CLIENT ALERT

Final Rule on Volcker Rule "Covered Funds" Becomes Effective October 1, 2020

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In June 2020, the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System (the "Board"), Federal Deposit Insurance Corporation ("FDIC"), Securities and Exchange Commission and Commodity Futures Trading Commission (collectively, the "Agencies") issued a final rule (the "Final Rule")[1] modifying certain provisions of the implementing regulations of Section 13 of the Bank Holding Company Act of 1956 (the "BHC Act"), commonly known as the "Volcker Rule," which generally prohibits banking entities[2] and their affiliates from engaging in proprietary trading and acquiring ownership interests in, or having certain relationships with, certain hedge funds and private equity funds ("covered funds"). The Final Rule will become effective on October 1, 2020.

The Final Rule is generally consistent with the notice of proposed rulemaking (the "Proposed Rule")[3] issued by the Agencies in January 2020, and notably: (i) exempts the activities of qualifying foreign excluded funds from the Volcker Rule's proprietary trading and covered fund restrictions; (ii) modifies existing exclusions from the definition of "covered fund" available to foreign public funds, loan securitization vehicles, public welfare funds and small business development companies; (iii) creates new "covered fund" exclusions for certain credit funds, venture capital funds, family wealth management vehicles and customer facilitation vehicles; (iv) creates an exclusion from the definition of "ownership

1 The Final Rule can be accessed here.

2 For purposes of the Volcker Rule, "banking entity" is defined to include: (i) insured depository institutions; (ii) companies that control insured depository institutions; (iii) bank holding companies (including foreign banking organizations or "FBOs"); and (iv) affiliates or subsidiaries of any of the foregoing.

3 The Proposed Rule can be accessed here. For more information on the Proposed Rule, please see our client alert entitled "Agencies Extend Comment Period on Proposed Volcker Rule "Covered Funds" Overhaul" (April 6, 2020), available here.

interest" for certain creditor's remedies, senior loans and other debt instruments; and (v) clarifies that certain investments made by banking entities alongside covered funds are not "ownership interests" subject to the Volcker Rule's limitations on such investments. Key provisions of the Final Rule are described below along with material differences from the Proposed Rule.

1. Qualifying Foreign Excluded Funds

The Final Rule codifies existing guidance from the Agencies that exempts certain activities of certain funds organized outside of the United States and offered to foreign investors ("qualifying foreign excluded funds" or "QFEFs")[4] from the restrictions of the Volcker Rule. Under the current regulatory framework, QFEFs, which are excluded from the definition of "covered fund," could be considered "banking entities" for the purposes of the BHC Act under certain circumstances (e.g., if the QFEF is controlled by a foreign banking entity) and thus become subject to the Volcker Rule's compliance obligations and limitations, including the prohibition on proprietary trading and restrictions on investing in or sponsoring covered funds. In consideration of the fact that QFEFs could be subject to more rigorous compliance obligations than those imposed on similarly situated U.S. covered funds, the OCC, Board and FDIC issued a policy statement in July 2017 (the "2017 Policy Statement") [5] providing that those agencies would not take action against foreign banking entities based on the attribution of the activities and investments of a QFEF to such foreign banking entity, or against a QFEF as a banking entity.

Consistent with the Proposed Rule, the Final Rule codifies the 2017 Policy Statement by exempting QFEFs from the restrictions on proprietary trading and investing in or sponsoring covered funds, provided that the acquisition or retention of the ownership interest in, or sponsorship of, the QFEF by the foreign banking entity meets the requirements under other existing implementing regulations under the Volcker Rule for permitted covered fund activities and investments conducted solely outside the United States. This relief is only available with respect to the asset management activities of QFEFs that are organized outside of the United States and operate pursuant to the local laws of foreign jurisdictions.

While the Agencies declined to exclude QFEFs from the definition of "banking entity" for the purposes of the Volcker Rule, the Final Rule clarifies that QFEFs are not required to have compliance programs or comply with the reporting and additional documentation requirements under Section __.20 of the implementing regulations of Section 13 of the BHC Act

[4] Under the Final Rule, a QFEF with respect to a foreign banking entity is an entity that: (i) is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (ii) 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; (iii) would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the entity; (iv) is established and operated as part of a bona fide asset management business; and (v) is not operated in a manner that enables the foreign banking entity to evade the requirements of the Volcker Rule.

[5] The 2017 Policy Statement can be accessed here.

(the "Implementing Regulations"), which is intended to ensure and monitor banking entities' compliance with the proprietary trading and covered fund provisions from which QFEFs will be exempt under the Final Rule. The Final Rule also specifies that QFEFs must not be operated in a manner that enables the banking entity that sponsors or controls the QFEF, or any other affiliated banking entity (other than a QFEF), to evade the requirements of Section 13 of the BHC Act or the Final Rule.

2. Modifications to Existing Covered Fund Exclusions

A. Foreign Public Funds

The Final Rule adopts the proposed amendments to the "foreign public funds" exclusion currently available to issuers that are organized or established outside of the United States and the ownership interests of which are: (i) authorized to be offered and sold to retail investors in the issuer's home jurisdiction; and (ii) sold "predominantly" through one or more "public offerings"[6] outside of the United States. Under current regulations, the exclusion is only available to U.S. banking entities 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.

In response to concerns that these requirements could result in certain non-U.S. funds that are similar to U.S. registered investment companies being treated as covered funds, the Final Rule amends the exclusion to include any fund that is authorized to offer and sell ownership interests, and such interests are offered and sold, through one or more public offerings outside of the United States. This change would permit foreign funds to qualify for the exclusion if they are organized in one jurisdiction but only authorized to be sold to retail investors in another jurisdiction and also provides relief for banking entities that must currently monitor the distribution history and patterns of a third-party sponsored fund or a sponsored fund whose interests are sold through third-party distributors to determine compliance with the exclusion.

The Final Rule also modifies the definition of "public offering" to include a new requirement that the distribution be subject to substantive disclosure and retail investor protection laws and provides that the distribution must comply with all applicable requirements in the jurisdiction where it is made, if the banking entity is acting as the investment manager, investment adviser, commodity trading advisor, commodity pool operator, or sponsor. In addition, the limitation on selling ownership interests of the fund to employees (other than senior executive officers) of the sponsoring banking entity or the fund (or affiliates of the banking entity or fund) has been eliminated. Finally, the Final Rule provides that an offering is made "predominantly" outside of the United States if 75 percent or more of the fund's interests are sold to investors that

[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.

are not residents of the United States, which represents a decrease from the 85 percent threshold previously articulated in existing regulations and the Proposed Rule.

B. Loan Securitization Vehicles

The Final Rule modifies the "covered fund" exclusion for loan securitization vehicles that (a) issue asset-backed securities and (b) hold only: (i) loans; (ii) certain rights and assets that arise from the structure of the loan securitization or from the loans supporting a loan securitization, including cash equivalents ("servicing assets"); and (iii) a small set of other financial instruments ("permissible assets"). Consistent with the Proposed Rule, the Final Rule codifies guidance from the Agencies (the "Loan Securitization Servicing FAQ")[7] providing that: (i) a servicing asset may or may not be a security, but if the servicing asset is a security, it must be a permitted security under the Volcker Rule; and (ii) "cash equivalents" are high-quality, highly liquid short-term investments, the maturity of which corresponds to the securitization's expected or potential need for funds and the currency of which corresponds to either the underlying loans or the asset-backed securities.

In addition, the Final Rule permits qualifying loan securitization vehicles to hold up to five percent of their total assets in non-loan assets. However, in contrast with the Proposed Rule, the Final Rule provides that such non-loan assets may only include debt securities that are not convertible debt securities or asset-backed securities. The Final Rule specifies that "total assets," for the purposes of calculating the five percent limit, includes only the value of the loans, debt securities, cash and cash equivalents held by the qualifying loan securitization vehicle and not the aggregate value of all of the vehicle's assets, calculated at the most recent time of acquisition of such assets.

C. Public Welfare Funds and Small Business Investment Companies

The Final Rule includes modifications to the exclusions available to public welfare funds (i.e., investments that are designed primarily to promote the public welfare) and small business investment companies ("SBICs"), which the Agencies proposed to amend and put forth for discussion in the Proposed Rule. In response to comments on the Proposed Rule, the Agencies have amended the public welfare funds exclusion to specifically include community development funds, rural business investment companies and opportunity zone funds. The Final Rule also adopts the SBIC modifications as proposed, expanding the exclusion to include issuers who have voluntarily surrendered their licenses to operate as a SBIC and who do not make subsequent investments after such voluntary surrender.

[7] The Loan Securitization Servicing FAQ can be accessed here.

3. New Covered Fund Exclusions

A. Credit Funds

The Final Rule creates a new exclusion from the definition of "covered fund" for certain 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. The exclusion specifically covers issuers that transact in or hold only: (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. For the purposes of the credit fund exclusion, "related rights and other assets" includes cash equivalents, securities received in lieu of debts previously contracted and equity securities (or rights to acquire equity securities). Any such equity securities or rights must be: (a) received on customary terms in connection with the fund's loans or debt instruments; and (b) related or incidental to acquiring, holding, servicing, or selling those loans or debt instruments. While the Agencies did not adopt a quantitative limit on the amount of equity securities (or rights to acquire equity securities) that may be held by an excluded credit fund, the Agencies expect that the equity securities or rights received in connection with an investment in loans or debt instruments of a borrower (or affiliated borrowers) should not exceed five percent of the value of the fund's total investment in the borrower (or affiliated borrowers) at the time the investment is made.

In addition to the foregoing asset requirements, banking entities seeking to qualify for the credit fund exclusion cannot guarantee the performance of the fund and the fund cannot hold any debt instruments or equities (or rights to acquire equity securities) received on customary terms in connection with loans or debt instruments held by the fund that the banking entity is not permitted to acquire and hold directly under applicable federal banking laws and regulations.

The activities of excluded credit funds are subject to a number of constraints under the Final Rule, including prohibitions on the issuance of asset-backed securities and proprietary trading, as if the fund were a banking entity. The Final Rule also imposes additional restrictions on a banking entity's investment in, and relationship with, excluded credit funds. A banking entity's investment in, and relationship with, the issuer must: (i) comply with the limitations in Section __.15 of the Implementing Regulations regarding material conflicts of interest, high-risk investments, and safety and soundness and financial stability, in each case as though the credit fund were a covered fund; and (ii) be conducted in compliance with, and subject to, applicable banking laws and regulations, including the safety and soundness standards applicable to the banking entity. Finally, banking entities that act as a sponsor, investment adviser, or commodity trading advisor to an

excluded credit fund are required to provide prospective and actual investors with the disclosures specified in Section __.11(a)(8)[8] of the Implementing Regulations.[9]

B. Venture Capital Funds

The Final Rule adopts the new exclusion for qualifying venture capital funds as proposed in the Proposed Rule. The venture capital fund exclusion is available to issuers that (i) meet the definition of a "venture capital fund" under Rule 203(l)-1 of the Investment Advisers Act of 1940 (the "Advisers Act") and (ii) do not engage in proprietary trading as if they were a banking entity for the purposes of the Volcker Rule.

Under the Final Rule, a banking entity that acts as sponsor, investment adviser, or commodity trading advisor to the qualifying venture capital fund, and that relies on the exclusion to sponsor or acquire an ownership interest in the qualifying venture capital fund, is required to: (i) provide in writing to any prospective and actual investor the disclosures required under Section __.11(a)(8) of the Implementing Regulations, as if the qualifying venture capital fund were a covered fund; (ii) ensure that the activities of the qualifying venture capital fund are consistent with the safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly; and (iii) comply with the restrictions imposed in Section __.14 of the of the Implementing Regulations (except that the banking entity may acquire and retain any ownership interest in the issuer), as if the qualifying venture capital fund were a covered fund. In addition, a banking entity that relies on the exclusion may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the qualifying venture capital fund.

C. Family Wealth Management Vehicles

The Final Rule includes the proposed exclusion for qualifying family wealth management vehicles ("FWMVs"), entities 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 Final Rule, the exclusion is available to include any entity that is not, and does not hold itself out as being, an entity or arrangement that raises money from investors for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, provided that: (i) if the entity is a trust, the grantor(s) of the entity are all family customers;[10] and (ii) if the entity

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[8] Section __.11(a)(8) requires issuers to disclose, among other things, that losses are borne solely by investors and not the banking entity, that investors should examine fund documents, and that ownership interests are not insured by the FDIC or guaranteed.

[9] The Agencies note that this requirement applies only to a sponsor, investment adviser, or commodity trading adviser that relies on the exclusion to sponsor or acquire an ownership interest in the credit fund and does not apply to any investment adviser or commodity trading advisor to a credit fund that does not also sponsor or acquire an ownership interest in the credit fund.

[10] Under the Final Rule, a "family customer" is a "family client" (as defined in Rule 202(a)(11)(G)-1(d)(4) under the Advisers Act) 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 spousal equivalent of any of the foregoing

is not a trust, (a) a majority of the interests are owned (directly or indirectly) by family customers and (b) the entity is owned only by family customers and up to five closely related persons of the family customers. The criteria for non-trust entities are slightly modified from those set forth in the Proposed Rule, which limited the number of closely related persons of the family customers to three and required that family customers own a majority of the "voting interests."

The exclusion is also available to banking entities, provided that any such banking entity: (i) provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the FWMV; (ii) does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the FWMV; (iii) complies with the disclosure obligations under Section __.11(a)(8) of the Implementing Regulations as if the FWMV were a covered fund; (iv) does not acquire or retain, as principal, an ownership interest in the entity, other than up to an aggregate 0.5 percent of the FWMV's outstanding ownership interests to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns; (v) complies with the requirements of the implementing regulations of Section 23B of the Federal Reserve Act[11] as if the FWMV were a covered fund; and (vi) complies with the requirements of the implementing regulations of Section 23A of the Federal Reserve Act[12] as if such banking entity and its affiliates were a member bank and the FWMV were an affiliate thereof, other than with respect to "riskless principal transactions."[13]

The FWMV exclusion is substantially similar to that outlined in the Proposed Rule. However, the Final Rule: (i) permits any entity (as opposed to just the banking entity) to hold a de minimis percentage of the interest in the FWMV; (ii) allows banking entities to engage in riskless principal transactions with the FWMV; and (iii) provides greater flexibility for the banking entity to modify the content and manner of the disclosures required under Section __.11(a)(8) of the Implementing Regulations to prevent such disclosures from being misleading and to accommodate the specific circumstances of the FWMV.

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[11] Section 23B of the Federal Reserve Act provides that covered transactions between banking entities and covered funds may be engaged in only on terms and under circumstances that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or in the absence of comparable transactions, on terms and under circumstances that in good faith would be offered to, or would apply to, nonaffiliated companies. Section 23B also prohibits, with certain exceptions, the purchase of securities or other assets as fiduciary from an affiliate, as well as the acquisition of a security during the existence of an underwriting or selling syndicate if a principal underwriter of that security is an affiliate of the banking entity.

[12] Section 23A of the Federal Reserve Act limits the aggregate amount of covered transactions between a member bank and its affiliates and prohibits or places limits on certain covered transactions, including certain collateralization requirements.

[13] Under the Final Rule, a "riskless principal transaction" is a transaction in which the riskless principal (the banking entity) buys and sells the same security contemporaneously, and the asset risk passes promptly from the customer (the FWMV) through the riskless principal to a third party.

D. Customer Facilitation Vehicles

Consistent with the Proposed Rule, the Final Rule creates a new exclusion for issuers that act as "customer facilitation vehicles." The customer facilitation vehicle exclusion is available to qualifying issuers that are 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 may only rely on the exclusion with respect to a qualifying issuer provided that: (i) all of the ownership interests of the issuer are owned by the customer (which may include one or more of its affiliates) for whom the issuer was created and (ii) the banking entity and its affiliates: (a) maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction, investment strategy, or service; (b) do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such issuer; (c) comply with the disclosure obligations under Section __.11(a)(8) of the Implementing Regulations as if such issuer were a covered fund, provided that the content may be modified to prevent the disclosure from being misleading and the manner of disclosure may be modified to accommodate the specific circumstances of the issuer; (d) do not acquire or retain, as principal, an ownership interest in the issuer, other than up to an aggregate 0.5 percent of the issuer's outstanding ownership interests for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns; (e) comply with the requirements of the implementing regulations of Section 23B of the Federal Reserve Act as if such issuer were a covered fund; and (f) comply with the requirements of the implementing regulations of Section 23A of the Federal Reserve Act as if such banking entity and its affiliates were a member bank and the issuer were an affiliate thereof, other than with respect to "riskless principal transactions."

The customer facilitation vehicle exclusion is substantially similar to the proposal outlined in the Proposed Rule, with modifications mirroring those discussed above with respect to FWMVs.

4. Permitted Transactions with Covered Funds

The Final Rule adopts the Proposed Rule's amendments to Section __.14 of the Implementing Regulations (commonly referred to as "Super 23A") to permit banking entities to engage in certain covered transactions with an affiliated 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 some transactions that would be exempt pursuant to Section 23A or Regulation W. Under the Final Rule, banking entities would be allowed to enter into short-term extensions of credit with, and purchase assets from, an affiliated 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. The Final Rule also permits banking entities to engage in riskless principal transactions with affiliated covered funds.

5. Ownership Interest

Consistent with the Proposed Rule, the Final Rule amends 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. The Proposed Rule excluded from the definition of "ownership interests" certain creditors' remedies available 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), absent other factors.

In response to comments on the Proposed Rule, the Final Rule expands the scope of such creditors' rights to include creditors' rights attached to debt interests that are not triggered exclusively by an event of default or acceleration. Such rights include the rights of a creditor to participate in the removal or replacement of an investment manager for cause in connection with: (i) the bankruptcy, insolvency, conservatorship or receivership of the investment manager; (ii) the breach by the investment manager of any material provision of the covered fund's transaction agreements applicable to the investment manager; (iii) the breach by the investment manager of material representations or warranties; (iv) the occurrence of an act that constitutes fraud or criminal activity in the performance of the investment manager's obligations under the covered fund's transaction agreements; (v) the indictment of the investment manager 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 his or her investment management activities; (vi) a change in control with respect to the investment manager; (vii) the loss, separation or incapacitation of an individual critical to the operation of the investment manager or primarily responsible for the management of the covered fund's assets; and (viii) other similar events that constitute "cause" for removal of an investment manager; provided that such events are not solely related to the performance of the covered fund or to the investment manager's exercise of investment discretion under the covered fund's transaction agreements.

The Final Rule also adopts the safe harbor from the definition of "ownership interest" for senior loans or other senior debt interests that meet the following criteria: (1) under the terms of the interest, the holders of such interest do not have the right to receive a share of the income, gains, or profits of the covered fund, but are entitled to receive only (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); (2) the entitlement to payments under the terms of the interest are absolute and could not be reduced based on 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 interest due and payable on the interest; and (3) the holders of the interest are not entitled to receive the

underlying assets of the covered 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). The safe harbor in the Final Rule is substantially similar to that outlined in the Proposed Rule. However, the Agencies modified the safe harbor to include senior loan and senior debt interests where contractual principal payments vary over the life of a senior loan or senior debt interest (e.g., due to amortization and acceleration), provided that the total amount of principal required to be repaid over the life of the instrument does not change.

6. Parallel Investments

The Final Rule adopts the parallel investment provisions of the Proposed Rule as written, codifying existing guidance that clarifies 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 an "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.

Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the Volcker Rule and the regulatory regime. We would be pleased to assist on your matters.

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