

Davis Polk

**Volcker Rule Materials
Hedge and Private Equity
Funds**

October 12, 2011

DPW Volcker Rule Slides

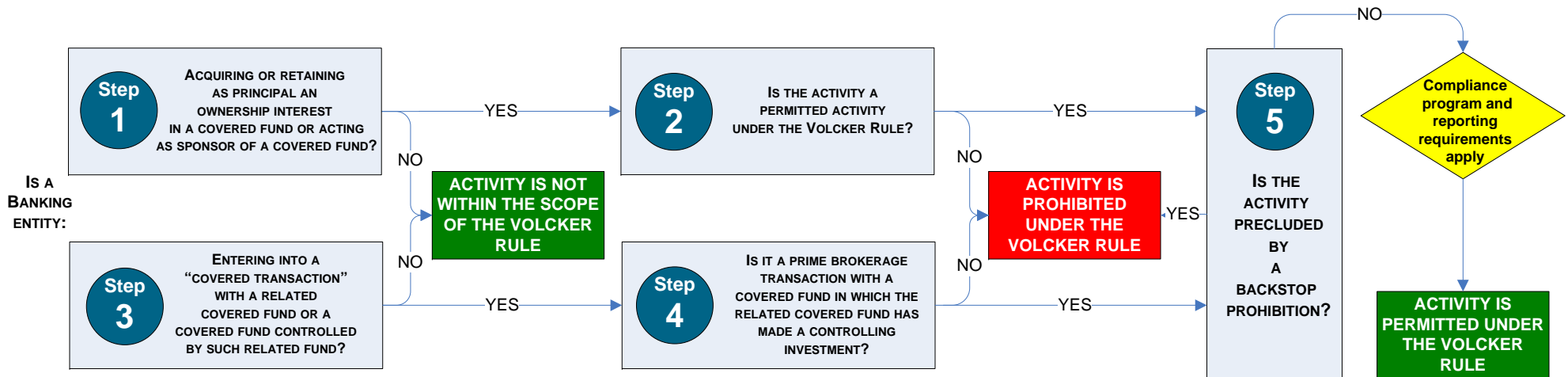


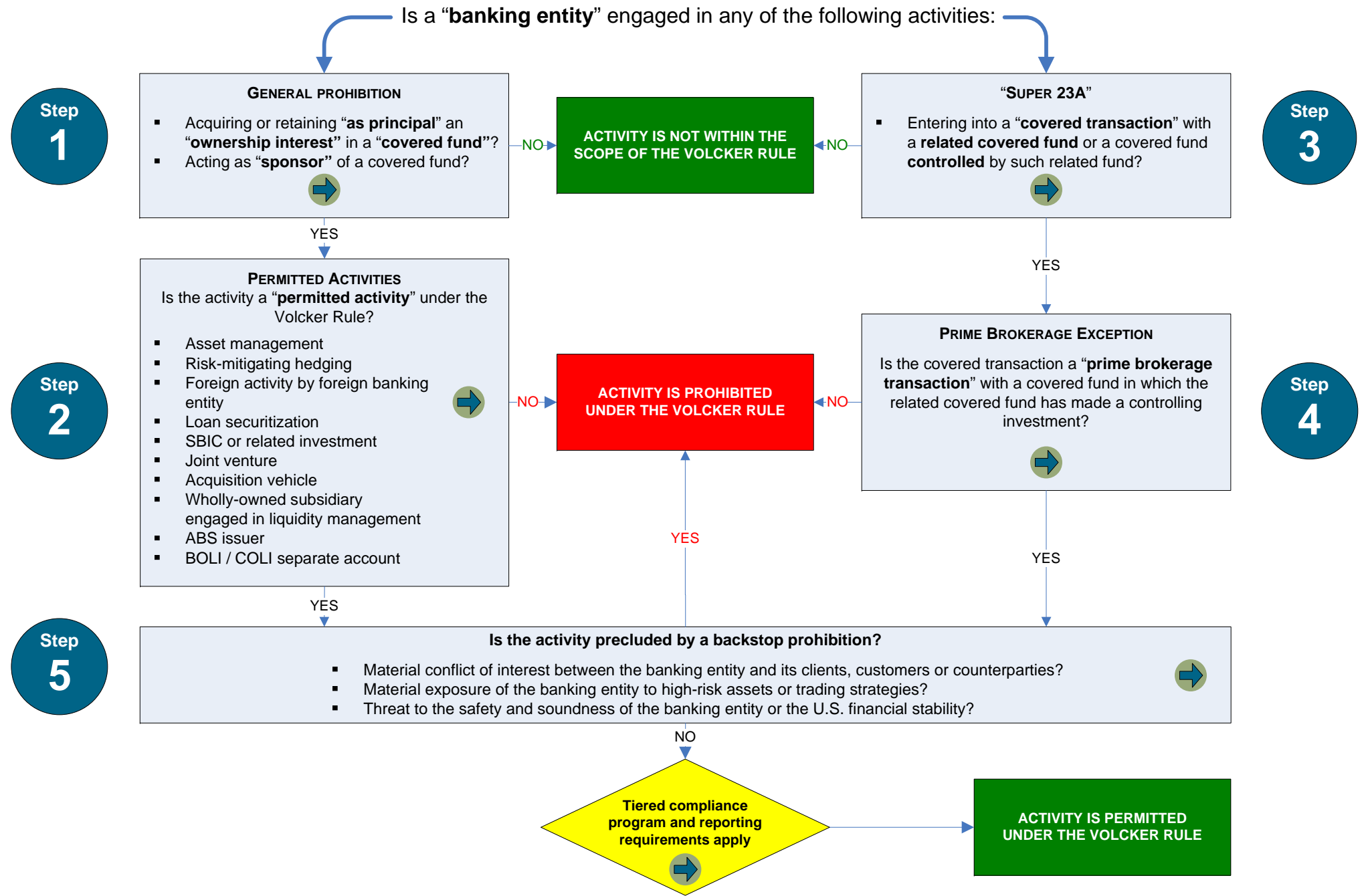
On October 11, 2011, the Federal Reserve, FDIC and OCC released proposed regulations implementing the Volcker Rule. The Dodd-Frank Act requires these three agencies and the SEC and the CFTC to consult and adopt rules restricting the ability of banking entities to invest, sponsor or enter into certain transactions with hedge funds or private equity funds.

Comments on the proposal are due January 13, 2012. The statutory Volcker Rule prohibitions will become effective on July 21, 2012, whether or not regulations are finalized by that date.

To make our summary and analysis of the proposed regulations more user-friendly, we have prepared a set of flowcharts that graphically maps the key restrictions on covered fund activities in lieu of a traditional law firm memo.

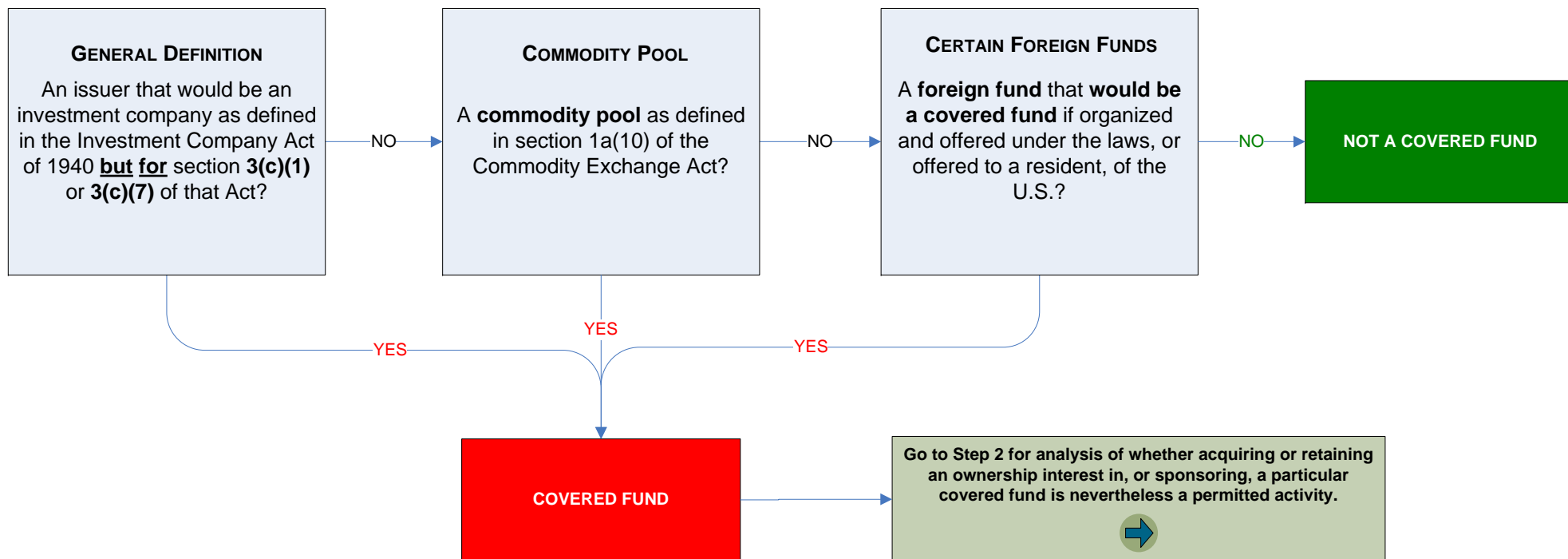
We are also pleased to announce the launch of the Davis Polk Portal, the new online home of our regulatory resources. An interactive version of these flowcharts is available at www.volckerrule.com, which is part of the Davis Polk Portal.







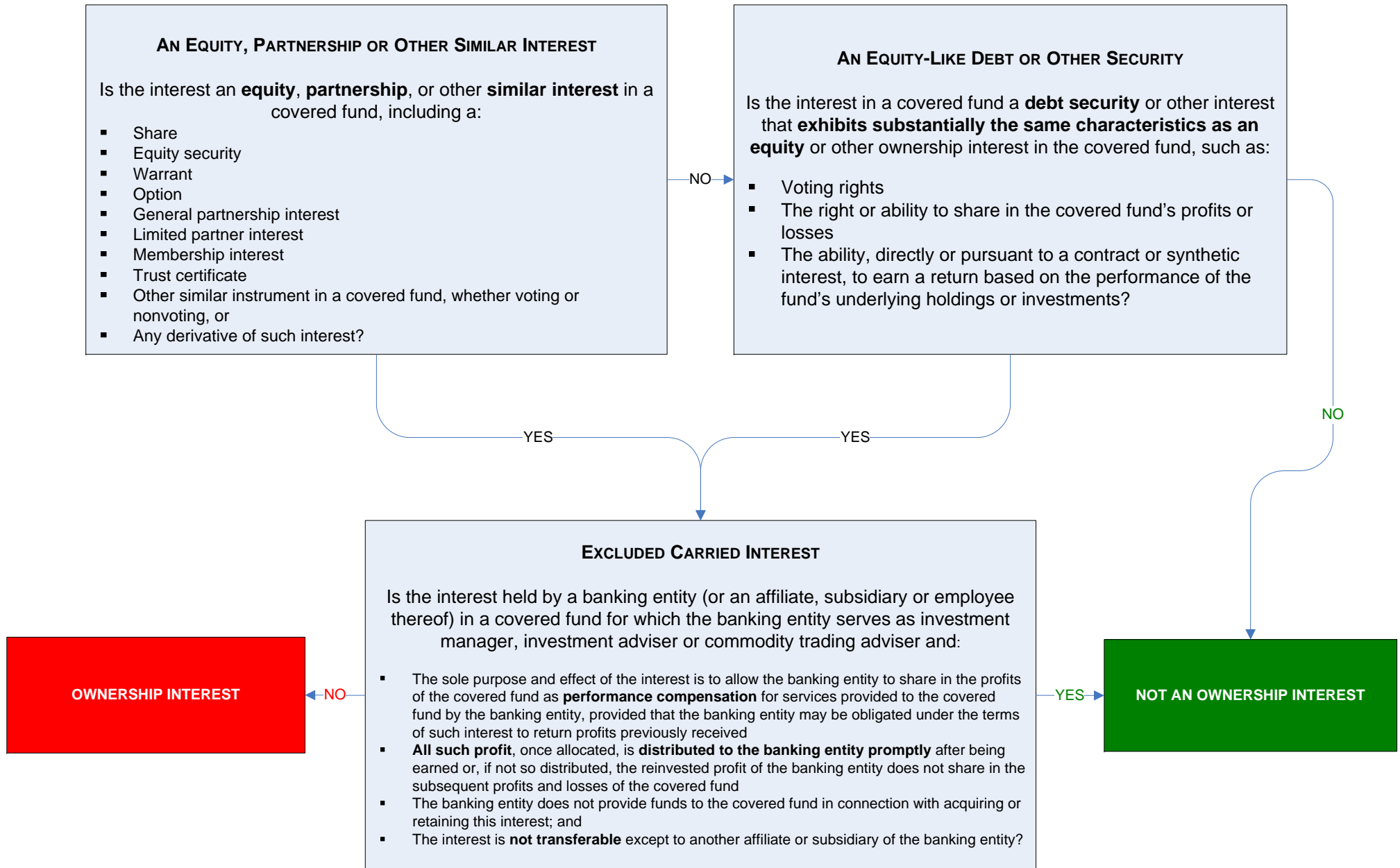
Is an entity:



GENERAL DEFINITION IS A “BUT FOR” TEST

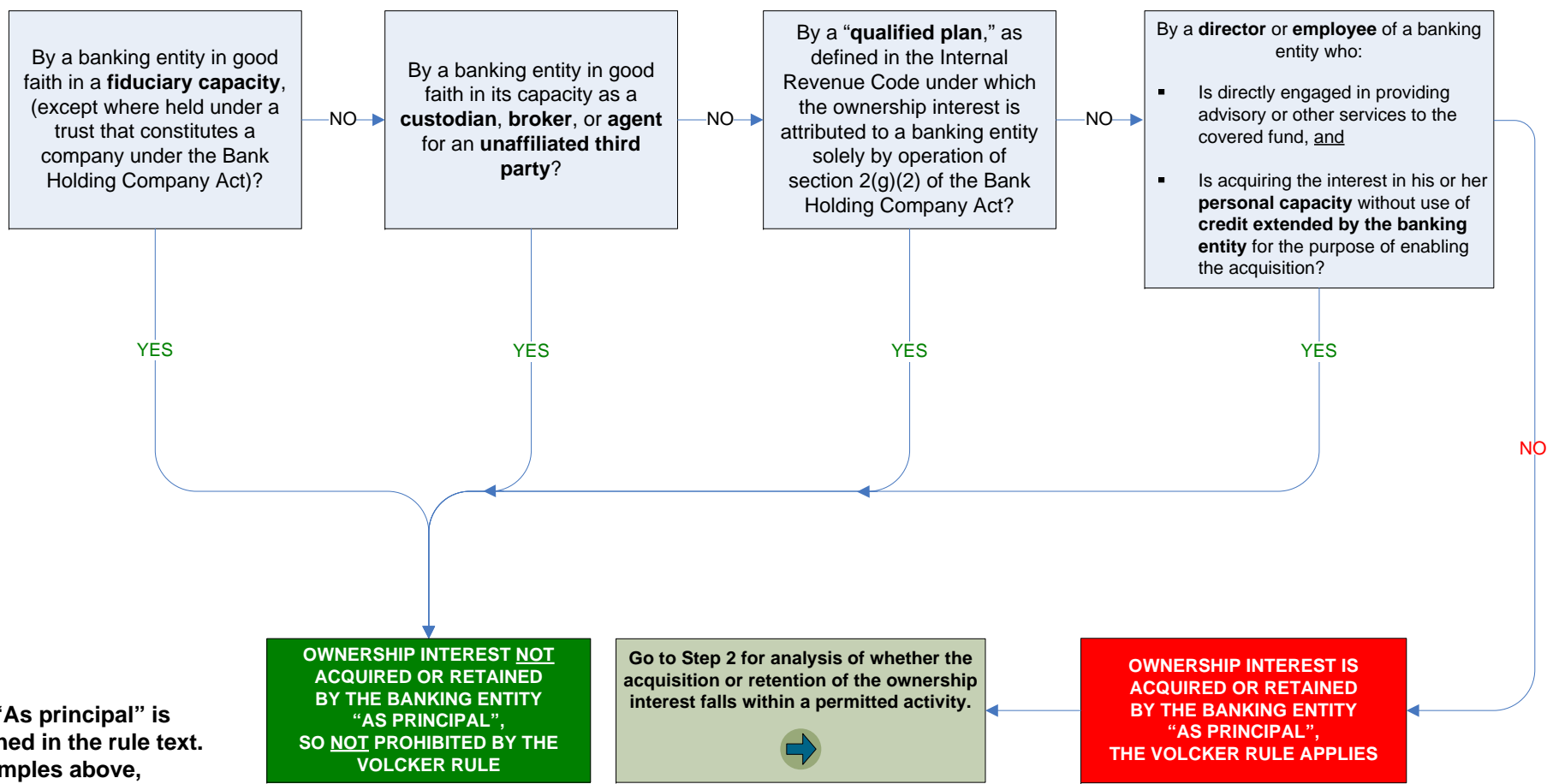
- An entity that may rely on any exemption from the definition of “investment company” under the Investment Company Act other than sections 3(c)(1) or 3(c)(7) is not a covered fund unless it is also a commodity pool or a foreign fund described above
- For example, an entity that may rely on the exemption under section 3(c)(3) of the Investment Company Act for common trust funds maintained by a bank exclusively for the collective investment of qualified assets would not fall within the general definition of covered fund

What is an “Ownership Interest”?



When is the Acquisition or Retention of an Ownership Interest in a Covered Fund Not the Acquisition or Retention of such Interest by a Banking Entity “As Principal”*?

Is the ownership interest in the covered fund being acquired or retained:

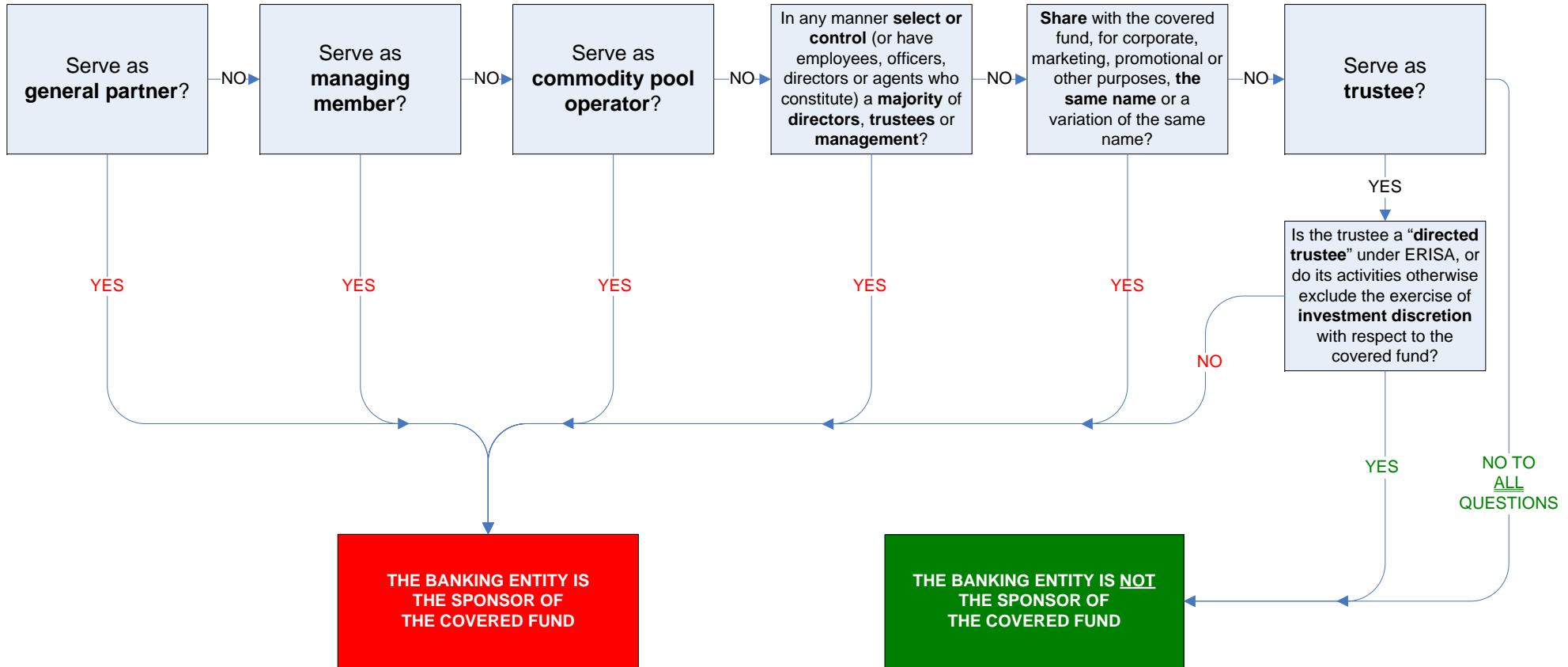


* Note: “As principal” is not defined in the rule text. The examples above, identified in the preamble, are not exclusive.

Step 1: What is a “Sponsor”?

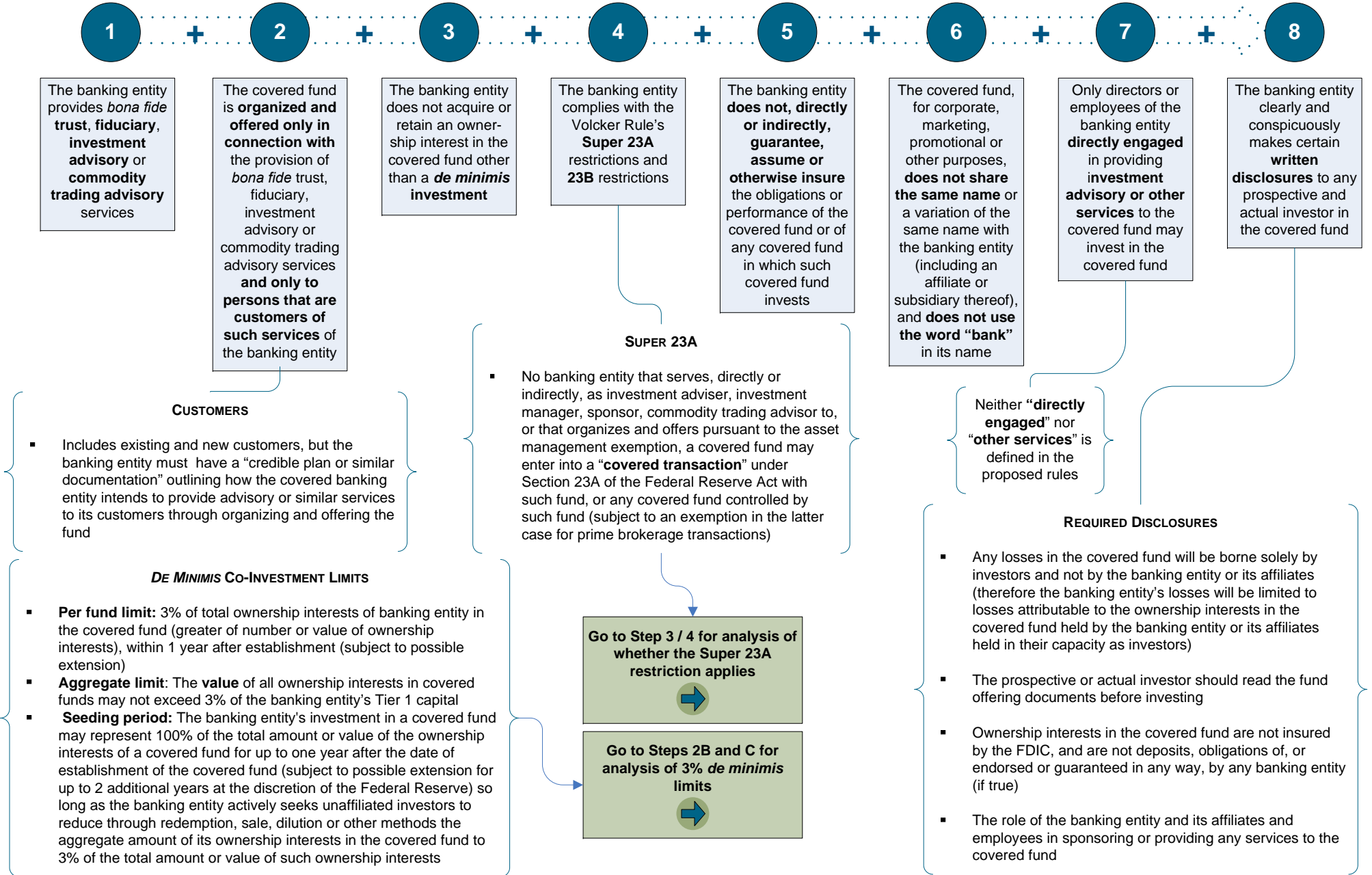


With respect to a covered fund, does the banking entity:

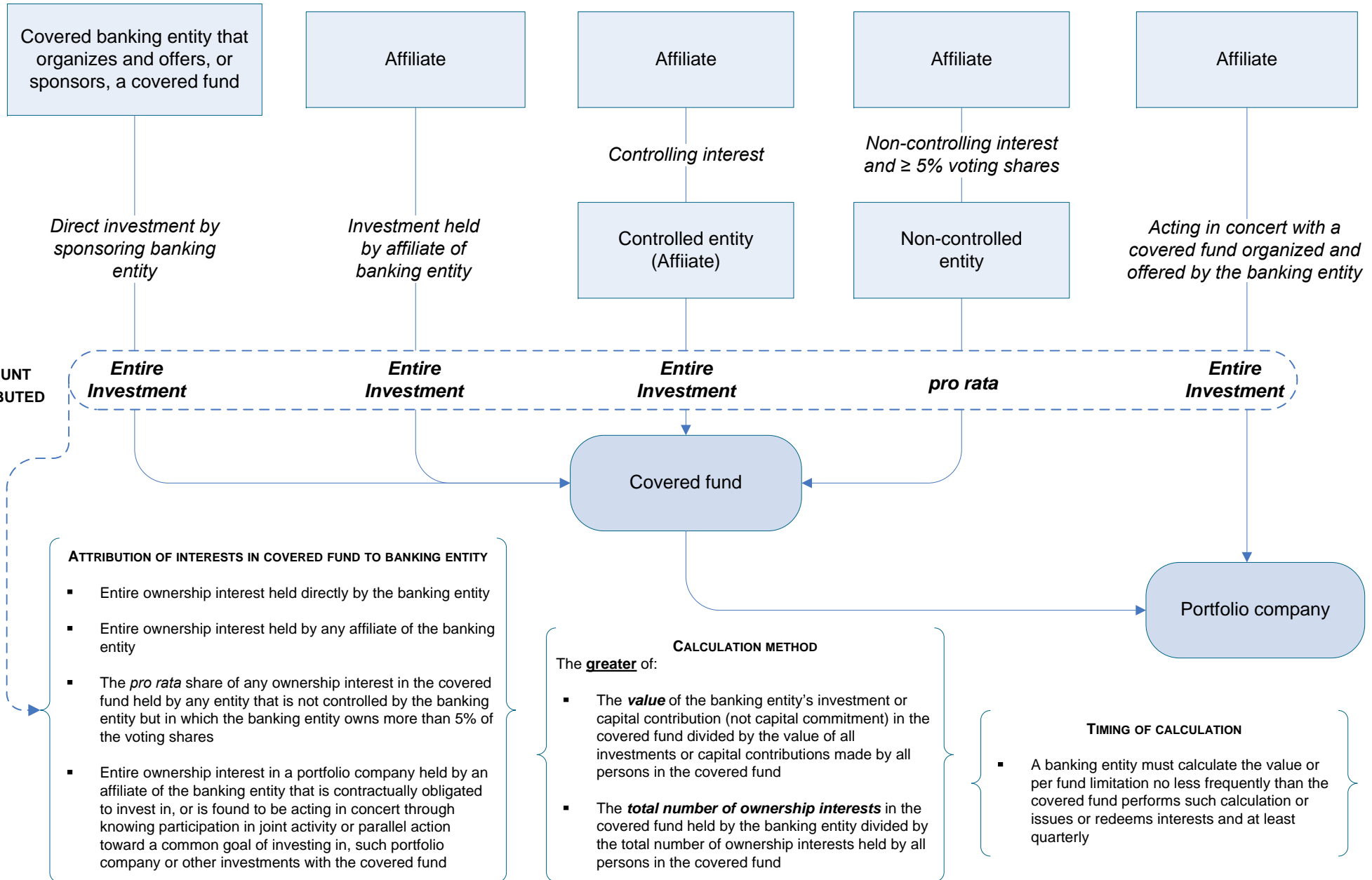


Permitted Activities: Asset Management

A banking entity may organize and offer, including serving as sponsor or commodity pool operator to, a covered fund if:



Permitted Activities: Asset Management (cont.) Calculation of Per Fund 3% *De Minimis* Limit

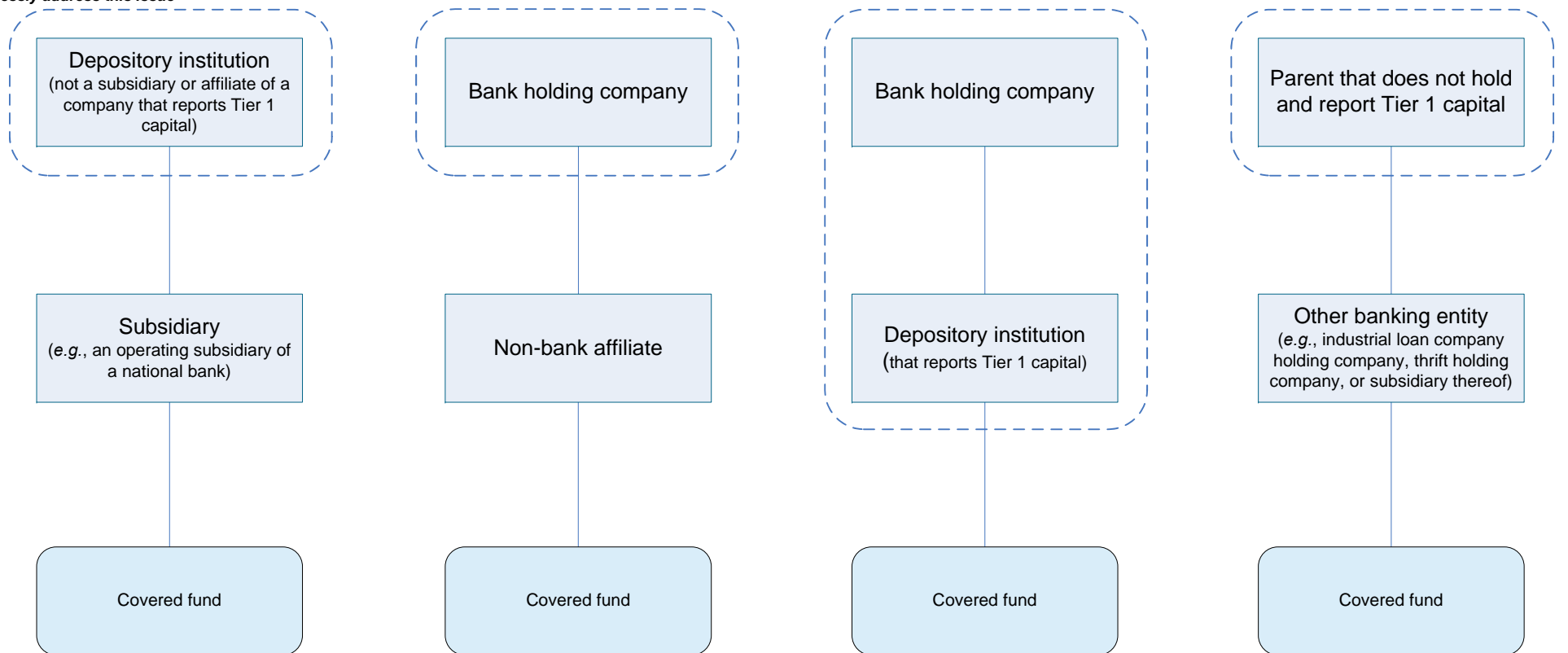


Permitted Activities: Asset Management (cont.)

Calculation of Aggregate 3% of Tier 1 Capital *De Minimis* Limit

Note: all references are to U.S. entities — presumably, any Tier 1 capital calculations required by foreign institutions will be based on home country standards, but the proposed rules do not expressly address this issue

Tier 1 capital for purposes of the 3% aggregate *de minimis* limit calculated at different levels in a banking entity's ownership structure depending on where in the structure Tier 1 capital is calculated and reported



- **Calculation method for aggregate investments in covered funds:** The sum of the *value* of each of the banking entity's investments in covered funds held under the asset management exemption
- **Timing of calculation of aggregate investments in covered funds and Tier 1 capital:** As of the last day of each calendar quarter
- **Deduction from Tier 1 capital:** Aggregate value of all investments in covered funds held under the asset management exemption must be deducted from the banking entity's Tier 1 capital

Depository Institution Controlled by Bank Holding Company

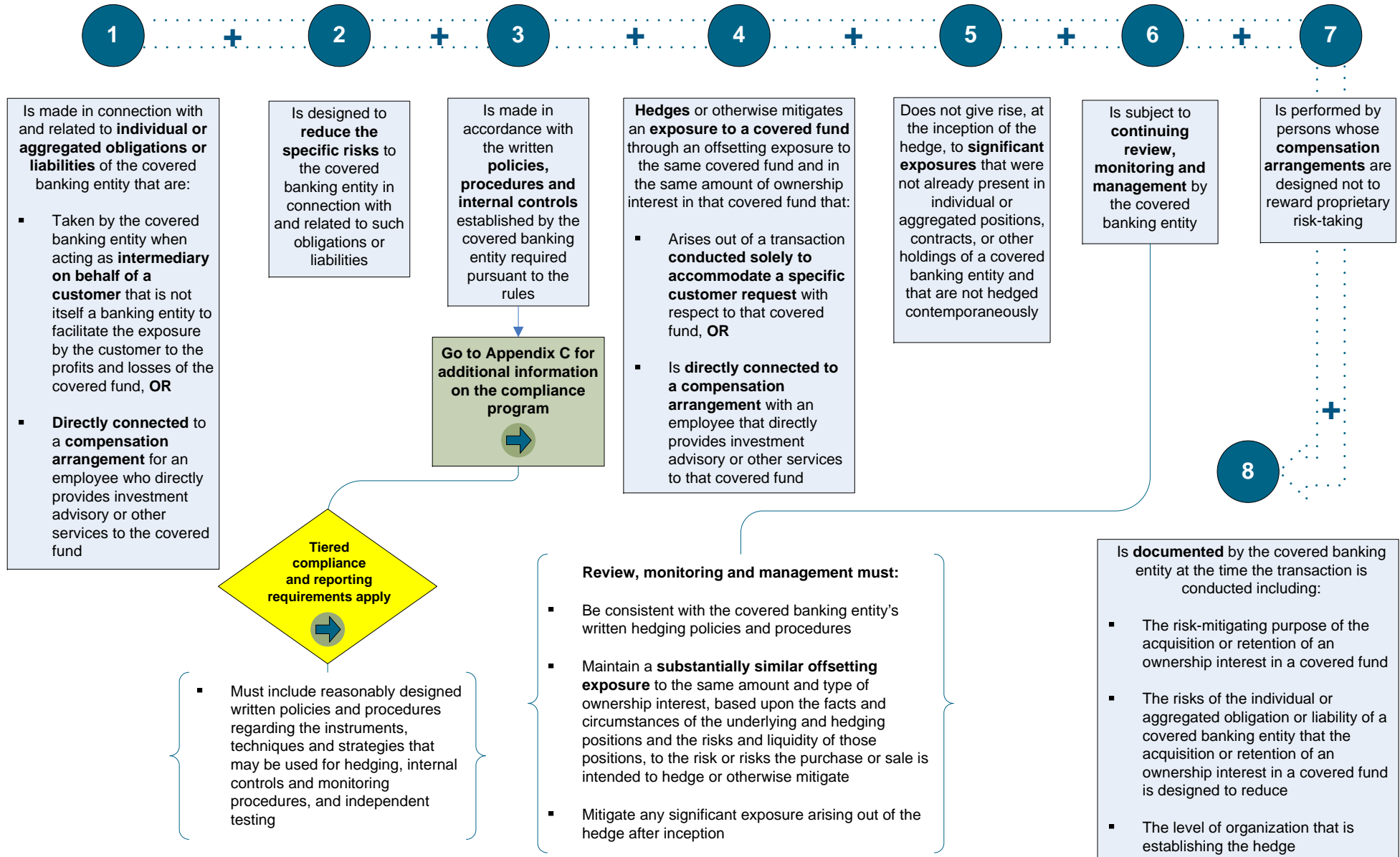
For investments by reporting depository institutions (and their subsidiaries) that are also subsidiaries or affiliates of a bank holding company, the 3% limit is calculated based on the lesser of the Tier 1 capital of the two reporting entities

No Reporting Entity in Control Structure

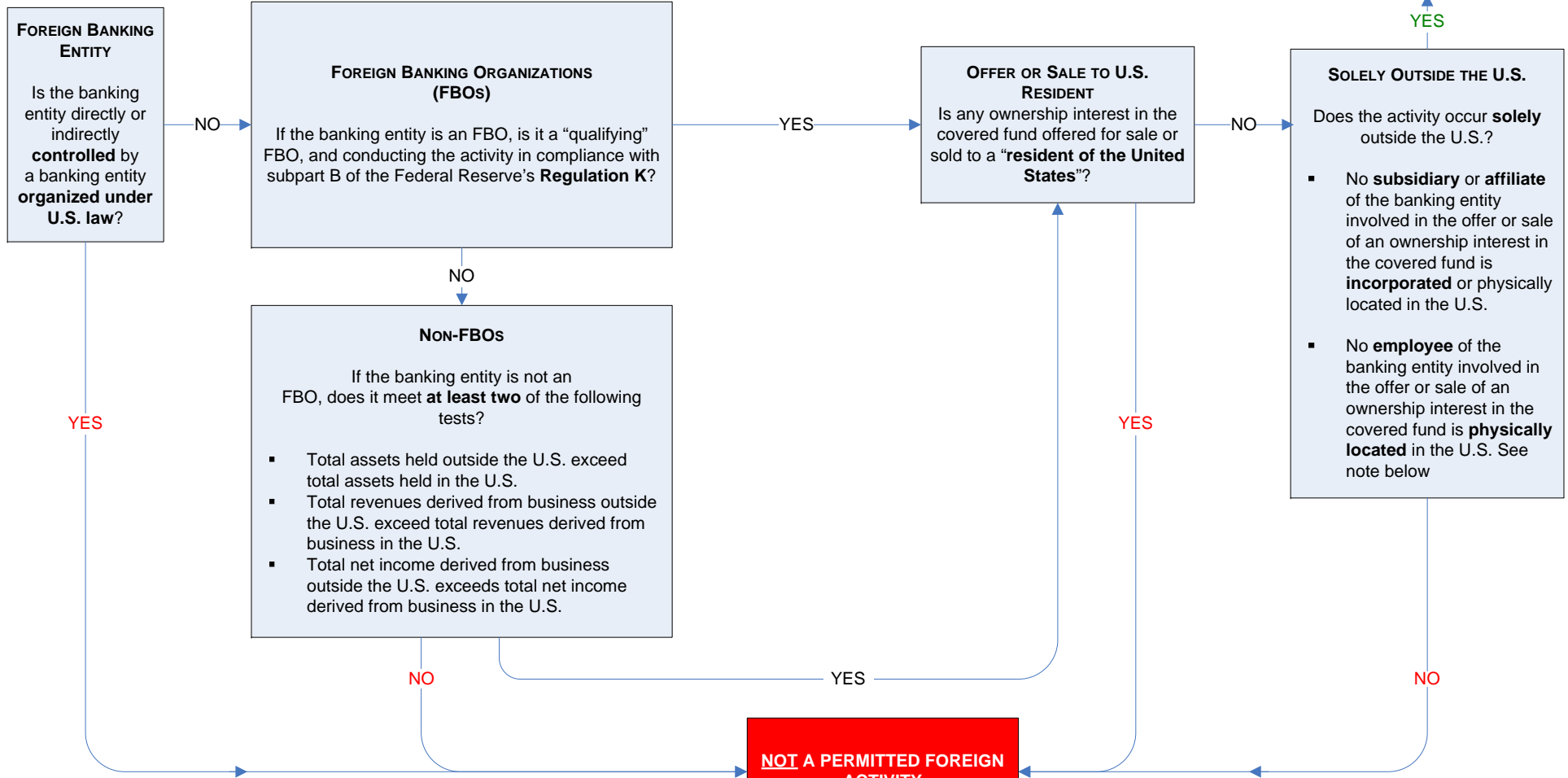
In lieu of Tier 1 capital, 3% limit calculated based on the total amount of the top-tier parent company's shareholders' equity on a consolidated basis

Permitted Activities: Risk-Mitigating Hedging

A banking entity may acquire or retain an ownership interest in a covered fund for risk-mitigating hedging purposes if the acquisition or retention of the ownership interest:



Permitted Activities: Foreign Activities by Foreign Banking Entities



“RESIDENT OF THE UNITED STATES”

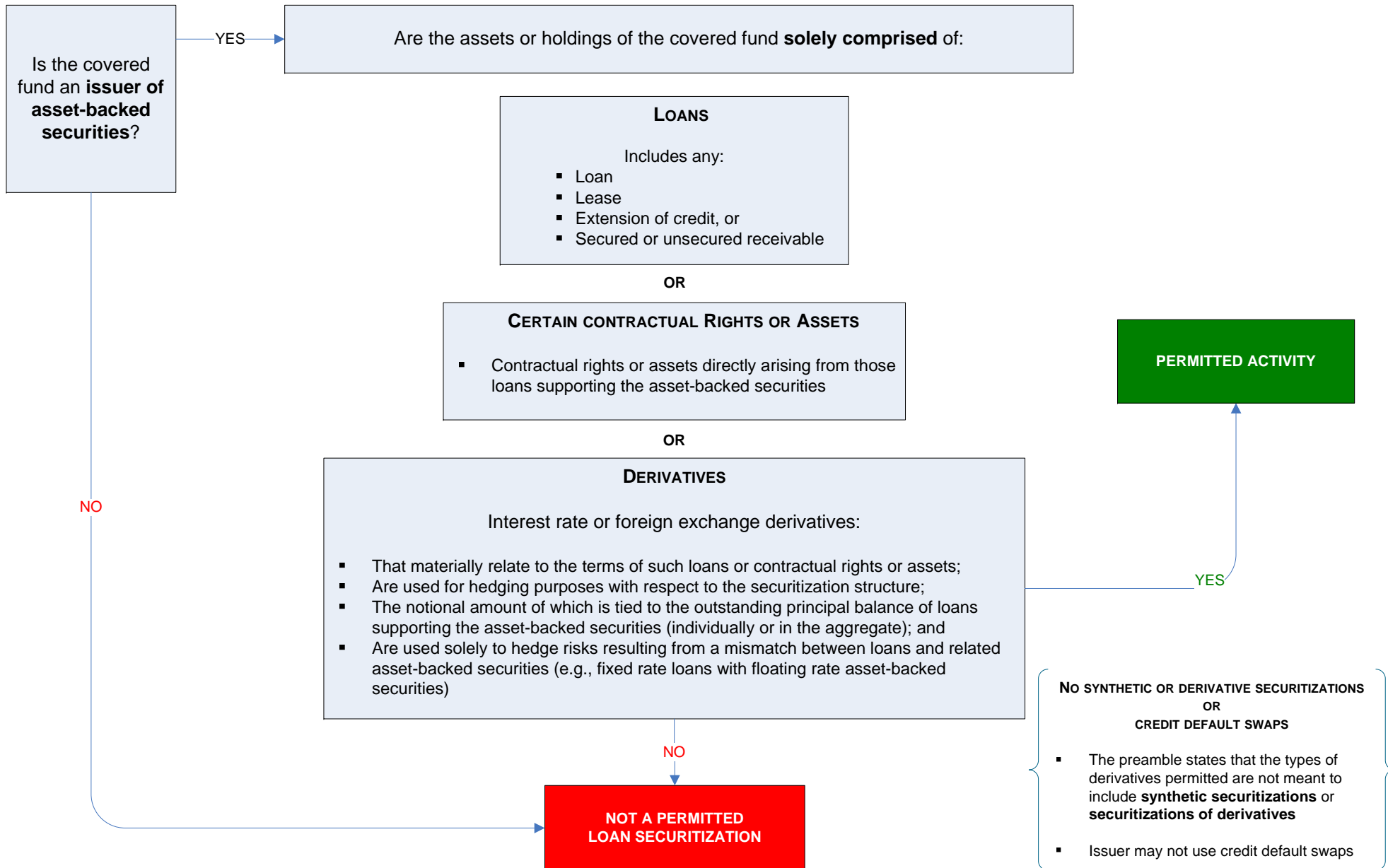
Adapts and expands the definition of “U.S. person” in the SEC’s Regulation S:

- Includes discretionary accounts held for a U.S. person by a non-U.S. dealer or fiduciary
- Omits exclusions, including for:
 - Offshore branches or agencies of U.S. entities
 - Discretionary accounts held for a non-U.S. person by a U.S. dealer or fiduciary

MINISTERIAL EXCEPTION FOR U.S.-BASED EMPLOYEES

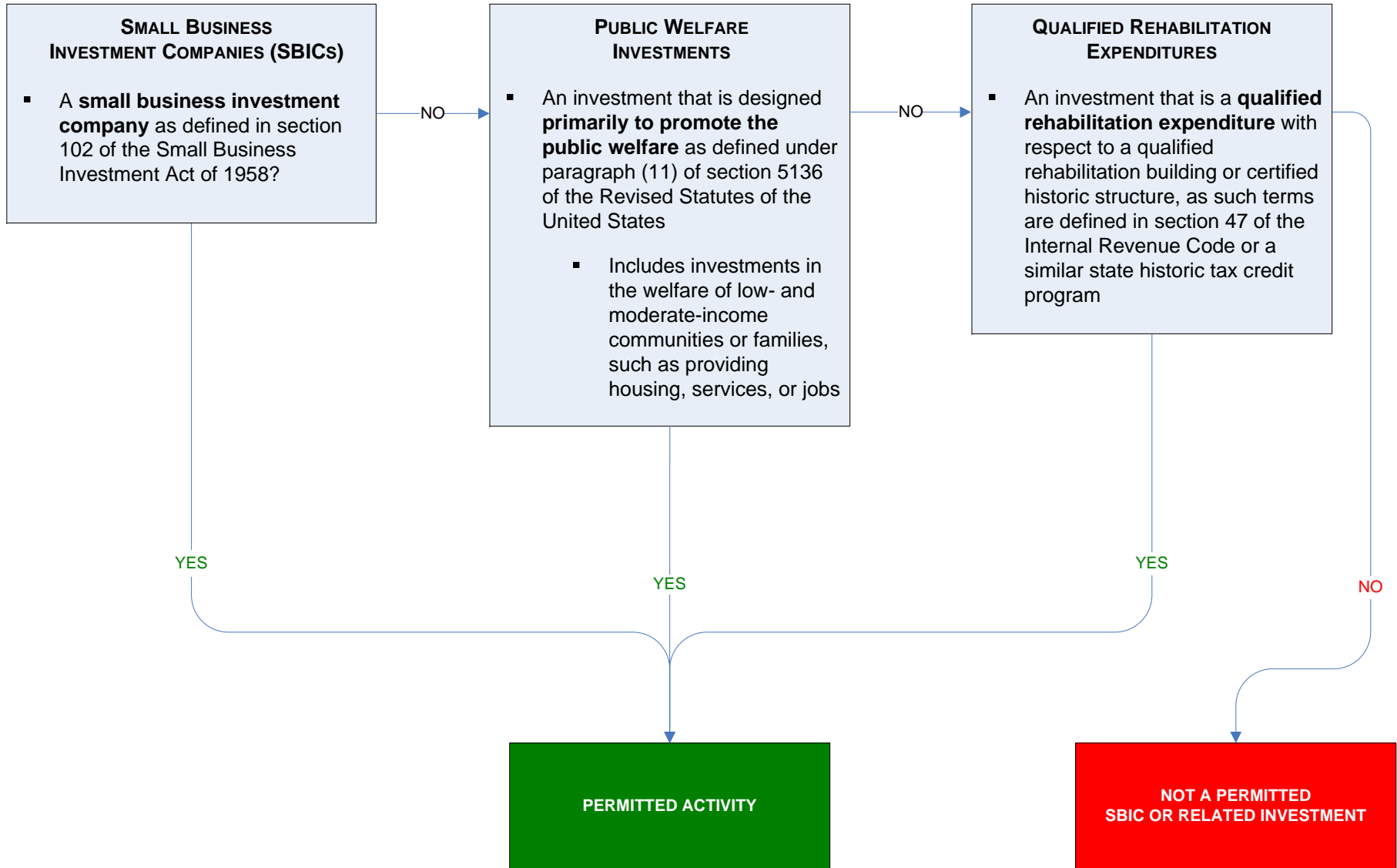
The preamble states that an employee or entity with **no customer relationship** and involved solely in providing **administrative services** or “**back office**” functions to the fund incident to activities permitted under the exception, including **clearing and settlement** or maintaining and preserving records of the fund

Step 2F: Permitted Activities: Loan Securitizations

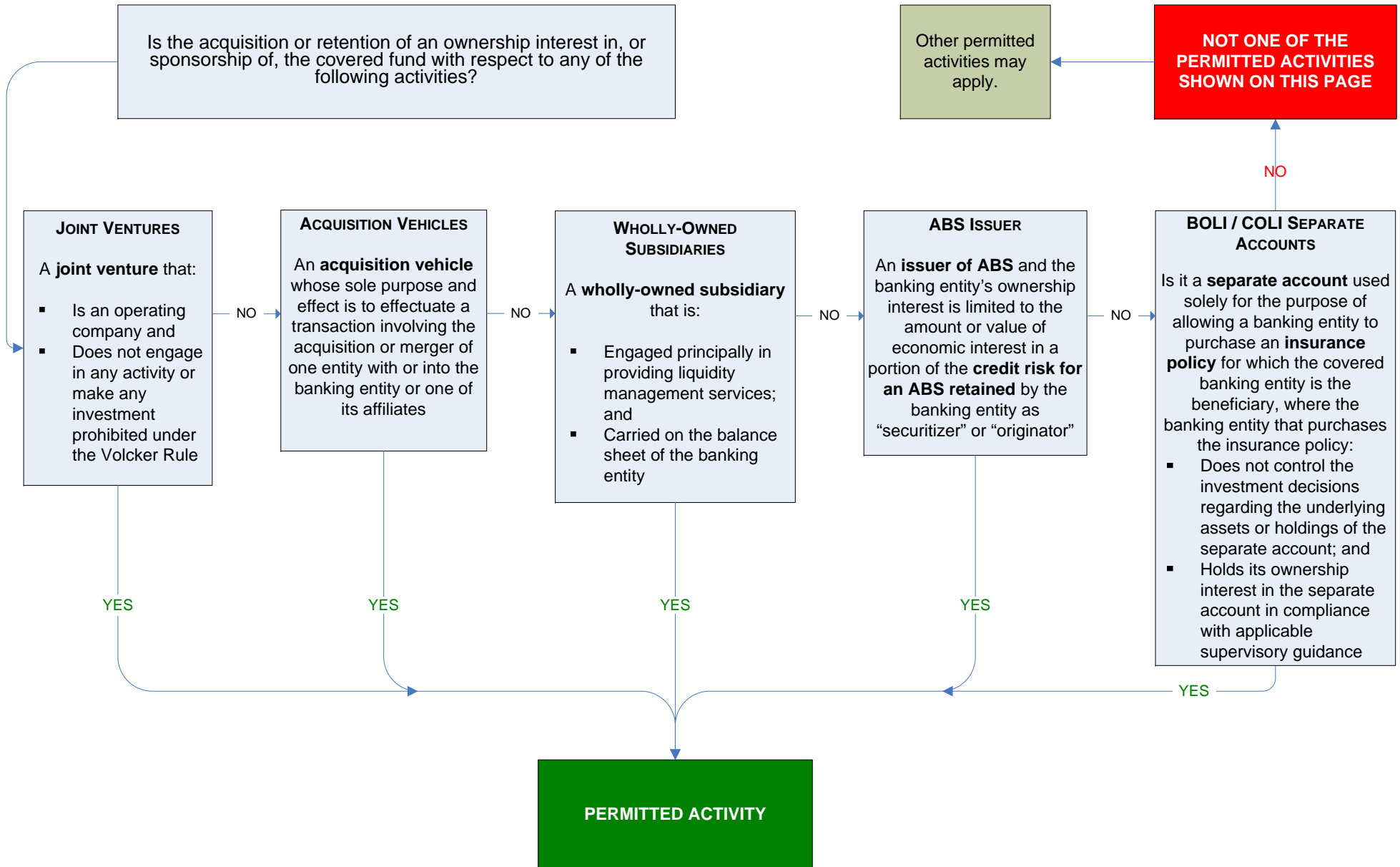


Permitted Activities: SBICs and Related Investments

Is the banking entity acquiring or retaining an ownership interest in, or sponsoring, a covered fund that is also:

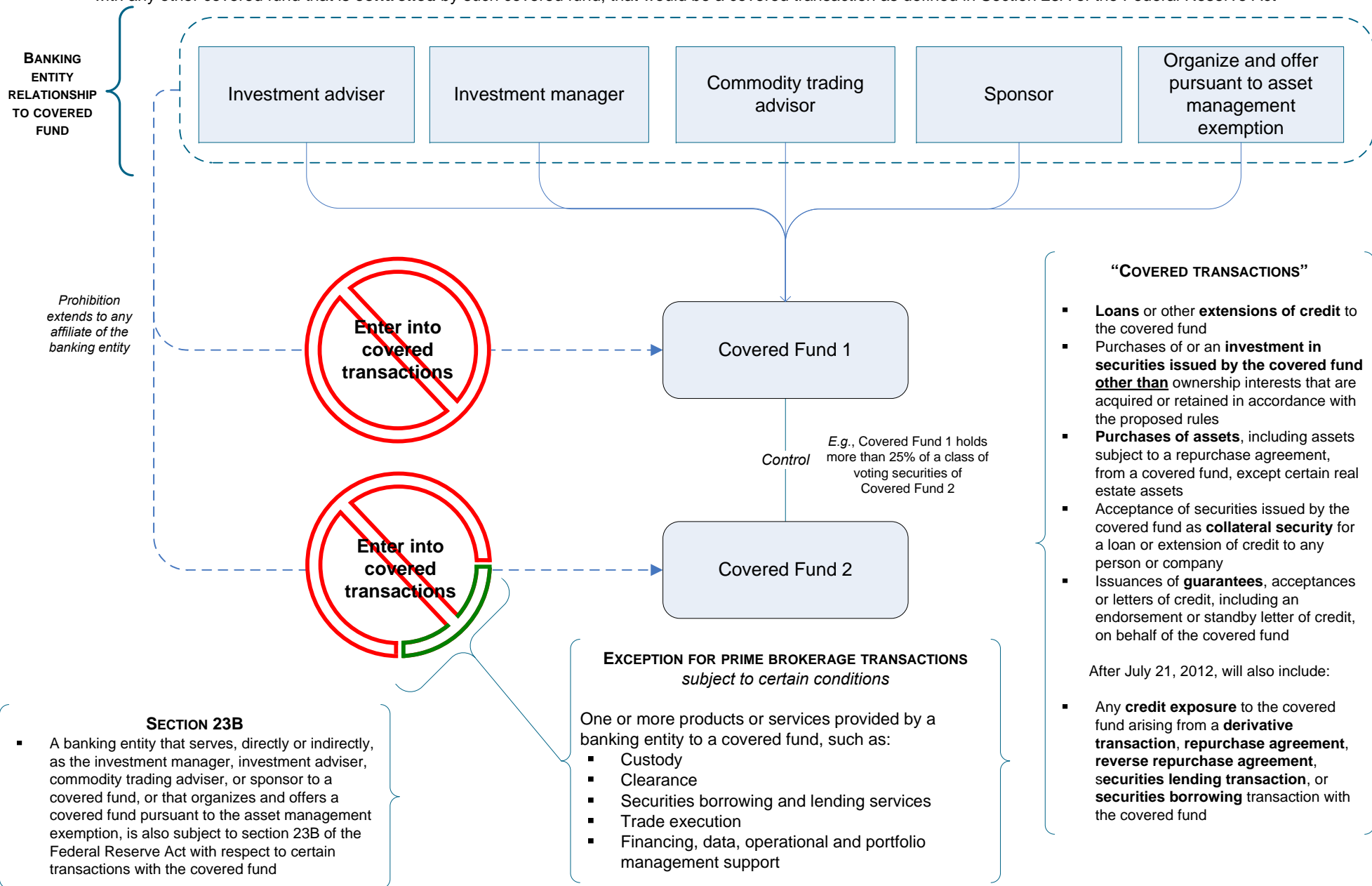


Permitted Activities: Investing in, or Sponsoring of, Certain Types of Vehicles



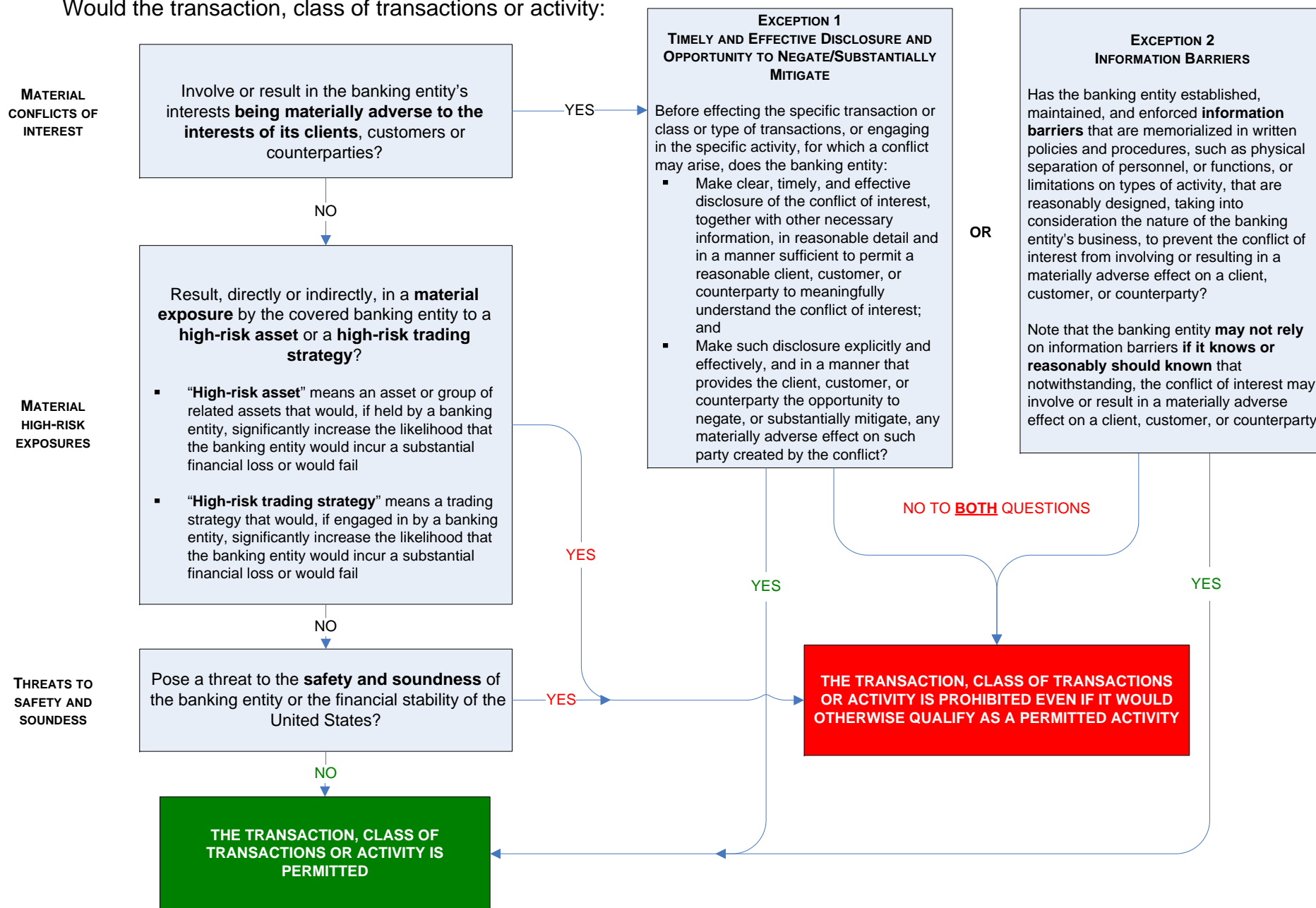
Do the “Super 23A” Restrictions Apply?

No banking entity **or its affiliate** that serves, directly or indirectly, as the **investment adviser, investment manager, commodity trading advisor, or sponsor** to a covered fund, or that **organizes and offers a covered fund pursuant to the asset management exemption**, may enter into a transaction with the covered fund, or with any other covered fund that is **controlled** by such covered fund, that would be a covered transaction as defined in Section 23A of the Federal Reserve Act



Is the Activity Precluded by a “Backstop” Prohibition?

Would the transaction, class of transactions or activity:



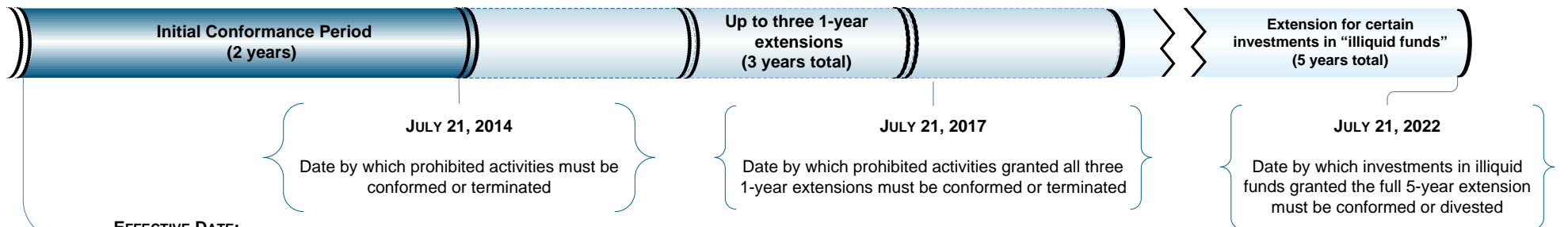


- **Applies to all covered investments and relationships.** Initial 2-year conformance period plus up to three 1-year extensions available for any investment made or relationship (see Super 23A) established with a covered fund prior to July 21, 2012. Up-to-5-year extended conformance period available only for certain investments in “illiquid funds” in existence on May 1, 2010
- **Conformance rules unchanged since final rulemaking.** Proposed rules implementing the Volcker Rule simply incorporate the February, 2011 final conformance rules with non-substantive conforming and technical changes. Proposed rules seek comment on whether the conformance rules should be revised in light of the content of the proposed rules
- **Extensions granted separately, run consecutively.** Banking entities must apply separately for each extension, at least 180 days prior to the expiration of the 2-year initial conformance period or any subsequent extension period

FACTORS FOR GRANTING OF EXTENSIONS BY FEDERAL RESERVE

Applications considered in light of all facts and circumstances, including but not limited to:

- market conditions
- degree of control held by the banking entity over investment decisions of the fund
- whether any assets that were illiquid when first acquired have become liquid
- expected wind-up / liquidation date of fund
- cost to banking entity of divesting or disposing of the activity or investment within the applicable period
- prior efforts to divest or conform the activity or investment
- any other factor the Board believes appropriate



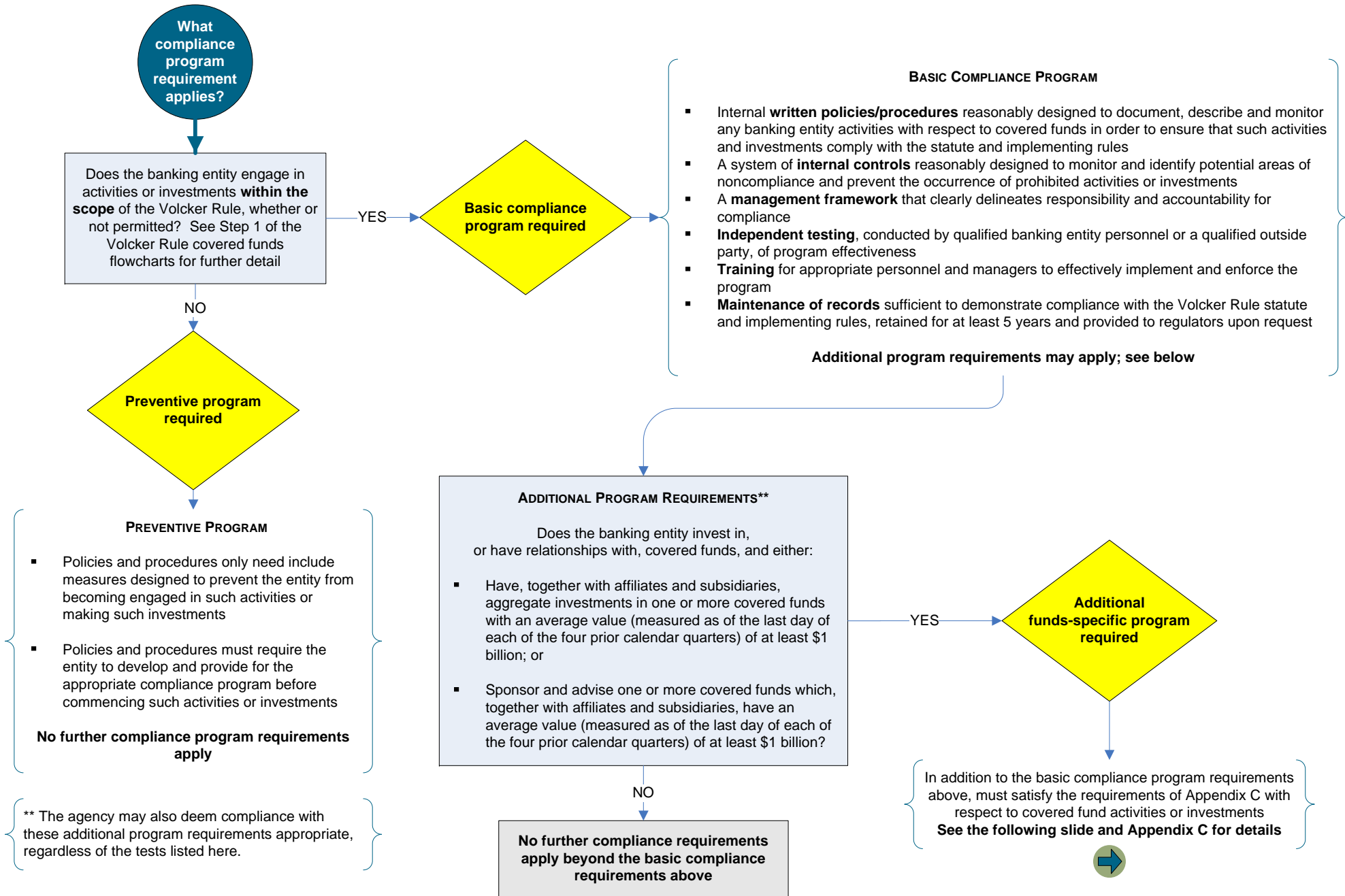
EFFECTIVE DATE:
JULY 21, 2012

UPON EFFECTIVE DATE:

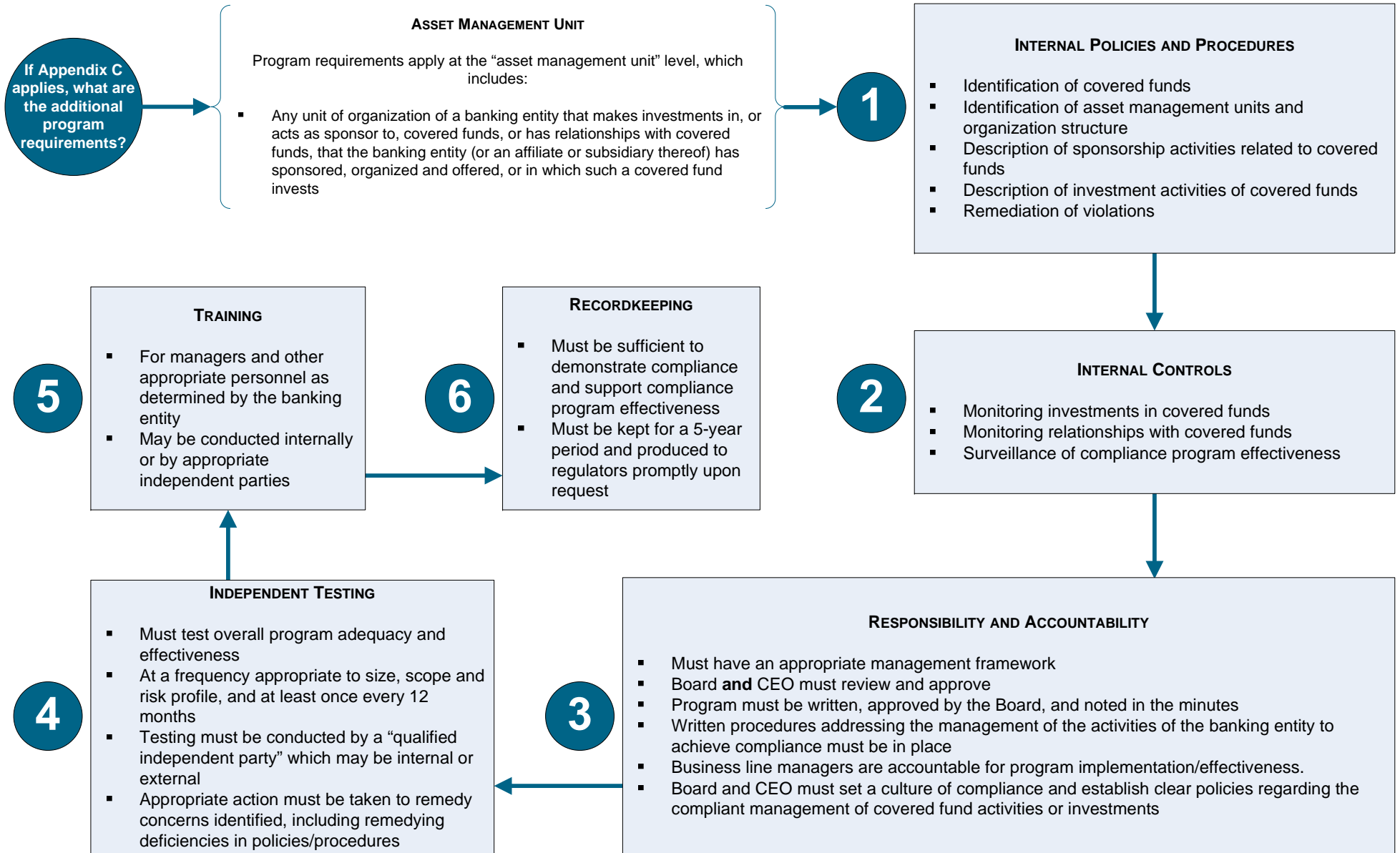
- **New Investments in or Sponsorships of Covered Funds** - A banking entity may not acquire or retain an ownership interest in or be the sponsor of a covered fund established on or after the effective date, except in accordance with the proposed rules, including the final conformance rules for pre-existing covered funds
- **New or Additional Covered Transactions with Related Covered Funds** – A banking entity may not enter into new or additional covered transactions with a related covered fund on or after the effective date
- **Compliance Program Must Be Implemented** - By the effective date, each banking entity would be required to have developed and implemented the required compliance program under Appendix C.

EXTENDED TRANSITION PERIOD FOR CERTAIN INVESTMENTS IN “ILLIQUID FUNDS”

- **Basic eligibility criteria:** In order for a banking entity to be eligible for the extended conformance period to retain or make additional investments in an illiquid fund:
 - The fund must be a covered fund that **as of May 1, 2010** was either **principally invested in illiquid assets** or invested to some degree and contractually committed to principally invest in illiquid assets; and
 - The investment must be **necessary** to fulfill a **contractual obligation** of the banking entity to retain or make additional investments that was in effect on May 1, 2010
- **Illiquid assets.** Any asset that:
 - Is **not** defined as a “liquid” asset, which in turn is defined as cash; assets traded on regulated exchanges or certain other markets with a sufficient volume of bids and offers to permit near instantaneous pricing reasonably related to the last sales price or a current competitive bid; assets traded on recognized inter-dealer quotation or similar systems with competitive bids and offers from multiple dealers; assets with prices routinely quoted in widely disseminated publications; certain short-term debt obligations; and any other asset designated by the Federal Reserve as liquid
 - Cannot be transferred because of statutory, regulatory or contractual restrictions on transfer
- **Principally invested.** A covered fund must have invested at least 75% of its consolidated assets in illiquid assets or risk-mitigating hedges related to such assets
- **Contractual obligation.** A contractual obligation to retain or make additional investments exists if the banking entity is prohibited from redeeming or transferring all ownership interests in a covered fund
- **Necessary.** An investment is deemed to be **necessary** to fulfill a contractual obligation only if the banking entity has no unilateral power to terminate the obligation and, if the consent of a general partner or other third party is needed, has used its reasonable best efforts to obtain such consent and such consent has been denied.



Additional Funds-Specific Compliance Programs, Policies and Procedures



If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Randall D. Guynn	212 450 4239	randall.guynn@davispolk.com
Yukako Kawata	212 450 4896	yukako.kawata@davispolk.com
Arthur S. Long	212 450 4742	arthur.long@davispolk.com
Gregory S. Rowland	212 450 4930	gregory.rowland@davispolk.com
Karen Pelzer	212 450 4652	karen.pelzer@davispolk.com
Alex Young-Anglim	212 450 4809	alex.young-anglim@davispolk.com



<p>Asset Management Unit</p>	<p>Each organizational unit of a banking entity that either:</p> <ul style="list-style-type: none"> ▪ Makes investments in or sponsors covered funds ▪ Has relationships with covered funds that the banking entity (or an affiliate or subsidiary) has sponsored, organized and offered or in which a covered fund sponsored or advised by the banking entity invests.
<p>Covered Fund Activity or Investment</p>	<ul style="list-style-type: none"> ▪ Sponsoring a covered fund ▪ Making investments in a covered fund or ▪ Otherwise having relationships with a covered fund for which the banking entity (or an affiliate or subsidiary thereof) acts as sponsor or organizes and offers



<p>General—Enhanced Compliance Program Requirements</p>	<p>A banking entity is subject to enhanced program requirements if, together with its affiliates and subsidiaries, it:</p> <ul style="list-style-type: none"> ▪ Has aggregate investments in covered funds the average value of which is, measured as of the last day of each of the four prior calendar quarters, at least \$1 billion; or ▪ Sponsors or advises one or more covered funds the average total assets of which are, measured as of the last day of each of the four prior calendar quarters, at least \$1 billion <p>Such banking entity must establish, maintain and enforce written policies and procedures reasonably designed to document, describe and monitor the banking entity’s covered fund activities or investments and the risks taken in these activities or investments.</p>
<p>Identification of Covered Funds</p>	<p>Written policies and procedures must specify how the banking entity identifies covered funds that it sponsors, organizes and offers, or in which the covered banking entity invests.</p>
<p>Identification of Asset Management Units and Organization Structure</p>	<p>Written policies and procedures must identify and document each asset management unit and map each asset management unit to the division, business line, or other organizational structure that the banking entity uses to manage or oversee the asset management unit’s activities.</p>
<p>Description of Sponsorship Activities and</p>	<p>Written policies and procedures for each asset management unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., the business model for generating revenues) of the asset management unit related to its sponsorship or organizing and offering of covered funds.</p>



<p>Description of Sponsorship Activities (cont.)</p>	<p>Written policies and procedures must include a description of:</p> <ul style="list-style-type: none"> ▪ The activities that the asset management unit is authorized to conduct, including the nature of any trust, fiduciary, investment advisory, or commodity trading advisory services offered to customers of the banking entity ▪ The types of customers to whom the asset management unit provides such services and to whom ownership interest in covered funds are sold ▪ The extent of any co-investment activities of the banking entity (including its directors or employees) in covered funds offered to such customers, and ▪ How the asset management unit complies with the requirements of the prohibitions on acquiring or retaining an ownership interest in, and having certain relationships with, a covered fund
<p>Description of Investment Activities of Covered Funds</p>	<p>Written policies and procedures for each asset management unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., the business model for the generation of revenues) of the asset management unit related to its investments in covered funds, including in particular:</p> <ul style="list-style-type: none"> ▪ The asset management unit’s practices with respect to seed capital investments in covered funds, including how the asset management unit reduces its investments in covered funds to amounts that are permitted <i>de minimis</i> investments within the required period of time



<p>Description of Investment Activities of Covered Funds (cont.)</p>	<ul style="list-style-type: none"> ▪ The asset management unit’s practices with respect to co-investments in covered funds, including certain parallel investments attributable to the banking entity related to the asset management unit ▪ How the asset management unit complies with the <i>de minimis</i> requirements with respect to individual and aggregate investments in covered funds ▪ With respect to other permitted covered fund activities or investments, how the asset management unit complies with the requirements for permitted activities ▪ How the asset management unit complies with the limitations on relationships with covered funds ▪ How the banking entity monitors for and prohibits potential or actual: <ul style="list-style-type: none"> ▪ Conflicts of interest between the banking entity and its clients, customers, or counterparties related to the asset management unit ▪ Transactions or activities that may threaten the safety and soundness of the banking entity related to the asset management unit and ▪ Material exposure to high-risk assets or high-risk trading strategies presented by each asset management unit
<p>Remediation of Violations</p>	<p>Written policies and procedures must require the banking entity to promptly document, address and remedy any violation of the Volcker Rule statute or implementing rules and document actual remediation efforts and include procedures designed to implement, monitor, and enforce required remediation and assess the extent to which a violation indicates that a modification to the compliance program is warranted.</p>



<p>General</p>	<p>Must establish, maintain and enforce written internal controls:</p> <ul style="list-style-type: none"> ▪ Reasonably designed to ensure that the covered funds activities or investments of each asset management unit are appropriate and consistent with the description of the unit’s mission, strategy and risk management process ▪ At a minimum, designed to ensure that the banking entity complies with the requirements of the asset management exemption with respect to any covered fund in which it invests, for which it acts as sponsor, or which it organizes and offers
<p>Monitoring Investments in a Covered Fund</p>	<p>Must implement and enforce internal controls in a way that monitors and limits the banking entity’s individual and aggregate investments in covered funds. At a minimum, controls must be reasonably designed to ensure that such investments are in compliance with the Volcker Rule statute and implementing rules, including:</p> <ul style="list-style-type: none"> ▪ Monitoring the amount and timing of seed capital investments for compliance with the <i>de minimis</i> investment limitations ▪ Calculating the individual and aggregate levels of ownership interests in covered funds under the <i>de minimis</i> investment limitations ▪ Describing procedures for remedying violations of the Volcker Rule implementing rules ▪ Attributing the appropriate instruments to the individual and aggregate ownership interest calculations under the <i>de minimis</i> investment limitations, and ▪ Making the required disclosures, in writing, to prospective and actual investors in any covered fund organized and offered or sponsored by the banking entity pursuant to the asset management exemption



Monitoring Relationships with a Covered Fund	The banking entity must implement and enforce internal controls in a way that monitors and limits the banking entity's sponsorship of, and relationships with, covered funds. At a minimum, the banking entity must establish, maintain, and enforce internal controls reasonably designed to ensure that covered fund activities and relationships are in compliance with the Volcker Rule statute and the implementing rules, including monitoring for and preventing any relationship or transaction between the banking entity and a covered fund that is prohibited under the "Super 23A" or 23B provisions of the implementing rules.
Surveillance of Program Effectiveness	The banking entity must regularly monitor the effectiveness of its program and take prompt action to address and remedy any deficiencies identified. <ul style="list-style-type: none">▪ Any remedial action taken must be documented and maintained as a record by the banking entity



<p>General</p>	<p>Must have an appropriate management framework reasonably designed to ensure that:</p> <ul style="list-style-type: none"> ▪ Appropriate personnel are responsible and accountable for effective implementation and enforcement ▪ A clear reporting line and chain of responsibility are delineated ▪ The board of directors (or similar body) and CEO reviews and approves the program
<p>Corporate Governance</p>	<p>The banking entity must ensure that its compliance program is reduced to writing, approved by the Board of Directors or similar corporate body, and noted in the minutes.</p>
<p>Management Procedures and Written Procedures</p>	<p>Must establish, maintain, and enforce procedures reasonably designed to achieve compliance with the Volcker Rule statute and implementing rules.</p>
<p>Business Line Managers</p>	<p>Managers with responsibility for one or more asset management units engaged in covered fund activities or investments are accountable for the effective implementation and enforcement with respect to the asset management unit.</p>
<p>Senior Management</p>	<p>Senior management must ensure that effective corrective action is taken when violations of the Volcker Rule implementing rules are identified.</p> <ul style="list-style-type: none"> ▪ May include divestiture of the position, cessation of the activity or disciplinary measures.



<p>Senior Management <i>(cont.)</i></p>	<ul style="list-style-type: none"> ▪ Senior management and Volcker Rule control personnel should report to the Board of Directors (or an appropriate Board committee) on the effectiveness of compliance at least once every 12 months, and with a frequency appropriate to the size, scope and risk profile of covered activities
<p>Board of Directors (or Similar Body) and CEO</p>	<p>The Board of Directors (or a similar body) and the CEO are responsible for setting an appropriate culture of compliance with the implementing rules and establishing clear policies regarding the management of covered fund activities or investments in compliance with the Volcker Rule implementing rules.</p> <p>Board or similar body must ensure that senior management is fully capable, qualified and properly motivated to manage compliance, in light of the organization’s business activities.</p> <ul style="list-style-type: none"> ▪ Must also ensure that senior management has established appropriate incentives to support compliance, including the implementation of the compliance program into management goals and compensation structures across the banking entity



<p>What Independent Testing Must Evaluate</p>	<p>Overall adequacy and effectiveness, including analysis of the extent to which the program meets all requirements specified in the interagency proposal.</p> <p>Effectiveness of written policies and procedures</p> <p>Effectiveness of internal controls</p> <ul style="list-style-type: none"> ▪ Must include an analysis and documentation of instances in which internal controls were breached, including how the breaches were addressed and resolved <p>Effectiveness of management procedures</p>
<p>Who May Conduct Independent Testing</p>	<p>A “qualified independent party” such as an internal audit department, outside auditors, consultants or others.</p>
<p>Frequency of Independent Testing</p>	<p>Frequency should be appropriate to the size, scope and risk profile of covered trading activities and covered fund activities or investments, and at least once every 12 months.</p>
<p>Action to Be Taken in Response</p>	<p>The banking entity must take appropriate action to remedy any concerns identified, including remedying deficiencies in controls and policies themselves.</p>





Goal of Training	To effectively implement and enforce the compliance program. The release does not otherwise specify the content of required training.
Who Must Receive Training	Trading personnel, managers and other appropriate personnel as determined by the banking entity.
Who May Conduct Training	Either internal or independent parties, as deemed appropriate by the banking entity based on size and risk profile.
Frequency of Training	Not specified, but frequency should be appropriate to the size and the risk profile of covered trading activities and covered fund activities/investments.




Content	Must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program.
Time Period	At least 5 years.
Format	Must be able to promptly produce records to regulators on request.



Proprietary Trading

- Summary 
- With Annex 

Hedge / PE Funds

- Summary 
- With Annex 