Volcker 3.0: The Agencies Propose Relief for Securitizations and Foreign Funds and New Exemptions from the Volcker Rule's Covered Fund Restrictions

February 5, 2020

On January 30, 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 proposed regulations (the "Proposed Regulations") revamping the regulations implementing the Volcker Rule, a centerpiece of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The issuance of the Proposed 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. The new Proposed 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 new Proposed Regulations and last year's Volcker Rule regulation amendments are the result of a proposal rulemaking and invitation for public comment issued by the Agencies in 2018 (the "2018 Proposal"). Both the new Proposed Regulations and last year's amendments come more than six years after the original Volcker Rule regulations were adopted in 2013.

The Proposed Regulations address changes to the covered fund and foreign fund aspects of the Volcker Rule for which comment was sought in the 2018 Proposal. In particular, the proposed changes, if adopted, would allow a small non-loan bucket for securitizations relying on the "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 proposed changes also would clarify the treatment of the Volcker Rule to funds controlled by banking organizations

[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.

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").

The Agencies have requested public comment on the Proposed Regulations, with the comment period scheduled to close on April 1, 2020. The Agencies are inviting comment on all aspects of the Proposed Regulations, but certain of the requests are of particular interest and are mentioned in this Memorandum.

The most significant aspects of the Proposed 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.[2] 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.[3] The Proposed Regulations would make a number of changes relevant to securitizations relying on this Loan Securitization Exclusion.

Non-Loan 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.[4]

The Proposed Regulations would permit the issuer relying on this exclusion to have a small amount of other "non-loan assets" not exceeding 5% of the issuer's total assets. These non-loan assets could include (but would not be limited to) securities. As a result, issuers relying on the Loan Securitization Exclusion (in particular, CLOs) would be permitted to resume including a "bond bucket" – a common practice for CLOs prior to the implementation of the Volcker Rule.

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[2] 12 C.F.R. § 248.10(c).

[3] *Id.* § 248.10(c)(8).

[4] 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(s), (y). 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.

In the Proposed Regulations, the Agencies have specifically sought public comment on the size of the bucket, or whether there should be eligibility criteria for the assets that may be included (such as credit quality or type). The Agencies also request comment on how the size of the bucket and the value of assets in the bucket should be calculated.

Presumption for Senior Loans and Senior Notes

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."[5]

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."[6] 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").[7] 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 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 Proposed Regulations would address this issue by creating a safe harbor for "senior loans" and "senior debt interests." The safe harbor would provide that a "senior loan" or a "senior debt interest" would not be considered an "ownership interest" if the "senior loan" or "senior debt interest" satisfies the following conditions:

[5] See 12 C.F.R. § 248.10(d)(6).
[6] *Id.* § 248.10(d)(6)(i).
[7] *Id.* § 248.10(d)(6)(i)(A).

(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) fixed principal payments on or before a maturity date (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 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).[8]

The above three conditions comprise three of the seven "other similar interest" criteria. In effect, the proposed safe harbor means that "senior loans" and "senior debt interests" are subject to only 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 no longer would be relevant in determining whether the instrument is an "ownership interest," enabling 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."[9]

The Proposed Regulations do not define the terms "senior loan" or "senior debt interest," and it is unclear whether the terms are limited to the senior-most class of notes or loans, or whether the terms include other, less senior loans or notes – for example, including all investment grade debt interests, even if not the most senior.

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[8] These three criteria track 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).

[9] It should be noted that while the proposed 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.

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."[10] The Agencies are proposing to expand this exception to include "the right to participate in the removal of an investment manager for cause or to nominate or to vote on a nominated replacement manager upon the investment manager's resignation or removal."[11]

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,"[12] and in June 2014 the Agencies issued a FAQ incorporated 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."[13]

The Agencies are now proposing to 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."[14]

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.[15] 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

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[10] 12 C.F.R. § 248.10(d)(6)(i)(A).

[11] The explanatory language accompanying the Proposed Regulations suggests that such events must constitute "defaults" under the relevant securitization documents, but the Agencies also invite comment whether other events that may not constitute express "defaults" under the documents, such as the investment manager's insolvency or loss of a key employee, should be included as well. Note also that, while this proposed modification to the "ownership interest" concept is particularly relevant to securitizations, it would apply to interest in other forms of covered funds.

[12] 79 Fed. Reg. 5536, 5690 (Jan. 31, 2014).

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

[14] The proposed definition would be "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)."

[15] 12 C.F.R. § 248.10(c)(8)(i)(B).

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.[16] The Proposed Regulations would 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[17] "and thus [leases] are permitted assets for loan securitizations under the current exclusion." The Agencies' response suggests 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.

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 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").[18] 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,[19] as if the banking entity (or its affiliate) were a "member bank" and the covered fund were an "affiliate."[20] 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."[21]

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[16] Volcker Rule FAQ #4, *supra* note 13.

[17] *See* 12 C.F.R. § 248.2(t).

[18] 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).

[19] 12 U.S.C. § 371c.

[20] *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.

[21] 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.

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.[22]

In the Proposed Regulations, the Agencies are now proposing 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. As a result, permissible transactions between a banking entity and its Related Covered Fund would include:

- 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;[23]
- purchases by the banking entity of liquid assets having a readily identifiable and publicly market quotation;[24] and
- intra-day extensions of credit by the banking entity.[25]

The Agencies are also proposing to 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. Such purchase or extensions of credit would be 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[26]; 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."[27]

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[22] 12 C.F.R. Part 223.
[23] *Id.* § 223.42(c).
[24] *Id.* § 223.42(g).
[25] *Id.* § 223.42(l).
[26] *See id.* § 223.42(l)(i)
[27] *See id.* § 223.42(l)(ii).

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."

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 sponsorship of 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[28]; 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.

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[28] *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.

The Agencies are now proposing to make permanent the relief contained in the policy statement. As proposed, qualifying foreign excluded funds would become expressly exempted from the Volcker Rule's proprietary trading and covered fund restrictions. The proposed exemption would largely track 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 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.[29]

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 2017 policy statement, the foreign excluded fund would be entirely exempted from the Volcker Rule's proprietary trading and covered fund restrictions, even if controlled by a FBO.[30]

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.[31] 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.[32] 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.

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[29] *See* 12 C.F.R. § 248.13(b).

[30] The qualifying foreign excluded fund presumably would 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.

[31] 12 C.F.R. 248.10(c)(1).

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

The Agencies are proposing 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 ownerships be sold through one or more public offerings, the Agencies would remove the "predominantly" requirement. Instead, in effort to draw a parallel to U.S. registered investment companies, the Agencies are proposing 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 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 adviser, commodity pool operator, or sponsor of the foreign public fund. This proposed change is 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 the third-party fund failed to comply with "all applicable requirements."

With respect to foreign public funds sponsored by U.S. banking entities, the existing Volcker Rule regulations 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. Due to the difficulty of tracking investments made by rank-and-file employees, the Agencies are proposing to replace the reference to "employees" with "senior executive officers" as such term is defined in the Federal Reserve's Regulation Y.[33]

Public Welfare Fund Exclusion

The existing Volcker Rule regulations' Public Welfare Fund Exclusion[34] 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.[35] 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 implementing the Community Reinvestment Act.[36] The Agencies are not proposing any changes to the Public Welfare Fund Exclusion at this time, but are requesting public comment as to whether changes are required to clarify this issue, including whether to specifically reference investing authority under related banking agency regulations.

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[33] *See* 12 C.F.R. § 225.71(c).
[34] 12 C.F.R. § 248.10(c)(11)(ii).
[35] 12 U.S.C. § 24 (Eleventh).
[36] *See*, *e.g.*, 12 C.F.R. Part 25.

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.[37] 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 Proposed Regulations would provide 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."

NEW COVERED FUND EXCLUSIONS

Credit Fund Exclusion

The Agencies are proposing to exclude from the "covered fund" definition an entity that is a "credit fund" as defined in the Proposed Regulations. A "credit fund" would be defined as an issuer the assets of which consist solely of:

- loans;
- debt instruments;
- related 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.[38]

A credit fund would be 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 terms with such loans or debt instruments" (such as an equity kicker). As proposed, the Agencies also would require that the credit fund not be an issuer of asset-backed securities, although the Agencies have requested comment on whether this requirement is necessary. In addition, the credit fund could not engage in proprietary trading (as defined in the Volcker Rule regulations[39]) as if it were a banking entity.

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[37] 12 C.F.R. § 248.10(c)(11)(i).

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

[39] *See* 12 C.F.R. § 248.3.

A banking entity would be 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.[40] In addition, the banking entity may sponsor the credit 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 credit fund, then the banking entity is barred from guaranteeing, assuming, or otherwise insuring the obligations or performance of the credit fund. In addition, 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,[41] and such transactions must be conducted in compliance with all applicable banking laws and regulations, including safety and soundness standards.

Qualifying Venture Capital Fund Exclusion

The Agencies are proposing to exclude from the "covered fund" definition an entity that meets the definition of a "venture capital fund" under SEC regulations,[42] provided that the entity does not

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[40] *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.

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

[42] 17 C.F.R. § 275.203(l)-1.

engage in proprietary trading (as defined in the Volcker Rule regulations[43]) as if it were a banking entity.

A banking entity would be 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 required in connection with banking entity sponsorship of covered funds under the Asset Management Exclusion.[44] 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 Volcker Rule regulations,[45] and must be conducted in compliance with all applicable banking laws and regulations, including safety and soundness standards.

The Agencies are inviting comment on a number of matters related to this exclusion, including whether the exclusion should be limited to venture capital funds that 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 are requesting 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).

Family Wealth Management Vehicle Exclusion

The Agencies are proposing to create a new exclusion from the "covered fund" definition for "family wealth management vehicles." Under the Proposed Regulations, a "family wealth management vehicle" would be defined as "any entity that is not, and does not hold itself out as being, an entity

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[43] *See* 12 C.F.R. § 248.3.

[44] *See* 12 C.F.R. § 248.11(a)(8). *See supra* note 40.

[45] *See supra* note 41.

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"[46]; and
- if the entity is *not* a trust, the entity is owned only by family customers and up to three "closely related persons"[47] of the family customers, and at least a majority of the voting interests in the entity are owned (directly or indirectly) by family customers.

A banking entity would be permitted to 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]." The banking entity would not be permitted to acquire, as principal, any ownership interest in the family wealth management vehicle "other than up to 0.5% of the issuer's outstanding ownership interests that may be held by the banking entity and its affiliates for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns."

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.[48] The banking entity would be 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 would not be subject to the restrictions of Super 23A. Rather, a banking entity's transactions with a family wealth management vehicle would be subject to the "arm's length" requirements of Super 23B,[49] and the banking entity generally would be barred from purchasing a "low-quality asset" from the family wealth management

[46] For purpose of the proposed Family Wealth Management Vehicle Exclusion, a "family customer" would be (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.

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

[48] *See* 12 C.F.R. § 248.11(a)(8). *See supra* note 40.

[49] *See* 12 C.F.R. § 248.14(b).

vehicle.[50] In addition, a banking entity's transactions with a family wealth management vehicle would be required to comply with the restrictions in Section 15 of the Volcker Rule regulations.[51]

Customer Facilitation Vehicle Exclusion

The Agencies have proposed to create a new exclusion from the "covered fund" definition for "customer facilitation vehicles." Under the Proposed Regulations, a "customer facilitation vehicle" would be 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 would be permitted to sponsor a customer facilitation vehicle, but would not be permitted to acquire an ownership interest in the customer facilitation vehicle "other than up to 0.5% of the issuer's outstanding ownership interests that may be held by the banking entity and its affiliates for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns." Rather, all of the ownership interests in the customer facilitation vehicle (apart from the 0.5%) must be held by the customer (or its affiliates) for which it was created. 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.[52] The banking entity would be barred from guaranteeing, assuming, or otherwise insuring the obligations or performance of the customer facilitation vehicle.

As in the case of a family wealth management vehicle, a banking entity's transactions with the customer facilitation vehicle would not be subject to the restrictions of Super 23A but instead would be subject to the "arm's length" requirements of Super 23B,[53] and the banking entity generally would be barred from purchasing a "low-quality asset" from the customer facilitation

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

[51] *See supra* note 41.

[52] *See* 12 C.F.R. § 248.11(a)(8). *See supra* note 40. 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.

[53] *See* 12 C.F.R. § 248.14(b).

vehicle.[54] In addition, a banking entity's transactions with a customer facilitation vehicle would be required to comply with the restrictions in Section 15 of the Volcker Rule regulations.[55]

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.[56] To simplify the calculation of the *de minimis* limits and capital deductions, the Agencies are proposing to make this aspect of the Volcker Rule regulations uniform, such that all employee or director "ownership interests" are attributable to the banking and entity – and thus includable in the *de minimis* limits and capital deduction calculations – only if financed by the banking entity.

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. The Agencies are proposing 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."

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 Proposed Regulations would provide that an employee's or director's parallel investments alongside the Related Covered Fund in portfolio companies are not attributable to the banking

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[54] *See supra* note 50.

[55] *See supra* note 41.

[56] 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.

entity for purposes of the *de minimis* limits and capital deduction requirements, even if financed by the banking entity.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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