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Client Alert Commentary

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Federal Regulatory Agencies Finalize Amendments to the Volcker Rule's Covered Fund-Related Restrictions

The amended rule includes modifications to existing exclusions and creates new exclusions for the activities and investments of certain issuers.

The US federal regulatory agencies responsible for implementing the Volcker Rule recently issued a rule (Final Rule)[1] to finalize proposed modifications to certain restrictions related to "covered funds" that were adopted in 2013 (2013 Rule).[2] The issuance of the Final Rule, whose effective date is October 1, 2020, followed an extended comment period after the release of a proposed rulemaking in February 2020[3] by the federal regulatory agencies, which comprise: the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

The Final Rule amends various aspects of the 2013 Rule's covered fund-related restrictions. This *Client Alert* summarizes the more noteworthy revisions.

Qualifying Foreign Excluded Funds

On July 21, 2017, the Federal Reserve, the OCC, and the FDIC (collectively, the federal banking agencies) released a policy statement (2017 Policy Statement) to address concerns about the potential unintended consequences and extraterritorial impact of the Volcker Rule on foreign funds that are excluded from the "covered fund" definition (foreign excluded funds), but that may nonetheless be subject to the Volcker Rule's proprietary trading restrictions by virtue of falling within the definition of "banking entity" (as defined in the Volcker Rule) as a result of being affiliated with a foreign banking entity. The 2017 Policy Statement provided temporary relief to such foreign banking entities by noting that no action would be taken against them based on attributions of the activities and investments of a qualifying foreign excluded fund to such foreign banking entities, or against a qualifying foreign excluded fund as a banking entity, while the federal banking agencies considered options to address these concerns. The federal banking agencies extended the temporary relief period to July 21, 2021 in a second policy statement released on July 17, 2019 (2019 Policy Statement).

The Final Rule includes new exemptions for the activities and investments of "qualifying foreign excluded funds" (as defined under the Volcker Rule) for both the proprietary trading restrictions and the covered fund-related restrictions in a manner that is consistent with the 2017 Policy Statement and 2019 Policy

Statement. In addition, the Final Rule clarifies that qualifying foreign excluded funds are not subject to the Volcker Rule's compliance program requirements that are otherwise applicable to banking entities.

Modifications to Existing Covered Fund Exclusions

Foreign Public Funds

The foreign public funds exclusion is intended to provide consistent treatment for US-registered investment companies and their foreign counterparts. Under the Final Rule, foreign public funds themselves no longer need to be authorized in order to be offered and sold in the issuer's home jurisdiction. Instead, such funds must simply be authorized to offer and sell "ownership interests." While fund interests must be offered and sold through one or more public offerings outside of the United States, the Final Rule dispenses with the requirement that the interests be sold *predominantly* through public offerings. The definition of "public offering" in the Final Rule has been modified to include the requirement that the distribution be subject to substantive disclosure and retail investor protection laws or regulations. To reduce compliance burdens, the condition that the distribution complies with all applicable requirements in the jurisdiction where it is made only applies in instances in which the banking entity acts as investment manager, investment adviser, commodity trading advisor, commodity pool operator, or sponsor to such foreign public fund.

The Final Rule makes additional revisions and clarifications to the foreign public fund exclusion, including that:

- There is no longer a limitation on selling ownership interests of the issuer to employees (other than senior executive officers) of the sponsoring banking entity, the issuer, or their respective affiliates.
- More than 75% of the issuer's ownership interests must be sold to persons other than the US banking entity sponsor and associated parties.
- A foreign public fund will not be treated as a banking entity if both of the following conditions are met:
    - Less than 25% of its voting shares are held by the banking entity and its affiliates in the aggregate.
    - The banking entity or its affiliates provide advisory, administrative, or other services to such fund.

Loan Securitizations

The 2013 Rule excluded from the definition of covered funds loan securitizations that issue asset-backed securities and hold only loans, certain servicing or structuring rights and assets (subject to certain requirements), and certain other financial instruments (subject to certain requirements). The Final Rule expands the types of assets that an asset-backed security issuer may hold by including debt securities, other than asset-backed securities and convertible securities, which meet certain specified criteria, including:

- Such debt security holdings may not exceed 5% of the aggregate value of loans, cash and cash equivalents, and debt securities.
- The value of such holdings must be calculated at par value at the time any such debt security is purchased.

- The limit must be calculated at the most recent time of acquisition of such assets.

The Final Rule also clarifies that "cash equivalents," which are securities that are permitted to be held by an asset-backed security issuer, are defined to mean high quality, highly liquid investments 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.

Public Welfare and Small Business Funds

The public welfare investment exclusion is designed primarily to promote certain types of public welfare. The Final Rule revises the public welfare exclusion to explicitly include funds whose business is to make investments that qualify for consideration under the federal banking agencies' regulations implementing the Community Reinvestment Act. In addition, rural business investment companies and qualified opportunity funds are explicitly excluded from the definition of covered fund.

The exclusion of small business investment companies (SBICs) is revised to also exclude those SBICs that surrender their licenses during wind-down phases and that do not make new investments (other than investments in cash equivalents) after such voluntary surrender.

Newly Created Covered Fund Exclusions

The Final Rule creates four new exclusions from the definition of covered fund for credit funds, venture capital funds, family wealth management vehicles, and customer facilitation vehicles.

Credit Funds

Under the Final Rule, a "credit fund" (for the purposes of the credit fund exclusion), is an issuer whose assets consist solely of:

- Loans
- Debt instruments
- Related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments, provided that each right or asset that is a security is either:
  - Cash equivalent
  - A security received in lieu of debts previously contracted with respect to such loans or debt instruments
  - An equity security (or right to acquire an equity security) received on customary terms in connection with such loans or debt instruments
- Interest rate or foreign exchange derivatives that meet certain criteria

To be eligible for the credit fund exclusion, an issuer may neither engage in activities that would constitute proprietary trading, as if the issuer were a banking entity, nor issue asset-backed securities. Banking entities that are sponsors, investment advisers, or commodity trading advisors to a credit fund must meet additional requirements relating to disclosure obligations and safety and soundness standards.

In addition, the credit fund exclusion is available only if the banking entity's investment in, and relationship with, the issuer:

- Complies with the conflicts of interest and high-risk asset and high-risk trading strategy provisions of the Volcker Rule, as if the issuer were a covered fund
- Is conducted in compliance with applicable banking laws and regulations

The banking entity must also not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of any entity to which such issuer extends credit or invests, and any assets the issuer holds must be permissible for the banking entity to acquire and hold directly under applicable federal banking laws and regulations.

Venture Capital Funds

A qualifying venture capital fund that is excluded from the definition of a covered fund must satisfy two core requirements:

- The fund is a venture capital fund, as defined in Rule 203(l)-1 of the Investment Advisers Act.[4]
- The issuer does not engage in any activity that would constitute proprietary trading, as if it were a banking entity.

Under Rule 203(l)-1, a "venture capital fund" has the following features:

- It represents to investors and potential investors that it pursues a venture capital strategy.
- Immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, it does not hold more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets that are not qualifying investments.
- It does not borrow, issue debt obligations, provide guarantees, or otherwise incur leverage greater than 15% of the private fund's aggregate capital contributions and uncalled committed capital. Any such borrowing, indebtedness, guarantee, or leverage is for a non-renewable term of no longer than 120 calendar days (except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit).
- The fund only issues 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 entitles holders to receive distributions made to all holders pro rata.
- The fund is not registered under Section 8 of the Investment Company Act, and has not elected to be treated as a business development company under Section 54 of the Investment Company Act.

In order for a banking entity that acts as a sponsor, investment adviser, or commodity trading advisor to a qualifying venture capital fund to rely on this exclusion, such banking entity must meet certain requirements relating to disclosure obligations, safety and soundness standards, and compliance with the Volcker Rule's restrictions on relationship with a covered fund. In addition, a banking entity that avails itself of the venture capital funds exclusion may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the venture capital fund.

A banking entity's ownership interest in or relationship with the issuer must also:

- Comply with the Volcker Rule's conflicts of interest and high-risk asset and high-risk trading strategy provisions, as if the issuer were a covered fund
- Be conducted in compliance with applicable banking laws and regulations

Family Wealth Management Vehicles

The family wealth management vehicle exclusion allows banking entities to form vehicles or structure arrangements catering to "family customers"[5] that might otherwise be considered covered funds under the existing regulations. To qualify for the exclusion, a banking entity is not permitted to raise money from investors primarily for the purposes of investing in securities for resale or other disposition, or otherwise trading in securities. With respect to family wealth management vehicles that are trusts, the grantors must be all family customers. For non-trust family wealth management vehicles, family customers must own a majority of the voting interests (directly or indirectly), as well as a majority of the interests in the entity. Ownership in these vehicles is limited to family customers and up to five "closely related persons" of the family customers — defined as those individuals with longstanding business or personal relationships with any family customer. There is a *de minimis* ownership allowance of up to an aggregate 0.5% of the vehicle's outstanding ownership interest for banking entities or other entities that do not fall under the umbrella of family customers or closely related persons and for corporate separateness purposes or to address bankruptcy, insolvency, or similar concerns.

The banking entity (or its affiliate) must also meet all of the following conditions to qualify for the exclusion:

- Provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the entity
- Not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such entity
- Comply with the disclosure obligations set forth under the Volcker Rule, as if such entity were a covered fund, subject to certain conditions
- Not acquire or retain, as principal, an ownership interest in the issuer greater than an aggregate 0.5% of the issuer's outstanding ownership interests
- Comply with the Volcker Rule's restrictions on transactions with covered funds, conflicts of interest provisions, and high-risk asset and high-risk trading strategy provisions, as if the entity were a covered fund
- Except for riskless principal transactions (as defined in the Volcker Rule), comply with the requirements relating to low-quality asset purchases from affiliates as set forth in 12 CFR § 223.15(a), as if such banking entity and its affiliates were a member bank and the issuer were an affiliate thereof

Customer Facilitation Vehicles

The customer facilitation vehicle exclusion will be available for any issuer that is formed by or at the request of the banking entity's customer, for the purpose of providing that customer (which may include affiliates of that customer) with exposure to a transaction, investment strategy, or other service provided

by the banking entity. The exclusion does not require a pre-existing customer relationship, as it will be available even if the customer relationship begins only in connection with the formation of the issuer.

To qualify for the exclusion, the banking entity must satisfy all of the following criteria:

- The customer for whom the issuer was created must own all of the ownership interests of the issuer.
- Up to an aggregate 0.5% of the issuer's outstanding ownership interests may be acquired or retained by one or more entities that are not customers if the ownership interest is acquired or retained by such parties for corporate separateness purposes or to address bankruptcy, insolvency, or similar concerns.
- The banking entity and its affiliates must:
    - Maintain documentation relating to the facilitation of the customer's exposure to such transaction, investment strategy, or service
    - Not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such issuer
    - Comply with the disclosure obligations under the Volcker Rule, as if such issuer were a covered fund, subject to certain conditions
    - Not acquire or retain, as principal, an ownership interest in the issuer greater than an aggregate 0.5% of the issuer's outstanding ownership interests
    - Comply with the Volcker Rule's restrictions on transactions with covered funds, conflicts of interest provisions, and high-risk asset and high-risk trading strategy provisions, as if the issuer were a covered fund
    - Except for riskless principal transactions (as defined in the Volcker Rule), comply with the requirements relating to low-quality asset purchases from affiliates as set forth in 12 CFR § 223.15(a), as if such banking entity and its affiliates were a member bank and the issuer were an affiliate thereof

Limitations on Relationships With a Covered Fund

The 2013 Rule's so-called "Super 23A" restrictions prohibit a banking entity that acts in a certain capacity and its affiliates from entering into any "covered transaction" (as defined under the Federal Reserve's Regulation W) with a covered fund (or any other covered fund that is controlled by such covered fund). In order to align the Volcker Rule with Section 23A of the Federal Reserve Act and its implementing Regulation W, the Final Rule permits banking entities to enter into exempt transactions permitted under Section 23A and Regulation W. In particular, a banking entity will be permitted to engage in certain covered transactions with a related covered fund that would be exempt from the quantitative limited, collateral requirements, and low-quality asset provision under Section 23A, including certain transactions that are exempt under Section 223.42 of Regulation W.

The Final Rule also allows banking entities to enter into riskless principal transactions with a related covered fund. In addition, there is now a separate exception from the Volcker Rule's "Super 23A"

restrictions for short-term extensions of credit or purchases of assets in connection with payment, clearing, and settlement services.

"Ownership Interest" Definition Clarification

The 2013 Rule defines an "ownership interest" as any equity, partnership, or "other similar interest." The term "other similar interest" is, in turn, defined by reference to certain specified conditions.

The Final Rule includes provisions to address the concern that the condition set forth under the "other similar interest" clause relating to the selection or removal of an investment manager of the covered fund could be broadly construed to include interests that the "ownership interest" definition was not intended to capture. Specifically, the Final Rule modifies the scope of such condition relating to the selection or removal of an investment manager of the covered fund by allowing the:

- Rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event

- Right to participate in the removal of an investment manager for "cause" (as defined under the Final Rule) or to participate in the selection of a replacement manager upon an investment manager's resignation or removal

In addition to the foregoing modifications the "other similar interest" clause, the Final Rule clarifies that any senior loan or other senior debt interest that meets all of the following characteristics would not be considered an "ownership interest":

- Holders of such interest do not receive any share of the income, gains or profits of the covered fund, but may receive only:

    - Interest payments that do not depend on the performance of the covered fund

    - Fixed principal payments, on or before a maturity date, in a contractually determined manner (which may include prepayment premiums intended solely to reflect, and compensate the holder of the interest for, foregone income resulting from an early prepayment)

- Entitlement to payments on the interest is absolute and may not be reduced because of the losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs, or charge-offs of the outstanding principal balance, or reductions in the amount of interests due and payable on the interest.

- Holders of such interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of creditors to exercise remedies upon an event of default or acceleration event).

Parallel Investments

The Final Rule clarifies that for purposes of calculating the per-fund and aggregate investment limits in connection with the acquisition of an "ownership interest" in a covered fund that a banking entity organizes and offers pursuant to the asset management, asset-backed security issuer, or underwriting and market-making exemptions under the Volcker Rule, a banking entity shall not be required to include any investment it makes alongside a covered fund as long as the investment complies with applicable laws and regulations, including applicable safety and soundness standards.

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[1] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, Final Rule, June 25, 2020, *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200625a1.pdf.

[2] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, Final Rule, 79 FR 5536 (January 31, 2014), *available at* https://www.fdic.gov/news/board/2013/2013-12-10-notice-dis-a-regulatory-text.pdf.

[3] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, Notice of Proposed Rulemaking, 85 FR 12120 (February 28, 2020), *available at* https://www.fdic.gov/news/board/2020/2020-01-30-notice-dis-a-fr.pdf.

[4] 17 CFR Section 275.203(l)-1.

[5] "Family customer" means (i) a family client, as defined in Rule 202(a)(11)(G)-1(d)(4) of the Investment Advisers Act (17 CFR Section 275.202(a)(11)(G)-1(d)(4)), or (ii) 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.