Volcker Relief: Agencies Simplify and Narrow the Rule's Covered Fund Provisions

July 22, 2020

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It was a modest proposal: following the 2008 financial crisis, former chairman of the Federal Reserve Board Paul Volcker suggested banning banks from trading and investing with their own capital. Included as section 619 of the Dodd-Frank Act, the Volcker Rule is intended to prohibit proprietary trading and certain relationships with various types of funds. The Volcker Rule is conceptually simple, but the layered, interconnected, and complex reality of the financial system all but guaranteed a cumbersome snarl of implementation.

When the federal financial regulators finally issued the Volcker Rule regulations in late 2013 (2013 Rule), they pleased nobody. The 2013 Rule was ambiguously broad, overly rigid, and difficult to effectuate. Even with interagency answers to frequently asked questions (FAQs) and efforts to tailor its implementation, the Volcker Rule remained a source of uncertainty and risk for a wide range of banking and investment entities.

On June 16, 2020, the Board of Governors of the Federal Reserve System (Federal Reserve), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Securities and Exchange Commission, and Commodity Futures Tradition Commission (collectively, the Agencies) issued a final rule (Final Rule) amending the covered fund provisions of the 2013 Rule. With these amendments the Agencies seek to (i) reduce the extraterritorial impact of the regulations, (ii) permit additional covered fund activities that do not present the risks the Volcker Rule was intended to address, and (iii) clarify and simplify compliance. The Final Rule adopts the amendments substantially as proposed in January 2020. The Final Rule will become effective October 1, 2020, without any transition period.

The Volcker Rule restricts banking entities and certain nonbank financial companies from engaging in proprietary trading and from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or a private equity fund (covered funds). With respect to covered funds, the Final Rule simplifies certain existing exclusions, adds additional exclusions, clarifies the definition of ownership interest, clarifies certain permitted investments and activities, and amends "Super 23A" to permit certain low-risk transactions with covered funds.

The breadth of the changes is extensive, and the regulatory relief and greater certainty provided by the Final Rule will touch nearly all of the financial system. Every financial institution, fund manager, and intuitional investor will want to evaluate the Final Rule to understand how a now simplified Volcker Rule creates new opportunities. Interested parties should contact the authors for more information on the modified covered fund provisions.

Below is a comprehensive analysis of the Final Rule. The Agencies note that, except where specified, the Final Rule does not modify or revoke any of the previously issued FAQs. We note the modifications where appropriate.

Covered Fund Exclusions Simplifications

To provide clarity and to simplify compliance, the Final Rule revises the exclusions from the definition of covered fund for loan securitizations, small business investment companies (SBICs), public welfare investment funds, and foreign public funds.

Loan Securitizations

The 2013 Rule excludes qualifying loan securitizations—those that issue asset-backed securities and hold only loans and certain other permitted assets—from the definition of covered fund. The permitted assets are rights and assets that arise from the structure of the loan securitization or from the loans supporting the securitization and certain other financial instruments. Permitted assets include cash equivalents, securities in lieu of debt previously contracted with respect to the loans supporting the securitization, certain servicing assets, certain interest rate and foreign exchange derivatives, special units of beneficial interest, and collateral certificates.

The Final Rule codifies FAQ 4, which clarified that any servicing asset that is a security must be a permissible security for purposes of the loan securitization exclusion—either a cash equivalent or a security in lieu of debt previously contracted and related to a loan supporting the securitization. The Final Rule generally codifies the definition of "cash equivalent" included in FAQ 4 to mean a high-quality, highly liquid investment whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities. Unlike the FAQ, however, the Final Rule does not require a cash equivalent to be short-term.

Moreover, to provide banking entities greater flexibility to structure permissible loan securitizations and to be consistent with industry practices, the Final Rule adds to the list of permitted assets a limited amount of debt securities (except asset-based securities and convertible securities). Specifically, the aggregate value of all debt securities may not exceed 5% of the aggregate value of the securitization's loans, cash and cash equivalents, and permitted debt securities. The Final Rule specifies the method for calculating the 5% limit, which is generally par value at the time of the most recent acquisition of any debt security. Fair market value may be used under certain circumstances.

Small Business Investment Companies (SBICs)

SBICs are already excluded from the 2013 Rule definition of covered fund. However, to cover the full life cycle of an SBIC and thereby provide greater compliance certainty, the Final Rule clarifies that the exclusion covers an SBIC that has voluntarily surrendered its license, as long as it does not make new investments, other than cash equivalents, after surrender.

Public Welfare Investment Funds

Section 13 of the Bank Holding Company Act permits banking entities to make and retain investments designed primarily to promote the public welfare (PWIs) of the type permitted under section 24(Eleventh) of the National Bank Act. The 2013 Rule includes as PWIs those investments that promote the welfare of low- and moderate-income communities or families (such as by providing housing, services, or jobs). The Final Rule clarifies that the PWI exclusion includes funds that make investments that qualify for consideration under the Community Reinvestment Act. In addition, the Final Rule adopts explicit exclusions from the definition of covered fund for rural business investment companies and qualified opportunity funds because these funds serve a purpose similar to that of PWIs.

Foreign Public Funds

To ensure consistent treatment between foreign public funds and U.S. registered investment companies (RICs), the 2013 Rule excludes foreign public funds from the definition of covered fund, subject to certain conditions. The Agencies found that some of these conditions are not necessary to ensure consistent treatment, including conditions that the foreign public fund be authorized to offer and sell ownership interests to retail investors in its home jurisdiction and that ownership interests be sold predominantly through one or more offerings outside the United States. The Final Rule eliminates these requirements, and

funds that are organized and established outside the United States are excluded if they are authorized to offer and sell ownership interests and those interests are offered through one or more public offerings. In addition, the Final Rule amends the definition of "public offering" to require that the distribution be subject to substantive disclosure and retail investor protection laws or regulations and, where the banking entity serves as the investment manager, investment adviser, commodity trading adviser, commodity pool operator, or sponsor, that the distribution complies with all applicable requirements in the jurisdiction in which the distribution is being made.

Under the 2013 Rule, if a U.S. banking entity sponsors the foreign public fund, no more than 14.9% of the fund's interest that may be sold to the U.S. banking entity and its related parties. Related parties include the fund itself, as well as affiliates, directors, and employees of the banking entity or the fund. To align the permitted ownership levels with that of U.S. RICs, the Final Rule extends the foreign public fund permitted ownership level to 24.9%. The Final Rule also narrows the pool of related parties by removing "employees" broadly and including only those that are "senior executive officers" as defined in the Federal Reserve's Regulation Y.

New Covered Fund Exclusions

The Final Rule adds four new covered fund exclusions to better tailor the provision to the types of entities the Volcker Rule was intended to cover: credit funds, venture capital (VC) funds, family wealth management vehicles (FWMVs), and customer facilitation vehicles (CFVs). For each of these exclusions, in addition to exclusion-specific requirements and restrictions, the following standard requirements (Standard Requirements) must be met:

- The banking entity may not, directly or indirectly, guarantee, assume, or otherwise ensure the obligations or performance of the issuer;
- A banking entity's ownership interest in or relationship with the fund must comply with the rules regarding material conflicts of interest, material exposure to high-risk assets, the safety and soundness of the banking entity, and the financial stability of the United States, as if the fund were a covered fund; and
- The fund must provide written disclosures to prospective and actual investors in the fund, including disclosures with respect to risk of loss, lack of government guarantee, and the role of the banking entity and its affiliates and employees sponsoring or providing any services to the fund, and any additional disclosures required by the Agencies designed to ensure that fund losses are borne solely by investors and not the banking entity or its affiliates.

Credit Funds

To permit banking entities to invest in funds engaged in traditional lending activities in which a banking entity can engage directly—specifically, long-term debt funds—the Final Rule adds an exclusion for qualifying credit funds. In addition to the Standard Requirements, the Final Rule imposes asset limitations and activity restrictions on such funds, including on the banking entities that sponsor or advise the fund.

To qualify for the exclusion, the assets of the credit fund may only include loans, debt instruments permissible for a banking entity to hold directly, rights and other assets related or incidental to acquiring, holding, servicing, or selling the loans, and certain interest rate and foreign exchange derivatives. The credit fund may not issue asset-backed securities or engage in proprietary trading as if the fund were a banking entity. In addition, any asset held by the fund must be permissible for the banking entity to acquire and hold directly under federal banking laws and regulation. A banking entity's relationship with the credit fund must be conducted in compliance with, and subject to, applicable safety and soundness standards.

If the banking entity sponsors or advises the credit fund, the banking entity also must (i) comply with Super 23A—the Volcker Rule provision that applies section 23A of the Federal Reserve Act (Section 23A) to fund sponsors and advisers—and section 23B of the Federal Reserve Act (Section 23B) as if the credit fund were a covered fund, except that the banking entity may acquire and retain any ownership interest in the fund, and (ii) ensure that the credit fund's activities are consistent with safety and soundness standards substantially similar to those that would apply to the banking entity if it engaged in the activity directly.

Venture Capital Funds

To support capital formation, job creation, and economic growth, particularly with respect to small businesses and start-up companies, the Final Rule adds a covered fund exclusion for qualifying VC funds. To qualify for the exclusion, a VC fund must be a venture capital fund for purposes of the Investment Advisers Act of 1940 (IAA) and may not engage in proprietary trading. This means that the VC fund must meet the following requirements:

- It must represent to investors and potential investors that it pursues a venture capital strategy;
- It must hold at least 80% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets that are qualifying investments (generally equity securities of any qualifying portfolio company—a private company that is not a fund of funds) or short-term holdings;
- It must not borrow, issue debt obligations, provide guarantees, or otherwise incur leverage in excess of 15% of the VC fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee, or leverage is for a non-renewable term no longer than 120 calendar days (except that any guarantee by the VC fund of a qualifying portfolio company's obligations up to the amount of the value of the VC fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit);
- It may only issue securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem, or require the repurchase of such securities but may entitle holders to receive distributions made to all holders, pro rata; and
- It is not a registered investment company and has not elected to be treated as a business development company.

In addition to the Standard Requirements, the banking entity's relationship with the fund must be conducted in compliance with, and subject to, applicable safety and soundness standards. Furthermore, if the banking entity sponsors or advises the VC fund, the banking entity also must (i) comply with Super 23A and Section 23B as if the VC fund were a covered fund, except that it may acquire and retain any ownership interest in the VC fund, and (ii) ensure that the VC fund's activities are consistent with safety and soundness standards substantially similar to those that would apply to the banking entity if it engaged in the activity directly.

Family Wealth Management Vehicles

The Final Rule also adds a covered fund exclusion for qualifying FWMVs, giving greater flexibility to banking entities that provide traditional banking and asset management services to FWMVs.

To qualify for the exclusion, the FWMV must be an entity that is (i) not, and does not hold itself out as being, a vehicle or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities and (ii) either a trust of whom all grantors are "family customers" or owned only by "family customers" and no more than five "closely related persons." However, if necessary to establish corporate separateness or to address bankruptcy, insolvency, or similar concerns, unrelated persons (including the banking entity), in the aggregate, may

own up to 0.5% of the vehicle's outstanding ownership interests. A banking entity would not be permitted to hold any other ownership interest in the FWMV.

In addition, to qualify for the exclusion, the banking entity must provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the FWMV. The FWMV must meet the Standard Requirements, though the content and manner of the disclosures may be modified to accommodate the specific circumstances of the vehicle. Furthermore, all transactions between the banking entity and the FWMV must comply with Section 23B, and the banking entity would not be permitted to acquire low-quality assets from the FWMV, other than through riskless principal transactions.

For purposes of the exclusion, a "family customer" is a family client (as defined in the IAA) or any natural person who is a father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law, or daughter-in-law of a family client, or a spouse or a spousal equivalent of any of the foregoing. A "closely related person" is a natural person (including the estate and estate planning vehicles of such person) who has long-standing business or personal relationships with any family customer.

Customer Facilitation Vehicles

To enable banking entities to offer customers financial products through a fund structure, the Final Rule also excludes qualifying CFVs from the definition of covered fund. To qualify, the vehicle must be formed by or at the request of a customer of the banking entity and for the purpose of providing the customer or its affiliates with exposure to a transaction, investment strategy, or other service provided by the banking entity. All CFV ownership interests must be owned by the customer (and its affiliates) for whom the vehicle was created. However, if necessary to establish corporate separateness or to address bankruptcy, insolvency, or similar concerns, unrelated persons (including the banking entity), in the aggregate, may own up to 0.5% of the vehicle's outstanding ownership interests. A banking entity would not be permitted to hold any other ownership interest in the CFV.

The banking entity must maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction, investment strategy, or service. In addition, the CFV must meet the Standard Requirements, though the content and manner of the disclosures may be modified to accommodate the specific circumstances of the vehicle. Furthermore, all transactions between the banking entity and the CFV must comply with Section 23B, and the banking entity would not be permitted to acquire low-quality assets from the CFV, other than through riskless principal transactions.

Clarification: Credit Exposures Not "Ownership Interests"

The Volcker Rule limits the ability of banking entities that sponsor or advise covered funds to hold ownership interests in those funds. "Ownership interest" is broadly defined as any equity, partnership, or other similar interest. "Other similar interest" includes the right to participate in the selection or removal of a general manager, managing member, board member, investment manager or adviser, or commodity trading adviser of the fund. The Final Rule clarifies that a credit exposure to a covered fund generally does constitute an ownership interest. Specifically, the Final Rule (i) clarifies that the circumstances under a creditor's right to participate in the removal of an investment manager for cause would not be deemed an other similar interest and (ii) provides a safe harbor from the definition of ownership interest for senior loans and senior debt with certain characteristics that are not equity-like.

Removal for Cause

The Final Rule clarifies that the right to remove an investment manager for cause and participate in the selection of a replacement manager upon resignation or removal of investment manager will not, by itself, cause an interest to become an ownership interest. "Cause" is defined to include any one of the following events related to the investment manager:

- Bankruptcy, insolvency, conservatorship, or receivership;
- Breach of any material provision of the fund's transaction agreements applicable to the investment manager;
- Breach of material representations and warranties;
- Conduct that constitutes fraud or criminal activity in the performance of the investment manager's obligations under the fund's transaction agreements;
- Indictment for a criminal offense, or the indictment of any officer, member, partner, or other principal of the investment manager for a criminal offense materially related to the investment management activities;
- A change in control;
- Loss, separation, or incapacity of an individual critical to the investment manager's operations or who is primarily responsible for management of the fund's assets; or
- Similar events that constitute "cause" for removal of an investment manager that are not solely related to the performance of the fund or the investment manager's exercise of investment discretion under the fund's transaction agreements.

Safe Harbor

The Final Rule provides that a senior loan or debt interest with the following non-equity-like characteristics would not be considered an ownership interest:

- The interest holder does not share in the income, gains, or profits of the fund but may receive (i) interest at a stated interest rate, as well as commitment fees or other fees, which are not determined by reference to the performance of the underlying assets of the covered fund and (ii) repayment of a fixed principal amount, on or before a maturity date, in a contractually determined manner (which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, forgone income resulting from an early prepayment);
- The entitlement to payments under the terms of the interest are absolute and cannot be reduced based on losses arising from the underlying assets of the fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest; and
- The interest holder is not entitled to receive the underlying assets of the fund after all other interests have been redeemed or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

Clarifications: Permitted Investments and Activities

Parallel Investments and Co-Investments

The 2013 Rule does not prohibit a banking entity from investing directly in the assets invested in by a covered fund that it sponsors or advises. The Final Rule clarifies that a banking entity is not required to include its parallel investments and co-investments in the calculation of covered fund investment limits if the investments are made in compliance with applicable laws and regulations and consistent with safe and sound banking standards. The Final Rule also provides that there is no limit on the amount of such investments, as long as the investments comply with the law and are consistent with safe and sound banking practices.

Qualifying Foreign Excluded Funds

The Volcker Rule generally excludes foreign funds organized by a foreign banking entity from the definition of covered fund. However, under the 2013 Rule, these funds may be subject to proprietary trading and other restrictions as a banking entity if the fund is an affiliate or subsidiary of the foreign banking entity. To limit the extraterritorial impact of the rule, the Final Rule exempts the activities of qualified foreign excluded funds (QFEFs) from these restrictions. For purposes of the exclusion, a QFEF means a banking entity that meets the following requirements:

- It is organized or established outside the United States, and the ownership interests are offered and sold solely outside the United States;
- It would be a covered fund if the entity were organized or established in the United States, or it 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;
- It would not otherwise be a banking entity except for the acquisition or retention of an ownership interest in, sponsorship of, or relationship with the entity, by another banking entity that (i) is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or any state and (ii) the banking entity's acquisition of an ownership interest in or sponsorship of the fund by the foreign banking entity meets the requirements for permitted covered fund activities and investments solely outside the United States;
- It is established and operated as part of a bona fide asset management business; and
- It is not operated in a manner that enables the banking entity that sponsors or controls the QFEF, or any of its affiliates, to evade the requirements of the Volcker Rule or its implementing regulations.

These QFEF requirements generally track the Statement Regarding Treatment of Certain Foreign Funds Under the Rules Implementing Section 13 of the Bank Holding Company Act issued initially by the Federal Reserve, FDIC, and OCC in July 2017 and then extended in July 2019, which provided temporary relief for such funds. In addition to exempting QFEFs from the proprietary trading and covered fund restrictions, the Final Rule also exempts such funds from its compliance and reporting requirements. QFEFs must, however, still comply with Super 23A.

Super 23A Revisions: Permitted Low-Risk Transactions

The Volcker Rule generally prohibits a banking entity that sponsors, manages, or advises a covered fund or that organizes and offers a covered fund or holds an ownership interest in a covered fund from entering into transactions with that fund if the transaction would be covered by Section 23A—a provision known as Super 23A. Under Section 23A, these transactions are generally permitted but are subject to certain requirements, such as quantitative limits, collateral requirements, and low-quality asset restrictions. To better facilitate the ability of banking entities to organize and offer covered funds, the Final Rule amends Super 23A to permit certain low-risk transactions with covered funds that will "promote and protect the safety and soundness of banking entities and U.S. financial stabilities" by reducing operational risk. These transactions include the following:

- Transactions that would be exempt from the quantitative, collateral, and low-quality asset requirements under Section 23A and its implementing Regulation W. These transactions would, however, be subject to the same limits and conditions as contained in Section 23A and Regulation W;
- Riskless principal transactions with a covered fund; and
- Extensions of credit to or purchases of assets from a covered fund in the ordinary course of business in connection with payment transactions, settlement services, or futures, derivatives, and securities clearing. Each extension of credit must be repaid, sold, or terminated by the end of five business days. In addition, the banking entity making each extension of credit

must meet the Regulation W requirements related to intraday extension of credit exemptions, such as maintaining policies and procedures, regardless of the duration of the extension of credit.

These transactions are also subject to Section 23B and may not involve a material conflict of interest, materially expose the banking entity to a high-risk asset or trading strategy, or pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.