

February 24, 2020

Proposed Revisions to the Volcker Rule—Prohibitions and Restrictions on Certain Interests in, and Relationships with, Covered Funds

On January 30, 2020, the Federal Reserve Board issued a notice of proposed rulemaking and asked for comments on a proposed rule to simplify, streamline and tailor the “covered fund” provisions under the regulation implementing section 13 (commonly known as the “Volcker Rule”) of the Bank Holding Company Act (“BHC Act”) (the “Proposal”).¹

The Proposal is the culmination of a process first announced in March 2018 to significantly revise all aspects of the Volcker Rule’s implementing regulations in light of the experience of the federal banking agencies—the Federal Reserve Board, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Federal Deposit Insurance Corporation (together, the “Agencies”)—since the final rule was issued in December 2013 (the “Final Rule”). It is the first time the Agencies have targeted the implementing regulations related to the Volcker Rule’s general prohibition on banking entities investing in or sponsoring hedge funds or private equity funds—known as “covered funds.”²

The Proposal will be of interest to the asset management industry. Working within the confines of the statute, the Proposal would introduce four new exclusions from the definition of covered fund (credit funds, venture capital funds, family wealth management vehicles and customer facilitation vehicles) and simplify three existing ones. In addition, it would expand the scope of permissible relationships that a banking entity may have with covered funds, codify existing guidance related to certain foreign funds and clarify issues surrounding ownership interests and permissible parallel investments by a banking entity and its employees.

Background of the Covered Fund Provisions

The general purpose of the Volcker Rule’s covered fund provisions was to ensure that a banking entity was not able to do indirectly via a fund structure that which it was prohibited from doing directly under the proprietary trading restrictions of the Volcker Rule—conceptually, putting taxpayer funds (*i.e.*, deposits) at risk through excessive exposure to speculative and risky investment activity.

In the years following the Final Rule, covered fund-related issues emerged as practitioners grappled with the new concepts and unprecedented breadth of the Final Rule. The Agencies from time to time acknowledged and addressed certain unintended consequences in policy statements and FAQ guidance.³

¹ See *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds; Final Rule; Notice of Proposed Rulemaking* (Jan. 30, 2020), available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/files/volcker-rule-fr-notice-20200130.pdf>.

² The Volcker Rule prohibits a banking entity from acquiring or retaining an ownership interest in, sponsoring or having certain relationships with covered funds, subject to certain exemptions. Generally, a covered fund is an issuer that must rely on Section 3(c)(1) or Section 3(c)(7) for exemption from the Investment Company Act of 1940, as well as commodity pools that are not publicly offered. The Final Rule, consistent with section 13 of the BHC Act, defines the term “banking entity” to include (i) any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and (iv) any affiliate or subsidiary of any entity described in clauses (i), (ii), or (iii).

³ See, *e.g.*, Volcker Rule Frequently Asked Questions, available at <https://www.federalreserve.gov/supervisionreg/faq.htm>. The Proposed rule would not modify or revoke any previously issued staff FAQs, unless otherwise specified.

In July 2018, the Agencies proposed rulemaking and invited public comment on both the proprietary trading prong and covered funds prong of the Volcker Rule. The Agencies tackled the proprietary trading provisions first and issued a final rule in November 2019, in which they noted that revisions to the covered fund provisions would follow in a separate rulemaking.⁴

Drawing from the Agencies’ experience with the rule over six years of implementation, the Proposal seeks to codify permission for certain fund-related activities that the Agencies believe do not present the risks that the Volcker Rule was intended to address. Notable topics are described below:

1. Four New Types of Permitted Funds

Banking entities are allowed to make limited investments in covered funds, subject to a number of restrictions designed to ensure that banking entities do not rescue investors in these funds from loss and are not themselves exposed to significant losses from investments in or other relationships with these funds.

The Proposal would add new exemptions that would permit banking entities to invest in and/or sponsor four specific types of funds, subject to limitations and guardrails. Notable requirements are below:

Credit Funds	
Overview	Although the Volcker Rule excludes loan securitizations from the definition of covered fund, the regulations implementing the Volcker Rule limit the ability of banking entities to invest in or sponsor substantially similar funds that make loans, invest in debt securities or otherwise extend credit (“credit funds”). ⁵ The Proposal would allow banking entities to invest in or sponsor credit funds that meet certain eligibility criteria.
Eligibility Criteria	<ul style="list-style-type: none"> • Assets must consist solely of (i) loans; (ii) debt instruments (including debt securities); (iii) other assets that are related or incidental to acquiring, holding, servicing or selling such loans or debt instruments; and (iv) certain interest rate and foreign exchange derivatives. • A limited amount of equity securities (or rights to acquire equity securities such as options or warrants) are permitted if received on customary terms in connection with the credit fund’s loans or debt instruments.
Issuer Restrictions	<ul style="list-style-type: none"> • May not engage in proprietary trading; • May not issue asset-backed securities; and • Must not be operated for evasory purposes.

⁴ See *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule*, 84 FR 61974 (Nov. 14, 2019), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20191008a1.pdf>. Those provisions became effective in January 2020; see also 83 FR 33471–87.

⁵ See Section 13(g)(2) of the BHC Act (12 U.S.C. § 1851(g)(2)) (providing that nothing in the Volcker Rule shall be construed to limit the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law). In the Proposal, the Agencies note that the legislative history of the Volcker Rule indicates that Congress targeted the covered funds provisions at private equity funds and short-term-focused hedge funds, not private long-term debt funds.

Banking Entity Investment	<ul style="list-style-type: none"> No prescribed limit on a banking entity's investment in the credit fund, but other applicable limitations and restrictions would still apply.⁶
Banking Entity that Is Sponsor or Adviser	<ul style="list-style-type: none"> May not guarantee, assume or otherwise insure the fund's obligations or performance (and must disclose this prohibition to investors); Must comply with the Super 23A limits (as described below) and restrictions prohibiting certain high-risk activities;⁷ Must ensure that the activities are consistent with safety and soundness standards as if the banking entity engaged in the activities directly.

Venture Capital Funds

Overview	Currently, venture capital funds that invest in small businesses and startup businesses may be covered funds subject to the restrictions of the Volcker Rule. The Proposal intends to reflect Congressional intent and allow banking entities that are financial holding companies to use their merchant banking authority to acquire or retain ownership interests in, or sponsor, qualifying venture capital funds.
Eligibility Criteria	<ul style="list-style-type: none"> Only "venture capital funds" as defined in existing regulations under the Investment Advisers Act of 1940 would qualify.⁸
Issuer Restrictions	<ul style="list-style-type: none"> May not engage in proprietary trading.
Banking Entity Investments	<ul style="list-style-type: none"> The banking entity must be permitted to engage in such activities under applicable law.⁹
Banking Entity that Is Sponsor or Adviser	<ul style="list-style-type: none"> May not guarantee, assume or otherwise insure the fund's obligations or performance (and must disclose this prohibition to investors); Must comply with the Super 23A limits (other than its ownership interest).

⁶ E.g., those under the BHC Act and the National Bank Act.

⁷ See 12 C.F.R. § 248.15, which prohibits transactions that would involve high-risk activities; result in a material conflict of interest with customers, clients or counterparties; or pose a threat to the safety and soundness of the banking entity or to the financial stability of the U.S.

⁸ 17 C.F.R. § 275.203(l)-1. The Proposal requests comment on whether the scope of qualifying venture capital funds should be further limited, for example, to funds that invest only in companies whose annual revenues are below a certain limit. This element of the proposal is intended to allow banking entities to invest in funds that serve an important role in providing financing for companies that do not have publicly traded securities at the time of the fund's investment, including smaller companies with fewer funding options.

⁹ For example, a banking entity that has elected to be treated as a financial holding company may be permitted to make an investment in a venture capital fund pursuant to its merchant banking investment authority, provided the banking entity complies with applicable merchant banking investment requirements. See 12 C.F.R. Part 225, Subpart J.

Family Wealth Management Vehicles (FWMVs)	
Overview	The Proposal would allow banking entities more flexibility to provide traditional banking and integrated asset management services to funds set up on behalf of a family.
Eligibility Criteria	<ul style="list-style-type: none"> • Vehicle must be owned only by members of a single family and no more than three closely related persons of the family customers.¹⁰ • Certain requirements depending on the form of the entity of the vehicle (<i>e.g.</i>, trusts).
Banking Entity Restrictions	<ul style="list-style-type: none"> • Must provide bona fide trust, fiduciary or advisory services to the fund; • Prohibited from guaranteeing performance (and must disclose this prohibition to fund investors); • Must comply with Super 23A limits with respect to such FWMVs; • Prohibited from having an ownership interest in the vehicle, other than up to 0.5% of the vehicle's outstanding ownership interests to the extent necessary for establishing corporate separateness; • Prohibited from acquiring low-quality assets from the FWMV;¹¹ • Additional limitations and restrictions to address evasious concerns.

Customer Facilitation Vehicles	
Overview	The Proposal would generally permit a banking entity to offer financial products to its customers through a fund structure (customer facilitation vehicles) in situations where the banking entity could otherwise enter into a contract directly with a customer to provide the same economic exposure to the underlying financial product (<i>e.g.</i> , a derivative).
Eligibility Criteria	<ul style="list-style-type: none"> • Vehicle must be designed to facilitate transactions between a banking entity and a single customer; • Must be used to facilitate a customer's exposures to a transaction, investment strategy or other service.
Banking Entity Restrictions	<ul style="list-style-type: none"> • Prohibited from guaranteeing the fund's performance (and must disclose this prohibition to the customer);

¹⁰ Under the Proposal, "closely related person" would mean "a natural person (including the estate and estate planning vehicles of such person) who has a longstanding business or personal relationship with any family customer."

¹¹ Specifically, a banking entity would be required to comply with the low-quality asset purchase requirements set forth in the Board's Regulation W (12 C.F.R. § 223.15(a)), as if such banking entity were a bank and the FWMV were an affiliate thereof.

- Prohibited from acquiring or retaining as principal an ownership interest in the fund, other than up to 0.5% of the entity's outstanding ownership interests to the extent necessary for establishing corporate separateness;
- Generally prohibited from acquiring low-quality assets from the fund.

2. Simplify Existing Covered Fund Exclusions: Loan Securitizations, Foreign Public Funds and Small Business Investment Companies

The Proposal would simplify the eligibility criteria for certain existing exclusions from the definition of covered fund in order to enable banking entities to use and confirm compliance with these existing exclusions.

(i) Loan Securitizations. The Volcker Rule expressly permits banking entities to sell and securitize loans in a manner otherwise permitted by law. In order to reflect this intent, the Proposal would amend two of the eligibility criteria required for a loan securitization to be excluded from the definition of covered fund.¹²

First, the Proposal would permit an issuer to hold a small pool of non-loan assets (no more than five (5) percent of the loan securitization's total assets) in order to provide banking entities with greater flexibility to sell and securitize loans. Second, the Proposal would codify existing guidance to clarify that "servicing assets" held by a loan securitization vehicle may include assets other than securities (*e.g.*, mortgage insurance policies supporting the mortgages in a loan securitization).

(ii) Foreign Public Funds. In order to provide consistent treatment between mutual funds and their foreign equivalents, the Proposal would simplify the eligibility requirements for foreign public funds to qualify for the exclusion from the definition of covered fund.¹³ Specifically, it would replace two requirements—the home jurisdiction requirement and the "predominantly" sold through one or more public offerings requirement¹⁴—with a single new requirement that ownership interests must be offered and sold through at least one public offering. In order to ensure that these funds are sufficiently similar to mutual funds, the Proposal also would modify the definition of "public offering" to add a new requirement that the distribution must be subject to substantive disclosure and retail investor protection laws or regulations in the jurisdiction where it is made.

(iii) Small Business Investment Companies. In order to give appropriate effect to the statutory exemption for Small Business Investment Company (SBIC) investments, the Proposal would clarify that an SBIC could remain eligible for the exclusion from the covered fund provisions during a wind-down period (during which time it may surrender its license), provided it makes no new investments after surrendering its license.

¹² The current rule excludes loan securitizations from the definition of covered fund, provided such issuers issue asset-backed securities and only hold loans and certain other permitted assets, among other eligibility criteria. 12 U.S.C. § 1851(g)(2); *see also* 12 C.F.R. § 248.10(c)(8).

¹³ U.S. registered investment companies (mutual funds) are not covered funds under the Volcker Rule. The current rule also excludes from the definition of covered fund certain foreign public funds that are authorized to be sold to retail investors, subject to eligibility criteria not applicable to mutual funds. A foreign public fund is defined as any investment fund that is organized outside of the U.S. and the ownership interests of which are (1) authorized to be sold to retail investors in the fund's home jurisdiction and (2) sold predominantly through one or more public offerings outside of the U.S. In the preamble to the Final Rule, the Agencies stated that they generally expect that an offering is made predominantly outside of the U.S. if 85 percent or more of the fund's interests are sold to investors that are not U.S. residents. 79 FR 5678.

¹⁴ The home jurisdiction requirement disqualifies funds used for structuring purposes that are organized in one foreign jurisdiction but only authorized to be sold to retail investors in another foreign jurisdiction. The requirement that a fund be sold "predominantly" through one or more public offerings has caused compliance and monitoring difficulties because banking entities may have limited visibility into the fund's distribution history.

3. Super 23A: Permissible Low-risk Transactions with Related Funds

The Volcker Rule generally prohibits all covered transactions between a banking entity and a covered fund that it advises or sponsors (a “related fund”).¹⁵ Specifically, with respect to a related fund, a banking entity is generally prohibited from entering into a transaction of a type that would be covered by section 23A of the Federal Reserve Act.¹⁶ While section 23A of the Federal Reserve Act includes certain exceptions from its prohibitions, the Volcker Rule did not incorporate those exceptions, leading to its nickname “Super 23A.”

The existing Super 23A limits prevented banking entities from providing certain traditional banking services—such as standard payment, clearing and settlement services—to related funds, meaning those services had to be outsourced to unaffiliated service providers.

The Proposal would permit a banking entity to provide those traditional banking services to related funds. The Proposal would also allow a banking entity to enter into transactions with a related fund that would be permissible without limit under section 23A of the Federal Reserve Act.¹⁷ The Agencies note that permitting these “low-risk” transactions between a banking entity and a related fund would reduce both the operational risks associated with the use of unaffiliated service providers and the interconnectedness among financial institutions in the U.S. financial system.

4. Relief for Qualifying Foreign Excluded Funds

The Proposal would provide permanent relief to resolve the unintended extraterritorial impact that the Volcker Rule has had on certain foreign funds that, but for lacking a U.S. nexus, would be covered funds (and, therefore, not banking entities).¹⁸

In order to permit foreign banking entities to conduct qualifying activities in accordance with the same laws and regulations applicable to their non-U.S. competitors, including investing in U.S. companies, the Proposal would exempt qualifying foreign excluded funds from the proprietary trading prohibition and covered fund provisions of the Volcker Rule using the same eligibility criteria set forth in existing policy statements.¹⁹

¹⁵ See 12 C.F.R. § 248.14.

¹⁶ 12 U.S.C. § 1851(f)(1). The term “covered transaction” is defined in section 23A and includes, among other things, extensions of credit, asset purchases and guarantees. See 12 U.S.C. § 371c.

¹⁷ These include intraday extensions of credit and extensions of credit fully secured by U.S. Treasury securities.

¹⁸ The current rule excludes covered funds from the definition of banking entity. 12 C.F.R. § 248.2(c)(2)(i). While the Agencies’ rules exclude certain foreign funds that are organized and offered outside of the U.S. from the definition of covered fund, if these foreign funds are affiliated with a banking entity, then they themselves could become banking entities subject to the Volcker Rule proprietary trading and other restrictions.

¹⁹ See *Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act* (July 17, 2019), available at

<https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190717a1.pdf> (addressing the potential attribution to a foreign banking entity of the activities and investments of qualifying foreign excluded funds). The eligibility criteria are that the fund (1) is organized or established outside the United States and its ownership interests are offered and sold solely outside the United States; (2) would be a covered fund were the entity organized or established in the United States, or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments; (3) would not otherwise be a banking entity except by virtue of the foreign banking entity’s acquisition or retention of an ownership interest in, or sponsorship of, the entity; (4) is established and operated as part of a bona fide asset management business; and (5) is not operated in a manner that enables the foreign banking entity to evade the requirements of section 13 or implementing regulations. See *id.*

5. Clarifications on Ownership Interests and Parallel Investments

(i) Ownership Interests Safe Harbor. The implementing regulations define an “ownership interest” in a covered fund to mean any equity, partnership or “other similar interest.” Currently, some loans by banking entities to covered funds could be deemed to be ownership interests based on standard covenants. To clarify that an ownership interest does not include certain credit instruments in the fund, the Proposal would provide a safe harbor for bona fide senior loans or senior debt instruments.

The Proposal would also clarify the types of credit rights that would be within the scope of ownership interest and adjust the calculation methods for purposes of complying with the ownership limits and conditions that apply to investments in related covered funds of a banking entity.²⁰

(ii) Parallel Banking Entity Investments. The Proposal would add a new rule of construction to clarify that banking entities are not required to treat certain types of direct investments alongside a covered fund as an investment in the covered fund, so long as certain conditions are met. Neither section 13(d)(4) of the BHC Act nor the text of the Final Rule require that a banking entity treat an otherwise permissible investment the banking entity makes alongside a covered fund as an investment in the covered fund.

* * *

Comments on the Proposal due by April 1, 2020. Please contact your usual legal advisor at Ropes & Gray with any questions about the Alert.

²⁰ See 12 U.S.C. § 1851(d)(4)(B)(ii)(I)–(II) (generally, the 3% per-fund and 3% of aggregate Tier 1 capital limits).