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

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

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

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

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**Step 1**
Is a banking entity:
- **Yes:** Proceed to Step 2.
- **No:** Proceed to Step 3.

**Step 3**
Entering into a “covered transaction” with a related covered fund or a covered fund controlled by such related fund?
- **Yes:** Proceed to Step 2.
- **No:** Proceed to Step 4.

**Step 2**
Is the activity a permitted activity under the Volcker Rule?
- **Yes:** Proceed to Step 5.
- **No:** Activity is not within the scope of the Volcker Rule.

**Step 4**
Is it a prime brokerage transaction with a covered fund in which the related covered fund has made a controlling investment?
- **Yes:** Proceed to Step 5.
- **No:** Proceed to Step 3.

**Step 5**
Is the activity precluded by a backstop prohibition?
- **Yes:** Activity is prohibited under the Volcker Rule.
- **No:** Activity is permitted under the Volcker Rule.

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Is a “banking entity” engaged in any of the following activities:

**Step 1**
- Acquiring or retaining “as principal” an *ownership interest* in a “covered fund”?
- Acting as “sponsor” of a covered fund?

**PERMITTED ACTIVITIES**
Is the activity a “permitted activity” under the Volcker Rule?
- Asset management
- Risk-mitigating hedging
- Foreign activity by foreign banking entity
- Loan securitization
- SBIC or related investment
- Joint venture
- Acquisition vehicle
- Wholly-owned subsidiary engaged in liquidity management
- ABS issuer
- BOLI / COLI separate account

**ACTIVITY IS NOT WITHIN THE SCOPE OF THE VOLCKER RULE**

**ACTIVITY IS PROHIBITED UNDER THE VOLCKER RULE**

**Step 2**
- Entering into a “covered transaction” with a related covered fund or a covered fund controlled by such related fund?

**PRIME BROKERAGE EXCEPTION**
Is the covered transaction a “prime brokerage transaction” with a covered fund in which the related covered fund has made a controlling investment?

**ACTIVITY IS PERMITTED UNDER THE VOLCKER RULE**

**Step 3**
- Material conflict of interest between the banking entity and its clients, customers or counterparties?
- Material exposure of the banking entity to high-risk assets or trading strategies?
- Threat to the safety and soundness of the banking entity or the U.S. financial stability?

**Step 4**
- Tiered compliance program and reporting requirements apply

**Step 5**
- Activity is permitted under the Volcker Rule
Step 1: What is a “Banking Entity”?

Is the entity:

An insured depository institution?

Yes

A company that controls an insured depository institution (e.g., a bank holding company)?

No

A company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act?

No

An affiliate or subsidiary (as defined in the Bank Holding Company Act) of any of the above?

No

Does the insured depository institution function solely in a trust or fiduciary capacity?

- Substantially all of its deposits are in trust funds and are received in a bona fide fiduciary capacity
- None of its insured deposits are offered or marketed by or through an affiliate of the institution
- The institution does not
  - Accept demand deposits or deposits that can be withdrawn by check or similar means for payment to third parties or others or make commercial loans
  - Obtain payment or payment related services from any Federal Reserve bank
  - Exercise Federal Reserve discount or borrowing privileges

Yes

Is the affiliate or subsidiary:

- A covered fund that is organized, offered and held by a banking entity pursuant to the asset management exemption and in accordance with the Volcker Rule’s compliance program requirements?
- An entity controlled by such a covered fund?
- An SEC-registered mutual fund that the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages in accordance with BHC Act rules?

Yes

Not a Banking Entity

BANKING ENTITY

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Step 1: What is a “Covered Fund”?

Is an entity:

**GENERAL DEFINITION**
An issuer that would be an investment company as defined in the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act?

**COMMODITY POOL**
A commodity pool as defined in section 1a(10) of the Commodity Exchange Act?

**CERTAIN FOREIGN FUNDS**
A foreign fund that would be a covered fund if organized and offered under the laws, or offered to a resident, of the U.S.?

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**GENERAL DEFINITION IS A “BUT FOR” TEST**

- An entity that may rely on any exemption from the definition of “investment company” under the Investment Company Act other than sections 3(c)(1) or 3(c)(7) is not a covered fund unless it is also a commodity pool or a foreign fund described above.

- For example, an entity that may rely on the exemption under section 3(c)(3) of the Investment Company Act for common trust funds maintained by a bank exclusively for the collective investment of qualified assets would not fall within the general definition of covered fund.

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Step 1: What is an “Ownership Interest”?

**AN EQUITY, PARTNERSHIP OR OTHER SIMILAR INTEREST**

Is the interest an equity, partnership, or other similar interest in a covered fund, including a:
- Share
- Equity security
- Warrant
- Option
- General partnership interest
- Limited partner interest
- Membership interest
- Trust certificate
- Other similar instrument in a covered fund, whether voting or nonvoting, or
- Any derivative of such interest?

**AN EQUITY-LIKE DEBT OR OTHER SECURITY**

Is the interest in a covered fund a debt security or other interest that exhibits substantially the same characteristics as an equity or other ownership interest in the covered fund, such as:
- Voting rights
- The right or ability to share in the covered fund’s profits or losses
- The ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund’s underlying holdings or investments?

**EXCLUDED CARRIED INTEREST**

Is the interest held by a banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which the banking entity serves as investment manager, investment adviser or commodity trading adviser and:
- The sole purpose and effect of the interest is to allow the banking entity to share in the profits of the covered fund as performance compensation for services provided to the covered fund by the banking entity, provided that the banking entity may be obligated under the terms of such interest to return profits previously received
- All such profit, once allocated, is distributed to the banking entity promptly after being earned or, if not so distributed, the reinvested profit of the banking entity does not share in the subsequent profits and losses of the covered fund
- The banking entity does not provide funds to the covered fund in connection with acquiring or retaining this interest; and
- The interest is not transferable except to another affiliate or subsidiary of the banking entity?

**NOT AN OWNERSHIP INTEREST**

**OWNERSHIP INTEREST**
Step 1: When is the Acquisition or Retention of an Ownership Interest in a Covered Fund Not the Acquisition or Retention of such Interest by a Banking Entity “As Principal”?

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

- By a banking entity in good faith in a fiduciary capacity, (except where held under a trust that constitutes a company under the Bank Holding Company Act)?
  
  NO

- By a banking entity in good faith in its capacity as a custodian, broker, or agent for an unaffiliated third party?
  
  NO

- By a “qualified plan,” as defined in the Internal Revenue Code under which the ownership interest is attributed to a banking entity solely by operation of section 2(g)(2) of the Bank Holding Company Act?
  
  NO

- By a director or employee of a banking entity who:
  - Is directly engaged in providing advisory or other services to the covered fund, and
  - Is acquiring the interest in his or her personal capacity without use of credit extended by the banking entity for the purpose of enabling the acquisition?
  
  YES

Ownership interest not acquired or retained by the banking entity “As Principal”, so not prohibited by the Volcker Rule

Go to Step 2 for analysis of whether the acquisition or retention of the ownership interest falls within a permitted activity.

Ownership interest is acquired or retained by the banking entity “As Principal”, the Volcker rule applies

* Note: “As principal” is not defined in the rule text. The examples above, identified in the preamble, are not exclusive.
Step 1: What is a “Sponsor”? 

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

- Serve as general partner?
  - NO

- Serve as managing member?
  - NO

- Serve as commodity pool operator?
  - NO

- In any manner select or control (or have employees, officers, directors or agents who constitute) a majority of directors, trustees or management?
  - NO

- Share with the covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name?
  - NO

- Serve as trustee?
  - YES
    - Is the trustee a “directed trustee” under ERISA, or do its activities otherwise exclude the exercise of investment discretion with respect to the covered fund?
      - NO
        - THE BANKING ENTITY IS NOT THE SPONSOR OF THE COVERED FUND
      - YES
        - NO TO ALL QUESTIONS
        - THE BANKING ENTITY IS THE SPONSOR OF THE COVERED FUND
A banking entity may organize and offer, including serving as sponsor or commodity pool operator to, a covered fund if:

1. The banking entity provides bona fide trust, fiduciary, investment advisory or commodity trading advisory services
2. 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
3. The banking entity does not acquire or retain an ownership interest in the covered fund other than a de minimis investment
4. The banking entity complies with the Volcker Rule’s Super 23A restrictions and 23B restrictions
5. The banking entity does 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. 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 (including an affiliate or subsidiary thereof), and does not use the word “bank” in its name
7. Only directors or employees of the banking entity directly engaged in providing investment advisory or other services to the covered fund may invest in the covered fund
8. The banking entity clearly and conspicuously makes certain written disclosures to any prospective and actual investor in the covered fund

SUPER 23A

- No banking entity that serves, directly or indirectly, as investment adviser, investment manager, sponsor, commodity trading advisor to, or that organizes and offers pursuant to the asset management exemption, a covered fund may enter into a “covered transaction” under Section 23A of the Federal Reserve Act with such fund, or any covered fund controlled by such fund (subject to an exemption in the latter case for prime brokerage transactions)

DE MINIMIS CO-INVESTMENT LIMITS

- Per fund limit: 3% of total ownership interests of banking entity in the covered fund (greater of number or value of ownership interests), within 1 year after establishment (subject to possible extension)
- Aggregate limit: The value of all ownership interests in covered funds may not exceed 3% of the banking entity’s Tier 1 capital
- Seeding period: The banking entity’s investment in a covered fund may represent 100% of the total amount or value of the ownership interests of a covered fund for up to one year after the date of establishment of the covered fund (subject to possible extension for up to 2 additional years at the discretion of the Federal Reserve) so long as the banking entity actively seeks unaffiliated investors to reduce through redemption, sale, dilution or other methods the aggregate amount of its ownership interests in the covered fund to 3% of the total amount or value of such ownership interests

CUSTOMERS

- Includes existing and new customers, but the banking entity must have a “credible plan or similar documentation” outlining how the covered banking entity intends to provide advisory or similar services to its customers through organizing and offering the fund

REQUIRED DISCLOSURES

- Any losses in the covered fund will be borne solely by investors and not by the banking entity or its affiliates (therefore the banking entity’s losses will be limited to losses attributable to the ownership interests in the covered fund held by the banking entity or its affiliates held in their capacity as investors)
- The prospective or actual investor should read the fund offering documents before investing
- 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 (if true)
- The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund

Go to Step 3 / 4 for analysis of whether the Super 23A restriction applies
Go to Steps 2B and C for analysis of 3% de minimis limits
**Step 2B:**
Permitted Activities: Asset Management *(cont.)*
Calculation of Per Fund 3% *De Minimis* Limit

**Covered banking entity** that organizes and offers, or sponsors, a covered fund

**Affiliate**

**Affiliate**

**Affiliate**

**Affiliate**

**Controlled entity** *(Affiliate)*

**Non-controlled entity**

**Non-controlled interest**

**≤ 5% voting shares**

**≥ 5% voting shares**

**Portfolio company**

**Portfolio company**

**Portfolio company**

**Entire ownership interest** held directly by the banking entity

**Entire ownership interest** held by any affiliate of the banking entity

**The pro rata share** of any ownership interest in the covered fund held by any entity that is not controlled by the banking entity but in which the banking entity owns more than 5% of the voting shares

**Entire ownership interest** in a portfolio company held by an affiliate of the banking entity that is contractually obligated to invest in, or is found to be acting in concert through knowing participation in joint activity or parallel action toward a common goal of investing in, such portfolio company or other investments with the covered fund

**CAlCULATION METHOD**

The greater of:

- The value of the banking entity's investment or capital contribution (not capital commitment) in the covered fund divided by the value of all investments or capital contributions made by all persons in the covered fund

- The total number of ownership interests in the covered fund held by the banking entity divided by the total number of ownership interests held by all persons in the covered fund

**TIMING OF CALCULATION**

- A banking entity must calculate the value or per fund limitation no less frequently than the covered fund performs such calculation or issues or redeems interests and at least quarterly

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Step 2C: Permitted Activities: Asset Management (cont.)

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

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

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

Note: all references are to U.S. entities — presumably, any Tier 1 capital calculations required by foreign institutions will be based on home country standards, but the proposed rules do not expressly address this issue.
Step 2D:
Permitted Activities: Risk-Mitigating Hedging

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

1. Is made in connection with and related to individual or aggregated obligations or liabilities of the covered banking entity that are:
   - Taken by the covered banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, OR
   - Directly connected to a compensation arrangement for an employee who directly provides investment advisory or other services to the covered fund

2. Is designed to reduce the specific risks to the covered banking entity in connection with and related to such obligations or liabilities

3. Is made in accordance with the written policies, procedures and internal controls established by the covered banking entity required pursuant to the rules

4. Hedges or otherwise mitigates an exposure to a covered fund through an offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that:
   - Arises out of a transaction conducted solely to accommodate a specific customer request with respect to that covered fund, OR
   - Is directly connected to a compensation arrangement with an employee that directly provides investment advisory or other services to that covered fund

5. Does not give rise, at the inception of the hedge, to significant exposures that were not already present in individual or aggregated positions, contracts, or other holdings of a covered banking entity and that are not hedged contemporaneously

6. Is subject to continuing review, monitoring and management by the covered banking entity

7. Is performed by persons whose compensation arrangements are designed not to reward proprietary risk-taking

8. Is performed by persons whose compensation arrangements are designed not to reward proprietary risk-taking

Review, monitoring and management must:

- Be consistent with the covered banking entity’s written hedging policies and procedures
- Maintain a substantially similar offsetting exposure to the same amount and type of ownership interest, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate
- Mitigate any significant exposure arising out of the hedge after inception

Tiered compliance and reporting requirements apply

- Must include reasonably designed written policies and procedures regarding the instruments, techniques and strategies that may be used for hedging, internal controls and monitoring procedures, and independent testing

Go to Appendix C for additional information on the compliance program

Is documented by the covered banking entity at the time the transaction is conducted including:

- The risk-mitigating purpose of the acquisition or retention of an ownership interest in a covered fund
- The risks of the individual or aggregated obligation or liability of a covered banking entity that the acquisition or retention of an ownership interest in a covered fund is designed to reduce
- The level of organization that is establishing the hedge
Step 2E: Permitted Activities: Foreign Activities by Foreign Banking Entities

**FOREIGN BANKING ENTITY**
Is the banking entity directly or indirectly controlled by a banking entity organized under U.S. law?

**FOREIGN BANKING ORGANIZATIONS (FBOs)**
If the banking entity is an FBO, is it a “qualifying” FBO, and conducting the activity in compliance with subpart B of the Federal Reserve’s Regulation K?

**NON-FBOs**
If the banking entity is not an FBO, does it meet at least two of the following tests?

- Total assets held outside the U.S. exceed total assets held in the U.S.
- Total revenues derived from business outside the U.S. exceed total revenues derived from business in the U.S.
- Total net income derived from business outside the U.S. exceeds total net income derived from business in the U.S.

**OFFER OR SALE TO U.S. RESIDENT**
Is any ownership interest in the covered fund offered for sale or sold to a “resident of the United States”?

**SOLELY OUTSIDE THE U.S.**
Does the activity occur solely outside the U.S.?

- No subsidiary or affiliate of the banking entity involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the U.S.
- No employee of the banking entity involved in the offer or sale of an ownership interest in the covered fund is physically located in the U.S. See note below

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

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

- Includes discretionary accounts held for a U.S. person by a non-U.S. dealer or fiduciary
- Omits exclusions, including for:
  - Offshore branches or agencies of U.S. entities
  - Discretionary accounts held for a non-U.S. person by a U.S. dealer or fiduciary
Step 2F:
Permitted Activities: Loan Securitizations

Is the covered fund an issuer of asset-backed securities?

Are the assets or holdings of the covered fund solely comprised of:

- **LOANS**
  - Includes any:
    - Loan
    - Lease
    - Extension of credit, or
    - Secured or unsecured receivable

- **CERTAIN CONTRACTUAL RIGHTS OR ASSETS**
  - Contractual rights or assets directly arising from those loans supporting the asset-backed securities

- **DERIVATIVES**
  - Interest rate or foreign exchange derivatives:
    - That materially relate to the terms of such loans or contractual rights or assets;
    - Are used for hedging purposes with respect to the securitization structure;
    - The notional amount of which is tied to the outstanding principal balance of loans supporting the asset-backed securities (individually or in the aggregate); and
    - Are used solely to hedge risks resulting from a mismatch between loans and related asset-backed securities (e.g., fixed rate loans with floating rate asset-backed securities)

NO SYNTHETIC OR DERIVATIVE SECURITIZATIONS OR CREDIT DEFAULT SWAPS

- The preamble states that the types of derivatives permitted are not meant to include synthetic securitizations or securitizations of derivatives
- Issuer may not use credit default swaps

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Step 2G: Permitted Activities: SBICs and Related Investments

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

- **Small Business Investment Companies (SBICs)**
  - A small business investment company as defined in section 102 of the Small Business Investment Act of 1958?
  
- **Public Welfare Investments**
  - An investment that is designed primarily to promote the public welfare as defined under paragraph (11) of section 5136 of the Revised Statutes of the United States
    - Includes investments in the welfare of low- and moderate-income communities or families, such as providing housing, services, or jobs
  
- **Qualified Rehabilitation Expenditures**
  - An investment that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code or a similar state historic tax credit program
  
**Permitted Activity**

**Not a Permitted SBIC or Related Investment**
Step 2H:
Permitted Activities: Investing in, or Sponsoring of, Certain Types of Vehicles

Is the acquisition or retention of an ownership interest in, or sponsorship of, the covered fund with respect to any of the following activities?

JOINT VENTURES
A joint venture that:
- Is an operating company and
- Does not engage in any activity or make any investment prohibited under the Volcker Rule

ACQUISITION VEHICLES
An acquisition vehicle whose sole purpose and effect is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates

WHOLLY-OWNED SUBSIDIARIES
A wholly-owned subsidiary that is:
- Engaged principally in providing liquidity management services; and
- Carried on the balance sheet of the banking entity

ABS ISSUER
An issuer of ABS and the banking entity’s ownership interest is limited to the amount or value of economic interest in a portion of the credit risk for an ABS retained by the banking entity as “securitizer” or “originator”

BOLI / COLI SEPARATE ACCOUNTS
Is it a separate account used solely for the purpose of allowing a banking entity to purchase an insurance policy for which the covered banking entity is the beneficiary, where the banking entity that purchases the insurance policy:
- Does not control the investment decisions regarding the underlying assets or holdings of the separate account; and
- Holds its ownership interest in the separate account in compliance with applicable supervisory guidance

Other permitted activities may apply.

NOT ONE OF THE PERMITTED ACTIVITIES SHOWN ON THIS PAGE

PERMITTED ACTIVITY

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Step 3 / Step 4:
Do the “Super 23A” Restrictions Apply?

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

**SECTION 23B**
- A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund, or that organizes and offers a covered fund pursuant to the asset management exemption, is also subject to section 23B of the Federal Reserve Act with respect to certain transactions with the covered fund.

**“COVERED TRANSACTIONS”**
- Loans or other extensions of credit to the covered fund.
- Purchases of or an investment in securities issued by the covered fund other than ownership interests that are acquired or retained in accordance with the proposed rules.
- Purchases of assets, including assets subject to a repurchase agreement, from a covered fund, except certain real estate assets.
- Acceptance of securities issued by the covered fund as collateral security for a loan or extension of credit to any person or company.
- Issuances of guarantees, acceptances or letters of credit, including an endorsement or standby letter of credit, on behalf of the covered fund.

After July 21, 2012, will also include:
- Any credit exposure to the covered fund arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction with the covered fund.

**EXCEPTION FOR PRIME BROKERAGE TRANSACTIONS**
subject to certain conditions

One or more products or services provided by a banking entity to a covered fund, such as:
- Custody
- Clearance
- Securities borrowing and lending services
- Trade execution
- Financing, data, operational and portfolio management support

Prohibition extends to any affiliate of the banking entity

Control
E.g., Covered Fund 1 holds more than 25% of a class of voting securities of Covered Fund 2

Covered Fund 1

Covered Fund 2

Organize and offer pursuant to asset management exemption

Investment adviser

Investment manager

Commodity trading advisor

Sponsor
Would the transaction, class of transactions or activity:

**Involve or result in the banking entity’s interests being materially adverse to the interests of its clients, customers or counterparties?**

- YES
- NO

**Result, directly or indirectly, in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy?**

- YES
- NO

- "High-risk asset" means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail

- "High-risk trading strategy" means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail

**Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States?**

- YES
- NO

**THE TRANSACTION, CLASS OF TRANSACTIONS OR ACTIVITY IS PROHIBITED EVEN IF IT WOULD OTHERWISE QUALIFY AS A PERMITTED ACTIVITY**

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**EXCEPTION 1**

**TIMELY AND EFFECTIVE DISCLOSURE AND OPPORTUNITY TO NEGATE/SUBSTANTIALLY MITIGATE**

Before effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise, does the banking entity:

- Make clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and

- Make such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on such party created by the conflict?

**EXCEPTION 2**

**INFORMATION BARRIERS**

Has the banking entity established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity’s business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty?

Note that the banking entity may not rely on information barriers if it knows or reasonably should know that notwithstanding, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.
**FACTORS FOR GRANTING OF EXTENSIONS BY FEDERAL RESERVE**

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

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

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**Initial Conformance Period**

(2 years)

**Up to three 1-year extensions**

(3 years total)

**Extension for certain investments in “illiquid funds”**

(5 years total)

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**Effective Date:**

JULY 21, 2012

**Upon Effective Date:**

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

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**Extended Transition Period for Certain Investments in “Illiquid Funds”**

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

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JULY 21, 2014

Date by which prohibited activities must be conformed or terminated

JULY 21, 2017

Date by which prohibited activities granted all three 1-year extensions must be conformed or terminated

JULY 21, 2022

Date by which investments in illiquid funds granted the full 5-year extension must be conformed or divested.
Does the banking entity engage in activities or investments within the scope of the Volcker Rule, whether or not permitted? See Step 1 of the Volcker Rule covered funds flowcharts for further detail.

**Preventive program required**

**Basic compliance program required**

- Internal written policies/procedures reasonably designed to document, describe and monitor any banking entity activities with respect to covered funds in order to ensure that such activities and investments comply with the statute and implementing rules.
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance and prevent the occurrence of prohibited activities or investments.
- A management framework that clearly delineates responsibility and accountability for compliance.
- Independent testing, conducted by qualified banking entity personnel or a qualified outside party, of program effectiveness.
- Training for appropriate personnel and managers to effectively implement and enforce the program.
- Maintenance of records sufficient to demonstrate compliance with the Volcker Rule statute and implementing rules, retained for at least 5 years and provided to regulators upon request.

Additional program requirements may apply; see below.

**Additional program requirements**

Does the banking entity invest in, or have relationships with, covered funds, and either:

- Have, together with affiliates and subsidiaries, aggregate investments in one or more covered funds with an average value (measured as of the last day of each of the four prior calendar quarters) of at least $1 billion; or
- Sponsor and advise one or more covered funds which, together with affiliates and subsidiaries, have an average value (measured as of the last day of each of the four prior calendar quarters) of at least $1 billion?

**Additional funds-specific program required**

In addition to the basic compliance program requirements above, must satisfy the requirements of Appendix C with respect to covered fund activities or investments. See the following slide and Appendix C for details.

**No further compliance requirements apply beyond the basic compliance requirements above**
If Appendix C applies, what are the additional program requirements?

**Asset Management Unit**
Program requirements apply at the “asset management unit” level, which includes:
- Any unit of organization of a banking entity that makes investments in, or acts as sponsor to, covered funds, or has relationships with covered funds, that the banking entity (or an affiliate or subsidiary thereof) has sponsored, organized and offered, or in which such a covered fund invests.

**Internal Policies and Procedures**
- Identification of covered funds
- Identification of asset management units and organization structure
- Description of sponsorship activities related to covered funds
- Description of investment activities of covered funds
- Remediation of violations

**Training**
- For managers and other appropriate personnel as determined by the banking entity
- May be conducted internally or by appropriate independent parties

**Recordkeeping**
- Must be sufficient to demonstrate compliance and support compliance program effectiveness
- Must be kept for a 5-year period and produced to regulators promptly upon request

**Internal Controls**
- Monitoring investments in covered funds
- Monitoring relationships with covered funds
- Surveillance of compliance program effectiveness

**Independent Testing**
- Must test overall program adequacy and effectiveness
- At a frequency appropriate to size, scope and risk profile, and at least once every 12 months
- Testing must be conducted by a “qualified independent party” which may be internal or external
- Appropriate action must be taken to remedy concerns identified, including remedying deficiencies in policies/procedures

**Responsibility and Accountability**
- Must have an appropriate management framework
- Board and CEO must review and approve
- Program must be written, approved by the Board, and noted in the minutes
- Written procedures addressing the management of the activities of the banking entity to achieve compliance must be in place
- Business line managers are accountable for program implementation/effectiveness.
- Board and CEO must set a culture of compliance and establish clear policies regarding the compliant management of covered fund activities or investments

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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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</tr>
</tbody>
</table>
### Asset Management Unit

Each organizational unit of a banking entity that either:
- Makes investments in or sponsors covered funds
- Has relationships with covered funds that the banking entity (or an affiliate or subsidiary) has sponsored, organized and offered or in which a covered fund sponsored or advised by the banking entity invests.

### Covered Fund Activity or Investment

- Sponsoring a covered fund
- Making investments in a covered fund or
- Otherwise having relationships with a covered fund for which the banking entity (or an affiliate or subsidiary thereof) acts as sponsor or organizes and offers
## General—Enhanced Compliance Program Requirements

A banking entity is subject to enhanced program requirements if, together with its affiliates and subsidiaries, it:

- Has aggregate investments in covered funds the average value of which is, measured as of the last day of each of the four prior calendar quarters, at least $1 billion; or
- Sponsors or advises one or more covered funds the average total assets of which are, measured as of the last day of each of the four prior calendar quarters, at least $1 billion

Such banking entity must establish, maintain and enforce written policies and procedures reasonably designed to document, describe and monitor the banking entity’s covered fund activities or investments and the risks taken in these activities or investments.

## Identification of Covered Funds

Written policies and procedures must specify how the banking entity identifies covered funds that it sponsors, organizes and offers, or in which the covered banking entity invests.

## Identification of Asset Management Units and Organization Structure

Written policies and procedures must identify and document each asset management unit and map each asset management unit to the division, business line, or other organizational structure that the banking entity uses to manage or oversee the asset management unit’s activities.

## Description of Sponsorship Activities and

Written policies and procedures for each asset management unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., the business model for generating revenues) of the asset management unit related to its sponsorship or organizing and offering of covered funds.
### Description of Sponsorship Activities

Written policies and procedures must include a description of:

- The activities that the asset management unit is authorized to conduct, including the nature of any trust, fiduciary, investment advisory, or commodity trading advisory services offered to customers of the banking entity.
- The types of customers to whom the asset management unit provides such services and to whom ownership interest in covered funds are sold.
- The extent of any co-investment activities of the banking entity (including its directors or employees) in covered funds offered to such customers, and
- How the asset management unit complies with the requirements of the prohibitions on acquiring or retaining an ownership interest in, and having certain relationships with, a covered fund.

### Description of Investment Activities of Covered Funds

Written policies and procedures for each asset management unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., the business model for the generation of revenues) of the asset management unit related to its investments in covered funds, including in particular:

- The asset management unit’s practices with respect to seed capital investments in covered funds, including how the asset management unit reduces its investments in covered funds to amounts that are permitted *de minimis* investments within the required period of time.
### Description of Investment Activities of Covered Funds (cont.)

- The asset management unit’s practices with respect to co-investments in covered funds, including certain parallel investments attributable to the banking entity related to the asset management unit
- How the asset management unit complies with the *de minimis* requirements with respect to individual and aggregate investments in covered funds
- With respect to other permitted covered fund activities or investments, how the asset management unit complies with the requirements for permitted activities
- How the asset management unit complies with the limitations on relationships with covered funds
- How the banking entity monitors for and prohibits potential or actual:
  - Conflicts of interest between the banking entity and its clients, customers, or counterparties related to the asset management unit
  - Transactions or activities that may threaten the safety and soundness of the banking entity related to the asset management unit
  - Material exposure to high-risk assets or high-risk trading strategies presented by each asset management unit

### Remediation of Violations

Written policies and procedures must require the banking entity to promptly document, address and remedy any violation of the Volcker Rule statute or implementing rules and document actual remediation efforts and include procedures designed to implement, monitor, and enforce required remediation and assess the extent to which a violation indicates that a modification to the compliance program is warranted.
## General

Must establish, maintain and enforce written internal controls:

- Reasonably designed to ensure that the covered funds activities or investments of each asset management unit are appropriate and consistent with the description of the unit’s mission, strategy and risk management process.

- At a minimum, designed to ensure that the banking entity complies with the requirements of the asset management exemption with respect to any covered fund in which it invests, for which it acts as sponsor, or which it organizes and offers.

## Monitoring Investments in a Covered Fund

Must implement and enforce internal controls in a way that monitors and limits the banking entity’s individual and aggregate investments in covered funds. At a minimum, controls must be reasonably designed to ensure that such investments are in compliance with the Volcker Rule statute and implementing rules, including:

- Monitoring the amount and timing of seed capital investments for compliance with the *de minimis* investment limitations.

- Calculating the individual and aggregate levels of ownership interests in covered funds under the *de minimis* investment limitations.

- Describing procedures for remedying violations of the Volcker Rule implementing rules.

- Attributing the appropriate instruments to the individual and aggregate ownership interest calculations under the *de minimis* investment limitations.

- Making the required disclosures, in writing, to prospective and actual investors in any covered fund organized and offered or sponsored by the banking entity pursuant to the asset management exemption.
## Monitoring Relationships with a Covered Fund

The banking entity must implement and enforce internal controls in a way that monitors and limits the banking entity’s sponsorship of, and relationships with, covered funds. At a minimum, the banking entity must establish, maintain, and enforce internal controls reasonably designed to ensure that covered fund activities and relationships are in compliance with the Volcker Rule statute and the implementing rules, including monitoring for and preventing any relationship or transaction between the banking entity and a covered fund that is prohibited under the “Super 23A” or 23B provisions of the implementing rules.

## Surveillance of Program Effectiveness

The banking entity must regularly monitor the effectiveness of its program and take prompt action to address and remedy any deficiencies identified.

- Any remedial action taken must be documented and maintained as a record by the banking entity
### General

Must have an appropriate management framework reasonably designed to ensure that:

- Appropriate personnel are responsible and accountable for effective implementation and enforcement
- A clear reporting line and chain of responsibility are delineated
- The board of directors (or similar body) and CEO reviews and approves the program

### Corporate Governance

The banking entity must ensure that its compliance program is reduced to writing, approved by the Board of Directors or similar corporate body, and noted in the minutes.

### Management Procedures and Written Procedures

Must establish, maintain, and enforce procedures reasonably designed to achieve compliance with the Volcker Rule statute and implementing rules.

### Business Line Managers

Managers with responsibility for one or more asset management units engaged in covered fund activities or investments are accountable for the effective implementation and enforcement with respect to the asset management unit.

### Senior Management

Senior management must ensure that effective corrective action is taken when violations of the Volcker Rule implementing rules are identified.

- May include divestiture of the position, cessation of the activity or disciplinary measures.
### Senior Management (cont.)
- Senior management and Volcker Rule control personnel should report to the Board of Directors (or an appropriate Board committee) on the effectiveness of compliance at least once every 12 months, and with a frequency appropriate to the size, scope and risk profile of covered activities.

### Board of Directors (or Similar Body) and CEO
- The Board of Directors (or a similar body) and the CEO are responsible for setting an appropriate culture of compliance with the implementing rules and establishing clear policies regarding the management of covered fund activities or investments in compliance with the Volcker Rule implementing rules.

- Board or similar body must ensure that senior management is fully capable, qualified and properly motivated to manage compliance, in light of the organization’s business activities.
  - Must also ensure that senior management has established appropriate incentives to support compliance, including the implementation of the compliance program into management goals and compensation structures across the banking entity.
| What Independent Testing Must Evaluate | Overall adequacy and effectiveness, including analysis of the extent to which the program meets all requirements specified in the interagency proposal.  
Effectiveness of written policies and procedures  
Effectiveness of internal controls  
  - Must include an analysis and documentation of instances in which internal controls were breached, including how the breaches were addressed and resolved  
Effectiveness of management procedures |
<p>| Who May Conduct Independent Testing | A “qualified independent party” such as an internal audit department, outside auditors, consultants or others. |
| Frequency of Independent Testing | Frequency should be appropriate to the size, scope and risk profile of covered trading activities and covered fund activities or investments, and at least once every 12 months. |
| Action to Be Taken in Response | The banking entity must take appropriate action to remedy any concerns identified, includingremedying deficiencies in controls and policies themselves. |</p>
<table>
<thead>
<tr>
<th>Goal of Training</th>
<th>To effectively implement and enforce the compliance program. The release does not otherwise specify the content of required training.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who Must Receive Training</td>
<td>Trading personnel, managers and other appropriate personnel as determined by the banking entity.</td>
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<tr>
<td>Who May Conduct Training</td>
<td>Either internal or independent parties, as deemed appropriate by the banking entity based on size and risk profile.</td>
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<tr>
<td>Frequency of Training</td>
<td>Not specified, but frequency should be appropriate to the size and the risk profile of covered trading activities and covered fund activities/investments.</td>
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<td>Content</td>
<td>Must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program.</td>
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<tr>
<td>Time Period</td>
<td>At least 5 years.</td>
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<td>Format</td>
<td>Must be able to promptly produce records to regulators on request.</td>
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<td>Proprietary Trading</td>
<td>Hedge / PE Funds</td>
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<tr>
<td>- Summary</td>
<td>- Summary</td>
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<td>- With Annex</td>
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