.** The Proposed Rule would allow a banking entity to engage in the sale and securitization of loans by acquiring and retaining an ownership interest in a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of:
  - Loans;
  - Contractual rights or assets directly arising from those loans supporting the asset-backed securities; and
  - Interest rate or foreign exchange derivatives that (i) materially relate to the terms of such loans or contractual rights or assets and (ii) are used for hedging purposes with respect to the securitization structure.

Exemptions based on promoting and protecting the safety and soundness of a banking entity and the financial stability of the United States

- **Investments in Bank-Owned Life Insurance (BOLI) separate accounts.** Banking entities have for many years invested in life insurance policies that cover key employees, in accordance with supervisory policies established by the federal banking agencies. These BOLI investments are typically structured as investments in separate accounts that are excluded from the definition of "investment company" under the Investment Company Act by virtue of Section 3(c)(1) or 3(c)(7) of that Act, which would define them as covered funds under the Volcker Rule. The Proposed Rule permits a banking entity to acquire and retain these BOLI investments, however, as well as act as sponsor to a BOLI separate account. The proposal includes a number of conditions designed to ensure that BOLI investments are not conducted in a manner that raises the concerns that the Volcker Rule is intended to address.

- **Investments in certain corporate vehicles.** The Proposed Rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to (i) a joint venture between the banking entity and any other person, provided that the joint venture is an operating company and does not engage in any activity or any investment not permitted under the Proposed Rule; (ii) an acquisition vehicle, provided that the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates; and (iii) a wholly-owned subsidiary of the banking entity that is engaged principally in providing bona fide liquidity management services and is carried on the balance sheet of the banking entity.
- **Risk retention investment in asset-backed securities.** The Proposed Rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to an issuer of asset-backed securities, but only with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a banking entity that is a "securitizer" or "originator" in compliance with the minimum requirements of the proposed Dodd-Frank risk retention rule for asset-backed securities.[3]
- **Investments acquired DPC.** Any ownership interest in a covered fund acquired for "debts previously contracted."

No exemption provided for insurance companies affiliated with an IDI. *The Proposed Rule provides an exemption from the proprietary trading restriction for the general accounts and separate accounts of both US and non-US regulated insurance companies affiliated with an IDI. However, the Proposed Rule does not address whether insurance company general and separate accounts also would be exempt from the covered fund investment restrictions. This is an area where further clarification is needed as there was no general intent in the Volcker Rule to affect the traditional business structure of insurers.*

Permissible investments may still be restricted material conflicts of interest, high-risk strategies, and unsafe and unsound activities

Material conflict of interest. The Proposed Rule provides that no permissible investment or activity by a banking entity under the proposal may involve or result in a "material conflict of interest" between the banking entity and any of its clients, customers, or counterparties.

A banking entity can address material conflicts of interest, prior to the relevant transaction, by either (i) providing timely, effective, and meaningful disclosure that includes the opportunity for the other party to negate or substantially mitigate the conflict of interest; or (ii) establishing information barriers in the banking entity's policies and procedures. The disclosure would need to be specific to the individual, class, or type of transaction or activity, not general or generic, and would need to be provided sufficiently close to the decision to engage in the transaction but also sufficiently in advance to allow the recipient to evaluate the information.

[3] On March 30, 2011, the SEC proposed rules (jointly with other agencies) regarding risk retention by securitizers of asset-backed securities

High-risk trading and unsafe or unsound activities. The Proposed Rule also prohibits any "high-risk" trading strategy or investment by a banking entity that would significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. A banking entity is also prohibited from engaging in any activity or investment that could pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

A common industry concern is that while the exemptions provided are helpful, their scope would probably be narrow in terms of the range of funds or entities likely to be captured inadvertently by the "but for" governing definition. In this regard, the Agencies have requested comment on whether the focus should be on the characteristics of a fund rather than on whether it meets the definition — which the Agencies admit is overbroad but nonetheless is in the statute. If the Agencies were to move more toward defining characteristics of hedge and private equity funds intended to fall within the prohibition, this may result in a more tailored approach, but will have its own definitional challenges.

The carve-out approach to the covered fund definition in the Proposed Rule requires more detail and complexity, as every exception has to be defined and conditions are almost always attached. Defining certain controlling or prevailing characteristics of hedge or private equity funds theoretically requires only one set of governing standards but could become no less complex if exemptions then had to be made to cover situations where the Agencies nonetheless wanted coverage. At the very least, there appears to be a need for some process that would allow for case-by-case exemptions/determinations, given the variety of entities relying on either of the exemptions currently and the inevitable development in the future of new types of investment vehicles.

Prohibited relationships with covered funds

The Proposed Rule bans a banking entity that serves directly or indirectly as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund or that organizes and offers a *de minimis* covered fund, and any affiliate thereof, from engaging in certain transactions with such covered fund or with any covered fund controlled by such covered fund.

Section 23A covered transactions. The Proposed Rule would specifically apply this ban to all "covered transactions" (as set forth in Section 23A of the Federal Reserve Act) including, for example, loans to or investments in a covered fund. This provision is referred to commonly as "Super 23A" because it applies to all entities (rather than just banks) in a banking entity and does not recognize certain standard exemptions available under Section 23A (e.g., loans fully secured by US Treasuries).

The Proposed Rule does not appear to incorporate the "attribution rule" from Section 23A, under which any transaction by a member bank with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate. The prohibition therefore applies only to covered transactions directly involving (i) a banking entity or its affiliate, and (ii) a covered fund that it sponsors or organizes or offers or a covered fund controlled by such fund.

***De minimis* covered fund exemption.** The Proposed Rule clarifies that a banking entity may acquire or retain an ownership interest in a *de minimis* covered fund in accordance with the requirements of the Proposed Rule without violating the covered transaction prohibition.

Prime brokerage exemption. The Proposed Rule also permits a banking entity to enter into any "prime brokerage transaction" with a covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, subject to certain conditions. Thus, for example, a banking entity could loan money to an underlying third-party fund, but could not loan money to a sponsored or advised covered fund invested in the third-party fund.

The Proposed Rule defines a "prime brokerage transaction" as one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution or financing, or data, operational, and portfolio management support. This definition does not expressly include or exclude any specific type of transaction, but merely lists these examples.

To engage in a prime brokerage transaction with a covered fund, (i) a banking entity must be in compliance with the Proposed Rule's limitations on organizing and offering *de minimis* covered funds; (ii) the chief executive officer (or equivalent) of the top-tier affiliate of the banking entity must make an annual written certification 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 fund invests; and (iii) the FRB must not have determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

Section 23B. The Proposed Rule also applies Section 23B of the Federal Reserve Act to certain transactions (including prime brokerage transactions) and investments between a banking entity and a covered fund for which it serves, directly or indirectly, as the investment manager, investment adviser, or commodity trading advisor, or which it sponsors or organizes and offers, as if such banking entity were a member bank and such covered fund were an affiliate thereof. Section 23B requires transactions between a bank and its affiliates to be on market terms and conditions.

Compliance and recordkeeping requirements

The Proposed Rule imposes significant specific compliance requirements on banking entities that engage in covered fund activities. At a minimum, the Proposed Rule requires that a banking entity's compliance program include (i) internal written policies and procedures reasonably designed to document, describe, and monitor the banking entity's covered fund activities and investments; (ii) internal controls reasonably designed to monitor and identify potential areas of noncompliance; (iii) a management framework that clearly delineates responsibility and accountability for compliance; (iv) independent testing for the effectiveness of the compliance program (including by internal audit); (v) training for trading personnel and managers to effectively implement and enforce the compliance program; and (vi) creation and maintenance of records to demonstrate compliance.

Additional requirements for larger banking entities. In addition to the above requirements, a banking entity with significant covered fund activities and investments (i.e., one that has aggregate investments in covered funds equal to or greater than $1 billion or sponsors or advises covered funds with total assets equal to or greater than $1 billion) must comply with additional "enhanced compliance program" requirements set forth in Appendix C of the Proposed Rule. These requirements are summarized below.

- **Internal policies and procedures.** A banking entity must establish and enforce written policies and procedures reasonably designed to document, describe, and monitor the covered banking entity's covered fund activities or investments and the risks taken in these activities or investments. The banking entity's policies and procedures must include (i) an identification of covered funds, (ii) an identification of asset management units and organization structure, (iii) a description of sponsorship activities related to covered funds, (iv) a description of investment activities related to covered funds, and (v) remediation of violations.
- **Internal controls.** A banking entity must also establish, maintain, and enforce internal controls that are reasonably designed to ensure that the covered fund activities or investments of its asset management units are appropriate and consistent with the description of the asset management unit's mission, strategy, and risk management process contained in the banking entity's written policies and procedures. These controls should include (i) monitoring investments in a covered fund, (ii) monitoring relationships with a covered fund, and (iii) surveillance of compliance program effectiveness.
- **Recordkeeping requirements.** A banking entity must create and retain, for a period of no less than five years, records that are sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program.
- **Enterprise programs**. A banking entity may satisfy the Proposed Rule by establishing a compliance program on an enterprise-wide basis to include its affiliates and subsidiaries collectively, provided the program meets certain requirements. Establishing an enterprise-wide program is not without risk, as the Proposed Rule states that an enterprise-wide program will be subject to supervisory review and examination by the banking entity's respective regulatory agency and that such agency will have access to *all* records related to such program.

The elements of the required compliance program are well-established aspects of compliance programs in other areas of the financial services industry: written policies and procedures, controls, testing, reporting and recordkeeping. Nonetheless, maintaining a specific statutorily required compliance program will entail significant care in organization, design, and implementation, as well as cost.

Banking entities covered by the Proposed Rule should be thinking now about whether they are covered by the basic compliance program requirements, or, for larger banking entities, by the enhanced compliance program requirements. In either case, they will want to consider (i) identifying covered funds; (ii) identifying the specific asset management units where they reside; (iii) identifying all investment activities related to those funds; (iv) identifying a process for monitoring covered funds, particularly to assure that the de minimis and seeding requirements are monitored; and (v) identifying a process to assure that new investments or relationships are reviewed and approved to assure they do not trigger prohibitions.

Banking entities will want to have an organized process for the development and creation of written policies and procedures, and to assure that sufficient expertise, resources, and care are dedicated to the process from the outset. In addition, banking entities will need to have a formal process for oversight and testing compliance, reporting any violations or weaknesses, and taking action to address violations.

The Agencies are likely to subject these compliance programs to specific and detailed oversight. Agencies have provided guidance in other contexts regarding compliance programs, and this guidance may be useful in creating new compliance programs as called for under the Proposed Rule.

What to do now: Assessing impact

Banking entities covered by the Volcker Rule that own, sponsor, or have relationships with funds that may be subject to the prohibition must develop an appropriate due diligence approach for identifying and categorizing what is clearly a covered fund (red light), what may be covered or not based on ambiguities or an absence of clarity or guidance (amber light), and what is exempt (green light).

For those funds or fund relationships that merit a red light, a banking entity needs to assess whether and how such investments or relationships could be made to conform with the Proposed Rule by the transition date of July 21, 2014, or sooner, given the Agencies' preference that nonconforming activities/investments be brought into line soon after the statutory effective date of July 21, 2012. This analysis may cause a number of issues to surface that would be an appropriate subject for comment to the Agencies before the comment period ends on January 13, 2012. For example, a banking entity may determine that given the nature of its covered fund investments, it will need the full transition period plus additional permitted extensions.

With respect to the covered funds provisions, there will be many "flashing amber lights" representing those situations where the scope of what is a covered fund seems unduly broad (e.g., commodity pools and foreign equivalent funds) or possibly unintended (requiring foreign banks with US banking operations to adhere to Super 23A restrictions in dealing with foreign funds). A number of other such instances are noted above. In such a case, a banking entity will need to analyze funds or relationships that might be covered (perhaps unintentionally), the impact of such coverage, options available to avoid or conform to the rule, and arguments that can be made to limit the Proposed Rule's impact.

While there are a number of exemptions (green lights) provided from treatment as a covered fund or from treatment as a prohibited relationship, the compliance requirements and expectations associated with such exemptions might pose difficulties that need to be addressed in regulatory comments, as well as in beginning to develop compliance strategies. See discussion above of compliance and recordkeeping requirements.

Additional information

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