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Memorandum

Federal Agencies Finalize Changes to Volcker Rule "Covered Fund" Provisions

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The five federal financial regulators responsible for implementing the Volcker Rule have issued a final rule to revise a number of provisions in the Volcker Rule's 2013 implementing regulations (the "2013 Rule"). The final rule, which is largely similar to the agencies' proposed rulemaking, issued in January 2020, provides some clarifying amendments to the Volcker Rule's current restrictions on sponsoring and investing in certain covered hedge funds and private equity funds, and also adds some new exemptions allowing banking entities to sponsor and invest without limit in credit funds, venture capital funds, customer facilitation funds and family wealth management vehicles. The final rule also loosens certain other restrictions on extraterritorial fund activities and direct parallel or co-investments made alongside covered funds. The final rule thus modestly expands the ability of banking entities to invest in and sponsor private funds.

Following is a high-level summary of certain key features of the final rule.

Modifications to Existing Covered Fund Exclusions

The final rule simplifies the eligibility criteria for certain of the 2013 Rule's exclusions from the definition of "covered fund," making it easier for banking entities to use and confirm compliance with these existing exclusions.

A. FOREIGN PUBLIC FUNDS

In order to provide consistent treatment between U.S. registered investment companies ("RIC") and their foreign equivalents, the 2013 Rule excludes investment funds that are organized outside of the United States, authorized to be sold to retail investors in the fund's home jurisdiction, and sold predominantly through one or more public offerings ("foreign public funds") from the definition of "covered fund," subject to certain eligibility requirements that do not apply to U.S. RICs.

Based on experience implementing the 2013 Rule, the agencies determined that certain conditions of the "foreign public fund" exclusion are not necessary to ensure consistent treatment of foreign public funds and RICs, and result in compliance difficulties for both funds and banking entities in determining whether a non-U.S. fund qualifies for the exclusion. For example, the requirement that the fund be authorized to be offered and sold to retail investors in the fund's home jurisdiction may disqualify certain funds that are organized in one jurisdiction but only authorized to be sold to retail investors in another jurisdiction, while the requirement that a fund be sold "predominantly" through one or more public offerings may cause compliance difficulties for banking entities with limited visibility into the distribution history of a third-party sponsored fund.

Accordingly, the final rule replaces these requirements with a requirement that fund ownership interests be offered and sold through at least one public offering subject to substantive disclosure and retail investor protection rules. Banking entities seeking to rely on the "foreign public fund" exclusion will be required to ensure that the distribution of fund interests complies with all applicable requirements in the applicable jurisdiction only where the banking entity acts as the sponsor, investment manager or adviser, commodity trading advisor or commodity pool operator (and not where the banking entity is investing in a third-party sponsored fund).

The final rule also eliminates the 2013 Rule's limitation on selling ownership interests of the issuer to employees (other than senior executive officers) of a sponsoring banking entity or the issuer. This change will help to align the treatment of foreign public funds with that of RICs, as the exclusion for RICs does not include such a limitation. In response to comments received on the proposed rule, the agencies amended the foreign public fund exclusion in the final rule to require that more than 75% of the fund's interests be sold to persons other than a sponsoring U.S. banking entity and associated parties, to align the permitted ownership threshold for U.S. banking entity sponsors of foreign public funds with the functionally equivalent threshold for banking entity investments in U.S. RICs.

B. LOAN SECURITIZATION VEHICLES

The 2013 Rule excludes loan securitization vehicles from the definition of "covered fund," provided such issuers meet various eligibility criteria, such as issuing asset-backed securities and only holding loans and certain other permitted assets. The current loan securitization exclusion is not available, however, to an issuer that holds any amount of securities, including debt securities, other than in very limited circumstances.

The final rule expands this exclusion to allow a loan securitization vehicle to hold up to 5% of assets in debt securities (other than certain asset-backed securities and convertible debt securities) without thereby being deemed a "covered fund." This expansion allows securitization vehicles to hold a limited basket of corporate bonds, interests in letters of credit, cash, derivatives, and senior secured bonds that do not significantly change the nature and risk profile of the securitization. In addition, the final rule codifies agency staff guidance to provide that servicing assets held by an excluded loan securitization vehicle may include assets other than securities (for example, mortgage insurance policies supporting the mortgages in a loan securitization).

Notably, the final rule pares back the proposed rule's expansion of the loan securitization vehicle exclusion, which would have allowed a loan securitization vehicle to hold up to 5% of assets in any non-loan assets. In limiting the expansion to debt securities only (rather than any non-loan assets), the agencies noted that non-loan assets with materially different risk characteristics from loans could change the character and complexity of an issuer and raise the type of concerns that the Volcker Rule is intended to address.

C. PUBLIC WELFARE AND SMALL BUSINESS FUNDS

The 2013 Rule permits banking entities to make investments designed primarily to promote the public welfare, as well as investments in Small Business Investment Companies ("SBICs") as long as the SBIC's license has not been revoked. The final rule clarifies that the exclusion for SBICs continues to apply to an issuer that voluntarily surrenders its SBIC license during a wind-down period, provided it makes no new investments (other than investments in cash equivalents) after surrendering its license.

In an expansion from the proposed rule, the final rule also revises the exclusion from the covered fund definition for public welfare investments to include investments that qualify for consideration under the regulations implementing the Community Reinvestment Act, as well as "rural business investment companies" that invest in rural and small businesses and "qualified opportunity funds" that invest in economically distressed areas.

Proposed Additional Covered Fund Exclusions

In addition to modifying certain existing exclusions to the "covered fund" definition as described above, the final rule adds several new exclusions to the 2013 Rule's "covered fund" definition to permit banking entities to own and sponsor certain types of funds that the banking agencies view as not raising the concerns that the Volcker Rule was intended to address.

A. CREDIT FUNDS

Although the Volcker Rule excludes loan securitization vehicles from the definition of "covered fund," the 2013 Rule limited the ability of banking entities to invest in or sponsor substantially similar credit funds that make loans, invest in debt securities, or otherwise extend credit.

The final rule adds an exclusion for such credit funds whose assets consist solely of loans and other debt instruments, rights or assets related or incidental to acquiring, holding, servicing or selling such loans and other debt instruments, and certain interest rate or foreign exchange derivatives.[1] To qualify for the exclusion, the credit fund will not be permitted to engage in proprietary trading or issue asset-backed securities. In addition, if a banking entity sponsors or serves as an investment adviser or commodity trading advisor to a credit fund, the banking entity will be required to provide certain effective disclosures and ensure that the fund's activities are consistent with safety and soundness standards. Further, a banking entity will not be permitted to rely on the credit fund exclusion if it guarantees the performance of the fund, or if the fund holds any debt or equity securities that the banking entity will not be permitted to acquire and hold directly. Banking entities will also need to comply with "Super 23A" restrictions on relationships with the credit fund and limitations regarding material conflicts of interest, high-risk investments, safety and soundness and financial stability, in each case as though the credit fund were a covered fund.

[1] An excluded credit fund would also be permitted to hold a limited amount of equity securities (or rights to acquire equity securities) that are received on customary terms in connection with the credit fund's loans or debt instruments.

B. VENTURE CAPITAL FUNDS

Under the current rule, venture capital funds that invest in small businesses and startup businesses may be covered funds subject to the restrictions of the Volcker Rule unless they otherwise qualify for an exclusion. The final rule adds a "covered fund" exclusion to allow banking entities to invest in or sponsor certain funds that meet the SEC's definition of a "venture capital fund" under the Investment Advisers Act and that meet several additional criteria.

To qualify as a "venture capital fund" under the Investment Advisers Act definition, the fund must (i) hold itself out as pursuing a venture capital strategy; (ii) hold no more than 20% of its aggregate capital commitments in non-qualifying investments (other than cash or cash equivalents); (iii) not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's capital contributions and uncalled committed capital;[2] (iv) not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; and (v) not be registered under the Investment Company Act or be treated as a business development company.

Qualifying investments, for purposes of the venture capital fund definition, include those in a portfolio company that is not reporting or foreign traded (or affiliated with a reporting or foreign traded company), does not borrow or issue debt in connection with the fund's investment and distribute such debt proceeds to the fund in exchange for its investment, and is not itself an investment company or private fund. The SEC has distinguished venture capital funds from leverage buyout funds and private equity funds due to their characteristic direct investment for the purpose of funding the expansion and development of a portfolio company's business (rather than buying out existing shareholders or leveraging the capital investment with debt financing).

Similar to the final rule's credit fund exclusion, a qualifying venture capital fund will also not be permitted to engage in proprietary trading and, if a banking entity sponsors or serves as an investment adviser or commodity trading advisor to the venture capital fund, the banking entity will be required to provide certain effective disclosures and ensure that the fund's activities are consistent with safety and soundness standards. Further, a banking entity will not be permitted to rely on the venture capital fund exclusion if it guarantees the performance of the fund, or if the fund holds any debt or equity securities that the banking entity will not be permitted to acquire and hold directly. Banking entities will also need to comply with the "Super 23A" restrictions on relationships with the venture capital fund and limitations regarding material conflicts of interest, high-risk investments, safety and soundness and financial stability, in each case as though the venture capital fund were a covered fund.

[2] In addition, any such borrowing, indebtedness, guarantee or leverage must be for a non-renewable term of no longer than 120 calendar days (except that certain guarantees of qualifying portfolio company obligations by the fund are not subject to the 120 calendar days limit).

C. FAMILY WEALTH MANAGEMENT AND CUSTOMER FACILITATION VEHICLES

The final rule excludes from the "covered fund" definition any family wealth management vehicle that, if organized as a trust, the grantor(s) of the entity are all family customers and, if not organized as a trust, the entity is owned only by family customers and up to five closely related persons of the family customers (with a majority of the voting interests, as well as a majority of total interests, owned by family customers). In an expansion from the proposed rule, however, the final rule permits up to 0.5% of the family wealth management vehicle's outstanding ownership interests to be held by entities other than family customers and closely related purposes, to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns. To qualify for the family wealth management vehicle exclusion, the vehicle will not be permitted to hold itself out as raising money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, and the banking entity will be required to provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the entity.

In addition, the final rule excludes from the "covered fund" definition any issuer that acts as a "customer facilitation vehicle" formed by or at the request of a customer of the banking entity for the purpose of providing such customer with exposure to a transaction, investment strategy, or other service provided by the banking entity. Similar to the final rule's criteria for excluded family wealth management vehicles, all of the ownership interests of an excluded customer facilitation vehicle must be owned by the customer or its affiliates for which the vehicle was created, except that up to 0.5% of the customer facilitation vehicle's outstanding ownership interests may be held by entities other than the customer to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

To rely on either the "family wealth management vehicle" or "customer facilitation vehicle" exclusions, a banking entity will be required to provide certain effective disclosures (as if the entity were a covered fund) and meet certain documentation requirements, and will not be permitted to guarantee, assume, or otherwise insure the obligations or the performance of the vehicle. In addition, the banking entity (or any other entities that are not customers) will not be permitted to acquire an ownership interest in the vehicle, other than in compliance with the applicable 0.5% allowance to establish corporate separateness or to address insolvency or similar concerns. A banking entity will also need to comply with Section 23B of the Federal Reserve Act in its relationships with the vehicle as well as Regulation W's restrictions on purchasing low-quality assets from the vehicle (except that a low-quality asset purchase from the vehicle may be permitted to the extent such purchase constitutes a "riskless principal" transaction).

Parallel Investments and Co-Investments

The 2013 Rule requires, among other things, that a banking entity organizing and offering a covered fund pursuant to the so-called "asset management" exemption (for covered funds that are intended primarily to provide investment management and certain other services to others) must, among other things, hold no more than 3% of the total ownership interests of the covered fund after a one-year seeding period, and must limit its aggregate investments in covered funds under the "asset management" exemption to no more than 3% of the banking entity's Tier 1 capital.

In adopting the 2013 Rule, the Federal Reserve and other regulatory agencies determined not to adopt a proposed rule that would have aggregated, for purposes of the 3% limits on investments in sponsored or advised covered funds, parallel investments made directly by a banking entity under separate legal authority. However, in the commentary accompanying the 2013 Rule, the agencies stated that they "continue to believe that the potential for evasion of [the 3%] limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors," and that in some circumstances a banking entity's direct side-by-side co-investment with a covered fund that it sponsors should be aggregated with the banking entity's investments in a covered fund for purposes of assessing compliance with the "asset management" exemption's investment restrictions.[3]

Significantly, the final rule clarifies that a banking entity is permitted to make direct parallel or co-investments alongside a covered fund—without restriction as to the amount of investment and without being required to include such direct parallel investments in the banking entity's calculations of compliance with the per-fund and aggregate investment limits under the "asset management" exemption—as long as the banking entity's direct investment is made in compliance with applicable banking and other laws and regulations, including applicable safety and soundness standards.[4]

Further, the final rule clarifies that direct investments by directors or employees of a banking entity made alongside a covered fund will not be treated as an investment by the director or employee in the covered fund, and will not be attributed to the banking entity as an investment in the covered fund, regardless of whether the banking entity arranged the transaction on behalf of the director or employee or provided financing for the investment.

"Super 23A" Limitations on Relationships With a Covered Fund

The Volcker Rule generally prohibits a banking entity from entering into a transaction with a covered fund for which it serves as investment manager, investment adviser, organizer or sponsor if such transaction would be a "covered transaction" for purposes of Section 23A of the Federal Reserve Act. However, the 2013 Rule does not incorporate or reference the exemptions from such affiliate transaction restrictions contained in Section 23A or the Federal Reserve's Regulation W, thus resulting in the Volcker Rule's restrictions on covered transactions with covered funds being referred to as "Super 23A."

[3] 79 Fed. Reg. 5734 (January 31, 2014).

[4] A banking entity would not be permitted to make a direct investment alongside a covered fund that the banking entity organizes and offers for the purpose of artificially maintaining or increasing the value of the fund's positions, and would need to comply with certain prudential backstops (such as providing effective disclosure for any investments that would result in a material conflict of interest with the banking entity's clients).

The final rule incorporates the exemptions provided in Section 23A and Regulation W into the Volcker Rule's limitations on covered transactions with sponsored, managed or advised covered funds, allowing a banking entity to enter into covered transactions with a related fund that would be permissible without limit under Section 23A of the Federal Reserve Act and the Federal Reserve's Regulation W (such as intraday extensions of credit and short-term extensions of credit or asset purchases in connection with payment, clearing, and settlement activities), provided such transactions meet the criteria specified in Regulation W for such exemption (including, in some cases, that the related covered fund meets the eligibility criteria to be a "securities affiliate" of the banking entity). In an expansion from the proposed rule, however, the final rule also permits banking entities to enter into "riskless principal" transactions with a related covered fund as a stand-alone exception. Under this separate exception, the final rule allows a banking entity to engage in "riskless principal" transactions with a related covered fund without needing to comply with other Regulation W criteria, including in circumstances where the related covered fund is not a "securities affiliate" of the banking entity.

Fund "Ownership Interests"

Currently, due to the 2013 Rule's broad definition of "ownership interest," certain loans by banking entities to covered funds could be deemed to be ownership interests in such funds. Specifically, the 2013 Rule defines an "ownership interest" in a covered fund to mean any equity, partnership, or "other similar interest," which in turn focuses on the attributes of the interest and whether it provides a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form.[5] Accordingly, under the 2013 Rule, a debt interest in a covered fund could be deemed to be an "ownership interest" in the fund if the interest has the same characteristics as an equity or other ownership interest (e.g., if the interest provides the holder with voting rights, the right or ability to share in the covered fund's profits or losses, or the ability to earn a return based on the performance of the fund's underlying holdings or investments).[6]

The final rule provides a safe harbor for bona fide senior loans or senior debt instruments, to make clear that such credit interests in a covered fund will not be considered an "ownership interest" in the fund so long as

- the holders of such interest receive only interest payments that are independent of the performance of the covered fund, and repayment of a fixed principal amount on or before a maturity date, and do not receive any profits of the covered fund;

[5] An "other similar interest" is defined under the 2013 Rule to include any interest that (i) has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund, (ii) has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund, (iii) has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full, (iv) Has the right to receive all or a portion of excess spread between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests, (v) provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, (vi) receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund, or (vii) includes any synthetic right to have, receive, or be allocated any of the rights above.

[6] The 2013 Rule excludes carried interest (restricted profit interest) from the definition of ownership interest, although only for certain purposes.

- the holders' entitlement to payments on the interest is absolute and may not be reduced because of the losses arising from the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the principal and interest payable; and
- the holders of the 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 (other than in the case of a creditor's right to exercise remedies upon the occurrence of an event of default or an acceleration event).

The final rule also clarifies that a debt interest allowing its holder to remove an investment manager for "cause" (including the bankruptcy or insolvency of the investment manager, the breach of a material contractual provision by the investment manager, fraud or criminal activity by the investment manager or certain related parties, a change in control of the investment manager, or the loss of certain of the investment manager's key persons), or to participate in the selection of a replacement manager upon an investment manager's resignation or removal, will not be considered an ownership interest for this reason alone.

In addition, the 2013 Rule currently requires that a banking entity must include any amounts paid by the banking entity's employees or directors to obtain a restricted profit interest in a sponsored covered fund for purposes of calculating the banking entity's compliance with the aggregate fund limit on ownership interests in covered funds organized or offered by the banking entity. The final rule limits the attribution of an employee or director's restricted profit interest in a covered fund organized or offered by the banking entity to only those circumstances when the banking entity has directly or indirectly financed the acquisition of the restricted profit interest.

Extraterritorial Impact

The 2013 Rule left open the possibility that certain entities excluded from the "covered fund" definition would nonetheless be considered "banking entities" (and therefore subject to the Volcker Rule) based on the interaction between the Volcker Rule's definition of the term "banking entity" and the 2013 Rule's definition of "covered fund." For example, certain funds that are organized outside of the United States and offered to foreign investors may be excluded from the "covered fund" definition, but nevertheless may be subject to the 2013 Rule as "banking entities" if they are controlled by a foreign banking entity. These so-called "foreign excluded funds" could thus be subject to more onerous compliance obligations than similarly situated covered funds despite their limited nexus to the United States.

To address possible unintended consequences and extraterritorial impact of the Volcker Rule, the federal banking agencies released a series of no-action guidance from 2017 to 2019 indicating that the agencies would stay enforcement actions against certain foreign excluded funds—or against foreign banking entities based on attribution of a qualifying foreign excluded fund's activities and investments—until July 2021 (in each case if certain criteria were met). The final rule effectively codifies this agency guidance, exempting the activities of qualifying foreign excluded funds from the Volcker Rule's restrictions on proprietary trading and covered fund activities that would otherwise be applicable to the fund as a "banking entity" if the foreign banking entity's sponsorship of or investment in the foreign excluded fund meets the other requirements of the so-called "SOTUS" exemption.

Similarly, the final rule also exempts qualifying foreign excluded funds from otherwise applicable Volcker Rule compliance program requirements (although any banking entity that owns or sponsors a qualifying foreign excluded fund will continue to be required to have in place appropriate compliance programs for itself and its other subsidiaries, including any applicable qualifying foreign excluded funds).

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