Clients&FriendsMemo

Volcker 3.0: The Agencies Relax the Volcker Rule Requirements for Securitizations and Foreign Funds and Grant New Exemptions from the Covered Fund Restrictions

June 26, 2020

On Thursday, June 25, 2020, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "Agencies") issued final regulations (the "2020 Final Regulations") revamping the existing regulations implementing the Volcker Rule, a centerpiece of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The issuance of the 2020 Final Regulations comes on the heels of Volcker Rule regulation amendments adopted by these Agencies in late 2019, which amendments focused largely on the compliance and proprietary trading aspects of the Volcker Rule.[2] The new 2020 Final Regulations now focus on the covered fund aspects of the Volcker Rule, as well as the application of the Volcker Rule to funds sponsored by foreign banks. Both the 2020 Final Regulations and last year's Volcker Rule regulation amendments are the result of a proposed rulemaking and invitation for public comment issued by the Agencies in 2018 (the "2018 Proposal").[3]

The 2020 Final Regulations address changes to the covered fund and foreign fund aspects of the Volcker Rule for which comment was sought in the 2018 Proposal, and largely adopt without change language that had been proposed by the Agencies earlier this year (the "2020 Proposal").[4] In particular, these changes allow a small debt security bucket for securitizations relying on the

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[1] These existing Volcker Rule regulations are codified in substantially identical form at 12 C.F.R. Part 248 (Federal Reserve), 12 C.F.R. Part 44 (OCC), 12 C.F.R. Part 351 (FDIC), 17 C.F.R. Part 255 (SEC), and 17 C.F.R. Part 75 (CFTC). For convenience, in this Memorandum we will refer to the version of the existing Volcker Rule regulations adopted by the Federal Reserve. The Volcker Rule regulations were first issued in 2014. *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*; Final Rule, 79 FED. REG. 5535 (Jan. 31, 2014).

[2] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds,*; Final Rule, 84 FED. REG. 61974 (Nov. 14, 2019).

[3] *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*; Proposed Rule. 83 FED. REG. 33432 (July 17, 2018).

[4] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds;* Proposed Rule, 85 FED. REG. 12120 (Feb. 28, 2020).

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"Loan Securitization Exclusion," create more exclusions from the covered fund definition (including for family wealth funds, venture capital funds, credit funds, and SPVs formed at the request of clients), and relax the "ownership interest" concept (in particular with respect to manager replacement rights as well as creating a safe harbor for senior loans and senior debt interests). The changes also clarify the treatment of the Volcker Rule as to funds controlled by banking organizations located overseas (referred to as "Foreign Excluded Funds") as well as to overseas funds that are comparable to U.S. registered investment companies (referred to as "Foreign Public Funds").

These changes become effective October 1, 2020.

The most significant aspects of the 2020 Final Regulations are discussed below.

SECURITIZATIONS

The Volcker Rule prohibits a banking entity from having an ownership interest in or sponsoring a "covered fund," defined as including an entity that would be an "investment company" under the Investment Company Act of 1940 but for the exclusions set forth in Sections 3(c)(1) or 3(c)(7) of that Act. The Volcker Rule regulations implement this prohibition, but then create a number of exclusions from the "covered fund" definition.[5] One such exclusion relates to issuers of asset-backed securities that meet the requirements of what is referred to as the "Loan Securitization Exclusion" of the Volcker Rule regulations.[6] The 2020 Final Regulations make several changes relevant to securitizations relying on this Loan Securitization Exclusion.

5% Debt Security Bucket

The Loan Securitization Exclusion currently requires that all of the issuer's assets consist of "loans" or certain other qualifying assets – cash equivalents, certain rate or foreign exchange derivatives, servicing assets, interests in a tax subsidiary or similar entity formed by the issuer for legal or tax purposes, and assets acquired by the issuer in a workout or foreclosure (*i.e.*, "in satisfaction of a debt previously contracted"). In particular, apart from the foregoing, the current Loan Securitization Exclusion does not permit the issuer to own securities.[7]

The 2020 Final Regulations permit the issuer relying on this exclusion to have a small amount of debt securities not exceeding 5% of the issuer's total assets. As a result, issuers relying on the Loan Securitization Exclusion (in particular, CLOs) may resume including a "bond bucket" – a

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[5] 12 C.F.R. § 248.10(c).

[6] *Id.* § 248.10(c)(8).

[7] The Volcker Rule regulations provide that an instrument that is a security is not a "loan" and, in this regard, incorporate by reference the definition of "security" found in the Securities Exchange Act of 1934 (the "'34 Act"). *See* 12 C.F.R. § 248.2(t), (aa). Thus, issuers typically rely on '34 Act concepts when determining whether an instrument is eligible to be included in a securitization relying on the Loan Securitization Exclusion.

common practice for CLOs prior to the implementation of the Volcker Rule – although of a very limited size.

In the 2020 Proposal, the Agencies sought public comment on the size of the bucket, whether the bucket should include any non-loan assets, and whether there should be eligibility criteria for the assets that may be included (such as credit quality or type). The Agencies elected to limit the bucket to debt securities only, and capped the size of the bucket at 5% of the loans, cash equivalents, and other debt securities then held by the issuer, with the valuation made solely at the time the debt securities are acquired, with such valuations based on par value in most cases. However, fair market value may be used in certain circumstances where the issuer is contractually obligated to use fair market value for other limit calculation purposes. The Agencies did not impose any restriction on the type or credit quality of the debt securities held in the bucket, other than to exclude debt securities that are either asset-backed securities or convertible debt securities.

Presumption for Senior Loans and Senior Debt Interest

As noted above, the Volcker Rule prohibits a banking entity from having an "ownership interest" in a covered fund, including an ownership interest in a securitization issuer that meets the definition of a "covered fund" because the issuer is relying on the exclusions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act but is unable satisfy the requirements of the Loan Securitization Exclusion (or other exclusion). The "ownership interest" definition includes not only traditional "equity" and "partnership" interests in the issuer, but also other interests (including potentially limited liability company, derivative, or even debt interests) that contain certain prescribed features – referred to as "other similar interests."[8]

The "other similar interest" definition in the current Volcker Rule regulations sets forth seven criteria, the existence of any one which criteria in an instrument could cause the instrument to be an "ownership interest."[9] If the instrument is an "ownership interest" and has been issued by a covered fund, then any banking entity would not be permitted to purchase or retain the instrument (subject to certain minor exceptions, for example, in order to comply with U.S. risk retention requirements).

One of those seven criteria defining an "other similar interest" is whether the instrument confers on the holder the right to participate in the selection or removal of the issuer's manager, adviser, director, trustee, or general partner (generally referred to as "manager removal rights").[10] Because the notes of the senior tranche of asset-backed securities often carry this right (and thus could be considered "ownership interests"), this aspect of the regulations has forced banking entities to

[8] *See* 12 C.F.R. § 248.10(d)(6).
[9] *Id.* § 248.10(d)(6)(i).
[10] *Id.* § 248.10(d)(6)(i)(A).

confirm (or attempt to confirm) that a particular issuer is not a "covered fund" prior to acquiring its senior tranche of notes – a sometimes difficult and time-consuming process.

The 2020 Final Regulations address this issue by creating a safe harbor for "senior loans" and "senior debt interests." The safe harbor provides that a "senior loan" or a "senior debt interest" is not considered an "ownership interest" if the obligation (or "interest") satisfies the following conditions:

(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, foregone income resulting from an early prepayment);

(2) the entitlement to payments under the terms of the interest is absolute and may 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).[11]

The above language is nearly identical to the language in the 2020 Proposal, with only slight modifications.

It should be noted that the above three conditions comprise three of the seven "other similar interest" criteria. In effect, the safe harbor means that "senior loans" and "senior debt interests" are subject to only these three (rather than all seven) of the "other similar interest" criteria. Notably, with respect to a "senior loan" or "senior debt interest," the existence of manager removal rights is no longer relevant in determining whether the instrument is an "ownership interest," enabling

[11] These three criteria parallel the language of existing clauses (B), (C) and (E) of the "other similar interest" definition. *See* 12 C.F.R. § 248.10(d)(6)(i).

banking entities to acquire the notes in the senior tranche of a securitization that have such a right, without having to first confirm that the issuer can rely on the Loan Securitization Exclusion or otherwise is not a "covered fund."[12]

The 2020 Final Regulations do not explicitly define the terms "senior loan" or "senior debt interest." It is unclear whether the Agencies intended that *any* loan or debt instrument that satisfies the above criteria would be considered a "senior loan" or "senior debt interest." Although commenters to the 2020 Proposal requested that the regulations provide that "senior loans" and "senior debt interests" include all investment grade debt interests, the Agencies declined to do so on the grounds that investment grade debt interests could contain "equity-like characteristics." In the Preamble to the 2020 Final Regulations, however, the Agencies do state that the fact that payments on an obligation are subject to a waterfall of priority does not disqualify obligations from being a "senior loan" or "senior debt interest."[13]

Clarification Regarding Manager Removal Rights

As mentioned above, if an instrument confers manager removal rights on the holder, the instrument is generally deemed to be an "ownership interest." The existing Volcker Rule regulations create an exception from this conclusion relating to "the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event."[14] In the 2020 Final Regulations, the Agencies expanded this exception to include "the right to participate in the removal of an investment manager for cause or to participate in the selection of a replacement manager upon the investment manager's resignation or removal," which is language very similar to the language appearing in the 2020 Proposal. However, in the 2020 Final Regulations, the Agencies also elected to add language to the Volcker Rule regulations explaining the concept of "for cause":

> For purposes of this paragraph …, "cause" for removal of an investment manager means one or more of the following events:
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> (i) the bankruptcy, insolvency, conservatorship or receivership of the investment manager;
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> (ii) the breach by the investment manager of any material provision of the covered fund's transaction agreements applicable to the investment manager;

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[12] It should be noted that while the modifications to the "ownership interest" definition creating a safe harbor for "senior loans" and "senior debt interests" are particularly relevant to securitizations, they are not limited to securitizations. For example, a "senior loan" or a "senior debt interest" involving other potential covered funds (such as a private equity fund or a commercial paper conduit) would be deemed to not constitute an "ownership interest" in these entities.

[13] The Preamble to the 2020 Final Regulations provides that the Agencies "clarify that a debt interest in a covered fund would not be considered an ownership interest solely because the interest is entitled to receive an allocation of collections from the covered fund's underlying financial assets in accordance with a contractual priority of payments." Preamble at p. 155. All citations to the Preamble in this memorandum refer to the version of the Preamble as published by the Board of Governors of the Federal Reserve System.

[14] 12 C.F.R. § 248.10(d)(6)(i)(A).

(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; or

(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 the investment manager's exercise of investment discretion under the covered fund's transaction agreements….

The final clause in the above definition appears to grant issuers fairly broad latitude to define "cause" with respect to the manager removal provisions in the management agreement or other transaction documents, provided that the concept of "cause" cannot be related solely to the performance of the fund or decisions made by the manager for which the relevant documents provide the manager discretion.

Cash Equivalents

As noted earlier, the Loan Securitization Exclusion limits the ability of an issuer to hold securities except certain permitted securities, which include "cash equivalents." The existing Volcker Rule regulations do not define the term "cash equivalent." Rather, the preamble accompanying the original Volcker Rule regulations contained a representative description of "cash equivalents,"[15] and in June 2014 the Agencies issued a FAQ incorporating this description, referring to "cash equivalents" as "high quality, highly liquid short term investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities."[16]

[15] 79 Fed. Reg. 5536, 5690 (Jan. 31, 2014).

[16] Volcker Rule FAQ #4 (June 10, 2014), *available at* https://www.federalreserve.gov/supervisionreg/faq.htm#4.

In the 2020 Final Regulations, the Agencies incorporate this description from the FAQ into the Volcker Rule regulations as a new definition of "cash equivalents," with minor changes, including the removal of the reference to "short term."[17]

Servicing Assets

The Volcker Rule's original regulations provide that an issuer is permitted to retain certain servicing related assets, "provided that each asset meets the requirements of paragraph (c)(8)(iii)," *i.e.*, the provision defining the scope of the securities that were permitted to be held.[18] This language implied that permissible servicing assets had to fall within the concept of permitted securities under the Loan Securitization Exclusion, which created considerable confusion regarding the concept of "servicing related assets." This confusion was clarified by a FAQ issued by the Agencies in June 2014, in which the Agencies stated that a "servicing asset" can be any form of asset, but *if* the servicing asset is in the form of a security the servicing asset must meet the concept of permitted securities.[19] The 2020 Final Regulations incorporate this concept into the regulations themselves.

Operating and Capital Leases

The Agencies declined to adopt a comment that the Loan Securitization Exclusion should be modified to address whether operating leases or capital leases are eligible as "loans." The basis for the comment was that operating leases and capital leases are often considered not to be "loans" for other bank regulatory purposes. The Agencies stated that a change was unnecessary because the term "loan" as defined in the Volcker Rule regulations specifically included leases[20] "and thus [leases] are permitted assets for loan securitizations under the current exclusion."[21] The Agencies' response indicates that operating and capital leases are permissible assets for the Loan Securitization Exclusion, even though such forms of leases are not considered "loans" for other purposes. The Agencies also declined to adopt an amendment allowing an issuer relying on the Loan Securitization Exclusion to retain off-lease assets at the expiration or termination of the lease, noting in the Preamble that "any residual value of such leased property upon expiration of an operating lease should meet the requirements to constitute an asset that is related or incidental to purchasing or otherwise acquiring and holding loans."[22]

SUPER 23A

The Volcker Rule prohibits a banking entity (or its affiliate) from engaging in certain transactions with a covered fund if that banking entity (or any of its affiliates) (i) serves as the investment

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[17] As a result, the definition is "high quality, highly liquid investments whose maturity corresponds to the issuer's expected or potential need for funds and whose currency corresponds to either the underlying loans or the debt instruments."

[18] 12 C.F.R. § 248.10(c)(8)(i)(B).

[19] Volcker Rule FAQ #4, *supra* note 16.

[20] *See* 12 C.F.R. § 248.2(t).

[21] Preamble at p. 47.

[22] Preamble at p. 48.

manager, investment adviser, commodity trading advisor, or sponsor to the covered fund, (ii) organizes and offers the covered fund under the so-called Asset Management or Asset-Backed Securitization Exclusions, or (iii) holds ownership interests in the covered fund under U.S. risk retention requirements (for purposes of the Memorandum, a "Related Covered Fund").[23] The scope of transactions prohibited with Related Covered Funds include any transaction that would be a "covered transaction" as that term is used in Section 23A of the Federal Reserve Act,[24] as if the banking entity (or its affiliate) were a "member bank" and the covered fund were an "affiliate."[25] Because this aspect of the Volcker Rule and its regulations incorporate by reference certain concepts from Section 23A of the Federal Reserve Act (but is, in fact, more stringent than Section 23A), this aspect of the Volcker Rule and its regulations is referred to as "Super 23A."[26]

The original Volcker Rule regulations' Super 23A provisions incorporate by reference the definition of "covered transaction" from Section 23A, and thus include a loan or extension of credit to, purchase of assets from, guarantees issued on behalf of, or certain derivative transactions with the Related Covered Fund. However, the original Volcker Rule regulations did not incorporate any of the exemptions from the definition of "covered transaction" as set forth in Section 23A or in its implementing regulation, Regulation W.[27]

In the 2020 Proposal, the Agencies proposed to exclude from the Super 23A prohibition any transaction that is completely excluded from "covered transaction" restrictions of Section 23A if such exclusions are found either in Section 23A's statutory language or in its implementing regulation, Regulation W. The Agencies decided to adopt these changes as proposed. As a result, permissible transactions between a banking entity and its Related Covered Fund include, for example:

- loans or extensions of credit by the banking entity if fully secured by U.S. Treasuries, by obligations fully guaranteed by the United States or its agencies, or by a segregated, earmarked deposit account at the banking entity;[28]

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[23] Note that the prohibition applies not only to transactions with the Related Covered Fund, but also to transactions with a covered fund controlled by that Related Covered Fund (excluding prime brokerage transactions).

[24] 12 U.S.C. § 371c.

[25] *See* 12 C.F.R. § 248.14. Notwithstanding this prohibition, the Volcker Rule regulations permit transactions with a Related Covered Fund if expressly allowed by other provisions of the Volcker Rule regulations, for example, when the banking entity is acting as a market-maker in Related Covered Fund ownership interests or is acquiring ownership interests in the Related Covered Fund subject to certain *de minimis* limits or for purposes of U.S. risk retention compliance.

[26] Unlike its Volcker Rule counterpart, Section 23A of the Federal Reserve Act restricts, but generally does not prohibit, "covered transactions" between a member bank and its affiliates.

[27] 12 C.F.R. Part 223.

[28] *Id.* § 223.42(c).

- purchases by the banking entity of liquid assets having a readily identifiable and publicly market quotation;[29] and
- intra-day extensions of credit by the banking entity.[30]

In the 2020 Final Regulations, the Agencies also decided that the scope of transactions permissible between a banking entity and a Related Covered Fund includes "riskless principal transactions," defined as "a transaction in which a banking entity, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security in the secondary market for its own account to offset a contemporaneous sale to (or purchase from) the customer."[31]

As was originally proposed, the 2020 Final Regulations also exclude from Super 23A any extension of credit to, or any purchase of assets from, the Related Covered Fund if conducted in the ordinary course of business in connection with payment transactions; settlement services; or futures, derivatives or securities clearing, even though such transactions are not expressly exempted in Regulation W itself. Such purchases or extensions of credit are subject to the following conditions:

- each extension of credit must be repaid, sold, or terminated within five business days;
- the banking entity must adopt certain policies and procedures comparable to those prescribed under Regulation W with respect to intra-day transactions[32]; and
- the banking entity must have "no reason to believe that the [Related Covered Fund] will have difficulty repaying the extension of credit in accordance with its terms."[33]

FOREIGN EXCLUDED FUNDS

With respect to the Volcker Rule's application to foreign banking organizations ("FBOs"), the definition of "covered fund" does not include a fund organized outside the U.S. provided that the fund is not subject to the Investment Company Act or the Commodity Exchange Act. As a result, an FBO is permitted to acquire an ownership interest, or sponsor, a fund organized outside the United States, provided that the fund is not open to U.S. investors. Such funds are referred to as "foreign excluded funds."

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[29] *Id.* § 223.42(g).

[30] *Id.* § 223.42(l).

[31] Although Regulation W contains an exemption for riskless principal transactions, the exemption is limited to transactions involving a "securities affiliate." 12 C.F.R. § 223.42(m). The express inclusion of the riskless principal exemption in the Volcker Rule regulations is intended to allow reliance on the exemption even though the Related Covered Fund is not a "securities affiliate." In the Preamble to the 2020 Final Regulations, the Agencies make clear that other exemptions in Regulation W applicable to transactions with a "securities affiliate" would not be available to a banking entity's transactions with a Related Covered Fund.

[32] 12 C.F.R. § 223.42(l)(i)

[33] *See id.* § 223.42(l)(ii).

While such a sponsorship in or investment in a foreign excluded fund would not be prohibited by the Volcker Rule, if such FBO's investment in or relationship with the foreign excluded fund is sufficient to cause the foreign excluded fund to be deemed "controlled" by the FBO, the foreign excluded fund would be deemed an "affiliate" of the FBO, would be deemed a "banking entity" for Volcker Rule purposes, and thus itself would be obligated to conform its own activities and investments with the requirements of the Volcker Rule.

To limit the application of the Volcker Rule to foreign excluded funds, in 2017 the Agencies issued a policy statement that stated that the Agencies would take no enforcement action against a "qualifying foreign excluded fund" regarding its compliance with the Volcker Rule[34]; this policy statement was renewed in 2019. The 2017 (and 2019) policy statement defined a "qualifying foreign excluded fund" as an entity that:

(1) is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;

(2) 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;

(3) would not otherwise be a banking entity except by virtue of the FBO's acquisition or retention of an ownership interest in, or sponsorship of, the entity;

(4) is established and operated as part of a *bona fide* asset management business; and

(5) is not operated in a manner that enables the FBO to evade the requirements of the Volcker Rule or implementing regulations.

The Agencies are now making permanent the relief contained in the policy statement, with only minor revisions to the anti-evasion clause.[35] As a result, under the 2020 Final Regulations, qualifying foreign excluded funds are expressly exempted from the Volcker Rule's requirements. The exemption largely tracks the language of the 2017 policy statement, including the condition that the FBO's acquisition of an ownership interest or sponsorship in the qualifying foreign

[34] *See* Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 21, 2017), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf.

[35] In the 2020 Final Regulations, the anti-evasion clause was amended to provide that the qualifying foreign excluded fund must not be "operated in a manner that enables the banking entity *that sponsors or controls the qualifying foreign excluded fund, or any of its affiliates*, to evade the requirements of section 13 of the BHC Act or this part." This was done to clarify the applicability of the anti-evasion clause.

excluded fund must meet the requirements of the Volcker Rule regulations' "SOTUS" exemption for fund activities conducted solely outside the United States. The SOTUS exemption requires that:

- the decision to acquire or retain the ownership interest or act as sponsor to the foreign excluded fund is not made by a banking entity or its personnel located in the United States or organized under the laws of the United States or of any State; and
- the investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, in the foreign excluded fund, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate of the FBO that is located in the United States or organized under the laws of the United States or of any State.[36]

Thus, provided that the FBO's sponsorship of, or ownership interest in, the foreign excluded fund is made pursuant to the SOTUS provisions, and the foreign excluded fund otherwise complies with the requirements of the conditions in the 2020 Final Regulations, the foreign excluded fund is entirely exempted from the Volcker Rule's proprietary trading, covered fund, compliance program, and metrics reporting requirements, even if controlled by a FBO.[37]

MODIFICATIONS TO EXISTING COVERED FUND EXCLUSIONS

Foreign Public Fund Exclusion

The existing Volcker Rule regulations contain an exclusion from the "covered fund" definition for "foreign public funds" meeting certain requirements.[38] These include the requirement that the foreign public fund's ownership interests are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and sold "predominantly" through one or more public offerings outside of the United States.[39] For purposes of these requirements, the accompanying preamble stated that "predominantly" means that 85% or more of the ownership interests of the fund must be sold to retail investors outside the United States.

In the 2020 Proposal, the Agencies proposed to remove completely the requirement that the foreign public fund be sold to retail investors in its home jurisdiction. In addition, while retaining the requirement that the fund's ownership interests be sold through one or more public offerings, the Agencies would remove the "predominantly" requirement. Instead, in an effort to draw a parallel to U.S. registered investment companies, the Agencies proposed to add a requirement that "the distribution is subject to substantive disclosure and retail investor protection laws or regulations." Thus, while the fund must be subject to such disclosures and laws, no longer would the ownership

[36] *See* 12 C.F.R. § 248.13(b).

[37] A qualifying foreign excluded fund could be required to comply with other aspects of U.S. banking law, however. For example, because the qualifying foreign excluded fund would be an "affiliate" of the FBO, the ability of the qualifying foreign banking entity's investment in U.S. companies must conform to the restrictions of the Bank Holding Company Act.

[38] 12 C.F.R. § 248.10(c)(1).

[39] *See* 12 C.F.R. § 248.10(c)(1)(B), (C).

interests have to be sold "predominantly" to retail investors. The Foreign Public Fund Exclusion would be further modified to narrow the existing requirement that the distribution comply with "all applicable requirements in the jurisdiction in which distribution is being made." Instead, this requirement would apply only to the extent the banking entity serves as investment manager, investment adviser, commodity trading advisor, commodity pool operator, or sponsor of the foreign public fund. This proposed change was intended to prevent a Volcker Rule violation if a banking entity were to invest in a third-party foreign public fund and it is later determined that such third-party fund failed to comply with "all applicable requirements."

In the 2020 Final Regulations, the Agencies adopted these revisions as proposed, with only slight modifications. With respect to a foreign public fund sponsored by a U.S. banking entity, the existing Volcker Rule regulations (as well as the 2020 Proposal) provide that the foreign public fund's ownership interests must be sold "predominantly" to persons other than the banking entity, its affiliates, or the employees and directors of the banking entity and its affiliates. In the 2020 Final Regulations, the Agencies are effectively reducing the "predominantly" standard to 75% rather than 85% to align the requirements of the Foreign Public Funds Exclusion with the standards applicable to U.S. registered investment companies. As amended, this aspect of the Volcker Rule regulations now provides that:

> With respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor, the sponsoring banking entity may not rely on the exemption in paragraph (c)(1)(i) of this section for such issuer unless more than 75 percent of the ownership interests in the issuer are sold to persons other than:
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> (A) such sponsoring banking entity;
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> (B) such issuer;
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> (C) affiliates of such sponsoring banking entity or such issuer; and
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> (D) directors and senior executive officers as defined in § 225.71(c) of the Board's Regulation Y (12 CFR 225.71(c)) of such entities.

Public Welfare Fund Exclusion

The existing Volcker Rule regulations' Public Welfare Fund Exclusion[40] excludes from the "covered fund" definition a fund that conforms to the requirements of the public welfare investing authority set forth in the National Bank Act.[41] The reference to public welfare investing authority in the Volcker Rule regulations does not explicitly include investments made under banking agency regulations, including qualifying investments made pursuant to banking agency regulations

[40] 12 C.F.R. § 248.10(c)(11)(ii).

[41] 12 U.S.C. § 24 (Eleventh).

implementing the Community Reinvestment Act.[42] In the 2020 Final Regulations, the Agencies modified the Public Welfare Exclusion specifically to include "investments that qualify for consideration under the regulations implementing the Community Reinvestment Act," as well as investments in rural business investment companies and qualified opportunity funds.

SBIC Exclusion

The existing Volcker Rule regulations exclude from the "covered fund" definition any SBA-licensed Small Business Investment Company, provided that its license has not been revoked.[43] The Agencies are proposing to modify the SBIC Exclusion in order to clarify that an SBIC that has surrendered its license as part of the wind-down process would not lose its exclusion. As a result, the 2020 Proposal would have provided that the SBIC Exclusion would continue to apply to an entity that has voluntarily surrendered its SBIC license, provided that it "does not make any new investments (other than investments in cash equivalents, which, for the purposes of this paragraph, means high-quality, highly liquid investments whose maturity corresponds to the issuer's expected or potential need for funds and whose currency corresponds to the issuer's assets) after such voluntary surrender."

In the 2020 Final Regulations, the Agencies adopted these changes as proposed.

NEW COVERED FUND EXCLUSIONS

Credit Fund Exclusion

In the 2020 Final Regulations, the Agencies are adopting an exclusion from the "covered fund" definition with respect to certain "credit funds," as was originally proposed, with only minor modifications. A "credit fund" is defined as an issuer the assets of which consist solely of:

- loans;
- debt instruments;
- rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments (excluding commodity forward contracts); and
- certain interest rate and foreign exchange derivatives the terms of which relate to the loan and debt instruments and which reduce the interest rate or foreign exchange risk.[44]

A credit fund is barred from holding securities other than cash equivalents, securities received in lieu of a debt previously contracted, debt securities that are eligible to be held directly by the banking entity, and any equity securities (including warrants or options) "received on customary

[42] *See*, *e.g.*, 12 C.F.R. Part 25.

[43] 12 C.F.R. § 248.10(c)(11)(i).

[44] The requirements with respect to interest rate and foreign exchange derivatives largely parallel those in the existing Loan Securitization Exclusion.

terms with such loans or debt instruments" (such as an equity kicker).[45] In addition, in the 2020 Final Regulations, the Agencies made clear that the permission to hold "rights and other assets" does not separately authorize the credit fund to hold derivatives, such that any derivatives held by the credit fund must be limited to qualifying interest rate and foreign exchange derivatives. Moreover, the credit fund may not engage in proprietary trading (as defined in the Volcker Rule regulations[46]) as if it were a banking entity.

The Agencies retained the requirement that the credit fund not be an issuer of asset-backed securities. As a result, the Credit Fund Exclusion is unavailable to securitization issuers; instead, such issuers will have to rely on the Loan Securitization Exclusion instead.

A banking entity is permitted to invest in a credit fund without limit under the Volcker Rule (although such investment must comply with other restrictions applicable to the banking entity, such as the investment restrictions of the National Bank Act and the Bank Holding Company Act). If the banking entity sponsors or advises the credit fund, then the banking entity must provide to potential or actual investors the same disclosures as required in connection with banking entity sponsorship of covered funds under the Asset Management Exclusion.[47] In addition, the banking entity may sponsor the credit fund only if the banking entity "[e]nsures that the activities of the issuer are

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[45] In the 2020 Final Regulations, the Agencies added a requirement that any such debt or equity securities received on customary terms must also be of the type that "would be permissible for the banking entity to acquire and hold directly under applicable federal banking laws and regulations."

Although the Agencies declined to impose any quantitative limits on such debt and equity securities received on customary terms with loans or debt instruments, in the Preamble the Agencies cautioned that the Agencies "generally expect that the equity securities or rights satisfying those criteria in connection with an investment in loans or debt instruments of a borrower (or affiliated borrowers) would 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," and that "the [A]gencies expect that the fund's exposure to equity securities (or other rights), individually and collectively and when viewed over time, would be managed on a basis consistent with the fund's overall purpose." Preamble at p. 70.

[46] *See* 12 C.F.R. § 248.3.

[47] *See* 12 C.F.R. § 248.11(a)(8). The required disclosures are:

(A) that "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate";

(B) that such investor should read the fund offering documents before investing in the covered fund;

(C) that the "ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case); and

(D) the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund.

Id.

consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly."

If the banking entity acquires an ownership interest in, or sponsors, the credit fund, then the banking entity is barred from guaranteeing, assuming, or otherwise insuring the obligations or performance of the credit fund. In addition, if the banking entity sponsors the credit fund, the banking entity's transactions with (apart from its ownership interest in) the credit fund must comply with the Super 23A restrictions (discussed previously) as well as the restrictions in Section 15 of the Volcker Rule regulations,[48] and such transactions must be conducted in compliance with, and subject to, all applicable banking laws and regulations, including applicable safety and soundness standards.

Qualifying Venture Capital Fund Exclusion

Consistent with the 2020 Proposal, the Agencies are excluding from the "covered fund" definition an entity that meets the definition of a "venture capital fund" under SEC regulations,[49] provided that the entity does not engage in proprietary trading (as defined in the Volcker Rule regulations[50]) as if it were a banking entity. A banking entity is permitted to invest in a qualifying venture capital fund without limit under the Volcker Rule (although such investment must comply with other restrictions applicable to the banking entity, such as the investment restrictions of the National Bank Act and the Bank Holding Company Act).

As in the case of the proposed Credit Fund Exclusion, if the banking entity sponsors or advises the qualifying venture capital fund, the banking entity must provide to potential or actual investors the same disclosures as those required in connection with banking entity sponsorship of covered funds under the Asset Management Exclusion.[51] In addition, the banking entity may sponsor the qualifying venture capital fund only if the banking entity "[e]nsures that the activities of the issuer 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."

If the banking entity acquires an ownership interest in, or sponsors, the qualifying venture capital fund, the banking entity is barred from guaranteeing, assuming, or otherwise insuring the obligations or performance of the qualifying venture capital fund. In addition, the banking entity's transactions with (apart from its ownership interest in) the qualifying venture capital fund must comply with the Super 23A restrictions (discussed previously) as well as the restrictions in Section 15 of the

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[48] *See* 12 C.F.R. § 248.15. This provision prohibits transactions that involve high-risk activities, that would result in a material conflict of interest with customers, clients, or counterparties, or that pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

[49] 17 C.F.R. § 275.203(l)-1.

[50] *See* 12 C.F.R. § 248.3.

[51] *See* 12 C.F.R. § 248.11(a)(8). *See supra* note 47.

Volcker Rule regulations,[52] and must be conducted in compliance with all applicable banking laws and regulations, including safety and soundness standards.

The Agencies initially invited comment on a number of matters related to this exclusion, including whether the exclusion should be limited to venture capital funds that invest only in small or early-stage companies by imposing, for example, a revenue limitation on the companies in which the venture capital fund may invest. In addition, the Agencies requested comment on whether they should impose more stringent requirements regarding venture capital fund investment than imposed under existing SEC regulations by requiring that all (rather than 80%) of the fund's investment be in qualifying investments (as defined by SEC regulations). In the 2020 Final Regulations, none of these concepts were adopted by the Agencies.

Family Wealth Management Vehicle Exclusion

Consistent with the 2020 Proposal, the Agencies are creating a new exclusion from the "covered fund" definition for "family wealth management vehicles." A "family wealth management vehicle" is defined as "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 further, that:

- if the entity is a trust, the grantor(s) of the entity are all "family customers"[53]; and
- if the entity is *not* a trust, the entity is owned only by family customers and up to five "closely related persons"[54] of the family customers, and at least a majority of the voting interests, as well as a majority of the interests in the entity, are owned (directly or indirectly) by family customers.

A banking entity may sponsor a family wealth management vehicle only if the banking entity also "[p]rovides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the [family wealth management vehicle]." A 0.5% de minimis interest of the issuer's outstanding ownership interests may be held by the banking entity and its affiliates, or by any third party who is not a family customer or a closely related person, "if the ownership interest is acquired or retained by such parties for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns."

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[52] *See supra* note 48.

[53] For the purpose of the Family Wealth Management Vehicle Exclusion, a "family customer" is (i) a "family client" as defined in Rule 202(a)(11)(G)-1(d)(4) of the Investment Advisers Act of 1940, 17 C.F.R. § 275.202(a)(11)(G)-1(d)(4); and (ii) any natural person who is a father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law or daughter-in-law of a family client, or a spouse or a spousal equivalent of any of the foregoing.

[54] For the purpose of the Family Wealth Management Vehicle Exclusion, a "closely related person" is "a natural person (including the estate and estate planning vehicles of such person) who has longstanding business or personal relationships with any family customer."

As in the case of the proposed Credit Fund and Qualifying Venture Capital Fund Exclusions, under the Family Wealth Management Vehicle Exclusion the banking entity must provide to the investors the same disclosures as required in connection with banking entity sponsorship of covered funds under the Asset Management Exclusion, provided that, in the case of the Family Wealth Management Vehicle Exclusion, "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 entity."[55] The banking entity is barred from guaranteeing, assuming, or otherwise insuring the obligations or performance of the family wealth management vehicle.

Unlike the case of credit funds and qualifying venture capital funds, though, a banking entity's transactions with the family wealth management vehicle are not subject to the restrictions of Super 23A. Rather, a banking entity's transactions with a family wealth management vehicle are subject to the "arm's length" requirements of Super 23B,[56] although the banking entity generally is barred from purchasing a "low-quality asset" from the family wealth management vehicle except on a riskless principal basis.[57] In addition, a banking entity's transactions with a family wealth management vehicle must comply with the restrictions in Section 15 of the Volcker Rule regulations.[58]

Customer Facilitation Vehicle Exclusion

The Agencies adopted a new exclusion from the "covered fund" definition for "customer facilitation vehicles," largely as proposed in the 2020 Proposal. Under the 2020 Final Regulations, a "customer facilitation vehicle" is defined as "an issuer that is formed by or at the request of a customer of the banking entity for the purpose of providing such customer (which may include one or more affiliates of such customer) with exposure to a transaction, investment strategy, or other service provided by the banking entity."

A banking entity is permitted to sponsor a customer facilitation vehicle, but may not acquire an ownership interest in the customer facilitation vehicle other than possibly a de minimis portion. This de minimis portion is limited to 0.5% of the issuer's outstanding ownership interests, and can be held by the banking entity, or by a third party, provided that "the ownership interest is acquired or retained by such parties for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns." Otherwise, all of the ownership interests in the customer facilitation vehicle (apart from the de minimis portion) must be held by the customer (or its affiliates) for which it was created. The banking entity is barred from guaranteeing, assuming, or otherwise insuring the obligations or performance of the customer

[55] *See* 12 C.F.R. § 248.11(a)(8). *See supra* note 47.

[56] *See* 12 C.F.R. § 248.14(b).

[57] In this regard, the 2020 Final Regulations incorporate the low-quality asset restrictions found in the Federal Reserve's Regulation W. *See* 12 C.F.R. § 223.15(a).

[58] *See supra* note 48.

facilitation vehicle. The banking entity must "[m]aintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction, investment strategy, or service."

As in the case of the proposed Credit Fund, Qualifying Venture Capital Fund, and Family Wealth Management Vehicle Exclusions, under the Customer Facilitation Vehicle Exclusion the banking entity must provide to the customer the same disclosures as required in connection with banking entity sponsorship of covered funds under the Asset Management Exclusion,[59] although in the case of the Customer Facilitation Vehicle Exclusion, the disclosures 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."

As in the case of a family wealth management vehicle, a banking entity's transactions with the customer facilitation vehicle are not subject to the restrictions of Super 23A but instead are subject to the "arm's length" requirements of Super 23B,[60] although the banking entity is barred from purchasing a "low-quality asset" from the customer facilitation vehicle unless conducted on a riskless principal basis.[61] In addition, a banking entity's transactions with a customer facilitation vehicle must comply with the restrictions in Section 15 of the Volcker Rule regulations.[62]

DE MINIMIS LIMITS

Employee and Director Investments

A banking entity's ownership interest in Related Covered Funds is subject to certain *de minimis* limits and capital deduction requirements. Moreover, employees and directors are not permitted to acquire an ownership interest in certain Related Covered Funds unless the employee or director is providing services to the Related Covered Fund. For purposes of calculating those limits, the existing Volcker Rule regulations generally do not include ownership interests held by any banking entity employee or director unless the purchase of the ownership interest was financed by the banking entity (or its affiliates). However, the Volcker Rule regulations applicable to "restricted profit interests" attribute *all* ownership interests held by employees or directors to the banking entity, regardless whether financed.[63] To simplify the calculation of the *de minimis* limits and capital deductions, in the 2020 Proposal the Agencies proposed to make this aspect of the Volcker

[59] *See* 12 C.F.R. § 248.11(a)(8). *See supra* note 46. The Agencies recognize that traditional offering documents typically are not prepared or distributed in connection with family wealth management vehicles. As a result, the Agencies are proposing to allow the required written disclosures to appear in the governing documents, the account opening materials, or the supplementary materials.

[60] *See* 12 C.F.R. § 248.14(b).

[61] *See supra* note 57.

[62] *See supra* note 48.

[63] This provision relates to whether "restricted profit interests" held by banking entity employees or directors with respect to Related Covered Funds should be attributed to the banking entity.

Rule regulations uniform, such that all employee or director "ownership interests" are attributable to the banking entity – and thus includable in the *de minimis* limits and capital deduction calculations – only if financed by the banking entity. In the 2020 Final Regulations, the Agencies adopted this revision as proposed.

Banking Entity Parallel Investments
As noted above, a banking entity's ownership interest in a Related Covered Fund is subject to certain *de minimis* limits and capital deduction requirements. The existing Volcker Rule regulations do not specifically address the treatment of "parallel investments" in which the banking entity invests directly in the same portfolio companies as does the Related Covered Fund. However, the preamble accompanying the issuance of the final regulations in 2013 stated that such parallel investments could be construed as an evasion of the Volcker Rule. In the 2020 Proposal, the Agencies proposed to amend the Volcker Rule regulations to provide that such parallel investments are not includable in the *de minimis* limits and capital deduction calculations, provided that "the investment is made in compliance with applicable laws and regulations, including safety and soundness standards." The Agencies adopted this change as proposed.

Employee and Director Parallel Investments
As discussed previously, an employee's or director's investment in a Related Covered Fund is attributable to the banking entity only if financed by the banking entity (or its affiliates). The 2020 Proposal provided that an employee's or director's parallel investments alongside the Related Covered Fund in portfolio companies are not attributable to the banking entity for purposes of the *de minimis* limits and capital deduction requirements, even if financed by the banking entity. This change was adopted as proposed.

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