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Financial Services Regulatory Point of View

The Volcker Rule:

A Deeper Look into the Prohibition on Sponsoring or Investing in Covered Funds

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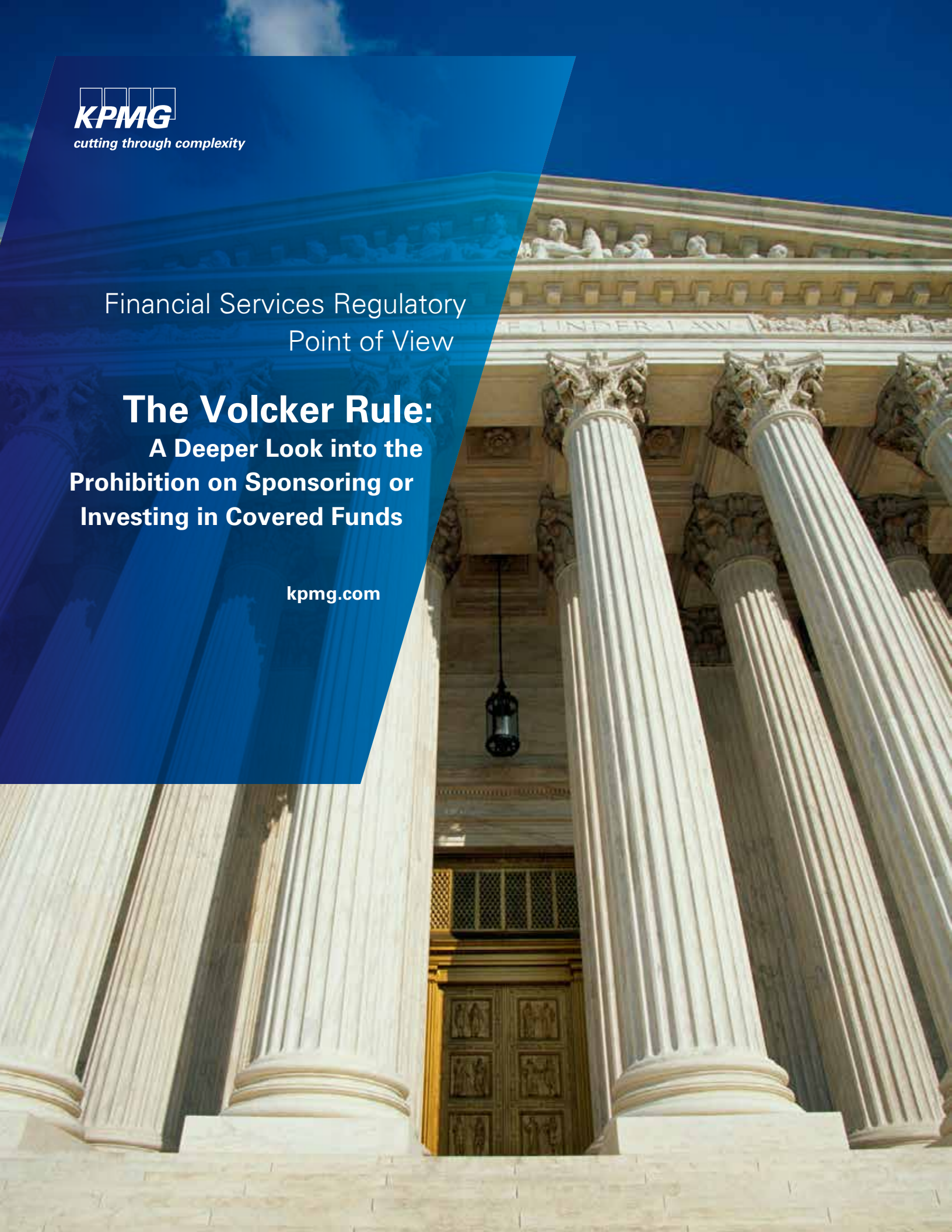


A Deeper Look into the Prohibition on Sponsoring or Investing in Covered Funds

In December 2014, the Federal Reserve Board ("Federal Reserve") announced that it had acted under Section 619 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")*, commonly known as the "Volcker Rule," to give banks until July 21, 2016, to conform their investments in, and relationships with, covered funds and foreign funds that were in place prior to December 31, 2013 ("legacy covered funds").

Notably, the Federal Reserve also announced its intention to grant banks an additional one-year extension of the conformance period, which would give banks a reprieve until July 21, 2017, and reiterated its ability to potentially provide banks with an additional transition period of up to five years to conform certain illiquid funds, an area of concern for many market participants. Just as importantly, however, while the Federal Reserve's extension grants banks additional time to divest or conform their legacy covered fund investments, all investments and relationships in a covered fund made after December 31, 2013 ("non-legacy covered funds"), will still need to be in full conformance with the final Volcker Rule's restrictions by July 21, 2015.[1]

For banks conducting an initial inventory of their existing fund activity, making decisions around their existing funds to determine exemptions from the regulation, or struggling to meet their compliance obligations, the extensions will likely provide little in the way of regulatory relief. Indeed, while stating that

[1] In addition to non-legacy covered funds, this extension does not apply to proprietary trading activities, as banks must still conform their related activities to the final rule by July 21, 2015. The Federal Reserve notes that it consulted with the other regulatory agencies charged with enforcing the Volcker Rule and these agencies plan to administer their oversight of banks under their respective jurisdictions in accordance with the Federal Reserve's conformance rule and conformance period extension.

their decision is primarily intended to prevent the disruptive effects that large-scale divestitures in covered funds could have on the broader market, the delay also acknowledges the complexity of the work that lies ahead for banks needing to comply with this highly intricate regulation.

Banks will also be expected to engage in "good-faith efforts" to conform their activities and investments to the final rule's requirements. These efforts will need to include evaluating the extent to which the bank is engaged in covered fund activities and investments as well as developing and implementing a specific conformance plan about how the bank plans to fully conform all of its covered activities and investments by the end of the conformance periods for legacy and non-legacy covered funds. In addition, during the extended conformance period, banks are expected to make plans well in advance regarding how they will conform or divest legacy covered fund investments in a manner that is both "orderly and safe and sound."

The Federal Reserve's delayed conformance period acknowledges the complexity of the work that lies ahead for banks to achieve compliance with the rule

A Deeper Look into the Prohibition on Sponsoring or Investing in Covered Funds (continued..)

Background

In December 2013, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "regulatory agencies") issued a final rule[2] implementing Section 13 of the *Bank Holding Act of 1956,* added under Section 619 of the *Dodd-Frank Act*, which:

- Prohibited banking entities[3] ("banks") from engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account under Subpart B (Proprietary Trading Prohibitions and Exemptions) of the final rule. However, this prohibition is subject to exemptions for underwriting, market making-related activities, risk mitigating hedging, activities of foreign banking entities solely outside the U.S., and certain other activities. Proprietary trading in U.S. government, agency, state, and municipal obligations continues to be permitted under the rule, which also permits, in more limited circumstances, proprietary trading in the obligations of a foreign sovereign or its political subdivisions.
- Required firms with significant trading operations to report a number of quantitative measurements to their regulator that are designed to assist in the identification of prohibited proprietary trading that might occur in the context of exempt activities.
- **Prohibited any bank from acquiring or retaining an ownership interest in, or having certain relationships with, a hedge fund or private equity fund ("covered fund") under Subpart C (Covered Fund Activities and Investments) of the final rule. However, this prohibition is subject to exemptions for investments made in connection with organizing and offering a covered fund, making and retaining *de minimis* investments in a covered fund, activities of foreign banking entities solely outside the United States ("SOTUS"), and certain other activities.**
- **Required banks to establish an internal compliance program designed to help ensure and monitor compliance with the Volcker Rule's prohibitions and restrictions.**

[2] See *KPMG Regulatory Practice Letter 13-21*.

[3] A "banking entity" is defined by statute as any insured depository institution, company that controls an insured depository institution, company that is treated as a bank holding company for purposes of Section 8 of the *International Banking Act*, or any affiliate or subsidiary of any of these entities.

"Covered Funds"

The final rule adopted a more tailored definition of covered funds that primarily limits the scope of application to the vehicles used for investment purposes, including:

Funds excluded from the investment company definition, which encompasses any issuer that would be an "investment company" under the *Investment Company Act of 1940 ("1940 Act")* if it were not otherwise excluded from the investment company definition by Section 3(c)(1) or Section 3(c)(7) of the *1940 Act* (i.e., most hedge or private equity funds), or similar funds as determined by the regulatory agencies by rule. The Section 3(c)(1) and 3(c)(7) exclusions are widely relied upon by hedge and private equity funds and exempt from the investment company definition any issuer (1) whose outstanding securities are beneficially owned by a maximum of one hundred persons and is not making, and does not presently propose to make, a public offering of its securities (other than short-term paper) or (2) whose outstanding securities are exclusively owned by persons who are qualified purchasers at the time of acquisition and is not making, and does not presently propose to make, a public offering of these securities.

Commodity pools meeting certain specified conditions, but generally defined as those vehicles that share the characteristics of issuers excluded from the *1940 Act* under Section 3(c)(1) or 3(c)(7) are also included in the covered fund definition.

Foreign funds, including certain entities that (1) are organized, offered, and sold solely outside of the United States, (2) hold themselves out as raising money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, and (3) have a U.S. bank as their sponsor or have issued an ownership interest that is directly or indirectly owned by the U.S. bank. Under this criteria, a foreign fund may be a covered fund with respect to the U.S. bank that sponsors the fund, but may not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.

Exclusions from the Covered Funds Definition

To address concerns raised by the industry about the unintended consequences of the proposed covered funds definition, a number of entities that do not engage in the types of investments or activities that the Volcker Rule was designed to address are excluded from the final rule's definition, including:

- Foreign public funds;
- Wholly-owned subsidiaries;
- Joint ventures that do not engage in investing in securities for resale or trading;
- Acquisition vehicles;
- Foreign pension or retirement funds;
- Insurance company separate accounts;
- Bank-owned life insurance;
- Loan securitizations;
- Qualifying asset-backed commercial paper conduits;
- Qualifying covered bonds;
- Small Business Investment Companies and public welfare investment funds;
- Registered investment companies and business development companies;
- Issuers in conjunction with FDIC receivership or conservatorship; and
- Other issuers identified for exclusion at the discretion of the regulatory agencies.

The regulatory agencies continue to work towards establishing a process to evaluate requests for exclusions from the covered fund definition and further guidance on this is likely to be forthcoming as they gain more experience with the final rule.

The Compliance and Monitoring Effort

The Volcker Rule provides for certain compliance program requirements that apply to all banks engaging in proprietary trading or permitted covered fund activities. These requirements are tailored to address bank size as well as the amount of activity conducted in order to reflect the heightened compliance risks of larger covered fund activities and investments. For instance, while larger banks will have to establish a more detailed compliance program, smaller banks engaged in modest amounts of activity will generally be subject to a simpler regime that is intended to provide some regulatory relief.

Specifically, a bank having $10 billion or less in total consolidated assets that engages in activities and investments covered by either the proprietary trading or covered fund provisions may satisfy the compliance program requirements by including references to the final rule's requirements in its existing compliance policies and procedures, adjusted to reflect the size, scope, and complexity of the bank's activities. However, banks with total consolidated assets greater than $10 billion must establish a new compliance program, while banks with at least $50 billion in assets are subject to enhanced compliance requirements, including a mandatory Chief Executive Officer ("CEO") attestation.

In addition to the final rule's minimum compliance program requirements, banks with more than $10 billion in assets will have to maintain additional documentation specific to their covered fund activities. This includes documenting the exclusions or exemptions other than Sections 3(c)(1) and 3(c)(7), as well as the exclusions provided under the final rule, that each bank-sponsored fund relied on to determine that the fund is not a covered fund.

The compliance program requirements are tailored to address both bank size and amount of activity conducted in order to better mirror the heightened risks of larger covered fund activities and investments

Minimum compliance program requirements under the final Volcker Rule

Element	Bank Asset Size	
	Total consolidated assets of $50 billion or more or, for a foreign banking entity, total U.S. assets of $50 billion or more[4]	Total consolidated assets greater than $10 billion and less than $50 billion
An **enhanced compliance program** that includes robust risk management and remediation processes, independent testing and reporting, and other compliance controls to govern the bank's covered trading and covered fund activities	✓	
Annual written **attestation** by the CEO[5] to the bank's regulator that the bank has a compliance program in place that is "reasonably designed" to achieve compliance with the final Volcker Rule	✓	
Internal written **policies and procedures** reasonably designed to document, describe, monitor, and limit (1) trading activities subject to the proprietary trading provisions under Subpart B and (2) activities and investments with respect to a covered fund subject to the covered fund provisions under Subpart C in order to "ensure" that all activities subject to the final rule are in compliance	✓	✓
A system of **internal controls** reasonably designed to monitor and identify potential areas of noncompliance in the bank's trading activities and covered fund activities and investments, and to prevent the occurrence of prohibited activities or investments	✓	✓
A **governance and management framework** that clearly delineates responsibility and accountability for compliance and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation, and other matters identified by the regulators or by management as requiring attention	✓	✓
Independent testing and audit of the compliance program's effectiveness that is conducted periodically by qualified bank personnel or by a qualified outside party	✓	✓
Training for trading personnel and managers, as well as other "appropriate" personnel, to effectively implement and enforce the compliance program	✓	✓
Making and keeping **records** sufficient to demonstrate compliance that are retained for at least five years and that can be provided promptly to the bank's regulator upon request	✓	✓

[4] Includes all subsidiaries, affiliates, branches, and agencies of the foreign banking entity operating, located, or organized in the United States.

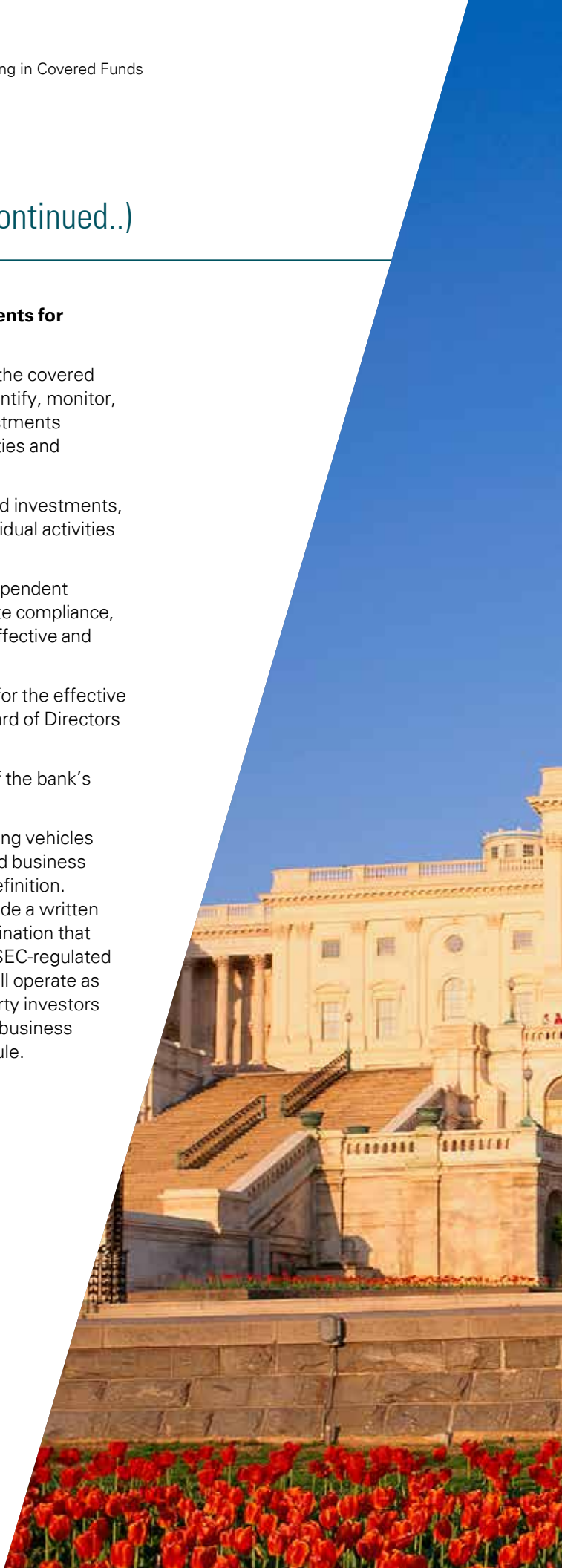
[5] The final rules clarifies that, for foreign banking entities with U.S. operations, the senior officer of the foreign banking entity's U.S. operations or the CEO of the U.S. bank may provide the required attestation.

The Compliance and Monitoring Effort (Continued..)

Under the final rule, the enhanced compliance program requirements for the largest banks must:

- Be reasonably designed to identify, document, monitor, and report the covered trading and covered fund activities and investments of the bank; identify, monitor, and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent prohibited activities and investments.
- Establish and enforce appropriate limits on the covered activities and investments, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the final rule;
- Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the bank's internal audit, corporate compliance, and internal control functions involved in the review and testing are effective and independent;
- Make senior management and others, as appropriate, accountable for the effective implementation of the compliance program and ensure that the Board of Directors and CEO review the compliance program's effectiveness; and
- Facilitate supervision and examination by the regulatory agencies of the bank's covered trading and covered fund activities and investments.

The final rule also contains certain provisions for banks operating seeding vehicles that will become a registered investment company or an SEC-regulated business development company, which are excluded from the covered funds definition. To rely on this exclusion, a bank operating a seeding vehicle must include a written plan within its compliance program that documents the bank's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company, the period of time that the vehicle will operate as a seeding vehicle, and the bank's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time frame designated by the final rule.

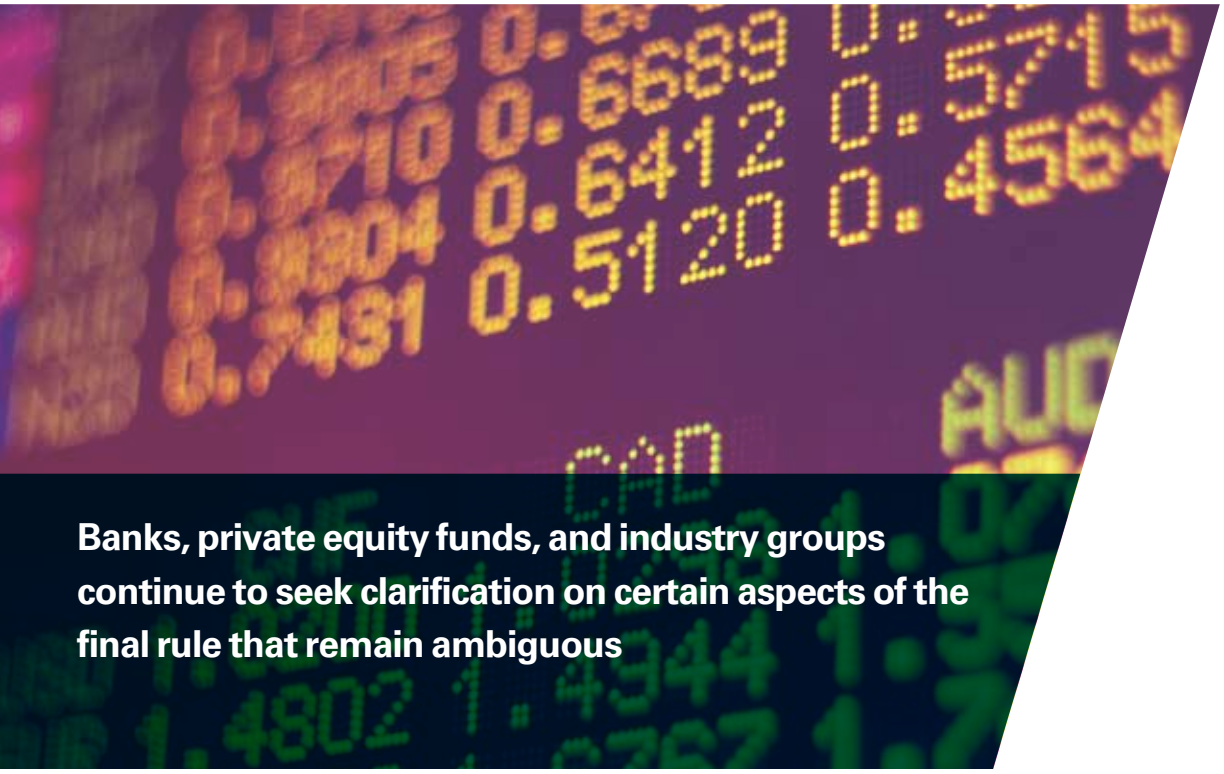


The Industry Response

Since approval of the final rule, a number of banks, private equity funds, trade associations, and members of Congress have requested additional extensions of the conformance period to allow banks additional time to identify the investments and relationships that are covered by the statutory provisions, determine whether those funds can be conformed to the statute and final rule or whether they must be divested, and divest or conform non-conforming investments in covered funds. The industry has argued that, prior to the final rule's adoption, banks were permitted to make significant investments in thousands of covered funds that, following adoption of the final rule, must be evaluated and conformed to the final rule's requirements. In addition, to avoid selling at an undesirable discount, banks have argued that they will need more time to allow for the orderly sale of covered fund interests that must be divested, including divestitures that must be made by employees, officers, and bank directors. Lastly, banks have contended that the requirements to change the names of covered funds and restrict relationships with covered funds that may be retained by banks would require additional time to allow consultation with, and the consent of, investors in and managers of covered funds.

Private funds that are sponsored by non-banking entities have also indicated that a number of investors in their funds include foreign banks subject to the final rule. These non-banking entities have requested additional time to restructure, conform, redeem, or sell investments by foreign banks in these third-party funds. Foreign funds that have some activities in the United States have also requested additional time to allow their managers and investors to determine whether they must take steps to modify their sales practices, governance, or ownership structure to ensure compliance with various provisions of the final rule.

However, industry groups are also seeking clarification on certain aspects of the final rule that remain ambiguous. The Institute of International Bankers ("IIB"), in particular, has sought clarification on behalf of its members regarding the application of the "banking entity" definition to certain privately and publicly offered foreign funds "controlled" by a bank under the *Bank Holding Company Act*. In order to avoid undue extraterritorial application of the final rule, the IIB has recommended that the regulatory agencies clarify that foreign private and public funds that either do not meet or are excluded from the covered fund definition will not be deemed "banking entities" under the final rule.



Banks, private equity funds, and industry groups continue to seek clarification on certain aspects of the final rule that remain ambiguous

Conclusion

Given the final rule's complexities and various open items that will need additional clarity from the regulatory agencies, establishing a strong compliance program with a clearly articulated governance and management framework and a flexible infrastructure to capture and report the relevant data will be critically important. Banks covered by the final rule should already be identifying and evaluating their covered fund investments and relationships in order to determine whether these funds can be conformed to the final rule's requirements or whether they must be divested.

For many banks, these provisions will require sizable investments to upgrade their existing infrastructures, but the largest banks, in particular, will be challenged to design and implement a robust global compliance program with monitoring, reporting, and retention capabilities at the sector, business line, and legal entity levels. Although banks that do not engage in covered fund activities are exempted from establishing compliance program that meets the rule's specifications, they will likely still need to demonstrate their eligibility for this exemption through diligent monitoring of their activities. While the final rule narrows the scope of vehicles covered by the restrictions by providing certain carve-outs from the covered funds definition, banks availing themselves of these exceptions will also likely be subject to more stringent compliance obligations.

Going forward, the covered fund provisions will likely strongly impact the different activities and longer-term funding decisions made by fund managers and investors. For covered fund interests that must be divested, questions also remain as to whether these investments will ultimately transfer to less-regulated sectors and at what discounted price these transactions may have to occur.

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