Agencies Extend Comment Period on Proposed Volcker Rule "Covered Funds" Overhaul

Comment Period Extended by One Month in Response to COVID-19 Disruptions

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On January 30, 2020, five federal agencies[1] (the "Agencies") issued a notice of proposed rulemaking (the "Proposed Rule")[2] regarding proposed revisions to Section 13 of the Bank Holding Company Act of 1956 (the "BHC Act") and its implementing regulations, commonly known as the "Volcker Rule," which generally prohibits banking entities and their affiliates from engaging in proprietary trading and acquiring ownership interests in or having certain relationships with "covered funds," (i.e., certain hedge funds and private equity funds).

The Proposed Rule includes a number of specific questions on which the Agencies have requested feedback. Comments were initially due by April 1, 2020, but the Agencies announced on April 2, 2020[3] that they are extending the comment period to May 1, 2020 in light of the disruptions caused by the spread of COVID-19.

BACKGROUND

The key provisions of the Proposed Rule are outlined below.

1 The Office of the Comptroller of the Currency, Department of the Treasury, Board of Governors of the Federal Reserve System (the "Board"), Federal Deposit Insurance Corporation, Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC").

2 The Proposed Rule can be accessed here.

3 For the Board press release, see here.

Qualifying Foreign Excluded Funds

The Proposed Rule would provide exemptions for certain activities of certain funds organized outside of the United States and offered to foreign investors ("Qualifying Foreign Excluded Funds" or "QFEFs"). As defined in a July 2017 policy statement released by federal banking regulators,[4] a QFEF, with respect to a foreign banking entity, is an entity that:

- is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;
- would be a covered fund were the entity organized or established in the United States, or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;
- would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the entity;
- is established and operated as part of a bona fide asset management business; and
- is not operated in a manner that enables the foreign banking entity to evade the requirements of the Volcker Rule.

Under the current regulatory framework, foreign funds may be excluded from the definition of "covered funds" and subject to regulation under the Volcker Rule as "banking entities" if they are controlled by a foreign banking entity. If deemed a "banking entity" as a result of such control, the foreign fund could be subject to the Volcker Rule's prohibition on proprietary trading, restrictions on investing in or sponsoring covered funds and compliance obligations.

The Proposed Rule would exempt the activities of QFEFs from the proprietary trading prohibition and covered fund restrictions on the purchase or sale of a financial instrument by a qualifying foreign excluded fund and the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a qualifying foreign excluded fund, if any acquisition or retention of an ownership interest in, or sponsorship of, the qualifying foreign excluded fund by the foreign banking entity meets the requirements for permitted covered fund activities and investments solely outside the United States. This relief would only be available with respect to the asset management activities of QFEFs which are organized outside of the United States and operate pursuant to the local laws of foreign jurisdictions.

[4] Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 21, 2017), available here.

Modifications to Existing Covered Fund Exclusions

Foreign Public Funds

The Proposed Rule would exclude "foreign public funds" from the definition of "covered fund" to provide consistent treatment between U.S. registered investment companies and their foreign equivalents. For the purposes of the Volcker Rule, a "foreign public fund" is generally defined as any issuer that is organized or established outside of the United States and the ownership interests of which are (1) authorized to be offered and sold to retail investors in the issuer's home jurisdiction and (2) sold "predominantly"[5] through one or more "public offerings"[6] outside of the United States.

Under the current regulatory framework, the foreign public fund exclusion is only available to a U.S. banking entity with respect to a foreign fund sponsored by the U.S. banking entity if, in addition to the requirements discussed above, the fund's ownership interests are sold predominantly to persons other than the sponsoring banking entity, the issuer (or affiliates of the sponsoring banking entity or issuer), and employees and directors of such entities. The Proposed Rule would modify this exclusion in several ways:

- the two ownership interest requirements would be replaced with a single requirement that the fund is authorized to offer and sell ownership interests, and such interests are offered and sold, through one or more public offerings (i.e., removing the requirement that interests be sold "predominantly" through such offerings);
- the definition of "public offering" would be amended to add a new requirement that the distribution be subject to substantive disclosure and retail investor protection laws or regulations similar to those applicable to U.S. registered investment companies;
- the foreign public fund exclusion would remain limited to funds that are authorized to be sold to retail investors in the United States, but such funds would not also be required to be authorized to be sold to retail investors in the jurisdiction where they are organized;

[5] The Agencies expect that an offering is made "predominantly" outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States.

[6] A "public offering" for the purposes of this exclusion means a distribution of securities in any jurisdiction outside the United States to investors, including retail investors, provided that (i) the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made; (ii) the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and (iii) the issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.

- the condition that the distribution comply with all applicable requirements in the jurisdiction where it is made would only apply to instances in which the banking entity acts as the investment manager, investment adviser, commodity trading advisor, commodity pool operator, or sponsor; and

- the limitation on selling ownership interests of the fund to employees (other than senior executive officers) of the sponsoring banking entity or the issuer (or affiliates of the banking entity or issuer) would be eliminated. However, such limitation would still apply to the sale of ownership interests to directors or senior executive officers of the sponsoring banking entity or the fund (and their affiliates).

Loan Securitization Vehicles

Under the current regulatory framework, loan securitization vehicles that issue asset-backed securities and hold only loans, certain rights and assets, and a small set of other financial instruments ("permissible assets") are excluded from the definition of "covered fund." The Proposed Rule would largely codify existing guidance regarding certain permissible assets to:

- define "loan" to include leases and permit loan securitization vehicles to hold rights or other assets ("servicing assets") that arise from the structure of the loan securitization vehicle or from the loans supporting a loan securitization vehicle;

- clarify that a servicing asset may or may not be a security, but if the servicing asset is a security, it must be a permissible asset; and

- define "cash equivalents" to mean high quality, highly liquid investments whose maturity corresponds to the loan securitization vehicle's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities. Unlike the existing guidance, the Proposed Rule would not require that cash equivalents be "short term."

In addition, the Proposed Rule would permit loan securitization vehicles to hold up to five percent of assets in non-loan assets.

Public Welfare Funds and Small Business Development Companies

The Proposed Rule would modify exclusions available to public welfare funds (i.e., investments that are designed primarily to promote the public welfare) and small business development companies ("SBICs"). While the Proposed Rule does not offer any specific modifications to the public welfare fund exclusion, the Agencies requested comments on the possibility of expanding the public welfare fund exclusion to include all permissible public welfare investments under any agency's regulation (e.g. community development funds, small business development companies, rural business

investment companies and opportunity zone funds). The SBIC exclusion would be amended to include issuers who have voluntarily surrendered their licenses to operate as a SBIC and do not make subsequent investments after such voluntary surrender.

New Covered Fund Exclusions

Credit Funds

The Proposed Rule would create a new exclusion for credit funds that make loans, invest in debt or otherwise extend the type of credit that banking entities may provide directly under applicable banking law. Specifically, the exclusion would cover issuers whose assets consist exclusively of (i) loans; (ii) debt instruments; (iii) related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments; and (iv) certain interest rate or foreign exchange derivatives. Excluded credit funds would not be allowed engage in activities that would constitute proprietary trading, as if the fund were considered a banking entity for the purposed of the Volcker Rule, or issue asset-backed securities.

The proposed exclusion borrows several features from the loan securitization vehicle exclusion, including the condition that any related rights or other assets held that are securities must be cash equivalents, securities received in lieu of debts previously contracted with respect to loans held or, unique to the proposed credit funds exclusion, certain equity securities (or rights to acquire equity securities) received on customary terms in connection with the credit fund's loans or debt instruments. Additionally, any derivatives held by the credit fund must relate to loans, permissible debt instruments, or other rights or assets held and such derivatives must reduce the interest rate and/or foreign exchange risks related to these holdings.

In addition, the Proposed Rule would also impose additional restrictions on banking entities that invest in or have a relationship with excluded credit funds:

- a banking entity that sponsors or serves as an investment adviser or commodity trading advisor to a credit fund would be required to provide certain disclosures and ensure that the activities of the fund are consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly;

- the exclusion would not be available to banking entities that guarantee the performance of the fund or banking entities that acquire and hold interest in a fund that holds any debt securities, equity or rights to receive equity that the banking entity would not be permitted to acquire and hold directly; and

- such investment and relationship would be required to comply with the limitations in Sections __.14 and __.15 of the BHC Act regarding material conflicts of interest, high-risk investments, and safety and soundness and financial stability as though the credit fund were a covered fund.

Venture Capital Funds

Under the current regulatory framework, venture capital funds that invest in small businesses and start-up businesses that would be investment companies but for the exclusion contained in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), are covered funds unless they otherwise qualify for an exclusion. The Proposed Rule would create a new exemption for venture capital funds that meet certain conditions ("qualifying venture capital funds").

A qualifying venture capital fund (1) may not engage in proprietary trading as if it were a banking entity for the purposes of the Volcker Rule and (2) must be a "venture capital fund," as defined by the SEC to mean a private issuer that:

- represents to investors and potential investors that it pursues a venture capital strategy;
- immediately after the acquisition of any asset, other than qualifying investments[7] or short-term holdings, holds no more than 20 percent of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;
- does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and 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[8] 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;
- 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 may entitle holders to receive distributions made to all holders pro rata; and
- is not registered under Section 8 of the Investment Company Act and has not elected to be treated as a business development company pursuant to Section 54 of the Investment Company Act.

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7 As defined in Rule 203(l)-1(c)(3) under the Investment Advisers Act of 1940, as amended (the "Investment Advisers Act").

8 As defined in Investment Advisers Act Rule 203(l)-1(c)(4).

Similar restrictions to those applicable to banking entities' investments in and relationships with credit funds would also apply to qualifying venture capital funds.

Family Wealth Management Vehicles

The Proposed Rule provides a new exclusion for family wealth management vehicles ("FWMVs"), designed to permit banking entities to provide traditional banking and asset management services to customers through vehicles used to manage the wealth and other assets of those customers and their families.

Under the proposed exclusion, a FWMV would include any entity that is not, and does not hold itself out as being, an entity 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, provided that: (1) if the entity is a trust, the grantor(s) of the entity are all family customers; and (2) if the entity is not a trust, a majority of the voting interests are owned (directly or indirectly) by family customers and the entity is owned only by family customers and up to three closely related persons of the family customers.[9]

A banking entity could rely on the proposed exclusion only if it (or an affiliate):

- provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the FWMV;
- does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such entity;
- complies with the disclosure obligations under Section __.11(a)(8) of the Volcker Rule, as if such FWMV were a covered fund;
- does not acquire or retain, as principal, an ownership interest in the entity, other than up to 0.5 percent of the FWMV's outstanding ownership interests that may be held by the banking entity and its affiliates for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns;

[9] A "family customer" is a family client (as defined in Investment Advisers Act Rule 202(a)(11)(G)-1(d)(4)) 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, spouse or spousal equivalent of any of the foregoing.

- complies with the requirements of Sections __.14(b)[10] and __.15[11] of the Volcker Rule as if such FWMV were a covered fund; and

- complies with the requirements of Regulation W, as if such banking entity and its affiliates were a member bank and the FWMV were an affiliate thereof.

Customer Facilitation Vehicles

The Proposed Rule would create a new exclusion for issuers that act as "customer facilitation vehicles." The proposed exclusion would be available for any issuer that is formed by or at the request of a customer of the banking entity for the purpose of providing such customer (including the affiliates of such customer) with exposure to a transaction, investment strategy or other service provided by the banking entity. A banking entity could rely on the proposed exclusion only if (i) all of the ownership interests of the issuer are owned by the customer (including the affiliates of such customer) for whom the issuer was created, other than a de minimis interest that may be held by the banking entity or its affiliates for specified purposes (as described below) and (ii) the banking entity and its affiliates maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction, investment strategy, or service. Additionally, the exclusion would only be available if the banking entity and its affiliates:

- do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such issuer;

- comply with the disclosure obligations under Section __.11(a)(8) of the Volcker Rule, as if the customer facilitation vehicle were a covered fund;

- do not acquire or retain, as principal, an ownership interest in the issuer, other than up to 0.5 percent of the customer facilitation vehicle's outstanding ownership interests that may be held by the banking entity and its affiliates for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns;

- comply with the requirements of Sections __.14(b) and __.15 of the Volcker Rule, as if such customer facilitation vehicle were a covered fund; and

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[10] Section __.14(b) generally requires that permitted transactions between a banking entity and a covered fund be made on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party.

[11] Section __.15 generally prohibits a banking entity from relying on any exemption to the prohibition on acquiring and retaining an ownership interest in, acting as sponsor to, or having certain relationships with, a covered fund, if the permitted activity or investment would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

- comply with the requirements of Regulation W, as if such banking entity and its affiliates were a member bank and the customer facilitation vehicle were an affiliate thereof.

Permitted Transactions with Covered Funds

The Proposed Rule would modify implementing regulations under Section 13(f)(1) of the BHC Act to permit a banking entity to engage in certain covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements and low-quality asset prohibition under Section 23A of the Federal Reserve Act, including certain transactions that would be exempt pursuant to Section 23A or Regulation W. In addition, banking entities would be allowed to enter into short-term extensions of credit with, and purchase assets from, a related covered fund in connection with payment, clearing, and settlement activities; provided that (1) each short-term extension of credit or purchase of assets would have to be made in the ordinary course of business in connection with payment transactions, securities, derivatives or futures clearing, or settlement services and (2) each extension of credit would be required to be repaid, sold, or terminated no later than five business days after it was originated.

Ownership Interest

The Proposed Rule would amend the definition of "ownership interest" to clarify that a debt relationship with a covered fund would typically not constitute an ownership interest under the regulations. Certain creditors' remedies upon the occurrence of an event of default or an acceleration event (e.g., an interest that allows its holder to remove an investment manager for cause upon the occurrence of an event of default) would not be considered an ownership interest, absent other factors.

The Proposed Rule would also offer a safe harbor from the definition of "ownership interest," available to senior loans or other senior debt interests that meet the following criteria:

- the holders of such interest do not receive any profits of the covered fund but may only receive: (i) interest payments which are not dependent on the performance of the covered fund; and (ii) fixed principal payments on or before a maturity date;

- the 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 (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

Parallel Investments

The Proposed Rule would codify previous guidance clarifying that an investment made by a banking entity directly in a portfolio company of a covered fund organized and offered by such banking entity is not considered "ownership interest" for the purposes of the Volcker Rules' investment limitations applicable to such funds; provided that the direct investment complies with applicable laws and regulations (e.g. a banking entity could not make a parallel investment for the purpose of artificially maintaining or increasing the value of the fund's positions). To the extent such investments would result in a material conflict of interest between the banking entity and its clients (e.g., because the banking entity may exit the position at a different time or on different terms than the covered fund), the banking entity would be required to provide timely and effective disclosure prior to making the investment.

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