DEBEVOISE & PLIMPTON LLP

CLIENT UPDATE D&P

THE VOLCKER RULE PROPOSALS ON BANK INVESTMENTS IN PRIVATE FUNDS: EXPECTED IMPACT AND OPEN QUESTIONS

October 18, 2011

To Our Clients and Friends:

On October 11th and 12th, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Securities and Exchange Commission (the "regulators") proposed for comment implementing rules (the "Proposed Rules") for Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Volcker Rule"). The Volcker Rule generally prohibits "banking entities" from engaging in proprietary trading and investing in hedge funds or private equity funds, subject to certain exemptions.

The Proposed Rules, which provide guidance on how the Volcker Rule is proposed to be applied in practice, address a number of significant issues raised by the statutory text of the Volcker Rule but leave open many important questions. Indeed, the release proposing the Proposed Rules (the "Proposing Release") includes almost 400 questions requesting comment on a range of issues, suggesting both that the Proposed Rules are a work in progress and that the regulators have not achieved consensus on many of the elements of the proposal. This memorandum focuses on the most significant issues relating to the prohibition on banking entities investing in and sponsoring private equity and hedge funds.

I. KEY POINTS

From the perspective of most banks and private funds, the Proposed Rules represent a mixed bag of good and bad. This Section I summarizes (*i*) the restrictions on banking entities under the Proposed Rules and (*ii*) the impact of the Proposed Rules on the ability of private funds to raise capital from banking entities. A more detailed discussion of the Proposed Rules follows in Sections II through VI below.

A. Restrictions on Banking Entities

- **Definition of Banking Entity** The definition of "banking entity" in the Volcker Rule and the Proposed Rules includes (and thus subjects to the Volcker Rule's restrictions) U.S. insured depository institutions and their affiliates, as well as non-U.S. banks with a U.S. banking presence.

- **Definition of Covered Fund** The Proposed Rules would restrict investments by banking entities in "covered funds," which term includes not only private equity funds and hedge funds but also a variety of other private investment vehicles, such as venture capital funds and certain corporate entities. In addition, the Proposed Rules add new expansive language regarding "foreign equivalent funds" that would treat many non-U.S. funds as covered funds subject to the Volcker Rule's restrictions.

- **Customer Fund or Asset Management Exemption** The Proposed Rules would clarify the so-called "customer fund" or "asset management" exemption in the Volcker Rule that permits banking entities to sponsor and make limited investments in customer funds (*i.e.*, investments in amounts that do not exceed the "3% limits" described in Section III.B below). Of particular importance, the Proposed Rules would allow a banking entity to offer a customer fund to both new and existing customers, without requiring pre-existing relationships between the banking entity and the investors in the customer fund.

  Furthermore, the Proposed Rules would not restrict customer funds from investing in unaffiliated (third-party) private equity and hedge funds. Thus, under the Proposed Rules, banking entities would be permitted to provide their customers with access to private fund investment opportunities by organizing customer funds that are direct investment funds, feeder funds and funds of funds.

  The Proposed Rules are silent on whether and how a covered fund organized and offered prior to the Volcker Rule's effective date could continue in existence as a customer fund.

- **Exemptions for Non-U.S. Banking Entities** The Proposed Rules would allow non-U.S. banking organizations with a U.S. banking presence to invest in covered funds (which, as noted above, include many non-U.S. funds), so long as those funds are offered solely to non-U.S. residents. These covered funds offered solely to non-U.S. residents would be permitted (*i*) to invest inside or outside the United States, (*ii*) to be organized inside or outside of the United States and (*iii*) to be advised by U.S. or non-U.S. investment advisers. In addition, non-U.S. banking organizations without a U.S. banking presence would not be subject to the Volcker Rule and, therefore, would not be subject to any of its restrictions on investing in or sponsoring covered funds.

- **Applicability to Insurance Companies** The Proposed Rules do not address whether insurance companies with bank affiliates would be permitted to invest in covered funds through their general account or separate accounts.

- **Applicability to Pension Plans and Employee Investments** The Proposed Rules would not restrict most bank-sponsored pension plans from investing in covered funds. The Proposed Rules would allow banking entity employees to invest in their personal capacities in covered funds to which those employees provide advisory and other services; however, such investments may be attributed to the banking entity if it extends credit to the employees for, or otherwise guarantees, the employees' investments. The Proposing Release and the Proposed Rules are not clear on whether banking entity employees could invest in their personal capacities directly in third-party private funds.

- **Treatment of Carried Interest** The Proposed Rules would clarify that the covered fund restrictions of the Volcker Rule would not prohibit a banking entity that serves as an investment manager or adviser to a covered fund from receiving either an advisory fee from, or a carried interest in, the covered fund.

B. Impact on the Ability of Private Funds to Raise Capital

- **General Prohibition** For U.S. and non-U.S. private equity and hedge fund managers that are not affiliated with banking entities, the Volcker Rule and the Proposed Rules would restrict the ability of these firms' funds to access the capital of U.S. banking organizations and non-U.S. banking organizations with a U.S. banking presence.

- **Relevant Exemptions** Under the Proposed Rules, U.S. and non-U.S. private equity and hedge fund managers would be able to raise capital for their funds from (*i*) banking entity-sponsored customer funds (organized as feeder funds or parallel funds), (*ii*) non-U.S. banks with no banking presence in the United States, (*iii*) non-U.S. banks that have a U.S. banking presence, so long as the funds in which those non-U.S. banks invest are offered only to non-U.S. persons and (*iv*) bank-sponsored pension plans. Such managers may also be able to raise capital from (*i*) insurance company general accounts and separate accounts and (*ii*) employees of banking entities; however, further guidance likely will be necessary.

C. What's Next?

- The regulators have proposed an extended comment period until January 13, 2012. The impact of the Commodity Futures Trading Commission (the "CFTC") on the rulemaking process is unknown. Despite the statutory mandate that it do so, the CFTC has not yet issued proposed implementing rules with respect to the banking entities within its jurisdiction. Many commenters will weigh in on the details of, and the open questions remaining under, the Proposed Rules, while banking entities prepare for the effective date of the Volcker Rule and the conformance period that will follow. The effective date of the Volcker Rule remains July 21, 2012.

II. SCOPE OF THE VOLCKER RULE

A. What Are the "Banking Entities" Subject to the Volcker Rule?

The broad definition of "banking entity" in the Proposed Rules includes virtually any entity affiliated with an insured depository institution. Under the Proposed Rules, both insurers and other financial and non-financial firms with bank affiliates (other than limited purpose trust companies) and non-U.S. banks with a U.S. banking presence would be subject to the Volcker Rule.

The Proposed Rules exclude from the definition of "banking entity" (*i*) "customer funds" (generally, permitted bank-sponsored hedge funds and private equity funds, discussed in Section III below) and (*ii*) entities controlled by customer funds. This exclusion is important, as it would clarify that customer funds may engage in proprietary trading or invest in other hedge funds and private equity funds. Furthermore, under the Proposed Rules, portfolio companies of customer funds would not be subject to the Volcker Rule, including if the portfolio companies are majority or wholly owned.

The Proposed Rules do not explicitly exclude registered investment companies from the definition of "banking entity," but the Proposing Release notes that the regulators believe that banking entities currently structure their advisory relationships with registered investment companies so that they are not viewed as affiliates for purposes of the Bank Holding Company Act (and, therefore, the Volcker Rule would not apply).

The Proposed Rules do not appear to exclude from the definition of "banking entity" bank-affiliated asset-backed securitization vehicles and bank-sponsored pension funds. That said, such pension funds appear to fall outside of the Volcker Rule's restrictions on investing in covered funds based on the Proposing Release's interpretation that the restrictions only apply where the banking entity is investing "as principal." Accordingly, it appears that qualified pension plan investments in covered funds would not be subject to the Volcker Rule's prohibitions.

B. What Funds Are Covered by the Volcker Rule's Restrictions?

Although the statutory definition of "hedge fund" and "private equity fund" was widely regarded by the banking industry as overly broad, the Proposed Rules would largely maintain the statutory definition and consolidate that definition in the term "covered fund." As in the statute, the term "covered fund" would include entities that rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") to avoid registration as an investment company under that Act. As a result, the Volcker Rule would generally restrict banking entities from sponsoring or making investments in most hedge, private equity and venture capital funds.

In addition, the Proposed Rules would expand the "covered fund" definition to include both commodity pools and so-called "foreign equivalent funds," which term appears to include virtually any investment fund not organized or offered in the United States. This approach would appear to prohibit a U.S. banking entity (and any of its U.S. or non-U.S. subsidiaries) from investing in any non-U.S. fund, including a private fund or a fund that is regulated and publicly offered in a non-U.S. jurisdiction (*e.g.*, an E.U.-established UCITS fund). In the Proposing Release, the regulators have asked for comment on whether it would be better to narrow this definition by referring only to funds that bear certain risks or characteristics.

C. What Funds Are *Not* Covered by the Volcker Rule's Restrictions?

The Proposed Rules would not restrict banking entities from investing in investment companies that either are registered or regulated under the Investment Company Act or do not rely on section 3(c)(1) or 3(c)(7) of that Act. Accordingly, unless otherwise restricted by the proprietary trading prohibition of the Volcker Rule, banking entities would be allowed to invest in mutual funds, business development companies, certain real estate and oil and gas funds, bank common and collective trust funds, employees' securities companies ("ESCs") and qualified pension plans.

In addition, the regulators propose to exempt from the covered fund investment restrictions certain types of entities that, although not traditionally considered hedge or private equity funds, may rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid registering under that Act. Specifically, the regulators propose to exempt investments in (*i*) bank owned life insurance ("BOLI"), (*ii*) certain corporate structures including wholly owned subsidiaries engaged principally in performing bona fide liquidity management activities, acquisition vehicles and joint ventures that are operating entities, (*iii*) loan and, to a limited extent, other asset-backed securitization vehicles and (*iv*) small business investment companies under the Small Business Investment Act of 1958 that invest in the welfare of low- and moderate-income communities or families or certain rehabilitation projects of historic structures. Although these exemptions remove many entities that clearly are not hedge or private equity funds, they remain more limited than what many in the bank industry had hoped for, in particular with respect to wholly-owned subsidiaries.

Because of the breadth of the "covered fund" definition, banking entities will need to evaluate all pools within their structure and possibly restructure arrangements long thought to be permissible. For example, collateral pools and many pools of bank-eligible investments conceivably fall within the definition of "covered fund." The Proposing Release requests comment as to whether corporate entities, venture capital funds or other types of funds should be excluded from the covered fund definition.

D. What Restrictions Apply to Banking Entity Investments in Covered Funds?

Under the Proposed Rules, a banking entity would not be permitted "as principal, directly or indirectly," to acquire an interest in or to act as sponsor to a covered fund. The Proposed Rules clarify that this prohibition would not apply, for example, when the banking entity is acting in a fiduciary capacity for its clients or, in certain circumstances, to interests acquired by a banking entity's employees, as discussed further below. The Proposed Rules also clarify that the restrictions generally would not prohibit a banking entity that serves as an investment manager or adviser to a covered fund from receiving either an advisory fee from, or a carried interest in, that fund.

E. What Restrictions Apply to Transactions by Banking Entities with Covered Funds?

The Proposed Rules also would ban a banking entity that acts as investment adviser or sponsor (or serves in a similar capacity) to a covered fund from engaging in certain transactions with that fund. The Proposed Rules would specifically apply this ban to all "covered transactions" (as set forth in section 23A of the Federal Reserve Act) including, for example, loans to a covered fund. Many refer to this provision as "Super 23A" because it applies to all entities (rather than just banks) in a banking organization and does not recognize certain standard exemptions available under section 23A (*e.g.*, loans fully secured by U.S. Treasuries).

Under the Proposed Rules, however, a banking entity would not appear to face similar restrictions with respect to transactions with portfolio companies of covered funds. Thus, for example, a banking entity should be able to lend to a portfolio company of a covered fund to which the banking entity provides advisory services. Such portfolio company loans, however, could still be restricted (under Section 23A's so-called "attribution rule") if the loan proceeds are directed to or benefit the covered fund investing in the portfolio company.

In addition, a banking entity could still perform certain "prime brokerage transactions"—including custody, clearance, securities borrowing or lending services, trade execution or financing and data, operational and portfolio management support—with a covered fund in which the banking entity has taken an ownership interest. These prime brokerage services would be required to be performed on substantially the same terms as transactions with unaffiliated companies (per section 23B of the Federal Reserve Act).

F. What Additional Restrictions Are Imposed for Material Conflicts of Interest?

Permissible covered fund investments by banking entities (including those discussed in Sections III and IV) are subject to an overall prohibition on an activity or investment that would involve or result in a material conflict of interest between the banking entity and any of its clients, customers or counterparties. The banking entity would be able to address these material conflicts of interest, prior to the relevant transaction, by either (*i*) providing timely, effective and meaningful disclosure that includes the opportunity for the other party to negate or substantially mitigate the conflict of interest or (*ii*) establishing information barriers in the banking entity's policies and procedures. The disclosure would need to be specific to the individual, class or type of transaction or activity, not general or generic. The disclosure also would need to be provided sufficiently close to the decision to engage in the transaction but also sufficiently in advance to allow the recipient to evaluate the information.

G. What Additional Restrictions are Imposed for High-Risk Activities and Strategies?

Permissible covered fund investments by banking entities (including those discussed in Sections III and IV) are subject to an overall prohibition on a "high-risk" activity or investment that would significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. The Proposed Rules and the Proposing Release do not provide additional guidance on high-risk activities and strategies, but the regulators generally would expect a banking entity to have compliance policies and procedures designed to identify and address them adequately. See Section VI for a discussion on the required compliance policies and procedures.

III. CUSTOMER FUNDS

The statutory text of the Volcker Rule includes an important exemption (sometimes referred to as the "customer fund" or "asset management" exemption) from the general prohibition on banking entities investing in and sponsoring private equity and hedge funds. This exemption allows a banking entity to establish and invest in funds "in connection with the provision of bona fide trust, fiduciary, or investment advisory services," subject to a number of requirements, many of which were ill-defined. The Proposed Rules attempt to flesh out components of the customer fund exemption.

A. What Relationship Must a Banking Entity Have with Investors in a Customer Fund?

As noted above, the text of the Volcker Rule provides that customer funds must be offered "only in connection with" the provision of bona fide asset management services (including trust, fiduciary and advisory services). A principal concern of many industry participants was whether that phrase would be interpreted to require a banking entity to have a pre-existing fiduciary or advisory relationship with an investor prior to that investor acquiring an interest in a customer fund.

The Proposed Rules do not take that approach. Instead, they focus on whether the customer fund is being created as part of the asset management services provided by the banking entity. Thus, customer funds could be offered to any third-party investors regardless of any pre-existing relationship between the banking entity and such investors. To ensure that the customer funds are a "manifestation" of the banking entity's asset management services, the customer funds would be required to be organized and offered "pursuant to a credible plan or similar documentation" outlining how the banking entity intends to provide asset management services via the customer funds. It is not clear what would be required to be included in such a plan.

B. What Limits Apply to a Banking Entity's Investment in a Customer Fund?

Banking entities would be permitted to make *de minimis* investments in customer funds. Specifically, under the Proposed Rules, a banking entity generally could invest (*i*) less than 3% of the total amount or value of each customer fund's outstanding ownership interests (the "per-fund limits") and (*ii*) an aggregate amount in all customer funds at a level that is less than 3% of the banking entity's tier 1 capital (the "tier 1 capital limit"; together with the per-fund limits, the "3% limits"). For these purposes, ownership interests include equity interests but not debt securities (unless they have equity characteristics) and also generally do not include rights to receive carried interest.

The per-fund limit would be triggered by the larger of (*i*) the value of all investments or capital contributions in a customer fund, divided by the value or capital contributions made by all persons in the fund and (*ii*) the total number of ownership interests held by the banking entity in the covered fund, divided by the total number of ownership interests held by all persons in the fund. This per-fund limit would be calculated on the same schedule, in the same manner and according to the same standards that the customer fund uses for its own internal purposes; however, the per-fund limit must be calculated at least on a quarterly basis.

Consistent with the statutory text of the Volcker Rule, the Proposed Rules would provide an exception to the per-fund limit for an initial "seeding period." Specifically, the Proposed Rules would allow a banking entity to hold more than 3% of a fund's interests for the first year following the establishment of a customer fund. Absent a Federal Reserve-granted extension, a banking entity would need to come into compliance with the per-fund limit within one year of the fund's establishment. The Proposed Rules do not clarify what constitutes the establishment of a fund; instead, the regulators inquire in the Proposing Release whether they need to specify when a customer fund will be considered to be established for these purposes.

The tier 1 capital limit would be the ratio, calculated at least quarterly, of (*i*) the aggregate value of the banking entity's customer fund investments and (*ii*) the banking entity's tier 1 capital. The aggregate customer fund investment amount in the numerator would not be a "snapshot" of the value at the time of the investment but rather would be required to be calculated on an ongoing basis according to the applicable accounting standards. The tier 1 capital amount in the denominator generally would be either the tier 1 capital reported to the relevant regulator or, if not available, the shareholders' equity. Since there would no ability to cure with respect to a breach of the tier 1 capital limit, a banking entity would need to include a margin sufficient to protect against either a large rise in the value of the covered fund or a drop in the tier 1 capital. In addition, the Proposed Rules would require a banking entity to deduct the aggregate value of its interests in customer funds from the banking entity's tier 1 capital for purposes of determining the compliance of the relevant entity with the applicable federal bank regulatory capital rules.

There had been questions as to whether the tier 1 capital calculation would also include other covered funds (that are not customer funds) in which a banking entity may be able to invest (as discussed in Section IV below). Although the text of the Proposed Rules is not explicit on this point, the discussion in the Proposing Release suggests that only customer funds would need to be included in this calculation.

Furthermore, the Super 23A restrictions discussed in Section II.E also apply to customer funds, except for the permitted *de minimis* investment described in this Section III.B.

C. What Marketing and Disclosure Restrictions Apply to a Customer Fund?

A customer fund would be subject to certain marketing restrictions and specific, enumerated disclosure requirements intended to make clear to investors that the banking entity does not guarantee the customer fund. These restrictions would include a prohibition from using the same name or variation of the same name of the banking entity *or any affiliate or subsidiary thereof*. This prohibition would mean, for example, that a customer fund could not share the same name as an investment adviser subsidiary of a banking entity. Furthermore, the Proposed Rules suggest that a customer fund would be prohibited from sharing the name (or a variation of the name) of any other customer fund offered by a banking entity. This may be a drafting error, since the inability of customer funds to share names would create a practical impediment without any clear benefit.

D. May an Existing Fund Continue as a Customer Fund?

Perhaps the most glaring omission from the Proposing Release and the Proposed Rules is the absence of a clear answer as to whether and how a fund organized and offered prior to the Volcker Rule's effective date could continue in compliance with the customer fund exemption. There is no stated prohibition on the ability of pre-existing funds to continue as customer funds, which is helpful.

That said, certain of the proposed requirements to qualify for a customer fund could be difficult for a pre-existing fund to satisfy retroactively. For example, it is not clear how the disclosure requirements mentioned in Section III.C could be satisfied by a pre-existing fund that seeks to continue as a customer fund. In addition, while the Proposed Rules do not require a fiduciary, advisory or other "special" relationship that might have raised difficulties for pre-existing funds, it is not clear whether the "credible plan" requirement, discussed in Section III.A, would be problematic for a pre-existing fund.

E. In What Assets May Customer Funds Invest?

A customer fund could (*i*) invest directly in portfolio companies, securities or assets or (*ii*) act as a fund of funds or feeder vehicle for a covered fund sponsored by a third party.

IV. OTHER WAYS TO INVEST IN COVERED FUNDS

In addition to the customer fund exemption, the Volcker Rule and Proposed Rules contain several other limited exemptions from the general prohibition on banking entities investing in and sponsoring covered funds.

A. May a Non-U.S. Banking Entity Invest in Covered Funds?

First, a non-U.S. banking organization that does not have a U.S. banking presence and does not fall within the definition of "banking entity" is not subject to the Volcker Rule and, therefore, would not be subject to the restrictions on investing in covered funds.

Second, consistent with the Volcker Rule, the Proposed Rules would allow non-U.S. banking entities to invest in and sponsor funds so long as the activity takes place "outside of the United States." The Proposed Rules clarify that this exemption would be available if each of the following requirements is met: (*i*) no ownership interest in the fund is offered to a U.S. resident (which includes corporate entities); (*ii*) the banking entity making the investment is not controlled by any U.S. banking entity and satisfies certain tests for foreign banking organizations under existing Federal Reserve Regulation K; and (*iii*) no U.S. subsidiary, affiliate or employee of the banking entity is involved in the offer or sale of an ownership interest in the fund.

This exemption would appear to allow a non-U.S. banking entity to invest in third-party covered funds (that are not offered to U.S. residents), even if those funds are managed by U.S. advisers and invest in U.S. portfolio companies and issuers. This exemption also should allow a non-U.S. banking entity to organize and sponsor a fund from abroad and to have that fund advised or sub-advised by a U.S.-based investment advisory affiliate of the non-U.S. banking entity.

B. May Insurance Companies that are Banking Entities Invest in Covered Funds?

The Proposed Rules do not directly address whether insurance company general accounts and separate accounts may invest in covered funds. The Proposed Rules would provide broad exemptions from the proprietary trading restriction with respect to the general accounts and separate accounts of both U.S. and non-U.S. regulated insurance companies. However, the Proposed Rules do not clarify whether insurance company general and separate accounts also would be exempt from the covered fund investment restrictions and, hence, would be permitted to invest in private equity and hedge funds. The statutory language of the Volcker Rule supports the view that insurance company general and separate accounts may invest in private equity and hedge funds, subject to compliance with applicable insurance laws and regulations.

C. May a Banking Entity Invest in a Covered Fund for Hedging Purposes?

A banking entity would be permitted to invest in a covered fund for very limited hedging purposes. Such positions would be allowed only for the purpose of hedging risks arising from when the banking entity is acting as an intermediary on behalf of a customer or from a compensation arrangement with a banking entity employee.

D. May a Banking Entity Invest in a Loan Securitization Vehicle?

A banking entity would be permitted to invest in a covered fund that is an issuer of asset-backed securities if the fund only invests in (*i*) loans, (*ii*) certain related contractual rights or assets and (*iii*) certain interest rate or foreign exchange derivatives used for limited hedging purposes. For these purposes, "loan" would be defined to include any loan, lease, extension of credit or secured or unsecured receivable, but would not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans.

V. EMPLOYEE ISSUES

A. May Banking Entity Employees Directly Invest in Covered Funds in their Personal Capacity?

The Proposed Rules would apply the Volcker Rule's restrictions to a banking entity's investments "as principal." As such, banking entity employees should be permitted to invest in their personal capacities in covered funds, particularly third-party covered funds. That said, the Proposing Release is not clear on this point, and it could be read to suggest that an employee of a banking entity could invest, in his or her personal capacity, in covered funds (including, but not limited to, customer funds) only if the employee is directly engaged in providing advisory "or other services" to these funds. If read this way, banking entity employees would not be able to invest in third-party covered funds, but that seems like an unintended result.

The Proposing Release did not provide guidance on what types of "other services" an employee could provide to a fund (in order to be able to invest in the fund) and also did not provide guidance on how or whether an employee should dispose of an illiquid interest in a covered fund if the employee stops providing services to a fund but remains an employee of the banking entity.

Under the Proposed Rules, if a banking entity extends credit to an employee to purchase an interest in a fund to which the employee is providing advisory or other services or guarantees the employee's investment, the investment would be attributed to the banking entity.

B. May Banking Entity Employees Invest in Covered Funds Through Pooled Investment Vehicles?

Employee investments made through pooled investment vehicles will face significant hurdles. A co-investment vehicle that is a covered fund would be subject to the Volcker Rule if, among other things, a banking entity acts as general partner or managing member. In these situations, the employee co-investment vehicle would be required to be structured either as a customer fund, as discussed in Section III above, or so that the banking entity was only acting in a fiduciary capacity.

Banking entities could also establish ESCs, which are pooled investment vehicles whose security holders are limited to current and former employees of the entity (or related entities), the employer itself and certain other persons. An ESC is generally exempt from many of the provisions of the Investment Company Act, although the employer must file an application with the Securities and Exchange Commission to obtain the exemptions for current and future ESCs. An ESC would not be a covered fund and, therefore, banking entities and their employees would not face any restrictions under the Volcker Rule with respect to their investments in ESCs. However, if the banking entity acts as general partner of the ESC or in similar capacity, or the banking entity (and it affiliates) invests a substantial amount in the ESC—both of which are common—the ESC could be considered a "banking entity" affiliate for purposes of the Volcker Rule. Under this reading, the ESC would be prohibited from making investments in covered funds, unless the banking entity's relationship with the ESC was restructured so that the banking entity was only acting in a fiduciary capacity.

VI. COMPLIANCE POLICIES

A. What Policies and Procedures Is a Banking Entity Required to Adopt?

The Proposed Rules would establish a multi-tiered approach with respect to the required compliance policies and procedures.

All banking entities engaged in covered fund activities would be required to adopt a compliance program that includes, at a minimum, (*i*) written policies and procedures, (*ii*) a system of internal controls, (*iii*) a management framework that clearly delineates responsibility and accountability for compliance, (*iv*) independent testing, (*v*) training and (*vi*) recordkeeping.

The Proposed Rules would impose heightened (and more specific) minimum requirements for banking entities that (together with their affiliates) either (*i*) invest more than $1 billion in covered funds or (*ii*) sponsor covered funds with more than $1 billion in assets.

B. Is a Banking Entity that Does Not Engage in Covered Fund Activities Required to Adopt the Policies and Procedures?

A banking entity that does not engage in covered fund activities would not be required to adopt the policies and procedures set out in the Proposed Rules. However, such a banking entity would need to incorporate into its existing policies and procedures measures that are designed to prevent the banking entity from becoming engaged in such activities.

It appears that "covered fund activities" for these purposes would include any sponsorship of or investment in a covered fund that would be prohibited but for the existence of a permitted activity exemption. For example, this seems to mean that a non-U.S. banking entity would still be required to adopt the policies and procedures required under the Proposed Rules, even if it only invests in covered funds (including funds registered in other jurisdictions) that are only offered to non-U.S. residents.

C. Is a CEO Required to Certify the Banking Entity's Compliance with the Volcker Rule?

The Financial Stability Oversight Council's study on the Volcker Rule, which preceded this proposed rulemaking, suggested that a public attestation of compliance by the chief executive officer could be required and the Proposing Release asks for comment on whether the Proposed Rules should be modified to require such an attestation. As currently drafted, the Proposed Rules would not require such an attestation. Still, the heightened compliance policies and procedures requirement for banking entities engaged in significant covered fund activities (see Section VI.A above) would impose supervisory duties on both the chief executive officer and the board of directors to (*i*) set an appropriate culture of compliance; (*ii*) establish clear policies regarding the management of proprietary trading activities and covered fund activities; (*iii*) ensure that senior management is fully capable, qualified and properly motivated to manage compliance; and (*iv*) ensure that senior management has established appropriate incentives to support compliance.

VII. EFFECTIVE DATE AND THE CONFORMANCE PERIOD

The regulators have proposed an extended comment period for the Proposed Rules until January 13, 2012. The CFTC is also required to propose implementing rules with respect to the Volcker Rule; however, it has not indicated when it will propose its rules or whether its proposed rules will be identical to the Proposed Rules.

The effective date of the Volcker Rule remains July 21, 2012. The Proposed Rules would require a banking entity to have implemented its compliance policies and procedures and to comply with the reporting and recordkeeping requirements by the effective date, which seems a tall order given that the requirements have not been finalized and that banking entities would be required to devote considerable resources to meeting the proposed requirements. A banking entity would be required to bring its covered fund activities into compliance with the Volcker Rule during a conformance period (that will run until at least July 21, 2014), subject to the previously released Federal Reserve rules.[1]

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1 *Please see our Client Update:* Federal Reserve Issues Final Regulation Implementing the Volcker Rule Conformance Period *(February 22, 2011), available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=214d8068-3f67-491b-ba7d-32b1e67039ef.*