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Two Major Bank Regulatory Final Rules with Asset Management Impact Now in Effect: (i) FRB's Control Framework and (ii) Volcker Rule Covered Funds Provisions

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Two final rules affecting the scope of bank involvement in the asset management industry went into effect September 30, 2020. The first revises the Federal Reserve Board's rules regarding the definition of control in the Bank Holding Company Act ("BHC Act") (the "Control Rule")[1] to provide greater clarity as to what constitutes "controlling influence" of a given investment. The second revises the Volcker Rule's covered funds provisions to remove various activities from the purview of the Volcker Rule's restrictions on banks' involvement in the private fund space.[2]

Together, these rules could facilitate partnerships within the asset management industry, including between banks and fintech companies and banks and other asset managers, by redefining non-controlling relationships and encouraging bank participation in the private fund industry. Each is discussed briefly below.

1. Revisions to the Federal Reserve Board's Control Framework

Control is a fundamental concept in the BHC Act and the banking regulations. Structuring investments to avoid situations where a bank or its affiliate would be deemed to have control of an entity for bank regulatory purposes is often a threshold goal of a transaction. Control introduces a host of unpalatable consequences, including Federal Reserve Board supervision and regulation and certain activities limitations. The control framework generally applies to investments by banks in other companies (including, for example, fintechs), as well as investments in banks.

The Federal Reserve Board issued the Control Rule in January 2020, which adopted the general form of the April 2019 proposed rule.[3] The effective date was initially April 1, 2020 but was delayed until September 30, 2020 due to the impact of COVID-19.

The statutory definition of control for bank regulatory purposes has three prongs. The BHC Act's control definition includes two bright line tests for control—(A) directly or indirectly owning, controlling or having power to vote 25% or more of any class of voting securities; and (B) controlling in any manner the election of a majority of the directors or trustees—and a third test dependent on facts and circumstances: the ability to directly or indirectly exercise a "controlling influence" over management or policies.

The Control Rule mainly addresses what "controlling influence" means in the context of the third prong.

Tiered Presumptions of Control. The Control Rule sets forth certain objective thresholds to apply to the "controlling influence" analysis. These thresholds are arranged in tiers based on the level of ownership of any class of voting securities—less than 5%; 5–9.99%; 10–14.99%; and 15–24.99%.

A voting interest exceeding the particular threshold combined with the presence of one or more other specified relationships would trigger a presumption of control. The tiered framework is designed to incorporate the major factors and thresholds that the Federal Reserve Board has historically viewed as presenting controlling influence concerns.

The presumptions are structured on a sliding scale: as an investor's ownership percentage of voting shares in a company increases, the other relationships and factors through which the investor could exercise a controlling influence must decrease in order to avoid triggering a presumption of control. Depending on an investor's ownership percentage of any class of voting shares, the permissible level of other relationships and factors vary. These relationships include:

- the size of the total equity investment (in each case, must be less than one third, measured at the time of investment);

- the rights to director and committee representation on the board of directors;
- the use of proxy solicitations;
- management, employee or director interlocks;
- covenants or other agreements that allow for influence or restrict management or operational decisions, such as investment management agreements; and
- the scope of the business relationships (based on revenue and measured on an ongoing basis.

The final rule clarifies that the statutory presumption of non-control for investments of less than 5% of voting equity under Section 4(c)(6) of the BHC Act will not be jeopardized due to the presence of other relationships but will remain subject to the one-third total equity limitation.

Summary of Tiered Presumptions Chart.

	Less than 5% voting	**5-9.99% voting**	**10-14.99% voting**	**15-24.99% voting**
Directors	Less than half	Less than a quarter	Less than a quarter	Less than a quarter
Director Service as Board Chair	N/A	N/A	N/A	No director representative is chair of the board
Director Service on Board Committees	N/A	N/A	A quarter or less of a committee with power to bind the company	A quarter or less of a committee with power to bind the company
Business Relationships	N/A	Less than 10% of revenues or expenses	Less than 5% of revenues or expenses	Less than 2% of revenues or expenses
Business Terms	N/A	N/A	Market Terms	Market Terms
Officer/Employee Interlocks	N/A	No more than 1 interlock, never CEO	No more than 1 interlock, never CEO	No interlocks
Contractual Powers	No management agreements	No rights that significantly restrict discretion	No rights that significantly restrict discretion	No rights that significantly restrict discretion
Proxy Contests (directors)	N/A	N/A	No soliciting proxies to replace more than permitted number of directors	No soliciting proxies to replace more than permitted number of directors

Total Equity (BHCs)	Less than one third	Less than one third	Less than one third	Less than one third

Control of Advised Investment Funds and One-year Seeding Period Exemption. The final rule adopts as proposed the approach to control of advised investment funds, including 1940 Act-registered investment companies, investment companies exempt from registration under the 1940 Act (including, generally, REITs and commodity funds) and their foreign equivalents. Under the final rule, subject to a one-year exception for the initial seeding period, an investment adviser owning 5% or more of the voting equity, or 25% or more of the total equity, of an investment fund will be presumed to control the fund.

Permissible Defensive Rights Attached to Investment Fund Interests. The final rule spells out certain defensive rights common to limited partnerships and limited liability companies that will not cause the ownership interests bearing such defensive rights to be considered voting securities for purposes of the control analysis. These include the right to vote on the removal of a general partner or managing member for cause; the right to vote for a replacement general partner or managing member following removal for cause or incapacitation; and voting on continuing or dissolving the fund following removal of the general partner or managing member.

Treatment of Various Instruments as Equity. The final rule confirms that convertible securities such as warrants, options and other exercisable or exchangeable instruments must be looked through—or considered as presently converted or exercised—for purposes of the control analysis, subject to certain exceptions.

The final rule also sets out factors to determine when a debt instrument must be treated as equity for purposes of the control analysis. Under the final rule, an instrument will be considered "functionally equivalent" to equity if it has equity-like characteristics, such as entitling its owner to a share of the profits. In the context of debt instruments, the final rule includes a list of examples of equity-like characteristics, including:

- extremely long-dated maturity;
- subordination to other previously issued debt instruments;
- qualification as regulatory capital under applicable regulatory capital rules;
- qualification as equity under applicable tax law;
- qualification as equity under U.S. GAAP or other applicable accounting standards;
- inadequacy of the equity capital underlying the debt at the time of the issuance; or
- issuance not on market terms.

Divestiture of Control. The final rule substantially revises the Federal Reserve Board's standards regarding divestiture of control. The final rule generally provides that a company that previously controlled a second company during the preceding two years would be presumed to continue to control such company if it owned 15% or more of any class of voting securities. The divestiture presumption would not apply if a majority of each class of voting securities would be controlled by a single unaffiliated individual or company after the divestiture.

2. Volcker Rule Covered Funds Final Rule—Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

On June 25, 2020, the Federal Reserve Board issued a final rule to simplify, streamline and tailor the "covered fund" provisions under the regulation implementing section 13 of the BHC Act (commonly known as the "Volcker Rule").

The final rule is the first targeted update to 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."[4] 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.*, insured deposits) at risk through excessive exposure to speculative and risky investment activity.

The final rule is largely similar to the proposed rule, with certain notable changes addressing public comments.[5] The final rule adds four new exclusions from the definition of covered fund (credit funds, venture capital funds, family wealth management vehicles and customer facilitation vehicles) and simplifies three existing exclusions. In addition, the final rule expands the scope of permissible relationships that a banking entity may have with covered funds under Super 23A, codifies existing guidance related to certain foreign funds and clarifies issues surrounding ownership interests and permissible parallel investments.

Credit Funds, Venture Capital Funds, Family Wealth Management Vehicles and Customer Facilitation Vehicles. The final rule adds new exemptions that permit banking entities to invest in and/or sponsor four specific types of funds subject to limitations and guardrails. The four new exemptions target types of investment funds that may rely on Section 3(c)(1) or 3(c)(7) from exemption from registration under the Investment Company Act of 1940 but the Agencies do not view as posing the types of risks that the Volcker Rule is intended to address. Certain aspects are discussed below.

Credit Funds	
Overview	Although the Volcker Rule excludes loan securitizations from the definition of covered fund, the regulations implementing the Volcker Rule had limited the ability of banking entities to invest in or sponsor substantially similar investment funds that make loans, invest in debt securities or otherwise extend credit.[6] The new credit fund exclusion addresses that incongruence. The final rule does not prescribe limits on a banking entity's investment in the credit fund, but other applicable limitations and restrictions still apply.[7]
Asset Criteria	Assets must consist solely of: i. loans; ii. debt instruments (including debt securities); iii. certain interest rate and foreign exchange derivatives, provided the written terms of the derivative directly relate to the loans, debt instruments or other rights or assets, and the derivative reduces the interest rate and/or foreign exchange risks related to the loans, debt instruments or other rights or assets; and iv. other assets that are related or incidental to acquiring, holding, servicing or selling such loans or debt instruments—a cash equivalent; a security received in lieu of debts previously contracted with respect to the loan or debt instrument; or an equity security (or right to acquire an equity security such as options and warrants) received on customary terms in connection with the loan or debt instrument—but in no case a commodity

	forward contract or any derivative other than as expressly permitted under prong (iii) above. The agencies declined to adopt a quantitative limit on permissible other assets held in connection with an investment in loans or debt instruments but noted that such other assets generally would not exceed 5% of the value of the fund's total investment in a given borrower at the time of investment.
Activities Restrictions	May not engage in short-term proprietary trading; May not issue asset-backed securities; and May not be operated for evasionary purposes.
Banking Entity ("BE") Sponsor or Adviser	May not directly or indirectly 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; 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	The final rule excludes qualifying venture capital funds that invest in small and startup businesses from certain restrictions associated with the Volcker Rule.[8] The definition of "venture capital fund" for purposes of this exception includes significant limitations on leverage and secondary transactions, which mean that this exemption likely will have limited use for most traditional private equity sponsors.
Eligibility Criteria	Limited to qualifying "venture capital funds" as defined in existing regulations under the Investment Advisers Act of 1940.[9] Requirements include, very generally: i. fund represents it pursues a venture capital strategy; ii. fund is not a registered investment company or a business development company; iii. limitations on borrowing/leverage amounts (15% of aggregate capital contributions and uncalled committed capital) and borrowing terms (must be non-renewable and no longer than 120 calendar days); iv. 80% of assets must be "qualifying investments" (*e.g.*, non-leveraged equity securities issued by U.S. non-reporting companies); and v. fund issues illiquid securities with limited withdrawal/redemption rights.

Activity Restrictions	May not engage in short-term proprietary trading.[10]
BE Involvement	The banking entity must be permitted to engage in such activities under laws applicable to it.
BE Sponsor or Adviser	Same as for credit funds.

Family Wealth Management Vehicles (FWMVs)	
Overview	The final rules allow banking entities more flexibility to provide traditional banking and integrated asset management services to investment funds set up on behalf of a family and its closely related persons. The agencies declined to adopt a requirement in the proposal that a banking entity sponsor would need to comply with Super 23A limits with respect to such a fund.
Eligibility Criteria	May not raise money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; Limitations on who may hold ownership interests (*e.g.*, up to five closely-related persons of family customers); and Requirements depending on form of vehicle (*e.g.*, trusts).
BE Sponsor or Adviser	Must provide bona fide trust, fiduciary or advisory services to the fund; Prohibited from guaranteeing performance (and must disclose this prohibition to fund investors); Prohibited from acquiring or retaining as principal more than a *de minimis* ownership interest;[11] Prohibited from acquiring low-quality assets from the fund (not including riskless principal transactions); and Additional limitations and restrictions to address evasionary concerns.

Customer Facilitation Vehicles	
Overview	The final rule excludes any issuer that is formed by or at the request of a customer of the banking entity for the purpose of providing such customer (which may include one or more affiliates of such customer) with exposure to a transaction, investment strategy, or other service provided by the banking entity. The exclusion permits a banking entity to offer financial products to its customers through a fund structure in situations where it could otherwise enter into a contract directly with a customer to provide the same economic exposure to the underlying financial product (*e.g.*, a derivative).

Eligibility Criteria	Must be formed by or at the request of the customer;[12] Must be designed to facilitate transactions between a banking entity and a single customer (and its affiliates); All ownership interest must be owned by that customer; and Must be used to facilitate a customer's exposures to a transaction, investment strategy or other service.
BE Sponsor or Adviser	Documentation requirements; Prohibited from guaranteeing the fund's performance; Prohibited from owning more than a *de minimis* ownership interest; and Generally prohibited from acquiring low-quality assets from the fund (except for riskless principal transactions).

Existing Covered Fund Exclusions Simplified: Loan Securitizations, Foreign Public Funds and Public Welfare Funds.

Loan Securitizations. The Volcker Rule expressly permits banking entities to sell and securitize loans in a manner otherwise permitted by law. In order to provide banking entities with flexibility to sell and securitize loans, the final rule permits an issuer to hold up to 5% of the loan securitization's total assets in "debt securities" (which may not include asset-backed securities or convertible securities).[13] The final rule also codifies existing guidance clarifying 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).

Foreign Public Funds. Under the final rule, the foreign public fund exclusion is available for a fund that (i) is organized or established outside of the U.S.; and (ii) is authorized to offer and sell ownership interests, and such interests are offered and sold through one or more public offerings.[14] If a banking entity sponsors or advises the fund, it must comply with all applicable requirements in the jurisdiction in which such distribution is made. The final rule permits a banking entity sponsoring a fund to own, together with affiliates, up to 24.99% of the fund—up from 14.99%—similar to the treatment of registered investment companies.

Public Welfare Exclusion. The final rule clarifies that a small business investment company will 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 other than investments in cash equivalents. The final rule adds an exclusion for rural business investment companies and certain investments under the Community Reinvestment Act.

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"). 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.[15] While section 23A of the Federal Reserve Act includes certain exceptions from its prohibitions, the Volcker Rule did not initially incorporate those exceptions, leading to its nickname "Super 23A."

The final rule permits a banking entity to provide traditional banking services to related funds by incorporating certain section 23A and Regulation W exemptions, including permitting intraday extensions of credit, entering into riskless transactions, and entering into short-term extensions of credit and purchase assets in the ordinary course of business relating to payment transactions, settlement services or futures, derivatives and securities clearing.

Qualifying Foreign Excluded Funds. The final rule codifies an existing policy statement by the agencies addressing unintended extraterritorial consequences when a foreign banking entity controls certain foreign funds.[16] Under the final rule, a qualifying foreign excluded fund is still a banking entity but is expressly exempt from the proprietary trading and covered fund restrictions and the compliance program requirement.

Ownership Interests Safe Harbor. The implementing regulations define an "ownership interest" in a covered fund to mean any equity, partnership or "other similar interest," and the final rule addresses the meaning of "other similar interest." The final rule provides a safe harbor for bona fide senior loans or senior debt instruments that do not permit the investor to participate in income, gains or profits of the covered fund. It also clarifies the types of creditor rights that would be within the scope of ownership interest, and it modifies the calculation methods for purposes of complying with the ownership limits and conditions applicable to investments in related covered funds of a banking entity.

Parallel Banking Entity Investments. The final rule adds 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.

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Please contact Joel Wattenbarger, Gideon Blatt or your usual legal advisor at Ropes & Gray with any questions about this Alert.

1. *See* Final Rule, Control and Divestiture Proceedings, Board of Governors of the Federal Reserve System (Jan. 30, 2020), *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/control-rule-fr-notice-20200130.pdf; 85 FR 12398 (March 2, 2020). The final rule also addresses similar concepts in the Home Owners' Loan Act.
2. *See* Final Rule, 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), a*vailable at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/volcker-rule-fr-notice-20200130.pdf.
3. For an overview of the proposed control rule, *see* Mark Nuccio and Gideon Blatt, *Proposed Changes for the Federal Reserve's Control Analysis, Harvard Law School Forum on Corporate Governance* (May 1, 2019), *available at* https://corpgov.law.harvard.edu/2019/05/01/proposed-changes-for-the-federal-reserves-control-analysis/. *See also* 84 FR 21634 (May 14, 2019); Notice of proposed rulemaking with request for comment, Federal Reserve Board (April 23, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/control-proposal-fr-notice-20190423.pdf.
4. Generally, a covered fund is an issuer that must rely on Section 3(c)(1) or Section 3(c)(7) for exemption from registering under the Investment Company Act of 1940, as well as commodity pools that are not publicly offered. "Banking entity" includes (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).
5. For an overview of the proposed rule, *see* Joel Wattenbarger and Gideon Blatt, *Proposed Revisions to the Volcker Rule: Prohibitions and Restrictions with respect to Covered Funds*, Harvard Law School Forum on Corporate Governance (March 19, 2020), *available at* https://corpgov.law.harvard.edu/2020/03/19/proposed-revisions-to-the-volcker-rule-prohibitions-and-restrictions-with-respect-to-covered-funds/.
6. *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).
7. *E.g.*, a third-party fund manager may not welcome the consequences arising from a bank-affiliated investor being deemed to control its fund.
8. Tested at the fund level and not at the advisor entity level.
9. As defined in 17 CFR 275.203(l)-1 (SEC Rule 203(1)-1).
10. The agencies declined to impose additional limitations on qualifying venture capital funds. The proposed rule included discussion of possible minimum securities holding periods, portfolio company revenue caps and additional quantitative limits on the use of leverage.

11. A banking entity may own up to 0.5% of the vehicle's outstanding ownership interests to the extent necessary for establishing corporate separateness.
12. The requirement does not preclude a banking entity from marketing its customer facilitation vehicle services or discussing with its customers prior to the formation of such vehicles the potential benefits of structuring such services through a vehicle.
13. The 5% limit must be calculated at the most recent time any debt security is acquired, and is based on the aggregate value of loans, debt securities and cash equivalents (at par value), but generally excluding derivatives.
14. "Public offering" generally means that the offering is not restricted to a net worth requirement, is subject to substantive disclosure and retail investor protection laws or regulations, and the issuer has filed publicly available offering disclosure documents with the appropriate regulator.
15. 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.
16. A qualifying foreign excluded fund, with respect to a foreign banking entity, means a banking entity that: (i) is organized or established outside the U.S. and the ownership interests of which are offered and sold solely outside the U.S.; (ii) would be a covered fund if the entity were organized or established in the U.S., 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; (iii) would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, sponsorship of, or relationship with, the entity; (iv) is established and operated as part of a bona fide asset management business; and (v) is not operated in a manner that enables the banking entity that sponsors or controls the fund, or any of its affiliates, to evade the requirements of the Volcker Rule. *See also* 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.