The Volcker Rule "Covered Funds" Rule: Eight Things To Know

On June 25, 2020, five federal financial regulators jointly issued a final rule that modifies existing regulations implementing the Volcker Rule's general prohibition on banking entities investing in, sponsoring, or having certain relationships with hedge funds or private equity funds (collectively, "covered funds"). The substance of the final rule is largely unchanged from the underlying proposed rulemaking issued in January 2020. The final rule, which follows a 2019 final rule revising the Volcker Rule's proprietary trading provisions, is intended to simplify the covered fund provisions and permit banking entities to engage in additional fund-related activities that do not present the risks that the Volcker Rule was intended to address.

1 The final rule adds four new regulatory exclusions to the definition of "covered fund" for credit funds, venture capital funds, family wealth management vehicles, and customer facilitation funds.

The most significant aspect of the final rule is the addition of four new exclusions from the definition of "covered fund," each of which is subject to a range of conditions and restrictions. According to the preamble, these new exclusions are intended to address the potential overbreadth of the existing "covered fund" definition. Specifically, the final rule excludes:

- ***Credit funds***, which are funds the assets of which consist solely of loans, debt instruments, and related or incidental assets (including certain interest rate and foreign exchange derivatives). To be eligible for the exclusion, the credit fund cannot engage in proprietary trading, nor may it issue asset-backed securities. A banking entity that invests in the credit fund must not guarantee the performance of the fund. A banking entity that sponsors or serves as investment advisor to the fund must (i) comply with the so-called "Super 23A" and "Super 23B" prohibitions on the banking entity's covered transactions with the fund, and other affiliate transaction limits and (ii) make certain disclosures to investors. The January 2020 proposed rule also would have imposed the "Super 23A" and "Super 23B" requirements on banking entities that were merely investors in the fund, but this limitation was not included in the final rule.

- ***Venture capital funds***, defined by reference to existing SEC regulations that describe private funds that represent to investors that they pursue a venture capital strategy, primarily invest in qualifying portfolio companies (covering the typical characteristics of investments made by venture capital funds, as opposed to private equity funds or hedge funds), limit investors' withdrawal rights, and limit their use of leverage, among other limitations. To be eligible for the exclusion, the venture capital fund cannot engage in proprietary trading, and any banking entity that invests in, sponsors, or serves as investment advisor to the venture capital fund is required to comply with the same guarantee, affiliate transaction, and disclosure requirements that apply to credit funds.

- ***Family wealth management vehicles***, which are funds owned only by members of a single family and no more than five closely related persons of the family. A banking entity is permitted to maintain an ownership interest of up to a 0.5 percent in the vehicle if necessary in order to establish corporate separateness. To be eligible for the exclusion, a banking entity must (i) provide bona fide trust, fiduciary, or advisory services to the vehicles, (ii) comply with "Super 23B" prohibitions on the banking entity's covered transactions with the fund, and other affiliate transaction limits, (iii) not purchase low-quality assets from the vehicle, and (iv) comply with the similar guarantee and disclosure requirements that apply to credit funds.

- ***Customer facilitation vehicles***, which are funds that facilitate transactions between the banking entity and a single customer, and typically take the form of structured finance and synthetic SPVs. A banking entity is permitted to maintain an ownership interest of up to a 0.5 percent in the fund if necessary in order to establish corporate separateness. To be eligible for the exclusion, a banking entity must (i) document how it intends to facilitate the customer's exposure to the transaction, (ii) comply with "Super 23B" prohibitions on the banking entity's covered transactions with the fund, and other affiliate transaction limits, (iii) not purchase low-quality assets from the fund, and (iv) comply with similar guarantee and disclosure requirements that apply to credit funds.

2 The final rule incorporates some (but not all) of the exemptions for "covered transactions" under section 23A of the Federal Reserve Act into the Volcker Rule framework, thus permitting banking entities to enter into certain low-risk transactions with related funds.

The Volcker Rule generally prohibits a banking entity from entering into transactions with a related fund that would be a covered transaction under section 23A of the Federal Reserve Act if the banking entity were a member bank and the fund were its affiliate. However, the existing regulations implementing the Volcker Rule do not incorporate any of section 23A's longstanding exemptions from the definition of "covered transaction." The final rule incorporates certain of these exemptions – specifically, those transactions permitted under section 23A "without limit." Thus, for example, the final rule permits a banking entity to extend credit to a related fund on an intraday basis or if the credit is fully secured by U.S. Treasury securities. In addition, the final rule permits a banking entity to purchase assets from or extend credit to a related fund on a short-term basis (*i.e.*, five business days) in the ordinary course of business in connection with payment transactions; securities, derivatives, or futures clearing; or settlement services. In a change from the proposed rule, the final rule also exempts riskless principal transactions with a covered fund. The market terms requirement of "Super 23B" and other safety and soundness conditions still apply.

3 The final rule provides permanent regulatory relief for qualifying foreign excluded funds.

The final rule codifies no-action relief previously granted by the agencies that exempts qualifying excluded funds that are "banking entities" from the Volcker Rule's proprietary trading prohibition and covered fund provisions. To qualify, a fund must satisfy certain criteria, including the following: (i) the fund must be organized or established outside of the United States, (ii) the fund's ownership interests must be offered or sold solely outside the United States, (iii) the fund would not otherwise be a banking entity except by virtue of a foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the fund, and (iv) the fund must be established and operated as part of a *bona fide* asset management business. The final rule also clarifies that a qualifying foreign excluded fund is not required to satisfy the Volcker Rule's compliance program requirement.

4 The final rule significantly simplifies the requirements to qualify as a foreign public fund, which is exempt from the definition of "covered fund."

Under the existing regulations implementing the Volcker Rule, foreign funds that are equivalent to U.S. registered investment companies are excluded from the definition of "covered fund." To qualify, these "foreign public funds" must satisfy several conditions, including that the fund is authorized to sell ownership interests to retail investors in the fund's home jurisdiction predominantly through one or more public offerings outside the United States. Under the final rule, an investment fund organized outside of the United States qualifies as an excluded foreign public fund if its ownership interests are offered through one or more public offerings that are subject to substantive disclosure and retail investor protection laws. This change permits, for example, a foreign fund organized in one foreign country and offering interests in another to qualify for the "covered fund" exclusion.

5 The final rule slightly expands the types of loan securitizations that are exempt from the definition of "covered fund."

The final rule codifies existing guidance regarding the conditions for the exemption of loan securitizations from the definition of "covered fund." The final rule permits issuers to hold a small pool of debt securities (up to 5 percent of the loan securitization's total loans, cash equivalents, and debt securities), (ii) clarifies that servicing assets held by a loan securitization vehicle may include assets other than securities (*e.g.*, mortgage insurance policies in the case of a mortgage loan securitization), and (iii) clarifies the types of cash equivalents that loan securitizations are permitted to hold. The proposed rule also would have allowed a loan securitization to hold any kind of asset in the 5 percent bucket, rather than limit such holdings to debt securities, but the final rule does not include that additional flexibility.

6 The final rule clarifies the definition of "ownership interest" to explicitly exclude senior loans, senior debt, and other debt interests with certain creditor rights.

A centerpiece of the Volcker Rule's covered funds restrictions is the definition of "ownership interest." The final rule clarifies the definition of "ownership interest" by specifying additional characteristics that are features of an ownership interest (*e.g.*, the right to participate in the selection or removal of a general partner, board director, or investment manager). It also clarifies that loan or debt interests with certain creditor rights are not ownership interests and expressly exempt senior loans and senior debt.

7 The final rule clarifies that the Volcker Rule does not restrict parallel direct investments and co-investments.

Although the existing Volcker Rule regulations do not explicitly limit a banking entity's ability to invest directly in the same assets invested in by a covered fund, language in the preamble to the 2013 final rule adopting the regulations could have been read to suggest an intent to impose such a limitation. The June 2020 final rule clarifies that for purposes of calculating an ownership interest in a covered fund, a banking entity need not include parallel direct investments and co-investments, provided such investments are made in compliance with other laws.

8 The final rule is effective October 1, 2020.

While several industry commenters urged the agencies to allow for voluntary early compliance with the final rule's amendments, the final rule does not expressly do so, and instead has a blanket effective date of October 1, 2020.

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