Main Program

Schulte Roth & Zabel

25TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

JANUARY 19, 2016

Partner
New York Office
+1 212.756.2124
philippe.benedict@srz.com

Practices

Tax

Real Estate Capital Markets & REITs

Philippe Benedict

Philippe focuses his practice on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments. He has advised on many major transactions involving sales or spinoffs of investment fund managers, including Senator Investment Group LP's sale of a minority stake to The Blackstone Group LP, Caxton Associates LP's sale of a minority interest to the Petershill II Fund affiliated with the Goldman Sachs Group Inc., and Credit Suisse's sale of Strategic Partners to Blackstone. Philippe advises on the tax aspects of securitizations, including his representation of affiliates of Fortress Investment Group LLC and affiliates of Highbridge Capital Management in the securitization of their leveraged facilities. He has also advised multiple alternative asset managers on the formation and structuring of funds, including Engineers Gate with the launch of a quant fund, Clearfield Capital with the launch of a hedge fund, Warlander Asset Management LP with the launch of a credit fund, and SG Capital Partners in the formation of a new fund; Gunnar Overstrom, formerly a partner at Maverick Capital Ltd., in the formation of Three Corner Global Investors LP; Junto Capital Management LP on the launch of Junto Capital Partners LP and Junto Offshore Fund Ltd.; Trian Fund Management LP on all aspects of launching new co-investment hedge funds; Sachem Head Capital Management LP with the launch of hedge funds and the establishment of long/short equity funds; and Capstone Investment Advisors LLC, JANA Partners, MKP Capital Management LLC and Scopia Fund Management LLC in their respective sales of a passive minority interest to Neuberger Berman Group-managed private equity fund Dyal Capital Partners. Philippe's recent real estate transactions include advising the Related/Oxford joint venture developing Hudson Yards on closing nearly $1.4 billion in equity investments and debt financing for the center's first tower, and advising Oxford in over $5 billion in financing of three office towers, a retail center and a residential building for the project; advising Arel Capital in a number of equity investments, including operating multi-family properties with significant retail components and ground-up development projects for modern condominium buildings in Manhattan and Brooklyn; and advising Perella Weinberg Partners on the acquisition of 50-percent ownership of interests in two hotels and the structuring of a REIT joint venture with Loews Corporation.

Chambers USA, *The Legal 500 United States*, *New York Super Lawyers* and *Tax Directors Handbook* have recognized Philippe as a leading lawyer. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and also speaks at prominent industry events, including PLI's Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2015 conferences in New York and San Francisco. He also recently presented on topics including FATCA, customized solutions for investors, and management company structuring and operations.

Philippe earned his LL.M. in taxation and his J.D. from New York University School of Law. While pursuing his J.D., he was the recipient of a Gruss Fellowship. He obtained his B.S., *summa cum laude*, from Adelphi University.

Partner
New York Office
+1 212.756.2542
stephanie.breslow@srz.com

Practices

Investment Management
Energy
Financial Institutions
Hedge Funds
Private Equity

Stephanie R. Breslow

Stephanie is co-head of Schulte Roth & Zabel's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (LBO, mezzanine, distressed, real estate, venture) and liquid-securities funds (hedge funds, hybrid funds) as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses, and she represents funds of funds and other institutional investors in connection with their investment activities.

Recently named chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a member of the board of directors of 100 Women in Hedge Funds, a member of the Board of Visitors of Columbia Law School and a member of the board of directors of the Girl Scouts of Greater New York. She is listed in *Chambers USA*, *Chambers Global*, *IFLR1000*, *The Legal 500 United States*, *Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which ranked her at the top of the world's 2014 "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Expert Guide to the World's Leading Women in Business Law* and *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the 2014 Who's Who Legal Awards and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute) and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private Equity Handbook 2005/06* (Practical Law Company) and a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

Partner

Washington, DC Office
+1 202.729.7480

New York Office
+1 212.756.2046

charles.clark@srz.com

Practices

Litigation

Complex Commercial Litigation

Regulatory & Compliance

Securities Enforcement

Securities Litigation

White Collar Defense & Government Investigations

Charles J. Clark

Charles represents financial institutions, public companies and accounting firms, and their senior executives, in securities-related enforcement proceedings before the SEC, DOJ, FINRA, CFPB, and other federal and state law enforcement and regulatory authorities. In particular, he counsels hedge funds, private equity firms, venture capital funds and other asset managers through regulatory scrutiny, including in routine and risk-based inspections and examinations and in enforcement proceedings. He defends investigations involving a broad spectrum of issues, including accounting and disclosure fraud, insider trading, foreign corruption, offering fraud, market manipulation, breach of fiduciary duty and conflicts of interest. In addition, Charles represents boards of directors and associated committees in internal investigations, and he provides guidance on corporate governance and trading practices for public companies and private funds. Prior to entering private practice, Charles served for nine years in the SEC's Divison of Enforcement, most recently as assistant director supervising the investigation and prosecution of some of the SEC's most significant matters, including its investigation of Enron Corporation.

A frequent speaker and panelist, Charles has addressing a wide variety of topics of interest to the white collar defense community, including, most recently, the Wells settlement process at the SEC and short-selling violations under Rule 105. He also serves as a resource for numerous media publications, including the *Bloomberg News*, *Financial Times*, *The Wall Street Journal* and *The Washington Post*.

Charles holds a J.D. from the New York University School of Law and a B.A., with high distinction, from the University of Virginia.

Partner
New York Office
+1 212.756.2758
brian.daly@srz.com

Practices

- Investment Management
- Cybersecurity
- Energy
- Hedge Funds
- Private Equity
- Regulatory & Compliance

Brian T. Daly

Brian advises hedge fund and private equity fund managers and commodity pool operators on regulatory, compliance and operational matters, including registration and disclosure obligations, trading issues, advertising and marketing, and the establishment of compliance programs. Having spent nearly a decade serving in-house as general counsel and chief compliance officer at several prominent hedge fund management firms, he is well-versed in a wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisors and has extensive experience designing and improving compliance processes and organizational systems. Brian has represented clients in the context of regulatory examinations, trading inquiries and enforcement actions, and in seeking no-action or similar relief in the United States, the United Kingdom and Asia.

Brian is well known for his thought leadership in the regulatory and compliance area as it affects alternative investment funds and is a key part of Schulte Roth & Zabel's educational outreach. In addition to hosting SRZ webinars, participating in firm-sponsored seminars and workshops, and authoring SRZ alerts and white papers, he recently published "Q&A with Brian T. Daly: SRZ's Systematic and Quantitative Strategies Practice" in *The Hedge Fund Journal* and "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief — Financial Regulation*. His recent speaking engagements addressed topics including how U.K. fund managers registered as CPOs or CTAs should prepare for NFA examinations, and hedge fund and management company structures. Brian also teaches legal ethics at Yale Law School, focusing on the challenges faced by in-house counsel. He is a chair of the Steering Committee for the Managed Funds Association's CTA/CPO Forum and a member of the CFTC Working Group for the Alternative Investment Management Association and of the New York City Bar Association's Private Investment Funds Committee. He formerly served as co-chair of the MFA's General Counsel Forum, its CTA, CPO & Futures Committee, and as a steering committee member of its Investment Advisory Committee.

Brian received his J.D., with distinction, from Stanford Law School, his M.A. from the University of Hawaii, and his B.A., *magna cum laude*, from Catholic University of America.

Partner
New York Office
+1 212.756.2009
jennifer.dunn@srz.com

Practices

Investment Management
Hedge Funds
Private Equity

Jennifer Dunn

Jenny advises hedge funds, private equity funds (including mezzanine and distressed funds), hybrid funds, funds of funds and investment advisers in connection with their structuring, formation and ongoing operational needs, general securities law matters, and regulatory and compliance issues. Her experience includes structuring and negotiating seed and strategic investments, advising investment managers regarding the structure and sale of their investment management businesses and the structure of their compensation arrangements, and representing investment managers in connection with managed accounts and single-investor funds.

Recognized by *The Legal 500 United States*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers* (Investment Funds) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds) and as an *IFLR 1000* "Rising Star" (Investment Funds), Jenny co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and recently presented at conferences on topics including compliance issues, hedge funds and management company structures, and considerations for emerging hedge fund managers.

Jenny earned her J.D. from Columbia University Law School, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from the University of Pennsylvania.

Partner
New York Office
+1 212.756.2269
david.efron@srz.com

Practices

Investment Management

Hedge Funds

Regulatory & Compliance

David J. Efron

David practices primarily in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and he structures seed-capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *The Legal 500 United States* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. In particular, *Chambers USA* has noted that David is "an outstanding lawyer, with excellent judgment and the necessary soft touch during the delicate negotiations that occur during a start-up/launch," and clients say "he is attuned to the business considerations and provides measured, reasoned advice that reflects his deep experience and industry knowledge." *The Legal 500 United States* has recognized him as "an extraordinarily capable attorney." A published author on subjects relating to investment management, David recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He also is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law and business schools. He most recently presented on current trends with emerging managers in a prime brokerage (consulting services) presentation, and on product and marketing strategies for growth for hedge fund COOs and CFOs.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law and his B.A. from Vassar College.

Partner
New York Office
+1 212.756.2553
marc.elovitz@srz.com

Practices

Regulatory & Compliance
Cybersecurity
Energy
Hedge Funds
Investment Management
Litigation

Marc E. Elovitz

Marc is the chair of Schulte Roth & Zabel's Investment Management Regulatory & Compliance Group. He advises private fund managers on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and CFTC, and on handling SEC and NFA examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation. He also regularly leads training sessions for portfolio managers, analysts and traders on complying with insider-trading and market manipulation laws, and he has developed and led compliance training sessions for marketing and investor relations professionals. Marc works closely with clients undergoing SEC examinations and responding to deficiency letters and enforcement referrals. He develops new compliance testing programs in areas such as trade allocations and conflicts of interest, and he leads macro-level compliance infrastructure reviews with fund managers, identifying the material risks specific to each particular firm and evaluating the compliance programs in place to address those risks.

Marc is frequently invited to discuss current industry-related topics of interest at leading professional and trade association events. He most recently presented on whistleblowing, regulatory and compliance issues for private funds, and SEC inspections and examinations of hedge funds and private equity funds. *The Legal 500 United States*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers* and *New York Super Lawyers* have recognized Marc as a leading lawyer in his field. He is a member of the Steering Committee of the Managed Funds Association's Outside Counsel Forum, the American Bar Association's Hedge Funds Subcommittee and the Private Investment Funds Committee of the New York City Bar Association. Marc recently co-authored "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief — Financial Regulation* and "Rule 105 Update: New Round of Enforcement Highlights SEC Approach on Short-Selling Violations" in *The Hedge Fund Journal*. He is also a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), the "Protecting Firms Through Policies and Procedures, Training, and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute) and the "Market Manipulation" chapter in the leading treatise *Federal Securities Exchange Act of 1934* (Matthew Bender). He also wrote the chapter on "The Legal Basis of Investment Management in the U.S." for *The Law of Investment Management* (Oxford University Press).

Marc received his J.D. from New York University School of Law and his B.A., with honors, from Wesleyan University.

Partner
New York Office
+1 212.756.2567
steven.fredman@srz.com

Practices

Investment Management

Hedge Funds

Private Equity

Regulatory & Compliance

Securities & Capital Markets

Steven J. Fredman

Steve is co-head of Schulte Roth & Zabel's Investment Management Group, where he concentrates his practice in the areas of investment funds (domestic and offshore), investment advisers and broker-dealers, the acquisition and related financing of investment management firms, and securities regulation. Steve structures and organizes private investment partnerships and offshore funds, including general equity, arbitrage, global investment, private equity, distressed company, small cap and funds of funds, and he counsels clients on issues relating to partnership law, new product development and other matters. He structures and organizes investment advisers and broker-dealers, handles the registration of commodity pool operators and commodity trading advisors, and also provides ongoing advice to investment advisers on securities laws, rules, regulations and information. He represents clients in connection with the acquisition and sale of investment management firms or their assets as well.

Steve is recognized by many ranking publications, including *Chambers Global*, *Chambers USA*, *The Legal 500 United States*, *Expert Guide: Best of the Best* (Investment Funds), *Expert Guide: Best of the Best USA* (Investment Funds), *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *International Who's Who of Private Funds Lawyers*, *The Best Lawyers in America* and *New York Super Lawyers*. A past member of the American Bar Association's Committee on Partnership and the New York City Bar Association's Committee on Art Law, Steve is a frequent speaker and writer in his areas of expertise. He most recently presented on ERISA issues for private investment funds and distressed investing issues for structured products. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and "Asset Manager M&A Deals," an SRZ white paper.

Steve holds a J.D. from Georgetown University Law Center and a B.A. from Columbia University, where he was Phi Beta Kappa.

Partner
New York Office
+1 212.756.2253
adam.harris@srz.com

Practices

Business Reorganization

Bankruptcy & Creditors' Rights Litigation

Distressed Debt & Claims Trading

Distressed Investing

Energy

Adam C. Harris

Adam is chair of Schulte Roth & Zabel's Business Reorganization Group and a member of the firm's Executive Committee. He practices in the areas of corporate restructurings, workouts and creditors' rights litigation, with a particular focus on representing investment funds and financial institutions in distressed situations. Adam represents a variety of clients in connection with distressed acquisitions by third-party investors or existing creditors through "credit bid" or similar strategies, as well as in court-supervised and out-of-court restructurings. In addition to representing creditors and acquirers in distressed situations, he has represented Chapter 11 debtors, as well as portfolio companies, in out-of-court exchange offers, debt repurchases and other capital restructurings. His recent representations include advising Cerberus Capital Management LP in connection with the Chapter 11 bankruptcy of RadioShack Corp., Mount Kellett Master Fund II in the Chapter 11 case of The Great Atlantic and Pacific Tea Company (as both lender and equity holder), and a group of private equity funds in the Allied Systems Holdings bankruptcy, in their capacity as first lien lenders, in a successful challenge to the efforts of a private equity sponsor that tried to acquire a controlling interest in the first lien debt.

Numerous ranking publications, including *The Best Lawyers in America*, *Chambers Global*, *Chambers USA*, *The K&A Restructuring Register* and *The Legal 500 United States*, have recognized Adam as a leader in his field. He has co-authored publications addressing cramdown plans, redemption option value, priming DIPs, out-of-court restructurings and proposals to reform Chapter 11. He also contributed to *Distressed Investing M&A* (SRZ in association with Mergermarket and Debtwire), and he co-authored "Health Care Business Restructuring for Secured Lenders," an SRZ guide republished by *Bloomberg BNA – Bankruptcy Law Reporter*. Adam also co-authors the "Out-of-Court Restructurings, the Bankruptcy Context, and Creditors' Committees" chapter in PLI's *Insider Trading Law and Compliance Answer Book*. He presents frequently on topics of concern to the private funds community, including, most recently, interlender arrangements, structuring credit funds, distressed investing in the health care sector, fraudulent conveyance laws and distressed private equity investments.

Adam received his J.D., *magna cum laude*, from Georgetown University Law Center and his B.A. from Emory University.

Partner
London Office
+44 (0) 20 7081 8002
christopher.hilditch@srz.com

Practices

Investment Management

Hedge Funds

Financial Institutions

Regulatory & Compliance

Christopher Hilditch

Chris heads Schulte Roth & Zabel's London office, where he advises a wide range of institutional and entrepreneurial managers on structuring and establishing investment funds, particularly hedge funds, funds of hedge funds, co-investment funds and other innovative products. On an ongoing basis, he counsels promoters and managers on operational issues, including prime brokerage arrangements, investment transactions and relations with investors. He also advises on regulatory issues affecting funds and their managers, as well as on corporate, securities and partnership law issues.

Listed as a leading hedge fund lawyer in *Chambers UK*, *The Legal 500 UK*, *PLC Cross-border Investment Funds Handbook*, *The International Who's Who of Private Fund Lawyers* and *Who's Who of Professionals*, Chris is a member of the Legal Experts Group for the Financial Conduct Authority, the Law Society, the City of London Solicitors Company and the International Bar Association, and he has participated in a number of ad hoc industry committees. He is a frequent speaker on hedge funds and related topics and a regular contributor to a variety of industry publications. He co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as numerous articles. He also contributed to *Investment Management: Law and Practice* (Oxford University Press). At recent speaking engagements, Chris has addressed investor needs and expectations, marketing challenges in the United States and the EU, and AIFMD and other EU regulatory issues.

Chris attended law school at the College of Law, Guildford and graduated with an M.A., with honors, from Oxford University.

Partner
New York Office
+1 212.756.2201
daniel.hunter@srz.com

Practices

Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance

Daniel F. Hunter

Dan concentrates his practice on the design, structure and regulation of alternative investment products, including hedge funds, hybrid funds and private equity funds. He regularly advises funds that invest in distressed debt, asset-backed securities and bank loans. Dan also provides day-to-day regulatory, operational, merger and acquisition, and restructuring advice to his fund clients, and he advises funds regarding the receipt or allocation of seed capital. As part of his compliance practice, he advises clients on the Treasury Forms (TIC Forms) and Bureau of Economic Affairs Forms (BEA Forms).

Dan has been recognized in *The Legal 500 United States* in the Investment Fund Formation and Management and Private Equity Funds categories. A sought-after speaker, he recently presented on topics including the structuring and management of funds, compliance and regulatory issues, and ERISA's impact on private equity and hedge funds. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he has served as a guest lecturer at the New York University School of Continuing and Professional Studies, where he taught "Introduction to Hedge Funds." He also serves on the University of Michigan Honors Alumni Council.

Dan received his J.D. from the University of Michigan Law School and his A.B., *cum laude* and with high honors in history, from the University of Michigan.

Partner
New York Office
+1 212.756.2454
taleah.jennings@srz.com

Practices

Litigation

Complex Commercial Litigation

Real Estate Litigation

Securities Enforcement

Taleah E. Jennings

Taleah's practice focuses on complex commercial litigation of all types. Her clients are primarily financial services entities, such as investment managers, private equity firms, interdealer brokerage firms and commercial real estate firms. Taleah has litigated cases in various state and federal courts, as well as regulatory and arbitration forums, from the commencement of claims through trials and appeals. She has represented a major interdealer brokerage firm in various arbitrations and civil litigations arising out of a global corporate raid by a fierce competitor, a large private equity firm in a case alleging alter ego liability arising out of alleged contractual breaches by a portfolio company, an investment manager in a dispute with a former employee who claimed an ownership interest in millions of dollars of client revenues, and many other clients in complex commercial disputes.

Recognized by *New York Super Lawyers* as a "Rising Star," Taleah is also a New York State Bar Association Empire State Counsel Honoree and a two-time recipient of Sanctuary for Families' Excellence in Pro Bono Advocacy Award. She has published on topics including competitor raids and misappropriation of trade secrets, and is the author of the "Penalties, Short-Swing Profits, and Whistleblower Awards" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). In recent speaking engagements, she has addressed trends in the use of restrictive covenants and trade secrets in employment alternative dispute resolution.

Taleah holds a J.D. from Rutgers-Newark Law School and a B.S. from the University of Maryland.

Partner
New York Office
+1 212.756.2760
jason.kaplan@srz.com

Practices

Investment Management
Hedge Funds
Private Equity
Regulatory & Compliance

Jason S. Kaplan

Jason's practice concentrates on corporate and securities matters for investment managers and alternative investment funds. He represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. He advises managers of hedge, private equity and hybrid funds regarding the structure of their businesses and on day-to-day operational, securities, corporate and compliance issues; structures and negotiates seed and strategic investments and relationships and joint ventures; and advises investment managers with respect to regulatory and compliance issues.

Jason has been recognized by both *IFLR1000* and *New York Super Lawyers* as a "Rising Star," and he publishes and speaks often about topics of concern to private investment funds. He is the co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and of "Information Security: Obligations and Expectations," a Schulte Roth & Zabel white paper. In his recent speaking engagements, he has discussed co-investments, considerations for managers in their first five years of operations, and marketing opportunities and challenges for funds.

Jason earned his J.D. from Fordham University School of Law and his B.S. from the University of Michigan.

Partner
Washington, DC Office
+1 202.729.7477
john.mahon@srz.com

Practices

Investment Management

Hedge Funds

Regulated Funds

Regulatory & Compliance

John J. Mahon

John primarily represents private equity firms and other financial sector participants in a wide range of capital markets and securities law matters. He regularly assists clients in connection with the establishment and operation of business development companies, registered closed-end funds and other similar public and private vehicles that comply with complex regulatory structures, including the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Dodd-Frank Act. With more than a decade of experience, John has been involved with more than 100 debt and equity offerings, including over 20 IPOs, reflecting an aggregate of over $10 billion in total proceeds. His work in securities law and mergers and acquisitions includes providing guidance to many New York Stock Exchange and Nasdaq-listed companies in connection with ongoing corporate governance and U.S. Securities and Exchange Commission reporting and compliance matters. John also routinely handles issues involving tender offers, proxy solicitations, going-private transactions and beneficial ownership reporting obligations.

John is a recipient of the SEC Capital Markets Award, and he was named a *Washington, DC Super Lawyers* “Rising Star.” He serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. He has spoken and written on topics that include SEC regulations and capital-raising, executive compensation disclosure and implications of Rule 144 revisions, and SPACs and M&A issues.

John holds a J.D. from Georgetown University Law Center and a B.S.B.A., *cum laude*, from the University of Richmond, where he was a member of Beta Gamma Sigma.

Partner
London Office
+44 (0) 20 7081 8037
anna.maleva-otto@srz.com

Practices

Investment Management

Cybersecurity

Hedge Funds

Regulatory & Compliance

Anna Maleva-Otto

Anna concentrates her practice on advising asset managers on a range of U.K. financial services regulatory matters, including the impact of EU directives and regulations. She has advises clients on the establishment of regulated businesses, financial crime (including market abuse, money laundering and bribery), financial promotion and offers of securities, regulatory reporting and disclosure obligations, regulatory capital, and conduct of business rules. Prior to joining Schulte Roth & Zabel, Anna gained substantial experience advising hedge fund managers, brokers, insurance firms and investment banks on a wide spectrum of regulatory matters in her roles in private practice and as an in-house counsel and compliance officer of a hedge fund manager. She frequently participates in industry working groups in connection with new and emerging regulatory initiatives, and has advised asset manager trade associations on their advocacy efforts related to several key pieces of recent EU legislation (including the Short Selling Regulation, Alternative Investment Fund Managers Directive, MiFID II and MAD II). Anna began her career as a regulatory consultant assisting clients in the financial services sector with the design and implementation of compliance procedures, conduct of internal compliance investigations, compliance audits and remediation exercises.

The Legal 500 UK has recognized Anna as a leading lawyer, and she is admitted to practice in England, Wales and New York. She frequently speaks and writes on topics related to her areas of expertise. She recently co-authored “AIFMD Update: ESMA Advice on Extension of Marketing Passport Published” in *The Hedge Fund Journal* and “Marketing Alternative Funds in Europe: A Changed Landscape” in *Risk & Compliance Magazine*, and her recent speaking engagements have addressed topics including trading compliance and CFTC updates, as well as systematic and quantitative strategies for funds.

Anna received her J.D. from Emory University School of Law and her M.A. from Saint Petersburg State University (Russia).

Partner
New York Office
+1 212.756.2227
david.nissenbaum@srz.com

Practices

Investment Management

Energy

Financial Institutions

Hedge Funds

Private Equity

David Nissenbaum

David's practice focuses on corporate, securities and bank regulatory matters. He primarily represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their businesses. He structures investment management and financial services firms as well as hedge, private equity, credit, distressed investing and hybrid funds, energy funds, co-investments, funds of funds and scalable platforms for fund sponsors. David provides legal and business advice on fund structuring, fundraising, management company partnerships, compensation plans, succession plans, seed and strategic investments and spinoffs of investment teams. His work also includes counseling clients on finding practical solutions to regulatory and compliance requirements, including the Volcker Rule, and managing conflicts of interest with an emphasis on reducing legal risk to the business.

David has been named a leader in his field by *Chambers Global* and *Chambers USA* and has been recognized by *The International Who's Who of Private Funds Lawyers*, *PLC Cross-border Private Equity Handbook*, *The Legal 500 United States* and *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*. A member of the Advisory Board of The Financial Executives Alliance and past member of the Banking Law Committee of the New York City Bar Association, David is a sought-after writer and speaker. Works he has authored or co-authored include the chapter "Management Company Structures and Terms" in *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), "Hedge Fund Names: What a Hedge Fund Manager Should Do Before It Starts Using a Name" in *The Hedge Fund Law Report* and "Just Like Starting Over: A Blueprint for the New Wall Street Firm," published by *The Deal*. He has addressed topics at conferences and seminars including co-investment vehicles, investing in the oil and gas sector, liquidity events, exits and succession planning.

Partner
New York Office
+1 212.756.2199
eliot.relles@srz.com

Practice

Finance

Eliot L. Relles

Eliot focuses his practice on commercial and corporate finance transactions, primarily representing hedge funds, private equity funds, commercial finance companies and investment banks in domestic and cross-border secured and unsecured finance transactions. He regularly handles matters including asset-based and cash flow financings; acquisition and leveraged buyout financings; subordinated and mezzanine financings; first-out/last-out, second lien and tranche B financings; and debtor-in-possession and exit financings. Eliot also counsels clients in debt restructuring and general corporate finance matters, and has recently represented clients in connection with secured loans, credit facilities and acquisition financings for a range of businesses.

Eliot has been recognized by *New York Super Lawyers* as a leader in his field. He has also spoken on topics of interest to the investment management community, including distressed investing in the retail industry and dividend recapitalizations.

Eliot received his J.D. from Hofstra University School of Law and his B.A. from the University of Michigan.

Partner
New York Office
+1 212.756.2048
ronald.richman@srz.com

Practices

Employment & Employee Benefits

Mergers & Acquisitions

Regulatory & Compliance

Insurance

Ronald E. Richman

Ron is co-head of Schulte Roth & Zabel's Employment & Employee Benefits Group, and his practice concentrates on the litigation of employment and employee benefits cases in federal and state courts throughout the United States involving trade secrets, non-competition, non-solicit, and breach of confidentiality and breach of loyalty issues. Ron defends employee benefit plans, fiduciaries, and employers in class actions and in cases brought by individual plaintiffs. He represents employee benefit plans before the U.S. Department of Labor, the Pension Benefit Guaranty Corporation and the Internal Revenue Service in connection with novel issues of law concerning plan mergers, terminations, spinoffs, fiduciary duties and prohibited transactions, and various aspects of withdrawal liability and mass withdrawal liability. He also represents employers (particularly hedge and private equity funds), employees and partners with respect to executive compensation and partnership issues.

Recognized by *New York Super Lawyers* and *The Best Lawyers in America* as a leading labor and employment litigation attorney, Ron is a Fellow of the American College of Employee Benefits Counsel and a member of the CPR Employment Dispute Committee of the CPR Institute for Dispute Resolution. He is a former board member for the Lawyers Alliance for New York, which recognized him in 2015 as a "15 Year Circle" honoree, and a former adjunct professor in the New York University School of Continuing Education's Certified Employee Benefits Specialist Program. Ron frequently speaks and writes on employee benefits and employment topics of interest to the human resources and investment management communities. He most recently presented on recent employee benefits issues for investment managers, ERISA and the impact of the *Dudenhoeffer* case. He is the co-author of "Recent Labor Department Actions Target Independent Contractor Misclassification, Overtime" and "2nd Circuit Adopts New 'Primary Beneficiary' Test for Determining if Unpaid Interns are Employees" in *Westlaw Journal — Employment* and "Now We Know How NYC's Credit Check Ban Will Be Interpreted" in *Law360*.

Ron received his J.D. from Columbia University School of Law, where he was a Harlan Fiske Stone Scholar and the recipient of the Emil Schlesinger Labor Law Prize, and his B.S. from the Industrial and Labor Relations School at Cornell University.

Partner
New York Office
+1 212.756.2450
paul.roth@srz.com

Practices

Investment Management
Hedge Funds
Mergers & Acquisitions
Private Equity
Regulatory & Compliance
Securities & Capital Markets

Paul N. Roth

Paul is a founding partner of Schulte Roth & Zabel and chair of its Investment Management Group. Throughout his career, he has acted as counsel to leading public and private companies in financial services and to their boards of directors. Paul's extensive private investment funds practice, an area in which he has more than 45 years of experience, includes the representation of hedge funds, private equity funds, offshore funds, investment advisers and broker-dealers in connection with fund formations and compliance, securities regulation, mergers and acquisitions (domestic and cross-border) and other financial transactions.

Paul has been consistently recognized as a leading funds lawyer by *The Best Lawyers in America*, which also named him New York City Private Funds/Hedge Funds Law Lawyer of the Year. He continues to be recognized by *Chambers Global*, *Chambers USA* and *The Legal 500 United States*, as well as many other ranking publications. Paul was honored at The Hedge Fund Journal Awards for his outstanding achievement in the hedge fund industry, and he received a Lifetime Achievement Award from Hedge Funds Care in recognition of his prominence in the hedge funds industry and his extraordinary commitment to philanthropy. He was also named to *HFMWeek*'s 2010 list of the 50 most influential people in hedge funds. Paul serves as a special adviser to the board of directors of the Managed Funds Association (MFA) and he is a former member of the Legal Advisory Board to the National Association of Securities Dealers (NASD). He chairs the Subcommittee on Hedge Funds of the American Bar Association's Committee on Federal Securities Regulation and is a former chair of the New York City Bar Association's Committee on Securities Regulation. Paul is a member of the boards of directors of the NAACP Legal Defense and Educational Fund and the Advisory Board of the RAND Center for Corporate Ethics and Governance, and he is a fellow of the New York Bar Foundation and the Phi Beta Kappa Society. He served on the Advisory Board of Harvard Law School's Center on Lawyers and the Professional Services Industry and formerly served as president, vice president and a trustee of the Harvard Law School Alumni Association of New York City. He is also a member of The Economic Club of New York. Additionally, Paul has served as a lecturer at the University of Pennsylvania's Wharton School, where he taught "Responsibility in Professional Services." He is also an adjunct professor of finance at NYU Stern School of Business, where he has taught "Managing Financial Businesses," and an adjunct professor of law at New York University School of Law, where he teaches "Advising and Managing Financial Services Businesses." He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press).

Paul received his J.D., *cum laude*, from Harvard Law School, after which he was awarded a Fulbright Fellowship to study law in the Netherlands. He received his A.B., *magna cum laude*, from Harvard College, where he was Phi Beta Kappa.

Partner and
Chief Executive Officer

Perella Weinberg Partners

Robert K. Steel

Bob is a partner and serves as chief executive officer at Perella Weinberg Partners. Prior to joining the firm, as New York City's Deputy Mayor for Economic Development from 2010 to 2013 he was responsible for Mayor Michael Bloomberg's administration's five-borough economic development strategy and job-creation efforts, overseeing such agencies as the Department of Housing Preservation and Development, Department of City Planning, Department of Small Business Services, NYC Economic Development Corporation and NYC & Company, and chairing the Brooklyn Bridge Park board. A key initiative of the Bloomberg administration was to encourage and grow the technology sector of New York City's economy, and Bob led the applied sciences initiative, which established the Cornell-Technion campus on Roosevelt Island and the New York University Center for Urban Science and Progress initiative in Brooklyn, New York.

Prior to his appointment as Deputy Mayor, Bob was the president and CEO of Wachovia where he oversaw the sale of the bank to Wells Fargo & Co. and served on the Wells Fargo board of directors until 2010. During his tenure at the U.S. Treasury as Under Secretary for Domestic Finance from 2006 to 2008, he revived the President's Working Group, the core group to respond to the global economic crisis of 2008. He managed the Department's Blueprint for Modernized Regulatory Structure, which recommended several of the reforms since pursued by the Obama administration. Bob also spent nearly 30 years at Goldman Sachs, rising to head of the global equities division, vice chairman of the firm and a member of its Management Committee. He began his Goldman Sachs career in Chicago and then spent more than seven years in London before returning to the United States to work in the New York headquarters. He also was a member of the board of directors of Barclays from 2005 to 2006.

Bob is a graduate of Duke University and the University of Chicago's Booth School of Business. He is chairman of the Aspen Institute's Board of Trustees and has served as chairman of Duke's Board of Trustees, Senior Fellow at Harvard University's Kennedy School of Government, a member of the FDIC Advisory Committee on Economic Inclusion, chairman of The After-School Corporation, and co-founder of SeaChange Capital Partners, an organization dedicated to helping nonprofits grow.

Partner
New York Office
+1 212.756.2510
shlomo.twerski@srz.com

Practices

Tax

Energy

Real Estate Capital Markets & REITs

Regulated Funds

Shlomo C. Twerski

Shlomo is co-head of the Tax Group at Schulte Roth & Zabel. He focuses his practice on the tax aspects of onshore and offshore investment funds, registered investment companies and business development companies, private equity partnerships, real estate and corporate transactions, restructurings and workouts, securitizations, and existing and emerging financial instruments. He also provides ongoing tax advisory services to a number of hedge fund managers regarding fund structuring and formation, distressed debt investments and other complex transactions.

Recognized as a leader in his field by *Chambers USA*, *The Best Lawyers in America*, *The Legal 500 United States* and the *Tax Directors Handbook*, Shlomo is a member of the Tax Section of the New York State Bar Association. He regularly speaks at industry conferences and events, and his most recent presentations have addressed hedge fund and management company structures, funds in the energy space, tax considerations for private investment funds and FATCA. He is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) as well as various SRZ alerts.

Shlomo earned his J.D. from Hofstra University School of Law.

Partner
New York Office
+1 212.756.2515
holly.weiss@srz.com

Practices

Employment & Employee Benefits

Cybersecurity

Holly H. Weiss

Holly focuses her practice on the representation of employers in all aspects of employment law and employee relations. She also serves as co-head of Schulte Roth & Zabel's Cybersecurity Group. Holly litigates disputes involving restrictive covenants, ERISA claims, executive compensation, employment agreements, statutory employment discrimination claims, and common law tort and contract claims in federal and state courts, before administrative and government agencies and in arbitral forums. She advises employers on employment law compliance, best practices, human resources matters, hiring and termination, and litigation avoidance; drafts and negotiates employment agreements, separation agreements, data security and privacy policies and other employment-related agreements; and provides training and conducts investigations.

Recognized as a leading lawyer by *The Best Lawyers in America* and as one of the "Top Women Attorneys in the New York Metro Area" by *New York Super Lawyers*, Holly is a member of the Labor and Employment Law Section of the New York State Bar Association. She speaks and writes often about topics of interest to employers in the investment management industry, having most recently addressed hedge fund compensation, hiring and employee agreement trends, as well as protecting workforces and hiring from competitors. Her recent publications include "Securities, Futures Regulators Increase Scrutiny, Expectations on Cybersecurity" in *Bloomberg Brief – Financial Regulation*, "Recent Labor Department Actions Target Independent Contractor Misclassification, Overtime" in *Westlaw Journal – Employment* and "Now We Know How NYC's Credit Check Ban Will Be Interpreted" in *Law360*.

Holly earned a J.D. from the University of Virginia School of Law and a B.A. from Emory University.

Partner
New York Office
+1 212.756.2140
boris.ziser@srz.com

Practice

Structured Finance &
Derivatives

Boris Ziser

Boris serves as co-head of Schulte Roth & Zabel's Structured Finance & Derivatives Group. With over 20 years of experience across diverse asset classes, he focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation advances and cell towers, in addition to other esoteric asset classes such as intellectual property and other cash flow-producing assets. Boris also represents investors, lenders, hedge funds, private equity funds and finance companies in purchases and dispositions of portfolios of assets and financings secured by those portfolios.

Boris serves as outside general counsel to the Institutional Longevity Markets Association (ILMA), and he is a member of the New York State Bar Association and the New York City Bar Association, as well as the Esoteric Assets Committee of the Structured Finance Industry Group. He is listed in *Chambers USA* and recognized by *The Legal 500 United States* for his work in structured finance. A frequent speaker at securitization industry conferences, Boris has conducted various securitization and life settlement seminars in the United States and abroad, having most recently addressed the current legal landscape for life settlements. He is also the co-author of "Structured Insurance Finance" and "Life Settlement Securitization" in *Securitizations: Legal and Regulatory Issues* (ALM Law Journal Press) and the author of "The Life Settlement Industry Today" in *The Journal of Structured Finance*.

Boris earned his J.D. from New York University School of Law and his B.A., with honors, from Oberlin College.

Evolving Terms and Considerations Across the Fund Spectrum

I. Trends in Capital Raising

A. The Evolving Dynamics of the Hedge Fund Industry

1. Growth continues to be a high priority for managers.

   (a) Many of the largest managers are focused on cross-selling products and becoming a "one-stop" shop for investor needs.

   (b) Managers are focused on offering new strategies or variations of existing strategies.

2. To attract additional capital, managers are adding strategies and seeking new investors.

   A recent survey of managers indicates that:

   (a) 61 percent of larger managers (over $10 billion of assets under management) are adding new hedge fund strategies.

   (b) 72 percent of mid-sized managers ($2 billion to $10 billion of assets under management) are expanding their investor base.

   (c) 86 percent of small managers (under $2 billion of assets under management) are expanding their investor base.[1]

B. Investor Concentration

1. In some instances, new funds are being offered to a concentrated group of institutional investors for various reasons including:

   (a) To obtain investments from larger institutional investors that are more likely to agree to longer lock-up periods and/or investor level gates;

   (b) Because the fund or investment strategy has limited capacity; or

   (c) To expedite the timing of launching the new product (e.g., co-investments).

2. Larger institutional investors are more likely to request material changes to fund terms and side letters (as discussed further below).

II. Trends in Structures, Terms and Products

A. Fees

1. Management Fee

   (a) Management fee rates face continued downward pressure.

---

[1] *See* Ernst & Young, 9th Annual EY Global Hedge Fund and Investor Survey.

(b) The standard management fee rate is no longer 2 percent. Management fee rates tend to range from 1.25 percent to 1.75 percent.

(c) In addition to a lower management fee base rate, investors have required some managers to scale down the management fee rate if the fund reaches a certain size. For example, if the fund reaches $1 billion in assets under management, the management fee rate may be reduced by up to 50 basis points.

(d) Specialized Funds, Strategies and Classes

(i) Commodities funds often charge the management fee on notional amounts.

(ii) Some lending funds charge the management fee on gross asset value.

(iii) Some levered funds also charge the management fee on gross asset value or increase the management fee rate.

(iv) Managers that utilize commitment classes (as discussed below) generally charge the management fee on "invested capital" or net asset value, and not on the capital commitment amount (as is the case in a private equity fund).

(v) Highly specialized trading funds (e.g., quantitative funds) with higher operational expenses may charge a higher management fee rate (e.g., a 3-percent management fee).

(vi) Single investor funds typically have customized management fee rate provisions.

2. Incentive Compensation

(a) Incentive compensation base rates have remained at 20 percent. However, managers typically offer discounts to early-stage and/or large investors.

(b) Specialized Funds, Strategies and Classes

(i) Managers with specialized investment strategies can command an incentive compensation rate higher than 20 percent (e.g., quantitative funds and commodities funds).

(ii) Long-only products typically charge the incentive compensation based on outperforming a hurdle rate or index.

(iii) Single-investor funds typically have customized incentive allocation provisions, including preferred return or hurdle mechanics.

3. Fee Breaks

(a) Managers have been more willing to agree to fee discounts for early-stage and/or large investors.

(b) In determining whether an investor is a "large" investor, managers often look at the overall relationship with the manager and its funds. Managers look at not only the size of an investor's investment in the applicable fund, but also the amount of an investor's investment on an aggregate basis across all of the funds and accounts managed by the same manager. Investors who are managed or advised by the same adviser on a discretionary basis may be aggregated in determining the aggregate investment by those investors for purposes of determining the discount on fees.

(c) Fee deals may be disclosed in the fund's confidential memorandum to provide transparency to investors and may be offered to all investors who meet a certain investment threshold.

4. Conduit Funds

(a) Some managers are accommodating larger investors who request a single fund (a "conduit fund") to facilitate investment in multiple funds managed by a single manager.

(b) A conduit fund allows an investor to get the benefit of paying fees on an aggregated basis.

(c) A conduit fund may be viewed as an affiliate of the manager and, as such, a manager may need to take into account ERISA considerations when structuring such a fund. A manager should also be cognizant of potential most-favored-nations implications, as the conduit fund may not pay fees at the underlying fund level.

B. Founders' Classes

1. Managers continue to offer "founders' classes" to entice early investors.

(a) Founders' classes typically provide discounts to the management fee and/or incentive compensation.

(b) In exchange, investors in founders' classes may agree to lock-up periods during which they either are unable to redeem capital or can redeem subject to a redemption charge.

(c) The fee discounts may depend on the size of investment and/or the length of lock-up period.

2. Expiration of Founders' Classes

(a) Founders' classes typically have an expiration that is tied to the fund reaching a certain level of assets under management or a time period (or both). For example, the expiration could be tied to the fund reaching $250 million in assets under management or the first six months after the initial close of the fund, whichever comes first.

(b) Managers typically retain the flexibility to extend the time period during which investors can purchase the founders' class.

3. Founders' class investors are sometimes granted a right to invest additional capital on the same terms as the founders' class even after the founders' class is otherwise closed, but typically only for a limited period of time.

4. The terms of founders' classes are typically found in the fund's confidential memorandum (as opposed to a supplement or side letter) to provide transparency to all investors.

C. Liquidity

1. Redemption Terms

(a) Redemption terms are more closely aligned to a fund's investment portfolio and/or strategy.

(b) A fund typically has less frequent redemption rights when its underlying assets are less liquid and/or where it is required by its strategy and investment horizon.

2. Gates

(a) Investor-level gates continue to be popular.

(b) Investor-level gates are used to stabilize cash flow out of the fund and provide a more predictable redemption schedule.

(c) 25-percent investor-level gates remain the most common investor-level gate.

(d) Certain investment strategies (e.g., credit, activism) may include gates that increase the length of time that it would take an investor to redeem completely under the investor-level gate from four quarters to eight quarters or even 12 quarters.

3. Lock-Up Periods

(a) Lock-up periods are becoming more common again.

(b) An initial one-year lock-up period (in addition to investor-level gates) is typical, although managers may ask for longer lock-up periods in exchange for discounts on fees in their founders' classes (as discussed above).

4. Redemptions During a Lock-Up Period

(a) "Soft" lock-up periods are being utilized more often, whereby an investor is permitted to redeem during the lock-up period, subject to a redemption charge. The redemption charge that is deducted from an investor's redemption proceeds typically ranges from 2 percent to 5 percent.

(b) Some funds that have a lock-up period that is longer than one year permit investors to redeem a certain percentage of their investment in the fund on an annual basis during the lock-up period.

5. Terms Applicable to Internal Capital Invested in the Fund

(a) Investors are focusing on internal capital (i.e., general partner/manager/principal) and the redemption terms applicable thereto. While internal capital invested in a fund used to have better liquidity than such fund's investors, the liquidity of internal capital is typically the same as the liquidity of third-party investors. Also if the general partner does not withdraw the incentive allocation within a certain time frame after it is allocated, then such amounts also often become subject to the same liquidity terms as the fund's third-party investors.

(b) A principal often commits to invest and keep a certain level of investment in the fund (e.g., a minimum investment amount or a portion of the principal's liquid net worth).

(c) Some institutional and other investors require notification when (or before) the general partner/principal redeems a certain amount or percentage of its investment from the fund. These notification rights typically include carve-outs for tax distributions and the prior year's incentive compensation. Carve-outs sometimes also include capital redeemed to invest in new products.

(d) Some managers have offered a proportional redemption right whereby an investor can redeem a proportionate amount from the fund when the general partner/principal makes a redemption.

6. Reserves and Holdbacks

   (a) Historically, audit reserves ranged from 5 percent to 10 percent.

   (b) Investors are more frequently requesting that the holdback percentage be consistent with the assets of the fund (e.g., a long/short equity fund is likely to have a lower audit holdback percentage, such as 2 percent).

   (c) Limits on Non-GAAP Reserves: Investors are seeking limits on the ability to take non-GAAP reserves, with certain investors requesting or even requiring that managers only take GAAP reserves.

7. Strategy-Specific Liquidity

   (a) Strategies that invest in less liquid assets (e.g., credit and distressed credit) have included more complicated liquidity terms such as “fast pay/slow pay.” Under these redemption terms, on each redemption date, assets are labeled as “fast-pay assets” and “slow-pay assets.” The investor is paid out the percentage of its redemption request that is attributable to the fast-pay assets within 30 to 45 days of the redemption date. The investor is paid from the proceeds from the slow-pay assets as they are liquidated in the ordinary course of the business of the fund. Slow-pay mechanics allow for the manager to liquidate the slow-pay assets as if the redemption request had not been made.

   (b) Investors expect long-only equity funds to offer quarterly, monthly or even more frequent liquidity.

   (c) Insurance-dedicated funds are funds designed exclusively for insurance policy investors. Such investors require the ability to redeem capital from time to time to pay for: (i) death benefits; and (ii) insurance policy premiums. Also, investors in insurance-dedicated funds can only receive cash as distribution proceeds.

D. Private Investments

1. Managers are showing a renewed interest in less liquid and private investments, and are seeking ways to make these investments.

2. Investments may be made: (i) in the general investment portfolio of the fund; (ii) by re-introducing side pocket provisions into the fund; or (iii) through a separate vehicle (e.g., co-investments, sidecars and traditional private equity funds).

3. Fiduciary issues may arise if a fund does not have side pocket mechanics and instead makes these investments through the general investment portfolio of the fund.

4. A side pocket is a mechanism used by a fund to segregate less liquid (or difficult to value) investments from the liquid portion of the fund’s investment portfolio. The side-pocketed investment is segregated from the rest of the fund’s investment portfolio, and incoming investors do not participate in existing side pocket investments. Investors generally are not permitted to redeem amounts that are side-pocketed until after the side-pocketed investment is realized, and typically,

performance compensation on any gains on the side-pocketed investment is not taken until the time of realization.

5. Investors may still be wary of side pockets.

   As a result, some managers have offered an opt-in/opt-out feature in connection with side pockets.

   (a) The opt-in/opt out feature allows an investor to elect to opt out of all (but generally not less than all) of the fund’s side-pocket investments at the time of its admission to the fund.

   (b) Some managers have also permitted an investor to elect to choose its level of participation in side pockets at the time of its admission to the fund (i.e., 10 percent or 20 percent of its investment in the fund).

   (c) An opt-out feature does not effectively deal with an existing investment held by the fund that is subsequently deemed to be illiquid.

E. Side Letters

1. Investors are requesting broader side-letter provisions, including:

   (a) Greater transparency on the business of the manager including disclosure in connection with:

      (i) A more comprehensive list of “regulatory events”;

      (ii) General partner/manager/principal redemptions;

      (iii) Changes in service providers;

      (iv) Changes in the allocation policy of the manager with respect to the fund;

      (v) Changes in the valuation policy of the fund; and

      (vi) Changes in the investment program of the fund.

   (b) Mandate that any in-kind distributions be made on a pro rata basis among the fund’s investors

   (c) Most-favored-nation clause on material terms in respect of the fund and any parallel vehicles (e.g., in respect of fees, liquidity and transparency) and the ability for the investor to convert its investment into any newly offered class

   (d) Limits on non-GAAP reserves

   (e) Decrease in the audit holdback

   (f) Scale down on the management fee rate when redemptions from the fund are suspended

   (g) Right to inspect the books and records of the fund

2. Some managers have built side-letter terms into the fund’s confidential memorandum to provide all investors with the same terms.

F. Expenses

1. Fund Expenses

   (a) Increased investor and regulatory scrutiny on expenses has led to reviews of the litany of "permitted expenses" that are disclosed and permitted to be charged to a fund. Investors have been closely scrutinizing fund expenses, especially regulatory, D&O insurance, investment-related travel, costs of shadow accounting and research expenses, and the use of soft dollars.

   (b) Managers are providing more detailed descriptions of the expenses borne by the fund in the confidential memorandum.

   (c) Clarifications in the confidential memorandum have been made in many cases so that software consultant fees, order management systems and certain forms and filings are included in the expense sections.

2. Fund expense caps are occasionally seen but remain rare. There tends to be two types of expense caps: (i) caps on organizational expenses; and (ii) caps on operating expenses.

3. Strategy-Specific Expenses: Some quantitative managers charge hardware and software expenses to the funds, which are typically a manager expense.

G. Capital Commitments

1. Some hedge fund managers are using a capital commitment structure. The circumstances where they are being used include:

   (a) Funds that are otherwise closed to new investors;

   (b) Funds that are still open to new investors where certain investors have specifically requested this class; and

   (c) New funds in order to secure capital for investments.

2. Capital commitments are typically seen in funds where the manager needs time to ramp up the investment portfolio or otherwise expects to make investments infrequently and does not want to tie up an investor's capital or dilute the internal rate of return if it does not have available investment opportunities.

3. Instead of the typical monthly subscriptions, an investor would commit a certain amount of capital to the fund that is drawn down by the manager as and when needed.

4. When establishing commitment classes, managers need to consider:

   (a) The time lag between calling capital and funding relative to the timing of making the investment; and

   (b) Default remedies in the event an investor does not fund its commitment.

5. Fund-Specific Considerations: Commitment classes have been offered across concentrated funds, credit funds and opportunistic funds.

Private Funds: The New Banks

I. Issues for Funds as Providers and Users of Leveraged Loans

A. Leveraged Loan Market in 2015

1. Compared to 2014, 2015 Was a Year of Slowly Tightening Liquidity, High Leverage and Default Rate Uptick

(a) U.S. leveraged loan volume in 2015 exceeded $424 billion as of Dec. 14, 2015, which is down almost 20 percent from the $526 billion at this point last year, according to data provider S&P Capital IQ.

(b) High-yield bond issuance totaled $263 billion as of Dec. 14, 2015, a 15-percent drop from the $310 billion at this point in 2014, according to S&P Capital IQ.

(c) According to Capital IQ, the average total debt to EBITDA leverage multiple for highly leveraged deals is 5.1x through Nov. 15, 2015, and slightly higher for middle market ($50 million of EBITDA or less) LBOs at 5.8x.

(d) Macroeconomic uncertainty about China's growth, U.S. monetary policy, and prices of oil and other commodities created significant headwinds to U.S. economic prospects during the second half of 2015 and served as a drag on leveraged loan activity.

(e) Notable sponsor-led LBO deals in 2015 include:

(i) The $8.6-billion acquisition of Petsmart, a retailer of pet supplies, by BC Partners closed in March 2015 and involved $5.0 billion of financing ($4.3-billion term loan and $750-million revolver).

(ii) The $6.5-billion acquisition of software provider Solera Holdings led by Vista Equity Partners was announced in September 2015 in a deal expected to close in Q1 2016 with expected financing of $4.23 billion ($0.3-billion revolver/$3.93-billion mix of term debt and unsecured debt).

(iii) The $4.9-billion acquisition of Informatica, a provider of enterprise data integration software and services, by Permira, closed in August 2015 with $2.5 billion of financing ($1.71-billion term loan, $150-million revolver and $650 million in bonds).

(iv) The $4-billion acquisition of gym operator Life Time Fitness by Leonard Green & Partners and TPG Capital closed in June 2015 with $1.95 billion of financing ($250 million revolver, $1.25 billion term loan and $450 million 144A bond).

(v) The $3-billion acquisition of department-store chain Belk Inc. by Sycamore Partners closed in December 2015 with $2.95 billion of financing ($900-million revolver, $1.5-billion first-lien term loan and $550-million second-lien term loan).

(f) Despite the high levels of leverage and the large amounts of distressed debt, the default rate of issuers in the S&P/LSTA Leveraged Loan Index stood at 1.54 percent as of November 2015. While this level represents a nine-month high and is impacted by recent defaults in energy-related sectors, it remains well inside the historical average of 3.15 percent for loans tracked in the S&P/LSTA Leveraged Loan Index.

2. Reasons for Low Levels of Default During Period of High Leverage

   (a) One key reason is the unprecedented levels of liquidity from non-traditional lenders, such as hedge funds and CLOs.

   (b) The large amount of liquidity provided by hedge funds and CLOs, together with low interest rates and a slowly expanding (albeit tepid) economy, have led to lower incidents of defaults (excluding defaults caused by the recent unusually sharp retraction in the energy sector).

   (c) The competition among lenders for deals during periods of robust merger and acquisition activity and ample liquidity sources has also resulted in thinner pricing and weaker covenant packages, such as the so-called “covenant lite” deals, and generous sponsor equity cure provisions affording borrowers with additional cushion on financial covenants to reduce the risk of defaults.

   (d) Views vary: Either (i) the highly leveraged companies today have better risk profiles than the highly leveraged companies during the 2003-2007 period; or (ii) today’s deals are creating the higher default rates of tomorrow.

B. Second-Lien Loans: What Are They, How They Started and What They Have Become

1. What Is a Second-Lien Loan?

   (a) A second-lien loan is typically a term loan secured by a lien on certain assets (typically, substantially all assets) of the borrower where: (i) the borrower has also granted another lender (the first-lien lender, which is typically a working capital lender) a lien on the same assets; and (ii) the first-lien lender has the right to receive and apply the proceeds from the sale, disposition of, or other realization from, those assets to the payment of the first-lien lender’s loan prior to the payment of the second-lien loan. A second-lien loan is typically not contractually subordinated debt.

   (b) In its simplest form, debt subordination provides that the senior debt (as contractually defined) is paid before payment on subordinated debt. In addition, debt subordination typically includes the following: payment blocks; remedy blocks (including acceleration and commencement of bankruptcy or other proceedings); in bankruptcy, no payment on subordinated debt before senior debt is paid in full and no right to receive securities unless subordinated at least to the same extent as the subordinated debt is subordinated to the senior debt; and turnover provision covering any money/value received from any source. Examples: typical high-yield bonds and certain mezzanine debt may be contractually subordinated debt.

2. How Is a Second-Lien Loan Different from Subordinated Debt?

   (a) Lien subordination involves no payment block; remedy blocks limited to remedies with respect to collateral; bankruptcy results in all collateral proceeds going to holder of senior lien; turnover provision only covers proceeds received from shared collateral and certain remedies related to collateral.

(b) A true lien subordination agreement typically provides that if the lien of the first-lien lender becomes unperfected, and the second-lien lender receives proceeds of shared collateral, the second-lien lender retains such proceeds. If the liens of both lenders are unperfected as to certain collateral, then their liens are pari passu with respect to that collateral. A senior lien must be valid, perfected and enforceable for lien subordination to apply.

(c) Debt subordination results in a subordinated debt holder being behind the senior debt and pari passu with the unsecured trade creditors. Lien subordination results in the subordinated lien holder being: (i) behind the senior lien holder to the extent of the shared collateral, and (ii) ahead of the unsecured trade creditors to the extent of its collateral.

(d) Resolution of intercreditor issues in the second-lien market are not as well defined as the intercreditor issues in the subordinated debt market.

3. Basic Dynamics Between First-Lien Lenders and Second-Lien Lenders

(a) First-lien lenders do not want to suffer diminution of their expected rights and remedies as secured creditors by virtue of a second-lien lender having a second priority lien on the same collateral — i.e., “they don’t want to lose anything meaningful.” First-lien lenders do not want any “Monday morning quarterbacking” or other increased litigation risk. The second-lien lender should not be able to use its status as a secured creditor to impede the first-lien lender’s exercise of rights and remedies.

(b) Second-lien lenders want to enjoy the benefits of secured creditor status, acknowledging that the first proceeds of the collateral must be used to repay the first-lien lenders. The degree to which the second-lien lender’s secured creditor rights are controlled or ratcheted back should be compensated for by the differential in coupon between the two classes of investments.

4. What Is the Difference Between Broadly Syndicated and Middle Market Second-Lien Debt?

(a) “Middle Market Second-Lien Deals” — Often hedge fund-originated deals

(i) “Aggressive second lien.”

(ii) First lien must be valid, perfected and enforceable for turnover provision to apply.

(iii) Few upfront consents/waivers in a bankruptcy.

(iv) Intercreditor points are more often hand-crafted to address deal specifics and commercial dynamics.

(b) “Broadly Syndicated Second-Lien Deals” — Wall Street Institutional Second Lien Deals — Larger Syndicated Second Lien Deals; High-Yield Bond Deals

(i) “Silent second lien” or “limited silent second lien”; typically much deeper lien subordination.

(ii) First lien need not necessarily be valid, perfected and enforceable for turnover provision to apply.

(iii) More upfront consents/waivers in a bankruptcy (i.e., consent to DIP, adequate protection, asset sales, plan classification, voting).

(iv) High-yield bond deals have similar structuring issues as the Wall Street Institutional Second Lien Deals.

5. How Second-Lien Loans Started and What They Have Become

(a) Second-lien loans started as a niche asset-based or rescue financing product in the late 1990s and early 2000s for borrowers facing liquidity problems.

(b) The market for second-lien loans started getting attention in 2003, and it exploded in 2004 and 2005.

(c) As the economy improved starting in 2003, second-lien loans were used not only for rescue financing but for buyout financing, dividend recapitalizations and refinancings.

(d) According to *The Deal*, in 2003, second-lien loans totaled about $3 billion. In 2005, second-lien loans rose to more than $17 billion. Fitch Ratings noted that second-lien issuance in 2014 totaled $38.7 billion, just shy of the 2007 record of $39.2 billion. However, through Nov. 15, 2015, second-lien issuance amounted to only $13.1 billion according to Thomson Reuters.

(e) Hedge funds, along with CLOs, have become significant investors in second-lien loans.

(f) Some recent second-lien deals include:

(i) $345-million loan to finance Apax Partners' acquisition of FullBeauty in October 2015

(ii) $305-million loan to finance Centerbridge Partners' acquisition of IPC Systems in March 2015

(iii) $260-million loan to finance Lone Star Funds' acquisition of Hanson Building in March 2015

(iv) $260-million loan to finance Apollo Management's acquisition of Protection One in July 2015

(v) $245-million loan to finance Warburg Pincus' acquisition of Universal Services of American in August 2015

(g) Most market participants believe that second-lien loans have become a permanent asset class.In bull markets they will be used to finance buyouts and dividends recapitalizations, and in bear markets they will be used as rescue financings.

(h) Today, many borrowers view second-lien loans as preferable to mezzanine loans and high-yield bonds for the following reasons:

(i) Faster execution than high-yield bonds

(ii) Cheaper transaction costs than high-yield bonds and lower interest rates than mezzanine loans

(iii) For nonpublic companies, no public reporting or Sarbanes-Oxley compliance

(iv) No onerous prepayment penalties

(v) No amortization

6. Significant Issues When Considering a Second-Lien Investment

   (a) Structural and Valuation Analysis: Despite what some may say, there are not standard terms and structures in the second-lien market.

   (b) Covenant Setbacks: Do they provide sufficient protection?

   (c) Intercreditor Agreement Terms

      (i) Pre-Bankruptcy

         (1) Extent and duration of standstill

         (2) Should the cap on first-lien debt be permanently reduced by payments?

         (3) Sales or Releases of Collateral: Waiver of prepayment by first-lien lender. Can the second-lien lender object to asset sales?

         (4) May a lender amend or waive its economic terms, financial covenants or other material terms without the consent of the other lender?

         (5) Does a buy-out right provide meaningful protection?

      (ii) Post-Bankruptcy

         (1) Consents to DIP financing and cash collateral: What are the conditions?

         (2) Rights to adequate protection and post-petition interest

         (3) Waivers with respect to Section 363 sales, classification of claims in a plan of reorganization and voting for a plan of reorganization

   (d) Post-Closing Monitoring: Do hedge funds have the resources to monitor and, if needed, restructure loans?

II. Volcker Rule Update: Agencies Clarify Ability of Non-U.S. Banks to Invest in Third-Party Funds

A. On Feb. 27, 2015, the Commodity Futures Trading Commission ("CFTC"), Federal Deposit Insurance Corporation ("FDIC"), Board of Governors of the Federal Reserve System (the "Board"), Office of the Comptroller of the Currency and Securities and Exchange Commission ("SEC") (collectively, the "Agencies") published a new FAQ on the Agencies' rule promulgated under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is commonly referred to as the "Volcker Rule."[2] The new FAQ now makes clear that the Volcker Rule does not necessarily prohibit non-U.S. banking entities from investing in third-party managed hedge funds and private equity funds, even where the ownership interests of such funds are marketed and sold to U.S. investors.[3]

---

[2] An SRZ *Alert*, "Summary of Final Volcker Rule Regulation — Fund Activities," available at www.srz.com/Summary_of_Final_Volcker_Rule_Regulation_Fund_Activities/, summarizes the Volcker Rule's effect on fund activities.

[3] The new FAQ (#13) is available on the Federal Reserve's website at www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

B. The Volcker Rule contains an exemption that permits eligible non-U.S. banking entities[4] to hold ownership interests in "covered funds," so long as such activity occurs "solely outside the United States." This exemption, commonly known as the "SOTUS exemption" requires, among other conditions, that "no ownership interest in the covered fund is offered for sale or sold to a resident of the United States."[5] However, the FAQ makes clear that this requirement does not prevent a third-party manager from offering or selling the fund's interests to U.S. investors, so long as *the banking entity* is not involved in such marketing or sales activity. In other words, eligible non-U.S. banking entities will still be able to invest in third-party funds regardless of whether those funds also have U.S. investors, so long as they do not participate in marketing the fund.[6]

C. To avail themselves of the SOTUS exemption, eligible non-U.S. banking entities will still have to ensure that:

1. The banking entity (or office thereof) holding the investment, as principal (and the banking entity (or office thereof) that has decision-making authority over the investment, if different), is not organized or located in the United States;

2. No relevant personnel of the banking entity with decision-making authority over the investment are located in the United States (excluding "back office" personnel);

3. The investment is not accounted for as principal, directly or indirectly, on a consolidated basis by a branch or affiliate organized or located in the United States; and

4. No financing for the investment is provided, directly or indirectly, by a branch or affiliate organized or located in the United States.

III. Summary of Final Volcker Rule Regulation: Proprietary Trading

On Dec. 10, 2013, the Agencies issued a final rule (the "Final Rule") implementing the Volcker Rule.[7] The Volcker Rule restricts the proprietary trading and private investment fund activities of U.S. banks and their affiliates, as well as foreign banks with a branch or agency office in the United States and their affiliates (collectively, "banking entities").[8]

---

[4] In order for a banking entity to use this exemption, the following criteria must be satisfied:

(i) The banking entity must not be organized, or directly or indirectly controlled by a banking entity organized, in a U.S. jurisdiction (including any U.S. territory or commonwealth);

(ii) If the entity is a "foreign banking organization" under 12 C.F.R. Part 211 ("Regulation K"), it must qualify for the exemption thereunder;

(iii) If the entity is not a "foreign banking organization" under Regulation K, it must satisfy at least two of the following:

a. Its total assets held outside the United States exceed those held in the United States;

b. Its total revenues from its non-U.S. business exceed those from its U.S. business;

c. Its total net income from its non-U.S. business exceed that from its U.S. business.

[5] E.g., 12 C.F.R. § 248.13(b)(iii).

[6] Furthermore, if the banking entity (or an affiliate) acts as sponsor or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund, the banking entity automatically will be deemed to be participating in the marketing of the fund's ownership interests.

[7] The Agencies, with the exception of the CFTC, issued a joint final rule release. The CFTC issued a separate but virtually identical release.

[8] For the purposes of the Final Rule, the term "affiliate" means any company that controls, is controlled by, or is under common control with another company. A company controls another company if: (i) the company directly or indirectly or acting through one or more other persons owns, controls or has power to vote 25 percent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors of trustees of the other company; or (iii) the board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company. For purposes of the Final Rule, the term "affiliate" would not include any affiliated entity that is: (i) a "covered fund" (as defined by the Final Rule); (ii) a portfolio company held by a bank, pursuant to its merchant banking authority; or (iii) a "portfolio concern" (as defined by 13 C.F.R. § 107.50) controlled by a "small business investment company" (as defined in the Small Business Investment Act of 1958).

The text of the Final Rule was more than 70 pages long, while the supplemental guidance issued with it numbered nearly 900 pages and contained more than 2,800 footnotes. While the Final Rule is largely similar to the Notice of Proposed Rulemaking issued by the Agencies in 2011 (the "Proposed Rule"),[9] it does contain numerous important modifications from the Proposed Rule. Banking entities had until July 21, 2015 to comply with the Final Rule's restrictions. However, banking entities with $50 billion or more in trading assets and liabilities[10] were required to comply with certain reporting obligations by June 30, 2014.

The Final Rule affects a banking entity's ability to engage in "proprietary trading,"[11] generally prohibiting a banking entity from engaging in such activity, subject to certain exemptions discussed below.

A. What Constitutes 'Proprietary Trading'?

"Proprietary trading" is defined as a banking entity engaging, as principal, in any purchase or sale of a "*financial instrument*" for a "*trading account*." Thus, the scope of the prohibition on proprietary trading is determined by the definitions of "financial instrument" and "trading account."

1. What Is a "Financial Instrument"?

As noted above, for a purchase or sale[12] to constitute proprietary trading under the Final Rule, it must involve a "*financial instrument*." The Final Rule defines a "financial instrument" as any:

(a) Security (as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 (the "'34 Act"));

(b) Derivative (including any: (i) swap; (ii) security-based swap; (iii) physically deliverable commodity forward (except where involving an "excluded commodity" under Section 1a(19) of the Commodity Exchange Act ("CEA")); (iv) deliverable foreign exchange forwards; (v) foreign exchange swaps; (vi) retail foreign exchange transaction; or (vii) retail commodity transaction);[13]

(c) Commodity future;[14] or

(d) Option on any of the foregoing.

The Final Rule explicitly excludes from the definition of financial instrument, any:

(e) Loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative;

(f) Foreign exchange or currency; or

[9] The Agencies, with the exception of the CFTC issued the Proposed Rule on Oct. 11, 2011. The CFTC issued its version on Feb. 14, 2012.

[10] Which for a U.S. banking entity is measured by the average gross sum of trading assets and liabilities (excluding those involving obligations of the United States or any U.S. agency), on a worldwide consolidated basis at the end of each of the previous consecutive four quarters. A non-U.S. banking entity need only include its combined U.S. operations (including all affiliates or offices operating, located or organized in the United States) in its calculation.

[11] See the SRZ *Alert*, "Summary of Final Volcker Rule Regulation — Fund Activities," available at www.srz.com/Summary_of_Final_Volcker_Rule_Regulation_Fund_Activities/, for a summary of the Final Rule's effect on fund activities.

[12] With respect to a derivative, such terms include the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

[13] However, excluded for this purpose are: (i) instruments that the SEC and CFTC have jointly determined are not swaps or security-based swaps; or (ii) any identified banking product, as defined in Section 402(b) of the Legal Certainty for Bank Products Act of 2000.

[14] For this purpose, a commodity future is a "contract of sale" (as defined in Section 1a(13) of the CEA) for "future delivery" (as defined in Section 1a(27) of the CEA).

(g) Commodity[15] (except for (i) any "excluded commodity" (as defined above), other than foreign exchange or currency; or (ii) any commodity that is, itself, a derivative or a commodity future or option thereon).[16]

2. What Is a "Trading Account"?

As noted above, the purchase or sale of a financial instrument by a banking entity will not constitute proprietary trading *unless* it is done for a "*trading account*."[17] Under the Final Rule, the following three categories of transactions would be deemed to occur for a trading account:

(a) Purpose Test: Any purchase or sale of a financial instrument principally for the purpose of: (i) short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more of the foregoing positions, would be deemed to occur in a trading account.

Rebuttable Presumption: A purchase or sale of a financial instrument will be presumed to occur in a trading account if the banking entity holds the instrument for less than 60 days (or "substantially"[18] transfers the risk of the instrument within 60 days of the transaction), unless the banking entity can demonstrate that it did not purchase (or sell) the financial instrument principally for any of the foregoing short-term trading purposes.[19]

(b) Market Risk Rule Test: If a banking entity (or any affiliate thereof) is an FDIC-insured depository institution (or a holding company thereof) that calculates risk-based capital ratios under the market risk capital rule, any purchase or sale of a financial instrument that is both a market risk capital rule covered position and a trading position under the rule (or a hedge of any such position), would also be deemed to occur in a trading account.[20]

(c) Dealer Test: If a banking entity is, or is required to be, licensed or registered with a U.S. regulator as a dealer, swap dealer, or security-based swap dealer[21] (or is acting in a similar capacity outside the United States), then any purchase or sale of a financial instrument in connection with the activities that trigger (or would, if occurring in the United States, trigger) the foregoing licensure or registration obligation would also be deemed to occur in a trading account, *even if the transaction is not made with any short-term trading intent*.[22]

[15] For this purpose, commodity has the same meaning as in Section 1a(9) of the CEA, except that a commodity does not include any security. However, as noted above, commodity *futures* do constitute financial instruments. Accordingly, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion.

[16] While some commenters requested that certain other instruments, such as foreign exchange swaps and forwards, be excluded from the definition of financial instrument, the Agencies indicated that these instruments appear to be, or operate in economic substance as, derivatives (which are, by statute, explicitly included within the scope of instruments subject to the prohibitions of the Volcker Rule).

[17] It is important to note that the term "trading account" is a statutory concept in the Volcker Rule, which the Agencies have clarified is not necessarily meant to refer to an actual account in the normal business or accounting sense. Instead, the Agencies explained, it is simply nomenclature for the categories of transactions that are subject to the Volcker Rule's prohibition.

[18] The Final Rule does not define, nor did the Agencies offer any guidance on, what "substantially" means in this context.

[19] It is important to note that this provision does not create a safe harbor or a reverse presumption. In other words, positions held for more than 60 days are *not* presumed to be outside the scope of proprietary trading.

[20] The Market Risk Rule Test would seem redundant with the Purpose Test, since "covered positions" under the market risk capital rules are positions that are generally held with the intent of sale in the short term. Thus, a market risk rule trading account would appear to also constitute a short-term trading account.

[21] As defined, respectively, in Section 3(a)(5) of the '34 Act, Section 1(a)(49) of the CEA and Section 3(a)(71) of the '34 Act.

[22] The Agencies indicated that they did not view it necessary to limit the scope of a dealer trading account based on short-term intent, because positions held by a registered dealer in connection with its dealing activity are generally held with such intent. Moreover, they argued that the Dealer Test is balanced by the exemptions in the Final Rule for activities typically engaged in by registered dealers, such as underwriting, market making and hedging. Finally, as noted above, this provision does not apply to transactions not related to the activities that require the banking entity to be licensed or registered. (However, such activities may be covered by the Purpose Test or Market Risk Rule Test.)

3. What Activity Does Not Constitute "Proprietary Trading"?

The Final Rule explicitly excludes the following activity from the scope of proprietary trading, even where such activity would otherwise appear to fit the definition:

(a) Non-Principal Activity: Any purchase or sale of a financial instrument by a banking entity that is acting solely as agent, broker or custodian.[23]

(b) Employee Compensation Plans: Any purchase or sale of a financial instrument by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the entity that is established in accordance with U.S. or non-U.S. law, if the transaction is executed directly or indirectly by the entity as trustee for the benefit of its current or former employees (or their immediate family members).[24]

(c) Repos/Reverse Repos and Securities Lending: Any purchase or sale of a financial instrument by a banking entity that arises under:

(i) A written repurchase agreement ("repo") or reverse repurchase agreement ("reverse repo") pursuant to which the entity has simultaneously agreed to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty; or

(ii) A transaction in which the entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and recall the loaned security on terms agreed by the parties.[25]

(d) Liquidity Management: Any purchase or sale of a *security*[26] by a banking entity for liquidity management purposes, provided it is in accordance with a written liquidity management plan that:

(i) Specifically contemplates and authorizes: (i) the particular securities to be used; (ii) the amount, types and risks of such securities that are consistent with liquidity management; and (iii) circumstances in which such securities may or must be used;

(ii) Requires that any purchase or sale of securities be principally for the purpose of managing the liquidity of the banking entity, and not for any purpose that would satisfy the Purpose Test described above;

---

[23] Such activity is excluded because, as noted above, proprietary trading only covers transactions where the banking entity is acting *as principal*. The exclusion also applies where the entity is acting on behalf of an affiliate. However, such activity must still be consistent with the Final Rule from the standpoint of the affiliate that is the principal party to the transaction.

[24] As with the preceding exclusion, this activity is outside the scope of proprietary trading because, here too, the banking entity is not acting as principal. While the Final Rule contains a specific exclusion for an entity's own plans, the Agencies noted that a banking entity's actions on behalf an unaffiliated plan would likely be covered by the preceding exclusion.

[25] This exclusion recognizes that such repo, reverse repos and securities lending transactions are the economic equivalent of secured loans and generally do not constitute proprietary trading (i.e., they are not based on anticipated movements in asset prices). For this reason, only the transactions pursuant to the repo, reverse repo or securities lending agreement are excluded. For example, the collateral or position financed by a repo or reverse repo arrangement is not excluded and, therefore, could involve proprietary trading. Moreover, if a banking entity uses a repo or reverse repo to finance a purchase of a financial instrument, other transactions involving that financial instrument may not qualify for this exclusion. Similarly, short positions resulting from securities lending agreements cannot rely upon this exclusion and may involve proprietary trading.

[26] In keeping with the liquidity management requirements proposed by the federal banking agencies, this exclusion is limited only to securities, rather than all financial instruments.

(iii) Requires that any securities purchased or sold be highly liquid and limited to securities that the entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;[27]

(iv) Limits any securities purchased or sold, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the entity's near-term funding needs, as estimated and documented pursuant to methods specified in the plan;

(v) Includes written policies and procedures, internal controls, analysis and independent testing to ensure that liquidity management activities are conducted in a manner consistent with the Final Rule and the entity's liquidity management plan; and

(vi) Is consistent with the requirements, guidance and expectations of the entity's primary federal regulator.[28]

(e) Existing Delivery or Legal Obligations: Any purchase or sale of a financial instrument by a banking entity that satisfies:

(i) An existing delivery obligation of the entity or its customers (including to prevent or close out a failure to deliver) in connection with delivery, clearing or settlement activity;[29] or

(ii) An obligation of the entity in connection with a judicial, administrative, self-regulatory organization or arbitration proceeding.

(f) Debt Previously Contracted: Any purchase or sale of a financial instrument by a banking entity in the ordinary course of collecting a debt previously contracted in good faith, provided that the entity divests the instrument as soon as practicable within the time period permitted by its primary federal regulator.[30]

(g) DCO/Clearing Agency Transactions: Any purchase or sale of a financial instrument by a banking entity that is a "derivatives clearing organization" ("DCO") or a "clearing agency" in connection with clearing financial instruments;[31]

(h) Clearinghouse Member Activity: Any "excluded clearing activities"[32] by a banking entity that is a member of a clearing agency, a DCO, or a "designated financial market utility" ("DFMU").[33]

[27] However, this requirement is not intended to prevent banking entities from recognizing profits (or losses) on securities held for liquidity management purposes.

[28] To ensure sufficient flexibility to respond to liquidity needs arising from changes in the economy, a banking entity should address a range of liquidity circumstances in its plan, and provide a mechanism for periodically reviewing and revising it.

[29] For example, this exclusion allows a banking entity that is an SEC-registered broker-dealer to take action to address failures to deliver arising from its own trading activity or the trading activity of its customers, as it may be required to do under SEC regulation. In addition, buy-in procedures of a clearing agency, securities exchange or national securities association may require a banking entity to deliver securities if a party with a "fail to receive" position takes certain action.

[30] This exclusion is important for myriad common situations. For example, it enables banking entities, including SEC-registered broker-dealers, to continue to take possession of, and liquidate, margined collateral following a customer's default or failure to meet a margin call, in accordance with applicable regulations. Similarly, a banking entity that is a CFTC-registered swap dealer or SEC-registered security-based swap dealer may take, hold and exchange any margin collateral as counterparty to a cleared or uncleared swap or security-based swap transaction, in accordance with applicable regulations. This exclusion also allows banking entities to comply with existing regulations regarding the divestiture of collateral taken in satisfaction of a debt.

[31] For this purpose, a DCO is: (i) an entity registered as a DCO under Section 5b of the CEA or that, pursuant to CFTC regulation, is exempt from such registration; or (ii) a foreign DCO that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC. "Clearing agency" has the same meaning as in Section 3(a)(23) of the '34 Act.

B. What Proprietary Trading Is Prohibited?

Consistent with the statutory language of the Volcker Rule, the Final Rule prohibits a banking entity from engaging in *any* proprietary trading, unless the particular trading activity at issue is permitted under one of several specific exemptions to the general ban (as discussed in the following section). Notwithstanding such exemptions, however, any activity or transaction will always be precluded if it:

1. Involves a "material conflict of interest" between the banking entity and its clients, customers or counterparties;

   Unless, prior to engaging in such activity or transaction, the entity: (i) gives the other party clear and effective disclosure of the conflict and the opportunity to negate or substantially mitigate its impact; or (ii) the entity has information barriers, memorialized in written policies and procedures, that are reasonably designed to prevent a materially adverse effect on the other party (except where the entity knows, or should reasonably know, that the barriers are unlikely to prevent a particular materially adverse effect);

2. Materially exposes the entity to an asset, group of assets or trading strategy that would significantly increase the likelihood of: (i) substantial loss by the banking entity; or (ii) a threat to U.S. financial stability; or (iii) a threat to the safety and soundness of the banking entity or U.S. financial stability.

C. What Proprietary Trading Activities Are Permitted?

The exemptions to the Final Rule's ban on proprietary trading are discussed below. A banking entity that wishes to avail itself of one or more of these exemptions (other than the exemption for U.S. government obligations discussed below) must establish a compliance program designed to ensure and monitor compliance with the Final Rule.[34] However, the complexity of the required program varies depending on the size of the entity and the volume of its trading activity.[35] Finally, entities with $10 billion or more in trading assets and liabilities (calculated as discussed above) will also be subject to certain reporting requirements.

1. Underwriting Activities

   (a) Proprietary trading conducted by a "trading desk"[36] of a banking entity as part of the entity's underwriting activities is permitted, so long as:

---

[32] The Final Rule defines "excluded clearing activity" as any purchase or sale: (i) necessary to correct trading errors made by, or on behalf of, a customer with respect to customer transactions that are cleared, provided that such transaction is conducted in accordance with the CEA, CFTC regulations, and/or the rules of the DCO, clearing agency or DFMU, as applicable; (ii) in connection with the management of a default or threatened imminent default of a customer, provided that the transaction is conducted in accordance with the CEA, CFTC regulations, and/or the rules of the DCO, clearing agency or DFMU, as applicable; (iii) in connection with the management of a default or threatened imminent default of a clearing agency, DCO, DFMU or any member of any of the foregoing (while the Final Rule references only explicitly employs the "imminent" qualifier with regard to the threatened default of a clearinghouse or FMU member, the Preamble to the Final Rule appears to indicate that the same standard applies with regard to a clearing agency, DCO or DFMU); or (iv) required by the rules or procedures of a clearing agency, DCO or DFMU to mitigate its risk resulting from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

[33] As defined in Section 803(4) of the Dodd-Frank Act.

[34] Moreover, as discussed below, the exemptions for underwriting, market-making and risk-mitigation hedging activities each impose additional components to the requisite compliance program.

[35] A banking entity with total consolidated assets of $10 billion or less (as reported at the end of the previous two calendar years) may satisfy this compliance program obligation by simply including in its *existing* policies and procedures appropriate references to the Volcker Rule and Final Rule, as applicable.

[36] Defined as "the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof." The focus is on functionality rather than legal status or corporate structure. Thus, a trading desk may include employees of multiple affiliates or book trades in multiple affiliates. In the underwriting context, a "trading desk" encompasses what is commonly thought of as an underwriting desk and would not necessarily be an active market participant that engages in frequent trading activities.

(b) The entity is acting as an "underwriter" for a "distribution" of securities and the desk's "underwriting position" is related to such distribution;[37]

(c) The banking entity is licensed or registered to engage in such activity, in accordance with applicable law;[38]

(d) The amount and type of securities in the desk's underwriting position[39] are designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties,[40] *and* reasonable efforts are made to sell or reduce the position within a reasonable period, taking into account the liquidity, maturity and depth of the market for the relevant security;

(e) The compensation arrangements of relevant employees are designed not to reward or incentivize prohibited proprietary trading;[41] and

(f) The entity has established and enforces an internal compliance program, as required by the Final Rule, that is reasonably designed to ensure compliance with the requirements of this underwriting exemption, including written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(i) The products, instruments or exposures each desk may purchase, sell or manage as part of its underwriting activities;

(ii) Limits for each desk, based on the nature and amount of its underwriting activities, including the reasonably expected near term demands of clients, customers or counterparties, on the: (i) amount, types and risk of its underwriting position; (ii) level of risk exposures arising from the position; and (iii) period of time a security may be held;

(iii) Internal controls and ongoing analysis of each desk's compliance with its limits; and

(iv) Authorization procedures (including escalation procedures) that require: (i) review and approval of any trade that would exceed a desk's limit; (ii) demonstrable analysis of the basis for any limit increase (even if only temporary); and (iii) independent review of such analysis and approval.

2. Market-Making Activities

---

[37] For this purpose, an "underwriter" is a person who has: (i) agreed with an issuer or selling security holder to purchase securities for distribution, engage in a distribution of securities, or manage a distribution of securities for or on behalf of the issuer or selling security holder; or (ii) agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder. A "distribution" is an offering of securities that is: (i) made pursuant to an effective registration statement under the Securities Act of 1933 (the "'33 Act"); or (ii) distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods (such as delivering sales documents or conducting road shows), whether or not the offering is subject to registration under the '33 Act. An "underwriting position" is the long or short positions held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a distribution for which the entity or affiliate is acting as an underwriter.

[38] However, not all entities engaged in activity under this exemption would have an obligation to be licensed or registered under applicable law.

[39] It is important to note that the underwriting exemption's requirements pertaining to a trading desk's underwriting position apply on a *distribution-by-distribution* basis, rather than on individual transactions. The desk may not aggregate positions acquired in connection with multiple distributions to determine its underwriting position. However, it may have more than one underwriting position at a particular point in time if the banking entity is acting as an underwriter for more than one distribution. A desk's underwriting position can include securities held at different affiliates if the banking entity maintains readily available records that identify any related positions held at an affiliate that are being included in its desk's underwriting position for purposes of this exemption.

[40] For a banking entity that acts as a primary dealer (or functional equivalent) for a sovereign government, the sovereign government and its central bank would each fit within this category for the purpose of this underwriting exemption, as well as the market making exemption discussed below.

[41] The Agencies explained that, although a banking entity relying on the underwriting exemption may appropriately take into account revenues from price movements to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk, the entity should provide compensation incentives that primarily reward customer revenues and effective customer service.

Proprietary trading related to the market-making activity of a banking entity is permitted, so long as:

(a) The trading desk[42] that establishes and manages the "financial exposure":[43] (i) routinely stands ready to purchase and sell financial instruments related to its financial exposure; and (ii) is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in such instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity and depth of the market for such instruments;[44]

(b) The entity is licensed or registered to engage in such activity, in accordance with applicable law;[45]

(c) The amount, types and risks of the instruments in the desk's "market-maker inventory"[46] are designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of clients, customers or counterparties,[47] based on: (i) the liquidity, maturity and depth of the market for the relevant instruments; and (ii) demonstrable analysis of historical demand, current inventory, and market and other factors regarding the amount, types, and risks of or associated with the relevant instruments, including through block trades;

(d) The compensation arrangements of relevant employees are designed not to reward or incentivize prohibited proprietary trading;[48]

(e) The entity has established and enforces an internal compliance program, as required by the Final Rule, that (as under the underwriting exemption) is reasonably designed to ensure compliance with the requirements of this underwriting exemption, including written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

    (i) The financial instruments each desk stands ready to purchase and sell, as part of its market-making activities;

---

[42] In the market-making context, the Agencies expect that a trading desk would be managed and operated as an individual unit and should reflect the level at which the profit and loss of market-making traders is attributed. As explained above, the location of individual traders is not dispositive for purposes of determining whether the traders may all belong to a single desk.

[43] For this purpose, "financial exposure" means the aggregate risks of the financial instruments and any associated loans, commodities, or foreign exchange or currency held by an entity (or an affiliate) and managed by a particular trading desk as part of the desk's market making-related activities.

[44] This requirement would not be satisfied, for example, if the desk only provides wide quotations on one or both sides of the market relative to prevailing market conditions or is only willing to trade on an irregular basis. It is important to note that the Final Rule's standard for exempted market-making is similar, but not identical, to activity that is considered market-making for purposes of other laws or regulations, such as the U.S. securities laws. In addition, the Agencies noted that a banking entity acting as an underwriter would continue to be treated as an underwriter for purposes of U.S. securities laws, regardless of whether it is able to meet the terms of the market-making exemption for its activities.

[45] However, not all entities engaged in activity under this exemption would have an obligation to be licensed or registered under applicable law.

[46] Defined as all of the positions in the instruments for which the desk stands ready to make a market in accordance with exemption that are managed by the trading desk, including open positions or exposures arising from open transactions. Like the underwriting exemption, the market-making exemption does not utilize a transaction-by-transaction approach, but instead focuses on two related aspects of market-making activity: a trading desk's "market-maker inventory" and its overall "financial exposure."

[47] For this purpose, another banking entity will not constitute a client, customer or counterparty if it has trading assets and liabilities of $50 billion or more, unless: (i) the trading desk documents how and why a particular unit of the other entity should be treated as a client, customer or counterparty of its market making-related services; or (ii) the purchase or sale by the desk is conducted anonymously on an exchange (or similar facility) that permits trading by a broad range of market participants. Furthermore, the Agencies explained that, for this purpose, an exchange-traded fund ("ETF") and any market participants seeking to purchase ETF shares will be considered clients, customers or counterparties of a banking entity that acts as an authorized participant for the ETF.

[48] As with the underwriting exemption, a banking entity relying on the market making exemption may appropriately take into account revenues from price movements to the extent that such revenues reflect the effectiveness with which personnel have managed retained principal risk, but it should provide compensation incentives that primarily reward customer revenues and effective customer service.

(ii) Limits for each desk, based on the nature and amount of its market making-related activities, including the reasonably expected near-term demands of clients, customers or counterparties, on the: (i) amount, types and risk of its market-maker inventory or the products, instruments and exposures used for risk-management purposes; (ii) level of exposure to relevant risk factors arising from financial exposure; and (iii) period of time an instrument may be held;

(iii) Internal controls and ongoing analysis of each desk's compliance with its limits;

(iv) Risk-mitigation policies, including: (i) actions the desk will take to significantly reduce or mitigate promptly the risks of its financial exposure consistent with the aforementioned limits; (ii) products, instruments and exposures permissible to use for risk-management purposes; (iii) techniques and strategies permissible to manage the risks of its market making-related activities and inventory; and (iv) processes, strategies and personnel responsible for ensuring that the actions taken to mitigate risk are, and continue to be, effective;[49] and

(v) Authorization procedures (including escalation procedures) that require: (i) approval of any trade that would exceed a desk's limit; (ii) demonstrable analysis of the basis for any limit increase (even if only temporary); and (iii) independent review of such analysis and approval; and

(f) To the extent that any limit identified above is exceeded, the desk takes action to comply with the limit as promptly as possible thereafter.

3. Risk-Mitigating Hedging

The prohibition on proprietary trading does not apply to the risk-mitigating hedging activities of a banking entity in connection with, and related to, *individual or aggregated*[50] positions, contracts or other holdings of the entity, so long as:

(a) The entity has established and enforces an internal compliance program, as required by the Final Rule, that (similar to the foregoing exemptions) is reasonably designed to ensure compliance with the requirements of this risk-mitigating hedging exemption, including:

(i) Reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including which positions, contracts or other holdings a particular trading desk may use, as well as position and aging limits with respect to such holdings;

(ii) Internal controls and ongoing monitoring, management and authorization procedures, including relevant escalation procedures; and

---

[49] It should be noted that such market-making-related hedging activity need not separately comply with the risk-mitigating hedging exemption discussed later herein. In addition, a desk engaged in market-making-related activities may direct another organizational unit of the banking entity or an affiliate to execute a risk-mitigating transaction on the desk's behalf. However, such other unit may rely on the market making exemption for these purposes only if: (i) the unit acts in accordance with the desk's market-making risk management policies and procedures; and (ii) the risk-mitigating position is attributed to the desk's, rather than the unit's, financial exposure and is included in the desk's daily profit and loss calculation. Otherwise, the unit must comply with the requirements of the hedging exemption for such activity.

[50] Like the statutory language of the Volcker Rule, the Final Rule explicitly permits hedging of aggregated positions under this exemption, as long as such activity relates to identifiable risks related to specific holdings. Accordingly, the Agencies explained that exempted hedging activity cannot be designed to: (i) reduce risks associated with the entity's assets or liabilities generally, general market movements or broad economic conditions; (ii) profit in the case of a general economic downturn; (iii) counterbalance revenue declines generally; or (iv) otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the entity.

(iii) The conduct of analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk being hedged (*and* such correlation analysis demonstrates that the hedging activity indeed achieves the foregoing objective[51]);[52]

(b) The risk-mitigating hedging activity:

(i) Is conducted in accordance with the foregoing written policies, procedures and internal controls;

(ii) Is designed (at its inception and at the time of any adjustments) to reduce or otherwise significantly mitigate (*and* demonstrably reduces or otherwise significantly mitigates) one or more *specific, identifiable risks*, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk or similar risks, arising in connection with and related to *identified* positions, contracts or other holdings of the entity (based on the relevant facts and circumstances);[53]

(iii) Does not give rise, at its inception, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this exemption;

(iv) Is subject to ongoing monitoring and management that:

(1) Is consistent with the written hedging policies and procedures discussed above;

(2) Is designed to reduce or otherwise significantly mitigate (*and* demonstrably reduces or otherwise significantly mitigates) the specific, identifiable risks that develop over time from the risk-mitigating hedging activities undertaken under this section and the underlying holdings of the entity (based on the relevant facts and circumstances); and

(3) Requires ongoing recalibration of the hedging activity to ensure that it satisfies the requirements of (i), (ii), (iii) and (iv)(1) and (2) above, and is not prohibited proprietary trading;

(c) The compensation arrangements of relevant employees are designed not to reward or incentivize prohibited proprietary trading;[54] and

(d) In certain instances (as discussed below), the banking entity must, contemporaneously with a purchase or sale, document (at a minimum): (i) the specific, identifiable risk(s) that the transaction is designed to reduce; (ii) the specific risk-mitigating strategy that the transaction

---

[51] However, the Agencies explicitly recognized that demonstrating correlation may not be possible in certain circumstances, in which case such analysis should explain why not and also how the position, technique or strategy is designed to reduce or significantly mitigate risk and how its efficacy can be demonstrated without correlation.

[52] The requisite scope and level of detail of the required compliance program will vary depending on the size, activities and complexity of the banking entity at issue.

[53] As explained by the Agencies, the Final Rule allows for dynamic hedging, because the risks from a permissible position may change over time, new risks may emerge, and hedges may become less effective over time in addressing the related risk. Anticipatory hedging is also permitted, so long as it is also risk reducing and not impermissible proprietary trading. If an anticipated risk does not materialize within a limited time period contemplated when the hedge is entered into, the banking entity would be required to extinguish the anticipatory hedge or otherwise demonstrably reduce its risk as soon as reasonably practicable.

[54] For instance, the Agencies indicated that a compensation arrangement that incentivizes an employee to exceed the potential losses associated with the risks of the underlying position, rather than reduce such risks, would also likely violate this requirement.

is designed to fulfill; and (iii) the desk or other unit that is establishing and responsible for the hedge.[55]

The foregoing documentation requirements apply to any purchase or sale made under this risk-mitigating hedging exemption that is established:

(i) By a different trading desk than the one establishing or responsible for the underlying holdings whose risks are being hedged;

(ii) By the desk establishing or responsible for the underlying holdings, but effected through an instrument, exposure, technique or strategy that is not specifically identified in the desk's written policies and procedures (discussed above) as permissible for hedging; or

(iii) To hedge aggregated positions across two or more trading desks.

4. Trading in U.S. Government Obligations

A banking entity may engage in proprietary trading of any financial instrument (but not any derivative thereof[56]) that is:

(a) An obligation of, or issued or guaranteed by, the United States;

(b) An obligation, participation or other instrument of, or issued or guaranteed by, a U.S. agency, Ginnie Mae, Fannie Mae, Freddie Mac, a Federal Home Loan Bank, Farmer Mac or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971;

(c) An obligation of any U.S. state or territory, any political subdivision of either, or any agency or instrumentality of any of the foregoing (including any municipal security); or

(d) An obligation of the FDIC, or any entity formed by or on behalf of the FDIC to facilitate the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act.

5. Trading in Non-U.S. Government Obligations

A banking entity may engage in proprietary trading of any financial instrument that is an obligation of, or issued or guaranteed by, a non-U.S. sovereign (including any multinational central bank of which such sovereign is a member), or any agency or political subdivision of such sovereign (but not any derivative of such an instrument),[57] under the following circumstances:

(a) U.S. Operations of Non-U.S. Banking Entities: The "U.S. operations" of a non-U.S. banking entity that is not ultimately controlled by a U.S. banking entity[58] may engage in proprietary trading of such an instrument, if:

[55] Such records must be retained for at least five years (or such longer period as required by other applicable law) in a form that allows the entity to promptly produce them upon the request of its primary federal regulator.

[56] Thus, this exemption does not permit a banking entity to engage in proprietary trading of derivatives of U.S. government or agency obligations. However, such activity may qualify for the market-making or risk-mitigating hedging exemptions.

[57] However, as noted above in the context of U.S. government obligations, trading in such derivatives may qualify under another exemption.

[58] A "non-U.S. banking entity" is a banking entity organized under the laws of a non-U.S. sovereign, whereas a "U.S. banking entity" is organized under the laws of the United States or any state, territory or commonwealth thereof. For this purpose, the "U.S operations" of a non-U.S. banking

The instrument is an obligation of, or issued or guaranteed by, the non-U.S. sovereign under whose laws the entity (or its control party) is organized (or by any: (i) agency or political subdivision of such sovereign; or (ii) multinational central bank of which such sovereign is a member); and

(b) The entity acting as principal is not an FDIC-insured depository institution.

6. Non-U.S. Operations of U.S. Banking Entities

A non-U.S. banking entity ultimately controlled by a U.S. banking entity may engage in proprietary trading of such an instrument, if:

(a) The non-U.S. banking entity is regulated by its home sovereign as a bank[59] or a securities dealer;

(b) The instrument is an obligation of, or issued or guaranteed by, the sovereign under whose laws the entity is organized (or by any: (i) agency or political subdivision of such sovereign; or (ii) multinational central bank of which such sovereign is a member); and

(c) The instrument is owned by the entity and not financed by an affiliate that is either organized or located in the United States.

7. Trading on Behalf of Customers

(a) The prohibition on proprietary trading does not apply to the purchase or sale of a financial instrument by a banking entity on behalf of its customers in the follow two contexts:

(i) Fiduciary Transactions: Where the entity is acting as trustee or in a similar fiduciary capacity, so long as: (i) the transaction is conducted for the account of, or on behalf of, a customer; and (ii) the entity does not have or retain beneficial ownership of the instrument;[60] and

(ii) Riskless Principal Transactions: Where the entity is acting as riskless principal in a transaction in which it, after receiving an order to purchase (or sell) the instrument from a customer, purchases (or sells) the instrument for its own account to offset a contemporaneous transaction with the customer.

8. Trading by a Regulated Insurance Company

(a) The prohibition on proprietary trading does not apply to the purchase or sale of a financial instrument by a banking entity that is a regulated insurance company (or an affiliate thereof), if the transaction:

---

entity would include: (i) any U.S. branch or agency of the entity; and (ii) any U.S. banking entity controlled by the non-U.S. banking entity. While this exemption is available only for the U.S. operations of non-U.S. banking entities, non-U.S. banking entities have a far broader exemption available for their non-U.S. operations, one that is not limited to sovereign obligations (as discussed later herein).

[59] To qualify as a "bank" for this purpose, the institution's ordinary course of business must include substantial deposit-taking and it must have the ability to accept demand deposits.

[60] It is not entirely clear why such a transaction would be considered proprietary trading in the absence of this exemption (i.e., why it would not be excluded from the definition as a situation where the entity was not acting *as principal*, such as when it as agent, broker or custodian). However, this exemption was contained in the statutory language of the Volcker Rule.

(i) Is conducted solely for the general account of the insurance company or for one or more separate accounts established by the insurance company; and

(ii) Complies with the insurance law of the jurisdiction in which the insurance company is domiciled (and the appropriate federal banking agencies have not determined that such law is insufficient to protect the banking entity's safety and soundness or U.S. financial stability).

D. Non-U.S. Trading Activity of Non-U.S. Banking Entities

1. Certain eligible non-U.S. banking entities are permitted to engage in proprietary trading of any financial instruments, provided the trading decisions and principal risks occur and are held outside the United States (as discussed below).

2. Eligible Non-U.S. Banking Entities: A non-U.S. banking entity is eligible to use this exemption, if:

(a) The entity is not directly or indirectly controlled by a U.S. banking entity;[61] and

(b) If the entity is a "foreign banking organization" under the Board's Regulation K, it qualifies for the exemption;[62] or

(c) If the entity is not a "foreign banking organization" under the Board's Regulation K, it must satisfy, on a fully-consolidated basis, at least two of the following:

(i) Its total assets held outside the United States exceed those held in the United States;

(ii) Its total revenues from its non-U.S. business exceed those from its U.S. business; and

(iii) Its total net income from its non-U.S. business exceed that from its U.S. business.

3. Eligible Trading Activity: An eligible non-U.S. banking entity may engage in proprietary trading under this exemption only if:

(a) The entity (or office thereof) acting as principal (and that makes the decision to engage in the transaction, if different) is not organized or located in the United States;[63]

(b) No personnel of the entity (or an affiliate) who arrange, negotiate, execute or make the decision to execute such transaction are located in the United States;[64]

---

[61] Thus, non-U.S. subsidiaries or non-U.S. offices of a U.S. banking entity may not take advantage of this exemption.

[62] Under Regulation K, a "foreign banking organization" is a foreign bank that operates a branch office, agency office, commercial lending company, bank subsidiary or Edge corporation in the United States, or any subsidiary of such an institution. To constitute a "qualifying foreign banking organization," it must satisfy two tests (unless otherwise permitted by the Board). First, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its total worldwide nonbanking assets; (ii) its revenues derived from the business of banking outside the United States exceed its total revenues derived from its worldwide nonbanking business; and (iii) its net income derived from the business of banking outside the United States exceeds its total net income derived from its worldwide nonbanking businesses. Second, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its banking assets held in the United States; (ii) its revenues derived from the business of banking outside the United States exceed its revenues derived from the business of banking in the United States; and (iii) its net income derived from the business of banking outside the United States exceeds its net income derived from the business of banking in the United States.

[63] For this purpose, any U.S. office of a non-U.S. bank (or any subsidiary of such office) is located in the United States, but the bank itself is not.

[64] Thus, for example, personnel in the United States cannot solicit or sell to or arrange for trades conducted under this exemption. However, the Agencies explained that personnel that engage in back-office functions, such as clearing and settlement of trades, could be located in the United States.

(c) The transaction (including any risk-mitigating hedging transaction related thereto) is not accounted for as principal directly, or on a consolidated basis by, any branch or affiliate that is organized or located in the United States;

(d) No financing for the transaction is provided, directly or indirectly, by any such branch or affiliate; and

(e) The transaction is not conducted with or through any entity that is, or is controlled by, or acting on behalf of, or at the direction of, any other entity that is, organized or located in the United States (collectively, a "U.S. entity"), other than:

(i) A transaction with the foreign operations of a U.S. entity if no personnel of such entity that are located in the United States are involved in the arrangement, negotiation or execution of such purchase or sale;

(ii) A transaction with an "unaffiliated market intermediary"[65] acting as principal, provided the transaction is promptly cleared and settled through a clearing agency or DCO acting as a central counterparty; or

(iii) A transaction through an unaffiliated market intermediary acting as agent, provided the transaction is conducted anonymously on an exchange or similar trading facility[66] and is promptly cleared and settled through a clearing agency or DCO acting as a central counterparty.

E. Timing

1. Conformance Date: Banking entities had until July 21, 2015 to conform their activities to the Final Rule.[67] This deadline represented a one-year extension of the Volcker Rule's conformance period, which the Board granted simultaneously with the issuance of the Final Rule.[68] However, as noted above, banking entities with $50 billion or more in trading assets and liabilities must have complied with certain reporting obligations by June 30, 2014.[69]

2. Conformance Period Obligations: Up until July 21, 2015, each banking entity was expected to engage in "good-faith efforts" to conform its activities and investments to the requirements of the Volcker Rule and the Final Rule. The Board explained that such good faith efforts should include "evaluating the extent to which the banking entity is engaged in activities and investments that are covered by [the Volcker Rule] and the [Final Rule], as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities by the end of the conformance period. In addition, entities that have stand-

---

[65] For purposes of this exemption, an "unaffiliated market intermediary" is an unaffiliated entity, acting as an intermediary, that is: (i) a broker or dealer registered with the SEC under Section 15 of the '34 Act; (ii) a swap dealer registered with the CFTC under Section 4s of the CEA; (iii) a security-based swap dealer registered with the SEC under section 15F of the '34 Act or exempt from registration; or (iv) a futures commission merchant registered with the CFTC under Section 4f of the CEA (or exempt from any of the foregoing registration obligations or excluded from regulation as any of the foregoing).

[66] The Agencies have indicated that a non-U.S. banking entity *would* be in compliance with this requirement even if the counterparty to its trade happened to be an affiliated entity, so long as it traded anonymously through an unaffiliated market intermediary on an exchange.

[67] Notwithstanding the foregoing, a company that was not a banking entity on July 21, 2010 must bring its activities into conformance before the later of: (i) July 21, 2015; or (ii) two years after the date on which the company becomes a banking entity.

[68] In doing so, the Board indicated that it will continue to monitor developments to determine whether additional extensions of the conformance period would be in the public interest and consistent with the statute.

[69] Banking entities with $25 billion or more in trading assets and liabilities and banking entities with $10 billion or more in trading assets and liabilities would be required to comply with reporting obligations beginning on April 30, 2016 and Dec. 31, 2016, respectively.

alone proprietary trading operations are expected to promptly terminate or divest those operations."

3. Potential Extensions: Under the Volcker Rule, the Board is empowered to grant a banking entity up to three one-year extensions. As indicated above, the Board has used one of those potential extensions to grant the entire industry a one-year delay of the conformance date. Thus, a banking entity could potentially seek up two additional one-year extensions.[70] However, given the Board's stated expectations, it would appear that an extension for non-exempt proprietary trading activities would be unusual.

IV. Summary of Final Volcker Rule Regulation: Fund Activities

On Dec. 10, 2013, the Agencies issued a final rule (the "Final Rule") implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is commonly referred to as the "Volcker Rule."[71] The Volcker Rule restricts the proprietary trading and private investment fund activities of U.S. banks and their affiliates, as well as foreign banks with a branch or agency office in the United States and their affiliates (collectively, "banking entities").[72]

The text of the Final Rule is more than 70 pages long, while the supplemental guidance issued with it numbers nearly 900 pages and contains more than 2,800 footnotes. While the Final Rule is largely similar to the Notice of Proposed Rulemaking issued by the Agencies in 2011 (the "Proposed Rule"),[73] it does contain numerous important modifications from the Proposed Rule. As discussed below, banking entities generally have until July 21, 2015 to comply with the Final Rule's restrictions.

This section analyzes the Final Rule as it would affect a banking entity's investments in, or sponsorship of, private investment funds. In this regard, the regulation has two parts. First, a banking entity is generally barred from acquiring or retaining, "as principal," an "ownership interest" in a "covered fund," subject to certain exceptions. Second, a banking entity may no longer "sponsor" any "covered fund," unless it abides by a series of new requirements (or the sponsorship falls within an exception for non-U.S. activity).

A. Prohibition on Fund Investments

1. What Is a "Covered Fund"?

(a) As noted above, the Final Rule's prohibition on fund investments only pertains to "covered funds." Under the Final Rule, a "covered fund" includes:

(b) Hedge or Private Equity Funds: The primary component of the definition of "covered funds" is any issuer that would be an investment company under the Investment Company Act of 1940

[70] Any extension request must be submitted in writing at least 180 days in advance and must contain a detailed explanation of the banking entity's plan for divesting or conforming the activity, as well as an analysis of numerous factors required by the Board.

[71] The Agencies, with the exception of the CFTC, issued a joint final rule release. The CFTC issued a separate, but virtually identical release.

[72] For the purposes of the Final Rule, the term "affiliate" means any company that controls, is controlled by or is under common control with another company. A company controls another company if: (i) the company directly or indirectly or acting through one or more other persons owns, controls or has power to vote 25 percent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors or trustees of the other company; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company. For purposes of the Final Rule, the term "affiliate" would not include any affiliated entity that is: (i) a covered fund; (ii) a portfolio company held by a bank, pursuant to its merchant banking authority; or (iii) a "portfolio concern" (as defined by 13 C.F.R. § 107.50) controlled by a "small business investment company" ("SBIC") (as defined in the Small Business Investment Act of 1958).

[73] The Agencies, with the exception of the CFTC, issued the Proposed Rule on Oct. 11, 2011. The CFTC issued its version on Feb. 14, 2012.

("'40 Act") but for the exemptions contained in Sections 3(c)(1) and 3(c)(7) therein ("3(c)(1)/3(c)(7) funds");[74] and

(c) Commodity Pool Equivalents: Certain Commodity Pools that are similar to 3(c)(1)/3(c)(7) funds are also included, specifically pools for which:

(i) The commodity pool operator ("CPO") has claimed an exemption under CFTC Rule 4.7;[75] or

(ii) The CPO is registered with the CFTC and the pool is primarily held by qualified eligible participants ("QEPs") and has not been publicly offered to non-QEPs.[76]

(d) Equivalent Non-U.S. Funds (if banking entity is U.S. or U.S.-controlled): Moreover, for any U.S. banking entity (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity) a "covered fund" would also include any issuer that:

(i) Is organized or established outside the United States;

(ii) Offers and sells its ownership interests outside the United States; and

(iii) Is, or holds itself out as, a vehicle for primarily investing or trading in securities (a "foreign fund");

(iv) *Unless* such foreign fund, were it subject to U.S. securities laws, could rely on an exemption from the '40 Act other than those contained in Section 3(c)(1) or 3(c)(7) therein.

(v) In contrast, a non-U.S. banking entity that is not directly or indirectly controlled by a U.S. banking entity would not have to treat a non-U.S. fund that meets the foregoing criteria as a covered fund (but, for this purpose, a U.S. branch or agency office of a non-U.S. bank would be treated as a U.S. banking entity).[77]

2. What Entities Are Excluded from the 'Covered Fund' Definition?

The following types of issuers do not constitute covered funds under the Final Rule, even where they otherwise would fit the definition:

(a) Certain Non-U.S. Public Funds: A public fund organized or established outside the United States, provided that:

(i) It is authorized to offer and sell ownership interests to retail investors in its home jurisdiction; and

[74] This would capture nearly all entities currently thought of as hedge funds or private equity funds. However, the Final Rule appears to make clear that an issuer that can rely on exemptions under the '40 Act other than Section 3(c)(1) or 3(c)(7), such as a real estate fund relying on Section 3(c)(5), will not be treated as a covered fund, even if it may also rely on Section 3(c)(1) or 3(c)(7).

[75] The Agencies chose to include "Rule 4.7" pools in the definition since they are most similar to 3(c)(1)/3(c)(7) funds, as they are only offered to investors who meet certain heightened qualification standards.

[76] The Agencies chose to include such funds so as to prevent a CPO from choosing full CPO compliance, rather than rely on Rule 4.7 (even though eligible to do so), simply to keep the pool outside the scope of the Final Rule.

[77] For example, such a fund would be a covered fund with respect to a U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a non-U.S. banking entity that invests in the fund (provided the entity is not U.S.-controlled). This bifurcated treatment of such non-U.S. funds, depending on the jurisdictional nature of the banking entity involved, is a significant change from the Proposed Rule and was meant to limit the extraterritorial effect of the Volcker Rule.

(ii) It sells such interests "predominantly"[78] through one or more public offerings outside the United States that: (i) comply with all applicable requirements in the applicable jurisdiction; (ii) are not restricted based on investor net worth; and (iii) include the filing of publicly available disclosure documents.

(iii) Moreover, *for any U.S. banking entity (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity)* to rely on this exemption to "sponsor" (as defined below) a non-U.S. public fund, the fund's ownership interests must be sold "predominantly" to persons other than: (i) the banking entity; (ii) the issuer; (iii) their affiliates; or (iv) employees or directors of such entities.[79]

(b) Certain Non-Funds: Three types of entities that would not normally be thought of as funds, but could otherwise sometimes fall within the broad definition of "covered funds," include:

(i) Wholly Owned/Nearly Wholly Owned Subsidiaries: An entity that is at least 95-percent owned by a banking entity, provided that any amount not owned by the entity is held by: (i) employees or officers (not to exceed 5 percent); or (ii) third parties (not to exceed 0.5 percent) where such third-party investor is needed to establish corporate separateness or address bankruptcy or similar concerns;

(ii) Joint Ventures: A joint venture ("JV") between a banking entity and others, provided: (i) there are no more than 10 unaffiliated co-venturers; and (ii) the JV vehicle does not invest, or hold itself out as investing, in securities for resale, but otherwise engages in activity that is permissible for the banking entity; and

(iii) Acquisition Vehicles: An issuer formed solely for the purpose of engaging in a bona fide acquisition or merger, which exists only for such period as necessary to effectuate such transaction.[80]

(c) Foreign Pension Funds: A broad-based plan, fund or program organized and administered outside the United States to provide retirement or similar benefits, provided that it is: (i) subject to regulation in its home jurisdiction; and (ii) established for benefit of citizens or residents of one or more non-U.S. sovereigns (or subdivisions thereof).

(d) Insurance Company Separate Accounts: Provided that no other banking entity besides the insurance company shares in the profits or losses of such account.

(e) Bank-Owned Life Insurance: Provided that the banking entity that purchases the policy does not: (i) control the investment decisions of the separate account; or (ii) participate in the profit or losses of such account, except in accordance with applicable supervisory guidance.

(f) Loan Securitizations: An issuer of asset-backed securities ("ABS"), provided that its assets are solely comprised of:

[78] For the purposes of this exclusion "predominantly" means 85 percent or more of the fund's ownership interests.

[79] Accordingly, unlike with non-U.S. equivalents of 3(c)(1)/3(c)(7) funds, U.S. banking entities (and non-U.S. banking entities controlled by a U.S. banking entity) may be able to invest in or sponsor a non-U.S. public fund without such activity being subject to the Final Rule. However, the Agencies intend to monitor U.S. banking entities' investments in non-U.S. public funds to ensure such funds are not used to evade the Volcker Rule.

[80] However, an acquisition vehicle that survives a transaction may then be eligible for either of the two preceding exclusions.

(i) Loans (defined as any loan, lease, extension of credit or receivable, that is not a security or derivative);

(ii) Any rights or other assets: (i) related or incidental to acquiring or holding the loans; or (ii) designed to assure the servicing or timely delivery of proceeds to the security holders ("Permitted Assets");

(iii) Interest rate or foreign exchange derivatives that are directly related to the loans or Permitted Assets held by the issuer or related ABS and are specifically designed to reduce the interest rate or foreign exchange risks related thereto;

(iv) Special units of beneficial interest and collateral certificates issued by a special purchase vehicle ("SPV"), provided that: (i) the SPV does not hold any assets impermissible for the issuer to hold; (ii) the interest or certificate is used solely to transfer to the issuer the economic risks and benefits of assets permissible for the issuer to hold (and does not transfer any interest in any other exposure); (iii) the interest or certificate is created solely to satisfy legal requirements or facilitate the structuring of the securitization; and (iv) both the SPV and the issuer are established by the same entity that initiated the securitization;

(v) Cash equivalents for the purposes of the Permitted Assets; or

(vi) Securities received in lieu of a debt previously contracted with respect to the loans supporting the ABS.

Moreover, an eligible loan securitization may not hold any commodity forward contract or, except as permitted above, any securities (including ABS) or derivatives.

(g) Certain Asset-Backed Commercial Paper Conduits: An issuer of asset-backed commercial paper ("ABCP") whose assets are solely comprised of: (i) loans and other assets permissible for an exempt securitization (as described above); or (ii) ABS supported solely by such assets and that were acquired by the ABCP issuer as part of an initial issuance either directly from the ABS issuer or from an underwriter, provided that:

(i) The ADCP conduit issues only ABS comprised of a residual interest and securities with a legal maturity of no more than 397 days; and

(ii) A "regulated liquidity provider"[81] has a legally binding obligation to provide full and unconditional liquidity coverage with respect to the ABS issued by the conduit (other than any residual interest) in the event that funds are required to redeem maturing ABS.

(h) Qualifying Covered Bonds: An entity holding a pool of loans or other assets permissible for an exempt securitization (as described above) for the benefit of holders of "covered bonds."[82]

[81] "Regulated liquidity providers" include: (i) an FDIC-insured depository institution; (ii) a U.S. bank or savings and loan holding company (or any subsidiary thereof); (iii) a non-U.S. bank whose home country supervisor has adopted capital standards consistent with Basel III (or a subsidiary thereof); or (iv) the United States or a non-U.S. sovereign.

[82] For this purpose a "covered bond" means: (i) a debt obligation issued by a non-U.S. banking entity (or a subsidiary thereof), the payment of which is fully and unconditionally guaranteed by the entity holding the pool of loans or other assets; or (ii) a debt obligation of the entity holding the pool of loans or other assets, where such entity is a "wholly-owned or nearly wholly-owned subsidiary" (as discussed above) of a non-U.S. banking entity (or a subsidiary thereof) and such parent fully and unconditionally guarantees the payment of such obligation.

(i) SBICs and Public Welfare Investment Funds: An issuer that is: (i) an SBIC under the Small Business Investment Act of 1958 (or a company that has received a notice to proceed to qualify for such a license); (ii) "Designed primarily to promote the public welfare" under Section 24(Eleventh) of the National Bank Act; or (iii) a "qualified rehabilitation expenditure" with respect to a qualified rehabilitation building or certified historic structure under Section 47 of the Internal Revenue Code of 1986.

(j) Registered Funds: An issuer that is: (i) registered as an investment company ("RIC") or regulated as a business development company ("BDC") under the '40 Act;[83] or (ii) formed pursuant to a written plan to become a RIC or BDC and, in the meantime, operates in compliance with the leverage requirements of the '40 Act.[84]

(k) FDIC-Related Issuers: An issuer that is formed for the purpose of facilitating the disposal of assets acquired by the FDIC as receiver or conservator.

In addition to the foregoing, the Agencies may exempt other types of issuers in the future, if they make a public determination that such exclusions would be consistent with the purposes of the Volcker Rule.

3. What Are "Ownership Interests" of a Covered Fund?

As noted above, the Final Rule only prohibits acquiring or holding an *"ownership interest"* in a covered fund. The Final Rule defines an "ownership interest" to mean any equity or partnership interest or any other interest that exhibits any of the following features or characteristics on a current, future, or contingent basis:

(a) Has the right to participate in the selection or removal of the covered fund's general partner, managing member, directors, trustees, investment manager, investment adviser or commodity trading advisor (although not including the remedial rights of a creditor upon the occurrence of an event of default or acceleration event);

(b) Has the right to receive a share of the income, gains or profits of the covered fund;

(c) Has the right to receive the residual assets of the covered fund (not including creditor rights, as discussed above);

(d) Has the right to receive all or a portion of the excess spread (i.e., difference between the aggregate interest payments from the covered fund's underlying assets and the aggregate interest paid to holders of other outstanding interests);

(e) Provides that the interest amounts payable by the covered fund could (as per the terms) be reduced based on losses arising from the underlying assets of the covered fund;

(f) 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;[85] or

[83] Absent this exemption, such entities could have constituted covered funds, to the extent that they also fit the definition of a covered commodity pool.

[84] This includes an investment company which relies on Section 3(c)(1) or 3(c)(7) during its seeding period.

[85] "Ownership interests" would therefore include a lending arrangement with a covered fund in which the interest or other payments are calculated by reference to the profits of the fund. However, this definition would generally not include a loan that provides for a step-up in interest rate margin when a covered fund has fallen below or breached a NAV trigger or other negotiated covenant. This provision is also not

(g) Any synthetic right to have, receive or be allocated any of the foregoing rights.

A restricted profits interest (e.g., carried interest) earned by a banking entity in its role as investment adviser (or as provider of other services) to a covered fund will *not* be deemed to be an ownership interest as long as the following conditions are met:

(a) The sole purpose and effect of the interest is to allow the banking entity (or current or former employee thereof) to share in the profits of the covered fund as performance compensation for investment management, investment advisory, commodity trading advisory, or other services[86] performed for the covered fund, provided that the banking entity (or current or former employee) may be obligated to return profits previously received;[87]

(b) All such profit, once allocated, is: (i) distributed to the banking entity (or current or former employee thereof) promptly after being earned; or (ii) retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund, and the reinvested profit does not share in the subsequent gains of the covered fund;[88]

(c) Any amounts invested in the covered fund in connection with obtaining the carried interest are, together with any other ownership interests in the fund held by the banking entity or its affiliates, within the limitations of the De Minimis Exception (or, if applicable, the Seeding Exception) and the Aggregate Limit (each discussed below);[89] and

(d) The interest held by the banking entity (or current or former employee thereof) is not transferable except to an affiliate (or employee of the banking entity or an affiliate), to immediate family members, or through the intestacy of the employee or former employee, or in connection with the sale of the business that gave rise to the carried interest to an unaffiliated party that provides services to the covered fund.[90]

4. When Is a Banking Entity Acting "as Principal"?

As noted above, the Final Rule's prohibition only applies where a banking entity acquires or holds an ownership interest in a covered fund *"as principal."* The Final Rule clarifies the scope of acting "as principal" by stating that the prohibition *does not* apply to a banking entity's acquisition or holding of an ownership interest in a covered fund, where the banking entity acts:

(a) Solely as agent, broker or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;

---

intended to encompass derivative transactions entered into in connection with typical prime brokerage activities of banking entities, provided such activities are not being used to evade the Volcker Rule.

[86] The Final Rule does not define the scope of such "other services," but the Agencies indicated that they would include acting, for example, as sub-advisor or placement agent.

[87] Unlike the Proposed Rule, the Final Rule would have permitted employees or former employees to retain carried interest after a change in employment status, so long as it was originally received for providing qualified services.

[88] This condition was modified from the Proposed Rule to allow for a "clawback": where the carried interest could be taken back and remain in the covered fund, until the occurrence of subsequent events (i.e., reaching specified rate of return levels).

[89] This condition was added to the Final Rule so as to allow the investment adviser or others to hold small amounts of ownership interest for the purpose of achieving the desired tax treatment for carried interest.

[90] While the Final Rule did lessen the restrictions on transferability, the rights to the carried interest still cannot be freely transferrable.

(b) Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with applicable U.S. or non-U.S. law, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of current or former employees of the banking entity (or affiliate);

(c) In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable (and within such period permitted by its primary federal regulator); or

(d) As trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

5. What Are the Exceptions to the Investment Prohibition?

Under the Final Rule, a banking entity, even when acting as principal, may acquire or hold an ownership interest in a covered fund, without regard to the prohibition, under the following circumstances:

(a) Funds "Organized and Offered" by the Banking Entity: A banking entity may invest in the ownership interests of any covered fund "*organized and offered"* by the banking entity or an affiliate, provided that certain per fund and aggregate limitations are satisfied. "Organizing and offering" a fund includes acting as "sponsor"[91] to the fund, but also includes other activities, such as serving as investment adviser (including sub-adviser), distributer, or broker to a covered fund. Accordingly, a banking entity may only use this exception to invest in covered funds with which it has such a relationship. Such investments are subject to the following:

(i) Per-Fund Limit: The aggregate investments[92] of the banking entity and its affiliates[93] cannot exceed 3 percent of the total number or value of that fund's outstanding ownership interests (or, in the case of a covered fund that issues ABS, three percent of the fund's fair market value,[94] unless a greater percentage is required under the risk-retention requirements of section 15G of the '34 Act[95]) (collectively, the "De Minimis Exception").[96]

---

[91] The term "sponsor," as discussed in more detail below, means: (i) serving as a general partner, managing member, commodity pool operator or as a trustee with investment discretion; (ii) selecting or controlling a majority of the directors, trustees, or management; or (iii) sharing the same name (or a variation thereof) with a covered fund.

[92] Funds that are committed by the banking entity, but not yet called, do not count towards the per-fund limitation.

[93] For this purpose a covered fund sponsored by the banking entity will not be considered an affiliate, so long as it is organized and offered in accordance with the Final Rule (as discussed later herein). RICs, BDCs and non-U.S. public funds will not be considered an affiliate, provided the banking entity provides its services in accordance with applicable law and does not control 25 percent or more of the voting shares of such vehicle.

[94] This is due to the fact that such entities do not have a single class of security and thus, the valuation of the ownership interests cannot be made on a per interest or single class basis.

[95] A banking entity may rely on any of the options available to it in order to meet the requirements of section 15G, but for purposes of the Volcker Rule, the amount held by the banking entity may not exceed the amount required under the chosen option.

[96] The De Minimis Exception is intended to allow a banking entity to demonstrate "skin in the game" to third-party investors. While many commenters on the Proposed Rule argued that a three percent limit is too low to achieve this purpose, the Agencies declined to increase the limit. Compliance with the De Minimis Exception must be measured as of the last day of each calendar quarter, except in the case of ABS issuers, where it should be measured as of the date of establishment (as defined below) or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund, and thereafter only when additional securities of the ABS issuer are priced for purposes of the sale of ownership interests to unaffiliated investors.

(1) In the case of a master-feeder structure, the foregoing limit only applies at the covered master fund — any investments made directly in the master will be aggregated with a pro rata share of any interest held through the covered feeder fund.

(2) Similarly, in the case of a fund of funds, any direct investment in a covered fund will be aggregated with a pro rata share of any interest held through a covered fund of funds.

Notwithstanding the foregoing, during the first year after a covered fund is "established,"[97] the banking entity and its affiliates may exceed the 3-percent limitation and own up to 100 percent of the covered fund's ownership interests, so long as it actively seeks outside investors during this period (the "Seeding Exception").[98] The Board may grant an extension of the Seeding Exception (not to exceed two years) requested by a banking entity, if such extension would be consistent with safety and soundness and not detrimental to the public interest.[99]

(ii) Aggregate Limit: The aggregate value of all covered fund ownership interests held by the banking entity and its subsidiaries cannot exceed 3 percent of the tier 1 capital of the banking entity (the "Aggregate Limit").[100] For this calculation, the aggregate value of such ownership interests is the sum of all amounts paid or contributed (including by an entity or employee in connection with a carried interest) on a historical cost basis.[101] Moreover, the Final Rule requires that the banking entity deduct from its tier 1 capital (for both the foregoing calculation and for measuring compliance with applicable U.S. regulatory capital requirements) the greater of: (i) the foregoing historical cost *plus* earnings; or (ii) the fair market value of such ownership interests, if the profits or losses of the investments were reflected on the entity's financial statements.[102]

The Proposed Rule also contained a provision intended to curb potential evasion of the foregoing per-fund and aggregate limitation through investments made outside, but parallel with, a covered fund. Specifically, the Proposed Rule provided that, to the extent that a banking entity is contractually obligated to invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the

[97] The Final Rule clarified that, for this purpose, a covered fund is deemed to be established on the date on which it begins to make investments. In order to account for the unique circumstances and manner in which securitizations are established, for a covered fund that is an issuer of ABS, the date of establishment is the date on which the assets are initially transferred into the issuer.

[98] While many commenters on the Proposed Rule argued that the one year period is often insufficient to build up a track record necessary to attract outside investors, the Agencies declined to increase the timeframe. However, they did reference the possibility of obtaining an extension from the Board in such cases.

[99] A banking entity must make any request for such an extension at least 90 days prior to the normal expiration of the Seeding Exception. In reviewing such a request, the Board may consider all relevant factors and facts, including: (i) whether the investment exposes the banking entity to high-risk assets or strategies; (ii) the contractual terms of the investment; (iii) the expected length of additional time necessary to attract sufficient outside investors; (iv) the banking entity's total exposure to the fund and the risks of maintaining, or disposing of, the investment to the entity or U.S. financial stability; (v) the cost of divesting the investment within the normal timeframe; (vi) any material conflicts of interest between the banking entity and any third-party to which it owes a duty that would result from approving or denying the request; (vii) the entity's prior efforts to reduce its ownership percentage; and (viii) market conditions.

[100] Measured as of the last day of each calendar quarter. If a banking entity is not required to calculate and report tier 1 capital, or is it directly or indirectly controlled by an entity that is so required, then tier 1 capital for this purpose is the total shareholder's equity for the entity's top-tier affiliate. While the Aggregate Limit must be calculated on a quarter-end basis, the Agencies expect banking entities to monitor their investments regularly and remain in compliance throughout the quarter.

[101] By requiring the use of historical cost, the Final Rule prevents a banking entity from increasing its exposure to covered funds in the event any particular covered fund investment declines in value.

[102] Therefore, profits resulting from investments in covered funds will not inflate the capital of the banking entity for U.S. regulatory compliance purposes. The Final Rule does not require a non-U.S. banking entity that makes a covered fund investment in the United States to deduct the aggregate value of the investment from the entity's tier 1 capital calculated under applicable home country standards.

banking entity (whether or not pursuant to an express agreement), such investment must be included in the calculation of a banking entity's per-fund limitation applicable to that fund. The Final Rule omitted this provision, but the Agencies indicated that a banking entity should not make any co-investment with a sponsored covered fund in a privately negotiated investment unless the value of such co-investment is less than three percent of the value of the total amount co-invested by other investors in such investment.[103]

(b) Underwriting and Market Making: The Final Rule added a specific provision (similar to that already contained in the proprietary trading section of the Proposed Rule) allowing banking entities to hold ownership interests in covered funds when the entity is engaged in underwriting and market making-related activities of ownership interests in such funds, so long as:

(i) The banking entity conducts the activities in accordance with the Final Rule's prohibition on proprietary trading;

(ii) Any covered fund ownership interests held by the banking entity and its affiliates pursuant to this exception are: (i) deducted from tier 1 capital (as discussed above); and (ii) within the Aggregate Limit (when aggregated with any other investments that are subject to the Aggregate Limit); and

(iii) If the banking entity (or an affiliate thereof): (i) acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund; (ii) otherwise acquires and retains an ownership interest in the fund in relation to organizing and offering the fund; (iii) acquires and retains an ownership interest in the fund and is either a "securitizer,"[104] or is acquiring and retaining an ownership interest in the fund in compliance with section 15G of the '34 Act; or (iv) directly or indirectly guaranties or insures the obligations or performance of the fund or of any covered fund in which the fund invests,[105] then in each such case the value of any ownership interests held by the banking entity and its affiliates pursuant to this exception in that fund are permissible under the De Minimis Exception (or, if applicable, the Seeding Exception) and the Aggregate Limit (when aggregated with any other investments that are also subject to such limits).

(c) Risk-Mitigating Hedging: The Final Rule permits a banking entity to hold an ownership interest in a covered fund in order to "demonstrably reduce" or "significantly mitigate" the "specific, identifiable" risks to the banking entity from a compensation arrangement with an employee (or an employee of an affiliate) that directly provides investment advisory or other services to that fund.[106] In other words, a banking entity may invest in a covered fund to hedge the risk

[103] Further, if 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 three percent of the sum of the total ownership interests in the co-investment fund and the covered fund.

[104] As that term is used in section 15G(a)(3) of the '34 Act.

[105] This restriction does not prohibit a banking entity from entering into or providing liquidity facilities or letters of credit for covered funds; however, it would apply to arrangements such as a put of the ownership interest in the covered fund to the banking entity.

[106] The Final Rule appears to be more stringent, in this regard, than the Proposed Rule, which merely required that the investment be "designed to reduce the specific risks" associated with the compensation arrangement. More importantly, while the Proposed Rule contained an additional exemption allowing a banking entity to invest in a covered fund in order to hedge risk arising when the banking entity serves as an intermediary for a customer to facilitate exposure by such customer to the fund, the Agencies omitted this exemption from the Final Rule. Currently, such a practice typically occurs when bank customers choose to obtain exposure to a covered fund via a derivative issued to them by a bank (this is done for a variety of reasons, including obtaining leverage). In turn, the banking entity invests in the fund to hedge its exposure to the customer. However, since the Agencies omitted the proposed exemption designed to permit such hedging from the Final Rule, such investors will need to consider alternative arrangements.

associated with employee compensation that is tied to that fund's performance.[107] Notwithstanding the foregoing, a banking entity may not enter into any hedging investment that, at its inception, gives rise to any significant new or additional risk that is not, itself, hedged contemporaneously.

In order to avail itself of this exemption, a banking entity must have internal written policies and controls to ensure compliance with the Final Rule's requirements associated with such hedging activity.

(d) Investments Made "Solely Outside the United States": Certain eligible non-U.S. banking entities are permitted to hold ownership interests in certain eligible covered funds, so long as such activity occurs "solely outside the United States."

(i) Eligible Banking Entities: In order for a banking entity to use this exemption, the following criteria must be satisfied:

(1) The banking entity is not organized, or directly or indirectly controlled by a banking entity organized, in a U.S. jurisdiction (including any U.S. territory or commonwealth).[108]

(2) If the entity is a "foreign banking organization" under the Board's Regulation K, it qualifies for the exemption.[109]

(3) If the entity is *not* a "foreign banking organization" under the Board's Regulation K, it must satisfy at least two of the following:

a. Its total assets held outside the United States exceed those held in the United States;

b. Its total revenues from its non-U.S. business exceed those from its U.S. business;

c. Its total net income from its non-U.S. business exceed that from its U.S. business.

(ii) Eligible Covered Funds: In order for an eligible non-U.S. banking entity to invest in a covered fund under this exemption, the fund must not sell its ownership interests in any offering that targets "U.S. persons" (as defined under the SEC's Regulation S).[110] (It is

[107] The compensation arrangement hedged under this exemption must relate solely to the covered fund in which the banking entity (or any affiliate thereof) has acquired an ownership interest, such that any losses on the ownership interest would be offset by corresponding decreases in the amounts payable under the compensation arrangement.

[108] Thus, non-U.S. subsidiaries or non-U.S. offices of a U.S. banking entity may not take advantage of this exemption. The disparate treatment of U.S. and non-U.S. banking entities is this regard is basically unchanged from the Proposed Rule. While numerous commenters on the Proposed Rule complained that it would impose a competitive disadvantage on U.S. banking entities, the Agencies indicated that, in addition to there being potential policy reasons to support such disparate treatment, they were bound by the express statutory language of the Volcker Rule.

[109] Under Regulation K, a "foreign banking organization" is a foreign bank that operates a branch office, agency office, commercial lending company, bank subsidiary or Edge Act corporation in the United States, or any subsidiary of such an institution. To constitute a "qualifying foreign banking organization," it must satisfy two tests (unless otherwise permitted by the Board). First, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its total worldwide nonbanking assets; (ii) its revenues derived from the business of banking outside the United States exceed its total revenues derived from its worldwide nonbanking business; or (iii) its net income derived from the business of banking outside the United States exceeds its total net income derived from its worldwide nonbanking businesses. Second, it must satisfy at least two of the following: (i) its banking assets held outside the United States exceed its banking assets held in the United States; (ii) its revenues derived from the business of banking outside the United States exceed its revenues derived from the business of banking in the United States; or (iii) its net income derived from the business of banking outside the United States exceeds its net income derived from the business of banking in the United States.

[110] This is a more forgiving standard than that of the Proposed Rule, which appeared to turn solely on whether any of the fund's ownership interest were actually owned by any U.S. resident. Instead, in promulgating the Final Rule, the Agencies indicated that (absent circumstances otherwise indicating a nexus with U.S. persons), the sponsor of a foreign fund would not be viewed as targeting U.S. persons if it: (i) conducts an offering directed to non-U.S. residents; (ii) includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to U.S. residents; and (iii) employs reasonable procedures to limit access to the materials to non-U.S. residents.

important to note that the Final Rule does not appear to predicate eligibility on where the covered fund invests, where its investment manager is located, or even in what jurisdiction the fund is organized.)

Master-Feeder Structures: A covered feeder fund that satisfies the foregoing will, nonetheless, not be eligible if the covered master fund it which it invests does not also satisfy the foregoing.

(iii) Eligible Activity: In order for activity to occur "solely outside the United States" the following criteria must be satisfied:

(1) The eligible banking entity (or office thereof) acting as principal (and that makes the decision to engage in the activity, if different) is not organized or located in the United States.[111]

(2) No relevant personnel of the entity responsible for the decision to engage in the activity is located in the United States (excluding "back office" personnel[112]);

(3) The activity is not accounted for as principal, directly or indirectly, on a consolidated basis by a branch or affiliate organized or located in the United States; and

(4) No financing is provided, directly or indirectly, by a branch or affiliate organized or located in the United States.

(e) Insurance Company Investments: The Final Rule added a specific provision (similar to that already contained in the proprietary trading section of the Proposed Rule) allowing banking entities that are regulated insurance companies (and their affiliates) to hold ownership interests in covered funds if the investment:

(i) Is held solely for the general account of the insurance company or for one or more separate accounts established by it; and

(ii) Complies with the insurance law in which the insurance company is domiciled (and the appropriate federal banking agencies have not determined that such law is insufficient to protect the banking entity's safety and soundness or the financial stability of the United States).

B. 'Prohibition'[113] on Sponsorship of Funds

1. What Does It Mean to "Sponsor" a Fund?

As noted above, a banking entity may no longer "sponsor" a covered fund, unless it abides by a series of new requirements on its relationship with such fund (or such sponsorship falls within the exemption for non-U.S. activity explained below). The Final Rule defines the term "sponsor" to mean:

[111] For this purpose, any U.S. office of a non-U.S. bank (or any subsidiary of such office) is located in the United States, but the bank itself is not.

[112] The Agencies explained that this permits U.S. employees to provide administrative services or similar support functions (such as clearing and settlement, maintaining and preserving records, furnishing statistical and research data, or providing clerical support).

[113] While the Volcker Rule purports to "prohibit" a banking entity from "sponsoring" a covered fund, subject to certain exceptions, in a practical sense, it instead imposes a series of new requirements on a banking entity's sponsorship activities.

(a) Serving as a general partner, managing member, trustee (excluding trustees that do not exercise investment discretion[114]), or commodity pool operator of a covered fund;

(b) Selecting or controlling, in any manner, a majority of the directors, trustees or management of a covered fund; or

(c) Sharing with a covered fund, for corporate, marketing, promotional or other purpose, the same name or a variation of the same name.[115]

However, sponsoring does not include other activities that may be part of organizing and offering a covered fund, such as merely acting as an investment adviser, sub-adviser, distributor or broker to the fund.

2. Under What Circumstances May a Banking Entity Sponsor a Covered Fund?

A banking entity may sponsor a covered fund[116] in connection with "organizing and offering" such fund (as discussed above), provided that the following requirements are satisfied:

(a) The banking entity must provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services.[117]

The covered fund must be offered only to persons that are customers of such services. However, such customer relationship need not be pre-existing or involve more than the relevant fund investment; the banking entity must merely demonstrate (through written documentation) that the fund is organized and offered for the purpose of providing one or more of the foregoing bona fide services to its customers (or those of an affiliate) and not for the purpose of evading the Volcker Rule.

(b) No director or employee of the banking entity may hold an ownership interest in the covered fund, except for a director or employee who is directly engaged in providing investment advisory, commodity trading advisory or other services[118] to such fund.[119] (However, directors or employees who received a permitted ownership interest may retain that interest after no longer serving in the same capacity.)

However, any ownership interest purchased by a director or employee pursuant to a loan, guarantee or extension of credit by the banking entity will be attributed to the banking entity itself.

(c) The banking entity must not hold an ownership interest in the covered fund (including any interest held by an employee or director that is attributed to the entity as explained above),

---

[114] Including a trustee that is subject to the direction of an unaffiliated fiduciary pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act, or a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to the foregoing.

[115] However, as indicated below, such name sharing is elsewhere prohibited by the Final Rule.

[116] Including a covered fund that is an ABS issuer.

[117] However, this requirement does not apply where the sponsored covered fund is an ABS issuer.

[118] The Agencies explained that this exemption also applies to directors or employees who provide "services that enable the provision or investment advice or investment management, such as oversight and risk management, deal orientation, due diligence, administrative or other support services."

[119] The authority for such employees to invest in the fund is based on a similar "skin in the game" concept as the De Minimis Exception (i.e., it aligns the manager or adviser's incentives with those of the banking entity's customers).

except as consistent with the De Minimis Exception (or, if applicable, Seeding Exception) or Aggregate Limit.

(d) The covered fund must not share the same name, or a variation of the same name, as the banking entity (or any affiliate thereof) for any purposes,[120] nor can it use the word "bank" in its name.

(e) The banking entity (and its affiliates) must 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 find invests.[121]

(f) The banking entity must provide written disclosure to prospective and actual investors that clearly and conspicuously: (i) indicates that all investors should read the fund offering documents before investing; (ii) describes the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and (iii) contains the following representations:

(i) "Any losses in [such 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 [such 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 restricted profit interest held by [the banking entity] or any affiliate"; and

(ii) "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).[122]

(g) The banking entity must take any additional steps required by the federal regulators to ensure that it is, in fact, not liable for any fund losses.

(h) When engaging in any transactions with the covered fund, the banking entity must comply with certain restrictions (as discussed below).[123]

3. When Is a Non-U.S. Banking Entity Exempt from the Foregoing Requirements?

The same exemption for activity occurring "solely outside the United States" discussed above in the context of acquiring covered fund ownership interests applies to sponsorship of covered funds. Thus, an "eligible banking entity" (as discussed above) may sponsor an "eligible covered fund," provided the sponsorship is deemed to occur "solely outside the United States" (each as discussed above).

---

[120] While numerous commenters on the Proposed Rule argued that the name-sharing prohibition should not apply with regard to banking entities that are an insured depository institution, the Agencies declined to provide such relief (suggesting that they were bound by the express statutory language of the Volcker Rule). Accordingly, the name of a covered fund that is sponsored by a banking entity must be dissimilar to that entity and *all* of its affiliates, including any serving as the fund's general partner or managing member.

[121] However, the Agencies indicated that a banking entity's issuance of a borrower default indemnification to a lending client in connection with a securities lending transaction involving a sponsored covered fund is not prohibited.

[122] Many banking entities that sponsor funds already include similar disclosure in the funds' offering documents. However, like the Proposed rule, the Final Rule appears to require that these two disclosures be given verbatim (with the insertion of the appropriate names).

[123] The Final Rule explicitly clarifies that the foregoing exemption also applies to sponsoring an ABS issuer, subject to the same rules (except that in such a case the requirements relating to the offering of bona fide trust, fiduciary, investment advisory, or commodity trading advisory services would not apply).

For the purpose of determining whether the activity satisfies the "solely outside the United States" requirement, the Agencies have indicated that the U.S. personnel of a non-U.S. banking entity may provide investment advice and recommendations to the manager or general partner of a covered fund so long as that investment advisory activity in the United States does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States.

4. What Rules Apply to Transactions Between a Banking Entity and Any Fund It Organizes and Offers?

The Final Rule imposes the following new rules on any transactions between a banking entity (or any of its affiliates) and any covered fund for which such entity serves as sponsor, investment manager, investment adviser or commodity trading adviser, or which it otherwise organizes and offers[124]:

(a) Market Terms Requirement: A banking entity (and its affiliates) may not provide any services or sell any assets to a such a covered fund, except as consistent with Section 23B of the Federal Reserve Act ("Section 23B").[125] As applied by the Final Rule, Section 23B requires that such transactions be conducted on terms, and under circumstances, that are at least as favorable to the banking entity as those prevailing at the time for comparable transactions involving unaffiliated companies.

If no relevant market terms exist, then the transaction must be on terms, and under circumstances, that in good faith would be offered by the banking entity to nonaffiliates.

(b) Prohibited Transactions: Except as provided below, a banking entity may not enter into any transaction with such a covered fund, if the transaction would constitute a "covered transaction" as defined in Section 23A of the Federal Reserve Act ("Section 23A").[126] In this context, "covered transactions" under Section 23A would include:

(i) Loans and other extensions of credit to the fund (including any purchase of assets subject to agreement to repurchase);

(ii) A purchase of, or an investment in, securities issued by the fund (except that acquisition or retention of ownership securities issues by the fund in a manner that is otherwise permitted by the Final Rule would not be prohibited);

(iii) A purchase of assets from the fund (other than such purchases of real and personal property as may be specifically exempted by the Board by order or regulation);

(iv) The issuance of a guarantee, acceptance or letter of credit (including an endorsement or standby letter of credit) on behalf of the fund; and

[124] This requirement applies even where the services provided to the covered fund were not themselves subject to the Final Rule's sponsorship prohibition (i.e., where the relationship does not constitute sponsoring or is otherwise exempt from the prohibition).

[125] By its terms Section 23B only applies to transactions between a banking entity that is a member of the Federal Reserve System ("member bank") and any of its affiliates. However, for this purpose, the Volcker Rule applies Section 23B as if: (i) the banking entity transacting with the covered fund were a member bank; and (ii) the fund were an affiliate of such banking entity.

[126] Like Section 23B, Section 23A only applies to transactions between a member bank and any of its affiliates. However, the Volcker Rule applies Section 23A on the same basis as Section 23B (as discussed above). Moreover, while Section 23A normally merely imposes certain qualitative requirements and quantitative limits on "covered transactions," the Volcker Rule prohibits them outright. Because the Volcker Rule, expands the scope of entities to which Section 23A applies and replaces its requirements/limits with a prohibition, the Volcker Rule's application of Section 23A has been commonly referred to as "Super 23A."

(v) A securities lending, securities borrowing or derivative transaction with the fund, to the extent it caused the banking entity to have credit exposure to the fund.[127]

(c) Prime Brokerage Transactions: The foregoing prohibition of covered transactions does not apply to "prime brokerage transactions" with a covered fund in which a covered fund sponsored, managed or advised by the banking entity (or an affiliate thereof) invests (however, such transactions would remain subject to the Section 23B requirements discussed above).[128]

(i) Scope: Under the Final Rule, a "prime brokerage transaction" is defined as "any transaction that would be a covered transaction [under Section 23A], that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support."

(ii) Prerequisites: This exemption is available only so long as: (i) the chief executive officer (or equivalent officer) of the banking entity[129] certifies annually that 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 fund invests; and (ii) the Board has not determined that the relevant transaction is inconsistent with the banking entity's safety and soundness.

C. Other Prohibited Activities

Notwithstanding any of the foregoing, a banking entity may not engage in any activity or transaction with a covered fund, otherwise permitted under the Final Rule, if such activity or transaction would:

1. Involve a "material conflict of interest" between the banking entity and its clients, customers or counterparties;

   Unless, prior to engaging in such activity or transaction, the banking entity: (i) gives the other party clear and effective disclosure of the conflict and the opportunity to negate or substantially mitigate its impact; or (ii) the banking entity has information barriers that are reasonably designed to prevent a materially adverse effect on the other party (except where the banking entity knows, or should reasonably know, that the barriers are unlikely to prevent a particular materially adverse effect);

2. Materially expose the banking entity to an asset, group of assets or trading strategy that would significantly increase the likelihood of: (i) substantial loss by the banking entity; or (ii) a threat to the financial stability of the United States; or

---

[127] Section 23A and its implementing regulation contain several exemptions that excuse certain covered transactions from some of the requirements of Section 23A. While numerous commenters on the Proposed Rule argued that such exemptions should be incorporated into Super 23A, the Agencies disagreed because the statutory language of the Volcker Rule makes no reference to such exemptions when it incorporates the "covered transaction" definition from Section 23A. However, on another issue, the Agencies' strict reading of the Volcker Rule's incorporation of Section 23A worked to the benefit of banking entities. The Agencies noted that the statutory language only prohibits covered transactions *with a covered fund*. Thus, while Section 23A and its implementing regulation treat certain transactions between a bank an unaffiliated third party as covered transactions — where an affiliate is a known beneficiary of the transaction — Super 23A does not prohibit such transactions. Accordingly, for example, a banking entity is permitted to extend credit to a customer where such lending is secured by shares of a covered fund that the entity organizes and offers (including pursuant to a margin account), even though such a transaction would ordinarily be considered a covered transaction under Section 23A.

[128] It is important to note that this exception for prime brokerage transaction does *not* apply to transactions with the covered fund sponsored, managed or advised by the banking entity, *only* to transactions with a "second-tier" covered fund (i.e., one in which the first fund invests). However, for reasons apart from the Volcker Rule, many banking entities already do not serve as prime broker for the funds they organized and offer.

[129] In the case of the U.S. operations of a non-U.S. banking entity, the senior officer of its U.S. operations may provide the required attestation.

3. Pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.[130]

D. Timing

1. Conformance Date: Banking entities had until July 21, 2015 to conform their activities to the Final Rule.[131] This deadline represented a one-year extension of the Volcker Rule's conformance period, which the Board granted simultaneously with the issuance of the Final Rule.[132]

2. Conformance Period Obligations: Until July 21, 2015, each banking entity was expected to engage in "good-faith efforts" to conform its activities and investments to the requirements of the Volcker Rule and the Final Rule, including developing and implementing the compliance program requirements of the Final Rule. The Board has explained that such good faith efforts should have included "evaluating the extent to which the banking entity is engaged in activities and investments that are covered by [the Volcker Rule] and the [Final Rule], as well as developing and implementing a conformance plan that is appropriately specific about how the banking entity will fully conform all of its covered activities and investments by the end of the conformance period."

3. Potential Extensions: Under the Volcker Rule, the Board is empowered to grant a banking entity up to three one-year extensions. As indicated above, the Board has now used one of those potential extensions to grant the entire industry a one-year delay of the conformance date. Thus, a banking entity could potentially seek up to two additional one-year extensions.[133] Additionally, the Board may *further* extend the conformance date, up to an additional five years, for the acquisition or retention of an ownership interest in any "illiquid fund" if: (i) such investment was made or contractually obligated by May 1, 2010; and (ii) the banking does not have the contractual right to terminate the investment or commitment.[134]

4. However, the Board cautioned that a banking entity "should not expand activities or make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted."

V. Permanent Capital Vehicles: Options for Creating Permanent Capital Vehicles for Existing Fund Managers

A. Benefits of Permanent Capital

1. Eliminates redemption risks

2. Eliminates limited fund life concerns

3. Allows longer-term strategies

---

[130] These are necessarily subjective analyses that a banking entity will have to undertake, but that will ultimately be judged (often with hindsight) by its primary federal regulator.

[131] Notwithstanding the foregoing, a company that was not a banking entity on July 21, 2010, must have brought its activities into conformance before the later of (i) July 21, 2015 or (ii) two years after the date on which the company becomes a banking entity.

[132] In doing so, the Board indicated that it will continue to monitor developments to determine whether additional extensions of the conformance period would be in the public interest and consistent with the statute.

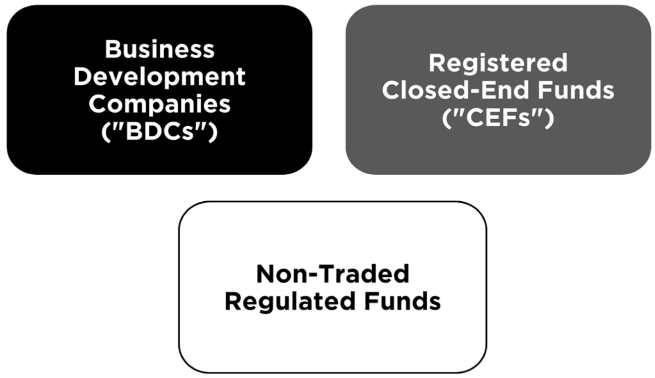
[133] Any extension request must be submitted in writing at least 180 days in advance and must contain a detailed explanation of the banking entity's plan for divesting or conforming the activity, as well as an analysis of numerous factors required by the Board.

[134] In other words, the conformance date for investments in "illiquid funds" could be extended to as late as July 21, 2022. An "illiquid fund" is a covered fund that, as of May 1, 2010, was principally invested in "illiquid assets" (as defined by the Board), or was invested in, and contractually committed to principally invest in, illiquid assets; and makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

4. Provides access to follow-on public debt and equity offerings

5. Provides similar management and incentive fee structures to many private funds

B. Regulated Funds That Utilize Permanent Capital



C. Permanent Capital Investment Strategies

1. Key focus is typically on income-producing portfolios that can generate attractive dividend yields for investors.

    (a) Credit strategies, particularly in the high-yield space

    (b) Cash flow focused strategies that target control investments with attractive cash flow potential

    (c) Real estate strategies that focus on commercial or residential mortgages or rental income properties

    (d) Capital gains focused strategies that target short term (i.e., less than one year) realized capital gains

    (e) Other strategies that target high ROI levels with an income component

D. Business Development Companies

1. What Are BDCs?

    (a) Special type of closed-end fund that is *regulated* rather than *registered* under the '40 Act

    (b) Hybrid between a public finance company and a registered investment company from a regulatory perspective

    (c) In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets

        (i) Typically U.S.-based nonpublic operating companies

        (ii) Extends to listed companies with market capitalizations of less than $250 million

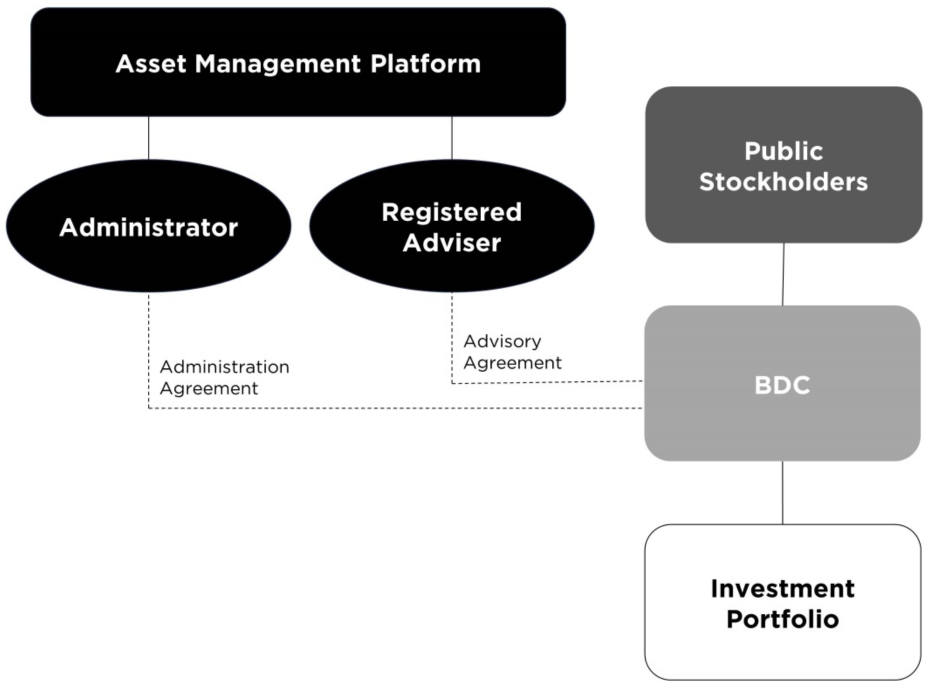
        (iii) Excludes "investment companies," including most private funds

(d) Must have at least a 200-percent asset coverage ratio (total assets/total debt) at the time of any new borrowings

(e) File annual, quarterly and current reports under the '34 Act on the same basis and in the same manner as traditional operating companies

(f) If not publicly traded, BDC public offerings are subject to "blue sky" registration in each state where an offering will be made

2. Typical BDC Structure



3. Benefits of the BDC Model

(a) Access to public capital markets

(b) Securities can be listed on national securities exchanges

(c) Flow-through tax treatment as a "regulated investment company" ("RIC")

(d) External model permits management fee and incentive fee structures similar to traditional private fund structures

(e) Increased transparency from publicly available quarterly financial information

(f) Certain offshore and tax-exempt investors can invest directly, rather than through offshore blockers

4. Other Considerations

(a) Federal Tax Compliance

(i) BDCs need to comply with applicable diversification and source of income requirements as RICs

(ii) Income must generally be distributed as earned — in short, it is often difficult to retain earnings to grow

(b) Leverage Restrictions

(i) BDCs have limits on their use of leverage, and must maintain a 200-percent asset coverage ratio

(ii) Those restrictions limit the ability to invest in lower-yielding investments where significant leverage would be required

(c) Restrictions on Transactions with Affiliates

(i) BDCs have specific restrictions on acquiring or selling assets to affiliates, and on participating in co-investment transactions with affiliates

(ii) Asset manager may need to obtain SEC exemptive relief to permit even pro rata investment allocations involving a BDC

(d) Public Reporting Requirements

(i) Subject to periodic reporting requirements with the SEC that mirror those applicable to publicly-traded operating companies

(ii) BDCs must comply with additional compliance requirements under the '40 Act, including with respect to:

(1) Custody of assets

(2) Maintenance of records

(3) Appointment of a chief compliance officer

(4) Restrictions on holding securities of asset managers, broker-dealers and other investment companies

E. Registered Closed-End Funds

1. What Are Registered Closed-End Funds ("CEFs")?

(a) CEF that *registers* under the '40 Act.

(b) Unlike BDCs, CEFs generally have no '40 Act limitations on nature and type of investments.

(c) As a result of greater investment flexibility, CEFs are often used by asset managers in lieu of a BDC structure to allow offshore or other investments that would be considered "bad" BDC assets.

(d) A CEF must have at least a 300-percent asset coverage ratio (total assets/total debt) at the time of any new borrowings.

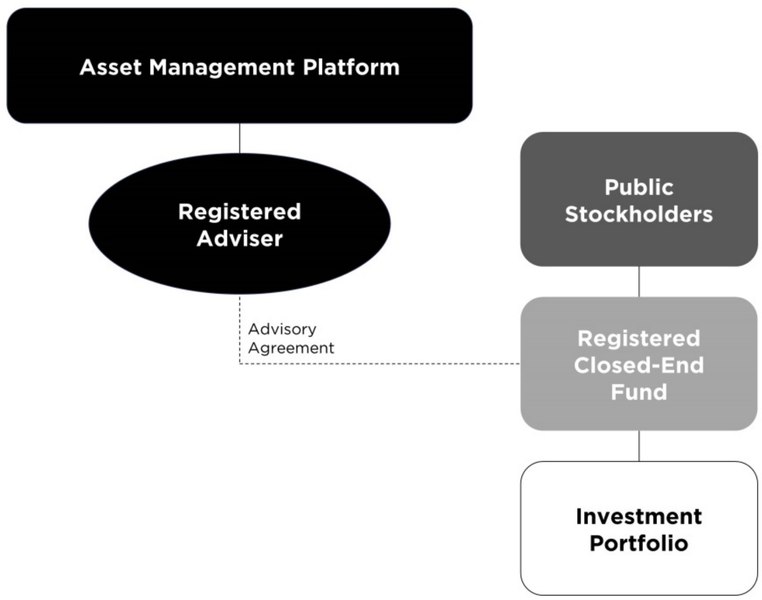
(e) A CEF must have at least a 200-percent asset coverage ratio (total assets/(preferred stock + total debt)) at the time of issuing any new preferred stock.

(f) Incentive fees on realized capital gains are generally prohibited.

(g) Public reporting requirements include an annual and semi-annual report, along with a publicly-filed schedule of investments on off quarters.

(h) Public offerings by non-traded CEFs are subject only to notice filings under state "blue sky" laws.

2. Typical Registered Closed-End Fund Structure



3. BDCs vs. Registered Closed-End Funds

(a) Business Development Companies

(i) Allow greater leverage than typical registered closed-end funds: Limit of "one-to-one" debt to equity vs. "one-to-two" debt to equity

(ii) Permit use of capital gains incentive fees for asset managers

(iii) Provide slightly greater flexibility for transactions with remote affiliates

(iv) Greater leverage permits investment in more liquid credit instruments, which lower unleveraged returns

(b) Registered Closed-End Funds

(i) Allow hedge funds or funds of funds to have broader investor bases, without relying on 3(c)(1) or 3(c)(7)

(ii) Permit an asset manager to target novel or unique asset classes that would be ineligible in a BDC structure

(iii) Frequently target investments in existing leveraged products, or where significant leverage at the fund level is unnecessary

(iv) Reduce state “blue sky” compliance for non-traded vehicle structures compared to BDCs

(v) Require a reduced public reporting burden compared to a BDC structure

F. Non-Traded Regulated Funds

1. What Are Non-Traded Regulated Funds?

(a) Structured as a BDC or registered closed-end fund

(b) Shares are *not* listed on an exchange

(c) Shares sold through continuous offerings up to preset maximum amount

(d) Liquidity offering through periodic repurchase offers

(e) Typically have fixed five- to seven-year period before exchange listing or traditional IPO

(f) Becomes public reporting company upon first closing

2. Non-Traded Regulated Fund Sponsors

(a) Non-traded regulated funds are generally structured as a combination of an investment adviser or sub-adviser and a distributor.

(b) For example:

(i) GSO/Blackstone serves as the sub-adviser for Franklin Square’s funds, while FS2 Capital Partners is the dealer manager.

(ii) KKR Asset Management is the investment sub-adviser for Corporate Capital Trust, while CNL Fund Advisors serves as the dealer manager.

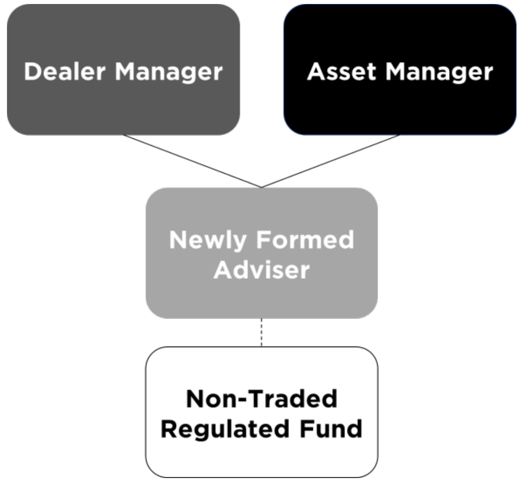
(iii) Apollo Global Management serves as investment sub-adviser for CION Investment Corp., while ICON Securities serves as the dealer manager.

(iv) SIC Advisors (investment personnel of Medley) is the investment adviser to Sierra Income Corporation, while SC Distributors is the dealer manager.

(c) Business Development Corporation of America is the only non-traded BDC that does not utilize a third-party investment adviser or sub-advise.

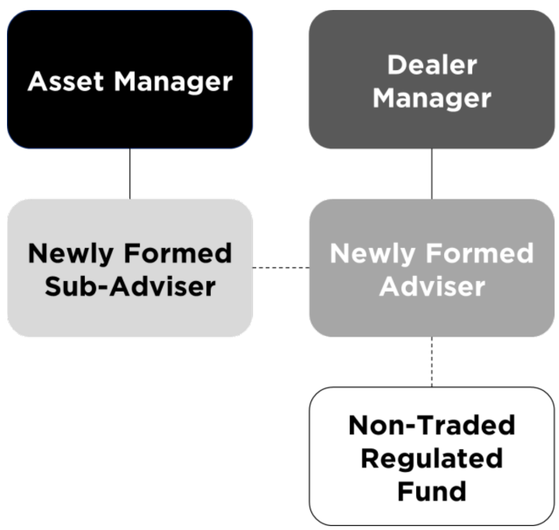
3. Typical Fund Sponsor Structures

(a) Jointly-Controlled Adviser



A newly formed regulated fund adviser is jointly owned by the co-sponsoring asset manager and dealer manager, who use the operating agreement of the new adviser to split economics for the joint venture.

(b) Adviser/Sub-Adviser Model



A newly formed adviser controlled by the dealer-manager enters into an advisory agreement with the regulated fund, as well as a sub-advisory agreement with a newly formed sub-adviser controlled by the asset manager, with the economics split between the advisory and sub-advisory agreements.

4. Current Non-Traded Regulated Funds

(a) These non-traded regulated funds are making continuous offerings and had raised in excess of $11.9 billion as of Dec. 31, 2014:

(i) Business Development Corporation of America — $1.6 billion

(ii) Business Development Corporation of America II — $200 million

Affiliated with AR Capital

(iii) CION Investment Corporation — $476 million

Affiliated with ICON Capital Corp. and Apollo Global Management

(iv) Corporate Capital Trust — $2.1 billion

Affiliated with CNL Fund Advisors Company and KKR Asset Management

(v) FS Energy and Power Fund — $2.9 billion

(vi) FS Energy and Power Fund II — escrow not yet broken

(vii) FS Investment Corporation II — $3.2 billion

(viii) FS Investment Corporation III — $649 million

Affiliated with GSO/Blackstone

(ix) HMS Income Fund — $236 million

Affiliated with Hines Securities and Main Street Capital Corporation

(x) MacKenzie Realty Capital — $14.7 million

Affiliated with MacKenzie Capital Management

(xi) NexPoint Capital — $10 million

Affiliated with NexPoint Advisors and Highland Capital Funds Distributor

(xii) Sierra Income Corporation — $555 million

Affiliated with Medley Capital and SC Distributors

(xiii) VII Peaks Co-Optivist Income BDC II — $50 million

Affiliated with VII Peaks Capital

VI. Esoteric Assets

A. Introduction

1. Banks are less active in the alternative/esoteric asset sector.

2. Funds have been filling the void.

B. Some Characteristics of Esoteric Assets

1. General concept is that the asset is not commoditized.

2. Some characteristics:

    (a) Wider spreads

    (b) More new structuring

    (c) More difficult to find investors and lenders

    (d) More difficult to get a rating

    (e) Fewer deals

    (f) Higher cost of financing

C. Some Examples of Esoteric Assets

1. Timeshare loans

    (a) Real estate- and non-real estate-based

    (b) Structured settlements

    (c) Lotteries

2. Life settlements

    (a) Secondary market

    (b) Tertiary market

    (c) Lending

3. Litigation advances

    (a) Pre-settlements

    (b) Post-settlements

    (c) Law firm loans

    (d) Mass torts

4. Merchant cash advances

    (a) Credit card receipts

    (b) ACH

    (c) Stacking issues

5. Music royalties

    (a) Catalogues

(b) Single artist

(c) Multi-artist

6. Film receivables

(a) Libraries

(b) Slates

The New Regulatory Challenges

I. SEC Examination Trends and Updates

A. Enhanced Examination Capabilities

1. The Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") has adopted tools and hired personnel that allow OCIE to more efficiently uncover violations of the Advisers Act during exams.

2. The National Exam Analytics Tool ("NEAT")

(a) NEAT is a sophisticated trade analysis program OCIE utilizes to obtain information about investment advisers' trading patterns and to detect any abnormalities in an investment adviser's trading activity.

(b) NEAT significantly reduces the amount of time OCIE staff needs to spend reviewing trades and allows OCIE staff to review all of an investment adviser's trading activity over the span of several years.

3. As OCIE notes in its Examination Priorities for 2016 list, it now utilizes data analytics in all of its examination initiatives.

4. OCIE has hired new personnel over the past several years that have significant private sector experience working in the private funds industry. As a result, OCIE is now more familiar with the industry and is in a better position to understand the operations of most private fund managers.

B. Common Examination Focus Areas

1. Expense Allocations

(a) OCIE has focused on expense allocations in examinations of both private equity sponsors and hedge fund managers. The Examination Priorities for 2016 list reflects that this will be a continuous area of focus for exams of all private fund managers. Common deficiencies that relate to expense allocation include:

(i) Over-allocation of expenses to one client as opposed to other clients;

(ii) Improperly allocating "mixed use" expenses between the manager and its clients; and

(iii) Charging to clients expenses that are not adequately disclosed to clients or (where such clients are funds) investors in funds.

2. Valuation

(a) OCIE often focuses its examinations on valuation processes and, in particular, on any gaps between the valuation procedures as disclosed to investors and as carried out in practice.

(b) OCIE has focused on situations where managers have changed their valuation methodologies and have either:

(i) Not properly disclosed the change in the valuation methodologies to clients; or

(ii) Failed to effectively adhere to the disclosed valuation methodology.

3. Marketing

Marketing materials have long been an area of focus during exams. During the past year, OCIE has focused on the use of hypothetical performance, cherry picking and the portability of prior performance.

4. Compliance Program

(a) OCIE frequently scrutinizes the compliance program an investment adviser employs, including whether adequate resources are dedicated to the compliance function and whether the firm has a "culture of compliance."

(b) Deficiency letters have identified perceived deficiencies in the knowledge and qualifications of chief compliance officers ("CCOs") in some cases.

5. Insider Trading

(a) Some examinations have focused in particular on the investment adviser's compliance with Section 204A of the Advisers Act. As in prior years, OCIE often closely scrutinizes relationships between the investment adviser and any outside consultants or expert networks. In addition, OCIE has focused on relationships between different buy-side firms, as well as information sharing with investors and the receipt of confidential information at certain industry conferences.

(b) Examination staff have taken the position in many recent examinations that advisers should keep logs of meetings with company management.

II. Developments Regarding Quantitative Investments

A. Regulation AT: Requirements and Definitions

1. The Commodity Futures Trading Commission ("CFTC") has issued a proposed rule for Regulation AT, which would govern algorithmic trading and impose requirements on persons and firms utilizing automatic trading. Regulation AT seeks to: (i) reduce risk; and (ii) increase transparency of "Algorithmic Trading."

2. The proposed rule for Regulation AT defines "Algorithmic Trading" as trading: (i) in any commodity interest (ii) on or subject to the rules of a designated contract market, where:

(a) A *computer algorithm* or system determines whether to initiate, modify or cancel an order, or otherwise makes determinations with respect to certain elements of an order; *and*

(b) Such order, modification or order cancellation is *electronically submitted* for processing on or subject to the rules of a designated contract market.

The full impact of the "electronic submission" element of the final text of Regulation AT will be key to determining the regulation's coverage.

3. Regulation AT will cover a manager that is registered or required to be registered as a commodity pool operator or commodity trading advisor and that engages in Algorithmic Trading. It also covers many categories of persons algorithmically trading for their own account, pulling them into the definition of a "floor trader."

B. Proposed Regulation AT Registration Requirements

Proposed new Rule 170.18 would require managers covered by Regulation AT to become members of at least one registered futures association (i.e., the National Futures Association).

C. Ongoing Regulation AT Requirements

1. Managers covered by Regulation AT would have to adopt a large list of risk controls to address the risks of Algorithmic Trading, including:

   (a) Pre-trade risk controls on items such as the maximum number of order messages, execution frequency, order price and maximum order size parameters; and

   (b) Order cancellation systems.

2. Covered managers would also have to implement a series of development, testing, training and monitoring processes.

3. The most contentious aspects of Regulation AT are requirements to retain the actual algorithmic source code, to ensure preservation of that source code by utilizing a "source code repository," and to make the source code available to examiners (without the need for a subpoena or other "good cause" requirements).

4. The proposed rule is in a comment period and various industry groups are currently considering the most effective means of providing feedback to the CFTC.

D. MiFID II Reforms

1. The EU legislative package consisting of a recast Markets in Financial Instruments Directive and the Markets in Financial Instruments Regulation (together, "MiFID II") is due to come into force on Jan. 3, 2017. The European Commission has recently proposed to delay the transposition of MiFID II reforms by one year (until 2018), citing concerns around the feasibility of the implementation by member state regulators, and the requirements to build complex IT systems necessary to accommodate the new pre- and post-trade transparency regime in the time remaining until the original deadline. It is likely that the legislative acts providing for such a delay will be published in January 2016.

2. MiFID II will have significant operational and trading infrastructure implications for EU asset managers. U.S. managers who access EU trading venues, trade with EU counterparties or provide managed account services to EU clients are also likely to be affected by the MiFID II reforms.

3. *Algorithmic and High-Frequency Trading*: MiFID II introduces a comprehensive regime of new organizational and systems resilience requirements for EU firms that engage in algorithmic and high-frequency trading. The definition of algorithmic trading in MiFID II is very broad and covers all forms of automated trading, not only high-frequency or "quant" strategies. Trading venues that allow direct electronic access and EU investment firms that provide their clients with direct market

access or sponsored access will be subject to extensive systems resilience, risk control and trade monitoring obligations. U.S. managers who currently benefit from direct market access or sponsored access to EU trading venues may be affected by the new requirements applicable to their sponsoring firms. As a result of MiFID II implementation, sponsoring firms are likely to revise the eligibility and due diligence requirements for direct electronic access and update the terms on which direct electronic access will be provided.

4. Other key MiFID II reforms that are likely to have an effect on U.S. managers include:

   (a) *Transparency and Market Infrastructure Reforms*: MiFID II creates new transparency regimes for non-equity financial instruments, such as bonds, structured finance products and derivatives. In addition, the existing pre-trade transparency waivers for equity instruments will be modified which, among other things, will have a direct effect on trading in dark pools. As a result of MiFID II, certain EU trading counterparties may be required to alter their business models or become authorized as a trading venue or a so-called systematic internalizer. Managers should analyze the impact of the reforms on their trading strategies and should engage with their EU trading counterparties to understand their status under MiFID II, their obligations to publish prices, and any changes to their terms of business or usual trading practices that may result from MiFID II.

   (b) *Commodity Derivatives Position Limits*: MiFID II introduces new position limits, position management powers, and position reporting regimes for commodity derivatives traded on EU trading venues and economically equivalent OTC contracts. Managers who trade commodities derivatives or emission allowances should assess the impact of these reforms on their trading strategies.

   (c) *Provision of Investment Services to EU Clients*: Non-EU managers who provide managed account and other investment services to EU clients should be aware that certain EU member states currently regulate provision of these services in their jurisdictions, even where the non-EU manager does not have a physical presence in their jurisdictions.

   (d) The so-called "third-country access" provisions in MiFID II create a new regime allowing non-EU managers to register with the European Securities and Markets Authority ("ESMA") in order to provide such services to professional clients, subject to the EU Commission first adopting an equivalence decision in respect of the home jurisdiction of the non-EU manager. MiFID II also specifies that member state regulators may require non-EU firms that provide services to so-called "elective professional clients" (e.g., local authority pension funds) to establish a branch in that member state and to obtain a license from the local member state regulator. Transposition of MiFID II third-country access provisions into local law of EU member states is likely to result in further restrictions on the provision of "cross-border" services in certain EU jurisdictions.

   (e) MiFID II includes a "reverse solicitation" exemption to these registration requirements that is similar to the one in the Alternative Investment Fund Managers Directive ("AIFMD") but defined more narrowly.

   (f) *Access to EU Trading Venues*: One further aspect of the third-country provisions is that some EU member states may restrict the ability of non-EU firms to become members of regulated exchanges in their jurisdictions or disallow such firms to take advantage of direct market access or sponsored access without obtaining a local license.

III. Cybersecurity

A. Updates on Cybersecurity Guidance

1. OCIE announced in January 2015 that it was going to begin focusing more on cybersecurity during exams and that it would conduct several sweep exams on cybersecurity in 2015.

2. OCIE issued a Risk Alert in September 2015 that provided additional information on this focus and noted that OCIE would be testing to assess the implementation of firm procedures and controls for cybersecurity.

3. In April 2015, the staff of the SEC's Division of Investment Management issued a guidance update outlining some of the features that it suggests investment managers adopt in order to address cybersecurity risk (to the extent they are relevant). This guidance can be summarized as a three-step approach whereby the SEC staff recommends that investment managers:

   (a) Use periodic assessments to assess threats, vulnerabilities and defensive measures currently in place;

   (b) Design a strategy to prevent, detect and respond to cybersecurity threats, specifically utilizing data encryption, firewalls, restrictions on the use of movable storage media, intrusion monitoring software, network segregation and "system hardening"; and

   (c) Implement the strategy the investment manager develops through customized written policies and procedures, either as a stand-alone document or as part of other policies designed to comply with applicable aspects of the securities laws.

4. In August 2015, the NFA submitted to the CFTC a proposed interpretive notice that would apply to NFA Compliance Rules 2-9, 2-36 and 2-49, which generally require firms to diligently supervise their employees and agents or their businesses. The NFA's proposal provides cybersecurity guidance but generally focuses on areas similar to those in OCIE's Risk Alert.

B. Enforcement Activity Relating to Cybersecurity

1. The SEC has not yet brought an enforcement action against a private fund manager for violations of the securities laws arising from cybersecurity-related matters. However, the SEC brought an enforcement action this year against an investment adviser for the first time under Regulation S-P as a result of a cyber breach that resulted in a hacker obtaining the personally identifiable information ("PII") of over 100,000 individuals, including some of the investment adviser's clients.

2. In *R.T. Jones Capital Equities Management, Inc.*, the SEC alleged that R.T. Jones Capital Equities Management Inc. ("R.T. Jones") failed to adopt written policies and procedures reasonably designed to protect customer records and information in violation of Rule 30(a) of Regulation S-P. R.T. Jones was not itself hacked; its third-party vendor was hacked, and as a result, PII of over 1000,000 individuals was exposed. The hack occurred in 2013, which was before any statement or initiative by the SEC relating to cybersecurity for investment advisers. Regardless, the SEC found that R.T. Jones had not adopted sufficient policies and procedures regarding the security and confidentiality of information stored by third-party service providers. The SEC imposed a $75,000 civil penalty.

3. To mitigate future risks, R.T. Jones also agreed to appoint an information security manager to oversee data security and to hire a cybersecurity firm to provide ongoing reports and advice, and

the firm also implemented a written information security policy that included maintaining sensitive information in an encrypted format and installing a new firewall.

C. Mitigating Cybersecurity Threats

1. Establishing a Formal Program

(a) Managers should adopt a written policy and utilize outside consultants to assist with day-to-day cybersecurity monitoring as necessary.

(b) Managers should not adopt any consultant's standard policies wholesale, but must be careful to tailor any policies or procedures to their business.

(c) The SEC and CFTC have noted several elements that they expect to see in a cybersecurity policy, including but not limited to: (i) multifactor authentication; (ii) firewalls; (iii) dynamic updating of personnel access rights; (iii) patch management practices; (iv) vulnerability scans; and (v) penetration testing.

2. Oversight

Managers should involve senior personnel throughout the firm in cybersecurity matters. Managers should also document the oversight and involvement of senior management and fund directors in real time.

3. Risk Assessments

(a) Risk assessment (and response) protocols should be treated as a continuous process. Managers should not wait for the annual compliance review to assess cybersecurity risks.

(b) If a risk is identified, managers should consider specifically addressing that risk in the firm's cybersecurity policies and procedures (as well as noting that those procedures are designed to address that risk).

4. Access Rights and Controls

Managers should perform an information transfer channel inventory and analysis on a periodic basis and compare the volume of data transmitted (by channel) on a relative basis and over time. Corrective action should be taken to limit or close transmission channels that present an unnecessary or unacceptable risk of theft or loss.

5. Vendor Management

Managers should be performing due diligence of vendors when they are selected, negotiating protections into vendor contracts related to access to firm networks or data (including the breach of confidential information), and monitoring vendors after they are on-boarded; this process should be documented. Managers should also ensure that they have "written contingency plans [with vendors] concerning … issues that might put the vendor out of business or in financial difficulty."[135]

6. Incident Reponses and Recovery

[135] Securities and Exchange Commission, OCIE's 2015 Cybersecurity Examination Initiative (Sept. 15, 2015), *available at* www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf.

Because examiners will be expecting to discuss incident responses, it is important to contemporaneously document each incident and the manager's response. As this can be challenging for compliance personnel without extensive technical training or experience, it underscores the need to partner with the information security staff from as early a point in time as possible.

7. Training

   Managers should be aggressive in scheduling training sessions and in documenting their use and effectiveness. Thought should also be given to tailoring training by employee function and classification.

D. Cybersecurity and Investor Due Diligence

1. Cybersecurity deals with enterprise-wide risk and should be accorded resources and attention as such. In addition to the problems associated with a potential SEC enforcement action relating to cybersecurity, it is important to note that an information security breach could have a substantial impact on both the firm's ability to maintain operations as well as attract new capital.

2. Cybersecurity has become a significant focus area during investor due diligence as investors begin to take into account both the greater likelihood of cyber attacks and the significant risk they pose to firms.

3. During diligence meetings, managers should be prepared to outline their cybersecurity policies and procedures as well as list any vendors they may use to assist in performing day-to-day cybersecurity functions.

IV. Enforcement Actions

A. The SEC pursued enforcement actions against several noteworthy firms based on various types of conflict of interest.

1. *In the Matter of Kohlberg Kravis Roberts & Co. L.P.* (June 29, 2015)

   (a) The SEC alleged that Kohlberg Kravis Roberts & Co. LP ("KKR") breached its fiduciary duty to clients by misallocating expenses. KKR incurred $338 million in expenses, including diligence, research, travel and professional fees, related to potential investment opportunities that ultimately are unsuccessful or go unexecuted. These broken deal expenses can be reimbursed through fee-sharing arrangements with its funds and co-investors. The SEC alleged that KKR improperly allocated these expenses by failing to allocate any of them to its co-investors (many of whom were internal firm personnel) and additionally failed to disclose in limited partnership agreements or otherwise that it did not allocate any broken deal expense to its co-investors. By doing so, KKR breached its fiduciary duty as an investment adviser and Section 206(2) of the Advisers Act.

   (b) The SEC also charged KKR with failing to adopt and implement a written compliance policy or procedure regarding its fund expense allocation practices in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The SEC discovered these violations through a 2013 OCIE Compliance Examination.

   (c) KKR agreed to pay over $28 million in total to settle the action.

2. *In the Matter of Blackstone Management Partners L.L.C., et al.* (Oct. 7, 2015)

    (a) The SEC alleged that Blackstone Management Partners LLC ("Blackstone") and certain of its affiliates breached their fiduciary duty to clients by inadequately disclosing certain information to funds and limited partners. Specifically, Blackstone failed to disclose a discount it received on legal fees being provided to the advisory entities but not to the funds. In addition, the SEC alleged that Blackstone failed to disclose its ability to accelerate monitoring fees to be paid in the future prior to the submission of capital commitments. The SEC alleged that these accelerating fees had the effect of reducing the value of the portfolio companies prior to their sale. In doing so, the SEC alleged that Blackstone violated Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

    (b) The SEC further alleged that Blackstone violated Section 206(4) and Rule 206(4)-7 for inadequate written policies and procedures reasonably designed to prevent conflicts of interest and failure to disclose information regarding monitoring fees.

    (c) To settle the matter, Blackstone agreed to pay $26,225,203 in disgorgement, $2,686,553 in prejudgment interest, and a $10-million civil penalty.

3. *In the Matter of BlackRock Advisors, LLC and Bartholomew A. Battista* (April 20, 2015)

    (a) The SEC alleged that BlackRock Advisors LLC ("BlackRock") failed to disclose that one of its portfolio managers was a general partner of and had a substantial investment in a company that formed a joint venture with a portfolio company. The portfolio manager caused BlackRock funds to increase the amount of their invested capital in the joint venture with his company. The SEC stated that this created a conflict of interest for BlackRock and that failure to disclose that conflict of interest resulted in a breach of BlackRock's fiduciary duty to its clients.

    (b) BlackRock was also charged with failing to adopt and implement adequate compliance policies and procedures, and its CCO was charged with causing that violation. Both BlackRock and the CCO were charged with causing the funds' failure to have BlackRock's CCO report to the board of directors the portfolio manager's violations of BlackRock's private investment policy.

    (c) As part of the settlement, BlackRock agreed to hire an independent compliance consultant. BlackRock agreed to pay a civil penalty of $12 million, and BlackRock's CCO agreed to pay a civil penalty of $60,000.

B. CFTC Enforcement Actions

1. The CFTC and the futures exchanges have become very active in seeking enforcement actions against market participants for both technical violations as well as more substantive manipulation and insider-trading violations.

2. The CFTC, in particular, has been asserting its litigation powers across the breadth of its jurisdiction. Several noteworthy enforcement actions include:

    (a) *In the Matter of Arya Motazedi* (Dec. 2, 2015)

(i) In the *Motazedi* case, the CFTC settled its first-ever insider-trading case, relying on new powers granted to it under the Dodd-Frank Act and embodied in CFTC Regulation Section 180.1 ("Rule 180.1").

(ii) According to the CFTC, Motazedi, a proprietary gasoline and energy trader at an unnamed public company in Chicago, had access to confidential, proprietary information concerning his employer's proprietary trading in energy commodities (e.g., timing, amounts and prices), and he used that knowledge to: (i) enter "opposite side" orders that matched with his employer's orders at least 34 times (causing the employer's account to buy energy futures at higher prices and sell at lower prices, profiting Motazedi and harming his employer), at least some of which were designed as "round trip" transactions (where both sides bought and sold with the other and neither party experienced a net change in its positions); and (ii) "front run," on at least 12 occasions, his employer's orders (allowing Motazedi to benefit from any subsequent price movement caused by the subsequent execution of the employer's oil and gas futures orders).

(iii) The CFTC issued a variety of sanctions against Motazedi, including:

(1) A "cease and desist" order;

(2) The requirement that Motazedi pay $216,955.80 in restitution;

(3) The requirement that Motazedi pay a civil monetary penalty of $100,000;

(4) A permanent ban on Motazedi's trading of commodity interests; and

(5) A permanent ban on Motazedi's registering with the CFTC as a futures professional in any capacity.

(b) *In the Matter of Total Gas & Power North America, Inc. and Therese Tran* (Dec. 7, 2015)

(i) The CFTC settled attempted manipulation charges where a trader allegedly attempted to manipulate the monthly index settlement prices of gas at four hubs which would in turn benefit the swap positions held by the trader.

(ii) This case marked the second time that the CFTC relied on Rule 180.1 (the first time was in *Motazedi*, discussed above).

(c) *In the Matter of JPMorgan Chase Bank, N.A.* (Dec. 18, 2015)

(i) The CFTC settled charges with JPMorgan for failure to disclose certain conflicts of interest to clients of its wealth management business. Specifically, JPMorgan allegedly failed to disclose its preference for investing its clients' funds in investment vehicles that provided additional fees or incentives to JPMorgan. JPMorgan agreed to a $100-million fine.

(ii) The *JPMorgan* case is notable because it so closely resembles the conflict of interest cases that the SEC has traditionally brought, and (together with the Rule 180.1 cases discussed above) may well be a harbinger of a shift to SEC-style enforcement.

C. European Union Enforcement Actions

1. In the past year, there has been a significant increase in enforcement actions taken by European Union ("EU") member state regulators for late filings of position disclosures (for both short and long positions) and uncovered short sales.

2. EU Short Selling Regulation. The requirements of the EU Short Selling Regulation[136] include the following:

   (a) *Equities*: Net short positions of 0.2 percent (and each 0.1 percent above that) must be notified to the local EU regulator for the market. Net positions of 0.5 percent (and each 0.1 percent above that) must be disclosed publicly.

   (b) *Sovereign Debt*: Net short positions must be disclosed to the relevant EU regulator if the following thresholds are crossed: 0.1 percent if the total amount of outstanding debt is less than 500,000 euros; 0.5 percent if outstanding debt is more than 500 million euros. Thresholds for each sovereign issuer are published on a quarterly basis.[137]

   (c) *Naked Short Selling*: The Short Selling Regulation prohibits uncovered short sales in shares and sovereign debt. The Short Selling Regulation specifies the types of arrangements (e.g., pre-borrow or "locate") that provide eligible "cover" for short positions.

   (d) *EU Sovereign CDS*: "Uncovered" sovereign credit default swap ("CDS") transactions are prohibited. Managers are required to have procedures in place to document that the sovereign CDS position is used to hedge a corresponding exposure to sovereign debt or another exposure that meets the correlation tests set out in the Short Selling Regulation.

   (e) *Short Selling Bans and Emergency Measures*: EU member states may from time to time bring in temporary bans or other restrictions on short selling. Announcements of temporary bans are published on the website of the local regulator and on ESMA's website.[138]

   (f) *Pre-Registration for Reporting*: Most EU member states require prior registration for the purposes of making short-selling filings, and it can take more than 24 hours to obtain reporting log-in or registration details. Managers should consider registering in advance in all EU member states where they may need to report in order to ensure that filings can be submitted before the deadline (3:30 pm local time on the following trading day) when required.

   (g) *Sanctions and Penalties*: ESMA has published a list of administrative measures and sanctions applicable in EU member states to infringements of the Short Selling Regulation.[139]

D. EU Major Shareholding Disclosure Requirements

1. All EU jurisdictions require notification of significant long positions. Notifications are made to the issuer and the local regulator for the market and published by the issuer. Initial notification thresholds range from 1 percent to 5 percent depending on the local rules; incremental disclosure obligations (which can also range between 1 percent and 5 percent) also apply.

[136] Regulation EU 236/2012.

[137] https://www.esma.europa.eu/regulation/trading/short-selling.

[138] *See id.*

[139] https://www.esma.europa.eu/sites/default/files/library/list_of_administrative_measures_and_sanctions.pdf.

2. As a result of the implementation of the EU Transparency Directive Amending Directive[140] ("TD Amending Directive") in November 2015, a number of changes have been made to the major shareholding disclosure regimes of EU member states. Notably, those member states (e.g., Spain) that did not previously require disclosure of long positions held through cash-settled equity swaps (or contracts for difference ("CFDs")) or convertible bonds now require such positions to be taken into account when calculating the total size of the position. ESMA has published an indicative list of financial instruments subject to the disclosure obligations.[141]

3. ESMA has published a standard form for notification of major holdings, and some member states have now replaced their old reporting forms with the ESMA template.[142]

4. The TD Amending Directive includes a regime of administrative sanctions and penalties for breaches of the disclosure requirements. The maximum penalty for breaches by a legal entity is 10 million euros or 5 percent of the turnover.

V. Personal Liability

A. Recent SEC Enforcement Actions Against Individuals

1. The SEC has more frequently been bringing enforcement actions against CCOs of investment advisory firms.

2. In terms of actual enforcement actions, the SEC has come down on both sides of the CCO liability front in 2015.

   (a) In *Pekin Singer Strauss Asset Management, Inc. et al.* (June 23, 2015), the SEC alleged that an investment manager had widespread and significant compliance failures, but the CCO was not responsible for them and was not charged by the SEC. To the contrary, the CCO had repeatedly informed upper management that the firm needed to strengthen its compliance program and needed more resources dedicated to compliance. SEC officials have cited this case as an example of a competent CCO not being held liable for the compliance failures of his or her company.

   (b) In *BlackRock Advisors, LLC*, the CCO agreed to pay a $60,000 civil penalty for causing his firm's alleged compliance-related violations — failing to adopt and implement written compliance policies and procedures reasonably designed to monitor and disclose conflicts related to outside business activities of firm employees. Specifically, the CCO was held partially responsible for a portfolio manager and the principals of the firm failing to disclose a conflict of interest to its funds. Additionally, the CCO was charged with causing some of the adviser's funds to violate Rule 38a-1(a) by not disclosing a "material compliance matter to the funds" boards.

   (c) In *SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason* (June 15, 2015), a CCO was also charged with causing his firm's alleged failure to implement compliance policies, as well as failure to conduct an annual compliance review, and causing a material misstatement in a Form ADV filing, all of which were related to firm principals allegedly

[140] Directive 2013/50/EU.

[141] https://www.esma.europa.eu/regulation/corporate-disclosure/transparency-directive.

[142] *Id.*

misappropriating client funds through their unilateral signatory power over client bank accounts. Notably, the CCO was held responsible for not implementing policies and procedures reasonably designed to prevent this misappropriation, and for failing to adequately implement the existing policies. The CCO was charged regardless of the fact that when he learned that the misappropriation had occurred, he conducted an internal investigation that resulted in the firing of the individual who misappropriated funds and a referral to criminal authorities. In addition, the CCO was charged with not conducting an annual review in the midst of the internal investigation.

(d) In *Sands Brothers Asset Management et al.* (Nov. 19, 2015), the SEC settled charges with an adviser who allegedly failed to properly distribute audited financial statements to investors in violation of Rule 206(4)-2 ("the Custody Rule"). The CCO was charged with aiding and abetting the alleged violation and failing to implement adequate policies and procedures reasonably designed to prevent these types of violations. In this case, however, the CCO raised these issues directly with management but was ineffective in persuading management to take actions to remedy deficiencies pointed out by the SEC staff.

3. A recent public memorandum by Deputy Attorney General Sally Yates — the second highest ranking member of the Department of Justice ("DOJ") — announced that the DOJ was formalizing in writing steps intended to strengthen its pursuit of individual corporate wrongdoing, which necessarily includes violations by investment advisers and their employees. Among other things, Yates' memorandum states that in order for an entity to receive credit for cooperating with a government investigation, it must provide all relevant facts relating to the individuals responsible for the misconduct, and all criminal and civil investigations should focus on individuals and their potential liability from the inception of the investigation. Other government regulators, including the SEC and the CFTC, have expressed similar views.

4. All employees — not just CCOs — have a personal interest in preventing compliance failures. Principals and portfolios managers and analysts alike must take personal responsibility for ensuring that the investment adviser is complying with its fiduciary obligations, and that its compliance policies and procedures are properly crafted to address any emerging risks.

5. In a speech in October 2015, Andrew J. Donohue, the SEC's chief of staff, outlined a number of areas that CCOs should focus on in performing their duties:

(a) The various laws and regulations that govern the manager and its business;

(b) The manager's compliance policies and procedures and how they are applied and monitored;

(c) How the manager identifies conflicts of interest, the frequency of any conflicts review, and how conflicts are disclosed, mitigated or resolved;

(d) The manager's internal operations, supervisory regime, and structure and interdependencies;

(e) The power and limitations of the manager's compliance and other technology platforms;

(f) The manager's clients, the offering in which they are invested, and their investment objectives;

(g) The types of investment products and strategies in the manager's portfolio;

(h) The practices and regulations in the various markets in which the firm operates; and

(i) The manager's performance across its various products, and how that compares with the corresponding advertising and marketing efforts and materials.

B. CCO Liability Issues in the United Kingdom

1. *FCA Final Notice: Anthony Rendell Boyd Wills*

In March 2015, the U.K. Financial Conduct Authority ("FCA") imposed a financial penalty on Wills, a former compliance officer at Bank of Beirut, for allegedly failing to deal with the FCA in an open and cooperative way and failing to disclose appropriately to the FCA information of which it would reasonably expect notice.[143] The FCA found that the information provided by Wills was misleading and that he had failed to inform the FCA of the deficiencies in the compliance monitoring identified by a third-party compliance audit and the fact that the compliance monitoring plan had not been fully implemented at the time of the communication. On announcing the fine, Georgina Philippou, acting Director of Enforcement and Market Oversight at the FCA, noted: "We are reliant on compliance officers and internal audit to act as an important line of defense, to support effective regulation at firms and to show backbone even when challenged by their colleagues."

2. New Senior Managers and Certification Regime

In October 2015, the HM Treasury announced[144] its plans to extend the Senior Managers and Certification regime to all sectors of the financial services industry, including FCA-authorized asset managers, replacing the existing approved persons regime. The new Senior Managers Regime is currently expected to apply to asset managers from 2018 and will have the following key features:

(a) A new statutory duty for senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility;

(b) An approval regime focused on senior management, with requirements on firms to prepare robust documentation on the scope of these individuals' responsibilities (note that a CCO would be considered a "senior manager" for the purposes of the new regime);

(c) A requirement on firms to certify as fit and proper any individual who performs a function that could cause significant harm to the firm or its customers (e.g., portfolio managers or traders who are not also senior management), both on recruitment and annually thereafter; and

(d) A power for the FCA to apply enforceable Rules of Conduct to any individual who can impact the FCA's statutory objectives.

VI. Marketing Under the AIFMD

The AIFMD[145] has been implemented in a majority of member states of the European Economic Area ("EEA"). The transitional provisions for certain marketing activities that were available in some EEA member states expired on July 22, 2014.

A. Reverse Solicitation

---

[143] https://www.fca.org.uk/static/documents/final-notices/anthony-rendell-boyd-wills.pdf.

[144] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/468328/SMCR_policy_paper_final_15102015.pdf.

[145] Directive 2011/61/EU.

1. Many U.S. managers continue to rely on the reverse solicitation exception when dealing with EEA investors. This exception is available in all EEA member states under the local legislative measures implementing the AIFMD. In broad terms, "marketing" for AIFMD purposes means an offer or placement made at the initiative of the alternative investment fund manager (or the "AIFM") or on behalf of the AIFM (e.g., by a placing agent).

2. "Marketing" excludes offers made at the initiative of the investor (or through reverse enquiry).

3. The boundaries of the reverse solicitation concept are most commonly tested in four scenarios:

   (a) Pre-marketing (e.g., initial meetings or calls with prospective investors);

   (b) Interactions with existing investors in respect of new investment opportunities;

   (c) Interactions with consultants and other third parties; and

   (d) Capital introduction by prime brokers (as discussed below).

4. Typical compliance measures that are being taken by managers to ensure that they able to rely on this exception include: (i) obtaining "own initiative" certifications and written requests for information from potential investors; (ii) removing any EU-based investors from distribution lists, except where a specific request for fund information has been received; (iii) deleting any references to new fund launches from newsletters sent to existing investors; and (iv) restricting the ability of third-party distributors, introducers or placement agents to market in Europe.

B. Compliance with National Private Placement Regimes

1. An increasing proportion of U.S. managers have either already registered their funds under the national private placement regimes of one or more of the EEA countries or are in the process of assessing the feasibility of such registrations. There are three key drivers for this trend: (i) the desire to launch new products and the need not to miss out on the EU altogether in those launches; (ii) pressure from placement agents who do not wish to be restricted from marketing in the EU; (iii) certain institutional investors in the EU asking managers to represent that there has not been a breach of local marketing restrictions. All of these factors are causing some managers to be more cautious.

2. In those EEA countries where a national private placement regime ("NPPR") is available, the local law has been amended to incorporate the minimum elements of the private placement rules set out in the AIFMD. These include:

   (a) The existence of cooperation arrangements between the home state regulator of the alternative investment fund ("AIF"), the home state regulator of the manager (or AIFM) and the EEA member state where the marketing takes place — to this end, the SEC, CFTC and the Cayman Islands Monetary Authority ("CIMA") have entered into cooperation agreements with a majority of member state regulators;

   (b) The AIFM must undertake to comply with the initial and ongoing investor disclosure obligations specified in the AIFMD; and

   (c) The AIFM must comply with Annex IV regulatory reporting obligations (similar to SEC Form PF).

3. For managers that acquire "control" of unlisted companies established in the EU or issuers of shares admitted to trading in the EU, an additional obligation to comply with the so-called "asset-stripping rules" applies. These rules: (i) impose restrictions on all forms of distributions by the EU portfolio company within the first 24 months of the AIFM acquiring control; and (ii) require the AIFM to make certain disclosures and notifications to various stakeholders.

4. Some countries have included additional requirements in their NPPRs, an approach often referred to in the EU as "gold-plating." These "gold-plating" measures range from requirements to apply for prior approval of the local regulator (e.g., Germany) before commencing marketing activities (a process that can take up to four months) to appointment of service providers to the AIF (e.g., a custodian and administrator) to carry out the functions of a "depositary" specified in the AIFMD (e.g., Denmark and Germany).

5. There is also a degree of variation in the local approaches to investor disclosure and regulatory reporting elements of the AIFMD (e.g., a requirement to produce a country supplement). As regards Annex IV reporting, some EEA regulators have announced that non-EU AIFMs with master feeder structures would only need to disclose feeder-level information in their Annex IV filings with no look-through to the positions of the underlying master fund. Other member state regulators expect a separate report to be submitted in respect of the master fund.

6. The most popular jurisdictions for NPPR registrations are currently the United Kingdom, the Netherlands, Finland, Sweden and Norway. Some countries (e.g., France and Italy) do not currently have an NPPR allowing non-EU AIFMs to market open-ended funds, which means that hedge fund managers may only make offers in response to a reverse enquiry in these countries.

C. Third-Country Marketing Passport

1. The AIFMD includes a so-called "third-country passport" mechanism (that is, a marketing passport for non-EU managers and non-EU funds). This passport, when available, would allow a non-EU fund to be marketed to professional investors throughout the EEA, including in circumstances where there is no NPPR available.

2. For the third-country passport to become available, ESMA must first produce a positive opinion on the extension of the passport to both the jurisdiction of the manager (e.g., the United States) and the fund (e.g., the Cayman Islands). Following such positive advice, the EU Commission would legislate to allow the third-country passport to be extended.

3. ESMA produced its first opinion and technical advice to the EU Commission on the viability of such a third-country passport in July 2015.[146] Positive advice was provided with respect to Guernsey, Jersey and Switzerland. No decision has been reached and some concerns were expressed with respect to Hong Kong, Singapore and the United States. ESMA continues with its assessment of the United States and plans to review the Cayman Islands in the next phase of the equivalence assessments.

4. If the third-country passport becomes available, the national private placement regimes may be abolished within three years. Until then, non-EU managers marketing in the EEA can choose between a passport and NPPR (where available). Some countries (e.g., Germany) have already announced that they intend to repeal their NPPR as soon as the third-country passport becomes

[146] For more information, see the SRZ *Alert*, "AIFMD Update: ESMA Advice on Extension of Marketing Passport Published," *available at* www.srz.com/AIFMD_Update_ESMA_Advice_on_Extension_of_Marketing_Passport_Published/.

available. Under the AIFMD, a U.S. manager who opts-in to the third-country passport would be required to register with an EU "member state of reference" (e.g., the country where it undertakes most of its marketing activities) and comply with the whole of the AIFMD. This would mean, among other things, a requirement to appoint an eligible depositary for the funds marketed in the EEA that is located either in the jurisdiction of the manager (e.g., the United States) or the jurisdiction of the fund (e.g., the Cayman Islands).

Disclaimer

Schulte Roth & Zabel

New York | Washington DC | London

www.srz.com