Hedge Fund and Private Equity Fund Sponsorship and Investments Under the Proposed Regulations

The Volcker Rule prohibits a banking entity from sponsoring or investing in a hedge fund or private equity fund, subject to certain exceptions. The proposed regulations expand the definitions of "hedge fund" and "private equity fund" to include commodity pools and certain non-U.S. counterparts of covered funds. These additions present a number of questions and may lead to unintended consequences. Additionally, the proposed regulations codify the Volcker Rule's statutory exemptions, including exceptions related to permitted funds, permitted risk-mitigating hedging and non-U.S. activities of non-U.S. banking entities. The proposed regulations also specify several permitted activities, such as bank-owned life insurance separate accounts, certain corporate organization vehicles that may otherwise be included in the definition of a "covered fund" and debt collection in the ordinary course. The agencies have requested public comment on all aspects of the proposed covered fund regulations, and both the volume of the questions posed by the regulators and the uncertainty that remains in these sections leads us to expect changes in or further guidance on the final rule.

I. Key Provisions

The proposed regulations prohibit any banking entity from "sponsoring" a "covered fund," or acquiring or retaining "as principal" any "ownership interest" in a covered fund, subject to certain exceptions.[1] The proposed regulations define these and other key terms as follows:

Covered Fund

1. an issuer that relies on the Section 3(c)(1) or 3(c)(7) exclusions[2] from the definition of investment company under the Investment Company Act of 1940, as amended (the Investment Company Act);[3]

2. a commodity pool;[4]

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[1] Proposed Regulations § __.10.

[2] Section 3(c)(1) of the Investment Company Act provides an exclusion from the definition of "investment company" for any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) of the Investment Company Act provides an exclusion for any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities.

[3] 15 U.S.C. 80(a)-1-64. This is a "but for" test. An issuer that relies on Section 3(c)(1) or 3(c)(7) and also may rely on another exclusion or exemption from the Investment Company Act (*e.g.*, Section 3(c)(5)(C) for certain real estate funds) is not covered by Clause 1 of the definition of covered fund. *See* Notice at 114.

[4] Commodity pool is defined in Section 1a(10) of the Commodity Exchange Act of 1936, as amended (the Commodity Exchange Act) 7 U.S.C. §§ 1-26, to mean any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests, including any: (i) commodity for future delivery, security futures product or swap; (ii) agreement, contract, or transaction described in Section 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the Commodity Exchange Act; (iii) commodity option authorized under Section 4c of the Commodity Exchange Act; or (iv) leverage transaction authorized under Section 23 of the Commodity Exchange Act.

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3. an issuer organized or offered outside of the U.S. that would, if organized or offered in the United States, satisfy Clause 1 or Clause 2 above;[5] or

4. any similar fund as may be designated by rule.

Clause 1 of this definition tracks the statutory application of the Volcker Rule, substituting the Dodd-Frank Act's defined terms "hedge fund" and "private equity fund" with a combined definition of a "covered fund."[6] Clauses 2 and 3 were added based on the statutory authority to expand the definition of covered fund using the designation of "similar funds." Clause 2 expands the definition to include commodity pools. Clause 3 expands the definition to include non-U.S. issuers that would be covered by Clauses 1 or 2 were they located in the U.S. or offered to U.S. persons.

The FSOC Study indicated that the agencies may designate as similar funds entities that have the characteristics or engage in the activities of a traditional hedge fund or private equity fund.[7] The proposed regulations, however, designate all commodity pools as covered funds without regard to whether any particular commodity pool has the characteristics of a hedge fund or private equity fund. The proposed regulations would bring many regulated entities not traditionally considered to be hedge funds or private equity funds within the definition of a covered fund.[8] For example, otherwise-regulated entities such as SEC-registered investment companies and bank collective trust funds often fall under the definition of commodity pool. The operators of these entities typically qualify for an exclusion from the CFTC's registration requirements (and accordingly are excluded from much of the CFTC's reporting requirements) due to their regulation by other federal regulators,[9] and are not within the spirit of similar funds meant to be covered by the Volcker Rule. The inclusion of commodity pools also would bring within the definition of covered funds certain companies that rely upon exemptions from the definition of investment company other than Section 3(c)(1) or 3(c)(7), which also do not appear to be within the spirit of similar funds meant to be covered by the Volcker Rule. The introduction to the proposed regulations requests public comment as to whether the inclusion of commodity pools is "consistent with the language and purpose of the statute."[10] We encourage interested parties to comment on this issue and hope that the agencies will revise the definition of covered fund in the final rules to exclude such entities from the scope of the Volcker Rule.

The proposed regulations also incorporate non-U.S. equivalents by including as a covered fund any issuer organized or offered outside of the U. S. that would be a covered fund if it were organized or offered in the U. S. or to one or more U.S. residents. Non-U.S. jurisdictions often approach the question of what

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[5] The applicability of the proposed regulations to such non-U.S. entities is stated as follows:

> Any issuer, as defined in section 2(a)(22) of the Investment Company Act of 1940, that is organized or offered outside of the United States that would be a covered fund [as defined herein] … were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States.

[6] Proposed Regulations § __10; *see* Dodd-Frank Act § 619(h)(2), 12 U.S.C. § 1851(h)(2).

[7] FSOC Study at 63. Indeed, even the language in the proposed regulations indicates that the agencies intended to include similar funds that are "generally managed and structured similar to" a hedge fund or private equity fund. *See* Notice at 184.

[8] The inclusion of commodity pools in the definition of covered fund follows a similar definition in the SEC's and CFTC's systemic risk-reporting regime on Form PF. Form PF defines the term hedge fund to include, among other things, any commodity pool that meets the definition of a private fund, also without reference to the CFTC's exemptions for certain commodity pool operators. The proposed regulations are in fact broader than Form PF, as the proposed regulations are applicable to all commodity pools, not only private funds.

[9] For example, CFTC Rule 4.5 exempts the commodity pool operators of registered investment companies and bank collective trusts from registration with the CFTC. 17 C.F.R. § 4.5 (2011).

[10] Notice at 117.

constitutes a public or private investment vehicle in a manner that is not directly analogous to the 3(c)(1) and 3(c)(7) exclusions or the commodity pool definition. Just as many U.S. investment vehicles are organized specifically to comply with U.S. regulatory requirements, many non-U.S. investment vehicles are organized specifically to comply with applicable non-U.S. regulatory requirements. Treating a non-U.S. fund as if it were organized or offered in the U.S. is incongruous with the purposes and methods of existing regulations in both the U.S. and overseas. The introduction to the proposed regulations requests comments as to whether non-U.S. funds instead should be defined by direct reference to the fund's structural criteria, such as whether it is limited in its number or type of investors and whether it operates without regard to regulatory requirements relating to the types of instruments in which it may invest or the degree of leverage it may incur.[11] We expect the public comments to include requests for further guidance on how to identify and incorporate non-U.S. funds.

As Principal

The proposed regulations prohibit a covered banking entity from acquiring or retaining an ownership interest in a covered fund "as principal."[12] The proposed regulations do not define the scope of the "as principal" limitation, but the introduction to the proposed regulations lists the following examples of permitted ownership interests in a covered fund:

- an ownership interest held by a banking entity in good faith in a fiduciary capacity (except where such ownership interest is held under a trust that constitutes a company as defined in Section (2)(b) of the Bank Holding Company Act, or BHC Act);
- an ownership interest held by a banking entity in good faith in its capacity as a custodian, broker or agent for an unaffiliated third party;
- an ownership interest held by a "qualified plan," as defined in Section 401 of the Internal Revenue Code of 1956, if the ownership interest would be attributed to a banking entity solely by operation of Section 2(g)(2) of the BHC Act; or
- an ownership interest held by a director or employee of a banking entity who (i) acquires the interest in his or her personal capacity and (ii) is directly engaged in providing advisory or other services to the covered fund (unless the banking entity extended credit for purposes of acquiring the ownership interest).[13]

Ownership Interest

The term "ownership interest" is defined broadly.[14] It is based on the attributes of the interest and whether the interest provides the banking entity with economic exposure to the profits and losses of the covered fund as opposed to the form of the interest. To the extent that a debt security or other interest exhibits

[11] Notice at 118.

[12] Proposed Regulations § __.10(a).

[13] Notice at 113.

[14] Ownership interest is defined as any equity, partnership or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest. *See* Proposed Regulations § __.10(b)(3)(i).

substantially the same characteristics as an equity interest, the agencies are likely to consider it to be an ownership interest.[15]

The proposed regulations exclude a carried interest received from a covered fund if the banking entity serves as investment adviser or commodity trading advisor, and:

- the sole purpose and effect of the interest is to allow the banking entity to share in the profits of the covered fund as performance compensation for services provided to the covered fund by the banking entity, provided that the banking entity may be obligated under the terms of such interest to return profits previously received;
- all such profit, once allocated, is distributed to the banking entity promptly after being earned or, if not so distributed, the reinvested profit of the banking entity does not share in the subsequent profits and losses of the covered fund;
- the banking entity does not provide funds to the covered fund in connection with acquiring or retaining this interest; and
- the interest is not transferable by the banking entity except to an affiliate or subsidiary thereof.[16]

Thus, the proposed regulations would allow banking entities to receive a carried interest notwithstanding the ownership restrictions but would prohibit them from reinvesting the proceeds of the carried interest in future profits and losses of the fund. This approach represents an attempt to compromise between an outright prohibition of carried interest and unrestricted use of carried interest (which regulators fear could be used as a means of circumventing the Volcker Rule's restrictions). The introduction to the proposed regulations requests public comment as to whether the proposed exemption is appropriate, adequately addresses existing carried interest arrangements, and is consistent with the current tax treatment of carried interest arrangements.[17]

Sponsorship

The proposed regulations define the term "sponsor" in the same manner as the statutory text of the Volcker Rule, with the addition of "commodity pool operator."[18] Specifically, the proposed regulations define the term sponsor as an entity that serves as a general partner, managing member, trustee or commodity pool operator of a covered fund; in any manner selects or controls (or has employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a covered fund; or shares with a covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.[19]

In the introduction to the proposed regulations, the agencies explain that the definition of sponsor focuses on the ability to control the decision-making and operational functions of the fund.[20] In keeping with this focus, the proposed regulations define the term "trustee" (which is a part of the definition of

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[15]Notice at 115.

[16]Proposed Regulations § __.10(b)(3)(ii)(A).

[17]Notice at 119.

[18]The addition is a result of Clause 2 of the definition of covered fund.

[19]Proposed Regulations § __.10(b)(5). *Cf.* Dodd-Frank Act § 619(h)(5), 12 U.S.C. § 1851(h)(5).

[20] Notice at 116.

sponsor) to exclude a trustee that does not exercise investment discretion with respect to a covered fund. The proposed regulations provide that a trustee includes any banking entity that directs a directed trustee[21] or any person who possesses authority and discretion to manage and control the assets of the covered fund.[22]

Prime Brokerage Transactions

The proposed regulations adopt a definition of "prime brokerage transaction" to effectuate the Dodd-Frank Act's exemption for permitted prime brokerage activities with respect to a covered fund. The proposed regulations define prime brokerage transaction to mean one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution or financing, data, operational and portfolio management support.[23]

II. Permitted Funds Exemption

The primary exemption from the general prohibition on sponsorship or investment in a covered fund is the eight-factor permitted funds exemption.[24] The proposed regulations codify this exemption as follows:

1. ***Bona Fide* Services:** The banking entity must provide *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services. The proposed regulations do not specify what services would qualify; instead, the proposed regulations track the statutory language and reflect the intention that as long as the banking entity provides such services in compliance with relevant statutory and regulatory requirements, this requirement generally would be deemed to be satisfied.

2. **Customer Requirement:** The covered fund must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity. The proposed regulations do not require that the customer relationship exist prior to the organization and offering of the covered fund. Rather, the organization and offering of a covered fund must be a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary or advisory services to the customer. To effectuate this requirement, banking entities must adopt a credible plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering the covered fund.[25] The absence of any requirement in this definition for a pre-existing relationship between the banking entity and the offerees would allow banking entities to continue to offer their funds and provide related services in a manner that is consistent with existing law and regulation. In the introduction to the proposed regulations, however, the agencies request public comment regarding the customer requirement, including whether the agencies should adopt a definition of "customer of such services" for purposes of this exemption.[26]

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[21] As defined in Section 403(a)(1) of the Employee's Retirement Income Security Act (ERISA), 29 U.S.C. § 1103(a)(1).

[22] Notice at 116.

[23] Proposed Regulations § __.10(b)(4).

[24] *Id.* § __.11(a)-(h).

[25] Notice at 123.

[26] *Id.* at 127.

3. **Investment Limitations:** The banking entity may not acquire or retain an ownership interest in the covered fund except as permitted under Subpart C of the proposed regulations relating to covered funds activities and investment. This section embodies the Volcker Rule's 3 percent *de minimis* ownership limitation with respect to single funds and in the aggregate.[27] The proposed regulations also codify the procedure for requesting an extension of time to divest an ownership interest.

   – **Single Fund Investment Limitations:** A banking entity may own up to 3 percent of the total amount or value of a covered fund, and the investment may not result in more than 3 percent of the losses of the fund being allocable to the banking entity's investment. The single fund investment limitation includes the following investments in a covered fund:

      • investments held directly by the banking entity;

      • investments held by any entity controlled, directly or indirectly, by the banking entity;

      • the *pro rata* amount of investments held by any entity not controlled by the banking entity if the banking entity holds more than 5 percent of the voting shares of such entity; and

      • any investments by the banking entity acting in concert with a covered fund.[28]

   – **Aggregate Investment Limitations:** A banking entity's aggregate investments in covered funds may not exceed 3 percent of its Tier 1 capital. The proposed regulations clarify how the 3 percent of a Tier 1 capital test would be calculated for various types of banking entities, including insured depository institutions, bank holding companies and other banking entities that themselves do not calculate Tier 1 capital.[29] Additionally, the proposed regulations provide a method of determining Tier 1 capital for complex banking entity structures for purposes of this provision.[30]

4. **Section 23A and 23B Relationships:** The banking entity must comply with the restrictions governing relationships with covered funds under Section __.16 of the proposed regulations. The proposed regulations incorporate the Volcker Rule's statutory "Super 23A" prohibition on "covered transactions" as defined in Section 23A of the Federal Reserve Act of 1913, as amended (the Federal Reserve Act), as if the banking entity (and any affiliate) were a member bank and the covered fund were an affiliate thereof. The proposed regulations apply Super 23A without incorporating any of the provisions in Section 23A that provide exemptions for certain types of covered transactions.[31]

5. **No Guarantees:** The banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests. The proposed regulations incorporate the statutory language preventing guarantees and do not provide any further guidance. This approach retains the ambiguity inherent in the

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[27] *See* Dodd-Frank Act § 619(d)(4), 12 U.S.C. § 1851(d)(4).

[28] Proposed Regulations § __.12(b).

[29] *Id.* § __.12(c).

[30] *Id.* § __.12(c)(2). *See also* Notice at 132.

[31] The proposed regulations do, however, incorporate the exclusion from the definition of covered transaction for certain purchases of real and personal property that are specifically exempted by the Federal Reserve. The introduction to the proposed regulations confirms that since these transactions, by definition, are excluded from the definition of covered transaction, they would not be covered by Super 23A. *See* Notice at 155. *See also* Dodd-Frank Act §§ 619(f)(1) & (2), 12 U.S.C. §§ 1851(f)(1) & (2).

statutory language, including the scope of the "directly or indirectly" limitation. In the introduction to the proposed regulations, the agencies request public comment concerning whether the proposed regulations effectively implement the prohibition on guarantees and request public comment as to potential alternative approaches.[32]

6. **Limitation on Name Sharing**: The covered fund, for corporate, marketing, promotional or other purposes, may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and may not use the word "bank" in its name. In a change from the statutory language, the proposed regulations extend this restriction to affiliates or subsidiaries of the banking entity and prohibit the use of the word "bank" in the name. The restriction on sharing the same name as affiliates or subsidiaries of the banking entity may present difficulties for asset management subsidiaries of banking entities, which in many cases have a different name than the parent banking entity and use such name for branding purposes. The agencies, in the introduction, request comment on whether the prohibition should be limited to specific types of banking entities (*e.g.*, insured depository institutions and bank holding companies) or only to the banking entity that organizes and offers the fund.[33]

7. **Limitation on Ownership by Directors and Employees:** No director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund. The proposed regulations provide no further guidance on what constitutes being "directly engaged" in providing investment advisory "or other services" to the fund. Due to the lack of guidance, the scope of this definition remains unclear. For example, the definition may include senior management-level employees who provide oversight or employees who provide services other than investment services. The introduction to the proposed regulations requests public comment on whether the agencies should provide additional guidance on what "other services" should be included for purposes of satisfying the permitted funds exemption.[34]

   Further, the introduction to the proposed regulations indicates that the agencies generally would attribute a director's or employee's ownership interest in a fund to the employing banking entity if the banking entity extends credit for the purchase of the interest, guarantees the purchase, or guarantees the director or employee against loss on the investment. The agencies describe this provision as a response to the opportunity for a banking entity to evade its ownership limitation by way of director or employee investments.[35]

8. **Disclosure Requirements:** The banking entity must clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund certain enumerated disclosures contained in the proposed regulations and comply with any additional rules of the appropriate agencies designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity. The proposed regulations specify information that must be disclosed to investors (such as through disclosure in the fund's offering documents). The required disclosure includes a statement that all losses of the fund are borne by the investors of the fund and not by the banking entity.[36]

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[32]Notice at 127.

[33]*Id.*

[34]*Id.*

[35]*Id.* at 125.

[36]Proposed Regulations § __.11(h)(1).

III. Additional Statutory Exceptions

Permitted Risk-Mitigating Hedging Activity

The proposed regulations codify the statutory exception that allows ownership of covered fund interests for permitted risk-mitigating hedging purposes.[37] Like many of the proprietary trading restrictions in the proposed regulations, this exception is extensive and imposes an onerous compliance burden; however, it may allow banking entities additional flexibility to continue to serve their customers and compensate their employees through permitted risk-mitigating hedges.

The general prohibition on ownership does not apply if the acquisition or retention of the ownership interest meets all of the following criteria:[38]

- The acquisition or retention is made in connection with and related to *individual or aggregated obligations or liabilities* of the banking entity that are:
  - taken by the banking entity when *acting as intermediary on behalf of a customer* that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or
  - *directly connected to a compensation arrangement* with an employee that directly provides investment advisory or other services to the covered fund.
- The acquisition or retention is *designed to reduce the specific risks* to the banking entity in connection with and related to such obligations or liabilities.
- The acquisition or retention is made in accordance with the *written policies, procedures and internal controls* established by the banking entity pursuant to the proposed regulations.
- The acquisition or retention *hedges or otherwise mitigates* an exposure to a covered fund through an offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that:
  - arises out of a transaction *conducted solely to accommodate a specific customer request* with respect to that covered fund, or
  - is *directly connected to its compensation arrangement* with an employee that directly provides investment advisory or other services to that covered fund.
- The acquisition or retention *does not give rise*, at the inception of the hedge, *to significant exposures* that were not already present in individual or aggregated positions, contracts or other holdings of a banking entity and that are not hedged contemporaneously.
- The acquisition or retention is *subject to continuing review*, monitoring and management by the banking entity that:

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[37] *Id.*

[38] *Id.*

- is consistent with its written hedging policies and procedures;
- *maintains a substantially similar offsetting exposure* to the same amount and type of ownership interest, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and
- *mitigates any significant exposure* arising out of the hedge after inception.

- The *compensation arrangements* of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.
- With respect to any acquisition or retention of an ownership interest in a covered fund by a banking entity pursuant to this paragraph, the banking entity must *document*, at the time the transaction is conducted:
  - the risk-mitigating purpose of the acquisition or retention of an ownership interest in a covered fund;
  - the risks of the individual or aggregated obligation or liability of a banking entity that the acquisition or retention of an ownership interest in a covered fund is designed to reduce; and
  - the level of organization that is establishing the hedge.

Non-U.S. Activities by Non-U.S. Banking Entities

The proposed regulations implement the Volcker Rule's exemption for non-U.S. banking entities engaged in sponsoring a covered fund or acquiring or retaining ownership interests in a covered fund solely outside of the United States.[39] The regulations define the type of non-U.S. banking entities eligible for the exemption and the activities allowable pursuant to the exemption.[40]

- **Non-U.S. Banking Entity.** A non-U.S. banking entity is eligible for the exemption if:
  - the banking entity is not controlled, directly or indirectly, by a banking entity organized under U.S. law; and
  - the non-U.S. banking entity meets one of the following criteria:
    - **Criteria Applicable to Foreign Banking Organizations.** With respect to a banking entity that is a foreign banking organization, the banking entity is a qualifying foreign banking organization and is conducting the activity in compliance with Subpart B of the Federal Reserve's Regulation K;[41] or

[39] Dodd-Frank Act § 619(d)(1)(I), 12 U.S.C. § 1851(d)(1)(I).

[40] Proposed Regulations § __.13(c).

[41] Regulation K, 12 C.F.R. 24.20 (2011), specifies a number of conditions and requirements that a foreign banking organization must meet in order to rely on such authority. Such conditions and requirements include, for example, a qualifying foreign banking organization test that requires the foreign banking organization to demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.

- **Criteria Applicable to Other Non-U.S. Banking Entites.** With respect to a non-U.S. banking entity that is not a foreign banking organization, the banking entity meets *at least two* of the following requirements:
  - total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;
  - total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or
  - total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

- **Activities Solely Outside the United States**. An activity by an eligible non-U.S. banking entity is exempt from the Volcker Rule's general prohibition if:
  - the banking entity engaging in the activity is not organized under the laws of the United States;
  - no subsidiary, affiliate, or employee of the banking entity that is *involved in the offer or sale of an ownership interest* in the covered fund is incorporated or physically located in the United States;[42] and
  - no ownership interest in the covered fund is offered for sale or sold to a resident of the United States.[43]

Other Exceptions

The proposed regulations also implement the statutory exceptions for loan securitization vehicles and small business investment companies and related investments.[44]

[42]The proposed regulations include an exemption from this requirement for employees or entities with no customer relationship and who are involved solely in providing administrative services or "back office" functions to the fund. *See* Notice at 146. The narrow scope of this exemption may require banking entities to closely monitor any such employees to ensure compliance.

[43]The agencies note that the defined term "resident of the United States" is similar, but not identical, to the definition contained in Regulation S under the Securities Act. Specifically, the proposed regulations expand the definition to include discretionary accounts held by a dealer or fiduciary for the benefit or account of a U.S. person. The proposed regulations also do not include the exclusions from the definition, including the exclusion for non-U.S. branches of U.S. entities. *See* Notice at 80.

[44]Proposed Regulations §§ __.13(a) & (d). The exemption for loan securitization vehicles is described in more detail in Impact of the Proposed Regulations on Securitizations.

IV. Permitted Activities

The Dodd-Frank Act grants regulators the authority to authorize certain activities that promote and protect the safety and soundness of a banking entity and the financial stability of the U.S.[45] The proposed regulations include the following permitted activities:

BOLI Separate Accounts

The proposed regulations allow banking entities to acquire and retain an investment in, as well as sponsor, a bank owned life insurance (BOLI) separate account. To qualify for this exception, the banking entity may not control the investment decisions regarding the underlying assets or holdings of the separate account and must hold its ownership interest in the separate account in compliance with applicable supervisory guidance regarding bank owned life insurance.[46]

Corporate Organization Vehicles

The agencies acknowledge that the definition of covered fund may include certain entities and corporate structures that typically would not be considered a hedge fund or a private equity fund. In order to allow banking entities to utilize such structures, the proposed regulations exempt from the general prohibition on sponsorship and investment the following types of entities:

- joint ventures, provided the joint venture is an operating company and does not engage in any activity or make any investment that is prohibited under the proposed regulations;[47]
- acquisition vehicles, provided the sole purpose and effect of the entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or an affiliate;[48]
- certain issuers of asset-backed securities in compliance with Section 15G of the Exchange Act;[49]
- liquidity management vehicles, provided that the vehicle is a wholly owned subsidiary of the banking entity that is engaged principally in performing *bona fide* liquidity management activities described in the proprietary trading section of the proposed regulations and carried on the balance sheet of the banking entity;[50] and
- a covered fund that is an issuer of asset-backed securities, as described more fully in the section of the proposed regulations relating to loan securitizations.[51]

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[45] Dodd-Frank Act § 619(d)(1)(J), 12 U.S.C. § 1851(d)(1)(J).

[46] Proposed Regulations § __.14(a)(1). *See* The Proposed Regulations and Insurance Company Investment Activities.

[47] Proposed Regulations § __.14(a)(2)(i).

[48] *Id.* § __.14(a)(2)(ii).

[49] *Id.* § __.14(a)(2)(iii).

[50] *Id.* § __.14(a)(2)(iv); *see also* Proposed Regulations § __.3(b)(2)(iii)(C).

[51] *Id.* § __.14(a)(2)(v). *See* Impact of the Proposed Regulations on Securitizations.

Ordinary Course of Debt Collection and Conformance Period

Finally, the proposed regulations provide an exemption from the general prohibition of sponsorship and ownership when the ownership interest is obtained in the ordinary course of collecting a debt previously contracted in good faith, provided the banking entity divests within applicable time periods provided by the applicable federal agency, or when the fund is owned or sponsored pursuant to the Volcker Rule's conformance or extended transition period.[52]

V. Compliance Program

The proposed regulations contain a detailed compliance program to ensure that banking entities establish, maintain and enforce compliance procedures and controls with respect to the requirements of the Volcker Rule.[53] The compliance program is broadly divided into six elements, which include:

- internal written policies and procedures reasonably designed to document, describe and monitor the covered activities in order to ensure they comply with the proposed regulations;
- a system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the proposed regulations;
- a management framework that clearly delineates responsibility and accountability for compliance with the proposed regulations;
- independent testing for the effectiveness of the compliance program, conducted by qualified internal or third-party personnel;
- training for appropriate personnel, including trading personnel and managers, to implement and enforce the compliance program; and
- making and keeping records sufficient to demonstrate compliance with the proposed regulations, which must be retained for at least five years and provided to the relevant supervisory regulator upon request.

In addition, certain banking entities with significant covered fund activities[54] will be subject to a heightened compliance program, which includes making senior and intermediate management accountable for the effective implementation of the compliance program and ensuring that the board of directors or chief executive officer reviews the effectiveness of the compliance program.

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[52] Proposed Regulations § __.14(b).

[53] *Id.* § __.20.

[54] Generally defined to include banking entities that, together with their affiliates, have more than $1 billion in aggregate covered fund investments or sponsor or advise covered funds with average total assets of more than $1 billion. *See* Proposed Regulations § __.20(c)(ii).

VI. Material Conflict of Interest Limitation

The proposed regulations implement the Dodd-Frank Act's "material conflict of interest" limitation on the exemptions described above.[55] The proposed regulations provide that no transaction or activity is permissible under the exemptions if such transaction or activity would:

- involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;
- result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy;[56] or
- pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.[57]

A material conflict of interest exists 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 covered 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."[58] The proposed regulations allow for material conflicts to be cured by (a) disclosure to the other party and the opportunity to mitigate or (b) the establishment and enforcement of information barriers within the banking entity.[59]

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[55] *See* Proposed Regulations § __.17.

[56] The proposed regulations define "high-risk asset" as "an asset or group of related assets that would, if held by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail" and "high-risk trading strategy" as "a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail." Proposed Regulations § __.17(c).

[57] *Id.* § __.17(a)(1)-(3).

[58] *Id.* § __.17(b).

[59] *Id.*