

COVERED FUNDS ASPECTS OF THE VOLCKER RULE

FREQUENTLY ASKED QUESTIONS

The Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (the “SEC”) issued a final rule, and the Commodity Futures Trading Commission (the “CFTC” and, collectively with the other regulatory agencies described herein, the “Agencies”) issued a parallel final rule (collectively, the “Final Rule”) on December 10, 2013, to implement the restrictions contained in Section 619 of the Dodd-Frank Act, commonly known as the “Volcker rule.” The Volcker rule generally prohibits banking entities from engaging in proprietary trading and from sponsoring and/or investing in certain types of private funds (e.g., covered funds).

In this summary, we provide answers to many frequently asked questions related to the covered funds aspects of the Volcker rule based upon the statutory language, the Final Rule, the regulatory history and the explanatory preamble that accompanied the issuance of the Final Rule (the “Preamble”). We plan to release in the near future a companion summary that will address the proprietary trading aspects of the Volcker rule.

Types of Organizations Subject to the Covered Funds Aspects of the Volcker Rule

1: What is a “banking entity” subject to the Volcker rule?

Section 13(h)(1) of the Bank Holding Company Act of 1956, as amended (the “BHC Act”) and Section __.2(c) of the Final Rule generally define a “banking entity” as:

- Any insured depository institution;
- Any company that controls an insured depository institution;
- Any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, as amended (the “International Banking Act”); and
- Any affiliate or subsidiary of the foregoing banking entities.¹

In general, the definition of “banking entity” covers most types of deposit taking institutions (including state banks, national banks, state and federally chartered savings associations, industrial banks, and credit card banks), bank holding companies, savings and loan holding companies, and companies that control limited purpose insured depository institutions such as credit card banks and industrial banks. The definition also includes foreign banks with a branch or agency office in the United States as well as any company that controls such a foreign bank. Credit unions and most limited purpose trust companies are not treated as insured depository institutions for purposes of the Volcker rule and, therefore, are not banking entities subject to the Volcker rule (unless they are within the definition for other reasons, such as being an affiliate of a banking entity).

As noted, the definition of “banking entity” also includes affiliates and subsidiaries of any of the types of entities described in the definition, which means that holding companies of banking entities and their non-bank subsidiaries and affiliates would fall within the definition of banking entity subject to the Volcker rule. However, the Final Rule contains an important exclusion from the definition of “banking entity” for any covered fund, any portfolio company held by a financial holding company in reliance upon the merchant banking authority in Section 4(k)(4)(H) or Section 4(k)(4)(I) of the BHC Act, or any portfolio concern that is controlled by a small business investment company (an “SBIC”), provided the covered fund, portfolio company or portfolio concern is not itself a banking entity by reason of being an insured depository institution, a company that controls an insured depository institution or a company treated as a bank holding company under Section 8 of the International Banking Act.² With respect to covered funds, this exclusion is significant because it permits a covered fund controlled by a banking entity in accordance with the Final Rule to invest in other covered funds, although fund-of-funds structures may require further consideration in the case of certain non-U.S. funds.

2: Does the Volcker rule apply to nonbank companies that are designated by the Financial Stability Oversight Council under Section 113 of the Dodd-Frank Act as being subject to prudential supervision by the Federal Reserve Board (“Non-bank SIFIs”)?

The Volcker rule does not prohibit Non-bank SIFIs from engaging in proprietary trading or sponsoring or investing in covered funds. However, it does require the Agencies to adopt rules imposing additional capital requirements and quantitative limitations on Non-bank SIFIs engaged in certain proprietary trading or covered funds activities subject to the Volcker rule.³ The Final Rule does not impose any additional restrictions applicable specifically to non-bank financial companies, but the Agencies noted that they are reviewing whether any such additional restrictions are necessary.

Types of Funds Subject to the Volcker Rule

3: What types of private funds are subject to the Volcker rule?

With limited exceptions, the Volcker rule prohibits a banking entity from sponsoring and/or acquiring or retaining an ownership interest in any “private equity fund” or “hedge fund.” Under Section 13(h)(2) of the BHC Act, the terms “hedge fund” and “private equity fund” mean any issuer that would be an investment company, as defined in the Investment Company Act of 1940, as amended (the “Investment Company Act”), but for Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, or such similar funds as the Agencies may determine by rule.⁴ The Final Rule refers to these types of funds as “covered funds.”

Section 3(c)(1) and Section 3(c)(7) are two of the Investment Company Act provisions most commonly relied upon by a variety of private funds. These provisions provide an exception from the definition of investment company in the Investment Company Act if the fund is not making or proposing to make a public offering and, in the case of Section 3(c)(1), has not more than 100 beneficial owners or, in the case of Section 3(c)(7), is limited to qualified purchasers under the Investment Company Act and certain other permitted investors.

In addition to these types of funds, the Final Rule also includes certain additional funds within the definition of covered fund, as follows:

- **Certain Commodity Pools.** The Final Rule provides that a commodity pool will be treated as a covered fund if it falls within the definition of “commodity pool” in Section 1a(10) of the Commodity Exchange Act and the commodity pool operator (the “CPO”) of such commodity pool is registered with the CFTC as a CPO and *either* (y) has claimed an exemption under 17 C.F.R. § 4.7, *or* (z) substantially all participation units of the commodity pool are owned by qualified eligible persons under 17 C.F.R. § 4.7(a)(2) and § 4.7(a)(3), and participation units of the commodity pool have not been publicly offered to persons who are not qualified eligible persons under 17 C.F.R. § 4.7(a)(2) and § 4.7(a)(3).⁵ 17 C.F.R. § 4.7 provides registered CPOs and commodity trading advisors relief from certain of the CFTC’s reporting, recordkeeping and disclosure requirements otherwise applicable to registered CPOs. To qualify for the Rule 4.7 relief, the commodity pool must be offered and sold only to “qualified eligible persons” as defined in Rule 4.7, among other conditions. The term “qualified eligible persons,” as defined in Rule 4.7, includes certain regulated entities and certain institutional and high net worth persons and entities. Importantly, unlike the proposed Volcker Rule implementing regulation,⁶ the definition of covered fund does not automatically include all commodity pools. As a result, if the operator of a commodity pool is excluded from the definition of CPO or is exempted from registering as a CPO, such commodity pool will not be treated as a covered fund solely because it may fall within the definition of commodity pool.
- **Non-U.S. Funds.** Unlike the Proposed Rule, the Final Rule only includes certain non-U.S. funds within the definition of covered fund. Specifically, with respect to any banking entity that is, or is controlled directly or indirectly by a banking entity located in or organized under the laws of the United States or of any state, the term “covered fund” includes an entity that:
 - (i) is organized or established outside of the United States and the ownership interests of which are offered and sold solely outside of the United States;
 - (ii) is, or holds itself out as being, an entity or arrangement that raises money from investors primarily to invest in securities for resale or other disposition or otherwise trading in securities; and
 - (iii) 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).⁷

For purposes of this aspect of the Final Rule, a U.S. branch, agency or subsidiary of a foreign banking organization is located in the United States, but a foreign bank is not considered to be located in the United States merely because it controls a branch, agency or subsidiary in the United States.⁸ In addition, a foreign fund will not be treated as a covered fund under this provision of the Final Rule if the issuer could rely on an exclusion or exemption from the definition of “investment company” under the Investment Company Act other than the exclusions contained in Section 3(c)(1) or Section 3(c)(7).⁹ The effect of these provisions is to substantially narrow the definition of covered fund as it purports to apply to non-U.S. funds so that it focuses on funds for which a U.S. banking entity is the sponsor or in which a U.S. banking entity has invested. As a result, with respect to a foreign banking organization, a non-U.S. fund that is offered or sold to U.S. investors in reliance upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act would be treated as a covered fund unless it meets the requirements for an exception or exclusion from that definition,¹⁰ but other types of non-U.S. funds may not be treated as covered funds. In the Preamble, the Agencies pointed out that a foreign fund may be treated as a covered fund with respect to a U.S.

banking entity that sponsors the fund but may not be a covered fund with respect to a foreign bank that invests in the fund outside of the United States.¹¹

4: What types of private funds are not covered funds?

The Final Rule provides 13 specific exclusions from the definition of covered fund, as well as a catch all provision that allows the Agencies to exclude additional funds in the future. Notably, because these excluded entities are not treated as covered funds, banking entities will not only be able to sponsor and invest in these excluded entities but their dealings with these entities will not become subject to the “Super 23A” affiliate transaction restrictions contained in the Volcker rule (See Question 27 for more detail on the Super 23A requirement). The types of funds excluded from the definition of covered fund include the following:

- **Foreign Public Funds.** The Final Rule provides an exclusion for non-U.S. funds that are the equivalent of mutual funds in the United States.¹² Specifically, this exclusion applies to an issuer that:
 - (i) is organized or established outside of the United States;
 - (ii) is authorized to offer and sell ownership interests to retail investors in its home jurisdiction; and
 - (iii) sells ownership interests predominantly through one or more public offerings outside of the United States. However, a U.S. banking entity may not rely on this exclusion to sponsor a foreign public fund unless ownership interests in the fund are sold predominantly to unaffiliated third parties.
- **Wholly-Owned Subsidiaries.** The Final Rule does not treat an entity that is directly or indirectly wholly-owned by a banking entity as a covered fund.¹³ An entity will qualify for this exclusion even if up to 5% of its ownership interests are held by employees or directors of a banking entity or its affiliate. Further, up to half a percent of ownership interests may be held by third parties for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns, but any amounts held by third parties will reduce the amount that may be held by employees or directors.
- **Joint Ventures.** The Final Rule carves out certain joint ventures from the definition of covered fund.¹⁴ To fall within this carveout, a joint venture between a banking entity and one or more third parties:
 - (i) must consist of no more than 10 unaffiliated co-venturers;
 - (ii) must be in the business of engaging in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and
 - (iii) must not be, or hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

In the Preamble, the Agencies stated that a banking entity may not use a joint venture to engage in merchant banking activities.¹⁵

- **Acquisition Vehicles.** The Final Rule excludes certain acquisition vehicles from the definition of covered fund.¹⁶ This exclusion applies to an issuer formed solely for the purpose of engaging in a bona fide merger or acquisition transaction that exists only for as long as necessary to effectuate the transaction.
- **Foreign Pension or Retirement Funds.** A foreign pension and retirement fund is not treated as a covered fund if it is:
 - (i) organized and administered outside the United States;
 - (ii) a broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and
 - (iii) established for the benefit of citizens or residents of one or more foreign sovereigns or any political subdivision thereof.¹⁷

As described in the response to Question 16, the Final Rule includes a related provision that also permits a banking entity to acquire or retain an interest in a covered fund through an employee benefit plan in certain circumstances.

- **Insurance Company Separate Accounts.** An insurance company separate account is carved out from the definition of covered fund, provided that no banking entity other than the insurance company participates in the account's profits and losses.¹⁸
- **Bank Owned Life Insurance.** The Final Rule provides an exception from the definition of covered fund for a separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which the banking entity or entities is beneficiary, provided that no banking entity that purchases the policy: (i) controls the investment decisions regarding the underlying assets or holdings of the separate account; or (ii) participates in the profits and losses of the separate account other than in compliance with applicable supervisory guidance regarding bank owned life insurance.¹⁹ The Final Rule does not provide a specific exclusion for bank owned life insurance that is not issued through a separate account because this type of arrangement should not involve issuing interests in a covered fund.
- **Loan Securitizations.** The Final Rule provides an exception from the definition of covered fund for certain issuers of asset backed securities.²⁰ To qualify for this exception, the issuing entity may only hold:
 - (i) loans;
 - (ii) rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans;
 - (iii) certain interest rate or foreign exchange derivatives; and

(iv) special units of beneficial interest and collateral certificates.

In general, an issuing entity may not hold securities, including an asset-backed security or an interest in an equity or debt security, derivatives other than permitted interest rate or foreign exchange derivatives, or commodity forward contracts. An issuing entity may hold securities if those securities are cash equivalents designed to assure the servicing or timely distribution of proceeds to holders or securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities. However, an issuing entity would not appear to be able to hold any bonds. The definition of “loan” for purposes of the Final Rule *excludes* loans that are securities (as defined in Section 3(a)(10) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) or derivatives, and the Agencies cautioned that merely characterizing a financial instrument as a “loan” is “not dispositive” and that the determination of whether the instrument is a loan, security, or derivative is based on the relevant statutes.²¹ For purposes of the loan securitization exclusion, the securitization vehicle must own the loan directly, and synthetic exposure through a derivative such as a credit default swap will not satisfy the requirements for this exclusion.²² With respect to derivatives, an issuing entity must limit its holdings of derivatives to interest rate or foreign exchange derivatives that (i) directly relate to the loans, the asset-backed securities, or the permitted contractual rights of other assets held by the issuer, and (ii) reduce the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities, or such contractual rights or other assets.²³ The assets or holdings of an issuing entity may also include collateral certificates and special units of beneficial interest issued by a special purpose vehicle in certain circumstances. The Agencies explained that they added this provision to accommodate the use of special titling trusts and master trust structures but that it is not intended to allow resecuritization transactions to qualify under the securitization exclusion.²⁴ Because securitization vehicles such as issuers of collateralized loan obligations and collateralized deposit obligations may hold debt securities that do not qualify as loans or may have synthetic exposure, these types of obligations may not qualify as excluded securitizations for purposes of the Final Rule. Going forward, asset backed securities marketed as investments to banking entities will need to be structured to comply with these provisions, and existing investments should be reviewed for compliance with these requirements.

- ***Qualifying Asset-Backed Commercial Paper Conduits.*** An issuing entity for asset backed commercial paper (“ABCP”) is not treated as covered fund if:
 - (i) the ABCP conduit holds only loans and assets permissible for an excluded issuer of asset-backed securities (see above) and asset-backed securities supported solely by assets that are permissible for an excluded issuer of asset-backed securities and acquired by the ABCP conduit as part of an initial issuance either directly from the issuing entity of the asset-backed securities or directly from an underwriter in the distribution of the asset-backed securities;
 - (ii) the ABCP conduit issues only asset-backed securities, comprised of a residual interest and securities with a legal maturity of 397 days or less; and
 - (iii) a regulated liquidity provider has entered into a legally binding commitment to provide full and unconditional liquidity coverage with respect to all of the outstanding asset-backed securities issued by the ABCP conduit (other than any residual interest) in the event that funds are required to redeem maturing asset-backed securities.²⁵

For purposes of this exclusion, regulated liquidity providers are insured depository institutions, bank holding companies and their subsidiaries, savings and loan holding companies whose activities consist entirely or substantially of activities permissible under Section 4(k) of the BHC Act and their subsidiaries, foreign banks subject to capital standards consistent with the Capital Accord for the Basel Committee on Banking Supervision, and the United States or a foreign sovereign.

- **Qualifying Covered Bonds.** The Final Rule provides an exception from the definition of covered fund for an entity owning or holding a dynamic or fixed pool of loans or other assets of the type that may be held by an excluded issuer of asset backed securities (see description above) for the benefit of the holders of covered bonds (a “covered bond collateral pool”).²⁶ For purposes of this exception, a covered bond means:
 - (i) a debt obligation issued by a foreign banking organization, the payment obligations of which are fully and unconditionally guaranteed by a covered bond collateral pool; or
 - (ii) a debt obligation of a covered bond collateral pool, provided that the payment obligations are fully and unconditionally guaranteed by a foreign banking organization and the covered bond pool is wholly-owned subsidiary by such foreign banking organization (except to the extent that employees and certain third parties may hold ownership interests in an excluded wholly-owned subsidiary as described above).

The Agencies recognize that this provision may not exclude all foreign covered bond programs.²⁷

- **Small Business Investment Companies and Public Welfare Investment Funds.** The Final Rule does not classify SBICs or funds that are designed primarily to promote the public welfare as covered funds.²⁸ Specifically, the exclusion applies to an SBIC, as defined in Section 103(3) of the Small Business Investment Act of 1958. SBICs typically do not qualify for a license under the Small Business Investment Act until they have completed their organization and obtained funded capital from outside investors, but the SBIC exclusion addresses this issue by excluding entities that have received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company, provided the notice has not been revoked. With respect to entities that make public welfare investments, an entity will qualify for an exclusion if its business is to make investments that are designed primarily to promote the public welfare, of the type permitted under 12 U.S.C. § 24(Eleventh), or qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar state historic tax credit program. Generally, public welfare investments are meant to benefit low- and moderate-income communities or individuals such as providing housing, services, or jobs.
- **Registered Investment Companies and Non-3(c)(1)/3(c)(7) Excluded Entities.** The Final Rule clarifies that registered investment companies, issuers that have elected to be regulated as business development companies (“BDCs”), and issuers 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 Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act (such as certain real estate funds, bank common trust funds and bank collective investment funds for pension assets) will not be treated as covered funds.²⁹ The exclusion for registered investment companies also applies to any entity that is formed and operated pursuant to a written plan to become a registered investment

company, and the exclusion for BDCs likewise applies to an entity that is formed and operated pursuant to a written plan to become a BDC. In the Preamble, the Agencies explained that this provision would permit a banking entity to provide seed capital to an investment company or BDC and to rely upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act to avoid investment company status during the seeding period.³⁰

- ***Other Issuers Excluded by Joint Determination of the Agencies.*** The Final Rule contains a provision that contemplates that the Agencies may jointly determine that any other type of entity may be excluded from the definition of covered fund to the extent consistent with the purposes of section 13 of the BHC Act.³¹

5: What types of entities are *not* specifically excluded from the definition of “covered fund”?

The Agencies considered excluding a number of other entities from the definition of “covered fund,” largely in response to public comments, but declined to do so for various reasons. In some cases, this was because the type of entity does not fall within the definition of “covered fund” (and therefore does not need to be excluded) or because it could potentially rely upon another exclusion or exemption. Therefore, the mere fact that the Agencies did not establish a specific exclusion does not necessarily mean that the entity in question is a covered fund or that a banking entity may not sponsor or invest in the entity in accordance with the Final Rule. Some entities that were not specifically excluded from the definition of “covered fund” include:

- ***Financial Market Utilities.*** Financial market utilities, which perform functions such as clearing and settlement between financial institutions, are not considered by the Agencies to be the type of investment vehicles that would generally be considered covered funds. The Agencies declined to create an exclusion from the covered fund definition for financial market utilities because the Agencies believe that financial market utilities do not generally rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. For example, the Agencies note that Section 3(b)(1) of the Investment Company Act excludes from the definition of “investment company” an entity that is primarily engaged in a business other than that of an investment company, and suggest that financial market utilities could generally rely on that exclusion. Because entities relying on an exclusion from the Investment Company Act other than Section 3(c)(1) or Section 3(c)(7) are not covered funds, the Agencies did not specifically exclude financial market utilities from the definition of “covered fund.”
- ***Cash Collateral Pools.*** Cash collateral pools are collective accounts holding cash collateral provided by borrowers in securities lending programs. Because they may rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, some commentators were concerned that they would be considered covered funds. The Agencies declined to specifically exclude cash collateral pools from the covered funds definition, noting that banks could choose to register cash collateral pools as investment companies or operate them as separate accounts, thereby excluding them from the covered fund definition. Alternatively, the Agencies suggest that a cash collateral pool could be a covered fund that is organized and offered under § __.11 of the Final Rule, which permits certain covered fund activities. However, organizing a fund in reliance upon this exemption would trigger the applicability of the “Super 23A” affiliate transaction limitations (See Question 27).

- **Pass-Through REITs.** Although some real estate investment trusts (“REITs”) sell securities in reliance on Section 3(c)(5) or Section 3(c)(6) of the Investment Company Act—which means they are not covered funds—some REITs may use a passive, pass-through statutory trust to issue REIT preferred securities to the public. These pass-through REITs may not be eligible for the exclusions contained in Section 3(c)(5) or Section 3(c)(6), so they often rely on Section 3(c)(1) or Section 3(c)(7), thereby subjecting them to the “covered fund” definition. The Agencies chose not to offer a separate exclusion for pass-through REITs because they were concerned that such an exclusion could be used to evade other parts of the Final Rule. The Agencies also noted that banking entities may issue REIT preferred securities in other ways that would allow them to avoid being covered funds but that existing pass-through REIT structures may need to be unwound or restructured prior to the end of the conformance period.³²
- **Municipal Securities Tender Option Bond Transactions.** The Agencies received a number of requests to exclude municipal securities tender option bond vehicles from the “covered fund” definition. The Agencies determined not to do so, however, in part because the Agencies excluded entities that (among other things) fall within a provision of the Volcker Rule that relates to the sale and securitization of loans; because the underlying assets of tender option bond vehicles are municipal securities and not loans, the Agencies did not believe an exclusion was warranted. In addition, the Agencies noted that they “do not believe that the resecuritization of municipal debt instruments should be treated differently than the resecuritization of other debt instruments.”³³ Money market mutual funds often invest in short term, floating rate securities issued through tender option bond structures for which a banking entity often serves as trustee and may also provide backup liquidity in the form of a standby purchase agreement as well as act as remarketing agent. Without an express exclusion from the definition of covered fund for issuers of tender option bonds, banking organizations involved in providing services that relate to tender option bond structures will need to evaluate whether those services are permitted under the Final Rule.
- **Venture Capital Funds.** Some commenters requested an exclusion for venture capital funds, which sometimes rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act and, according to commenters, do not generally possess high leverage or engage in the risky trading activities that conventional hedge funds and private equity funds engage in. The Agencies declined to exclude venture capital funds, however, in part because the statutory language suggests that Congress did not want venture capital funds to be excluded. The Agencies note that “Congress explicitly recognized and treated venture capital funds as a subset of private equity funds in various parts of the Dodd-Frank Act” but treated venture capital funds differently from private equity funds in certain respects, indicating that “Congress knew how to distinguish venture capital funds from other types of private equity funds when it desired to do so.”³⁴ Therefore, the Agencies did not believe that they had the statutory authority to exclude venture capital funds.
- **Credit Funds.** Some commentators requested an exclusion for “credit funds,” which are entities generally formed as partnerships with third-party capital that invest in loans, make loans, or otherwise extend certain credit to banks. The Agencies refused to provide such an exclusion, however, because they were “unable effectively to distinguish credit funds from other types of private equity funds or hedge funds in a manner that would give effect to the language and purpose of” the statute “and not raise concerns about banking entities being able to evade” the statutory requirements.³⁵ The Agencies

suggested some credit funds may be joint ventures or qualify as loan securitizations,³⁶ but these limited exceptions are not likely to benefit most credit funds.

- **Employee Securities Companies.** Several commenters requested an exclusion from the “covered fund” definition for employee securities companies, which are investment companies or similar issuers whose outstanding securities are generally all held by employees and certain related persons, such as certain non-qualified benefit plans. The Agencies declined to provide the exclusion because employee securities companies may either use another exclusion from the “covered fund” definition or may seek an exemption available under Section 6(b) of the Investment Company Act. The Agencies were not moved by comments that conceded that employee securities companies may rely on Section 6(b), which would remove them from the “covered fund” definition, but often choose to rely instead on Section 3(c)(1) or Section 3(c)(7) because Section 6(b) requires an application to the SEC.

6: Is a fund that uses swaps or other derivatives treated as a covered fund?

It depends. As described above in the response to Question 3, the definition of “covered fund” in the Final Rule includes any commodity pool whose operator is registered as a CPO and has claimed an exemption under CFTC Rule 4.7, which permits a registered CPO meeting certain criteria to claim relief from certain disclosure, periodic reporting, annual reporting, and recordkeeping obligations otherwise applicable to registered CPOs. The Final Rule’s “covered fund” definition also includes any commodity pool that is not publicly offered to persons who are not qualified eligible persons, whose operator is registered as a CPO and with respect to which “substantially all participation units” of that commodity pool are owned by qualified eligible persons. “Qualified eligible person” is a technical term that generally refers to certain regulated entities and institutional investors and individuals, including several categories of CFTC registrants, certain other registered or regulated entities (such as investment advisers, banks, and insurance companies), certain business entities with total assets in excess of \$5 million, and certain individuals such as “knowledgeable employees” and accredited investors, in each case meeting certain criteria.

7: If a fund could rely on Section 3(c)(1) or Section 3(c)(7) to avoid being treated as an investment company but may also avoid investment company status for another reason, is it a covered fund?

No. If a fund could rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act but also meets the requirements for another exclusion or exemption from investment company status and relies upon that alternative exemption or exception, then it would not be treated as a covered fund.³⁷ For example, a real estate fund that was offered only to qualified purchasers under Section 3(c)(7) but also manages its portfolio to comply with Section 3(c)(5) and Section 3(c)(6) would not be a covered fund.

Issues Related to Sponsorship of a Covered Fund

8: What constitutes sponsorship of a covered fund?

Under the Final Rule, a banking entity will be regarded as having sponsored a covered fund if the banking entity:

- Serves as a general partner, managing member, or trustee of the covered fund, or serves as a commodity pool operator with respect to a commodity pool that is included within the definition of covered fund (see Questions 3 and 6);
- 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 the covered fund; or
- Shares with the covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.³⁸

The definition of sponsorship in the Final Rule is substantively the same as the proposed definition and closely tracks the definition of “sponsor” in Section 13(h)(5) of the BHC Act.³⁹

9: If a banking entity serves as directed trustee, has it sponsored a fund?

In many cases, no. For purposes of determining whether a banking entity has sponsored a fund, the definition of “trustee” specifically *excludes* a trustee that does not exercise investment discretion with respect to a covered fund (including (i) 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 Retirement Income Security Act or (ii) a trustee that is subject to substantially similar fiduciary standards imposed under foreign law).⁴⁰ However, a banking entity that directs a trustee or that possesses authority and discretion to manage and control the investment decisions of a covered fund for which the banking entity serves as trustee, will be considered a trustee of the covered fund. In the Preamble, the Agencies clarified that a trustee that is authorized to replace an investment adviser with an unaffiliated party when the investment adviser resigns would not be treated as a trustee for purposes of the Final Rule provided the trustee does not have investment discretion.⁴¹

10: Can a banking entity initially select the directors, general partner or trustee of a covered fund without having sponsored it?

No. If a banking entity selects the initial directors, general partner, trustees or management of a fund, then the banking entity will be regarded as having sponsored the fund. In the Preamble, the Agencies explained that “selection of the directors, trustees or management of a fund is an action characteristic of a sponsor and is essential to the creation of a covered fund.”⁴² However, they went on to explain that “that the statute and the final rule allow banking entities to sponsor covered funds, including selecting the initial board of directors, trustees and management, so long as the banking entity observes certain requirements and conforms any initial investment in the covered fund to the limits in the statute and regulation during the relevant conformance period.”⁴³ Importantly, the Agencies also stated that “a banking entity that does not continue to select or control a majority of the board of directors would not be considered to be a sponsor

under this part of the definition once that role or control terminates”⁴⁴ and that “[i]n the case of a covered fund that will have a self-perpetuating board of directors or a board selected by the fund’s shareholders, this would not be considered to have occurred until the board has held its first re-selection of directors or first shareholder vote on directors without selection or control by the banking entity.”⁴⁵ This may provide flexibility for existing funds, among others.

11: What happens if an employee of a banking entity serves as general partner of a limited partnership or as managing member of a limited liability company that holds investments for his or her family members?

As noted in the response to Question 8, a banking entity may be regarded as having “sponsored” a covered fund, among other circumstances, if the banking entity in any manner controls, *or has employees, officers, directors, or agents who constitute*, a majority of the directors, trustees or management of a covered fund. If an employee of a banking entity serves as general partner of a partnership or as managing member of a limited liability company that, for example, holds personal or family investments, there appears to be a reasonable basis to conclude that the banking entity would not be regarded as having sponsored those funds, provided that the employee is not acting within the scope of his or her employment.

Issues Related to Ownership Interests

12: What is an “ownership interest”?

As defined in the Final Rule, an “ownership interest” is any equity, partnership or “other similar interest” in a covered fund.⁴⁶ An “other similar interest” refers to an interest that has any of the following characteristics:

- 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);
- The right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;
- The right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);
- The right to receive all or a portion of excess spread (*i.e.*, 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 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
- Provides a synthetic right to have, receive, or be allocated any of the rights or characteristics described above.

As explained below in the response to Question 14, carried interest that meets certain requirements is not treated as an ownership interest.

13: Are debt securities issued by a covered fund treated as ownership interests?

Yes, in some circumstances. In the Preamble, the Agencies explained that “to the extent that a debt security or other interest in a covered fund exhibits specified characteristics that are similar to those of equity or other ownership interests (e.g., provides the holder with the ability to participate in the election or removal of a party with investment discretion, the right or ability to share in the covered fund’s profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund’s underlying holdings or investments), the instrument would be an ownership interest under the final rule.”⁴⁷ As a result, debt instruments issued by a covered fund that pay a return based on the fund’s underlying performance, allow the debt-holder to participate in the selection of a new investment manager, or have other equity-like characteristics described in the Final Rule would be considered ownership interests. The Agencies declined to create a specific definition of ownership interest for securitization structures.⁴⁸ A traditional bank loan made to a fund with a fixed or floating interest rate determined independently from the fund’s performance should not be treated as an ownership interest, provided the loan does not otherwise have characteristics of equity.

14: How is carried interest treated for purposes of the Volcker rule?

The definition of “ownership interest” in the Final Rule specifically excludes “restricted profit interest” held by a banking entity (or an employee or former employee thereof) in a covered fund for which the banking entity (or employee thereof) serves as investment manager, investment adviser or commodity trading adviser, or other service provider, so long as the interest meets certain requirements.⁴⁹ To be excluded, the restricted profit interest must meet the following requirements:

- 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;

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- 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 certain quantitative limitations established by the Volcker rule and the Final Rule, generally determined by reference to historical cost (See Question 23); 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.

The definition of “restricted profit interest” in the Final Rule is very similar to the type of carried interest that the Proposed Rule excluded from the definition of ownership interest. However, the definition of “restricted profit interest” includes revisions that respond to certain issues raised by commenters. In particular, a restricted profit interest in a covered fund may be held by a former employee of a banking entity who received the interest as compensation for the performance of services to the fund. In addition, under the Proposed Rule, a banking entity was not permitted to pay any consideration for excluded carried interest. However, under the Final Rule, a banking entity may provide consideration to acquire a restricted profit interest, but the banking entity must include any amounts invested by the banking entity in the fund, including any amounts paid by the banking entity and its employees and former employees to acquire the restricted profit interest, for purposes of determining compliance with the 3% of ownership interests limitation applicable to investments in a single covered fund organized and offered by the banking entity and the aggregate 3% of tier 1 capital limitation for all such investments (See Question 22).

15: May a banking entity hold an ownership interest in a covered fund in a fiduciary or custodial capacity?

Yes, a banking entity may hold an ownership interest in a covered fund as agent, broker or custodian as long as the interest is held in such capacity for an unaffiliated third party customer and the banking entity and its affiliates do not have or retain any beneficial interest in the ownership interest,⁵⁰ which is likely a broader concept than mere ownership. Similarly, a banking entity may hold an ownership interest in a covered fund 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 customer’s account and the banking entity and its affiliates do not have or retain any beneficial ownership of the ownership interest.⁵¹ However, in the Preamble, the Agencies pointed out that the exclusion in the Final Rule for agency, brokerage and custodial activities does “not permit a banking entity to engage in establishing, organizing and offering, or acting as sponsor, to a covered fund in a manner other than as elsewhere permitted in the rule.”⁵²

16: Are investments in covered funds made by employees of a banking entity or employee benefit plans controlled by a banking entity subject to the Volcker rule?

In general, the Volcker rule does not limit investments in covered funds made by an employee of a banking entity in his or her personal capacity. However, for purposes of the per fund and aggregate investment limits, the Final Rule includes a provision that attributes an ownership interest held by a director or employee of a banking entity to the banking entity if the banking entity directly or indirectly extended credit

to the employee for the purpose of enabling the employee to acquire the ownership interest and the proceeds of such extension of credit were used to purchase the ownership interest.⁵³ In addition, as described in the response to Question 14, a banking entity must take into account amounts paid by employees and former employees to obtain restricted profit interest for purposes of the per-fund and aggregate investment limits in covered funds organized and offered by the banking entity.

In addition, a banking entity may be regarded as having “sponsored” a covered fund if the banking entity in any manner controls, *or has employees, officers, directors, or agents who constitute*, a majority of the directors, trustees or management of a covered fund.⁵⁴ If an employee of a banking entity serves as general partner of a partnership or as managing member of a limited liability company that, for example, holds personal or family investments, there is would appear to be a reasonable basis to conclude that the banking entity would not be regarded as having sponsored those funds, provided that the employee is not acting within the scope of his or her employment with the banking entity.

With respect to investments made by employee benefit plans, the Final Rule permits a banking entity to acquire or retain an ownership interest in a covered fund through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity (or an affiliate thereof).⁵⁵

Permitted Activities with Respect to Covered Funds

17: Does the Volcker rule permit a banking entity to sponsor and invest in funds sold to customers as part of an asset management business?

Yes, subject to certain requirements. Section 13(d)(1)(G) of the BHC Act and Section __.11 of the Final Rule provide an exemption from the Volcker rule that permits a banking entity to acquire or retain an ownership interest in a covered fund or act as sponsor to a covered fund in connection with organizing and offering the fund and serving as general partner, managing member, trustee or commodity pool operator of the fund or in certain other capacities that would constitute sponsorship of the fund, subject to the following requirements:

- ***The Covered Fund Must be Organized as Part of an Asset Management or Advisory Business.*** In order to rely upon the Customer Funds exemption, a banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, and the covered fund must be organized and offered only in connection with the provision of these services and only to persons that are customers of these services of the banking entity.
- ***Written Plan.*** The banking entity must offer the fund to customers of its trust, fiduciary, investment advisory or commodity trading advisory business pursuant to a written plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering the fund.
- ***Limitation on Ownership Interests.*** A banking entity may acquire or retain an ownership interest in a fund organized and offered pursuant the Customer Fund exemption for the purposes of (i) establishing

the fund and providing the fund with sufficient initial capital to permit the fund to attract unaffiliated investors, or (ii) making and retaining a *de minimis* investment in the fund that does not exceed 3% of the total ownership interests in the fund. With respect to an investment made for the purpose of providing seed capital to the fund, the investment must not exceed 3% of the total amount or value of outstanding ownership interests of the fund not later than one year after the date of establishment of the fund (unless the banking entity obtains additional time from the Federal Reserve Board to conform the investment to this limitation), and the banking entity must actively seek unaffiliated investors to reduce its ownership interest in the fund through redemption, sale, dilution, or other methods so that it complies with this limitation. The aggregate value of all ownership interests of the banking entity and its affiliates and subsidiaries in all covered funds may not exceed 3% of the banking entity's Tier 1 capital.

- ***Affiliate Transaction Limitation.*** A banking entity must comply with certain restrictions relating to transactions between the banking entity and its affiliates, on the one hand, and a covered fund the banking entity organizes in reliance on this exemption, on the other hand. (See Question 27)
- ***No Guarantee of Fund Obligations.*** A covered banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of fund organized and offered in reliance upon the Customer Funds exemption.
- ***Name Limitations.*** A banking entity and its affiliates may not share the same name or variation on the same name with a covered fund, and the fund may not use the word “bank” in its name.
- ***Limitations on Directors or Employees Investing in the Fund.*** No director or employee of a banking entity or its affiliates may take or retain an ownership interest in a covered fund organized and offered by the banking entity in reliance upon the Customer Fund exemption except for a director or employee who is directly engaged in providing investment advisory or other services to the fund at the time such person acquires an ownership interest.
- ***Required Disclosures.*** In order to rely upon the Customer Fund exemption, the banking entity must clearly and conspicuously disclose to prospective and actual investors in a the fund that:
 - (i) Any losses in the fund will be borne solely by investors in the fund and not by the banking entity and its affiliates; therefore, the banking entity's losses in the fund will be limited to losses attributable to the ownership interests in the fund held by the banking entity and its affiliates in their capacity as investors in the fund;
 - (ii) The investor should read the fund offering documents before investing in the fund; and
 - (iii) Ownership interests in the fund are not insured by the Federal Deposit Insurance Corporation, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity.

The banking entity must also disclose the role of the banking entity and its affiliates, subsidiaries and employees in sponsoring or providing any services to the fund.⁵⁶ As described in the response to Question 29, the Volcker rule also limits material conflicts of interest between a banking entity and third parties and requires that certain conflicts be disclosed.

The Agencies also included an underwriting and market making exemption with respect to covered funds activities that permits a banking entity to engage in underwriting and market making activities with respect to covered funds in certain circumstances.⁵⁷ However, among other requirements, if the banking entity's investment in the fund is subject to the per fund 3% of ownership interests limitation, then the banking entity must take into account interests acquired as part of underwriting and market making activities for purposes of determining compliance with this limitation.

18: Who are “customers” for purposes of the Customer Fund exemption from the Volcker rule?

In order to rely upon the exemption for Customer Funds, among other requirements, a banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, and the covered fund must be organized and offered only in connection with the provision of these services and only to persons that are customers of these services of the banking entity.⁵⁸ The Final Rule does not explicitly address who is a customer of the banking entity for purposes of this exemption. However, in the Preamble, the Agencies explained that a pre-existing customer relationship is not required and that a “customer relationship . . . may be established through or in connection with the banking entity’s organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to the customer.”⁵⁹

19: What are *bona fide* trust, fiduciary, investment advisory or commodity trading services?

There is no explanation in the Final Rule or in the Preamble of what constitutes *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services. However, in the preamble to the Proposed Rule, the Agencies explained that “[b]anking entities provide a wide range of customer-oriented services which may qualify as *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services.”⁶⁰ The Agencies went on to explain that the Proposed Rule “does not specify what services would qualify as ‘*bona fide* trust, fiduciary, investment advisory or commodity trading advisory services . . . [but] [i]nstead reflects the intention that so long as a banking entity provides trust, fiduciary, investment advisory services in compliance with relevant statutory and regulatory requirements, the requirement contained in § __.11(a) of the proposed rule will generally be deemed to be satisfied.”⁶¹ The Agencies do not appear to have taken a different approach in the Final Rule.

20: What constitutes an acceptable “written plan”?

The Final Rule does not provide any meaningful guidance on what constitutes a sufficient “written plan.” In the Preamble, the Agencies stated that “the plan must be credible and indicate that the banking entity has conducted reasonable analysis to show that the fund is organized and offered for the purpose of providing *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to customers of the banking entity (or an affiliate thereof) and not to evade the restrictions of section 13 of the BHC Act.”⁶²

21: May a banking entity sponsor an issuer of asset-backed securities?

Yes, a banking entity may sponsor an issuer of asset-backed securities subject to certain requirements. As explained in the response to Question 4, certain issuers of asset-backed securities are excluded from the definition of covered fund. As a result, the Volcker rule does not preclude a banking entity from acquiring or

retaining an ownership interest in or sponsoring these excluded issuers. In addition, the Final Rule includes an exemption that permits a banking entity to acquire or retain an ownership interest in, or act as sponsor to, a covered fund that is an issuer of asset-backed securities in connection with directly or indirectly organizing and offering that issuing entity, subject to certain requirements.⁶³ For purposes of this exemption, a banking entity organizes and offers an issuing entity of asset-backed securities if the banking entity is the “securitizer,” as defined in Section 15G of the Exchange Act (as added by Section 941 of the Dodd-Frank Act) and any implementing regulations issued thereunder. To qualify for this exemption, the banking entity must comply with the requirements applicable to organizing a Customer Fund (see Question 17), except for the requirements that the banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and the requirement that banking entity organize the entity only in connection with the provision of such services to customers. As explained in the response to Question 22, a banking entity’s investment in an issuer of asset-backed securities that it organizes and offers in reliance upon this exemption is subject to certain limitations.

22: Can a banking entity acquire up to 3% of the ownership interests in any covered fund?

No. The Volcker rule prohibits a banking entity from acquiring or retaining an ownership interest in any covered fund unless an exemption applies. However, as explained below, a banking entity may acquire an ownership interest in certain types of covered funds, subject to certain quantitative limitations.

More specifically, a banking entity may make a *de minimis* investment consisting of not more than 3% of the ownership interests of a fund organized and offered by the banking entity in reliance upon the exemption for Customer Funds (see Question 17). A banking entity may also provide seed capital to a covered fund that it organizes and offers in reliance upon this exemption, provided that its ownership interest is reduced to not more than 3% of the fund’s ownership interests within one year from the date of the fund’s formation (or within such additional period of time, not to exceed two years, as the Federal Reserve Board may permit upon finding that an extension would be consistent with safety and soundness and not detrimental to the public interest).⁶⁴

In addition, a banking entity may also acquire or retain an ownership interest in a covered fund that is an issuer of asset-backed securities in connection with directly or indirectly organizing the issuing entity, subject to certain requirements (see Question 21). Among other requirements, an investment by a banking entity in a covered fund that is an issuer of asset-backed securities may not exceed 3% of the total fair market value of the ownership interests of the fund measured in accordance with requirements set forth in the Final Rule, unless a greater percentage is retained by the banking entity and its affiliates in compliance with the risk retention requirements of section 15G of the Exchange Act (as added by Section 941 of the Dodd-Frank Act) and the implementing regulations issued thereunder, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the amount, number, or value of ownership interests of the fund required under section 15G of the Exchange Act and the implementing regulations issued thereunder.⁶⁵

These investments in Customer Funds and issuers of asset-backed securities are subject to an aggregate limit of 3% of the banking entity’s Tier 1 capital and surplus. The statute provides that these investments must also be “immaterial” to the banking entity,⁶⁶ but the Final Rule does not further elaborate on this requirement. A banking entity is also required to deduct from its Tier 1 capital the amount of its investments in covered funds subject to the per fund 3% limitation. Specifically, a banking entity must

deduct the *greater* of (i) the sum of (a) 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 (see Question 14 for more detail on restricted profit interests)), on a historical cost basis, plus (b) any earnings received; *and* (ii) the fair market value of the banking entity's ownership interests in the covered fund as determined in accordance with certain valuation rules (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.

The Final Rule includes certain attribution rules that a banking entity must take into account for purposes of measuring its compliance with the Final Rule's quantitative limitations on covered fund investments. In particular, the amount and value of a banking entity's permitted investment in a single covered fund includes any interest held directly by the banking entity and any of its affiliates.⁶⁷ However, a covered fund will not be considered to be an affiliate of a banking entity for this purpose so long as it is held in compliance with the requirements of the Final Rule.⁶⁸ In addition, for purposes of determining compliance the quantitative investment limitations, a registered investment company, a BDC or a foreign public fund (see Question 4 for additional description of these types of entities) will not be treated as an affiliate so long as the banking entity (i) does not own, control or hold with power to vote 25% or more of the voting shares of the company or fund, and (ii) provides investment advice, commodity trading advisory, administrative, and other services to the company or fund.

With respect to master-feeder fund investments, if the principal investment strategy of a feeder fund that is a covered fund is to invest substantially all of its assets in another single covered fund that is a master fund, then for purposes of the single fund 3% of ownership interests limitation, the banking entity's permitted investment in such funds is measured only by reference to the value of the master fund, and the banking entity's permitted investment in the master fund shall include 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 a feeder fund.⁶⁹ With respect to fund-of-funds investments, if a banking entity organizes and offers a covered fund in reliance upon the Customer Fund exemption for the purpose of investing in other covered funds and that fund of funds itself invests in another covered fund in which the banking entity is permitted to hold an ownership interest, 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.⁷⁰

23: Does a banking entity need to take into account investments made in parallel with a covered fund for purposes of complying with the 3% ownership interest limitation?

In some circumstances, yes. The Proposed Rule included an express requirement that, to the extent that a banking entity is contractually obligated to invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement), the banking entity would be required to include those investments for purposes of determining compliance with the per-fund quantitative limitation.⁷¹

The Agencies did not include this requirement in the Final Rule. In the Preamble, they acknowledged that "many investments made by banking entities are made for the purpose of serving the legitimate needs of

customers and shareholders, and not for the purpose of circumventing the per-fund and aggregate funds limitations in section 13 [of the BHC Act].”⁷² However, the Agencies explained that:

[T]he potential for evasion of [the quantitative] limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors. For instance, the Agencies understand that it is relatively common for the sponsor of a covered fund in connection with a privately negotiated investment to offer investors co-investment opportunities when the general partner or investment manager for the covered fund determines that the covered fund does not have sufficient capital available to make the entire investment in the target portfolio company or determines that it would not be suitable for the covered fund to take the entire available investment. In such circumstances, a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund in a privately negotiated investment unless the value of such co-investment is less than 3% of the value of the total amount co-invested by other investors in such investment. Further, if the co-investment is made through a co-investment vehicle that is itself a covered fund (a “co-investment fund”), the sum of the banking entity’s ownership interests in the co-investment fund and the related covered fund should not exceed 3% of the sum of the ownership interests held by all investors in the coinvestment fund and related covered fund. Finally, the Agencies note that if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity’s investment in the covered fund.⁷³

24: How does the Volcker rule affect fund-of-funds structures?

The definition of “banking entity” for purposes of the Volcker rule includes any insured depository institution, any company that controls an insured depository institution, any foreign bank or company that is made subject to the BHC Act by Section 8 of the International Banking Act, *and any affiliate or subsidiary* of any of these types of banking entities.⁷⁴ As a result, absent an exclusion or exemption, if a banking organization sponsors and controls a fund, that fund would itself become a banking entity and would be prohibited from making investments in other covered funds.

However, the definition of “banking entity” in Section __.2(c)(2)(i) of the Final Rule *excludes* a covered fund so long as the covered fund is not itself an insured depository institution, a company that controls an insured depository institution or a company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act. As a result, for example, a banking entity could organize and offer a fund-of-funds as a Customer Fund in reliance upon this provision, and that fund may in turn invest in other covered funds.⁷⁵ On its face, this provision does not appear applicable to funds organized outside of the United States by a foreign banking organization that do not fall within the definition of covered fund.

25: Can a non-U.S. banking entity sponsor and/or invest in a covered fund outside of the United States?

As described in the response to Question 3, the Final Rule treats a non-U.S. fund that is not offered or sold to U.S. resident investors as a covered fund only with respect to a U.S. banking entity that acts as sponsor to the fund or that has an ownership interest in the fund. In the Preamble, the Agencies explained that “[a] foreign fund . . . may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.”⁷⁶

The Final Rule also includes an exemption that permits a banking entity to acquire or retain an ownership interest in and/or to sponsor a covered fund outside of the United States, subject to the following requirements:

- The banking entity must not be 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;
- Any activity or investment by the banking entity in reliance upon this exemption must be pursuant to Section 4(c)(9) or Section 4(c)(13) of the BHC Act. For purposes of this requirement, the Final Rule provides that an activity or investment is pursuant to Section 4(c)(9) or Section 4(c)(13) of the BHC Act only if it is conducted in accordance with the requirements of the exemption and the banking entity is either a qualifying foreign banking organization (“QFBO”) or a foreign banking entity that meets standards similar to those required of QFBOs (in general, to be treated as a QFBO, a foreign banking organization must demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States). The Final Rule does not retain the requirement in the Proposed Rule that any activity by a QFBO be conducted in compliance with all of subpart B of the Federal Reserve Board’s Regulation K. However, the Agencies noted that, to the extent a banking entity is a foreign banking organization, it remains subject to the Regulation K and must, as a separate matter, comply with any and all applicable rules and requirements of that regulation.
- No “ownership interest” in the covered fund may offered for sale or sold to a resident of the United States (for a discussion of the definition of ownership interest, see Question 12). For purposes of this requirement, resident of the United States has the same meaning as “U.S. person” in the SEC’s Regulation S under the Securities Act of 1933, as amended. The Final Rule provides that an ownership interest in a covered fund is offered for sale or sold to a resident of the United States for purposes of the foreign fund exemption only if it is sold or has been sold pursuant to an offering that “targets” residents of the United States.
- The activity or investment must occur solely outside of the United States. The Final Rule treats an activity as occurring outside of the United States only if:
 - (i) the banking 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;

(ii) the banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any state;

(iii) 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; and

(iv) 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.⁷⁷

Because the Agencies narrowed the definition of “covered fund” with respect to foreign banking entities so that it does not include non-U.S. funds that are not offered or sold in the United States in reliance upon Section 3(c)(1) or Section 3(c)(7), the usefulness of this exemption would appear to be somewhat limited.

26: Can an insurance company rely upon the insurance company general account exemption to invest in a covered fund?

Yes. The Final Rule includes an exemption that permits a regulated insurance company, or an affiliate thereof, to acquire or retain an ownership interest in, or sponsor, a covered fund if:

- 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;
- The insurance company and its affiliate comply with applicable insurance company investment laws; and
- 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 law, regulation, or written guidance relating to insurance company investments is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.⁷⁸

Other Issues

27: What is the “Super 23A” provision of the Volcker rule?

The Final Rule imposes restrictions on transactions with or involving a banking entity and certain covered funds. More specifically, subject to a very narrow exception for certain prime brokerage transactions, these restrictions prohibit a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund as permitted by the Final Rule or that continues to hold an interest in a covered fund that is an issuer of asset-backed securities in accordance with the Final Rule (and any affiliate of such entity) from

entering into a transaction with the covered fund or any other covered fund that is controlled by such covered fund that would be a “covered transaction” as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c), as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereof.⁷⁹ Generally, the following types of transactions will be considered a “covered transaction” for this purpose:

- (i) making a loan or extending credit (including on a daylight basis) to the fund, including credit exposure arising out a derivative contract, repurchase agreement or securities lending or borrowing transaction in which the fund is a counterparty;
- (ii) purchasing an asset from the fund;
- (iii) investing in securities of the fund other than to the extent permitted by the Proposed Rule, and
- (iv) guaranteeing the obligations of the fund.⁸⁰

In addition, even if a proposed relationship or transaction with or involving a covered fund is not a “covered transaction,” a banking entity having a relationship of the type described above with a covered fund may only enter into a transaction with the fund if the transaction is conducted on terms and under circumstances that would be at least as favorable to the banking entity as those prevailing with respect to comparable transactions with or involving unaffiliated third parties. In the absence of comparable transactions, the transaction must be conducted on terms and circumstances that the banking entity believes in good faith would apply to a transaction with or involving an unaffiliated third party.⁸¹

28: Is there an attribution rule for purposes of the “Super 23A” provision?

No. Section 23A of the Federal Reserve Act includes an attribution rule under which a transaction between a member bank and any person will be treated as a transaction with an affiliate if the proceeds of the transaction are transferred to or used for the benefit of the affiliate.⁸² However, neither the statutory language of the Volcker rule nor the Final Rule expressly incorporate this attribution rule. In the Preamble, the Agencies confirmed that there is no attribution rule and explained that “[t]he Agencies believe that . . . transactions between a banking entity and a third party that is not a covered fund are not covered by the terms of section 13(f) [of the BHC Act], which (as discussed above) make specific reference to transactions by the banking entity with the covered fund.”⁸³ However, the Agencies went on to state that they “expect banking entities not to structure transactions with third parties in an attempt to evade the restrictions on transactions with covered funds”⁸⁴

29: How does the Volcker rule restrict material conflicts of interest?

Notwithstanding the exemptions for certain types of transactions involving covered funds, the Volcker rule provides no transaction, class of transactions or activity may be permitted if it would:

- Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

- Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or
- Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.⁸⁵

Under the Final Rule, unless a banking entity takes certain mitigating actions, a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity.⁸⁶ To mitigate a conflict of interest, prior to effecting a specific transaction or class or type of transactions, or engaging in the specific activity, a banking entity may give 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.⁸⁷ Such disclosure must be 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.⁸⁸ Alternatively, a banking entity may establish, maintain, and enforce 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. However, 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 conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.⁸⁹

The Final Rule defines a high-risk asset as an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. It defines a high-risk trading strategy as a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.⁹⁰

30: What sort of compliance program does a banking entity need to maintain?

Section ____ .20 of the Final Rule requires each banking entity engaged in covered funds activities to develop and administer a compliance program that is reasonably designed to ensure compliance with the Volcker rule's restrictions on covered fund activities. The compliance procedures must, at a minimum, include written policies and procedures, internal controls, a management framework that delineates responsibility and accountability for compliance, independent testing and audit, training and maintenance of certain records for at least five years.

In addition, banking entities that engage in significant proprietary trading and that are subject to certain reporting requirements, banking entities that reported total consolidated assets as of the previous year end of \$50 billion or more (or, in the case of a foreign banking entity, total U.S. assets of \$50 billion or more),

and other banking entities designated by an appropriate regulatory agency will become subject to additional compliance program standards described in an appendix to the Final Rule.⁹¹ Several aspects of these enhanced standards apply specifically to covered funds. For example, the compliance program must provide a process for identifying and documenting covered funds sponsored or organized by each unit of the banking entity's organization as well as covered funds in which each such unit invests. The compliance program must also identify, document, and map each unit within the organization that is allowed to sponsor or hold an interest in any covered fund. In addition, the compliance program must "explain" how the banking entity monitors for and prohibits a number of impermissible activities, such as certain conflicts of interest between the banking entity and its clients and exposure to certain high-risk assets or trading strategies.

The banking entity's internal controls must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity or investment that may indicate potential violations. The compliance program must properly document, address and remedy any such violations and must document all proposed and actual remediation efforts. It must also include written policies and procedures to assess whether modifications to the compliance program are warranted and to ensure that appropriate modifications are implemented.

Similarly, a banking entity is required to establish, maintain, and enforce a governance and management framework reasonably designed to ensure that appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program, that a clear reporting line is delineated, and that the compliance program is reviewed periodically by senior management. The compliance program, which must be approved by the board of directors (or appropriate committee thereof) and by senior management, must provide for prompt notification to both senior management and the board of directors of any material weakness or significant deficiencies in the design or implementation of the compliance program; the board of directors and senior management should, under the governance and management framework, have the appropriate authority and access to personnel and information within the organization, and appropriate resources, to conduct their oversight activities effectively. Various provisions require the designation and accountability of appropriate senior management and business line managers with responsibility for each trading desk and organizational unit engaged in covered fund activities.

Finally, the board of directors and senior management are held responsible for setting and communicating a culture of compliance. This includes ensuring that senior management is fully capable, qualified, and properly motivated to manage compliance, and ensuring that senior management has established appropriate incentives and adequate resources to support compliance. Importantly, the bank's CEO must attest in writing, on an annual basis, that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the compliance program in a manner reasonably designed to achieve compliance with the Volcker rule and the Final Rule.

31: How do the covered funds aspects of the Volcker rule affect community banks?

The federal banking agencies issued a document entitled "The Volcker Rule: Community Bank Applicability" in which they asserted that "[t]he vast majority of . . . community banks [with less than \$10 billion in total consolidated assets] have little or no involvement in prohibited proprietary trading or investment activities in covered funds" and that these community banks would "not have any compliance obligations under the Final Rule if they do not engage in any covered activities other than trading in certain

government, agency, State or municipal obligations.” However, community banks should evaluate their investment portfolios to determine whether they have holdings of instruments that may be subject to the covered funds aspects of the Volcker rule, such as holdings of collateralized loan obligations and collateralized debt obligations that may not conform to the exclusion for qualifying issuers of asset backed securities (see Question 4). In addition, community banks with wealth management operations should evaluate their activities if they sponsor or manage pooled investment vehicles. Community banks should also consider revising their policies and procedures as appropriate to ensure that they do not engage in activities subject to the Volcker rule without further evaluation.

32: What is the conformance period for the Volcker rule and how can it be extended?

The Volcker rule became effective on July 21, 2012, but the statute provides for a two year conformance period and permits the Federal Reserve Board to extend the conformance period for up to three, one year periods. In connection with the issuance of the Final Rule, the Federal Reserve Board extended the conformance period, by one year, until July 21, 2015. During the conformance period, banking entities may continue to engage in activities covered by the Volcker rule. However, a banking entity must engage in good-faith efforts, appropriate for its activities and investments, that will result in conformance of all activities and investments to the requirements of the Volcker rule by the end of the conformance period. In its order granting an extension of the conformance period, the Federal Reserve Board explained that such good faith efforts include evaluating the extent to which a banking entity's activities and investments are covered by the Volcker rule as well as developing and implementing an appropriately tailored conformance plan. The Federal Reserve Board also cautioned that banking entities should not expand their activities with the expectation that additional time to conform those activities to the requirements of the Volcker rule may be granted.

The Federal Reserve Board previously issued rules addressing the manner in which a banking entity may request additional time to conform to the Volcker rule—including an additional five year conformance period with respect preexisting investments in illiquid funds as of May 1, 2010.⁹²

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¹ See 12 U.S.C. § 1851(h)(1).

² See Final Rule at § __.2(c)(2)(i) and (ii).

³ See 12 U.S.C. § 1851(a)(2).

⁴ See 12 U.S.C. § 1851(h)(2).

⁵ Final Rule at § __.10(b)(1)(ii).

⁶ The Agencies other than the CFTC issued a proposed Volcker rule implementing regulation in November 2011 (See 76 Fed. Reg. 68,846 (Nov. 7, 2011), and the CFTC issued a substantially similar proposed rule in February 2012 (See 77 Fed. Reg. 8,332 (Feb. 14, 2012) (referred to collectively as the “*Proposed Rule*”).

⁷ Final Rule at § __.10(b)(1)(iii).

⁸ Final Rule at § __.10(b)(3).

⁹ Final Rule at § __.10(b)(2).

¹⁰ See Preamble at pg. 485.

¹¹ *Id.*

¹² Final Rule at § __.10(c)(1).

¹³ Final Rule at § __.10(c)(2).

¹⁴ Final Rule at § __.10(c)(3).

¹⁵ See Preamble at pg. 517.

¹⁶ Final Rule at § __.10(c)(4).

¹⁷ Final Rule at § __.10(c)(5).

¹⁸ Final Rule at § __.10(c)(6).

¹⁹ Final Rule at § __.10(c)(7).

²⁰ Final Rule at § __.10(c)(8).

²¹ See Preamble at pg. 529.

²² See Preamble at pgs. 542-43.

²³ Final Rule at § __.10(c)(8)(iv).

²⁴ See Preamble at pgs. 555-56.

²⁵ Final Rule at § __.10(c)(9).

²⁶ Final Rule at § __.10(c)(10).

²⁷ See Preamble at pg. 574.

²⁸ Final Rule at § __.10(c)(11).

²⁹ Final Rule at § __.10(c)(12).

³⁰ See Preamble at pgs. 496-97.

³¹ Final Rule at § __.10(c)(14).

³² See Preamble at pg. 590.

³³ Preamble at pg. 594.

³⁴ Preamble at pgs. 598-599.

³⁵ Preamble at pg. 602.

³⁶ See Preamble at pg. 602.

³⁷ Final Rule at § __.10(c)(12); see Preamble at pg. 476.

³⁸ Final Rule at § __.10(d)(9).

³⁹ 12 U.S.C. §1851(h)(5).

⁴⁰ Final Rule at § __.10(d)(10).

⁴¹ See Preamble at pg. 631.

- 42 Preamble at pg. 630.
- 43 *Id.*
- 44 Preamble, pages 630-631.
- 45 Preamble at pg. 631,
- 46 Final Rule at § 10(d)(6).
- 47 Preamble at pg. 607.
- 48 See Preamble at pg. 610.
- 49 Final Rule at § 10(d)(6)(ii).
- 50 Final Rule at § 10(a)(2)(i).
- 51 Final Rule at § 10(a)(2)(iv).
- 52 Preamble at pg. 469.
- 53 Final Rule at § 12(b)(1)(iv).
- 54 Final Rule at § 11(a).
- 55 Final Rule at § 10(a)(2)(ii).
- 56 See Final Rule at § 11(a)(8)(i)(A).
- 57 See Final Rule at § 11(c).
- 58 See Final Rule at § 11(a).
- 59 Preamble at pg. 642.
- 60 See 76 Fed. Reg. 68,846, 68,900 (Nov. 7, 2011).
- 61 *Id.* at 68,901.
- 62 Preamble at pg. 643.
- 63 Final Rule at § 11(b).
- 64 Final Rule at § 12(a)(2)(i)(B) and § 12(e).
- 65 Final Rule at § 12(a)(2)(ii)(B). On August 28, 2013, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Securities and Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development issued a revised Notice of Proposed Rulemaking that would implement the risk retention requirements of Section 941 of the Dodd-Frank Act; however, these agencies have not yet adopted this proposal as a final rule. See 78 Fed. Reg. 57,928 (Sept. 20, 2013).
- 66 12 U.S.C. § 1851(d)(4)(B)(ii)(II).
- 67 Final Rule at § 12(b)(1)(i).
- 68 Final Rule at § 12(b)(1)(ii).
- 69 Final Rule at § 12(b)(4)(i).
- 70 Final Rule at § 12(b)(4)(ii).
- 71 See Proposed Rule at § 12(b)(2)(ii).
- 72 Preamble at pg. 710.
- 73 Preamble at pgs. 710-711.
- 74 12 U.S.C. § 1851(h)(1); Final Rule at § 2(b).
- 75 See 76 Fed. Reg. 68,846, 68,856 (Nov. 7, 2011).
- 76 Preamble at pg. 485.
- 77 Final Rule at § 13(b).
- 78 Final Rule at § 13(c).
- 79 See 12 U.S.C. § 1851(f)(1); Final Rule at § 14(a).
- 80 See 12 U.S.C. § 371c(b)(7); 12 C.F.R. § 223.2(h).
- 81 See 12 U.S.C. § 1851(f)(2); Final Rule at § 14(b).
- 82 See 12 U.S.C. § 371c(a)(2).
- 83 Preamble at pgs. 755-756.
- 84 Preamble at pg. 756.
- 85 Final Rule at § 15(a).
- 86 Final Rule at § 15(b)(1).
- 87 Final Rule at § 15(b)(2)(i)(A).
- 88 Final Rule at § 15(b)(2)(i)(B).
- 89 Final Rule at § 15(b)(2)(ii).
- 90 Final Rule at § 15(c).

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- ⁹¹ Final Rule at § __.20(c); Final Rule at Appendix B.
⁹² See 12 C.F.R. § 225.181.