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Revised Volcker Rule Broadens Exclusions to Covered Funds

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The Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Securities and Exchange Commission (collectively, the "Agencies") finalized a rule modifying the regulations implementing the so-called "Volcker Rule" provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Revised Volcker Rule"). Among the most notable amendments to the Volcker Rule are the following:

- Adding new exclusions from the definition of "covered fund" for credit funds, venture capital funds, family wealth management vehicles, and customer facilitation vehicles (subject to certain conditions and limitations);
- Modifying conditions to qualify for the existing exclusions from the term "covered fund" for foreign public funds, loan securitizations, public welfare investment funds, and small business investment companies;
- Permitting certain low-risk transactions (including short-term extensions of credit and acquisitions of assets in connection with payment, clearing, and settlement services) between a banking entity, on the one hand, and a covered fund for which the banking entity serves as investment adviser or sponsor, on the other hand; and
- Granting banking entities more flexibility to make investments alongside a covered fund.

The Revised Volcker Rule is generally consistent with the proposed rule from January 2020 and becomes effective October 1, 2020.

Exclusions from Covered Funds

The Revised Volcker Rule adds several new exclusions from the term "covered fund" that will permit banking entities to invest in and sponsor several types of funds that the Agencies determined do not raise the concerns that the Volcker Rule was intended to address. These exclusions are for credit funds, venture capital funds, family wealth management vehicles, and customer facilitation vehicles.

- ***Credit Funds.*** Funds 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 (including certain equity securities and warrants), and certain interest rate or foreign exchange derivatives.

- There is no quantitative limit on the amount of equity securities (or rights to acquire equity securities) that may be held by a credit fund.
- Such equity securities or rights are limited by the requirements that they be (a) received on customary terms in connection with the credit fund's loans or debt instruments and (b) related or incidental to acquiring, holding, servicing, or selling those loans or debt instruments.
- Qualifying credit funds may not engage in prohibited proprietary trading, issue asset-backed securities, or engage in any transactions with a sponsoring or advising banking entity that would be prohibited under the so-called Super 23A transactions with affiliates provisions of the Volcker Rule.
- A banking entity may not rely on the credit fund exclusion if:
  - It guarantees the performance of the credit fund; or
  - The fund holds any debt instruments or equities (or rights to acquire an equity security) received on customary terms in connection with loans or debt instruments held by the credit fund that the banking entity is not permitted to acquire and hold directly under applicable federal banking laws and regulations.

- ***Venture Capital Funds*.** Funds that meet the definition of a "venture capital fund" under the SEC's regulations promulgated under the Investment Advisers Act of 1940 and that do not engage in any activity that would constitute proprietary trading.
  - With respect to any banking entity that acts as sponsor, investment adviser, or commodity trading advisor to the venture capital fund, and that relies on the exclusion to sponsor or acquire an ownership interest in the venture capital fund, the banking entity will be required to:
    - Provide prospective and actual investors the disclosures required under the asset management exemption;
    - Ensure that the activities of the venture capital fund are consistent with the safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly; and
    - Comply with the so-called Super 23A transactions with affiliates provisions of the Volcker Rule with respect to the venture capital fund.
  - A banking entity that relies on the exclusion may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the venture capital fund.
- ***Family Wealth Management Vehicles*.** Trusts the grantors of which are all family customers and certain non-trust entities that are owned by family customers and up to five (increased from three in the proposed rule) "closely related persons" of the family customers (e.g., estate

planning vehicles and persons with a long-standing business or personal relationship with the family customers) will no longer be deemed to be a covered fund.

- ***Custom Facilitation Vehicles.*** Fund vehicles formed by, or at the request of, a banking entity's customer in order to provide the customer exposure to a transaction, investment strategy, or other service provided by the banking entity, so long as the vehicle is wholly owned by the customer and its affiliates (other than a de minimis amount—up to 0.5%—that may be held by the banking entity) will no longer be deemed to be a covered fund.

Simplifies Existing Covered Fund Exclusions

The Revised Volcker Rule also simplifies the eligibility criteria for certain exclusions from the definition of "covered fund."

Foreign Public Funds

The Revised Volcker Rule excludes foreign public funds from the definition of "covered fund," subject to certain eligibility requirements in order to provide similar treatment between U.S. registered investment companies, which are not treated as covered funds, and their foreign equivalents.

Under the Volcker Rule, a foreign public fund is defined as any investment fund that is organized outside of the U.S. and the ownership interests of which are (1) authorized to be sold to retail investors in the fund's home jurisdiction and (2) sold predominantly through one or more public offerings outside of the United States. Additionally, for a U.S. banking entity that sponsors a foreign public fund, the fund's ownership interests must be sold predominantly to persons other than the banking entity and certain associated parties.

To address consistency and compliance concerns and better align the treatment of foreign public funds with that of U.S. registered investment companies, the Revised Volcker Rule eliminates the home jurisdiction requirement and replaces the requirement that a fund be sold predominantly through public offerings with a requirement that a fund be offered and sold through at least one public offering. To help ensure that these funds are sufficiently similar to U.S. registered investment companies, the Revised Volcker Rule also modifies the definition of "public offering" to require that the distribution be subject to substantive disclosure and retail investor protection laws or regulations in the jurisdiction where it is made. Additionally, the Revised Volcker Rule aligns the permitted ownership threshold for U.S. banking entity sponsors of foreign public funds with the functionally equivalent threshold for banking entity investments in U.S. registered investment companies, or 24.9%.

Loan Securitizations

- The Volcker Rule has long excluded loan securitizations from the definition of covered fund, provided such issuers meet various eligibility criteria, such as issuing asset-backed securities and only holding loans and certain other permitted assets. The Revised Volcker Rule augments the existing exclusion to:
  - Permit up to 5% of the total assets of a qualifying loan securitization vehicle to also consist of debt securities (excluding convertible debt securities and asset-backed securities).
  - Clarify that the limit on non-convertible debt securities must be calculated at the time of acquisition of such assets and the measurement must be based only on the value of the

loans and debt securities held under and the cash and cash equivalents held by the fund rather than the aggregate value of all of the issuing entity's assets.

- Clarify that a loan securitization vehicle may hold servicing assets that are not securities (e.g., mortgage insurance policies supporting the mortgages in a loan securitization) through the codification of the Loan Securitization Servicing FAQ (FAQ #4).

Small Business Investment Companies

The Volcker Rule currently excludes from the definition of "covered fund" small business investment companies ("SBICs"), as long as the SBIC's license has not been revoked. The Revised Volcker Rule clarifies that a SBIC could remain eligible for the exclusion from the covered fund provisions during a wind-down period, provided that the fund makes no new investments, other than investments in cash equivalents, after surrendering its SBIC license.

Public Welfare Funds

The Revised Volcker Rule amends the exclusion from the "covered fund" definition for public welfare investments to clarify that the exclusion also includes investments that qualify for consideration under the regulations implementing the Community Reinvestment Act. The Revised Volcker Rule also excludes rural business investment companies and qualified opportunity funds from the covered fund definition.

Limits Extraterritorial Impact on "Qualifying Foreign Excluded Funds"

Although certain foreign funds organized and offered by a foreign banking entity outside of the U.S. are excluded from the definition of "covered fund," such foreign funds may still be considered "banking entities" if they are, among others, controlled by their foreign banking entity sponsor. As a banking entity, such foreign funds would be subject to the proprietary trading and other restrictions of the Volcker Rule. Since 2017, the Agencies have recognized this unintended result and through regulatory guidance have forborne from taking enforcement action against foreign banking entities based on the activities and investments of foreign funds that meet certain conditions ("qualifying foreign excluded funds"), while they sought a legislative fix to this challenge. Given the lack of Congressional action, the Revised Volcker Rule addresses the unintentional application of the Volcker Rule to qualifying foreign excluded funds by exempting their activities from the Volcker Rule's restrictions. The Revised Volcker Rule defines a qualifying foreign excluded fund using the same eligibility criteria set forth in the policy statements, which include that the fund:

- Is organized or established outside the U.S. and its ownership interests are offered and sold solely outside the U.S.;
- Would be a covered fund were the entity organized or established in the U.S., or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;
- Would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the entity;

- Is established and operated as part of a bona fide asset management business; and
- Is not operated in a manner that enables the foreign banking entity to evade the requirements of the Volcker Rule.

The Revised Volcker Rule also makes clear that qualifying foreign excluded funds are not subject to the Volcker Rule compliance program requirements applicable to banking entities.

Permits Limited, Low-Risk Transactions with Covered Funds

The Revised Volcker Rule allows a banking entity to enter into covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under Section 23A of the Federal Reserve Act. The Revised Volcker Rule also allows banking entities to provide short-term extensions of credit to, and purchase assets from, a related covered fund, subject to appropriate limits. Under the Revised Volcker Rule, each short-term extension of credit or purchase of assets must be made in the ordinary course of business in connection with payment transactions, securities, derivatives or futures clearing, or settlement services. Each extension of credit must be required to be repaid, sold, or terminated no later than five business days after it was originated. Finally, the Revised Volcker Rule permits a banking entity to enter into riskless principal transactions with a related covered fund, regardless of whether that covered fund is a "securities affiliate" as defined in Regulation W.

Clarifies the Definition of "Ownership Interest"

Under the Volcker Rule, a banking entity that organizes and offers a covered fund is subject to investment limits and capital deductions with respect to its "ownership interests" in covered funds. The Volcker Rule defines "ownership interest" to include any equity, partnership, or other "similar interest" which is defined by reference to a list of characteristics, including the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of a covered fund.

The Revised Volcker Rule amends the list of characteristics to clarify that a loan or debt interest with certain traditional creditor rights would not be deemed to be an "ownership interest," and provides an express safe harbor for senior loans and senior debt. The Revised Volcker Rule also clarifies the limited types of creditor rights that would be considered within the scope of the definition of "ownership interests."

Clarifies Ambiguity for Parallel and Co-Investments

The Revised Volcker Rule clarifies that a banking entity need not include its investments made alongside a covered fund in the covered fund limits to the extent that the investment is made in compliance with applicable laws and safety and soundness standards. Subject to several conditions, banking entities would not be required to treat direct investments alongside covered funds as an investment in a covered fund, so long as the banking entity has independent authority to make such investments. In addition, the agencies would expect that direct investments by directors and employees alongside covered funds would not be required to be counted as investments in covered funds or be subject to the condition that such persons provide services to the relevant fund. As a result, these investments would be not be attributed to the banking entity, even if the banking entity arranged or provided financing for the transaction.

Paul Hastings attorneys are actively working with clients to identify and address issues and risks related to implementation of the Volcker Rule, as amended. We are available to advise you with respect to these matters and the impact of the revised rule on your banking entity's activities.

If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings lawyers:

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