BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date:	June 16, 2020
To:	Board of Governors
From:	Staff[1]
Subject:	Final Rule Amending the Covered Fund Provisions of the Board's Volcker Rule Regulations

ACTION REQUESTED

Staff seeks approval of the attached draft final rule and *Federal Register* notice that would amend the regulations implementing section 13 of the Bank Holding Company Act—commonly known as the Volcker Rule—relating to hedge fund and private equity fund, known as covered fund, restrictions.[2] The draft final rule would be issued jointly by the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission once the agencies have completed their approval processes. Staff also requests authority to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register*.

EXECUTIVE SUMMARY

- In February 2020, the agencies issued a proposal to revise the covered fund provisions of the regulations implementing the Volcker Rule. The proposed revisions were intended to:
    - Clarify and simplify compliance;
    - Reduce the extraterritorial application of the requirements; and
    - Permit additional fund activities that do not present the risks that the Volcker Rule was intended to address.

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[2] Section 13 of the Bank Holding Company Act (BHC Act) (12 U.S.C. § 1851).

- The draft final rule is generally similar to the proposal, with certain targeted adjustments. Specifically, the draft final rule would, among other things:
    - Limit the extraterritorial impact of the rule on foreign funds offered by foreign banks to foreign individuals;
    - Permit certain low-risk transactions (including intraday credit and payment, clearing, and settlement transactions) between a banking entity and covered funds for which the banking entity serves as investment advisor or sponsor;
    - Simplify existing provisions of the rule related to foreign public funds, loan securitizations, small business investment companies, and public welfare investments;
    - Permit banking entities to invest in or sponsor certain types of funds that do not raise the concerns the Volcker Rule was intended to address, such as credit funds, venture capital funds, customer facilitation funds, and family wealth management vehicles;
    - Clarify that credit exposures to a covered fund would generally not constitute fund ownership interests under the Volcker Rule; and
    - Clarify the treatment of parallel investments made by a banking entity in the same underlying investments as a sponsored covered fund.
- The final rule would be effective on October 1, 2020.
- Following completion of voting on this matter, the memorandum to the Board, final rule, and *Federal Register* notice will be posted to the Board's public website.

DISCUSSION

The Volcker Rule prohibits any banking entity from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a covered fund, subject to certain exemptions. The Volcker Rule defines a covered fund as an issuer that would be an investment company as defined in the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the agencies by rule determine.

The regulations implementing the Volcker Rule define covered fund by incorporating the statutory definition as well as providing certain additions (e.g., commodity pools that are not publicly offered) and exclusions (e.g., foreign public funds). The proposal included a number of changes intended to improve, streamline, and clarify the covered fund provisions of the regulation. The draft final rule would finalize the changes contemplated in the proposal, with certain targeted adjustments. The draft final rule would continue to restrict relationships between banking entities and covered funds, in accordance with the statute, but would provide more clarity and certainty for firms.

A. Limit Extraterritorial Impact on Foreign Excluded Funds

While certain foreign funds that are organized and offered by a foreign banking entity outside of the United States are excluded from the definition of "covered fund," these foreign funds could become subject to the proprietary trading and other restrictions of the Volcker Rule because they are affiliated with the foreign banking entity.[3] Staff believes that this extraterritorial impact was not intended by Congress and imposes unnecessary burden on such foreign banking entities and funds.

To temporarily address these issues, the federal banking agencies announced in 2017[4] that they would not take enforcement action against foreign banking entities based on the activities and investments of foreign funds that meet certain criteria (qualifying foreign excluded funds).[5]

The draft final rule, like the proposal, would address these issues by exempting the activities of qualifying foreign excluded funds[6] from the Volcker Rule's restrictions. Staff believes that it is appropriate for the agencies to exercise their statutory rulemaking authority to

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[3] The current rule excludes covered funds from the definition of "banking entity" and, therefore, from the proprietary trading restrictions of the Volcker Rule. 12 CFR 248.2(c)(2)(i). However, because these foreign funds are not covered funds, they can become banking entities through affiliation with their foreign banking entity sponsor.

[4] *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; Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 17, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190717a1.pdf.

[5] The conditions are that the fund: (1) is organized or established outside the United States and its ownership interests 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 foreign banking entity'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 foreign banking entity to evade the requirements of section 13 or implementing regulations. *See supra* note 4.

[6] The draft final rule would define a qualifying foreign excluded fund using the same eligibility criteria set forth in the policy statements.

provide relief for qualifying foreign excluded funds. As the Volcker Rule specifically permits foreign banking entities to conduct certain trading and investment activities outside of the United States,[7] providing relief from the unintentional application of these restrictions would further limit the extraterritorial impact of the Volcker Rule on foreign asset management activities with little direct nexus to the U.S. financial system.

Further, as described in the preamble to the draft final rule, staff believes exempting qualifying foreign excluded funds from the restrictions of the Volcker Rule would promote the safety and soundness of foreign banking entities by permitting such entities to conduct their foreign asset management activities in accordance with the same laws and regulations applicable to their non-U.S. competitors, thus reducing competitive inequality. Because qualifying foreign excluded funds are permitted to invest in U.S. companies, staff also believes that this exemption would promote U.S. financial stability by facilitating the provision of capital and liquidity to U.S. financial markets from diverse sources.

B. Permit Limited, Low-Risk Transactions with Related Covered Funds

A banking entity that serves as an investment advisor or sponsor to a covered fund (related covered fund) is generally prohibited from entering into a transaction with the related covered fund of a type that would be covered by section 23A of the Federal Reserve Act, referred to as Super 23A.[8]

To facilitate the ability of banking entities to organize and offer covered funds, as expressly permitted by the Volcker Rule,[9] the draft final rule, like the proposal, would allow a banking entity to enter into low-risk transactions with a related covered fund that would be permissible without limit under section 23A of the Federal Reserve Act.[10] This would include, for example, intraday extensions of credit and extensions of credit fully secured by U.S. Treasury securities. Also like the proposal, the draft final rule would allow a banking entity to engage in certain transactions with a related covered fund in connection with payment, clearing, and

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[7] *See, e.g.*, sections 13(d)(1)(H) and (I) of the BHC Act (12 U.S.C. § 1851(d)(1)(H), (I)).

[8] 12 U.S.C. § 1851(f)(1). The term "covered transaction" is defined in section 23A and includes, among other things, extensions of credit, asset purchases, and guarantees. *See* 12 U.S.C. § 371c.

[9] Section 13(d)(1)(G) of the BHC Act (12 U.S.C. § 1851(d)(1)(G)).

[10] *See* 12 U.S.C. § 371c.

settlement activities. Additionally, in response to comments received on the proposal, the draft final rule would clarify that a banking entity is permitted to enter into riskless principal transactions with a related covered fund.

Allowing these types of transactions would give banking entities greater flexibility to provide custody and other traditional financial services to a related covered fund, rather than requiring such services to be provided by an unaffiliated service provider. Staff believes that it also would reduce operational risks associated with the use of unaffiliated service providers and, therefore, reduce interconnectedness among financial institutions in the U.S. financial system.

C. Simplify Existing Covered Fund Exclusions

The draft final rule would simplify the eligibility criteria for certain exclusions from the definition of "covered fund," making it easier for banking entities to use and confirm compliance with such exclusions.

1. Foreign Public Funds

In order to provide similar treatment between U.S. registered investment companies, which are not covered funds, and their foreign equivalents, the current rule excludes foreign public funds from the definition of "covered fund," subject to certain eligibility requirements.

Under the current rule, a foreign public fund is defined as any investment fund that is organized outside of the United States 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.[11] 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.[12]

To address consistency and compliance concerns and better align the treatment of foreign public funds with that of U.S. registered investment companies, the draft final rule, like the

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[11] The agencies stated in the preamble to the regulations implementing the Volcker Rule in 2013 that they generally would consider an offering to be made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States. 79 FR 5678.

[12] The agencies stated in the preamble to the regulations implementing the Volcker Rule in 2013 that they generally would consider this requirement to be met if 85 percent or more of the fund's ownership interests are sold to investors other than the banking entity and associated parties. *Id.*

proposal, would eliminate the home jurisdiction requirement and replace 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 draft final rule also would modify 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.[13] Additionally, in response to comments received on the proposal, the draft final rule would align 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, which is 24.9 percent.

Together, these changes would help ensure that qualifying foreign public funds are limited to those that are authorized to be sold to retail investors, while also more closely aligning the treatment of foreign public funds with that of U.S. registered investment companies.

2. Loan Securitizations

The Volcker Rule expressly permits banking entities to sell and securitize loans in a manner otherwise permitted by law.[14] As such, the current rule excludes 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.[15] The draft final rule would amend two key eligibility criteria to qualify for the exclusion.

First, the draft final rule, like the proposal, would permit five percent of the total assets of a qualifying loan securitization to consist of non-loan assets. In a change from the proposal, only debt securities, other than convertible debt securities and asset-backed securities, could be held in this five percent bucket. Permitting an issuer to hold a small pool of such assets would

[13] Under the draft final rule, a banking entity that acts as an investment adviser or sponsor to a foreign public fund also would be required to ensure that the distribution complies with all applicable requirements in the jurisdiction where the fund is offered.

[14] Section 13(g)(2) of the BHC Act (12 U.S.C. § 1851(g)(2)).

[15] 12 CFR 248.10(c)(8).

provide banking entities with greater flexibility to structure their permissible loan securitizations and would be consistent with past industry practice.

Second, the draft final rule, like the proposal, would 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). Servicing assets that are securities must meet additional eligibility criteria set forth in the regulations.[16]

3. Small Business Investment Companies

The Volcker Rule and the current regulations exclude from the definition of "covered fund" small business investment companies (SBICs), as long as the SBIC's license has not been revoked. In some cases, an SBIC may surrender its license during a wind-down period, which may call into question its continued eligibility for the SBIC exclusion. The draft final rule, like the proposal, would clarify that an SBIC could remain eligible for the exclusion from the covered fund provisions during a wind-down period, provided that it makes no new investments, other than investments in cash equivalents, after surrendering its license. Allowing SBICs to retain their eligibility for the exclusion from the covered fund definition during their wind-down periods would help facilitate banking entities' investments in SBICs and give appropriate effect to the statutory exemption for SBIC investments.

4. Public Welfare Investments

The draft final rule amends the exclusion from the covered fund definition for public welfare investments to clarify that it includes investments that qualify for consideration under the regulations implementing the Community Reinvestment Act. The draft final rule also would exclude rural business investment companies[17] and qualified opportunity funds[18] from the

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[16] *See* Volcker Rule Frequently Asked Questions, Question 4 (June 10, 2014), *available at* https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

[17] Rural business investment companies, as described in 15 U.S.C. § 80b-3(b)(8)(A) or (B), are funds that invest in rural and small businesses.

[18] Qualified opportunity funds, as defined in 26 U.S.C. § 1400Z-2(d), are funds that invest in economically distressed areas.

covered fund definition, because such funds serve a similar purpose as public welfare investments and, thus, are not the types of funds that the Volcker Rule was intended to address.[19]

D. Additional Permitted Funds

The draft final rule would permit banking entities to invest in and sponsor several additional types of funds that do not raise the concerns that the Volcker Rule was intended to address.

1. Credit Funds

Although the Volcker Rule excludes loan securitizations from the definition of "covered fund,"[20] the regulations implementing the Volcker Rule have limited the ability of banking entities to invest in or sponsor substantially similar funds that make loans, invest in debt securities, or otherwise extend credit. The legislative history of the Volcker Rule indicates that Congress targeted the covered funds provisions at private equity funds and short-term-focused hedge funds, not private long-term debt funds. Staff believes that it is appropriate to permit banking entities to engage in traditional lending activities, which they are permitted to engage in directly, through credit funds. Therefore, the final rule, like the proposal, would allow banking entities to invest in or sponsor credit funds that meet certain eligibility criteria.

A qualifying credit fund would be a fund whose assets consist solely of (1) loans; (2) debt instruments; (3) other assets that are related or incidental to acquiring, holding, servicing, or selling loans (including equity securities, or rights to acquire equity securities, received on customary terms in connection with the credit fund's loans or debt instruments); and (4) certain interest rate or foreign exchange derivatives. A qualifying credit fund would be subject to certain restrictions, including a prohibition on proprietary trading by the fund. Additionally, a banking entity that acts as a sponsor or investment adviser to the fund would be prohibited from guaranteeing the fund's performance, required to disclose this prohibition to fund investors, and required to comply with the Super 23A restrictions, as if the credit fund were a covered fund. Both the credit fund eligibility requirements and these additional limits would help to ensure that

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[19] The proposal did not contain these changes to the public welfare investment exclusion but specifically requested comment on whether such changes were appropriate.

[20] *See* Section 13(g)(2) of the BHC Act (12 U.S.C. § 1851(g)(2)) (providing that nothing in the Volcker Rule shall be construed to limit the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law).

the fund is providing long-term credit and is not being used by the banking entity to evade the requirements of the Volcker Rule.

2. Venture Capital Funds

Under the current rule, venture capital funds that invest in small and startup businesses may be covered funds subject to the restrictions of the Volcker Rule unless they otherwise qualify for an exclusion. The draft final rule, like the proposal, would allow banking entities to acquire or retain ownership interests in, or sponsor, certain venture capital funds, to the extent the banking entity is permitted to engage in such activities under applicable law.[21]

Only "venture capital funds" as defined in Securities and Exchange Commission regulations would qualify for the exclusion.[22] The draft final rule would also prohibit a qualifying venture capital fund from engaging in proprietary trading. Furthermore, a banking entity that acts as a sponsor or investment adviser to the venture capital fund would be prohibited from guaranteeing the fund's performance, required to disclose this prohibition to fund investors, and required to comply with the Super 23A restrictions as if the fund were a covered fund.

Venture capital funds serve an important role in providing financing for non-publicly traded companies, including companies with limited funding options. During congressional consideration of the Volcker Rule, several members of Congress expressed support for permitting banking entities to engage in venture capital activities.[23] In addition, Congress authorized SBICs, which have similarities to venture capital funds.[24] The limitations on qualifying venture capital funds would help to address the policy goals of Congress when enacting the Volcker Rule, including eliminating incentives that a banking entity may have to bail out a covered fund during times of stress.

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[21] For example, a banking entity that has elected to be treated as a financial holding company may be permitted to make an investment in a venture capital fund pursuant to its merchant banking investment authority, provided the banking entity complies with applicable merchant banking investment requirements. *See* 12 CFR Part 225, Subpart J.

[22] 17 CFR 275.203(*l*)-1.

[23] *See, e.g.*, 156 Cong. Rec. E1295 (daily ed. July 13, 2010) (statement of Rep. Eshoo); 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (statement of Sen. Dodd); and 156 Cong. Rec. S6242 (daily ed. July 26, 2010) (statement of Sen. Scott Brown).

[24] 12 U.S.C. § 1851(d)(1)(E).

3. Family Wealth Management Vehicles

The draft final rule, like the proposal, would allow banking entities more flexibility to provide traditional banking and asset management services to family wealth management vehicles, which are funds set up on behalf of a family. A fund would qualify as a family wealth management vehicle under the draft final rule if the fund were owned only by members of a single family and a limited number of closely related persons to the family customers.[25] The proposal would have only permitted three closely related persons to invest alongside the family customer; however, based on comments received, the draft final rule would permit five closely related persons to invest in the vehicle.

A banking entity that sponsors a family wealth management vehicle would need to comply with a number of restrictions under the draft final rule. First, the banking entity must provide bona fide trust, fiduciary, or advisory services to the family wealth management vehicle. The banking entity also would be prohibited from guaranteeing the vehicle's performance (and must disclose this prohibition to fund investors), and would be required to comply with certain limitations with respect to transactions with such vehicles.[26] Furthermore, the banking entity would be prohibited from having an ownership interest in the vehicle, other than up to 0.5 percent of the vehicle's outstanding ownership interests to the extent necessary for establishing corporate separateness of the vehicle. The banking entity also would generally be prohibited from acquiring low-quality assets from the family wealth management vehicle (other than through riskless principal transactions).[27]

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[25] Under the draft final rule, "closely related person" would mean "a natural person (including the estate and estate planning vehicles of such person) who has a longstanding business or personal relationship with any family customer."

[26] Specifically, a banking entity would be required to comply with requirements of section __.14(b) of the draft final rule, which requires that transactions between the fund and banking entity be on market terms, and section __.15 of the draft final rule, which prohibits transactions involving material conflicts of interest, certain high risk transactions, and transactions that would threaten the safety and soundness of the banking entity or the financial stability of the United States.

[27] Specifically, a banking entity would be required to comply with the low-quality asset purchase requirements set forth in the Board's Regulation W (12 CFR 223.15(a)), as if such banking entity were a bank and the vehicle were an affiliate thereof.

This element of the draft final rule would give banking entities greater flexibility to structure services or transactions for families, and the additional limitations and requirements would help ensure that banking entities do not use family wealth management vehicles to evade the requirements of the Volcker Rule.

4. Customer Facilitation Funds

In some circumstances, the Volcker Rule may constrain the manner in which a banking entity provides financial services to its customers. For example, a customer may obtain exposure to a financial product (e.g., a derivative) by entering into a contract directly with a banking entity, or by acquiring ownership interests in a standalone fund vehicle that has entered into a contract with the banking entity. Although each structure provides a customer with the same economic exposure to the underlying financial product, when financial products are provided through a fund, the fund may constitute a covered fund under the Volcker Rule. As a result, a banking entity may face obstacles to offering financial products to its customers through such a fund structure.

The draft final rule, like the proposal, would exclude from the covered fund restrictions funds designed to facilitate transactions between a banking entity and a single customer. This new exclusion would provide banking entities with greater flexibility to provide banking and financial services to customers. Under the draft final rule, banking entities sponsoring customer facilitation funds would be subject to the same restrictions and requirements that would apply with respect to family wealth management vehicles. Such requirements would help to ensure that banking entities do not evade the requirements of the Volcker Rule.

E. Clarify 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 a capital deduction with respect to its "ownership interests" in covered funds. The current rule defines "ownership interest" to include any equity, partnership, or other "similar interest." "Similar interest" 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 adviser of a covered fund.

The draft final rule, like the proposal, would amend this list of characteristics to clarify that a loan or debt interest with certain traditional creditor rights would not be an ownership

interest, and would provide an express safe harbor for senior loans and senior debt. The draft final rule also would clarify the limited types of creditor rights that would be considered within the scope of the definition of "ownership interests."

F. Clarify Ambiguity for Parallel and Co-Investments

The Volcker Rule does not impose any separate limits on direct investments by banking entities in the same assets invested in by a covered fund. However, the preamble to the current rule discusses the potential for evasion of the per-fund and aggregate funds ownership limitations and states that, "if a banking entity makes investments side by side in substantially the same positions as the covered fund, the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund."[28] The preamble also states that "a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund in a privately negotiated investment unless the value of such co-investment is less than 3[percent] of the value of the total amount co-invested by other investors in such investment."[29]

This preamble language has created confusion as to whether the covered fund limits in the Volcker Rule apply to direct side-by-side investments by a banking entity, and whether a banking entity has a legal obligation to track and monitor its side-by-side investments in the same assets held by a covered fund organized and offered by the banking entity. The draft final rule, like the proposal, would clarify that a banking entity need not include its investments made alongside a covered fund in these limits to the extent that the investment is made in compliance with applicable laws and safety and soundness standards. This change should help simplify compliance with the applicable covered fund limits, and would be consistent with the scope of the statute.

RECOMMENDATION

Staff recommends that the Board approve the attached draft final rule for publication in the *Federal Register*. Staff also recommends that the Board authorize staff to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register*.

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[28] 79 FR 5734.

[29] *Id.*