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BANKING REGULATION

This is the second of a two-part series exploring the requirements and issues for compliance with the final Volcker rule regulation issued by five federal agencies on Dec. 10, 2013. This article discusses the interagency final regulation's treatment of the Volcker rule restrictions on the ability of a banking entity to sponsor or have an ownership interest in ''covered funds,'' including hedge funds and private equity funds. In addition, the article discusses the statutory and regulatory exclusions to ''covered fund'' treatment and available exemptions for certain permitted activities under the Volcker rule. Finally, the article discusses certain additional restrictions imposed on the activities of a banking entity and its affiliates, other potential prohibitions, fund structuring considerations, and potential challenges for implementing, supervising and complying with the requirements of the final regulation.

Securities

Implementing the Volcker Rule: The Covered Fund Restrictions

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Among the numerous regulations implementing various Sections of the Dodd-Frank Act (''DFA''), the so-called Volcker rule, set forth in Section 619 of the DFA,[1] is one of the law's most recognizable and most controversial provisions. Both the legislative history of the provision and the challenges imposed on the five federal agencies (the ''Agencies'') charged with its implementation define the lore of the Volcker rule.[2] Starting with a November 2011 interagency proposal by four of the five Volcker rule agencies that included almost 400 questions seeking comment on various aspects of the proposed rule,[3] to an unrealistic July 21, 2012, statutory deadline that the regulators missed by almost 18 months and still had to scramble to get out the final Volcker rule regulation (''Final Regulation''),

[1] DFA § 619, codified at 12 U.S.C. § 1851.

[2] The five federal agencies implementing the Final Regulation were the Federal Reserve Board (''FRB''), Federal Deposit Insurance Corporation (''FDIC''), Office of the Comptroller of the Currency (''OCC''), Securities and Exchange Commission (''SEC''), and the Commodity Futures Trading Commission (''CFTC'').

[3] 76 Fed. Reg 68846 (Nov. 7, 2011).

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to the 882 page preamble to the Final Regulation itself,[4] Section 619 of the DFA has been the catalyst for compelling interest and drama in the banking world. To make things even more interesting, affected industry participants are only beginning the real work required to understand and apply the Final Regulation, both domestically and internationally, and particularly in connection with the Volcker rule's covered fund provisions.

As with the Volcker rule restriction on proprietary trading, the covered fund restrictions involve a generally straightforward concept – a banking entity is prohibited from sponsoring, investing in or having certain relationships with a hedge fund or private equity fund (and certain similar entities identified in the Final Regulation). Again, as with the proprietary trading prohibition, while simple in concept, the Volcker rule gets decidedly complicated in sorting through the issues of what is a covered fund, what is excluded from covered fund treatment, and what activities are permitted pursuant to an exemption to the covered fund provisions of the Volcker rule. As was evident almost immediately after issuance of the Final Regulation, notwithstanding the promise of greater certainty brought by a final rule, considerable complexity and confusion remain. Industry concerns include uncertainty regarding longer-term consequences of the Volcker rule, as well as immediate concerns regarding various unanticipated and/or unintended consequences.

To many industry observers, these concerns are well-founded, particularly given the many other aspects of the DFA that fundamentally alter the regulatory and supervisory landscape for banks, with significant uncertainty about how everything will ultimately fit together in our ever more complex financial system. With respect to the Volcker rule, these concerns were validated within days after the issuance of the Final Regulation when it was discovered that certain collateralized debt obligations backed by bank-issued trust-preferred securities (''TruPS CDOs'') would be treated as covered funds under the Volcker rule, which (as discussed below) had an immediate effect on many banks requiring them to mark-to-market their holding of TruPS CDOs as of Dec. 31, 2013. Succumbing to significant industry and political pressure to fix the unintended impact of the TruPS CDO issue, the regulators intervened by issuing an interim final rule to provide relief. That rule was issued a little more than a month after the Final Regulation, which, as noted above, was several years in the making. Clearly, there is much we do not know and cannot necessarily anticipate regarding the impact of the Volcker rule and other DFA provisions, including the interaction or ''chemical reaction'' of these various provisions down the road.

[4] The preamble to the interagency Final Regulation, issued Dec. 10, 2013, was accompanied by a 71-page common interagency rule (''Common Rule'') implementing DFA § 619.

As with the Volcker rule restriction on proprietary trading, the covered fund restrictions involve a generally straightforward concept – a banking entity is prohibited from sponsoring, investing in or having certain relationships with a hedge fund or private equity fund (and certain similar entities identified in the Final Regulation).

This article surveys a number of the issues and nuances of the covered fund provisions of the Final Regulation, which becomes effective April 1, 2014, but due to a delayed conformance period, will not wholly take effect until July 21, 2015, at the earliest. Discussed in this segment are a general overview of the contours of the regulation of covered funds under the Volcker rule and what we should expect in the months ahead as regulators and industry participants grapple with implementation issues.

Definition of 'Covered Fund.' The Volcker rule defines the terms ''hedge fund'' and ''private equity fund'' to mean an issuer that *would be* an investment company, *but for* Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the ''1940 Act''), or ''such similar funds'' as the Agencies may, by rule, determine.[5] In the Final Regulation, the Agencies exercised their authority to define ''such similar funds'' by combining the terms ''hedge fund'' and ''private equity fund'' into a single definition of a ''covered fund.''[6] In response to comments received on the proposal, the Final Regulation significantly narrows the definition of ''covered fund,'' including making clarifications that exclude certain foreign private funds and a number of common corporate entities that are not conventionally thought of as a ''hedge fund'' or ''private equity fund,'' such as joint ventures, wholly-owned subsidiaries, and other entities that the Agencies deem not to be within the focus of the Volcker rule.[7]

Under the Final Regulation, an issuer may be a ''covered fund'' under one of three circumstances, provided the fund is not otherwise eligible for any of the 13 express definitional exclusions, or not otherwise granted

[5] 12 U.S.C. § 1851(h)(2) *referencing* 15 U.S.C. §§ 80a-1 *et seq*. (emphasis added).

[6] *See* Preamble to the Final Regulation at p. 470 (noting that, ''[g]iven that the statute defines ''hedge fund'' and ''private equity fund'' without differentiation, the proposed rule and the final rule combine the terms into the definition of a ''covered fund'').

[7] *See, e.g.*, Preamble to the Final Regulation at p. 464 (noting that the ''Agencies have tailored the final definition [of ''covered fund''] to include entities of the type that the Agencies believe Congress intended to capture in its definition of private equity fund and hedge fund in Section 13(h)(2) of the BHCA by reference to Section 3(c)(1) and 3(c)(7) of the Investment Company Act).

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an exclusion by the Agencies as they may jointly determine to be appropriate.[8]

Investment Company Status

The first circumstance under which a fund may be a ''covered fund'' for purposes of the Volcker rule is where an issuer *would be* an investment company, as defined in the 1940 Act,[9] *but for* Section 3(c)(1) or 3(c)(7) of that Act.[10] This language tracks the Volcker rule statutory definition of ''hedge fund'' and ''private equity fund'' by reference to the two provisions most commonly relied on by such private funds for exemption from registration as an investment company under the 1940 Act.[11] The significance of the ''but for'' language is to exclude from the scope of the definition entities that do not rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act for exemption from investment company registration, provided the entity satisfies the conditions of another exclusion or exemption under such Act. Thus, for example, bank common trust and collective funds that qualify for the exclusion from the definition of investment company pursuant to Section 3(c)(3) or 3(c)(11) of the 1940 Act are not ''covered funds'' for purposes of the Volcker rule, as they would not be an investment company *but for* Section 3(c)(1) or 3(c)(7) of that Act.

Foreign Covered Funds

The Volcker rule applies to the global operations of U.S. banking entities, which is consistent with the legislative goal to ''reduce the risk to the U.S. financial system of activities with and investments in covered funds.''[12] Specifically, the Agencies noted their concern that excluding all foreign funds from the definition of covered fund ''would allow U.S. banking entities to be exposed to risks and engage in covered fund activities'' outside the U.S. that are specifically prohibited in the U.S., which ''would undermine Section 13 and pose risks to U.S. banking entities and the stability of the U.S. financial system that Section 13 was designed to prevent.''[13] At the same time, however, the Agencies were cognizant of the provisions of the Volcker rule that ''explicitly limit its extra-territorial application to the activities of foreign banks'' outside the U.S.[14]

In light of these counterbalancing interests and in consideration of the public comments received, the Agencies revised the definition of covered fund in the Final Regulation to include certain foreign funds under certain circumstances. In particular, a foreign fund that is not subject to the 1940 Act (and therefore would not need to rely on any exemption to avoid registration as an investment company) would still be a covered fund in the hands of a U.S. banking entity under certain circumstances. Specifically, for ''any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State,'' a foreign fund is a ''covered fund'' where the fund: (i) is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (ii) is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and (iii) has as its sponsor the U.S. banking entity (or an affiliate thereof) or has issued an ownership interest that is owned directly or indirectly by the U.S. banking entity (or an affiliate thereof).[15]

Under this definition, a foreign fund becomes a covered fund only with respect to a U.S. banking entity (or foreign affiliate of a U.S. banking entity) that acts as a sponsor to the foreign fund or has an ownership interest in the foreign fund. As noted by the Agencies, ''[a] foreign fund therefore 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 U.S.''[16]

Notably, the Final Regulation eliminates the problematic hypothetical test that would have been required under the proposal for foreign funds that are established outside the U.S. and do not have interests that are offered to U.S. investors and therefore do not come within the scope of the 1940 Act. Under the proposal, such foreign private funds issuing securities that are never offered or sold to U.S. investors would nonetheless have been swept into the proposed definition of ''covered fund,'' and thus treated as such for purposes of the Volcker rule. The Final Regulation clarifies that, with respect to such foreign private funds, the test for whether an issuer would be an investment company under the 1940 Act *but for* Section 3(c)(1) or 3(c)(7) of that Act is a test of *actual* reliance on Section 3(c)(1) or 3(c)(7), rather than a hypothetical test that asks whether the issuer would need to rely on Section 3(c)(1) or 3(c)(7) if it were hypothetically organized or offered in the U.S. and thus subject to the 1940 Act. This complete exclusion of foreign private funds in the final rule definition of ''covered fund'' is regarded as a big ''win'' for foreign

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[8] *See generally* Final Regulation, Common Rule § __.10(b)(c).

[9] 15 U.S.C. § 80a-1 *et seq*.

[10] Final Regulation, Common Rule § __.10(b)(1)(i) (emphasis added); referencing 15 U.S.C. § 80a-3(c)(1) or (7).

[11] Section 3(c)(1) of the Investment Company Act provides an exception from the definition of ''investment company'' for ''[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.'' 15 U.S.C. § 80a-3(c)(1). Section 3(c)(7) of the Investment Company Act provides an exception from the definition of ''investment company'' for ''[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.'' 15 U.S.C. § 80a-3(c)(7).

[12] Preamble to the Final Regulation at p. 484.

[13] Preamble to the Final Regulation at p. 484-485.

[14] Preamble to the Final Regulation at p. 485.

[15] Final Regulation, Common Rule § __.10(b)(1)(iii).

[16] Preamble to the Final Regulation at p. 485-486.

banking entities involved in fund activities outside the U.S. that are not subject to the 1940 Act.

Notably, the Final Regulation eliminates the problematic hypothetical test that would have been required under the proposal for foreign funds that are established outside the U.S. and do not have interests that are offered to U.S. investors and therefore do not come within the scope of the 1940 Act.

To be clear, however, any foreign fund (i.e., a fund that is established outside the U.S.) that is offered or sold in the U.S. in actual reliance on the exclusions in Section 3(c)(1) or 3(c)(7) of the 1940 Act would be included in the definition of ''covered fund'' under the investment company status discussion above, unless it meets the requirements of a definitional exclusion (see below).[17] This treatment is consistent with the discussion in the preamble to the Final Regulation in which the Agencies noted that ''the rule is designed to provide parity and no competitive advantages or disadvantages between U.S. and non-U.S. funds sold within the United States.''[18]

Commodity Pools

Under the Final Regulation, the Agencies used their authority to expand the definition of ''covered fund'' to include commodity pools as defined in Section 1a(10) of the Commodity Exchange Act.[19] The Final Regulation adopts a tailored approach and limits the scope of commodity pools that would be treated as ''covered funds'' for purposes of the Volcker rule to those that meet one of two alternative tests and do not otherwise qualify for an exclusion from the covered fund definition.[20]

Under the Commodity Exchange Act, a commodity pool is defined to mean ''any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests.''[21] The Agencies explained that commodity pools are included in the definition of covered fund because ''some commodity pools are managed and structured in a manner similar to a covered fund.''[22]

The initial proposal to include all commodity pools in the ''covered fund'' definition was met with public criticism,[23] and the Agencies have narrowed the circumstances under which a commodity pool would be treated as a covered fund for purposes of the Volcker rule. In particular, the Agencies noted that they have taken a more tailored approach in the Final Regulation ''that is designed to more accurately identify those commodity pools that are similar to issuers that would be investment companies as defined [in the 1940 Act] but for Section 3(c)(1) or 3(c)(7) of that Act, consistent with [the Volcker rule].''[24]

Thus, for purposes of performing a covered fund analysis under the Final Regulation, a collective investment vehicle must first make a threshold determination of whether it is a ''commodity pool'' as that term is defined in Section 1a(10) of the Commodity Exchange Act.[25] If a collective investment vehicle meets that definition, the commodity pool would be considered a ''covered fund'' *if* it meets one of two alternative tests, *and* does not also qualify for an exclusion from the covered fund definition (e.g., the exclusion for registered investment companies).[26]

Under the first of two alternative tests, a commodity pool will be a covered fund if it is an ''exempt pool'' under Section 4.7 of the CFTC's regulations,[27] meaning that it is a commodity pool ''for which a registered commodity pool operator has elected to claim the exemption provided by Section 4.7 of the CFTC's regulations.''[28]

Alternatively, a commodity pool that is not an exempt pool under Section 4.7 may nonetheless be a ''covered fund'' for purposes of the Volcker rule if the following elements are met: (i) a commodity pool operator is registered with the CFTC in connection with the operation of the commodity pool; (ii) substantially all participation units of the commodity pool are owned by ''qualified eligible persons;''[29] and (iii) participation units of the commodity pool have not been publicly offered to persons who are not ''qualified eligible persons.''[30]

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[17] Final Regulation, Common Rule § __.10(b)(1)(i).

[18] Preamble to the Final Regulation at p. 486.

[19] *See* Proposed Regulation, Common Rule § __.10(b)(1)(ii) and Final Regulation, Common Rule § __.10(b)(1)(ii), *referencing* 7 U.S.C. § 1a(10).

[20] Final Regulation, Common Rule § __.10(b)(1)(ii), *referencing* 7 U.S.C. § 1a(10).

[21] 7 U.S.C. § 1a(10).

[22] Preamble to the Final Regulation at p. 487.

[23] *See* Preamble to the Final Regulation at p. 487-488, noting public comments raising objections including that expanding the definition of covered fund in such a manner is ''beyond the scope of Section 13'' and that ''the CFTC has ample authority to regulate the activities of commodity pools and commodity pool operators, and nothing in Section 13 indicates that Congress intended Section 13 to govern commodity pool activities or investments in commodity pools.''

[24] Preamble to the Final Regulation at p. 489.

[25] 7 U.S.C. § 1a(10).

[26] *See* Final Regulation, Common Rule § __.10(b)(1)(ii) and (c).

[27] 17 C.F.R. § 4.7(a)(1)(iii).

[28] Preamble to the Final Regulation at p. 490, *referencing* 17 C.F.R. § 4.7(a)(1)(iii). The Agencies noted in the preamble that they believe that such commodity pools are appropriately considered covered funds because, like funds that rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act, ''these commodity pools sell their participation units in restricted offerings that are not registered under the Securities Act of 1933 and are offered only to investors who meet certain heightened qualification standards.'' Preamble to the Final Regulation at p. 490. According to such rationale, the Agencies have therefore ''determined that they properly are considered ''such similar funds'' as specified in [the Volcker rule].'' *Id.*

[29] *See* 17 C.F.R. § 4.7(a)(2) and (a)(3).

[30] Final Regulation, Common Rule § __.10(b)(1)(ii)(B). The Agencies noted that they ''are including the alternative definition of commodity pools that are covered funds because, if the Agencies had included only pools for which exempt pool status had been elected, covered fund status for pools in which banking entities are invested could easily be avoided merely by not electing exempt pool status under Section 4.7.'' *See* 17 C.F.R. § 4.7(a)(2) and (a)(3). Preamble to the Final Regulation at p. 491.

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Determination of an Ownership Interest. Along with the determination of what is deemed a covered fund, it is important to understand what is deemed an ''ownership interest'' for purposes of the covered fund provisions of the Final Regulation. An ownership interest includes any equity or partnership interest in a covered fund, and also includes any ''other similar interest'' in a covered fund.[31] Under the Final Regulation, an ''other similar interest'' includes an interest in a covered fund that includes any of the following:

- The right to participate in the selection or removal of the fund's general partner, managing member, investment manager, investment adviser and certain other parties of the fund;
- The right to share in the income, gains or profits of the fund;
- The right to receive any residual interest in fund assets after all other interests have been redeemed and/or paid in full;
- The right to receive all or a portion of the excess spread of the fund;
- The right to receive income on a pass-through basis, or a return based on the performance of fund assets (but not carried interest); or
- An interest that, by its terms, provides that amounts payable by the fund with respect to the interest may be reduced based on losses to fund assets or reductions in and the amount of interest otherwise due and payable on the interest.

Importantly, the Final Regulation (like the original proposal) clarifies that a restricted profit interest, i.e., a so-called ''carried interest,'' in a covered fund is not deemed an ownership interest, subject to certain conditions.[32] Thus, an interest in a covered fund held by an investment manager or investment adviser as performance compensation for services provided to a covered fund is not deemed to be an ownership interest in the fund.

A final important consideration with respect to what is deemed to be an ''ownership interest'' is that a banking entity's ownership of an interest in a covered fund is restricted only where the banking entity holds the interest in the fund ''as principal.'' Generally, an ownership interest is *not* held ''as principal'' (and, thus, is not restricted under the Volcker rule) where the interest is held by a banking entity:

- As agent, broker or custodian for the account of, or on behalf of a customer and the banking entity does not have beneficial ownership of such interest;
- As trustee of a deferred compensation, stock bonus, profit sharing or pension plan;
- In the ordinary course of collecting a debt previously contracted in good faith, subject to reasonable and timely divesture; or
- As trustee or in a similar fiduciary capacity on behalf of a customer that is not itself a covered fund.[33]

Determination of Fund Sponsorship. A final important determination before turning to the heart of the covered fund provisions set forth in the exclusions and exemptions of the Final Regulation is who is deemed a ''sponsor'' of a covered fund. The Final Regulation provides that a sponsor includes:

- A general partner, managing member or trustee (not acting in a fiduciary capacity, as discussed below) of a covered fund or an entity that serves as a commodity pool operator (as defined in CFTC regulations) of a covered fund;
- An entity that in any manner selects or controls (or has employees, officers or directors, or agents who constitute) a majority of the directors, trustees or management of a covered fund; or
- An entity that shares the same name (or a variation of the same name) as a covered fund, for corporate, marketing, promotional or other purposes.[34]

A trustee of a covered fund is not deemed to be a sponsor where the trustee does not exercise investment discretion with respect to the fund, including where the trustee is acting at the direction of another trustee who is deemed a sponsor of the covered fund.[35] However, a trustee arrangement cannot be structured to hide trustee sponsorship of a covered fund. Thus, while a trustee lacking investment discretion would not be deemed a sponsor, if its activities are being directed by a trustee with investment discretion, the directing trustee would be deemed a sponsor of the covered fund.

The issue of control is an important concept in understanding the applicability of the sponsorship role to a banking entity ''organizing and offering'' a covered fund (discussed below). Notwithstanding the ability initially to select the board of directors of a covered fund, which will cause the selecting entity to be deemed a sponsor of the fund (and which is a permitted activity in connection with organizing and offering a covered fund, as discussed below), after the effect of the initial action is no longer operative, such as by the subsequent vote of the fund's shareholders for a new board of directors, then sponsorship by the initial entity of the covered fund terminates.[36] Thus, while a banking entity may initially be deemed a sponsor in connection with permissible organizing and offering activities, the banking entity may shed that mantle after ceding control of the covered fund to the new owners.

Definitional Exclusions From 'Covered Fund' Treatment. An issuer that is a ''covered fund'' under one of the three circumstances described above may nonetheless be eligible for one of the 13 definitional exclusions, or otherwise be granted an exclusion by the Agencies as they deem to be appropriate and consistent with the Volcker rule.[37] As noted by the Agencies, the exclusions are intended to ''more effectively tailor the definition of covered fund to those types of entities that [the Volcker rule] was designed to focus on.'' In particular, the exclusions are designed to ''provide certainty, mitigate compliance costs and other burdens and address the potential over-breadth of the covered fund definition

[31] Final Regulation, Common Rule § __.10(d)(6).
[32] Final Regulation, Common Rule § __.10(d)(6)(ii).
[33] Final Regulation, Common Rule § __.10(a)(2).
[34] Final Regulation, Common Rule § __.10(d)(9).
[35] Final Regulation, Common Rule § __.10(d)(10).
[36] Preamble to the Final Regulation at p. 630-631.
[37] Final Regulation, Common Rule § __.10(c).

and related requirements without such exclusions by permitting banking entities to invest in and have other relationships with entities that do not relate to the statutory purpose of [the Volcker rule].''[38] Following is an overview of the definitional exclusions.

Foreign Public Funds

The Final Regulation provides an exclusion from the definition of covered fund for any issuer that is organized or established outside of the U.S., the ownership interests of which are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and are sold predominantly through one or more public offerings outside of the U.S.[39]

The term ''home jurisdiction'' is not defined. In the banking context, the term generally refers to the jurisdiction where an entity is organized or established.[40] However, in the securities context, an entity's home jurisdiction could also refer to the principal foreign market where the entity's securities are listed or quoted, in addition to the entity's place of incorporation or organization.[41] Accordingly, while there is some indication that the Agencies may have intended to refer to the jurisdiction in which a fund is organized or formed by their reference to ''home jurisdiction'' for purposes of the foreign public fund exclusion,[42] it is unclear whether this exclusion could still be available to a fund that is established in one jurisdiction, but does business in, and is registered for trading on a public market in, another jurisdiction. In any event, the Agencies have indicated that the foreign public fund exclusion is intended to capture the types of foreign funds that would generally be subject to home-country regulation, such as UCITS and foreign mutual funds.[43] In particular, this exclusion is intended to ''prevent the extension of the definition of covered fund from including foreign funds that are similar to U.S. registered investment companies, which are by statute not covered by [the Volcker rule].''[44]

Foreign funds that meet the requirements of the foreign public fund exclusion will not be treated as ''covered funds,'' except that an additional condition applies to U.S. banking entities (including their foreign affiliates) with respect to the foreign public funds they sponsor.[45] Specifically, the foreign public fund exclusion is only available to a U.S. banking entity (including any foreign affiliate) with respect to a foreign fund sponsored by the U.S. banking entity if, in addition to the requirements discussed above for the exclusion, the fund's ownership interests are sold predominantly[46] to persons other than the sponsoring banking entity, affiliates of the issuer and the sponsoring banking entity, and employees and directors of such entities.[47] The term ''public offering'' is defined and includes certain conditions that must be met in order for a banking entity to avail itself of the foreign public fund exclusion.[48]

To more effectively monitor the use of this exclusion by U.S. banking entities against potential evasion of the Volcker rule, the Agencies imposed certain documentation requirements for U.S. banking entities above a certain size that also have substantial investments in foreign public funds. Specifically, a U.S. banking entity with more than $10 billion in total consolidated assets will be required to document its investments in foreign public funds, broken out by each foreign public fund and each foreign jurisdiction in which any foreign public fund is organized, if the U.S. banking entity and its affiliates' ownership interests in foreign public funds exceed $50 million at the end of two or more consecutive calendar quarters.[49]

Wholly-Owned Subsidiaries

The Final Regulation provides an exclusion for wholly-owned subsidiaries that are typically used by companies for organizational convenience and are not expected by the Agencies to have ''the characteristics, risks, or purpose of a hedge fund or private equity fund, which involves unaffiliated investors owning interests in the structure for the purpose of sharing in the profits and losses from investment activities.''[50]

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[38] Preamble to the Final Regulation at p. 501. As expected, the Agencies have noted their wariness for potential evasion of the Volcker rule and that they will ''monitor use of the exclusions for attempts to evade the requirements of [the Volcker rule] and intend to use their authority where appropriate to prevent evasions of the rule.'' Preamble to the Final Regulation at p. 502.

[39] Final Regulation, Common Rule § __.10(c)(1)(i).

[40] *See, e.g.*, 12 C.F.R. § 217.61.

[41] *See, e.g.*, 17 C.F.R. § 230.800(f).

[42] Preamble to the Final Regulation at p. 504.

[43] Preamble to the Final Regulation at p. 504. ''UCITS'' refer to ''Undertakings For The Collective Investment Of Transferable Securities,'' which are funds that can be marketed within all countries that are a part of the European Union, provided that the fund and fund managers are registered within the domestic country.

[44] Preamble to the Final Regulation at p. 486-487.

[45] The additional condition only applies to U.S. banking entities with respect to the foreign public funds they sponsor because the Agencies believe that a foreign public fund sponsored by a U.S. banking entity may ''present heightened risks of evasion.'' Preamble to the Final Regulation at p. 508. As explained by the Agencies, ''[a]bsent the additional condition, a U.S. banking entity could establish a foreign public fund for the purpose of itself investing substantially in that fund and, through the fund, making investments that the banking entity could not make directly under [the Volcker rule].'' Preamble to the Final Regulation at p. 508.

[46] Consistent with the Agencies' view concerning whether a foreign public fund has been sold predominantly outside of the U.S., the Agencies generally expect that a foreign public fund will satisfy this additional condition if 85 percent or more of the fund's interests are sold to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity. Preamble to the Final Regulation at p. 508.

[47] Final Regulation, Common Rule § __.10(c)(1)(ii).

[48] Final Regulation, Common Rule § __.10(c)(1)(iii).

[49] Final Regulation, Common Rule § __.10(e)(4). *See* Preamble to the Final Regulation at p. 509-510.

[50] Preamble to the Final Regulation at p. 511.

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To more effectively monitor the use of this exclusion by U.S. banking entities against potential evasion of the Volcker rule, the Agencies imposed certain documentation requirements for U.S. banking entities above a certain size that also have substantial investments in foreign public funds.

This exclusion is available for any entity, all of the outstanding ownership interests of which are owned directly or indirectly by a banking entity (or an affiliate thereof), except that: (i) up to 5 percent of the entity's outstanding ownership interests may be held by employees or directors of the banking entity or such affiliate (including former employees or directors if their ownership interest was acquired while employed by or in the service of the banking entity); and (ii) within such 5 percent ownership interest, up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.[51]

Importantly, while the exclusion allows a wholly-owned subsidiary of a banking entity to be excluded from the definition of covered fund, such subsidiary would still itself be deemed a ''banking entity'' (which, as noted above, includes all affiliates and subsidiaries of an insured depository institution and companies that control an insured depository institution), and therefore would remain subject to the Volcker rule restrictions.[52]

Joint Ventures

The Final Regulation also provides an exclusion for joint ventures, which the Agencies note are ''a common form of business, especially for firms seeking to enter new lines of business or new markets, or seeking to share complementary business expertise.''[53]

Specifically, a joint venture is excluded from the definition of covered fund if the joint venture is established between or among the banking entity or any of its affiliates and no more than 10 unaffiliated co-venturers, is in the business of engaging in activities that are permissible for the banking entity other than investing in securities for resale or other disposition, and is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.[54]

Notably, a banking entity may not use a joint venture to engage in merchant banking activities (which are permissible for financial holding companies under the Bank Holding Company Act [''BHCA''][55]), as that would involve acquiring or retaining shares, assets, or ownership interests for the purpose of ultimate resale or disposition of the investment, and thus disqualify the issuer from eligibility for the exclusion.[56]

Acquisition Vehicles

For largely the same policy reasons contemplated by the Agencies for excluding wholly-owned subsidiaries and joint ventures from the definition of covered fund, the Final Regulation provides an exclusion for acquisition vehicles that are formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction, and that exist only for such period as necessary to effectuate the transaction.[57] Notably, an acquisition vehicle that survives a transaction would likely be excluded from the definition of covered fund anyway under the separate exclusion for either joint ventures or wholly-owned subsidiaries.[58]

Foreign Pension or Retirement Funds

An exclusion from the definition of covered fund is also provided for any plan, fund, or program providing pension, retirement, or similar benefits that is: (i) organized and administered outside the U.S.; (ii) a broad-based pension, retirement or similar plan, subject to certain conditions; and (iii) established for the benefit of citizens or residents of one or more foreign sovereigns or any political subdivision thereof.[59]

As noted by the Agencies, an exclusion is appropriate for foreign pension plans because such plans could potentially be deemed to be covered funds where they may need to rely on the exemptions in Section 3(c)(1) or 3(c)(7) of the 1940 Act in order to avoid being an investment company under such Act if such plans are offered to citizens of the foreign sovereign who are in the U.S.[60] As noted by the Agencies, providing an exclusion for foreign pension plans ''is similar to the treatment provided to U.S. pension funds by virtue of the exclusion from the definition of investment company under the Investment Company Act for certain broad-based employee benefit plans provided by Section 3(c)(11) of that Act.''[61] Specifically, the definitional exclusion provided for foreign pension plans is intended to be available for *bona fide* plans established for the benefit of employees or citizens outside the U.S., even if some of the beneficiaries of the fund reside in the U.S. or subsequently become U.S. residents.[62]

Insurance Company Separate Accounts

The Final Regulation provides an exclusion from the definition of covered fund for insurance company separate accounts, which are separate accounts established by banking entities that are insurance companies, generally to allow policyholders of variable annuity and variable life insurance to allocate premium amounts for the purpose of engaging in various investment strategies that are tailored to the requirements of the individual policyholder.[63]

[51] Final Regulation, Common Rule § __.10(c)(2). *See* Preamble to the Final Regulation at p. 512-513.
[52] *See* Preamble to the Final Regulation at p. 514-515.
[53] Preamble to the Final Regulation at p. 515.
[54] Final Regulation, Common Rule § __.10(c)(3).
[55] 12 U.S.C. § 1843(k)(4)(H).
[56] *See* Preamble to the Final Regulation at p. 517-518.
[57] Final Regulation, Common Rule § __.10(c)(4).
[58] Preamble to the Final Regulation at p. 521.
[59] Final Regulation, Common Rule § __.10(c)(5).
[60] *See* Preamble to the Final Regulation at p. 522.
[61] Preamble to the Final Regulation at p. 523.
[62] Preamble to the Final Regulation at p. 523.
[63] Final Regulation, Common Rule § __.10(c)(6). *See* Preamble to Final Regulation at p. 524.

A ''separate account'' is an account established and maintained by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company's other assets, under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.[64]

To prevent this exclusion from being used to evade the restrictions on investments in and sponsorship of covered funds by a banking entity, the Final Regulation provides that no banking entity other than the insurance company that establishes the separate account may participate in the account's profits and losses.[65] Accordingly, the availability of this exclusion is narrowly tailored for banking entities that are insurance companies and apparently not available to a banking entity that did not establish the insurance company separate account.

Bank Owned Life Insurance Separate Accounts

In recognition of the long-standing and common practice of banking entities that have invested in life insurance policies covering their key employees, the Final Regulation contains an exclusion from the definition of covered fund that allows banking entities to continue such practice by permitting them to invest in and sponsor bank owned life insurance (''BOLI'') separate accounts, subject to meeting safety and soundness standards.

Similar to the insurance company separate account exclusion, the exclusion is narrowly tailored and is available only for a separate account of a banking entity 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.[66]

Loan Securitizations

The Final Regulation also provides a definitional exclusion from the term covered fund for loan securitizations. For purposes of the exclusion, an issuing entity[67] for asset-backed securities would not be a ''covered fund'' if the underlying assets or holdings are comprised *solely* of:

To prevent this exclusion from being used to evade the restrictions on investments in and sponsorship of covered funds by a banking entity, the Final Regulation provides that no banking entity other than the insurance company that establishes the separate account may participate in the account's profits and losses.

- ''Loans,'' which refer to ''any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative;''[68]
- Any rights or other assets: (i) designed to assure the servicing or timely distribution of proceeds to security holders, or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans, provided that such assets are ''permitted securities'' as defined in the Final Regulation;
- Certain interest rate or foreign exchange derivatives; and
- Certain special units of beneficial interests and collateral certificates (together, ''loan securitizations'').[69]

The term ''asset-backed security'' is defined as: (i) a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset. . .; and (ii) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.[70]

Importantly, the Agencies have rejected a broad definition of the term ''loan'' that would permit additional assets that are loan-related, e.g., re-securitizations of loan securitizations, to be held under the loan securitization exclusion.[71] This has created challenges for banking entities holding investments issued by securitization vehicles that have underlying assets that may be based on – but are not solely comprised of – eligible loan assets.[72]

In rejecting requests by commenters for a broader exclusion that would cover a greater variety of loan secu-

[64] Final Regulation, Common Rule § __.2(bb).

[65] Final Regulation, Common Rule § __.10(c)(6). *See* Preamble to Final Regulation at p. 525.

[66] Final Regulation, Common Rule § __.10(c)(7).

[67] An ''issuing entity'' means, with respect to asset-backed securities, the special purpose vehicle that owns or holds the pool assets underlying asset-backed securities and in whose name the asset-backed securities supported or serviced by the pool assets are issued. Final Regulation, Common Rule § __.10(d).

[68] Final Regulation, Common Rule § _.2(s).

[69] Final Regulation, Common Rule § _.10(c)(8)(i).

[70] Final Regulation, Common Rule § _.10(d)(2), *referencing* 12 U.S.C. § 78c(a)(79).

[71] *See* Preamble to Final Regulation at p. 539. The Agencies believe such an expansion of the exclusion would not be consistent with the rule of construction in Section 13(g)(2) of the BHCA, which specifically refers to the ''sale and securitization of loans.'' 12 U.S.C. § 1851(g)(2).

[72] *See, e.g.*, Katy Burne and Ryan Tracy, ''*Banks Sell More Slices of Collateralized Loan Obligations - Divestments Come*

  BBR ISSN 0891-0634

ritization vehicles, the Agencies have expressed a concern that a broad definition of the term ''loan'' – and therefore a broad exclusion for transactions that are structured as securitizations of pooled financial assets – ''could undermine the restrictions Congress intended to impose on banking entities' covered fund activities, which could enable market participants to use securitization structures to engage in activities that otherwise are constrained for covered funds.''[73] Permitted securities are (i) cash equivalents for purposes of any rights or assets designed to assure the servicing or timely distribution of proceeds to security holders, or related to purchasing or acquiring and holding the loans; or (ii) securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities.[74] Impermissible assets for purposes of this exclusion include: (i) any security, including an asset-backed security, or an interest in an equity or debt security (other than a permitted security); (ii) any derivative, other than certain interest rate or foreign exchange derivatives satisfying certain conditions;[75] or (iii) a commodity forward contract.[76]

The loan securitization exclusion is narrowly construed and only available for asset securitization vehicles with assets or holdings that are comprised solely of ''loans'' and certain closely-related types of eligible assets set forth under the Final Regulation. Loan securitizations that meet the conditions of the exclusion are not deemed to be covered funds and, consequently, banking entities are not restricted under the Volcker rule regarding their ownership of such entities or their ongoing relationships with such entities.

As noted, on Jan. 14, 2014, the Agencies issued an interim final rule amending the Final Regulation in order to authorize banking entities to continue holding interests in certain TruPS CDOs that are collateralized debt obligations backed primarily by trust preferred securities that have been issued by banks with total assets of less than $15 billion.[77] Without such regulatory relief, TruPS CDOs, which are generally securitizations of securitizations, would have been treated as covered funds, as they would not have qualified for any definitional exclusion, including the loan securitization exclusion under its strict definition of the term ''loan.'' The Agencies are currently considering public comments in connection with the interim final rule, and may consider providing similar regulatory relief for other common types of securitization vehicles that are secured by assets that are not comprised solely of loans.

An important issue in the context of this discussion involves what the industry views as some unfinished business with respect to the continuing ''covered fund'' treatment of certain TruPS CDOs (backed by insurance companies and real estate investment trusts) not covered by the Agencies' interim final rule and, raising the most significant concerns, the treatment of certain collateralized loan obligations (''CLOs'') as ''covered funds.''[78] In the latter case, the issue revolves around the fact that nonqualifying CLOs are not comprised *solely* of loans, as required by the statute. What has the industry most upset – and legitimately so – is that not only are there legitimate safety and soundness reasons for the CLOs to hold certain assets other than loans, often the nonqualifying assets are bonds (effectively, securities backed *solely* by loans). Thus, the Agencies eschewed the typical type of pass-through analysis that the federal banking agencies, in particular, often apply in dealing with loans, as well as loan securitizations and participations in the traditional banking context.

Asset-Backed Commercial Paper Conduits

The Final Regulation also provides an exclusion from the definition of ''covered fund'' for qualifying asset-backed commercial paper (''ABCP'') conduits that hold only: (i) loans or other assets that would be permissible for the loan securitization exclusion (discussed above), and (ii) asset-backed securities that are supported solely by assets permissible for the loan securitization exclusion and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.[79] Moreover, a qualifying ABCP conduit must issue only asset-backed securities, comprised of a residual interest and securities with a term of 397 days or less. A final element for this exclusion is that a ''regulated liquidity provider'' must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding short term asset-backed securities issued by the qualifying ABCP conduit in the event that funds are required to redeem the maturing securities.[80]

The definition of ''regulated liquidity provider'' includes a depository institution; a holding company[81] or a subsidiary thereof; certain qualifying foreign banks or their subsidiaries;[82] and the United States or a foreign sovereign.[83]

Ahead of a Volcker-Rule Ban,'' American Banker (Jan. 8, 2014).

[73] Preamble to Final Regulation at p. 540.

[74] Final Regulation, Common Rule § _.10(c)(8)(iii).

[75] Specifically, the written terms of the derivative must directly relate to the loans, the asset-backed securities, or the contractual rights or assets designed to assure the servicing or timely distribution of proceeds to security holders, or related or incidental to purchasing or otherwise acquiring, and holding the loans. Also, the derivatives must reduce the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities or the contractual rights or assets designed to assure the servicing or timely distribution of proceeds to security holders, or related or incidental to purchasing or otherwise acquiring, and holding the loans. Final Regulation, Common Rule § _.10(c)(8)(ii)(B), *referencing* Final Regulation, Common Rule § _.10(c)(8)(iv).

[76] Final Regulation, Common Rule § _.10(c)(8)(ii).

[77] Interim Final Rule, *Treatment of Certain Collateralized Debt Obligations Backed Primarily By Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds* (Jan. 14, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140114b1.pdf.

[78] Comment Letter from the American Bankers Association to the Agencies dated March 3, 2014.

[79] Final Regulation, Common Rule § __.10(c)(9)(i)(A).

[80] Final Regulation, Common Rule § __.10(c)(9)(i)(B)-(C).

[81] Including a savings and loan holding company, provided or substantially all of the holding company's activities are permissible for a financial holding company. *See* 12 U.S.C. § 1843(k).

[82] Specifically, the foreign bank must have a home country supervisor (*see* 12 C.F.R. § 211.21(q)) that has adopted capital standards consistent with the Capital Accord for the Basel Committee on Banking Supervision, as amended, and that is subject to such standards.

[83] Final Regulation, Common Rule § __.10(c)(9)(ii).

What has the industry most upset – and legitimately so – is that not only are there legitimate safety and soundness reasons for the CLOs to hold certain assets other than loans, often the nonqualifying assets are bonds (effectively, securities backed *solely* by loans).

Covered Bonds

Related to the loan securitization exclusion, the Final Regulation provides a separate exclusion for banking entities that own or hold ''a dynamic or fixed pool of loans'' or other assets that are permissible for the loan securitization exclusion for the benefit of the holders of covered bonds.[84] For purposes of this exclusion, a covered bond refers to: (i) a debt obligation issued by an entity that is a foreign banking organization,[85] the payment obligations of which are fully and unconditionally guaranteed by the banking entity; or (ii) a debt obligation of the banking entity, provided that the payment obligations are fully and unconditionally guaranteed by an entity that meets the definition of foreign banking organization and the entity is a wholly-owned subsidiary[86] of such foreign banking organization.[87]

Public Welfare and Similar Funds

The Final Regulation provides an exclusion for investments in and sponsorship of funds designed to promote the public welfare, small business investment companies (''SBICs'')[88] and other tax credit funds, in light of ''the valuable funding and assistance these investments provide in facilitating community and economic priorities and the role these investments play in the ability of banking entities, especially community and regional banks, to achieve their financial and Community Reinvestment Act (''CRA'') goals.''[89]

Specifically, the Final Regulation excludes from the definition of covered fund an issuer that is a SBIC[90] or the business of which is to make investments that are: (i) designed primarily to promote the public welfare,[91] including the welfare of low- and moderate-income communities or families (such as providing housing, services or jobs); or (ii) qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure.[92]

Registered Investment Companies and Business Development Companies

Registered investment companies and business development companies are generally not deemed covered funds because they do not rely on either Section 3(c)(1) or 3(c)(7) of the 1940 Act, and are instead registered or regulated in accordance with such Act. However, in recognition of the circumstance that an entity that becomes a registered investment company or business development company might, during its seeding period, rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act, the Agencies have provided an exclusion for these seeding vehicles from the covered fund definition.

Noting that it would be inappropriate to treat as covered funds registered investment companies and business development companies, which are regulated by the SEC as investment companies, the Agencies provide an exclusion in the Final Regulation for any issuer: (i) that is registered as an investment company under the 1940 Act, or that is formed and operated pursuant to a written plan to become a registered investment company and that complies with the requirements of the 1940 Act;[93] (ii) that may rely on an exclusion or exemption from the definition of ''investment company'' under the 1940 Act[94] other than the exemptions contained in Section 3(c)(1) and 3(c)(7) of that Act; or (iii) that has elected to be regulated as a business development company[95] and has not withdrawn its election, or that is formed and operated pursuant to a written plan to become a business development company[96] and that complies with the requirements of the 1940 Act.[97]

Issuers Formed by the FDIC

An exclusion from the definition of covered fund is provided for any issuer that is an entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's capacity as conservator or receiver under the Federal Deposit Insurance Act or pursuant to the FDIC's orderly liquidation authority under Title II of the DFA.[98]

Other Excluded Issuers

As noted by commenters, the types of entities that may be required to rely on the exclusions in Section 3(c)(1) or 3(c)(7) of the 1940 Act are diverse and could result in additional unidentified entities becoming subject to the definition of ''covered fund.''[99] Accordingly, to ensure that the Final Regulation ''effectively addresses the full scope of entities that may inadvertently be included within the definition of covered fund,'' the Final Regulation includes a mechanism to exclude other entities from the term ''covered fund'' if the Agencies determine such an exclusion is appropriate.[100] The Agencies indicated that they are working to establish a process within which to evaluate requests for exclu-

[84] Final Regulation, Common Rule § __.10(c)(10)(i). The assets in the pool must be comprised solely of assets that are permissible for the loan securitization exclusion.

[85] 12 C.F.R. § 211.21(o).

[86] *See* definition in Final Regulation, Common Rule § __.10(c)(2).

[87] Final Regulation, Common Rule § __.10(c)(10).

[88] As defined in Section 103(3) of the Small Business Investment Act of 1958, *codified at* 15 U.S.C. § 662.

[89] Preamble to Final Regulation at p. 577.

[90] If the entity is not a SBIC, then alternatively, the entity has received from the Small Business Administration notice to proceed to qualify for a license as an SBIC, which notice or license has not been revoked. Final Regulation, Common Rule § __.10(c)(11)(i).

[91] *See* paragraph (11) of Section 5136 of the Revised Statutes, 12 U.S.C. § 24.

[92] As defined under Section 47 of the Internal Revenue Code of 1986 ''or a similar State historic tax credit program.'' Final Regulation, Common Rule § __.10(c)(11).

[93] 15 U.S.C. § 80a-18.

[94] 15 U.S.C. §§ 80a-1 *et seq*.

[95] 15 U.S.C. § 80a-53.

[96] See the requirements of the written plan, as described in note 97 above.

[97] Final Regulation, Common Rule § __.10(c)(12).

[98] Final Regulation, Common Rule § __.10(c)(13).

[99] Preamble to the Final Regulation at p. 582-583.

[100] Final Regulation, Common Rule § __.10(c)(14).

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sions and expect to provide additional guidance on this matter as the Agencies gain experience with the Final Regulation.[101] To ensure transparency and that both banking entities and the public may understand what entities are and are not included within the definition of covered fund, the Final Regulation provides that a determination by the Agencies to exclude an entity from the definition of covered fund would promptly be made public.[102]

The Agencies indicated that they are working to establish a process within which to evaluate requests for exclusions and expect to provide additional guidance on this matter as the Agencies gain experience with the Final Regulation.

Exemptions for Permitted Covered Fund Activities. As with the Volcker rule proprietary trading prohibition, an important aspect of the covered fund provisions of the Final Regulation are the exemptions for permitted covered fund activities. The Final Regulation generally tracks the statutory exemptions for permitted covered fund activities. However, there are a few developments from the November 2011 proposed rule to the Final Regulation; these included augmenting the organizing and offering exemption for asset management activities with an expanded exemption for asset-backed securities (''ABS'') activities, and limiting the availability of the risk-mitigating hedging exemption (both of which are discussed below). The following discussion highlights the activities permitted via an exemption to the general prohibition on investments in and sponsorship of a covered fund.

Asset Management Services Exemption

The most prominent covered fund exemption involves an investment in or sponsorship of a covered fund ''organized and offered'' by a banking entity where the banking entity provides *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services (collectively, ''Asset Management Services'') to the fund.[103] The exemption is subject to various conditions, including that:

- The fund may only provide Asset Management Services and such services may only be provided to customers of the bank or an affiliate;
- Such services must be provided pursuant to a written plan outlining how the services will be provided;
- The banking entity and its affiliates must comply with applicable affiliate transaction restrictions, including the so-called Super 23A prohibition of the Final Regulation;[104]
- The banking entity and its affiliates may not directly or indirectly gaurantee the obligations or performance of the fund or any covered fund in which the fund invests;
- The covered fund must adhere to restrictions on name-sharing with the banking entity;
- Only directors or employees of the banking entity (or its affiliates) directly engaged in providing investment advisory or similar services to the fund may invest in the fund; and
- Clear written disclosures must be provided to investors in the covered fund.

In addition to the above conditions, a banking entity's ownership interest in the covered fund is subject to the following quantitative restrictions:

- The banking entity cannot own more than 3 percent of the total number or value of the outstanding ownership interests of the covered fund (the ''per-fund limit''); and
- The total value of all ownership interests of the banking entity and its affiliates in all covered funds cannot exceed 3 percent of the tier 1 capital of the banking entity (the ''aggregate limit'').[105]

Notwithstanding these numerical limits, during the so-called ''seeding period,'' i.e., where a banking entity is actively seeking unaffiliated investors to reduce its ownership stake in the covered fund, a banking entity is permitted to provide a covered fund with sufficient initial equity investment to attract unaffiliated investors such that its ownership may exceed the 3 percent per fund limit, but only during the first year after the date the covered fund is established.[106]

ABS Issuer Exemption

Similar to the Asset Management Services exemption, there is an exemption for a banking entity that directly or indirectly organizes and offers a covered fund that is an issuer of asset-backed securities (''ABS Issuer'').[107] The ABS Issuer exemption is also subject to the following similar conditions:

- The banking entity and its affiliates must comply with applicable affiliate transaction restrictions, including the Super 23A prohibition of the Final Regulation, as applied to the ABS Issuer; [108]
- The banking entity and its affiliates must not directly or indirectly gaurantee the obligations or performance of the ABS Issuer or any covered fund in which the ABS Issuer invests;
- The ABS Issuer must adhere to restrictions on name-sharing with the banking entity;
- Only directors or employees of the banking entity (or its affiliates) directly engaged in providing investment advisory or similar services to the ABS Issuer may invest in the ABS Issuer; and

[101] Preamble to the Final Regulation at p. 584.
[102] Final Regulation, Common Rule § __.10(c)(14)(ii).
[103] Final Regulation, Common Rule § __.11(a).
[104] *See* Final Regulation, Common Rule § __.14.
[105] Final Regulation, Common Rule § __.12(a)(2).
[106] According to the Preamble to the Final Regulations, ''[i]n general, the date of establishment is the date on which an investment adviser or similar party begins to make investments that execute an investment or trading strategy for the covered fund. Preamble to the Final Regulation at p. 675.
[107] Final Regulation, Common Rule § __.11(b).
[108] See Final Regulation, Common Rule § __.14.

■ Clear written disclosures must be provided to investors in the ABS Issuer.

In addition to the above conditions, a banking entity's ownership interest in an ABS Issuer is subject to the same per-fund and aggregate limits and ''seeding period'' allowance applicable to the Asset Management Services exemption.[109] However, if a banking entity is required to maintain an ownership interest in an ABS Issuer pursuant to the credit risk retention requirements of Section 941 of the DFA (the ''Credit Risk Retention Requirement''),[110] the banking entity may retain an ownership interest in the ABS Issuer that exceeds 3 percent. The amount, number or value of that ownership interest must not be more than that required to comply with the Credit Risk Retention Requirement, which, as currently proposed, is 5 percent of the fair value of all ABS interests.[111]

Underwriting and Market-Making Exemption

Pursuant to the covered fund underwriting and market-making exemption, a banking entity may acquire or retain an ownership interest in a covered fund as underwriter if the underwriting activities are conducted pursuant to the requirements for permitted underwriting activities under the proprietary trading restrictions of the Final Regulation.[112] These include acting as an underwriter; maintaining position limits designed not to exceed the reasonably expected near-term demand of customers, clients or counterparties; compensation arrangements that do not reward or incentivize prohibited training; and effective compliance programs.[113]

Similarly, a banking entity may acquire or retain an ownership interest in a covered fund as a market-maker if the market-making activities are conducted pursuant to the requirements for permitted market-making activities under the proprietary trading restrictions of the Final Regulation.[114] These requirements include standing ready to purchase and sell securities in which the entity is making a market; holding only commercially reasonable amounts of securities to satisfy anticipated demands through market cycles; position limits designed not to exceed the reasonably expected near-term demand of customers, clients or counterparties; compensation arrangements that do not reward or incentivize prohibited training; and effective compliance programs.[115]

Importantly, a banking entity that acquires or retains an ownership interest in a covered fund under the market-making or underwriting exceptions is subject to the 3 percent per-fund limit and the 3 percent aggregate limit for ownership of a covered fund.[116]

Risk-Mitigating Hedging Exemption

Another exemption permits an investment in a covered fund that is designed as a risk-mitigating hedge related to employee compensation arrangements. Sounding a familiar cautionary note, the Agencies elected to curtail a broader exemption that would have included investment in a covered fund to hedge certain obligations or liabilities arising from a banking entity acting on behalf of a customer to facilitate the customer's exposure to the profits and losses of the covered fund. The more limited compensation arrangement exemption allows for a banking entity to acquire or retain an ownership interest in a covered fund ''provided that the ownership interest is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund.''[117] Pursuant to the exemption, a banking entity may not hedge its ownership interests in a covered fund for which an employee does not provide services.

Similarly, a banking entity may acquire or retain an ownership interest in a covered fund as a market-maker if the market-making activities are conducted pursuant to the requirements for permitted market-making activities under the proprietary trading restrictions of the Final Regulation.

The exemption is subject to various conditions, including:

■ Being subject to an internal compliance program and written policies and procedures reasonably designed to ensure compliance with the requirements of the exemption;

■ The ownership interest is designed to ''reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with the compensation arrangement with the employee'' providing services to the covered fund;

■ The ownership interest does not present any significant additional risks that are not hedged in accordance with the requirements for the risk-mitigating hedging exemption;'' and

■ Ownership of the interest is subject to continuing review, monitoring and management.[118]

Foreign Fund 'Off-Shore' Exemption

Notwithstanding the almost complete carve out from the definition of ''covered fund'' for activities of foreign banking entities that involve funds that are organized

[109] Final Regulation, Common Rule § __.12(a)(2).

[110] Codified at Section 15G of the Exchange Act, 15 U.S.C. § 78o-11. Once finalized, the implementing regulations for Section 15G will appear at 12 C.F.R. Part 246. The general credit risk retention requirement is located at § __.4(b) of the proposed Credit Risk Retention rule. *See* 78 Fed. Reg. 57928, 58029 (Sept. 20, 2013).

[111] Final Regulation, Common Rule § _.12(a)(2)(ii)(B).

[112] Final Regulation, Common Rule § __.11(c)(1), referencing Common Rule § __.4(c).

[113] Final Regulation, Common Rule § _.4(a).

[114] Final Regulation, Common Rule § __.11(c)(1), referencing Common Rule § __.4(b).

[115] Final Regulation, Common Rule § _.4(b).

[116] Final Regulation, Common Rule § _.11(c)(2) and (3).

[117] Preamble to the Final Regulation at p. 723.

[118] Final Regulation, Common Rule § __.13(a)(2).

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or established outside of the U.S. and offer or sell fund ownership interests solely outside of the U.S. (i.e., the fund would not be an investment company under the 1940 Act *but for* Section 3(c)(1) or 3(c)(7) of that Act), an activity exemption is provided for activities of foreign banking entities involving funds that *do* meet the definition of a covered fund.[119]

Notably, however, this activity exemption for foreign funds is not available to U.S. banking entities (nor any of their foreign affiliates worldwide). Specifically, a condition for this exemption requires that 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.''[120]

Thus, the foreign fund ''off-shore'' exemption (as distinguished from the foreign fund exclusion from the definition of covered fund) permits a foreign banking entity to acquire or retain an ownership interest in, or have certain relationships with, a covered fund if the activity or investment is conducted by the foreign banking entity pursuant to paragraph (9) or (13) of Section 4(c) of the BHCA,[121] no ownership interest in such fund is offered for sale or sold to a ''resident of the United States,'' and the activity occurs ''solely outside of the United States.''[122]

Section 4(c)(9) of the BHCA relates to the nonbanking activities of foreign banking entities,[123] and while the statutory language of the Volcker rule references Section 4(c)(13) of the BHCA,[124] the FRB has in practice applied the authority contained in that Section only to the international activities of U.S. banking holding companies.[125] Given that the express language of the Volcker rule limits the availability of this exemption to foreign banking entities that are not controlled by a banking entity organized under the laws of the U.S. (or of one or more States), Section 4(c)(9) of the BHCA is the relevant reference for purposes of this element.

The Final Regulation provides that an activity will be considered to be conducted pursuant to Section 4(c)(9) of the BHCA only if the covered banking entity conducts the activity in accordance with the requirements of the exemption and the foreign banking entity meets the definition of a ''qualifying foreign banking organization'' (''Q-FBO'') under the FRB's Regulation K.[126] Foreign banking entities with banking operations in the U.S. are subject to the FRB's Regulation K and will generally be able to confirm their status regarding whether they are Q-FBOs.

An ownership interest in a covered fund is not ''offered for sale or sold to a resident of the United States'' if ''it is sold or has been sold pursuant to an offering that does not target residents of the United States.''[127] To meet this requirement, fund managers and organizers must ensure that no ownership interests in the foreign fund are offered for sale or sold to a ''resident of the United States.'' In this regard, we note that for foreign funds in which there appear to be no obvious U.S. investors, fund managers should consider precautions to assure that any investors do not hold dual citizenships, one of which is a U.S. citizenship.

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[119] Final Regulation, Common Rule § __.13(b).

[120] Final Regulation, Common Rule § __.13(b)(1)(i).

[121] 12 U.S.C. § 1843(c)(9) and (13).

[122] 12 U.S.C. § 1851(d)(1)(I); Final Regulation, Common Rule § _.13(b).

[123] Section 4(c)(9) of the BHCA generally provides that the restrictions on nonbanking activities under the BHCA do not apply to the ownership of shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the U.S., if the FRB by regulation or order determines that the exemption would not be substantially at variance with the purposes of the BHCA and would be in the public interest. 12 U.S.C. § 1843(c)(9).

[124] 12 U.S.C. § 1851(d)(1)(I).

[125] See Section 3550.0 of the BHC Supervision Manual.

[126] Final Regulation, Common Rule § _.13(b)(2)[(A)], *referencing* 12 C.F.R. § 211.23(a), (c) or (e). A ''foreign banking organization'' means: ''(1) A foreign bank, as defined in Section 1(b)(7) of the IBA (12 U.S.C. 3101(7)), that: (i) Operates a branch, agency or commercial lending company subsidiary in the United States; (ii) Controls a bank in the United States; or (iii) Controls an Edge corporation acquired after March 5, 1987; and (2) Any company of which the foreign bank is a subsidiary.'' 12 C.F.R. § 211.21(o). With respect to a foreign banking entity that is a ''foreign banking organization'' (''FBO''), to be considered a Q-FBO, an FBO must generally meet certain tests indicating that more than half of its worldwide business is banking (disregarding banking activities in the U.S.) and more than half of its banking business is outside the U.S. *See generally* 12 C.F.R. § 211.23.

With respect to a banking entity that is not an FBO, (i.e., the entity is not itself a foreign bank nor does it control one) a proposed activity can nonetheless be considered to be conducted pursuant to Sections 4(c)(9) of the BHCA if the covered banking entity conducts the activity in accordance with the requirements of the exemption, the banking entity is not organized under the laws of the U.S. (or of one or more States), and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements: (i) total assets of the banking entity held outside the U.S. exceed total assets of the banking entity held in the U.S.; (ii) total revenues derived from the business of the banking entity outside of the U.S. exceed total revenues derived from the business of the banking entity in the U.S.; or (iii) total net income derived from the business of the banking entity outside of the U.S. exceeds total net income derived from the business of the banking entity in the U.S. Final Regulation, Common Rule § _.13(b)(2)(B).

[127] Final Regulation, Common Rule § _.13(b)(3). The definition of the term ''resident of the United States'' refers to the definition of ''U.S. person,'' as defined under the securities laws. Generally, the ''U.S. person'' definition includes: (i) any natural person resident in the United States; (ii) any partnership or corporation organized or incorporated under the laws of the United States; (iii) any estate of which any executor or administrator is a U.S. person; (iv) any trust of which any trustee is a U.S. person; (v) any agency or branch of a foreign entity located in the United States; (vi) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or (if an individual) resident in the United States; and (viii) any partnership or corporation if: (A) Organized or incorporated under the laws of any foreign jurisdiction; and (B) Formed by a U.S. person principally for the purpose of investing in securities not registered under the Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in § 230.501(a)) who are not natural persons, estates or trusts. 17 C.F.R. § 230.902(k)(1) (emphasis added). By contrast, the regulation provides that the term ''U.S. person'' does not include any agency or branch of a U.S. person located outside the United States if: (A) the agency or branch operates for valid business reasons; and (B) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located. 17 C.F.R. § 230.902(k)(2)(v).

Finally, the requirement for the activity or investment of the foreign banking entity to occur ''solely outside of the United States'' is met for a foreign banking entity if, among other conditions, the foreign banking entity is not acting through a banking entity that is located in the U.S.,[128] and 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 U.S. or organized under the laws of the U.S. or of any State.[129,130]

Regulated Insurance Company Exemption

The Final Regulation provides an activity exemption for investments in and activities with respect to a covered fund by a regulated insurance company.[131] Such activities are only permitted under the Final Regulation so long as: (i) the insurance company or its affiliate[132] 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; (ii) the acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations and written guidance of the state or jurisdiction in which the insurance company is domiciled; and (iii) the appropriate federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the states and relevant foreign jurisdictions, as appropriate, have *not* jointly determined, after notice and comment, that a particular law, regulation or written guidance described in (ii) above is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the U.S.[133] In providing this activity exemption, the Agencies note that insurance companies are ''already subject to a robust regulatory regime, including limitations on their investment activities.''[134]

Scope of Exemptions and Exclusion

As noted in the previous article discussing the Volcker rule proprietary trading prohibition, how the Agencies implement the covered fund exemptions and exclusions will determine the impact of the compliance burden, as well as the legal and supervisory impact on the industry of the Volcker rule's effectiveness and utility. Among the key issues are how the Agencies will approach interpretive issues given their different supervisory perspectives; the manner in which the Agencies will issue guidance; whether the Agencies will operate in lock-step; how enforcement and compliance issues will be handled with respect to covered fund activities, particularly given the obvious crossover between the 1940 Act and federal banking laws; how restrictive the Agencies will be in administering covered fund exemptions and exclusions; and the Agencies' expectations regarding compliance programs, policies and procedures, technical violations and regulatory flexibility for banking entities to design programs that fit their covered fund risk profile, rather than a cookie-cutter approach imposed by the Agencies.

Special Ownership Attribution Rules. In addition to the rules of construction for determining the ownership interests in covered funds acquired or retained under an exemption specified above, the Final Regulation proscribes general rules of construction for attributing ownership interests to a banking entity. Under the general attribution rule, a banking entity is only required to account for an investment in a covered fund for purposes of determining compliance with the per-fund limit and aggregate limit if the investment is made by the banking entity or an affiliate of the banking entity.[135] Ownership interests in a covered fund held in a personal capacity by an employee or director of a banking entity sponsoring such fund will be attributed to the banking entity where the banking entity extends financing to enable the employee/director to acquire the ownership interest.[136]

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[128] Final Regulation, Common Rule § _.13(b)(4)(i). For example, a U.S. branch, agency or subsidiary of a foreign banking entity is located in the U.S.; in this regard, a subsidiary (wherever located) of a U.S. branch, agency or subsidiary of a foreign bank is also considered itself to be located in the U.S. for purposes of this requirement. Final Regulation, Common Rule § _.13(b)(5). *See* Preamble to Final Regulation, p. 737. However, a foreign bank that operates or controls such a branch, agency, or subsidiary is not considered to be located in the U.S. solely by virtue of operation of the U.S. branch, agency, or subsidiary. Final Regulation, Common Rule § _.13(b)(5). As explained in the preamble to the Final Regulation, this provision ''helps give effect to the statutory language limiting the foreign fund exemption to activities of foreign banking entities that occur ''solely outside of the United States'' by clarifying that the U.S. operations of foreign banking entities may not sponsor or acquire or retain an ownership interest in a covered fund as principal based on this exemption.'' Preamble to Final Regulation, p. 737.

[129] The preamble to the Final Regulation notes that the decision-making activities do not include so-called ''back office'' activities that do not involve sponsoring or acquiring or retaining an ownership interest in a covered fund; as such, the Final Regulation does not impose restrictions on U.S. personnel of a foreign banking entity engaging in these activities in connection with one or more covered funds. This allows providing administrative services or similar functions to the covered fund as an incident to the activity conducted under the foreign fund exemption (such as clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data or providing clerical support for the fund). Preamble to Final Regulation, pgs. 737 - 738.

[130] Moreover, the investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, must not be accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State; and no financing for the foreign banking entity's ownership or sponsorship may be provided, directly or indirectly, by any branch or affiliate that is located in the U.S. or organized under the laws of the U.S. or of any State. Final Regulation, Common Rule § _.13(b)(4)(iii) and (iv).

[131] 12 U.S.C. § 1851(d)(1)(F).

[132] The term ''affiliate'' refers to any company that controls, is controlled by, or is under common control with another company. Final Regulation, Common Rule § _2(a), referencing 12 U.S.C. § 1841(k).

[133] Final Regulation, Common Rule § _.13(c).

[134] Preamble to Final Regulation at 750.

[135] Final Regulation, Common Rule § __.12(b)(1)(i); *see also* Preamble to the Final Regulation at p. 704.

[136] Final Regulation, Common Rule § _.12(b)(1)(iv).

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Under the general attribution rule, a banking entity is only required to account for an investment in a covered fund for purposes of determining compliance with the per-fund limit and aggregate limit if the investment is made by the banking entity or an affiliate of the banking entity.

Special ownership attribution rules also apply to certain multi-tier fund structures. For example, if a banking entity organizes and offers a covered fund for the purpose of investing in other covered funds (a fund of funds), and the fund of funds invests in another covered fund that the banking entity is permitted to own, then the banking entity must count both its investment in the underlying fund and its pro-rata share of any ownership interest in such fund held through the fund of funds.[137] Similarly, if the principal investment strategy of a covered fund (a feeder fund) organized and offered by a banking entity is to invest substantially all of its assets in another single covered fund (a master fund), then the banking entity's investment in such funds is measured only by reference to the value of the master fund.[138]

A final important consideration involves parallel investment strategies. In the Final Regulation, the Agencies determined to avoid requiring banking entities to aggregate various parallel investments in covered funds to prevent evasion of the per-fund and aggregate limits. The basis for this determination is that many such investments ''are made for the purpose of serving the legitimate needs of customers and shareholders, not for the purpose of circumventing the per-fund and aggregate fund limitations in [the Volcker rule].''[139] However, the Agencies warned that ''the potential for evasion of these limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors.''[140] Examples of when coordinated investments will be attributed to a banking entity for purposes of the per-fund and aggregate limits are where the banking entity: (i) makes a co-investment alongside a sponsored covered fund; (ii) investments through a co-investment vehcile that is also a covered fund; and (iii) makes investments side-by-side in substantially the same positions as a covered fund.[141]

Restricted Relationships With Covered Funds ('Super 23A' and 'Super 23B' Restrictions)

The Volcker rule also prohibits banking entities from having certain relationships with covered funds. Pursuant to the so-called ''Super 23A'' provision, no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading adviser or sponsor to a covered fund, or that organizes and offers a covered fund pursuant to the asset management exemption, or that holds an ownership interest in the fund pursuant to the asset-backed securitization exemption, and no affiliate of the banking entity, may enter into a ''covered transaction'' as defined in Section 23A of the Federal Reserve Act (e.g., a purchase of assets, credit transaction, etc.)[142] with the covered fund, or with any other covered fund that is controlled by such covered fund.[143] This restriction is subject to certain limited exceptions, including for prime brokerage transactions that meet certain requirements. Importantly, any affiliate of a banking entity is treated as a ''member bank'' and thus, a covered fund (or a fund controlled by the covered fund) is its affiliate, for purposes of the Section 23A and 23B restrictions. This effectively bars the ability of a banking entity to extend credit to a covered fund in which it has an ownership interest or serves as a sponsor. The related so-called ''Super 23B'' provision generally requires that all transactions not otherwise prohibited by the Super 23A restriction between the banking entity (or any affiliate) and covered fund (or other fund that is controlled by the covered fund) must be on arms' length terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving unaffiliated companies.[144]

Prudential Backstop Provisions. As with the proprietary trading prohibition, the covered fund provisions of the Final Regulation include a ''backstop prohibition'' that essentially bars certain transactions that otherwise satisfy applicable compliance criteria. Pursuant to the backstop provisions, while an investment in or sponsorship of a covered fund may generally be permissible under the Final Regulation, if the activity would ''involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States,''[145]then it will be prohibited.

Thus, notwithstanding the specific requirements for satisfying an exclusion or exemption to the covered fund provisions, there is the possibility that a covered fund activity could be barred. While most expect that this authority would be used only in the most pressing of circumstances, it remains nonetheless an important consideration, particularly for funds pursuing innovative strategies to avoid covered fund treatment.[146]

[137] Final Regulation, Common Rule § _.12(b)(4)(i).

[138] Final Regulation, Common Rule § _.12(b)(4)(ii). This includes any investment by the banking entity in the master fund and the banking entity's pro-rata share of any ownership interestof the master fund held through the feeder fund.

[139] Preamble to the Final Regulation at p. 711.

[140] Preamble to the Final Regulation at p. 711.

[141] Preamble to the Final Regulation at p. 712.

[142] 12 U.S.C. § 371c.

[143] 12 U.S.C. § 1851(f)(1), implemented at § _.14 of the Final Regulation.

[144] Section 23B of the Federal Reserve Act, *codified at* 12 U.S.C. § 371c-1. In the absence of comparable transactions, the transaction must be on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, non-affiliated companies.

[145] Preamble to the Final Regulation at p. 18, referencing criteria set forth in Final Regulation at § __.7(a).

[146] A more detailed analysis on the backstop provisions (discussed in the context of the proprietary trading backstop) is set forth in the Part 1 segment of this two-part series on the Volcker rule.

Conclusion. Much remains to be done to implement and understand the full implications of the covered fund provisions of the Volcker rule. Underscoring the complexities and uncertainty with the Final Regulation are issues that have been playing out in recent weeks – and continue to play out – in connection with lobbying efforts to address both the treatment of TruPS CDO and CLOs under the Final Regulation. While the TruPS CDO issue was addressed by the issuance of an interim final rule by the Agencies on Jan. 14, 2014, as of the date of this writing the CLO issue has attracted bipartisan attention on Capitol Hill, but not much traction with the regulators. It remains to be seen whether the CLO issue and the issue with TruPS CDOs that are backed by insurance companies and REITs (that were not addressed by the interim final rule) may be resolved. And the obvious next question is what will be the next Volcker rule issue requiring action by the regulators and/or a plea to Capitol Hill for intervention.

Certainly, the Volcker rule will reshape segments of the banking industry, as well as the securities and capital markets, but will the costs it has incurred and will continue to incur exceed its benefits? To a large extent, that determination now rests in the hands of the regulators. Among the more pressing challenges for the Agencies are coordinating on the implementation of guidance, compliance criteria, and examination and enforcement standards. It appears that the regulators understand this challenge and have convened a standing working group to address issues and questions and pursue common and consistent interpretations. The importance of this effort to the industry, as well as to the integrity, utility and effectiveness of the Volcker rule going forward, cannot be understated. While the Final Regulation has not provided the degree of certainty many hoped for, the Agencies' efforts to implement a process to work toward consistency and stability in the application of the Final Regulation is an important development that may ultimately remove much of the controversy that continues to envelope the Volcker rule.

At this point, many questions remain, including about the competitive impact of the rule on U.S. banks relative to foreign banks; the effectiveness of bank programs in complying with the covered fund provisions of the Final Regulation; how the Agencies will supervise and enforce the Final Regulation; the impact of the rule on lending, liquidity and capital formation; the impact of the rule on smaller banks; compliance costs; the extent of flexibility that the Agencies will provide for innovative solutions to fund formation, investments and sponsorship; and numerous other issues. Beyond this backdrop, there are questions related to the interaction of the Volcker rule with other laws, both Dodd-Frank and otherwise. Thus, while the Final Regulation answers many questions, it also raises new ones. And it will take time for the regulators and the industry to sort through these issues. For now, while we understand the issues, it is difficult to know how this will all play out. As Yogi Berra once observed, ''It's tough to make predictions, especially about the future.''

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