VOLCKER REVAMP VIEWED VIVIDLY: WHAT YOU NEED TO KNOW ABOUT THE AGENCIES' PROPOSAL TO MODIFY RESTRICTIONS ON COVERED FUNDS

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On January 30, 2020, the Board of Governors of the Federal Reserve System, the Board of Directors of the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission, (collectively, the "Agencies") proposed changes to their regulations ("Implementing Regulations") that implement Section 13 of the Bank Holding Company Act of 1956 (the "Volcker Rule"). If adopted, these changes would ease some of the restrictions on relationships between banking entities and certain types of investment funds, known under the Volcker Rule as "covered funds."

The Agencies have requested comments on all aspects of the proposal and whether further relief would be appropriate. Comments are due by April 1, 2020.

I. WHY ARE THE AGENCIES PROPOSING TO CHANGE THE IMPLEMENTING REGULATIONS?

In general, under the Volcker Rule and the Implementing Regulations, a banking entity may not sponsor, have an ownership interest in, or engage in certain transactions with "covered funds." "Covered funds" are defined as pooled investment funds that would be investment companies under the Investment Company Act of 1940 ("1940 Act") but for the fact that they rely on exclusions contained in Section 3(c)(1) and/or Section 3(c)(7) of the 1940 Act, as well as certain privately offered commodity pools and similar private foreign investment vehicles. However, the Implementing Regulations currently exclude 14 types of funds from the covered fund definition.

The Agencies have suggested that the Implementing Regulations are too restrictive in some areas and need clarification in others. They now propose to (a) exclude four additional types of investment funds from the definition of a covered fund, (b) simplify three of the existing exclusions from the covered fund definition, (c) clarify certain portions of the rules, and (d) allow more flexibility with respect to relationships and transactions between banking entities and covered funds.

II. WHAT NEW TYPES OF FUNDS WOULD NO LONGER BE COVERED FUNDS?

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The proposal would exclude four types of investment vehicles from the covered fund definition: credit funds, venture capital funds, family funds, and customer facilitation funds. Each proposed exclusion is discussed in detail below.

A. Credit Funds

Credit funds make loans, invest in debt, or otherwise extend the type of credit that banking entities may provide directly. Under the proposal, a "credit fund" would be defined as an issuer whose assets consist solely of: (1) loans; (2) debt instruments that are not guaranteed by the banking entity and that a banking entity may own directly; (3) rights and other assets that are related or incidental to acquiring, holding, servicing, or selling such loans or debt instruments; and (4) interest rate or foreign exchange derivatives held for purposes of hedging the portfolio. However, the rights and other assets described in item (3) could not include securities other than cash equivalents, securities received in lieu of debt(s) previously contracted, debt securities that would be eligible for the banking entity to hold directly, and certain equity securities that are received on customary terms with such loans or debt instruments (including warrants, rights, and equity kickers).

The proposed exclusion for credit funds would be broader than the currently existing exclusion for loan securitizations because a credit fund would be permitted to transact in debt instruments other than "loans." However, it would not include the "5 percent other asset" feature that is proposed for the loan securitization exclusion (discussed below). An open question that will likely draw industry comments is how to resolve the tension between the exclusion of securities and the inclusion of "debt instruments," which could include bonds and other instruments that may be regarded as securities.

The Volcker Rule and Implementing Regulations also restrict banking entities from engaging in proprietary trading. In order to ensure that a credit fund is not used as a means to evade this restriction, the fund would be subject to the proprietary trading restrictions as if it were a banking entity itself. A banking entity that invests in the credit fund could not guarantee the fund's performance, and a banking entity that sponsors the fund would be required to disclose that it is prohibited from doing so. The relationship between the credit fund and banking entity sponsoring and/or investing in the credit fund would also be subject to the Implementing Regulations' "Super 23A" restrictions (discussed below) as if the credit fund were a covered fund.

B. Venture Capital Funds

The proposal would create a new exclusion for "venture capital funds," as defined in SEC regulations under the Investment Advisers Act of 1940. [1] A banking entity would be permitted to acquire or retain ownership interests in, or sponsor, such a venture capital fund, to the extent that the banking entity is permitted to engage in such activities under otherwise applicable law. [2] The activities of the fund would have to be consistent with safety and soundness standards similar to those that would apply if the banking entity engaged in those activities directly.

As with the credit fund proposal, a qualifying venture capital fund would be prohibited from engaging in proprietary trading as if it were a banking entity. A banking entity that invests in or sponsors the fund would be subject to restrictions that parallel those described above with respect to credit funds.

C. Family Funds

The proposal also would allow banking entities more flexibility to provide traditional banking and asset management services via family wealth management vehicles. For these purposes, the relevant vehicle would have to be (1) a trust where all the grantors are family customers, or (2) an entity where the majority of voting

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interests are owned by family customers and the entity is owned by members of a single family and up to three "closely related persons." [3] A banking entity could hold up to 0.5 percent of the vehicle's outstanding ownership interests to the extent necessary for establishing corporate separateness of the vehicle or addressing bankruptcy and similar concerns.

Several conditions would apply. First, the banking entity must provide bona fide trust, fiduciary, investment advisory, or commodity trading services to the family wealth management vehicle. The banking entity could not guarantee the vehicle's performance (and would have to disclose this fact to the investors). Compliance with the "Super 23A" rules would not be required, but the banking entity could not acquire any low-quality assets from the family wealth management vehicle. Further, the "arm's-length terms" requirements of Section 23B of the Federal Reserve Act (the "FR Act") and Regulation W would apply to transactions between the banking entity and the family wealth management vehicle.

D. Customer Facilitation Funds

The proposal would create a new exclusion from the "covered fund" definition for customer facilitation funds, better known as funds of one. A customer facilitation fund would be an issuer created by, or at the request of, a customer in order to permit that customer (or that customer's affiliates) to have exposure to a transaction, strategy or other service provided by the banking entity. This exclusion would allow a banking entity to provide services to a customer through a special purpose vehicle similar to the manner in which it might provide services directly. The customer also could be a new customer — there would be no requirement for a preexisting relationship. The banking entity could hold up to 0.5 percent of the customer facilitation fund's outstanding ownership interests to the extent necessary for establishing corporate separateness of the fund from the customer or to address bankruptcy and similar concerns.

The banking entity would be prohibited from guaranteeing the fund's performance and would be required to disclose this fact to the customer. Compliance with the "Super 23A" rules would not be required, but the banking entity would be prohibited from acquiring low-quality assets from the fund, and the "arm's-length terms" requirements of Section 23B of the FR Act and Regulation W would apply to transactions between the fund and the banking entity.

III. COULD ANY OTHER TYPES OF FUNDS BE ADDED TO THE LIST OF EXCLUDED FUNDS?

Yes, although the prospect is uncertain.

The Volcker Rule allows banking entities to invest in and sponsor certain funds that are meant to promote public welfare, including investments designed primarily to benefit low- and moderate-income communities, such as by providing housing. The rule to implement this provision of the statute is broadly worded, but the Agencies have inquired whether it should be revised to "clarify that all permissible public welfare investments, under any agency's regulation, are excluded from the covered fund restrictions." [4] This would encompass both direct and indirect investment through fund structures.

The Agencies have requested information as to whether banking entities have avoided potential investments in this area due to compliance burdens or regulatory uncertainty. They have also inquired whether specific types of investment vehicles should be specifically excluded from the Volcker Rule standards, such as Rural Business

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Investment Companies and Qualified Opportunity Funds formed to enable investments in Opportunity Zones under the Tax Cuts and Jobs Act of 2017, and they inquired whether funds that qualify for Community Reinvestment Act credit should automatically be excluded.

Outside the context of social welfare investments, the Agencies have inquired whether they should "exclude other types of funds that, like qualifying venture capital funds, provide important capital to businesses through long-term investments." [5] As an example, the Agencies have suggested an exclusion for an issuer that holds investments in assets a banking entity could hold directly for a minimum time period, such as two years. The suggestion, however, was not accompanied by a formal proposed rule and may not lead to substantive changes at this time. It could, however, signal a willingness by the Agencies to consider data and arguments in support of relief in the future.

IV. WOULD THE PROPOSAL CHANGE ANY OF THE EXISTING COVERED FUND EXCLUSIONS?

Yes. The Agencies are proposing to clarify and provide flexibility to the current exclusions from the covered fund definition for foreign public investment funds, loan securitizations, and small business investment companies ("SBICs").

A. Foreign Public Investment Funds

Under the Implementing Regulations, U.S.-registered investment companies are not treated as "covered funds." In order to ensure parallel treatment for non-U.S. public investment funds (such as funds subject to the European Union's Undertakings for Collective Investment in Transferable Securities Directive), the rules stipulate that "foreign public funds" are also not covered funds. At present, to benefit from this exclusion, a "foreign public fund" must be organized outside of the United States, and its ownership interests must be:

1. Authorized for sale to retail investors in its home jurisdiction (that is, the fund must be available for sale to investors in the jurisdiction where it is organized), and
2. Sold "predominantly" through one or more public offerings outside of the United States.

The Agencies are proposing to remove the "home jurisdiction" requirement because it disqualifies funds organized in one foreign jurisdiction that are only authorized for sale to investors in another foreign jurisdiction. To make compliance and monitoring easier, the proposal would replace the requirement that a fund be sold "predominantly" through one or more public offerings with one that fund interests be offered and sold through *at least one* public offering subject to substantive local disclosure and retail investor protection. It also would restrict the exclusion's existing condition that the distribution comply with all applicable requirements in the jurisdiction where it is made to cases where the banking entity acts as the fund's sponsor investment adviser or manager, commodity trading advisor, or pool operator. Finally, the foreign public fund exclusion currently restricts the fund from being sold to "employees" of a banking entity that sponsors the fund. In order to ease the compliance burden of tracking purchases by line employees of a large organization, this restriction would be limited to senior executives, rather than employees.

B. Loan Securitizations

Subject to numerous conditions, the current Implementing Regulations exclude an issuer of asset-backed securities from the definition of a "covered fund." Among other things, the issuer must limit its assets to (1) loans,

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(2) certain rights and assets designed to assure servicing and timely distribution of proceeds or that are related to purchasing or holding the underlying loans ("servicing assets"), (3) interest rate and foreign exchange derivatives that hedge the underlying portfolio, and (4) certain special units of beneficial interest and collateral certificates that facilitate securitizations of equipment leases and other specialized financial assets.

The proposal would permit asset-backed issuers to hold up to 5 percent of their assets in assets other than loans, including bonds and other securities. Securities that are servicing assets would not count toward the 5 percent limit. This addresses a perceived need for a bond bucket for collateralized loan obligations ("CLOs") in order to increase their diversification and enable collateral managers to respond flexibly to changing market conditions, although it appears that the increased risk associated with unsecured bonds will restrict the use of bond buckets to deals with more well-regarded managers.

Even where investor demand exists, the small bond bucket may not be sufficient to permit CLOs with European assets to comply with the loan securitization exemption because of European Central Bank programs that cause many obligations to be structured as asset-backed securities rather than loans. Such CLOs may have to continue to rely on 1940 Act Rule 3a-7 to avoid becoming a covered fund, even at the cost of limitations on active management, unless they can qualify for the foreign excluded fund exemption or be structured as "credit funds." The former would be inaccessible for CLOs marketed in the United States. The latter would be questionable unless the Agencies delineate the line between permitted "debt instruments" and forbidden "securities."

As noted above, current rules permit an asset-backed issuer to hold "servicing assets." Servicing assets may include limited types of securities, including "cash equivalents." The Volcker Rule does not define this term, but an FAQ issued by the Agencies in 2014 stated that "cash equivalents" are high-quality liquid short-term investments with maturities that correlate to the fund's expected or potentially necessary liquidity requirements. [6] The proposal would codify this interpretation with some changes, notably removing the presumption that cash equivalents are "short term" instruments. The proposal would also codify the Agencies' current interpretation that permissible "servicing assets" include both assets other than securities (for example, mortgage insurance policies supporting the mortgages in a securitization) and servicing assets that are securities but that meet certain additional eligibility criteria. [7]

C. Small Business Investment Companies

SBICs are not deemed to be "covered funds." The proposed rule changes would clarify that this exclusion continues to apply to an SBIC that voluntarily surrenders its license during a wind-down period.

V. ARE THERE ANY PROPOSED CHANGES FOR FOREIGN EXCLUDED FUNDS?

Yes, but they are limited and meant to codify existing interpretations.

One unintended consequence of the Implementing Regulations' wording was that an investment fund that is organized and offered outside of the United States and that is excluded from the definition of a covered fund could be swept into the definition of a "banking entity" and become subject to the Volcker Rule's prohibitions on proprietary trading and other restrictions. This could occur, for example, where a foreign banking entity has a control relationship with a fund due to its ability to select the majority of the fund's directors or trustees.

The Agencies previously addressed this matter by issuing policy statements in which they announced that no enforcement action would be taken against a foreign banking entity based on the activities and investments of

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non-U.S. funds meeting certain criteria, known as "qualifying foreign excluded funds." [8] Among other things, these criteria require the qualifying foreign excluded fund to be organized, offered, and sold outside the United States as part of a bona fide asset management business and not be operated so as to evade the Volcker Rule. A qualifying foreign excluded fund was also required to be organized, offered, and sold outside the United States as provided in the exemption for fund activities conducted solely outside the United States [9] as if the fund were a covered fund. Thus, the decision to invest in or sponsor the fund could not be made by any person or entity located in the United States. Nor could the investment or sponsorship be accounted for as principal by a branch or affiliate located or organized in the United States. The proposal would effectively codify this position.

This aspect of the proposal would provide exemptions for *activities* of qualifying foreign excluded funds. However, it would not exclude such funds from the "banking entity" definition. As such, a qualifying foreign excluded fund that is in a control relationship with a foreign banking entity (and thus a banking entity) may be subject to the compliance program requirement and backstop provisions of the Volcker Rule.

VI. HOW WOULD THE PROPOSAL AFFECT CREDIT RELATIONSHIPS BETWEEN BANKING ENTITIES AND COVERED FUNDS?

The proposal would clarify that certain debt relationships with a covered fund do not amount to "ownership." Thus, it may become slightly easier for banking entities to provide credit to covered funds and for covered funds to receive credit from banking entities.

The Implementing Regulations currently define an "ownership interest" to include any equity, partnership, or other "similar interest." They then define a "similar interest" by reference to a list of characteristics, including the right to participate in the selection or removal of a general partner, managing member, director, trustee, investment manager, or the like. The proposal would amend this list to clarify that a loan or debt interest with certain creditor rights that arise upon an event of default or an acceleration event, including management removal rights or the right to nominate or vote on replacement managers, would not be an ownership interest. This is particularly helpful in variable interest entities, including many CLOs, where management kick-out rights may be important for generally accepted accounting principles consolidation analysis.

To address concerns that some ordinary debt could be interpreted as "ownership," the proposal also would create an express safe harbor for senior loans and senior debt where:

- The holders receive no income or profits from the covered fund but only receive: (i) interest payments, commitment fees, or other fees that do not depend on the performance of the covered fund; and (ii) fixed principal payments on or before a maturity date;
- The entitlement to interest payments is absolute and may not be reduced due to losses arising from the assets of the covered fund; and
- The holders 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 default or acceleration rights).

VII. HOW WOULD THE PROPOSAL AFFECT THE *DE MINIMIS* INVESTMENTS THAT BANKING ENTITIES MAY HOLD IN COVERED FUNDS?

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The proposal would provide some flexibility in this area by clarifying that parallel investments and co-investments are not to be counted toward the *de minimis* investments that banking entities are permitted to hold in covered funds.

The current rules permit a banking entity to retain a *de minimis* investment of up to 3 percent of the total number or value of the ownership interests of a covered fund that it organizes and offers. [10] When the Agencies approved the original Implementing Regulations, the preamble stated that "if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund." [11] The proposal would effectively overrule this prior statement, so that a banking entity would not be restricted in the amount of any investment that it might make alongside a covered fund. However, traditional safety and soundness standards would still apply, as well as prohibitions on guaranteeing the fund or otherwise evading the purpose of the rules.

VIII. HOW DO THE "SUPER 23A" CHANGES FIT IN?

The Volcker Rule and the Implementing Regulations generally prohibit a banking entity or its affiliates from entering into a transaction with a covered fund that the banking entity organizes, offers, holds, advises, or sponsors (a "related fund") if the transaction would be a "covered transaction" under Section 23A of the FR Act. [12] Such transactions include loans and other extensions of credit, guarantees, asset purchases, and investments in or with the covered fund. Whereas Section 23A and its implementing Regulation W place limits on "covered transactions" between a bank and its affiliates, and allow certain exceptions, the Volcker Rule provisions are more restrictive — hence the "Super 23A" moniker.

Various market participants have asserted that the "Super 23A" restrictions unduly restrict the ability of banking entities to organize and offer covered funds or to provide services in connection with payment, clearing, and settlement activities. The Agencies are therefore proposing to amend the rules by allowing banking entities to engage in transactions with related funds that would be permissible under Section 23A and Regulation W without limit. [13] This would include intraday extensions of credit and extensions of credit fully secured by U.S. Treasury securities and other obligations fully guaranteed by the United States.

The proposal also would allow a banking entity to extend short-term (up to five business days) credit to, or purchase assets from, a related fund in connection with ordinary course payment, clearing, and settlement activities. Thus, a banking entity could perform these services for a related fund, rather than the fund having to use an unaffiliated service provider.

IX. HOW WILL THE AGENCIES EVALUATE THE PROPOSAL? ARE THERE ANY OBJECTIONS?

The Agencies' leadership has not been unanimous on every aspect of the proposal. For example, Federal Reserve Board Governor Lael Brainard objected to allowing banking entities to invest in venture capital funds and credit funds, as well as excluding parallel investments from investment limits. [14] Other leaders of the Agencies expressed the view that the Volcker Rule was not intended to restrict investments in venture capital funds and that the proposed reforms would foster capital investment in local economies. SEC Chairman Jay Clayton, in particular, noted that "the proposal could allow banking entities with a presence in and knowledge of the areas

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where venture capital and other types of financing are less readily available — i.e., 'between the coasts' — to provide critical financing to businesses in those areas, as they have traditionally done." [15]

Various aspects of the proposal may be shaped by these diverse viewpoints. For example, in addition to the points described above, the Agencies will consider:

- Whether issuers of asset-backed securities should be permitted to hold more or less than 5 percent of their assets in non-loan assets and whether such non-loan assets should be limited to debt securities or other types of instruments?
- Whether credit funds should be permitted to issue asset-backed securities?
- Whether there should be quantitative limits on the amount of equity securities that a credit fund could hold?
- Whether the venture capital fund exclusion should be limited to ensure that investments are made only in funds that provide capital to early-stage ventures, such as companies whose annual revenues are below $50 million or some other specified limit?

Market participants should consider how the proposal may affect their businesses, including opportunities involving new categories of excluded funds and expanded permissible activities, and consider providing information and viewpoints to the Agencies. The financial services team at K&L Gates continues to follow these and other Volcker Rule developments to help our clients understand and plan for the impact on their global operations.

NOTES

[1] 17 C.F.R. 275.203(l)-1. Venture capital funds focus investments on small businesses and start-up enterprises.

[2] For example, financial holding companies have the authority to engage in merchant banking activities under section 4(k)(4)(H) of the Bank Holding Company Act.

[3] A "closely related person" would mean a natural person (including their estate and estate planning vehicles) who has a longstanding business or personal relationship with a family customer.

[4] 85 Fed. Reg. 12120, 12130 (Feb 28, 2020).

[5] *Id.* at 12120, 12137.

[6] Volcker Rule Frequently Asked Questions ("FAQ"), Question 4 (Jun. 10, 2014).

[7] *Id.*

[8] *See* Statement Regarding Treatment of Certain Foreign Funds Under the Rules Implementing Section 13 of the Bank Holding Company Act (July 17, 2019); Statement Regarding Treatment of Certain Foreign Funds Under the Rules Implementing Section 13 of the Bank Holding Company Act (July 21, 2017).

[9] 12 C.F.R. 248.13(b).

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[10] The *de minimis* limit comes into play after the fund's initial seeding and sales period, when the banking entity is permitted to hold all of the interests of the covered fund.

[11] 79 Fed. Reg. 5535, 5734 (Jan. 31, 2014).

[12] 12 U.S.C. 371c.

[13] 12 C.F.R. pt. 223.

[14] *See* Statement by Governor Lael Brainard (Jan. 30, 2020).

[15] *See* Statement on Proposed Amendments to the Volcker Rule by SEC Chairman Jay Clayton (Jan. 30, 2020).

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