

Davis Polk

Final Volcker Rule Regulations

January 6, 2014

FLOWCHARTS: FUNDS
SUBSTANTIVE RULES

Davis Polk VOLCKER RULE — HEDGE FUNDS / PRIVATE EQUITY FUNDS

January 6, 2014

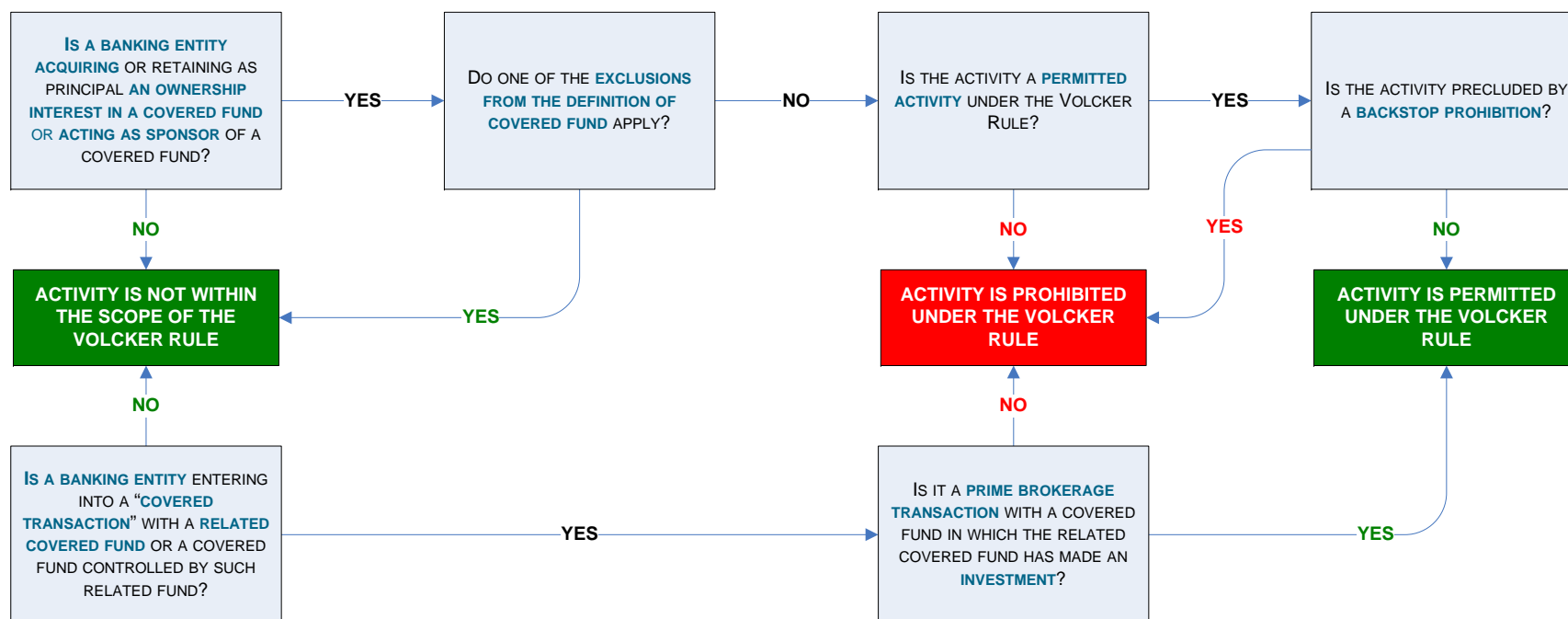
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These Davis Polk flowcharts are designed to assist banking entities in identifying permissible and impermissible covered fund activities, investments and relationships under the final regulations implementing the Volcker Rule, issued by the Federal Reserve, FDIC, OCC, SEC and CFTC on December 10, 2013.

The flowcharts graphically map the key elements of the covered fund provisions in the final regulations. An introduction to the new covered funds compliance requirements will also be available soon as a stand-alone module and in a single combined document.

Davis Polk's proprietary trading flowcharts are available at www.volckerrule.com

SAMPLE GRAPHIC

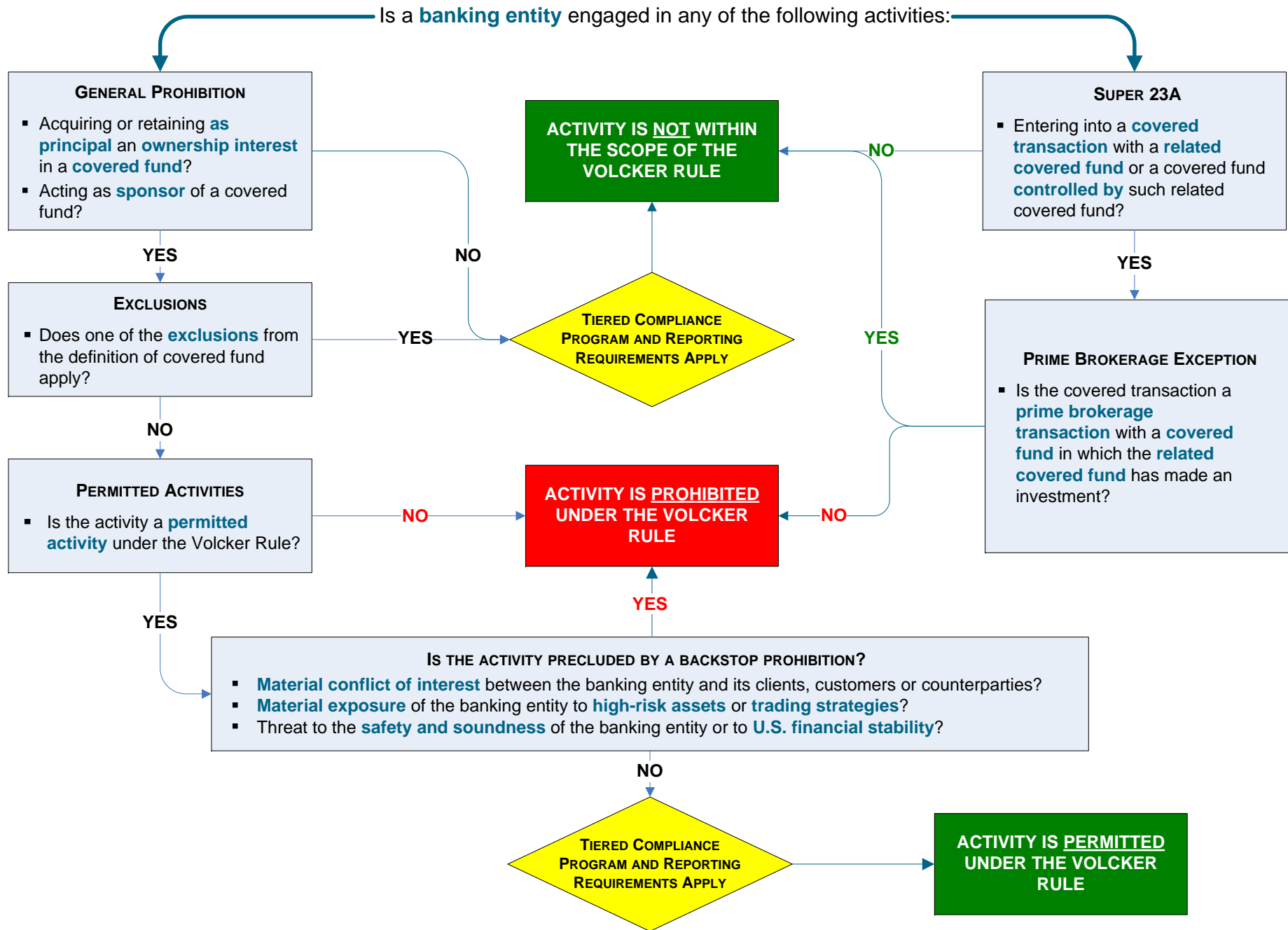


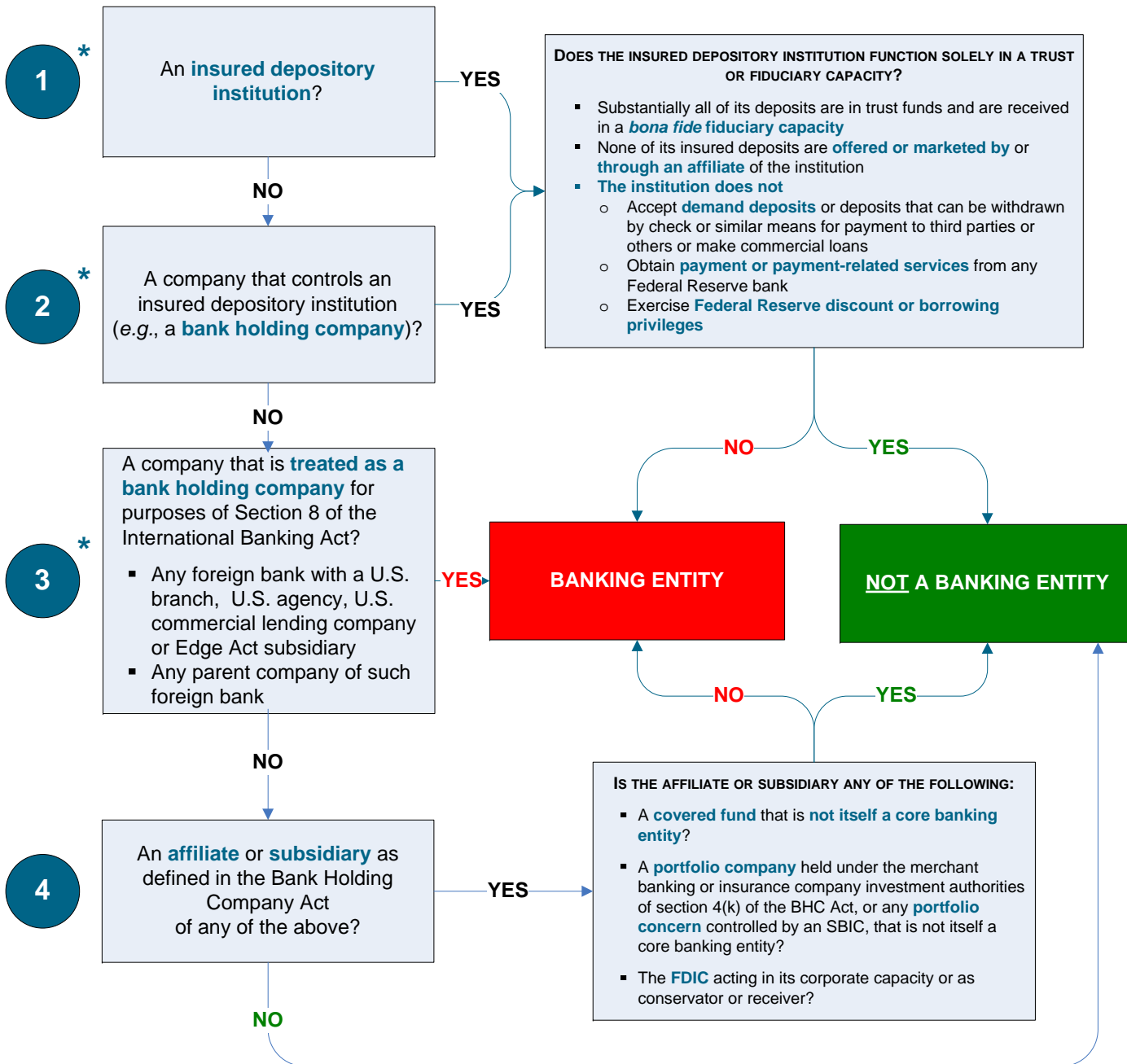
Davis Polk VOLCKER RULE — HEDGE FUNDS / PRIVATE EQUITY FUNDS

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RICs, BDCs OR FOREIGN PUBLIC FUNDS

Although the term “banking entity” is defined in the final regulations to incorporate the terms “affiliate” and “subsidiary” from the BHC Act, and therefore the BHC Act’s definition of “control,” the agencies indicated in the preamble that whether a banking entity controls another entity under the BHC Act may vary depending on the type of entity in question.

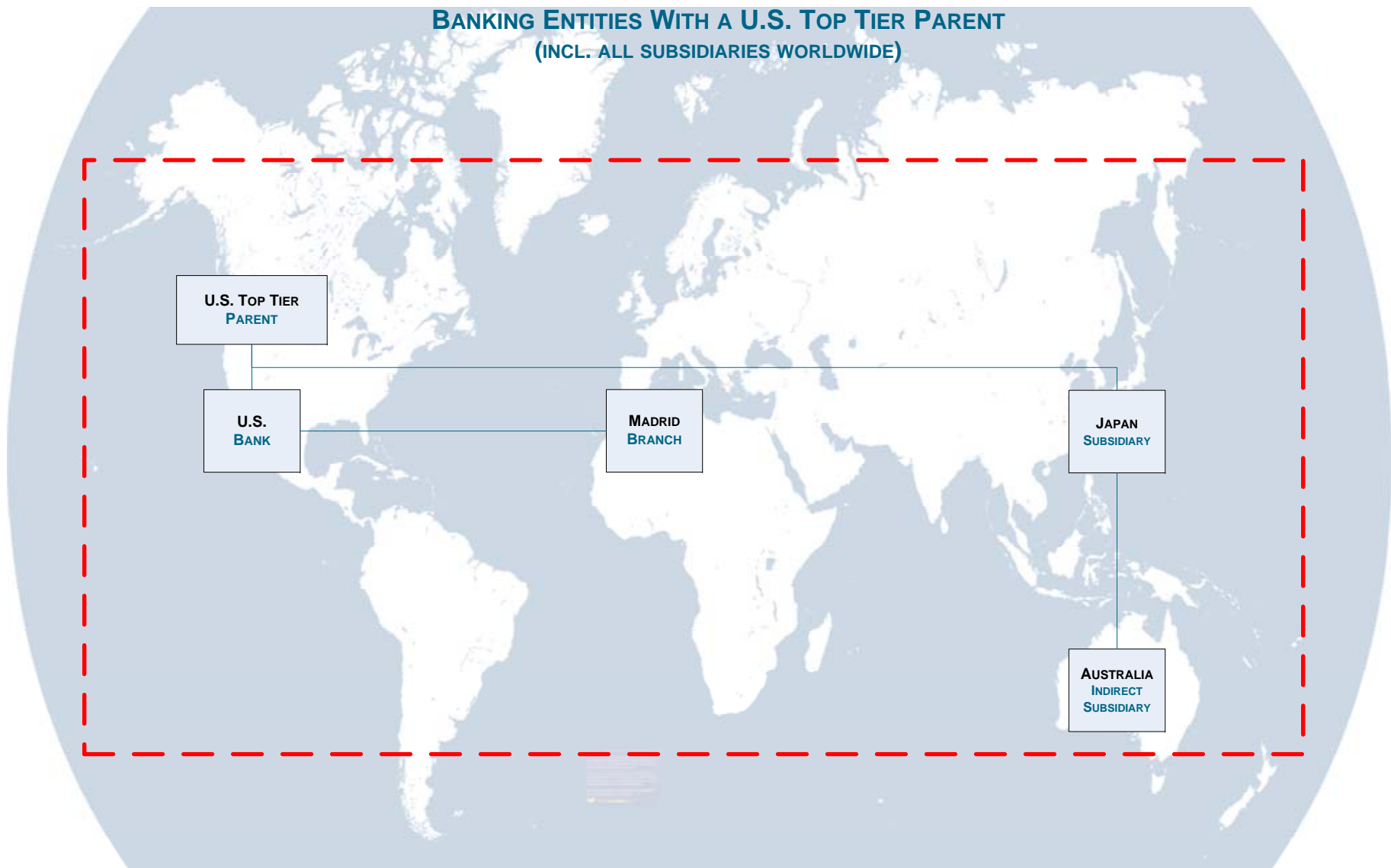
The agencies indicated in the preamble that, absent other facts and circumstances establishing that a core banking entity or any of its affiliates has control over a RIC, BDC or foreign public fund, the RIC, BDC or foreign public fund will not be treated as a banking entity or an affiliate of a banking entity for purposes of the Volcker Rule if all of the following conditions are satisfied:

- No core banking entity or any of its affiliates:
 - Owns, controls or holds with the power to vote 25% or more of the voting shares, or appoints or has the power to appoint 25% or more of the directors, trustees or other managers, of the RIC, BDC or foreign public fund, or
 - Provides any investment advisory, commodity trading advisory, administrative or other services to the RIC, BDC or foreign public fund other than in compliance with any limitations under applicable regulation, order or other authority, and
- The RIC, BDC or foreign public fund is not itself a core banking entity.

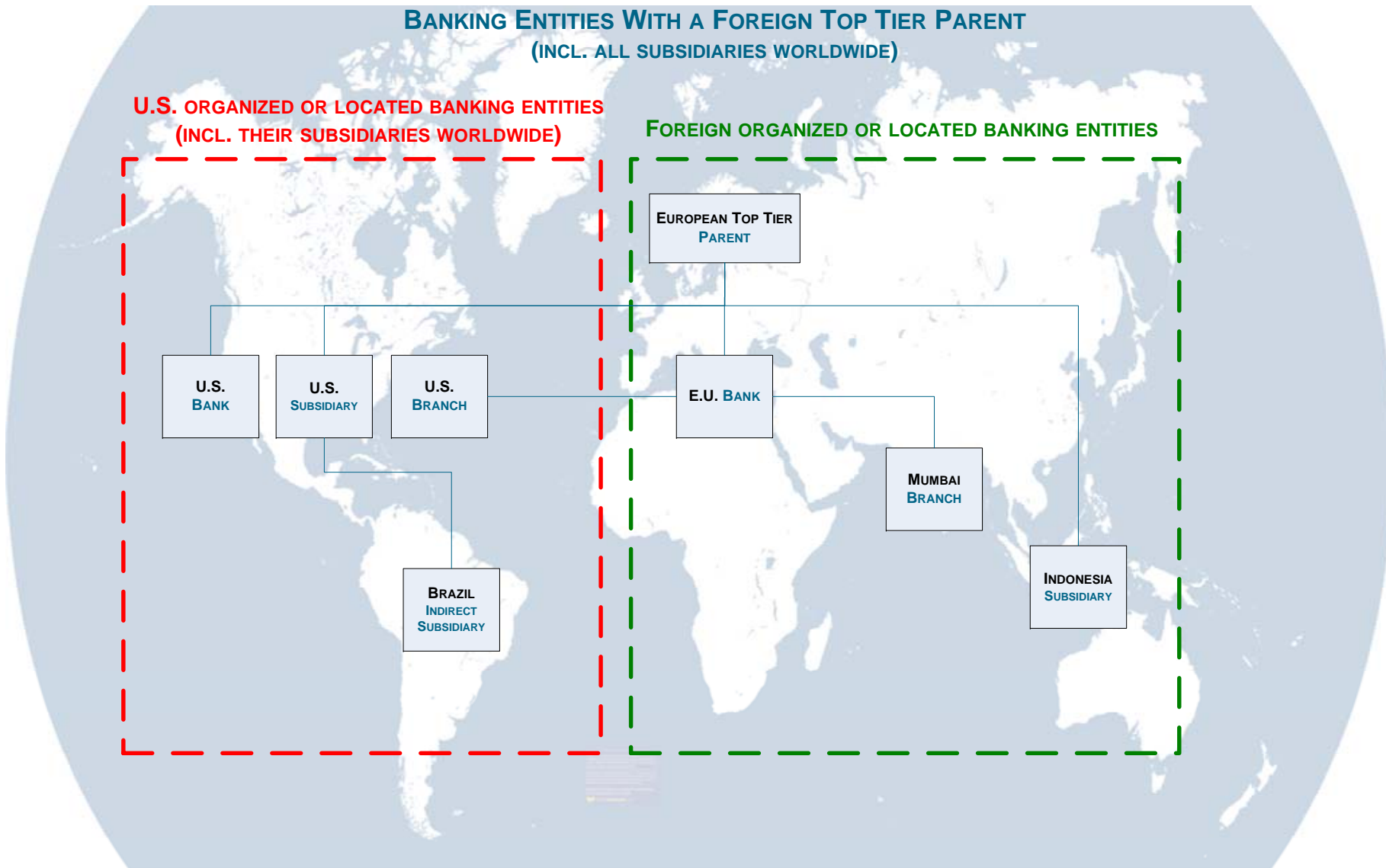
Such a RIC, BDC or foreign public fund would not be subject to the prohibitions in the Volcker Rule on proprietary trading or sponsoring or investing in, or entering into a covered transaction with, a covered fund.

***CORE BANKING ENTITY**

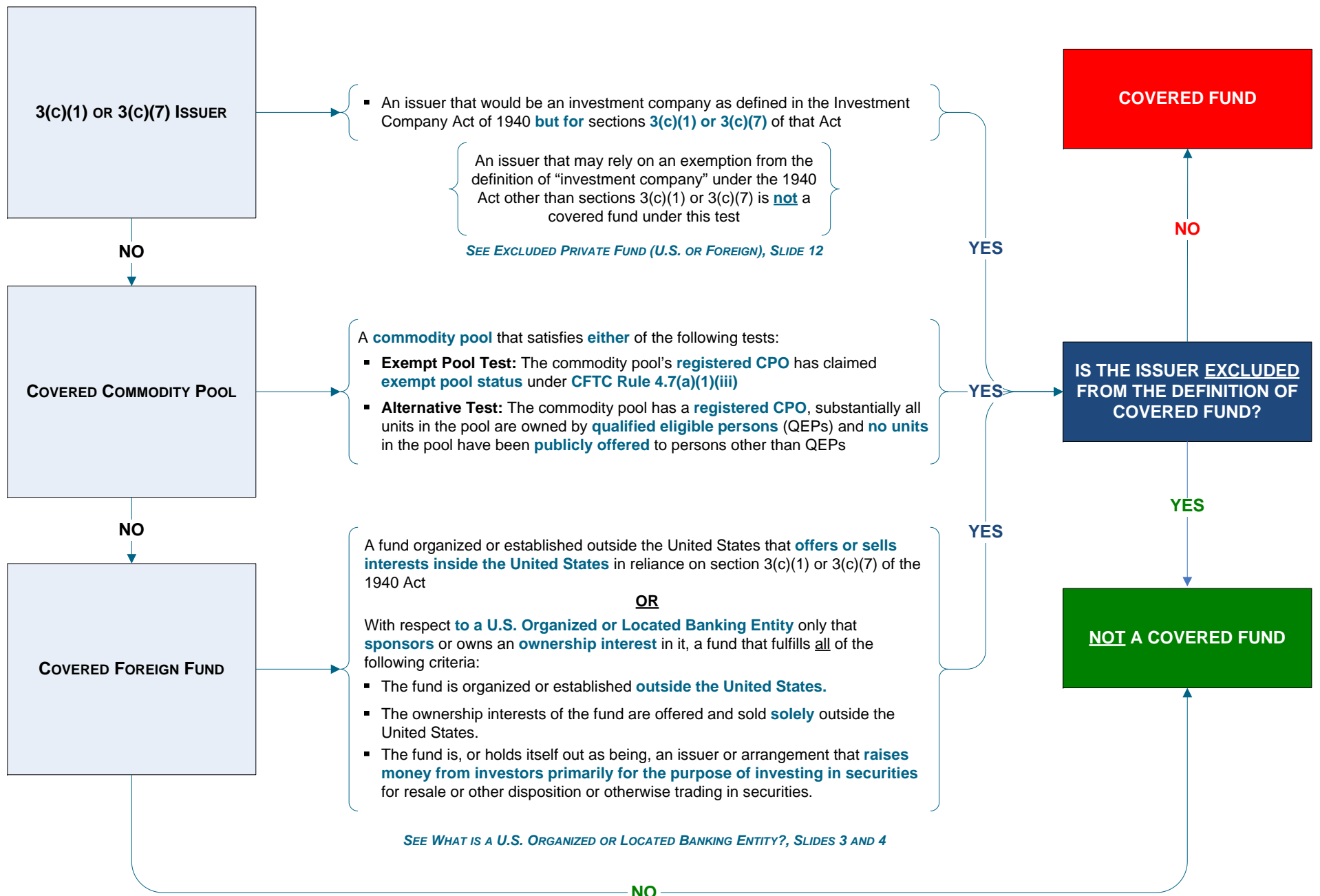
- A “core banking entity” means a banking entity as defined in boxes 1, 2 or 3.



SEE *WHAT IS A COVERED FUND?* AND *FOREIGN PUBLIC FUND*, SLIDES 5 AND 13

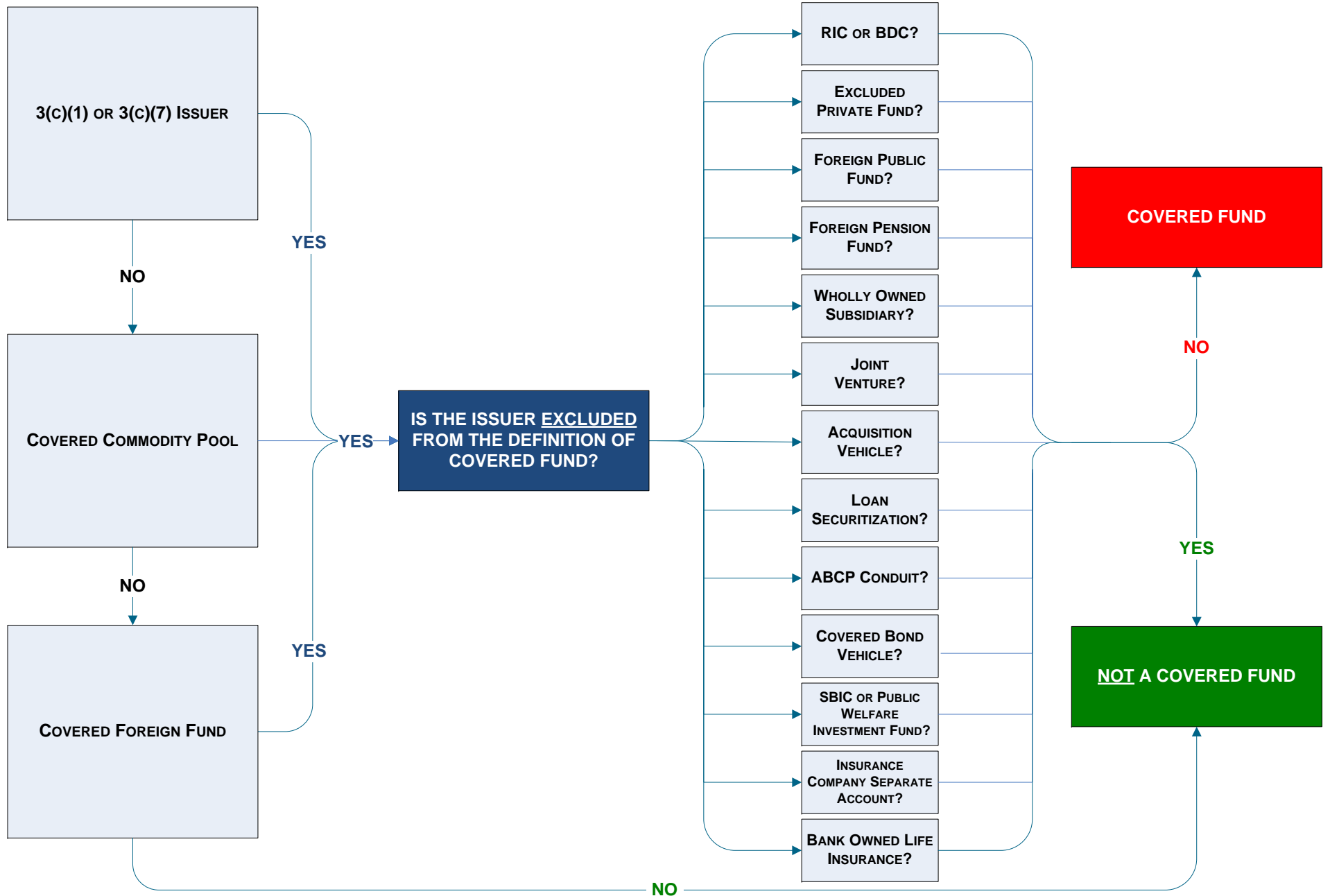


SEE WHAT IS A COVERED FUND?, FOREIGN PUBLIC FUND AND OFFSHORE EXEMPTION, SLIDES 5, 13 AND 34



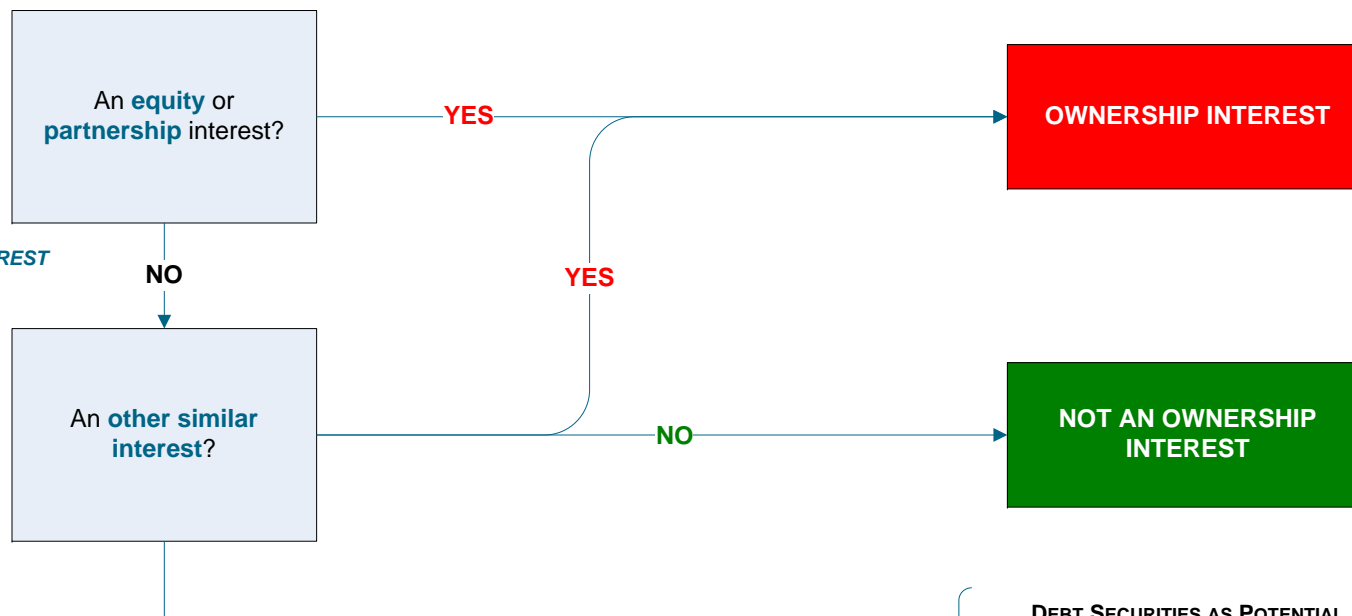
EXCLUSIONS FROM THE DEFINITION OF COVERED FUND

COVERED FUND



Other than a **restricted profit interest (carried interest)**, is the interest in the **covered fund** acquired or retained by the **banking entity**:

SEE EXCLUSION FOR RESTRICTED PROFIT INTEREST (CARRIED INTEREST), SLIDE 8



SPECIFIED CHARACTERISTICS OF AN "OTHER SIMILAR INTEREST"

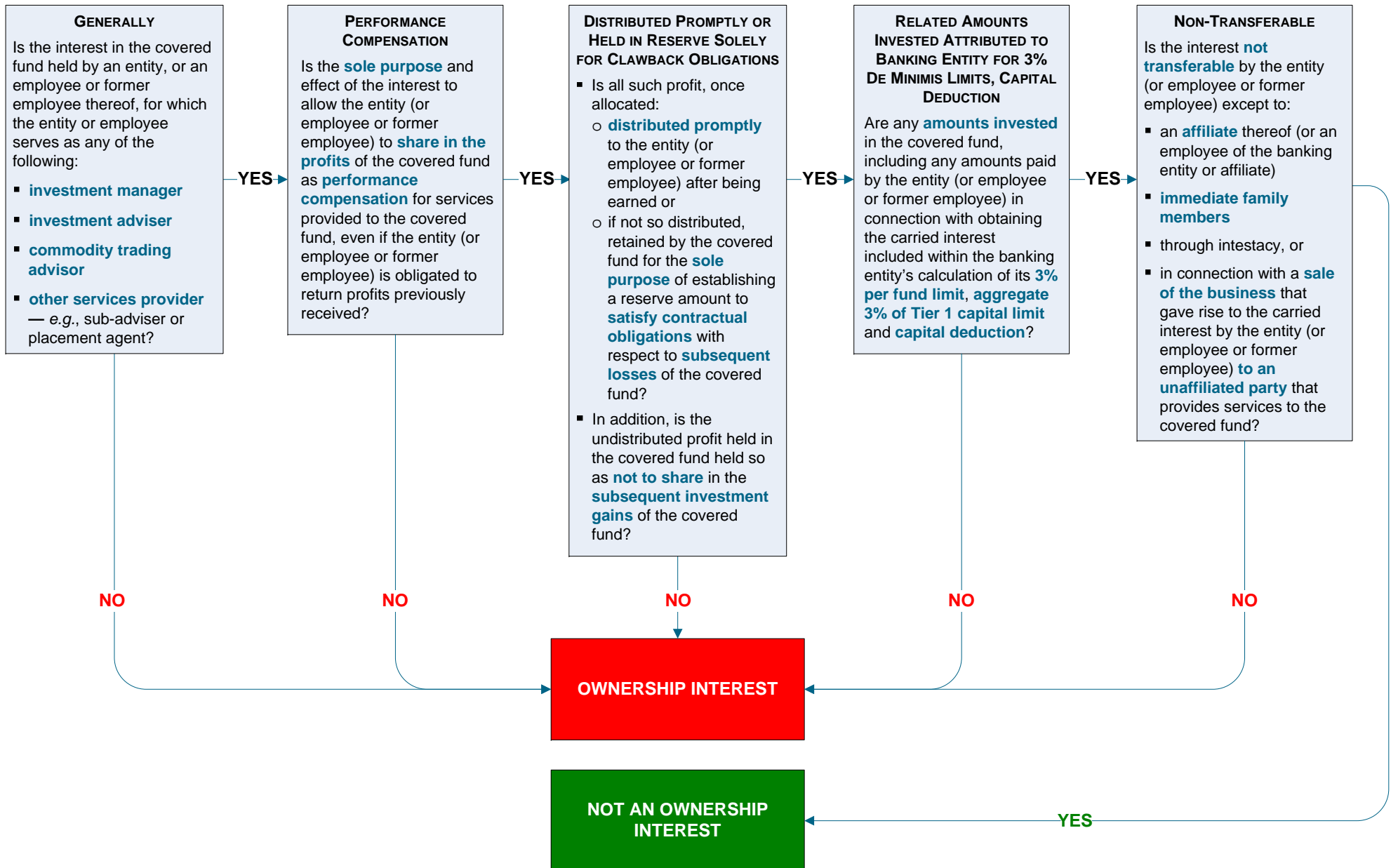
An "other similar interest" includes any interest in or security issued by a covered fund that exhibits any of the following characteristics on a current, future or contingent basis:

- **Selection or removal of manager.** The right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading advisor of the covered fund (excluding the rights of a creditor upon an event of default or acceleration)
- **Share in income, gains or profits.** The right under the terms of the interest to receive a share of the income, gains or profits of the covered fund, whether or not pro rata with other owners or holders of interests
- **Residual interest in assets.** The right to receive the underlying assets of the covered fund after all other interests have been redeemed or paid in full (excluding the rights of a creditor upon an event of default or acceleration)
- **Excess spread.** The right to receive all or a portion of excess spread (i.e., the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests)
- **Write-down of amounts payable due to losses.** Provides that, under the terms of the interest, the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest
- **Return based on performance of assets.** Receives income on a pass-through basis or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund
- **Synthetic rights.** Synthetic right to have, receive or be allocated any of the rights above

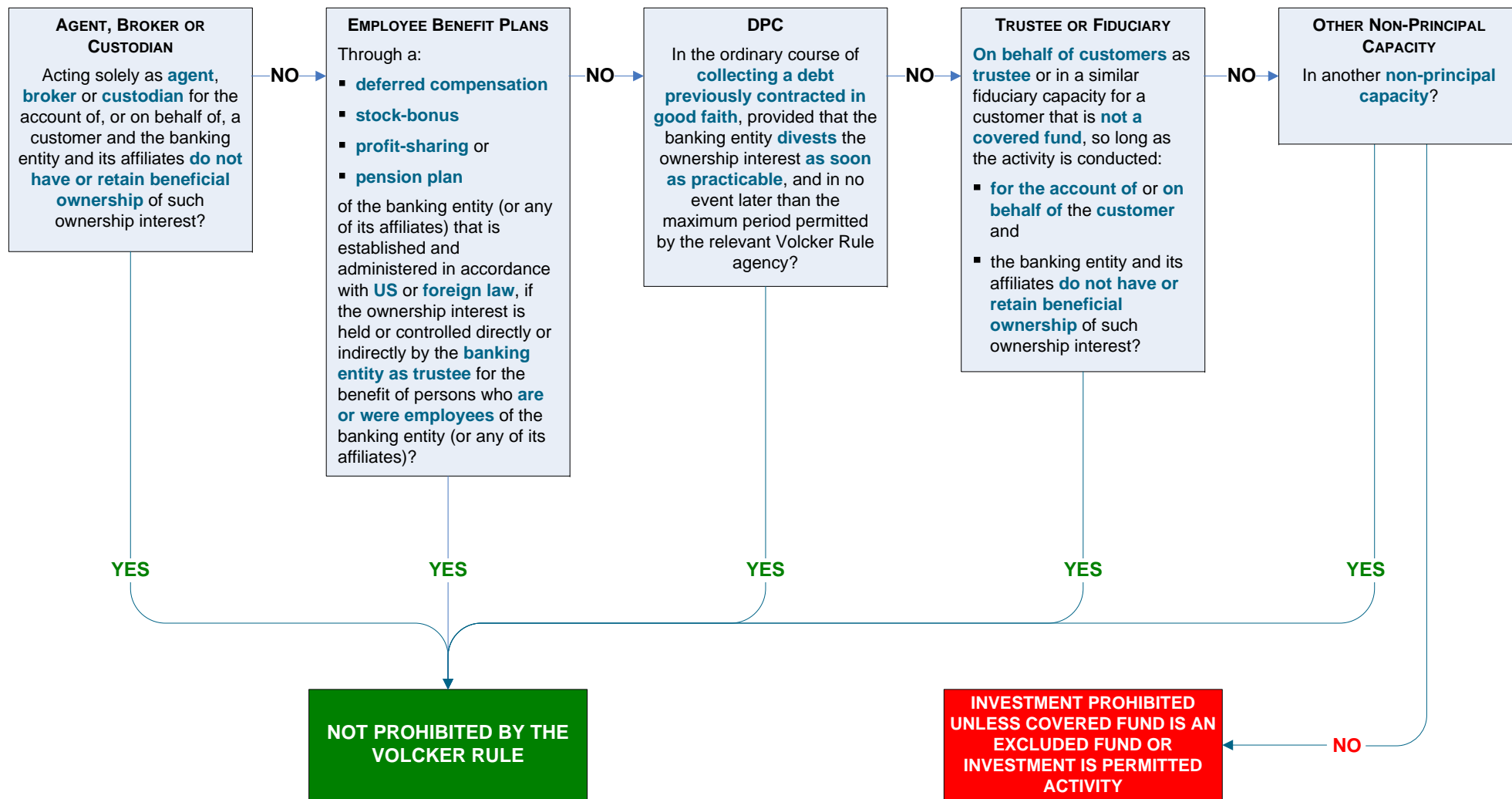
DEBT SECURITIES AS POTENTIAL OWNERSHIP INTERESTS

- The agencies indicate in the preamble that an ownership interest does not generally cover **typical extensions of credit** the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate.
- However, a debt security or other interest in a covered fund that exhibits specified characteristics that are **similar to those of equity or other ownership interests would be an ownership interest.**

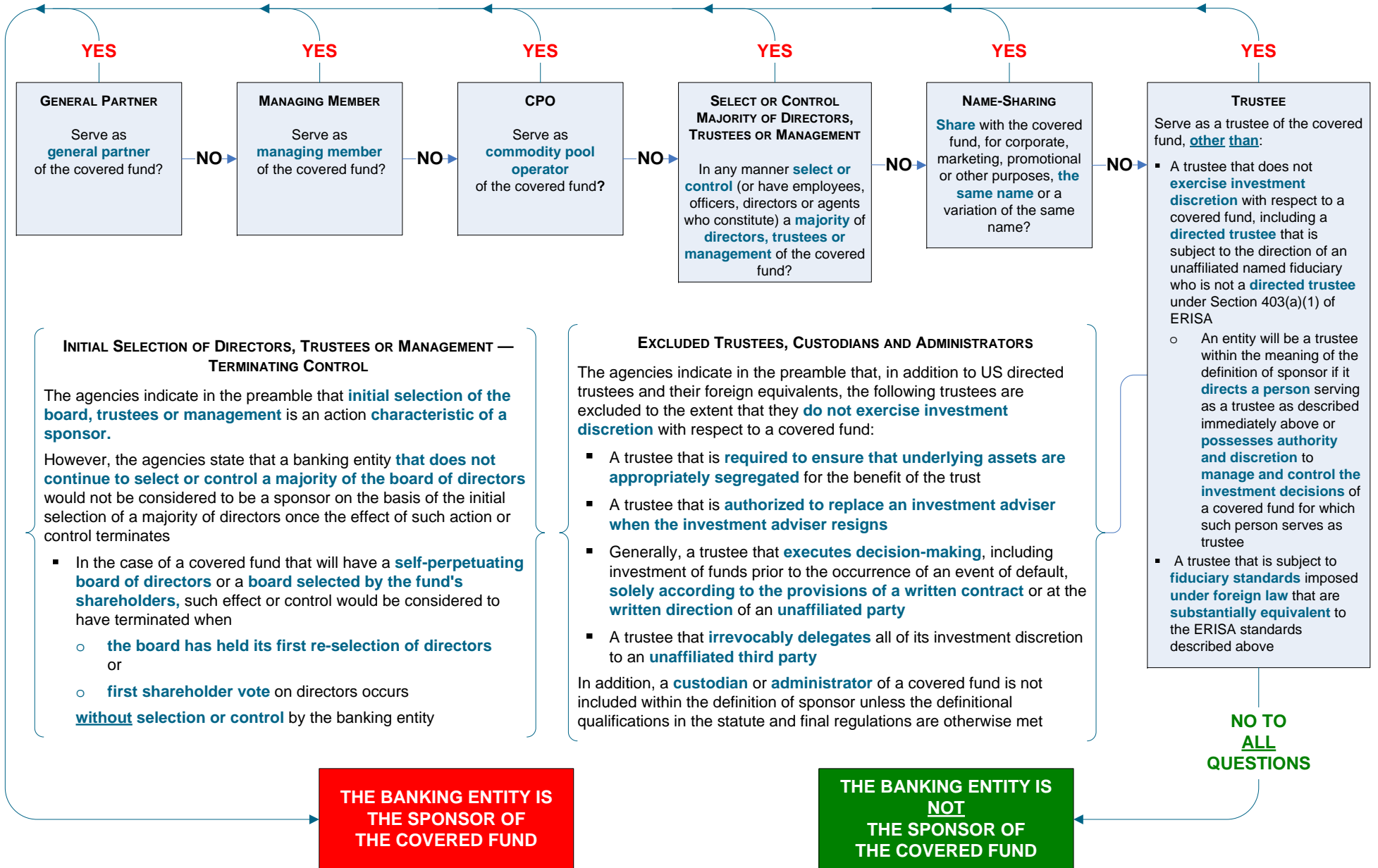
EXCLUSION FOR RESTRICTED PROFIT INTEREST (Carried Interest)



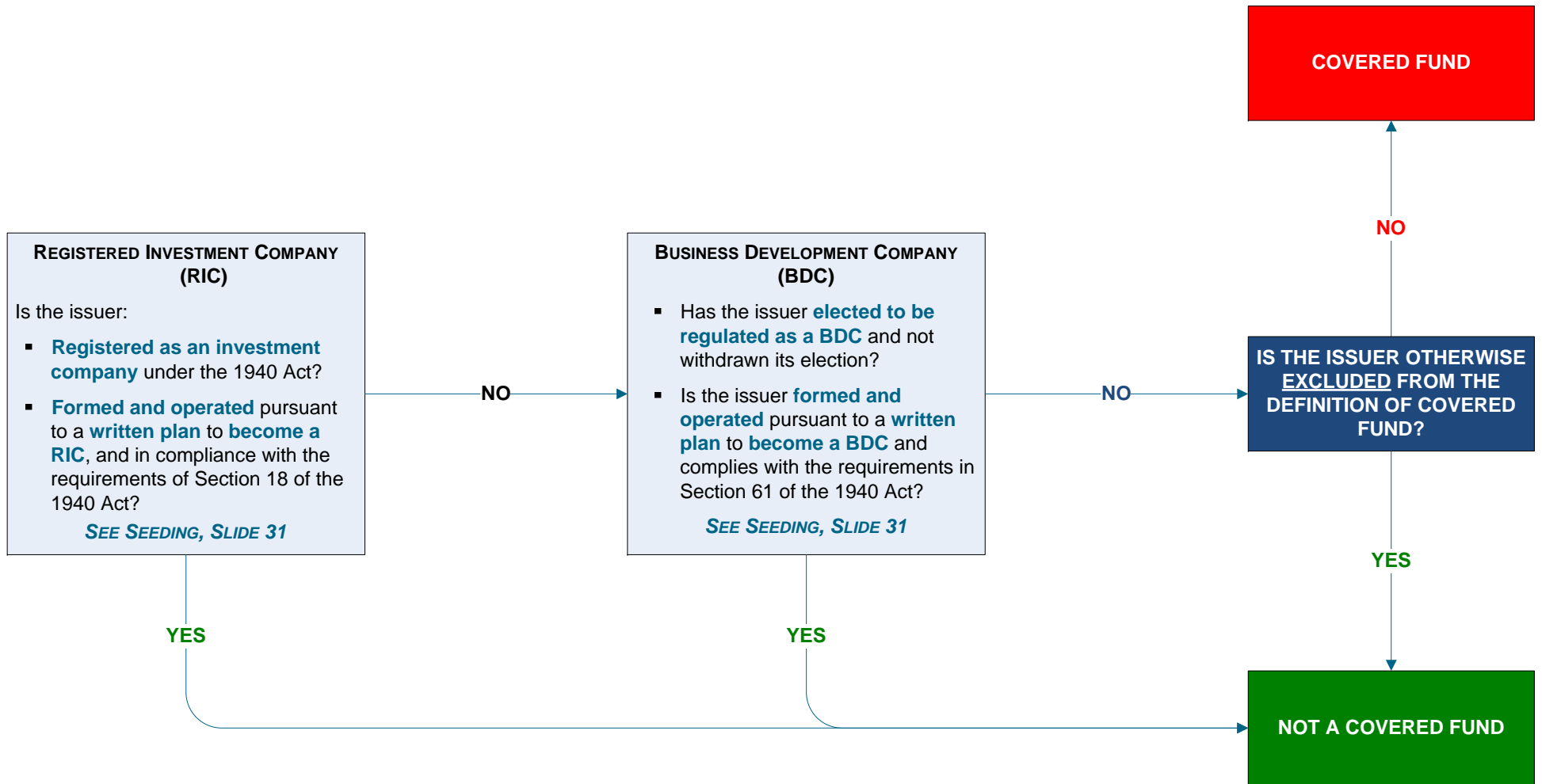
Is the **ownership interest** in the covered fund acquired or retained by the banking entity:



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

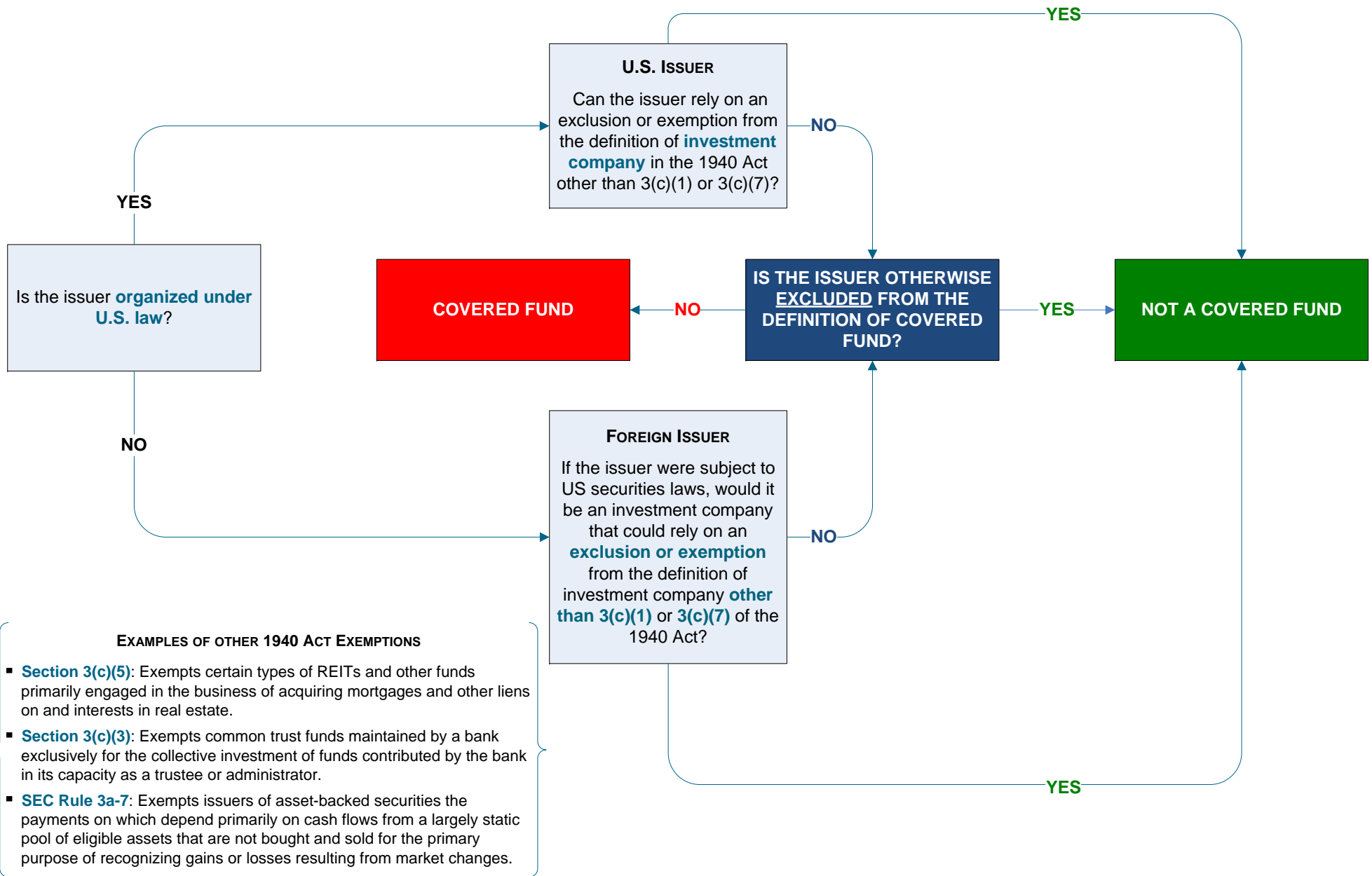


EXCLUSIONS FROM DEFINITION OF COVERED FUND RIC or BDC

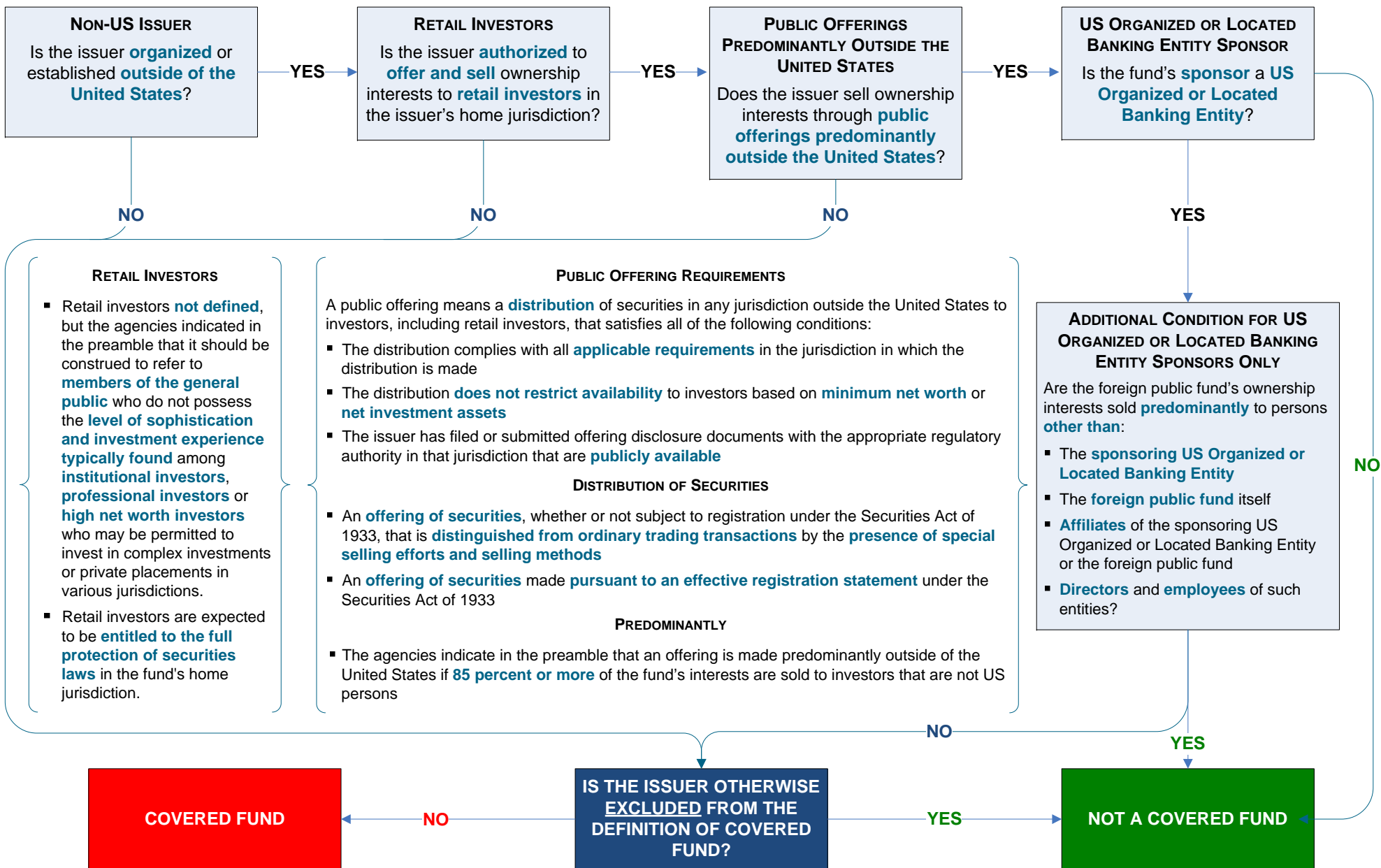


EXCLUSIONS FROM DEFINITION OF COVERED FUND

Excluded Private Fund (U.S. or Foreign)



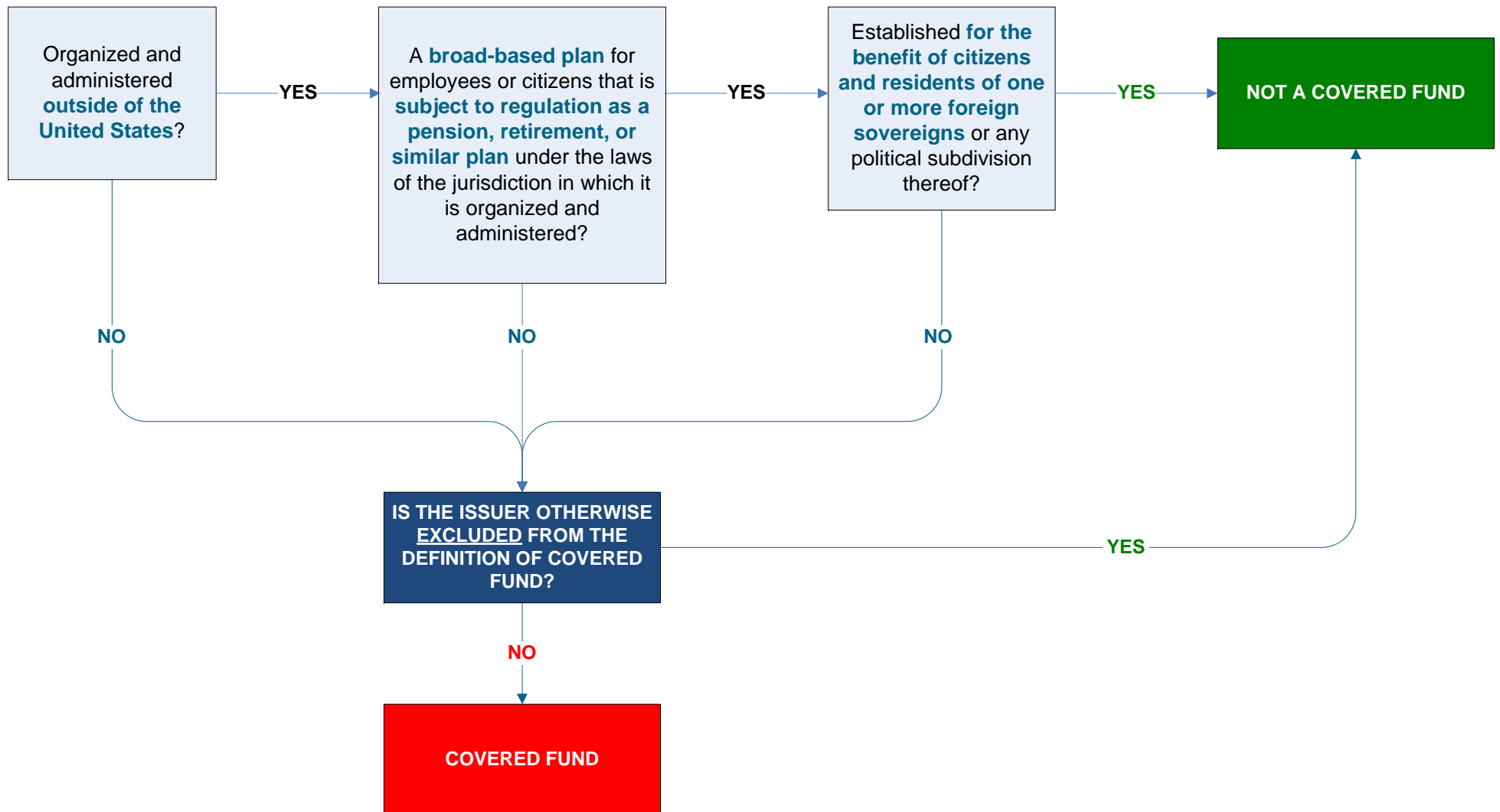
Foreign Public Fund



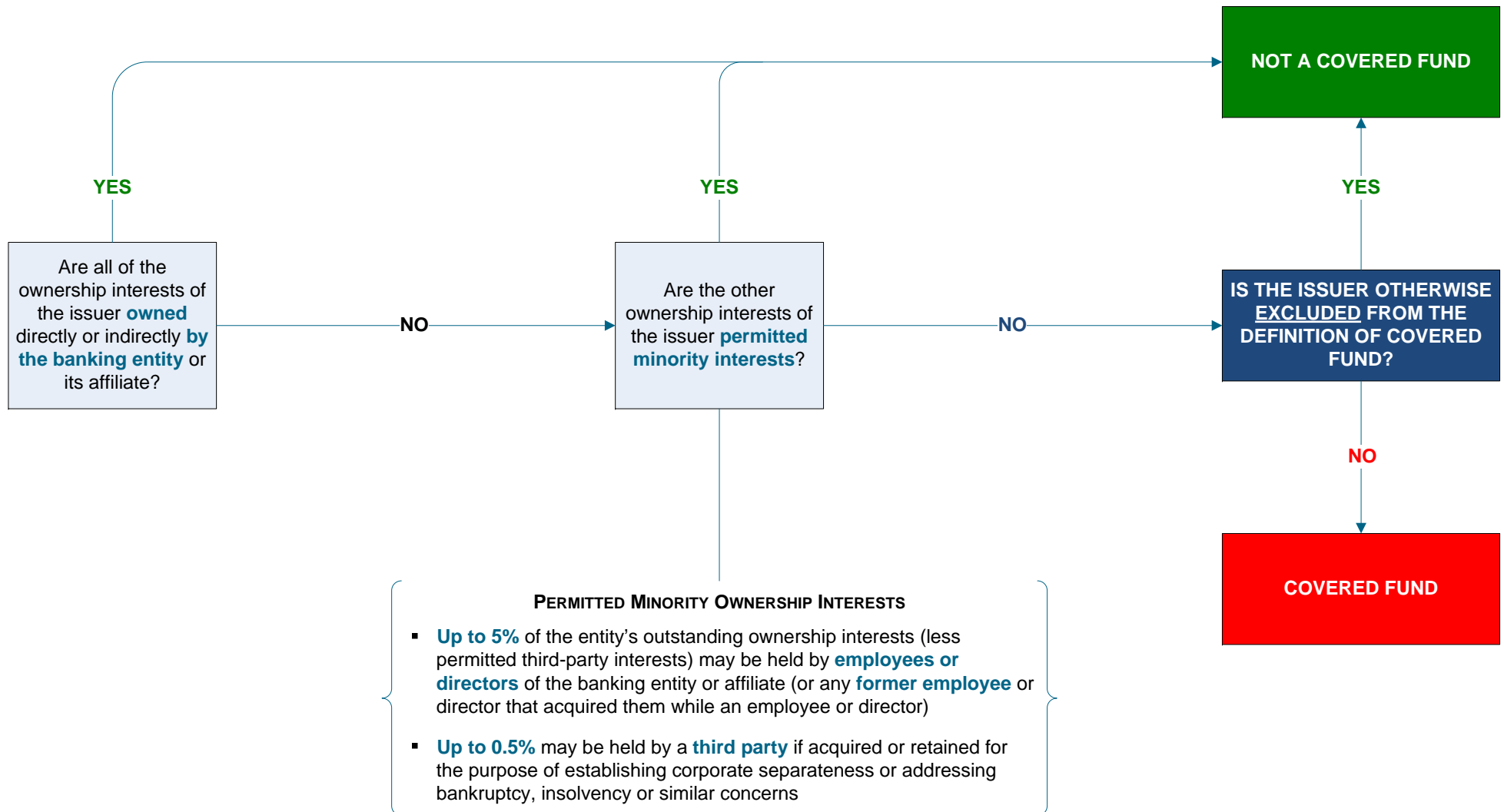
EXCLUSIONS FROM THE DEFINITION OF COVERED FUND

Foreign Pension Fund

Is the **plan, fund or program** providing **pension, retirement or similar benefits**:

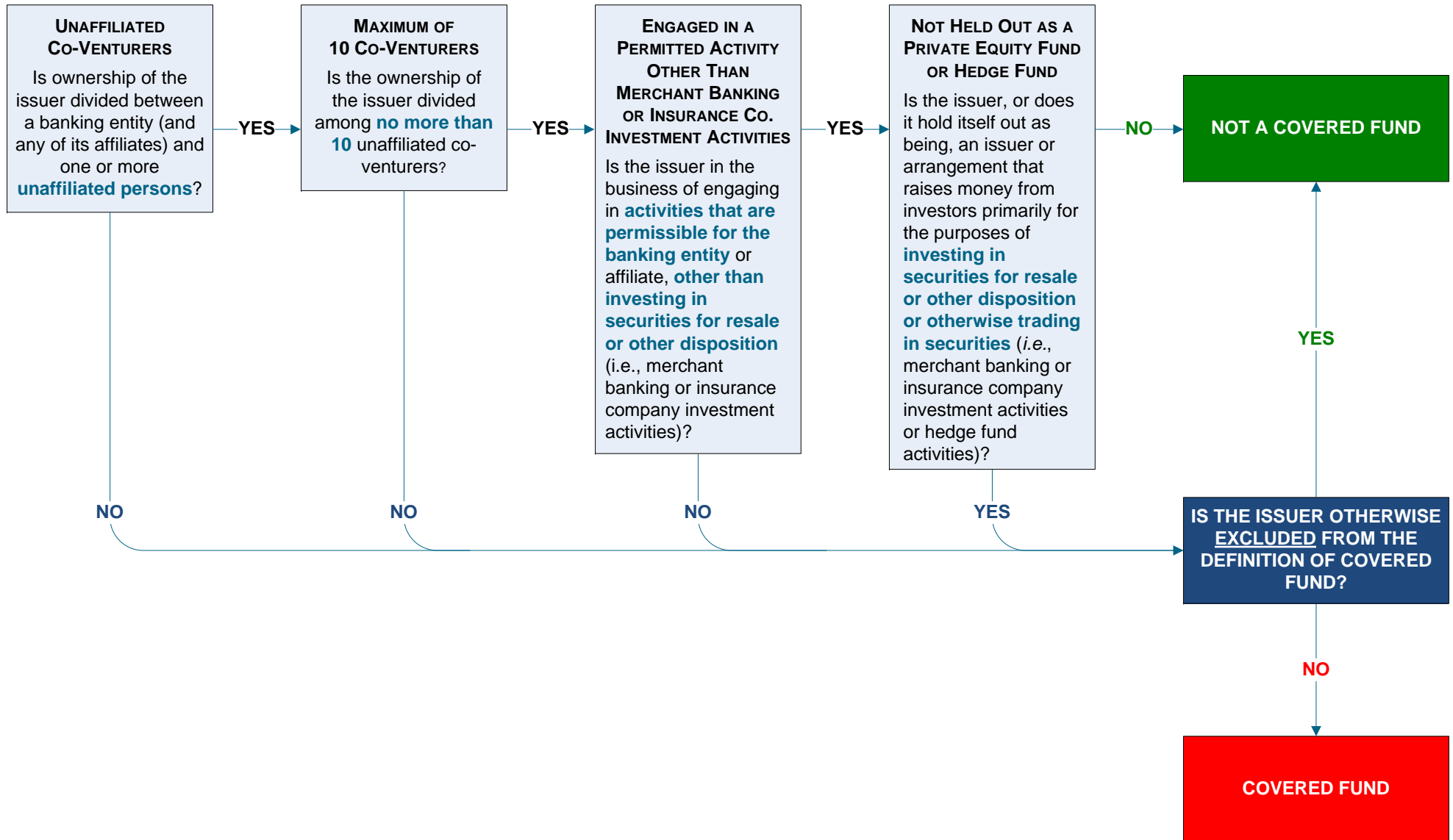


EXCLUSIONS FROM THE DEFINITION OF COVERED FUND Wholly Owned Subsidiary

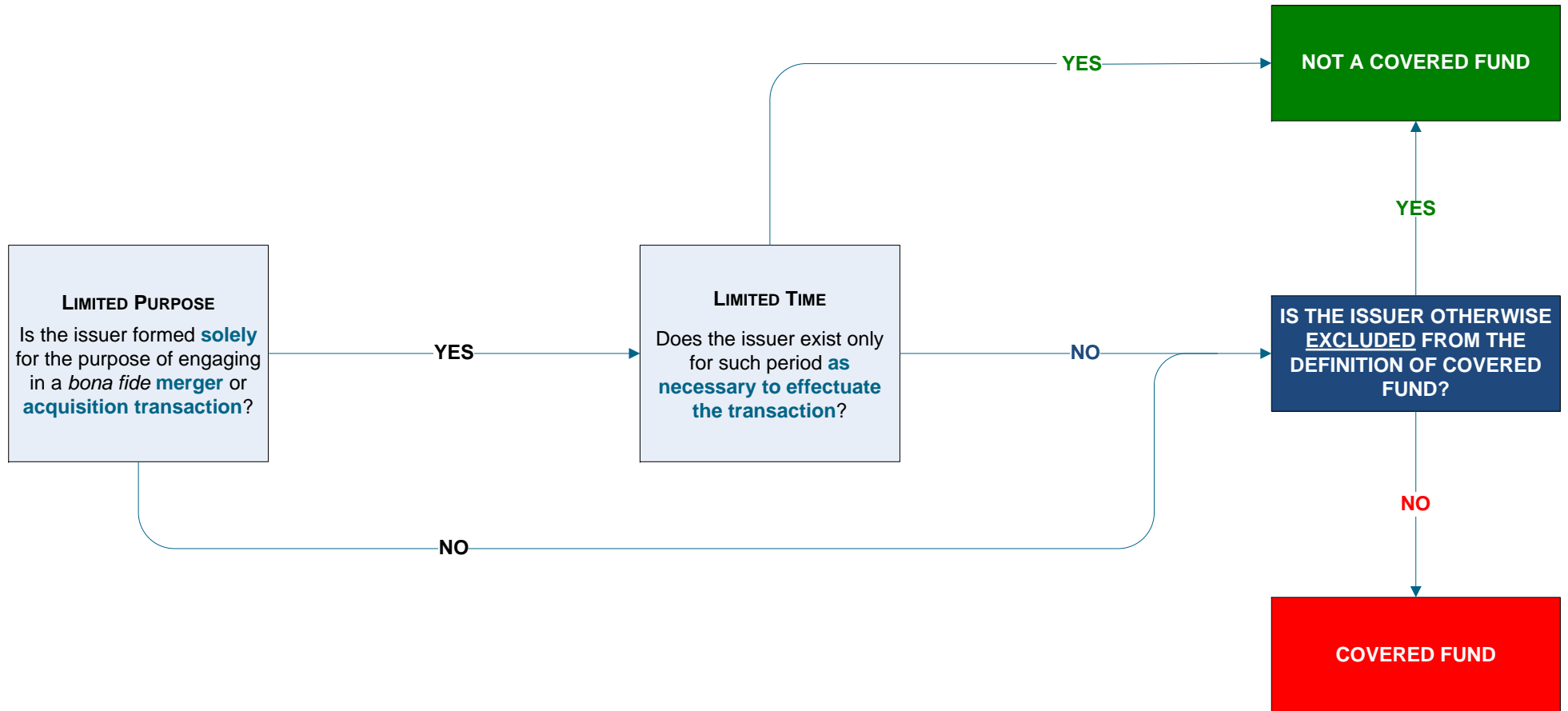


EXCLUSIONS FROM THE DEFINITION OF COVERED FUND

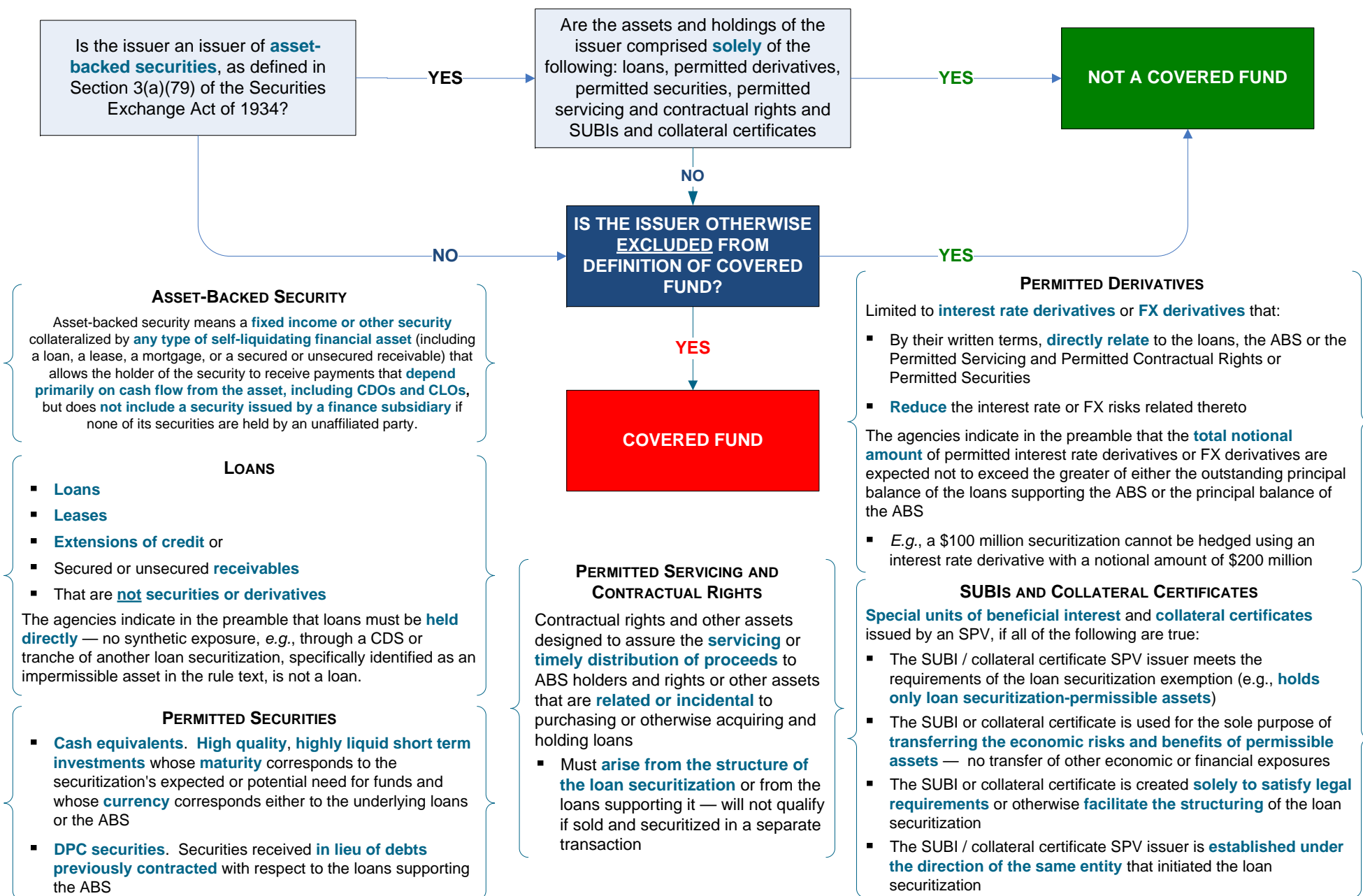
Joint Venture



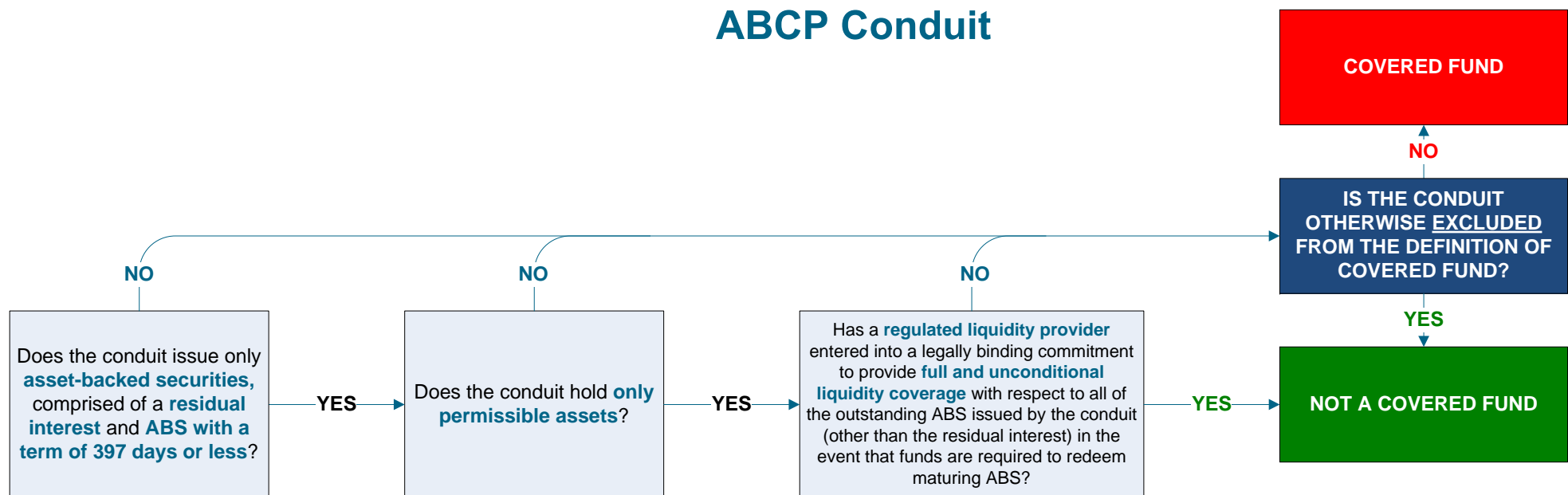
EXCLUSIONS FROM THE DEFINITION OF COVERED FUND Acquisition Vehicle



Loan Securitization



ABCP Conduit



- PERMITTED ASSETS**
- Assets permissible for a loan securitization
 - Loans
 - Permitted servicing and contractual rights
 - Permitted securities
 - Permitted derivatives
 - SUBIs and collateral certificates
 - ABS supported solely by assets permissible for a loan securitization
 - See above
- SEE LOAN SECURITIZATION, SLIDE 18*

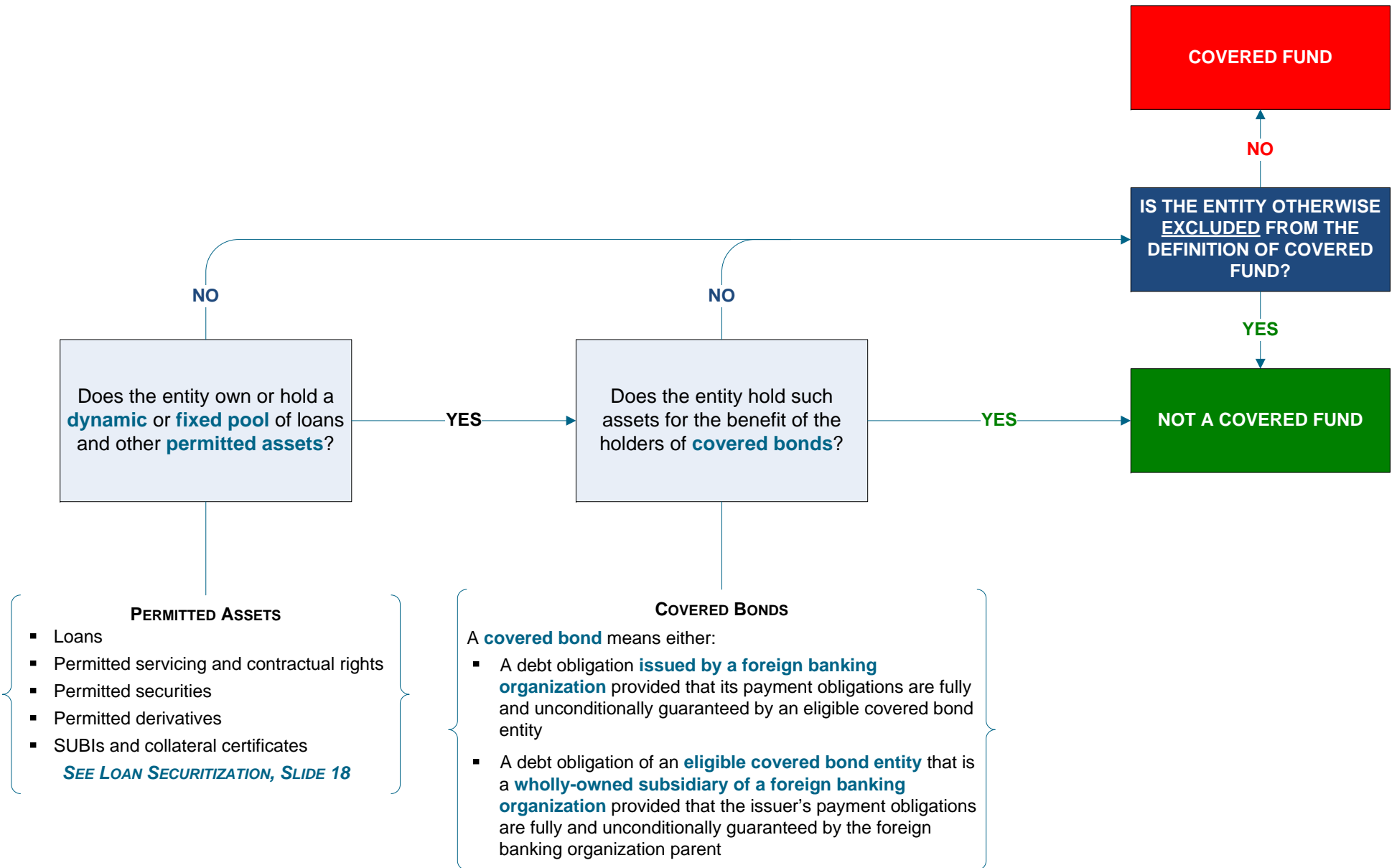
- REGULATED LIQUIDITY PROVIDER**
- A regulated liquidity provider is any of the following:
- Insured depository institution
 - Bank holding company or any of its subsidiaries
 - Savings and loan holding company provided that all or substantially all of its activities are permissible for a financial holding company under Section 4(k) of the BHC Act
 - Foreign bank whose home country supervisor has adopted capital standards consistent with Basel III and that is subject to such standards, or any of its subsidiaries
 - The United States or a foreign sovereign

- 100% LIQUIDITY COVERAGE**
- 100% liquidity coverage means that:
- in the event the conduit is unable for any reason to repay maturing asset-backed securities issued by the conduit, the total amount for which the regulated liquidity provider may be obligated is equal to 100 percent of the amount of asset-backed securities outstanding plus accrued and unpaid interest

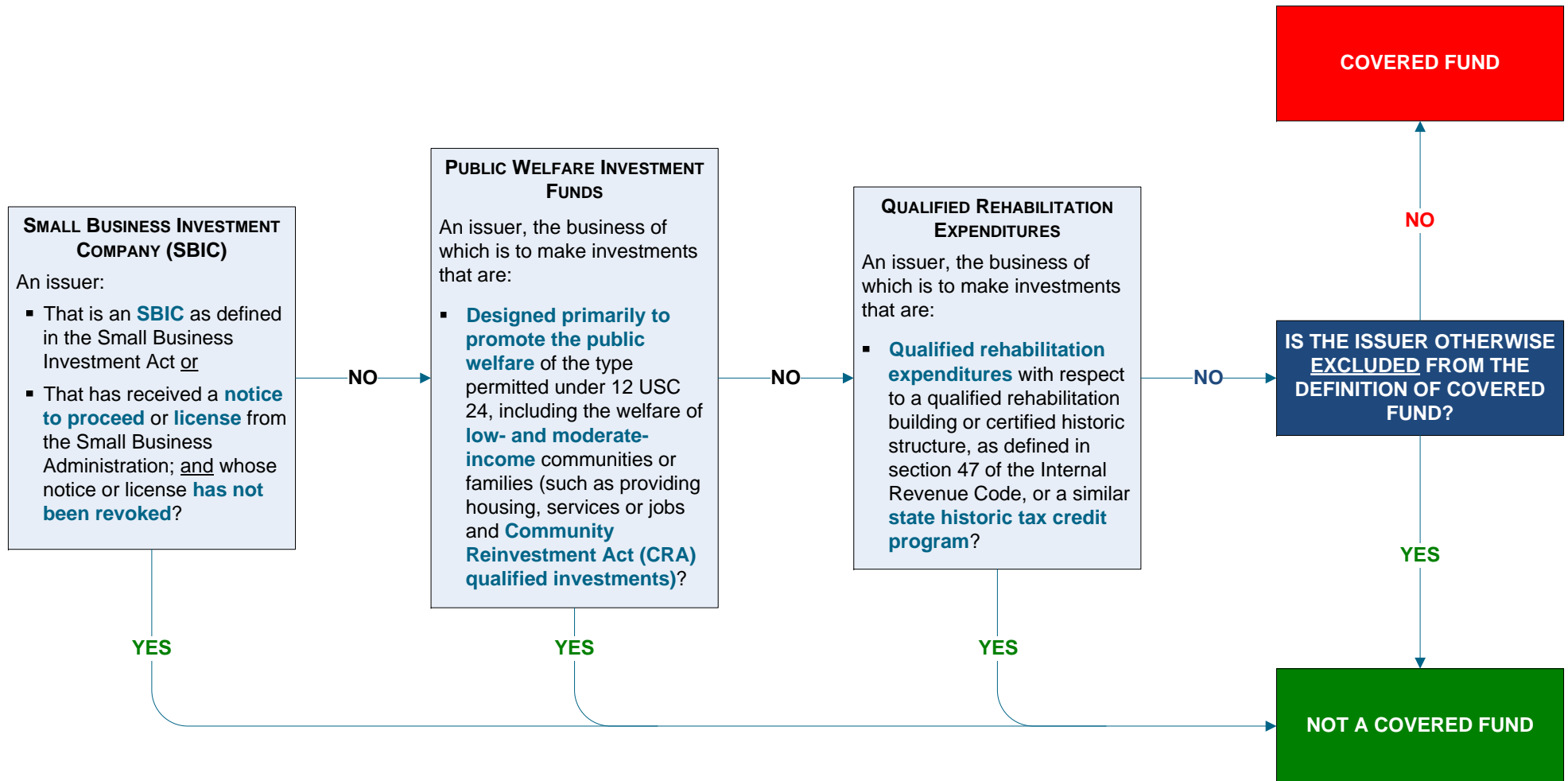
- PERMISSIBLE FORMS OF LIQUIDITY COVERAGE**
- Lending facility
 - Asset purchase agreement
 - Repurchase agreement or
 - Similar arrangement

EXCLUSIONS FROM THE DEFINITION OF COVERED FUND

Covered Bond Entities



EXCLUSIONS FROM THE DEFINITION OF COVERED FUND SBIC or Public Welfare Investment Fund



EXCLUSIONS FROM THE DEFINITION OF COVERED FUND Insurance Company Separate Account

For a **separate account** established by a banking entity that is an **insurance company**:

Does a banking entity **other than the insurance company** that established the separate account **participate in the account's profits and losses**?

NO

NOT A COVERED FUND

YES

IS THE ENTITY OTHERWISE EXCLUDED FROM THE DEFINITION OF COVERED FUND?

YES

NO

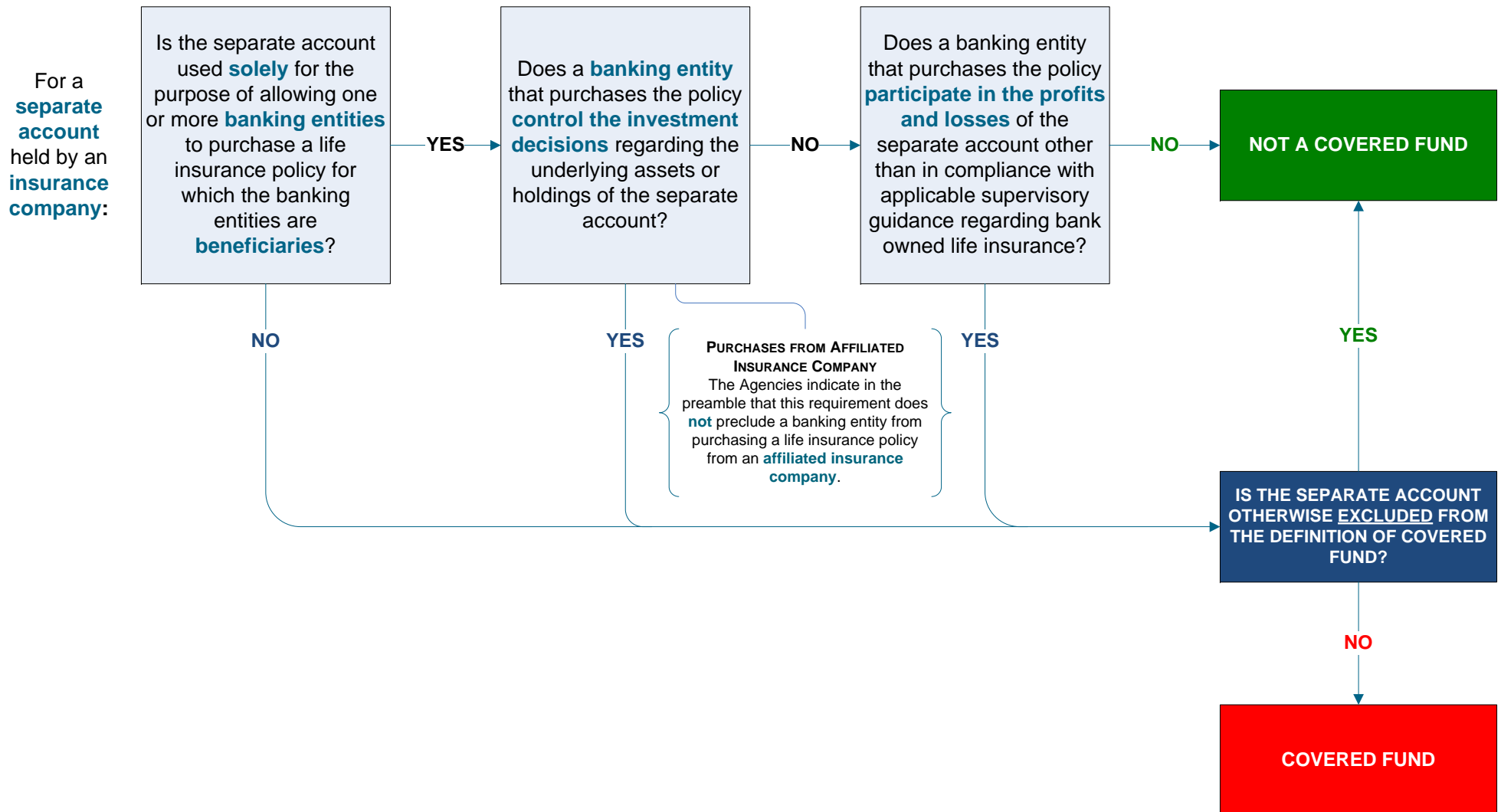
COVERED FUND

SEPARATE ACCOUNT

An account **established and maintained by an insurance company** in connection with one or more insurance contracts to hold assets that are **legally segregated from the insurance company's other assets**, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

EXCLUSIONS FROM THE DEFINITION OF COVERED FUND

Bank Owned Life Insurance



PERMITTED ACTIVITIES

Asset Management Exemption

A banking entity may acquire or retain an ownership interest in, or act as a sponsor to, a covered fund, in connection with directly or indirectly organizing and offering the covered fund if:



1
PROVIDES BONA FIDE SERVICES

The banking entity or an affiliate provides *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services

2
CUSTOMERS OF BONA FIDE SERVICES

The covered fund is **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 or an affiliate

3
COMPLIANCE WITH INVESTMENT LIMITS

The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund other than a *de minimis* investment in compliance with investment limits

4
SUPER 23A

The banking entity and its affiliates comply with the Volcker Rule's Super 23A restrictions and 23B restrictions

5
NO GUARANTEES

The banking entity and its affiliates **do 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

6
NO NAME SHARING

The covered fund, for corporate, marketing, promotional or other purposes, **does not share the same name** or a variation of the same name with the banking entity or its affiliates, and **does not use the word "bank"** in its name

7
RESTRICTIONS ON INVESTMENTS BY DIRECTORS AND EMPLOYEES

Only directors or employees of the banking entity or an affiliate **directly engaged** in providing **investment advisory, commodity trading advisory or other services** to the covered fund at the time the director or employee takes the ownership interest may invest in the covered fund

8
WRITTEN DISCLOSURES

The banking entity clearly and conspicuously makes certain **written disclosures** to any prospective and actual investor in the covered fund

OTHER SERVICES

The preamble indicates that **director and employees** who provide any of the following examples of **"other services"** to a covered fund that **enable the provision of investment advice or investment management** — including any former director or employee who provided such services to the covered fund at the time of investment — may invest in or retain an investment in the covered fund:

- Oversight
- Risk Management
- Deal Origination
- Due Diligence
- Administrative
- Other Services

CUSTOMERS

Includes **existing and new customers**, but the banking entity must have a **"written 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

SUPER 23A, 23B

SEE DO THE "SUPER 23A" RESTRICTIONS APPLY?, SLIDE 36

INVESTMENT LIMITS AND CAPITAL DEDUCTION

SEE INVESTMENT LIMITS, SLIDES 27-31

SEE SEEDING, SLIDE 32

REQUIRED DISCLOSURES

- Any **losses in the covered fund** will be borne solely by investors in the covered fund and not by the banking entity or its affiliates; therefore the banking entity's losses in the covered fund will be **limited to losses attributable to the ownership interests** in the covered fund held by the banking entity and any affiliate in its capacity as investor in the covered fund or as beneficiary of a carried interest held by the banking entity or any affiliate
- The prospective or actual investor should read the fund offering documents before investing in the covered fund
- Ownership interests in the covered fund are **not insured by the FDIC**, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case)
- The **role of the banking entity** and its affiliates and employees in sponsoring or providing any services to the covered fund

PERMITTED ACTIVITIES ABS Issuer Exemption

A banking entity may acquire or retain an ownership interest in, or act as a sponsor to, a covered fund that is an issuing entity of asset-backed securities in connection with directly or indirectly **organizing and offering*** that issuing entity, if:



* **Organizing and offering** a covered fund that is an issuing entity of asset-backed securities means:

- Acting as the **securitizer** for the issuer, as defined in the Securities Exchange Act; or
- Acquiring or retaining an ownership interest in the issuing entity as required by the **credit risk retention requirements** of Section 15G of the Securities Exchange Act and its implementing regulations

SECURITIZER

The term **securitizer** is defined in the Securities Exchange Act to mean:

- An issuer of an asset-backed security; or
- A person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.

RISK RETENTION

- Section 15G of the Exchange Act requires certain parties to a securitization transaction to retain and maintain a minimum of 5% of the risk of the securitization, which is permitted under the 3% per fund investment limits
- The final rule does not provide an exemption to permit banking entities to comply with any risk retention requirement imposed under foreign law

SEE 3% PER FUND LIMIT, SLIDE 28

SUPER 23A, 23B
SEE DO THE "SUPER 23A" RESTRICTIONS APPLY?, SLIDE 36

REQUIRED DISCLOSURES
SEE ASSET MANAGEMENT EXEMPTION, SLIDE 24

OTHER SERVICES
SEE ASSET MANAGEMENT EXEMPTION, SLIDE 24

INVESTMENT LIMITS AND CAPITAL DEDUCTION
SEE INVESTMENT LIMITS, SLIDES 27-31
SEE SEEDING, SLIDE 32

Underwriting and Market Making

1

A banking entity may acquire or retain ownership interests in a covered fund as underwriter or market-maker if:

2

CONDUCTED IN ACCORDANCE WITH REQUIREMENTS APPLICABLE TO THE RELEVANT PROP TRADING PERMITTED ACTIVITY

The underwriting or market making-related activities are conducted in accordance with the requirements for permitted **underwriting** or **market making-related activities** in the proprietary trading provisions of the final regulations.

SUBJECT TO INVESTMENT LIMITS, AS APPLICABLE

THIRD PARTY COVERED FUNDS

The underwriting and market-making exemption applies to ownership interests in any covered fund, including covered funds organized, offered, sponsored, advised or controlled by an unaffiliated third party.

- SUMMARY OF KEY APPLICABLE REQUIREMENTS – UNDERWRITING (§.4(a))**
- Banking entity is acting as an underwriter for a distribution of ownership interests in a covered fund and the trading desk's underwriting position is related to such distribution
 - Amount and type of ownership interests in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties
 - Reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period
 - Internal compliance program established and enforced (may include metrics requirements)
 - Compensation arrangements designed not to reward or incentivize prohibited prop trading
 - Banking entity is licensed or registered to engage in underwriting, if required

- SUMMARY OF KEY REQUIREMENTS – MARKET MAKING (§.4(b))**
- Trading desk that acquires ownership interests in a covered fund routinely stands ready to purchase and sell such ownership interests
 - Such trading desk is willing and available to quote, purchase and sell such ownership interests for its own account in commercially reasonable amounts throughout market cycles
 - Amount, types and risks of ownership interests in the trading desk's market-maker inventory are designed not to exceed the reasonably expected near term demand of clients, customers or counterparties
 - Internal compliance program established and enforced (may include metrics requirements)
 - Prompt return to compliance when any limits exceeded
 - Compensation arrangements designed not to reward or incentivize prohibited prop trading
 - Banking entity is licensed or registered to engage in market making-related activities, if required

- 3% PER FUND LIMITS**
- Ownership interests acquired **or** retained by a banking entity pursuant to the underwriting and market-making exemption are subject to the 3% per fund limits if they are or were issued by a covered fund:
- Asset management or ABS issuer exemptions.** As to which the banking entity is a sponsor or in which the banking entity acquires and retains an ownership interest pursuant to the asset management or ABS issuer exemptions, or
 - Other related covered funds:**
 - As to which the banking entity is otherwise a sponsor, investment adviser or commodity trading advisor, or
 - As to which the banking entity **directly or indirectly guarantees, assumes or otherwise insures** the obligations or performance of such fund or any covered fund in which such fund invests.
 - The agencies indicated in the preamble that a banking entity would **not** be treated as guaranteeing the obligations or performance of a covered fund if it enters into arrangements, such as providing liquidity facilities or letters of credit, that are not entered into for the purpose of guaranteeing the obligations or performance of the covered fund
- The 3% per fund limit **does not apply** to ownership interests acquired or retained pursuant to the underwriting and market making exemption in any covered fund organized and offered by the banking entity pursuant to the asset management or ABS exemptions during the **seeding period** for such fund.
- The 3% per fund limit is calculated as of the **end of each quarter**, but the agencies indicated in the preamble that if a banking entity becomes aware that it has exceeded the 3% limit for a given fund at any time, the agencies expect the banking entity to take steps to ensure that it complies promptly with the 3% per fund limit.

- AGGREGATE 3% OF TIER 1 CAPITAL LIMIT AND CAPITAL DEDUCTIONS**
- Ownership interests in any covered fund, including a third-party fund, which are acquired **and** retained by a banking entity pursuant to the underwriting and market-making exemption are subject to the aggregate 3% of Tier 1 capital limits and capital deductions.
 - The aggregate 3% of Tier 1 capital limit is **calculated as of the end of each quarter**, but the agencies indicated in the preamble that they expect banking entities to monitor their investments in covered funds regularly and remain in compliance with the aggregate 3% of Tier 1 capital limit throughout the quarter.

SEE DAVIS POLK PROPRIETARY TRADING FLOWCHARTS, SLIDES 6-8 FOR DETAILS ON THESE PERMITTED ACTIVITIES

SEE INVESTMENT LIMITS, AND SEEDING SLIDES 27-32

PERMITTED ACTIVITIES

3% Per Fund Limit: Asset Management Exemption

Except as permitted during the seeding period and for multi-tier fund investments, the following rules apply for calculating a banking entity's ownership interests in a single covered fund that the banking entity organizes and offers or sponsors under the **asset management exemption**, including ownership interests acquired or retained under the **underwriting and market making exemption**

3% PER FUND BY NUMBER AND VALUE

3% of Total Number or Value. The maximum permissible investment or other holding by a banking entity and its affiliates in a single covered fund under the asset management exemption, when aggregated with any ownership interests acquired or retained under the underwriting and market making exemption, is **3%** of the **total number or value** of the **outstanding ownership interests** of the covered fund (all measured without regard to funds **committed but not yet called** for investment):

- **Total number:** The total number of outstanding ownership interests **held by the banking entity** under the asset management or underwriting and market making exemptions divided by the total ownership interests **held by all investors** or other holders in that fund
- **Total fair market value.** The **aggregate fair market value of all investments or other holdings in** and **capital contributions** made to the covered fund by the banking entity under the asset management or underwriting and market making exemptions divided by the **value of all investments or other holdings in** and **capital contributions made** to the covered fund **by all investors**
 - **If fair market value cannot be determined,** then the value will be the **historical cost basis** of the investments or other holdings and capital contributions

CONSISTENCY OF CALCULATION

- **Consistent with financial statements and regulatory reports.** The agencies indicated in the preamble that a banking entity should use the **same methodology** for valuing its investments and capital contributions as the banking entity uses to prepare its **financial statements** and **regulatory reports**
- **Same manner and standards.** Once a valuation methodology is chosen, the banking entity must calculate the value of **its investment** or other holding and the **investments or other holdings of all others** in the covered fund in the same manner and according to the same standards

TIMING

Quarterly. The 3% per fund limit is calculated as of the **last day of each calendar quarter.**

- **3% limit applies at all times.** The agencies indicate in the preamble that the 3% per fund limitations apply to investments or other holdings in covered funds under the asset management or underwriting and market making exemptions **at all times following the end of the seeding period**
- **Prompt compliance expected if 3% per fund limit exceeded.** They also indicate in the preamble that if a banking entity becomes aware that it has **exceeded the 3% limit** for a given fund at any time, the agencies expect the banking entity to **take steps to ensure that it complies promptly** with the 3% per fund limit

ATTRIBUTION *

SEE ATTRIBUTION RULES, SLIDES 30-31

OTHER 3% PER FUND LIMITS

SEE 3% PER FUND LIMIT: ABS ISSUER EXEMPTION, SLIDE 28

SEE UNDERWRITING AND MARKET MAKING EXEMPTION (3% PER FUND LIMITS — OTHER RELATED COVERED FUNDS), SLIDE 26

SEEDING PERIOD

SEE SEEDING, SLIDE 32

AGGREGATE 3% OF TIER 1 CAPITAL LIMIT**

SEE AGGREGATE 3% OF TIER 1 CAPITAL LIMIT, SLIDE 29

* Includes Multi-Tier Investments
** Includes Deductions from Capital

PERMITTED ACTIVITIES

3% Per Fund Limit: ABS Issuer Exemption

Except as permitted during the seeding period and for multi-tier fund investments, the following rules apply for calculating a banking entity's ownership interests in a single covered fund that the banking entity organizes and offers or sponsors under the **ABS issuer exemption**, including ownership interests acquired or retained under the **underwriting and market making exemption**

3% DE MINIMIS OR 5% RISK RETENTION

The maximum permissible investment or other holding by a banking entity and its affiliates in a single covered fund organized and offered under the ABS issuer exemption, when aggregated with any ownership interests acquired or retained under the underwriting and market making exemption, is:

- **3%** of the **total fair market value** of the outstanding ownership interests in the fund
unless
- The banking entity and its affiliates are **required to retain a greater percentage** in compliance with the **credit risk retention requirements of Section 15G** of the Securities Exchange Act and its implementing regulations, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the **amount, number, or value** of ownership interests of the fund required thereunder.
 - **Risk retention requirements.** Section 15G requires certain parties to a securitization transaction to retain and maintain **a minimum of 5%** of the risk of the securitization
 - **No accommodation for foreign risk retention requirements.** The agencies note in the preamble that the final rule does not provide an exemption to permit banking entities to comply with any **risk retention requirement imposed under foreign law**

VALUATION

- **Fair market value of assets.** The aggregate value of the outstanding ownership interests in the covered fund will be the **fair market value of the assets transferred to the issuing entity** of the securitization and any other assets otherwise held by the issuing entity at such time, determined in a manner that is consistent with its determination of the fair market value of those assets for financial statement purposes
- **Not calculated by class or tranche.** The agencies note in the preamble that the 3% per fund limit for ownership interests in ABS issuers is calculated based **only on the value of the ownership interest** in relation to the **value of all ownership interests in the issuing entity** of the asset-backed security and are not calculated on a class by class, or tranche by tranche, basis
- **Date of establishment.** As of the date on which the assets were initially transferred into the ABS issuing entity or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund
- **Valuation consistency.** The valuation methodology used to calculate the **fair market value** of the ownership interests must be the **same** for both the **ownership interests held by the banking entity** and the **ownership interests held by all others in the covered fund** in the **same manner** and according to the **same standards**

TIMING OF 3% PER FUND LIMIT CALCULATION:

NOT SUBJECT TO RISK RETENTION REQUIREMENTS
OR
COMPLETED PRIOR TO RISK RETENTION COMPLIANCE DATE

SUBJECT TO RISK RETENTION REQUIREMENTS AND AFTER RISK RETENTION COMPLIANCE DATE

As of the **date on which the assets were initially transferred** into the ABS issuing entity
or
Such **earlier date** on which the transferred assets have been **valued for purposes of transfer** to the covered fund

As of the **date** and pursuant to the **methodology applicable pursuant to the risk retention requirements** of section 15G of the Exchange Act and its implementing regulations

RECALCULATION ONLY UPON ADDITIONAL ISSUANCE

- **Recalculation** of the banking entity's **3% per fund limit** is not required unless the covered fund **sells additional securities**

OTHER 3% PER FUND LIMITS

SEE 3% PER FUND LIMIT: ASSET MANAGEMENT EXEMPTION, SLIDE 27

SEE UNDERWRITING AND MARKET MAKING EXEMPTION (3% PER FUND LIMITS — OTHER RELATED COVERED FUNDS), SLIDE 26

ATTRIBUTION*

SEE ATTRIBUTION RULES, SLIDES 30-31

SEEDING PERIOD

SEE SEEDING, SLIDE 32

AGGREGATE 3% OF TIER 1 CAPITAL LIMIT**

SEE AGGREGATE 3% OF TIER 1 CAPITAL LIMIT, SLIDE 29

* Includes Multi-Tier Investments

** Includes Deductions from Capital

Aggregate 3% of Tier 1 Capital Limit/Capital Deductions

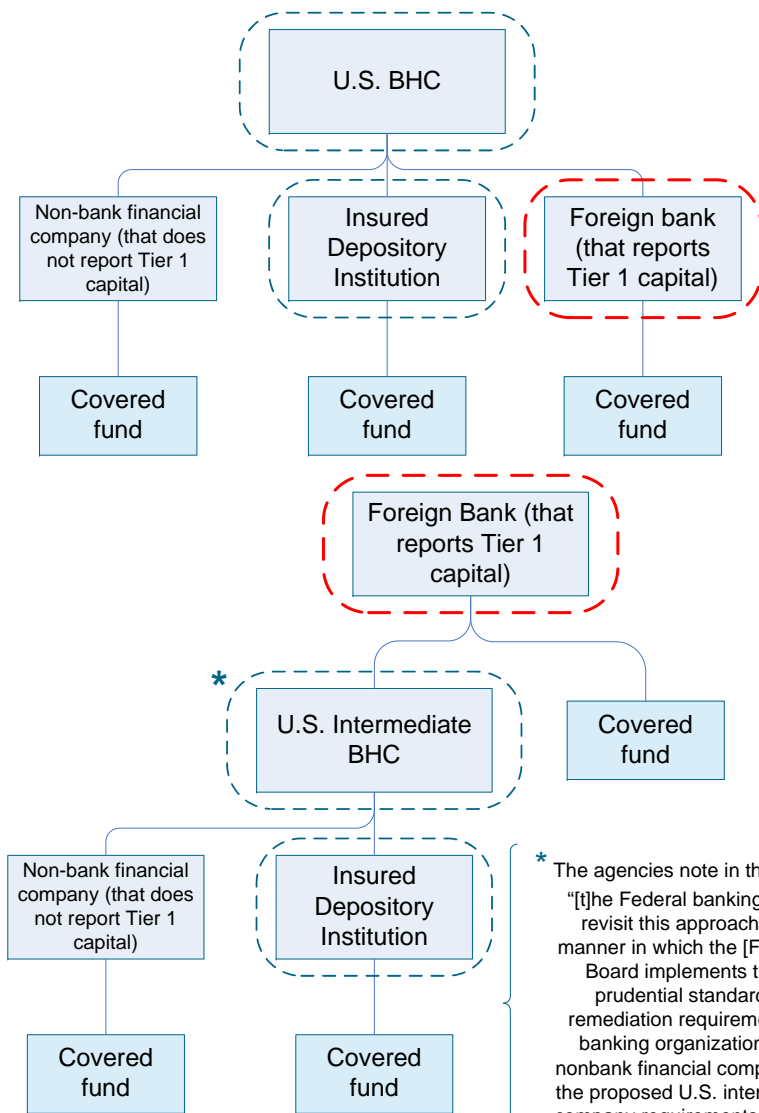
The aggregate value of all ownership interests in covered funds acquired and retained by a banking entity under the asset management, ABS issuer and underwriting and market making exemptions will be the **sum of all amounts paid or contributed** by the banking entity in connection with acquiring or retaining an ownership interest in covered funds (together with any amounts of investments made by the entity, or any of its employees, in connection with obtaining a restricted profit or carried interest).

GRAPHICS ON THIS PAGE

BLUE DOTTED LINES: Entities at which aggregate 3% of Tier 1 capital limit must be calculated and complied with on a consolidated basis and investments and other holdings must be deducted from consolidated Tier 1 capital.

RED DOTTED LINES: Entities at which aggregate 3% of Tier 1 capital limit must be calculated in accordance with **home country standards** and complied with on a consolidated basis; no capital deduction required.

GREEN DOTTED LINES: Entities at which the aggregate limit is based on 3% of **shareholders' equity**, as determined under applicable accounting standards, not Tier 1 capital; no capital deduction required.



CALCULATION OF THE AGGREGATE 3% OF TIER 1 CAPITAL LIMIT

- **Valuation Method.** The investments or holdings are valued at **historical cost**.
- **Monitoring.** The agencies note in the preamble that banking entities are expected to monitor investments in covered funds regularly and remain in compliance with the limitations on covered fund investments throughout the quarter and that the agencies intend, through their respective supervisory processes, to monitor covered fund investment activity to ensure that a banking entity is not attempting to evade the requirements of the Volcker Rule.

CAPITAL DEDUCTIONS

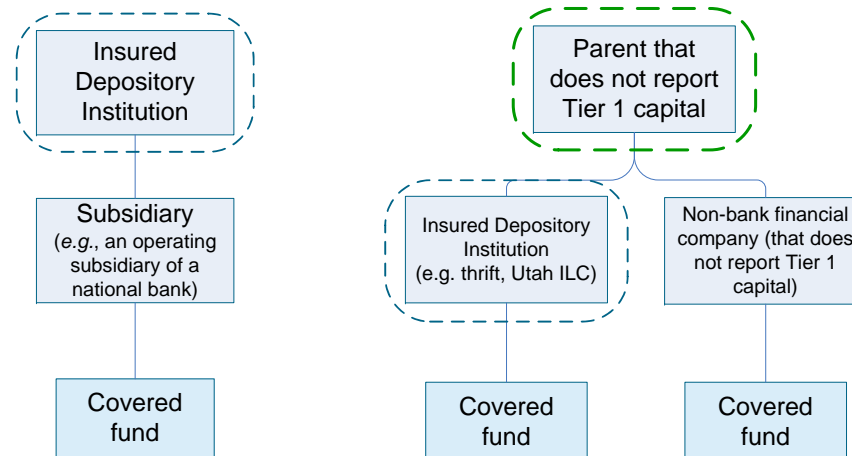
The aggregate value of all ownership interests of a banking entity and its affiliates in all covered funds acquired or retained under the asset management, ABS issuer or underwriting and market making exemptions must be **deducted from a banking entity's Tier 1 capital**

- **Valuation Method.** The investments or holdings are valued at the **greater of historical cost (plus earnings) and fair market value**.
- **Interaction with Basel III.** The agencies indicate in the preamble that the U.S. banking regulators intend to review the interaction between the Volcker Rule capital deduction and U.S. Basel III and expect to propose steps to reconcile the two rules

BOTH

- **Timing.** The aggregate funds limitation and capital deduction must be calculated at the end of each calendar quarter or at such other time as the appropriate Federal banking agency may request such a calculation.

* The agencies note in the preamble that "[t]he Federal banking agencies may revisit this approach in light of the manner in which the [Federal Reserve] Board implements the enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies, including the proposed U.S. intermediate holding company requirements under that rule."



PERMITTED ACTIVITIES

Attribution Rules — Generally

GENERAL APPROACH TO ATTRIBUTION

- The agencies described their **general approach** to the **attribution** of ownership interests for purposes of the investment limits as follows:

"Under the final rule, a banking entity must account for an investment in a covered fund for purposes of the per-fund and aggregate funds limitations **only if the investment is made by the banking entity or another entity controlled by that banking entity**. Accordingly, the final rule does not generally require that a banking entity include the pro rata share of any ownership interest held by any entity that is not controlled by the banking entity, and thus reduces the potential compliance costs of the final rule. The Agencies believe that this concept of attribution is more consistent with how the [Federal Reserve] has historically applied the concept of 'control' under the BHC Act for purposes of determining whether a company subject to that Act is engaged in an activity or whether to attribute an investment to that company." Preamble, pg. 704.

CORE BANKING ENTITY

- **A core banking entity.** An insured depository institution, bank holding company or other company that controls an insured depository institution, or a foreign bank with a U.S. commercial banking presence or a company that controls such a foreign bank.
- A "**U.S. commercial banking presence**" means having a U.S. branch, U.S. agency, U.S. commercial lending company or Edge Act subsidiary

NORMAL COVERED FUNDS

A **normal covered fund** is a covered fund that is not itself a "**core banking entity**".

A normal covered fund is **excluded** from the term banking entity for the purposes of the Volcker Rule.

Consequently:

- A normal covered fund is **not** itself subject to the prohibitions or restrictions of the Volcker Rule, including the limits on acquiring or retaining ownership interests in another covered fund
- Subject to the **special attribution rules for master-feeder funds, funds-of-funds, and parallel funds**, ownership interests acquired or retained by a normal covered fund in another covered fund are **not** attributable to a banking entity that sponsors, advises or controls the normal covered fund

RICs, BDCs AND FOREIGN PUBLIC FUNDS

For purposes of the investment limits, a registered investment company, business development company or foreign public fund is **not** treated as an affiliate of a banking entity, as long as the other banking entity satisfies **both** of the following conditions:

- Does not own, control or hold with the power to vote 25% or more the voting shares of the company or fund; and
- Any investment advisory, commodity trading advisory, administrative and other services provided by the banking entity or an affiliate to the RIC, BDC or foreign public fund is provided in compliance with any limitations under applicable regulation, order or other authority.

Consequently, **subject to the special attribution rules for master-feeder funds, funds-of-funds, and parallel funds**, ownership interests acquired or retained in a covered fund by a RIC, BDC or foreign public fund are **not** attributable to a banking entity for purposes of the investment limits, if the banking entity satisfies **both** of the conditions set forth above with respect to the RIC, BDC or foreign public fund.

SEE WHAT IS A BANKING ENTITY? (RICs, BDCs OR FOREIGN PUBLIC FUNDS), SLIDE 2

**SEE ATTRIBUTION RULES —
MULTI-TIER FUNDS AND PARALLEL
INVESTMENTS, SLIDE 31**

EMPLOYEES AND DIRECTORS

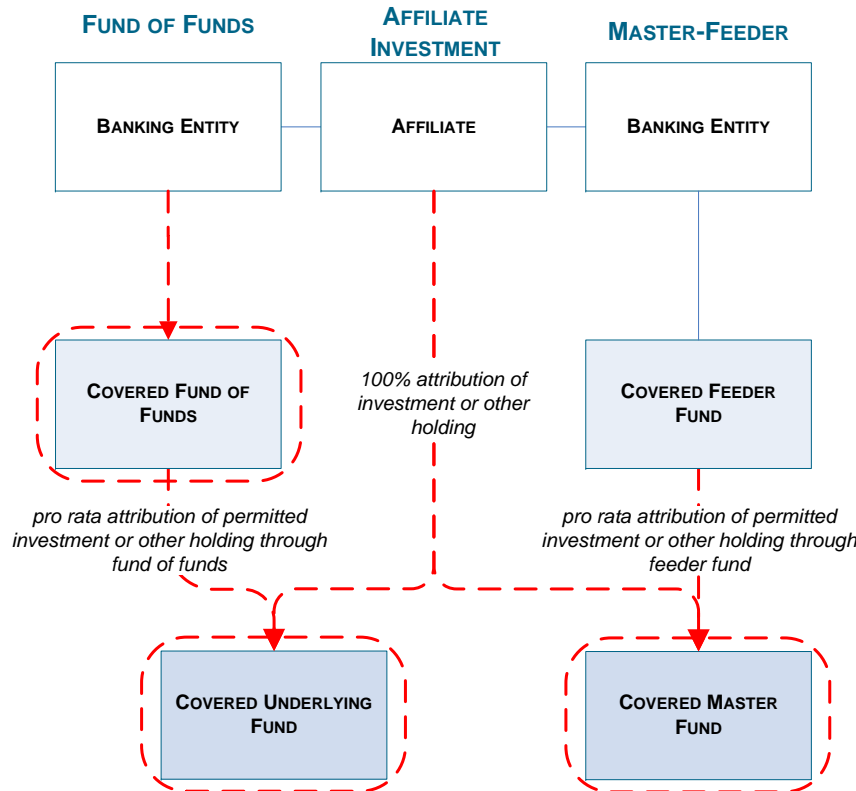
For purposes of the investment limits, ownership interests acquired or retained by a director or employee of a banking entity in a covered fund sponsored by the banking entity, **other than** ownership interests acquired and retained in connection with obtaining a restricted profit interest (carried interest), will **not** be attributed to the banking entity as long as **both** of the following conditions are satisfied:

- The director or employee acquires such ownership interests in his or her **personal capacity**
- The banking entity does **not, directly or indirectly, extend financing** for the purpose of enabling the director or employee to acquire the ownership interest in the fund **or** the financing is not used to acquire the ownership interests

In the preamble, the agencies:

- Clarified that a **guarantee** by the banking entity of the director or employee's obligations on financing obtained from a third party constitutes indirect financing by the banking entity
- Explained that so long as the investments are truly made with personal resources, and are not funded by the banking entity, they would not expose the banking entity to loss
- Stated that ownership interests **acquired and retained** by a director or employee of a banking entity in a covered fund sponsored by the banking entity in **connection with obtaining a restricted profit interest (carried interest)** will be attributed to the banking entity, **regardless** of whether the banking entity **finances** the acquisition or retention of such ownership interests
- Stated that they intend to **monitor** investments by directors and employees of banking entities to ensure that investments by directors or employees are not used by banking entities to circumvent the investment limits, and that they will consider the following factors in evaluating whether any **evasion** is taking place:
 - Whether the benefits of the acquisition and retention, such as dividends, inure to the benefit of the director or employee and not the banking entity
 - Whether the voting or control of the ownership interests is subject to the direction of, or otherwise controlled by, the banking entity
 - Whether the director or employee, rather than the banking entity, determines whether the director or employee should make the investment.

Attribution Rules — Multi-Tier Funds and Parallel Investments



FUND OF FUNDS INVESTMENTS

- If a banking entity organizes and offers a covered fund **for the purpose of investing in other covered funds (a fund of funds)**, and the fund of funds invests in **another covered fund** that the banking entity is permitted to own, then the banking entity's permitted investment in the **underlying fund** shall include both:
 - Any investment by the banking entity in the underlying fund, plus
 - The banking entity's **pro-rata share of any ownership interest** in the underlying fund that is held through the fund of funds.
- The agencies indicated in the preamble that the banking entity's investment in the fund of funds must "also meet the investment limitations contained in § __.12 of the rule text."

MASTER-FEEDER INVESTMENTS

- If the **principal investment strategy** of a covered fund (the **feeder fund**) organized and offered by a banking entity is to invest **substantially all of its assets** in another single covered fund (the **master fund**), then for purposes of the **per-fund investment limitations**, the banking entity's permitted investment in such funds shall be measured **only be reference** to the **value of the master fund**
- The banking entity's permitted investment in the **master fund** shall include both:
 - Any investment by the banking entity **in the master fund**, plus
 - The banking entity's **pro-rata share of any ownership interest** of the master fund that is held through the feeder fund.
- Although this attribution rule only applies by its terms to the per fund limit, it seems logical that it would also apply to the aggregate limit as a practical matter.

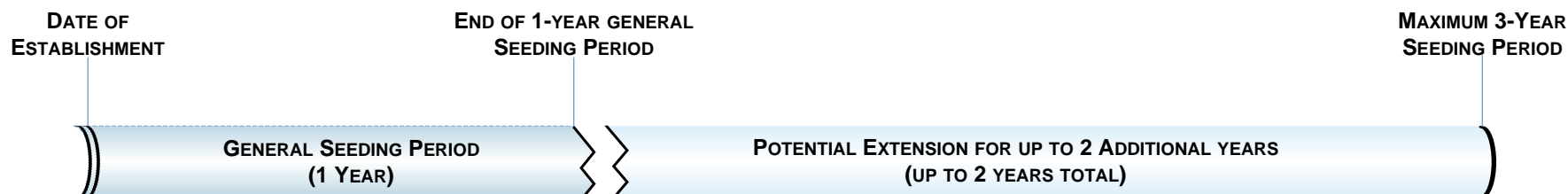
PARALLEL INVESTMENTS

The agencies explained in the preamble that they had decided not to adopt a proposed rule that would have required banking entities to aggregate a wide range of parallel investments made with covered funds to prevent evasion of the investment limits because many investments made by banking entities in the same companies as related covered funds "are made for the purpose of serving the legitimate needs of customers and shareholders, and not for the purpose of circumventing the per-fund and aggregate fund limitations in [the Volcker Rule]."

Coordinated Investments. They nevertheless warned that "the potential for evasion of these limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors." They gave three examples when coordinated investments should be aggregated for purposes of the investment limits:

- **Co-Investments with Sponsored Covered Funds.** "[I]t is relatively common for the sponsor of a covered fund . . . to offer investors co-investment opportunities when the general partner or investment manager for the covered fund determines that the covered fund does not have sufficient capital available to make the entire investment in the target portfolio company or determines that it would not be suitable for the covered fund to take the entire available investment. In such circumstances, a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund . . . unless the value of such co-investments is less than 3% of the value of the total amount co-invested by other investors in such investment."
- **Co-Investment Vehicles.** "[I]f the co-investment is made through a co-investment vehicle that is itself a covered fund (a "co-investment fund"), the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed 3% of the sum of the ownership interests held by all investors in the co-investment fund and related covered fund."
- **Pattern of Parallel Investing.** "[I]f a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund."

Subject to certain conditions, a banking entity is permitted to establish and seed a covered fund with sufficient initial equity to permit the covered fund to attract unaffiliated investors, notwithstanding the general prohibition on investing in ownership interests in covered funds or the 3% per fund investment limits



SEEDING PERIOD FOR COVERED FUNDS

A banking entity may provide a covered fund that it organizes and offers pursuant to the asset management or ABS issuer exemptions with seed equity if it:

- **Actively seeks to reduce ownership** by actively seeking unaffiliated investors to conform its investment to the 3% per fund limits
- **Conforms its investment** to the 3% per fund limits **within 1 year after the date of establishment** of the covered fund, or such longer period as the **Federal Reserve** may allow

DATE OF ESTABLISHMENT

- **In general**, the date on which the investment adviser or similar entity to the covered fund **begins making investments** pursuant to the written strategy for the fund
- For a fund organized and offered under the **ABS issuer exemption**, the date on which the assets were initially transferred into the ABS issuing entity

APPLICABLE LIMITS DURING THE SEEDING PERIOD

- A banking entity must comply with the aggregate 3% of Tier 1 capital limit during the seeding period
- **No strict dollar limit** on the amount of funds a banking entity may use to seed, organize and offer a covered fund

SEE INVESTMENT LIMITS, SLIDES 27-31

EXTENSION OF SEEDING PERIOD

- Upon application by a banking entity, the **Federal Reserve** may extend the seeding period for **up to two additional years** if it finds that an extension of time would be consistent with the safety and soundness of the banking entity and not detrimental to the public interest
- An application must:
 - Be submitted at least 90 days prior to the expiration of the seeding period
 - Provide the reasons for the application
 - Explain the banking entity's plan for reducing the permitted investment in the covered fund as required by the seeding period investment limits

FACTORS IN THE REVIEW OF THE EXTENSION OF SEEDING PERIOD

In deciding whether to grant an extension, the Federal Reserve may consider all the facts and circumstances, including all of the following:

- **High-risk assets or trading strategies**
- **Contractual terms**
- Projected compliance **timing**
- **Risks to the banking entity or financial stability**
- **Cost to the banking entity** of divesting or disposing of the investment within the applicable period
- **Conflict of interest**
- **Prior efforts** to reduce its ownership interests in the covered fund
- **Market conditions**

SEEDING REQUIREMENTS FOR RICs AND BDCs

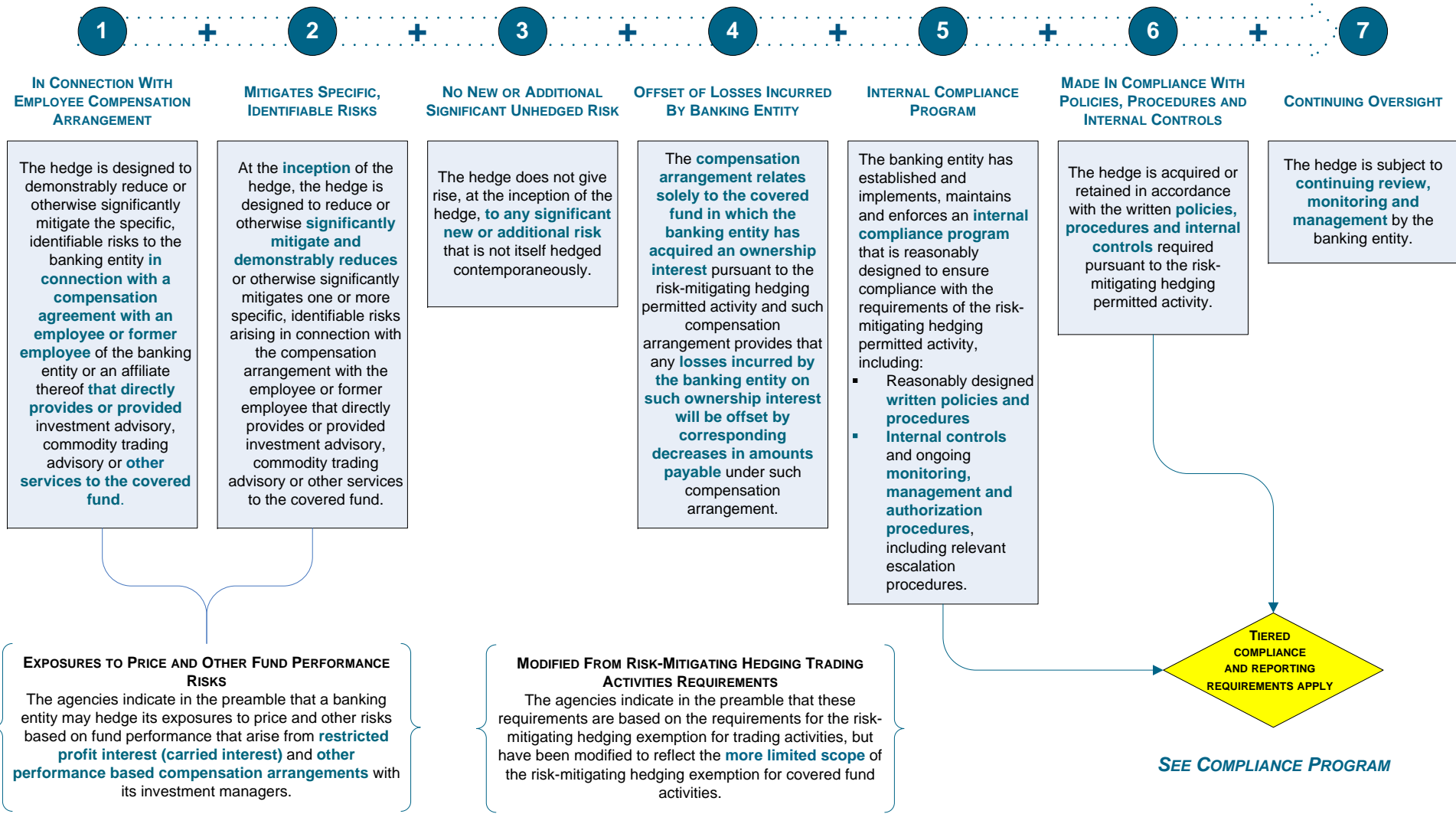
A seeding vehicle that is formed and operated **pursuant to a written plan to become a RIC or a BDC, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a RIC or BDC within the time period provided by the final rule for seeding a covered fund** and complies with the **limitations on leverage** under the 1940 Act that apply to RICs and BDCs, is **excluded from the definition of covered fund**.

A banking entity with **more than \$10 billion in consolidated assets** must maintain records with respect to such issuers that include all of the following:

- A **written plan** documenting the banking entity's determination that the seeding vehicle will become a RIC or BDC
- The **period of time** during which the vehicle will operate as a seeding vehicle
- The banking entity's **plan to market the vehicle to third-party investors** and convert it into a RIC or BDC

Risk-Mitigating Hedging of Employee Compensation

A banking entity is permitted to acquire or retain ownership interests in covered funds organized and offered or sponsored by the banking entity pursuant to the asset management or ABS issuer exemptions to hedge risks in connection with an employee compensation arrangement provided that:



Offshore Exemption: Sponsorship of or Investments in a Covered Fund by a Foreign Organized or Located Banking Entity with a Foreign Top Tier Parent

HOW TO COMPLY WITH SECTION 4(c)(9) OF THE BHC ACT FOR PURPOSES OF OFFSHORE EXEMPTION

The activity or investment is deemed to comply with the offshore exemption in the BHC Act if:

- **FBOs.** If the banking entity is an **FBO**, it meets the qualifying foreign banking organization requirements of section 211.23(a), (c) or (e) of the Federal Reserve's Regulation K.
- **Non-FBOs.** If the banking entity is **not** an FBO, then the banking entity is not organized under U.S. law and it meets **at least two** of the following tests on a fully consolidated basis:
 - Total assets held outside the U.S. exceed total assets held in the U.S.
 - Total revenues derived from the business of the banking entity outside the U.S. exceed total revenues derived from business in the U.S.
 - Total net income derived from the business of the banking entity outside the U.S. exceeds total net income derived from business in the U.S.
- The activity or investment is conducted in accordance with the requirements of the Volcker Rule regulations.

TARGET RESIDENTS OF THE U.S.

The agencies indicate in the preamble that the sponsor of a foreign fund would **not** be viewed as **"targeting"** residents of the U.S. if all of the following are true:

- It conducts an offering directed to residents of one or more countries **other than the U.S.**
- It includes in the offering materials a **prominent disclaimer** that the securities are not being offered in the U.S. or to residents of the U.S.
- It includes **other reasonable procedures** to restrict access to offering and subscription materials to persons that are not residents of the U.S.

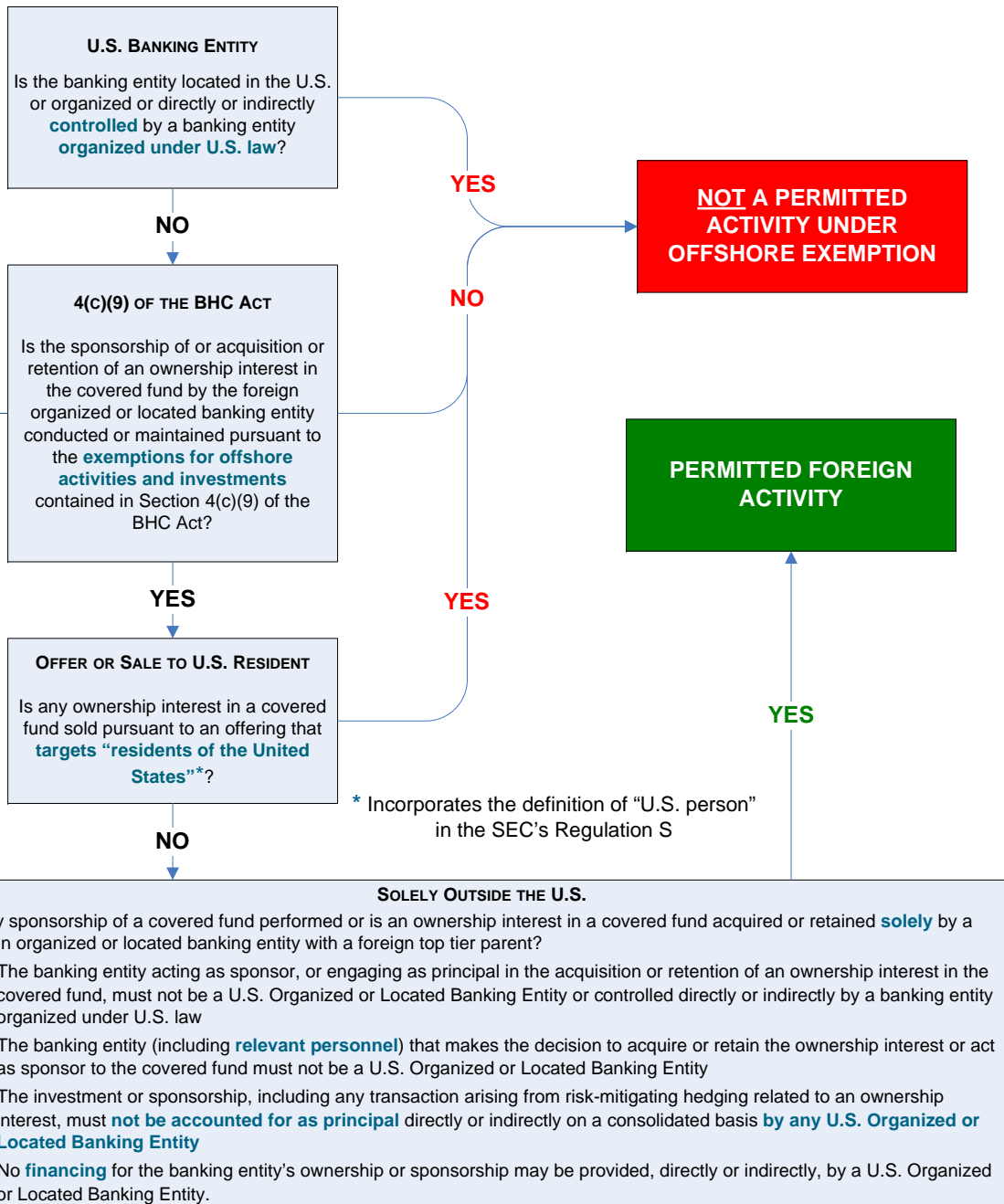
U.S. PERSONNEL

The agencies indicate in the preamble that the personnel of any U.S. Organized or Located Banking Entities with a foreign top tier parent are **permitted to act as investment adviser** to a covered fund in certain circumstances.

- For instance, such personnel may provide **investment advice** and **recommend investment selections** to the manager or general partner of a covered fund so long as that investment advisory activity in the U.S. does not result in such personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the U.S.

The agencies indicate in the preamble that such personnel may engage in **"back office" activities** in connection with one or more covered funds.

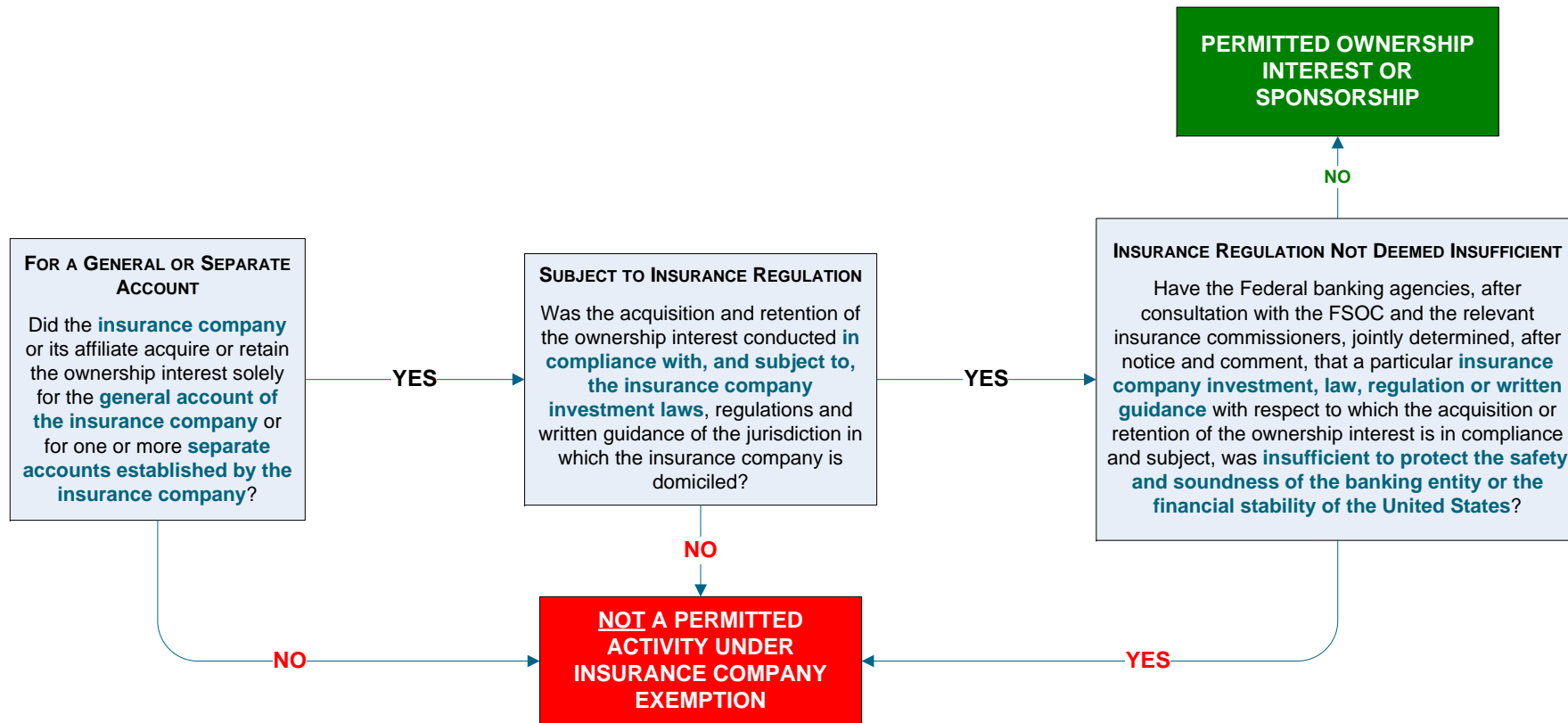
- This allows **administrative services** or similar functions to be provided by such personnel to a covered fund as an incident to activity conducted under the offshore exemption (such as clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data, or providing clerical support for the fund).



PERMITTED ACTIVITIES

Regulated Insurance Companies

An insurance company or its affiliate is permitted to acquire or retain an ownership interest in or sponsor a covered fund if the activity satisfies the following conditions:

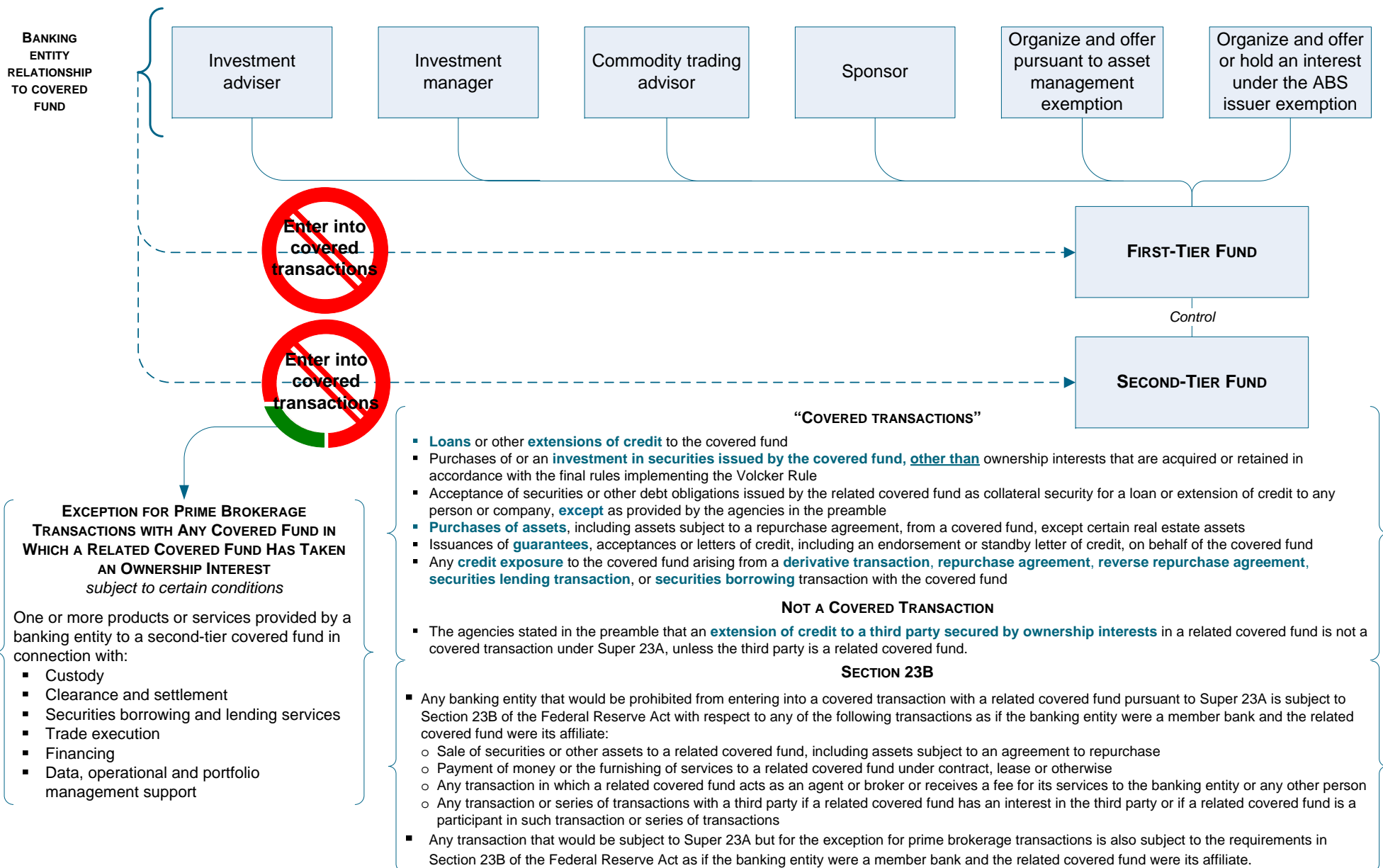


“INSURANCE COMPANY”
A company that is organized as an insurance company, is **primarily and predominantly engaged** in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the provisions of the Volcker Rule.

“GENERAL ACCOUNT”
All of the assets of an insurance company except those allocated to one or more separate accounts.

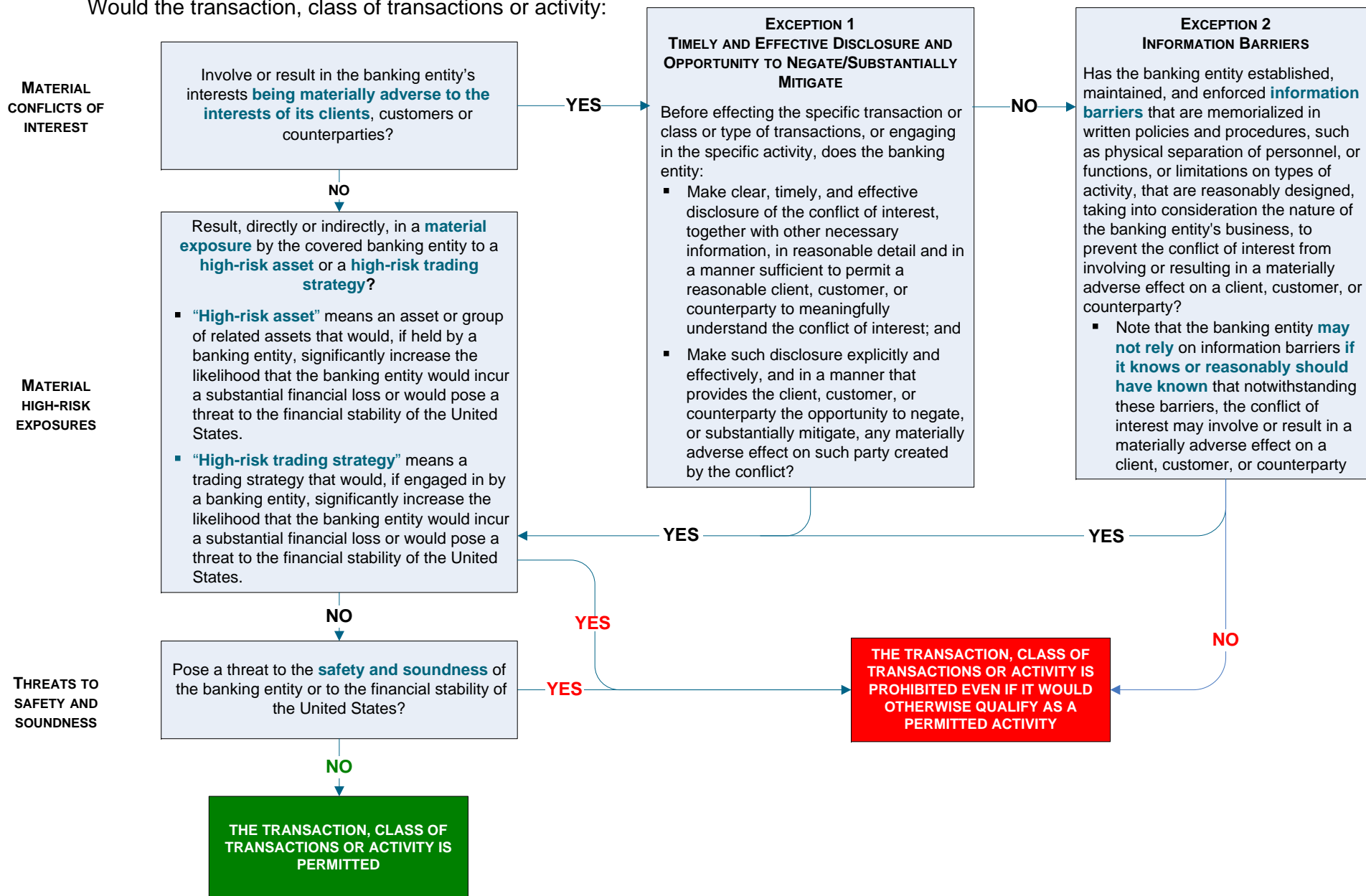
“SEPARATE ACCOUNT”
An account **established and maintained** by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company’s other assets, under which **income, gains and losses**, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

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 under the asset management or ABS issuer exemption, or that retains an ownership interest under the ABS issuer exemption, may enter into a transaction with the covered fund, or with any other covered fund controlled by such covered fund, that would be a covered transaction as defined in Section 23A of the Federal Reserve Act as if the banking entity were a member bank and the related covered fund were its affiliate



IS AN OTHERWISE PERMITTED ACTIVITY PRECLUDED BY A “BACKSTOP” PROHIBITION?

Would the transaction, class of transactions or activity:

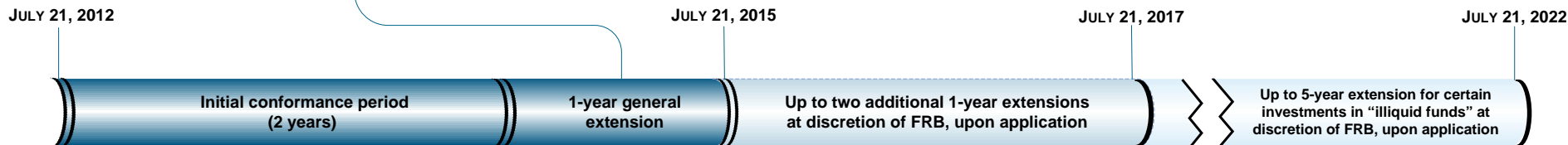


ONE-YEAR GENERAL EXTENSION UNTIL JULY 21, 2015

- Each banking entity is expected to engage in **good-faith efforts**, appropriate for its activities and investments, that will result in the conformance of all of its activities and investments to the requirements of the Volcker Rule by no later than the end of the conformance period, including:
 - Evaluating the extent to which the banking entity is engaged in covered activities
 - Implementing a conformance plan that is "appropriately specific" about how the banking entity will fully conform.
- Activities and investments should not be expanded during the conformance period with an expectation that additional time for conformance will be granted.

CONFORMANCE PERIOD GENERALLY

- Applies to all covered investments and relationships.** Initial 2-year conformance period, 1-year general extension granted upon adoption of final rule, and up to two 1-year extensions available for any activity, investment or relationship that may be prohibited or restricted by the Volcker Rule.
- Illiquid funds.** Up-to-5-year extended conformance period available only for certain investments in "illiquid funds" in existence on May 1, 2010.
- Extensions granted separately, run consecutively.** Banking entities must apply separately for each extension, at least 180 days prior to the expiration of any subsequent extension period.
- Industry-wide 1-year extension:** Uses up one of the three statutory 1-year extensions available to the Federal Reserve Board in the Dodd-Frank Act.



ESTABLISH COMPLIANCE PROGRAM BY END OF EXTENDED CONFORMANCE PERIOD

- The one-year general extension of the conformance period was intended to give markets and firms an opportunity to adjust to the prohibitions and requirements and any implementing rules.
- Each banking entity must establish the compliance program required for that entity as soon as practicable and in no case later than the end of the conformance 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 Federal Reserve believes appropriate

EXTENDED CONFORMANCE PERIOD FOR CERTAIN INVESTMENTS IN "ILLIQUID FUNDS"

- Basic eligibility criteria:** In order for a banking entity to be eligible for the up-to-5 year 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 either:
 - 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, or
 - 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.

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.

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