COVINGTON

COVINGTON & BURLING LLP

ADVISORY | Dodd-Frank Act

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VOLCKER RULE: FINAL REGULATIONS – COVERED FUND PROVISIONS

On December 10, 2013, the Federal Reserve Board, Commodity Futures Trading Commission, Office of the Comptroller of the Currency, Securities and Exchange Commission, and Federal Deposit Insurance Corporation (collectively, the "Agencies") jointly released long-awaited final regulations implementing section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the "Volcker Rule."[1]

The final regulations will become effective on April 1, 2014 and, with the exception of certain reporting and recordkeeping requirements relevant to proprietary trading activities, are subject to an extended conformance period ending on July 21, 2015. Each banking entity subject to the Volcker Rule is expected to engage in good-faith efforts appropriate for its activities and investments that will result in full conformance with the Volcker Rule by the end of this conformance period. The Board of Governors of the Federal Reserve (the "Board") may grant an extension of the conformance period for up to two additional one-year periods (either generally or on a case-by-case basis for individual banking entities) if, in the judgment of the Board, an extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. The Board may also grant a banking entity one additional extension for up to five years, to the extent necessary for the banking entity to fulfill a contractual obligation in effect on May 1, 2010 to provide additional capital to an illiquid fund.

The Volcker Rule consists of two key restrictions. First, banking entities are prohibited from engaging in proprietary trading (the "Proprietary Trading Provisions").[2] Second, banking entities are prohibited from sponsoring or investing in specified "covered funds" such as private equity or hedge funds, or extending credit to or engaging in other covered transactions with affiliated covered funds (the "Covered Fund Provisions"). The Proprietary Trading Provisions are covered in Subpart B of the final regulations, and the Covered Fund Provisions are covered in Subpart C of the final regulations. Compliance program requirements are covered in Subpart D of the final regulations. This client advisory outlines the Covered Fund Provisions.

The Covered Fund Provisions include numerous substantial changes from the version proposed by the Agencies over 2 years ago. A few of these are:

- The "covered fund" definition has been substantially revised to, among other things:

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[1] A copy of the final rule is available on the Federal Reserve website at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf. It was accompanied by a joint release issued by the Agencies which provides useful discussion of the rule, comments received by the Agencies, and their reasons for making certain changes or additions to the proposed form of the rule first issued on October 11, 2011. For an overview of the Volcker Rule, please see our previous client advisories Final Volcker Rule Provisions (July 21, 2010) and Volcker Rule Study by the Financial Stability Oversight Council (January 31, 2011).

[2] For an overview of the Proprietary Trading Provisions, please see the client advisory Volcker Rule: Final Regulations – Proprietary Trading Provisions (December 18, 2013).

- exclude certain foreign public funds, effectively permitting both U.S. and foreign banking entities to sponsor and invest in such funds,
- exclude certain other foreign funds vis-à-vis foreign banking entities and their non-U.S. affiliates, effectively permitting such entities to sponsor and invest in such funds,
- exclude "wholly-owned subsidiaries" of banking entities and their affiliates and expand the exclusion for joint ventures, and
- narrow its application to commodity pools.

- Some categories of permitted covered fund activities and investments under the proposed version have been converted into exclusions from the "covered fund" definition under the final regulations. As a result, these activities and investments will not be subject to the "Super 23A" and other transaction restrictions imposed by the Covered Fund Provisions.
- The Covered Fund Provisions now include substantially expanded provisions addressing asset securitizations.
- The exemption for risk-mitigating hedging activities has been narrowed, and is now limited to hedging related to specified employee compensation arrangements.
- The requirements to qualify for the "SOTUS" (solely outside the United States) exemption have been clarified in certain respects, including introduction of "risk-based" criteria in determining whether an activity or investment occurs solely outside of the United States. These "risk-based" criteria replace the proposed regulations' broad disqualification based upon involvement of any U.S.-based subsidiary, affiliate, or employee in the offer or sale of covered fund interests.
- Other exclusions and exemptions have been added, including an exclusion for specified foreign pension and retirement funds, and exemptions for specified underwriting and market making activities, and specified investments and activities by regulated insurance companies.

PROHIBITION ON SPONSORING OR INVESTING IN COVERED FUNDS

- ***What kind of activities are prohibited under the final Covered Fund Provisions?***
  - A "banking entity" may not, as principal, directly or indirectly, "sponsor" or acquire or retain any "ownership interest" in any "covered fund", subject to certain exemptions described below.
- ***What is a "banking entity"?***
  - "Banking entity" includes (i) insured depository institutions, (ii) companies that control insured depository institutions, (iii) companies that are treated as bank holding companies for purposes of section 8 of the International Banking Act of 1978, and (iv) any affiliate or subsidiary of an entity described in (i) through (iii).
  - "Banking entity" does not include the following entities, so long as any such entity is not itself a banking entity described in (i) through (iii) above:
    - a "covered fund";
    - a portfolio company held under a banking entity's authority to engage in merchant banking or insurance company investment activity under Section 4(k)(4)(H) or (I) of the Bank Holding Company Act of 1956 (the "BHC Act"); or

- a portfolio concern controlled by a small business investment company under Section 103(3) of the Small Business Investment Act of 1958.

- "Banking entity" also does not include the FDIC, acting in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.

- ***What is a "covered fund" for purposes of the prohibition?***
  - "Covered fund" includes the following entities:
    - any issuer that would be an investment company but for the exemptions provided by section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "'40 Act");[3]
    - a commodity pool for which:
      - the operator has claimed an exemption under 17 C.F.R. 4.7; or
      - (i) the operator is registered with the CFTC in connection with the operation of the commodity pool, (ii) substantially all participation units are owned by "qualified eligible persons" as defined in 17 C.F.R. 4.7(a)(2) and (a)(3), and (iii) participation units have not been publicly offered to persons other than qualified eligible persons; and
    - for any "U.S. banking entity"[4], an entity that (i) is organized or established outside the United States, and whose ownership interests are offered and sold solely outside the United States, (ii) raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, and (iii) is sponsored by, or has issued an ownership interest owned by, such U.S. banking entity or its affiliate.
      - An entity is not a "covered fund" under this provision if, were it subject to U.S. securities laws, it could rely on an exemption from the definition of "investment company" other than section 3(c)(1) or 3(c)(7) of the '40 Act.
      - This exclusion provides that a foreign fund that meets the above requirements is only a covered fund vis-à-vis any U.S. banking entity that sponsors the fund or has an ownership interest in the fund (or whose U.S. or foreign affiliate does so). It would not be a covered fund vis-à-vis a foreign banking entity – meaning a banking entity not located in the United States or organized under U.S. law or controlled, directly or indirectly, by such an entity – or its non-U.S. affiliates. Note, however, that such a foreign fund may separately qualify as a "covered fund" under other provisions of the definition of "covered fund"; for instance if, because of its activities and connections with the United States (such as sale of private placement debt securities to U.S. investors), it would need to rely on the exemption provided by Section 3(c)(1) or 3(c)(7) of the '40 Act in order to avoid being an investment company in the United States.
  - "Covered fund" excludes the following entities:

[3] Section 3(c)(1) of the '40 Act is available to funds owned by 100 or fewer investors. Section 3(c)(7) of the '40 Act is available to funds owned solely by "qualified purchasers."

[4] For purposes of this client advisory, "U.S. banking entity" means any banking entity that is, or is controlled directly or indirectly by, a banking entity located in or organized under the laws of the United States or of any State (defined to include specified U.S. territories). A U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States; however, the controlling foreign bank is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

- *Foreign Public Funds.* An issuer that is organized or established outside of the United States, is authorized to offer and sell ownership interests to retail investors in its home jurisdiction, and sells ownership interests predominantly through one or more "public offerings" outside of the United States.
    - If the foreign public fund is sponsored by a U.S. banking entity, the banking entity may not rely on the "foreign public fund" exclusion, unless the ownership interests in the issuer are predominantly sold to persons other than the sponsoring banking entity, the issuer, affiliates of the sponsoring banking entity and the issuer, and the directors and employees of such entities.
    - A "public offering" means a distribution of securities in any jurisdiction outside of the United States to investors, including retail investors, provided that (i) the distribution complies with all applicable requirements in the jurisdiction where the distribution is made, (ii) the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets, and (iii) the issuer has filed or submitted publicly available offering disclosure documents with the appropriate foreign regulatory authority.
- *Wholly-Owned Subsidiaries.* An entity all of whose outstanding ownership interests are owned directly or indirectly by the banking entity or its affiliate, provided that
    - (i) up to 5 percent of the entity's ownership interests, minus any amount held under (ii) below, may be held by employees or directors of the banking entity or the affiliate, including former employees or directors whose ownership interest was acquired while in the service of the banking entity; and
    - (ii) up to 0.5 percent of the entity's ownership interests may be held by a third party if the ownership interest was acquired or retained for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.
- *Joint Ventures.* A joint venture between a banking entity or its affiliates and one or more unaffiliated persons, provided that the joint venture:
    - has no more than 10 unaffiliated co-venturers;
    - is engaged in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and
    - does not raise money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.
- *Acquisition Vehicles.* An acquisition vehicle that is formed for the sole purpose of engaging in a *bona fide* merger or acquisition transaction and exists only so long as necessary to effect the transaction.
- *Foreign Pension or Retirement Funds.* Specified foreign broad-based regulated employee or citizen pension or retirement programs.
- *Insurance Company Separate Accounts.* An insurance company separate account, provided that no banking entity other than the insurance company participates in the account's profits and losses.
- *Bank-Owned Life Insurance.* A separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which

the banking entities are beneficiaries, provided that none of the banking entities controls the investment decisions regarding the underlying assets or holdings, or participates in the profits and losses of the separate account other than in compliance with applicable supervisory guidance.

- *Loan Securitizations.* An issuer of asset-backed securities, the assets or holdings of which are solely comprised of loans; certain related or incidental contractual rights or assets; certain related interest rate or foreign exchange derivatives; and certain related collateral certificates and special units of beneficial interest. With limited exceptions, such assets and holdings may not include securities (as defined in the Securities Exchange Act of 1934 (the "Exchange Act")), non-qualifying derivatives, or commodity forward contracts.
- *Qualifying Asset-Backed Commercial Paper Conduits.* An issuer of asset-backed commercial paper, the assets or holdings of which are solely comprised of loans, other assets permissible for the "loan securitization" exclusion as referred to above, and certain related asset-backed securities. The issuer may issue only asset-backed securities, comprised of a residual interest and securities with a maturity of 397 days or less, and must meet specified requirements regarding liquidity coverage from a qualifying regulated liquidity supporter.
- *Qualifying Covered Bonds.* An entity owning or holding a pool the assets of which are solely comprised of loans and other assets permissible for the "loan securitization" exclusion as referred to above, held for the benefit of certain qualifying covered bonds issued or guaranteed by a foreign banking organization.
- *Small Business Investment Companies and Public Welfare Investment Funds.* A small business investment company as defined in section 103(3) of the Small Business Investment Act of 1958, or an issuer that has received a notice to proceed to qualify for a license as a small business investment company from the Small Business Administration; and issuers the business of which is to make investments for specified qualifying types of public welfare or building rehabilitation purposes.
- *Registered Investment Companies and Excluded Entities.* An issuer that either is an investment company registered under the '40 Act; has a qualifying written plan to become a registered investment company; is eligible for an exclusion or exemption from the definition of "investment company" other than section 3(c)(1) and 3(c)(7); or has elected to be regulated as a business development company or has a qualifying written plan to become a business development company.
- *Issuers In Conjunction With the FDIC's Receivership or Conservatorship Operations.* An issuer 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 Title II of the Dodd-Frank Act.
- *Other Excluded Issuers.* An issuer that the appropriate federal banking agencies, the SEC, and the CFTC jointly determine the exclusion of which is consistent with the purposes of section 13 of the BHC Act.

- ***What does it mean to "sponsor" a covered fund?***
  - To "sponsor" a covered fund means:
    - serving as a general partner, managing member, trustee, or commodity pool operator of the fund;

- in any manner selecting or controlling (or having employees, officers, directors or agents who constitute) a majority of the directors, trustees, or management of a fund; or
- sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

- ***What constitutes an "ownership interest" in a covered fund?***
  - An "ownership interest" in a covered fund is any equity, partnership or "other similar interest." An "other similar interest" means an interest that has or provides any of the following:
    - the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise default remedies);
    - the right to receive a share of the income, gains, or profits of the covered fund;
    - the right to receive the underlying assets of the fund after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise default remedies);
    - the right to receive all or a portion of excess spread (defined as any positive difference between the aggregate interest payments received from the covered fund's underlying assets and the aggregate interest paid to the holders of other outstanding interests);
    - under the terms of the interest, the amounts payable by the covered fund could be reduced based on losses arising from the covered fund's underlying assets, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;
    - income is received on a pass-through basis from the covered fund, or a rate of return is received based on the performance of the covered fund's underlying assets; or
    - any synthetic right to have, receive, or be allocated any of the above rights.
  - "Ownership interest" does not include "restricted profit interest", i.e., an interest in a covered fund held by an entity (or its employee or former employee) as to which:
    - the entity (or its employee) serves as investment manager, investor adviser, commodity trading advisor, or other service provider to the covered fund;
    - the sole purpose and effect of the interest is to allow the entity (or its employee or former employee) to share in the profits of the covered fund as performance compensation for the services provided to the covered fund;
    - profit received with respect to the interest that is not distributed to the entity (or employee or former employee) is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund, and does not share in the subsequent investment gains of the covered fund;
    - any amounts invested in the covered fund, including amounts paid by the entity (or its employee or former employee) in connection with obtaining the interest, are within the limits of the "permitted investment" exception described below; and

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

EXEMPTIONS FROM PROHIBITIONS ON SPONSORING OR INVESTING IN COVERED FUNDS

Exemptions for Activities and Investments In Connection with an Investment Advisory Business, Organizing Asset Backed Issuers or Underwriting and Market Making Activities

As described in more detail below, the Covered Fund Provisions expressly permit a banking entity to sponsor, and acquire and retain ownership interests in, a covered fund that the banking entity organizes and offers (i) in connection with a bona fide investment advisory business, or (ii) that is an issuer of asset-backed securities. Any ownership interests acquired or retained pursuant to these exemptions must constitute "permitted investments" under the Covered Fund Provisions, which limit the amount of investment that a banking entity can make in a particular covered fund and on an aggregate basis in all covered funds. A banking entity may also, subject to specified conditions, acquire and retain ownership interests in a covered fund in connection with underwriting and market making activities involving such fund that are permitted under the Proprietary Trading Provisions. These activities and investments also remain subject to the limitations described below under "Limitations on Transactions and Other Relationships with Related Covered Funds" and "Blanket Limitations Applicable to Covered Fund Activities."

- ***Exemption for activities and investments involving covered funds offered in connection with an investment advisory business.***
  - A banking entity may acquire or retain an ownership interest in or sponsor a covered fund in connection with organizing and offering such covered fund if:
    - the banking entity (or its affiliate) provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;
    - the covered fund is organized and offered only in connection with such services and only to customers of such services of the banking entity (or an affiliate), pursuant to a written plan or similar documentation outlining how the banking entity (or its affiliate) intends to provide advisory or similar services to its customers through organizing and offering such fund;
    - any ownership interest in the covered fund acquired or retained by the banking entity and its affiliates constitutes a "permitted investment" as described below;
    - no director or employee of the banking entity (or its affiliates) takes or retains an ownership interest in the covered fund unless he or she is directly engaged in providing services to the covered fund at the time he or she takes the ownership interest;
    - the banking entity and its affiliates do not guarantee or otherwise assume or insure the obligations or performance of the covered fund; and
    - certain other conditions are met, including prohibitions on use of the banking entity's or affiliates' names (or the word "bank") in the covered fund's name, specified disclosure requirements, and compliance with any other rules of the applicable

regulators designed to ensure that losses in the covered fund are borne solely by investors in the covered fund.

- ***Exemption for activities and investments involving issuers of asset-backed securities.***
  - A banking entity may acquire or retain an ownership interest in or sponsor a covered fund that is an issuing entity of asset-backed securities in connection with organizing and offering such entity if:
    - any ownership interest in the covered fund acquired or retained by the banking entity and its affiliates constitutes a "permitted investment" as described below;
    - no director or employee of the banking entity (or its affiliates) takes or retains an ownership interest in the covered fund unless he or she is directly engaged in providing services to the covered fund at the time he or she takes the ownership interest;
    - the banking entity and its affiliates do not guarantee or otherwise assume or insure the obligations or performance of the covered fund; and
    - certain other conditions are met, including prohibitions on use of the banking entity's or affiliates' names (or the word "bank") in the covered fund's name, specified disclosure requirements, and compliance with any other rules of the applicable regulators designed to ensure that losses in the covered fund are borne solely by investors in the covered fund.
  - "Organizing and offering" an issuing entity of asset-backed securities means acting as the securitizer (as defined by Section 15G(a)(3) of the Exchange Act) of such entity or acquiring or retaining an ownership interest in such entity as required by Section 15G of the Exchange Act.
- ***Exemption for underwriting or market making-related activities.***
  - A banking entity is permitted to acquire and retain an ownership interest in a covered fund in connection with underwriting or market making-related activities involving such covered fund, provided that:
    - the banking entity's activities are conducted in accordance with the permitted underwriting and market making-related activities exceptions to the prohibition on proprietary trading in the Proprietary Trading Provisions;
    - any ownership interest in such covered fund acquired by the banking entity (or any affiliate) in connection with such activities is included in the calculation of the banking entity and its affiliates' "permitted investment" in such covered fund, <u>if</u> the banking entity or any affiliate:
      - is engaged in activities or investments involving such covered fund in reliance on the "investment advisory business" exemption or the "securitizer of asset-backed securities" exemption described above, or
      - directly or indirectly guarantees, assumes, or insures the obligations or performance of the covered fund or of any covered fund in which such fund invests; and
    - the banking entity includes the aggregate value of all ownership interests of the banking entity and its affiliates acquired and retained under the "underwriting and market making," "investment advisory business," and "securitizer of asset-backed securities" exemptions in calculating the banking entity's aggregate limit on permitted investments and its deductions from Tier 1 capital described below.

- *What is a "permitted investment"?*
  - A "permitted investment" is any ownership interest acquired or retained by a banking entity in a covered fund that the banking entity or an affiliate organizes and offers under the exemptions listed above, provided that such investment qualifies as either (i) a seed capital investment, or (ii) a de minimis investment.
    - *Seed Capital Investment*. An investment in a covered fund qualifies as a seed capital investment if (i) the investment is made in order to establish the covered fund and provide the covered fund with sufficient equity capital to attract unaffiliated investors; (ii) no later than 1 year after the date the covered fund is established, the banking entity's and its affiliates' ownership interest in the covered fund are reduced to the per fund ownership limitation described below; (iii) the banking entity and its affiliates actively seek unaffiliated investors to dilute its investment in the covered fund to such level within such one-year period; and (iv) the aggregate ownership limitation described below is met. The one-year period may be extended in certain circumstances upon application to the Board, in consultation with the banking entity's primary regulator.
    - *De Minimis Investment*. An investment in a covered fund qualifies as a de minimis investment if (i) the banking entity's and its affiliates' ownership interest in the particular covered fund are within the per fund ownership limitation described below and (ii) the aggregate ownership limitation described below is met.
    - *Ownership Limitations*.
      - *Per Fund Limitation.* A banking entity's and its affiliates' per fund ownership limitation in a particular covered fund is (i) in the case of a covered fund that is not an issuer of asset-backed securities, 3% of the total number or value of the outstanding ownership interests of such covered fund, or (ii) in the case of a covered fund that is an issuer of asset-backed securities, 3% of the total fair market value of the ownership interests of such issuer or, if greater, such percentage as may be required to comply with Section 15G of the Exchange Act.
      - *Aggregate Limitation.* The aggregate value of all "permitted investments" of a banking entity and its affiliates in covered funds (including all seed capital and de minimis investments, and investments made in reliance on the underwriting and market making exemptions described above) may not exceed 3% of the banking entity's Tier 1 capital.
      - *Calculating Per Fund and Aggregate Ownership Limitations.* The final regulations provide specific instructions for calculating the number and the value of outstanding ownership interests in covered funds, and for determining the applicable Tier 1 capital amount, for purposes of determining whether a banking entity's "permitted investments" exceed the per fund or aggregate ownership limitations.
    - *Tier 1 Capital Treatment.* For purposes of calculating compliance with regulatory capital requirements, a banking entity which acquires or retains an ownership interest in any covered fund shall deduct from its Tier 1 capital the greater of (i) the sum of all amounts paid or contributed by the banking entity in acquiring or retaining the ownership interests in the covered fund on a historical cost basis, plus any earnings received; and (ii) the fair market value of the banking entity's ownership interests in the covered fund, if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements; together, in either case, with any

amounts paid by the entity or its employees to obtain a restricted profit interest that would otherwise be deemed an ownership interest.

Other Exemptions from Prohibitions on Sponsoring or Investing in Covered Funds

The following exemptions from the general prohibition on sponsoring or investing in covered funds are also available. These exemptions are not subject to the "permitted investment" limitations described above, but the activities remain subject to the limitations described below under "Limitations on Transactions and Other Relationships with Related Covered Funds" and "Blanket Limitations Applicable to Covered Fund Activities."

- ***Exemption for risk-mitigating hedging activities for employee compensation arrangements.***
  - A banking entity may hold an ownership interest in a covered fund if it is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity (or its affiliate) that directly provides investment advisory, commodity trading advisory, or other services to the covered fund, provided that:
    - the banking entity has established an internal compliance program that is reasonably designed to ensure the banking entity's compliance with the exemption's limitations, including reasonably designed written policies and procedures, and internal controls and ongoing monitoring, management, and authorization procedures (including relevant escalation procedures); and
    - the acquisition or retention of the ownership interest:
      - is made in accordance with such written policies, procedures, and internal controls;
      - is designed at its inception to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates, one or more specific, identifiable risks arising in connection with the relevant compensation arrangement;
      - does not give rise at its inception to any significant new or additional risk that is not itself hedged contemporaneously in accordance with the same restrictions; and
      - is subject to continuing review, monitoring, and management by the banking entity; and
    - the relevant compensation arrangement relates solely to such covered fund and provides that any losses incurred by the banking entity on such ownership interest will be offset by corresponding decreases in amounts payable under such compensation arrangement.
- ***Exemption for activities by foreign banking entities outside of the United States.***
  - The acquisition or retention of any ownership interest in, or sponsorship of, a covered fund by a banking entity is not prohibited if:
    - the banking entity is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or of one or more States;

- the activity or investment by the banking entity is pursuant to paragraph 9 or paragraph 13 of Section 4(c) of the BHC Act;[5]
  - If the banking entity is a foreign banking organization, the banking entity must meet the qualifying foreign banking organization requirements of Section 211.23(a), (c) or (e) of the Board's Regulation K.
  - If the banking entity is not a foreign banking organization, the banking entity must meet at least two of the following requirements on a fully-consolidated basis: (i) the banking entity's total assets held outside of the United States exceed the total assets held in the United States; (ii) total revenues from the banking entity's business outside of the United States exceed total revenues from the banking entity's business within the United States; or (iii) total net income from the banking entity's business outside of the United States exceeds total net income from the banking entity's business within the United States.
- no ownership interest in such covered fund is offered for sale or sold to a resident of the United States; i.e., sales have been made only pursuant to offerings that do not target residents of the United States (defined as "U.S. persons" as defined in Rule 902(k) of Regulation S under the Securities Act of 1933); and
- the activity or investment occurs solely outside of the United States, meaning that:
  - the banking entity acting as sponsor or holding an ownership interest as principal is not itself, and is not controlled by, a banking entity located in the United States or organized under the laws of the United States or any State;
  - the banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or any State;
  - the investment or sponsorship (including any risk-mitigating hedging related to an ownership interest) is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or any State; and
  - no financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or any State.

- A U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is deemed located in the United States for purposes of this exemption; however, a foreign bank of which that branch, agency, or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.

- ***Exemption for regulated insurance companies.***
  - A regulated insurance company (or its affiliate) may acquire and retain an ownership interest in, or act as sponsor of, a covered fund if:
    - the acquisition is solely for the general account of the insurance company, or for one or more separate accounts established by the insurance company;

[5] Paragraph 9 of Section 4(c) is available to foreign companies the greater part of whose business is conducted outside of the United States, while paragraph 13 of Section 4(c) is available to foreign companies that do no business in the United States except as an incident to their international or foreign business.

- the ownership interest is acquired and retained in compliance with applicable insurance company investment laws, regulations, and written guidance of the State or jurisdiction where the insurance company is domiciled; and
- the appropriate federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and foreign jurisdictions, have not jointly determined after notice and comment that such laws, regulations, or written guidance are insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.

- ***Agency, fiduciary, and debt collection activities.***
  - The prohibition on acquiring or retaining ownership interests in covered funds does not apply to (i) specified agency, fiduciary, and other activities conducted for customers (and certain employee benefit plans of the banking entity and affiliates) where the banking entity and its affiliates do not have or retain beneficial ownership; or (ii) transactions in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event retains such ownership interest for longer than such period permitted by the appropriate federal agency.

LIMITATIONS ON TRANSACTIONS AND OTHER RELATIONSHIPS WITH RELATED COVERED FUNDS

The Covered Fund Provisions contain prohibitions on certain relationships and transactions between banking entities, on the one hand, and certain related covered funds, on the other hand. These prohibitions are commonly referred to as "Super 23A." The Covered Fund Provisions also contain restrictions on the relationships and transactions between such entities which are not prohibited by "Super 23A."

- ***What kind of relationships are subject to these limitations?***
  - These limitations apply to relationships between any banking entity and any of its affiliates, on the one hand, and any "related covered fund", on the other hand. For purposes of this client advisory, a "related covered fund" is any covered fund (i) for which such banking entity serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor or sponsor, (ii) that is organized and offered by such banking entity pursuant to the exemptions for investment advisory funds or asset-backed issuers described above under "Exemptions for Activities and Investments In Connection with an Investment Advisory Business, Organizing Asset Backed Issuers or Underwriting and Market Making Activities", or (iii) in which such banking entity holds an ownership interest pursuant to the exemption for asset-backed issuers described above in the same section.

- ***What are the Super 23A prohibitions?***
  - Under the Super 23A prohibitions, no banking entity and no affiliate of any such banking entity may enter into a "covered transaction" with a related covered fund or any covered fund controlled by any such fund.
    - "Covered transaction" is defined by section 23A of the Federal Reserve Act and includes, among other things, (i) any loan or extension of credit to the fund, (ii) any purchase of or investment in securities issued by the fund, (iii) the issuance of a guarantee, acceptance or letter of credit on behalf of the fund, and (iv) any derivatives transaction or transaction that involves the borrowing or lending of securities, in either case to the extent that the transaction causes the covered entity to have credit exposure to the fund.

- Transactions specifically excluded from the prohibition are:
  - holdings of ownership interests in covered funds permitted by the Covered Fund Provisions; and
  - prime brokerage transactions between the banking entity and a covered fund in which the related covered fund has taken an ownership interest, subject to certain conditions, including a requirement that the transactions be on arms' length market terms, consistent with the requirements of Section 23B of the Federal Reserve Act.

- ***What limitations apply to transactions with related covered funds not prohibited by Super 23A?***
  - Any transactions between a banking entity and any related covered fund which are not prohibited by Super 23A must be on arms' length market terms, consistent with the requirements of section 23B of the Federal Reserve Act.

BLANKET LIMITATIONS APPLICABLE TO COVERED FUND ACTIVITIES

- None of the permitted activities or other transactions described above with respect to covered funds are permitted if the activity or transaction:
  - would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;
  - would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; or
  - would pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.
- *Definition of Material Conflict of Interest*. Under the Covered Fund Provisions, a material conflict of interest would exist between a banking entity and its clients, customers, or counterparties if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, <u>if</u> the banking entity <u>has not</u> taken at least one of the following actions:
  - prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity has clearly and effectively disclosed the conflict of interest to the client, customer, or counterparty in compliance with specific prescribed standards; or
  - the banking entity has established, maintained, and enforced information barriers that are reasonably designed to prevent the conflict of interest from involving or resulting in a materially adverse effect on the client, customer, or counterparty and that comply with specific prescribed standards.
- *Definition of High-Risk Asset and High-Risk Trading Strategy.*
  - High-risk asset means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or pose a threat to the financial stability of the United States.
  - High-risk trading strategy means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or pose a threat to the financial stability of the United States.

COMPLIANCE PROGRAM REQUIREMENTS

Each banking entity is required to develop a program reasonably designed to ensure and monitor compliance with the prohibitions on covered fund activities and investments. The terms, scope, and detail of the compliance program must be appropriate for the types, size, scope, and complexity of activities and business structure of the entity.

- *Minimum Requirements*. Except as described below for banking entities with modest activities or with no covered activities, the minimum requirements for the program include:
  - written policies and procedures reasonably designed to document, describe, monitor and limit activities and investments with respect to covered funds to ensure that such activities comply with section 619 of the Dodd-Frank Act and the final regulations;
  - a system of internal controls reasonably designed to monitor compliance with section 619 of the Dodd-Frank Act and the final regulations and to prevent the occurrence of activities or investments that are prohibited by section 619 of the Dodd-Frank Act and the final regulations;
  - a 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 in the final regulations or by management as requiring attention;
  - independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the entity 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; and
  - records sufficient to demonstrate compliance with section 619 of the Dodd-Frank Act and the final regulations, which the entity must promptly provide to the appropriate federal agency upon request and retain for a period of at least five years, or such longer period as required by the appropriate federal agency.
- *Enhanced Compliance Requirements for Certain Banking Entities.* Certain banking entities are subject to detailed "enhanced compliance program" requirements with respect to their fund investments and activities, which are contained in Appendix B to the final regulations. In addition to the detailed Appendix B requirements addressing mechanical and other aspects of the compliance policies and procedures for specific activities, the Appendix also prescribes a governance and management framework as described below.
  - *Banking Entities Subject to Enhanced Compliance Requirements.* These banking entities generally include:
    - any banking entity (other than a foreign banking entity) that engages in permitted proprietary trading and that has, together with its affiliates and subsidiaries, trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, equals or exceeds $50 billion beginning on June 30, 2014, $25 billion beginning on April 20, 2016, and $10 billion beginning on December 31, 2016;
    - any foreign banking entity that engages in permitted proprietary trading and whose combined U.S. operations (including all subsidiaries, affiliates, branches, and

agencies of the foreign banking entity operating, located, or organized in the United States, and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) have trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, equals or exceeds $50 billion beginning on June 30, 2014, $25 billion beginning on April 20, 2016, and $10 billion beginning on December 31, 2016;

- any banking entity (other than a foreign banking entity) that has reported total consolidated assets of $50 billion or more;
- any foreign banking entity that has total U.S. assets (including all subsidiaries, affiliates, branches, and agencies of the foreign banking entity operating, located, or organized in the United States) of $50 billion or more; and
- any banking entity that is notified by the appropriate federal agency in writing that it must satisfy such additional compliance requirements.

- *Governance and Management Framework.* Banking entities which are required to establish enhanced compliance programs must establish, maintain, and enforce a governance and management framework that is reasonably designed to ensure that appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program, a clear reporting line with a chain of responsibility is delineated, and the compliance program is reviewed periodically by senior management.
  - *Accountability for Business Line Managers.* Managers with responsibility for one or more trading desks of the banking entity are accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading desks.
  - *Accountability for Board of Directors and Senior Management.* The board of directors, or similar corporate body, and senior management are responsible for setting and communicating an appropriate culture of compliance with section 619 of the Dodd-Frank Act and the final regulations, and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with section 619 of the Dodd-Frank Act and the final regulations. The final regulations also impose several specific new duties on the board of directors and senior management regarding the implementation and enforcement of the banking entity's enhanced compliance program.
  - *CEO Attestation.* Based on a review by the CEO of the banking entity, the CEO of the banking entity must annually attest in writing to the appropriate federal agency that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the banking entity's enhanced compliance program in a manner reasonably designed to achieve compliance with section 619 of the Dodd-Frank Act. In the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations of the foreign banking entity who is located in the United States.

- *Additional Documentation for Covered Funds.* Any banking entity with total consolidated assets of more than $10 billion, as reported on December 31 of the previous two calendar years, is also required to maintain specified records regarding documentation of certain exclusions and exemptions relied upon under the Covered Fund Provisions and documentation of the value of certain investments in foreign public funds.
- *Banking Entities With Modest Activities.* A banking entity with total consolidated assets of $10 billion or less, as reported on December 31 of the previous two calendar years, that engages in proprietary trading (other than permitted trading in U.S., State, or municipal government obligations and specified FDIC obligations) or sponsors or invests in covered funds may satisfy its compliance program requirements by including in its existing compliance policies and procedures appropriate references to the requirements in Section 619 of the Dodd-Frank Act and the final regulations, with adjustments as appropriate given the activities, size, scope, and complexity of the banking entity.
- *Banking Entities With No Covered Activities*. If a banking entity does not engage in proprietary trading (other than permitted trading in U.S., State, or municipal government obligations and specified FDIC obligations) or sponsor or invest in covered funds, the entity may satisfy the compliance program requirements by establishing the required compliance program prior to becoming engaged in such activities.

If you would like to discuss the final regulations, please contact the following lawyers in our firm:

Warren Caywood (co-author)	+1.212.841.1069	wcaywood@cov.com
Carey Roberts (co-author)	+1.212.841.1034	croberts@cov.com
Frederick Knecht (co-author)	+1.212.841.1193	fknecht@cov.com
Bruce Bennett	+1.212.841.1060	bbennett@cov.com
John Dugan	+1.202.662.5051	jdugan@cov.com
Keith Noreika	+1.202.662.5497	knoreika@cov.com
William Sturman	+1.212.841.1014	wsturman@cov.com
Daniel Nazar (co-author)	+1.212.841.1091	dnazar@cov.com