

# Volcker Rule 2.0: Covered Funds Proposal

January 31, 2020

Yesterday, the Federal Reserve Board and the other implementing agencies proposed revisions (the “Proposal”) to the regulations implementing section 13 of the Bank Holding Company Act (referred to as the “Volcker Rule”). The Proposal addresses covered funds and related issues, filling the gap left by last year’s adoption of revisions related primarily to the proprietary trading, compliance and metrics requirements, discussed in detail in our analysis [here](#). Comments on the Proposal are due on April 1.

Below are our preliminary takeaways on select issues. We anticipate providing a comprehensive summary of the Proposal in the future. A redline showing proposed changes to the current regulatory text is available [here](#).

## PROPOSED CHANGES

### Covered Fund Exclusions

- **Foreign Public Funds.** The Proposal would streamline the foreign public fund (“FPF”) exclusion. Key requirements would include that: (1) the fund is authorized to offer and sell ownership interests (not necessarily in its home jurisdiction, as currently required) and such interests are offered and sold through one or more public offerings (rather than “predominantly” through public offerings, as currently required); and (2) the distribution is subject to substantive disclosure and retail investor protection laws or regulations. The public offering definition also would be revised to require that the distribution comply with all applicable requirements in the jurisdiction where it is made only when the banking entity acts as the adviser or sponsor to the FPF. The Proposal would revise the limit applicable to U.S. banking entities on selling ownership interests of a FPF to affiliated persons so that the limit only covers directors and senior executive officers (as opposed to all employees) of the sponsoring U.S. banking entity.
- **Credit Funds.** The Proposal would provide a new exclusion for credit funds that invest in loans and other debt instruments. A credit fund would be permitted to hold

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certain related rights and other assets, including equity securities, options and warrants received in connection with investing in a loan or debt instrument. Among other conditions, banking entities would be prohibited from bailing out credit funds. Credit funds also would be prohibited from proprietary trading and would be subject to Super 23A and the Volcker Rule's so-called "prudential backstops," as if they were covered funds.

- **Venture Capital Funds.** The Proposal would provide a new exclusion for qualifying venture capital funds. Venture capital funds would be defined using the Securities and Exchange Commission's definition of "venture capital fund" provided by a rule under the Investment Advisers Act for purposes of qualifying for an exemption from registration as an investment adviser. Among other conditions, banking entities would be prohibited from bailing out venture capital funds. Venture capital funds also would be prohibited from proprietary trading and would be subject to Super 23A and the prudential backstops, as if they were covered funds. The agencies request comment on whether there should be a portfolio company revenue cap, designed to ensure the fund's investments are made in small and early-stage companies.
- **Long-term Investment Funds.** The agencies request comment on whether certain long-term investment funds that would not be qualifying venture capital funds also should be excluded from the covered fund definition.
- **Customer Facilitation Vehicles.** The Proposal would provide a new exclusion for client facilitation vehicles. This exclusion would be available for an issuer that is formed by or at the request of a customer for the purpose of providing the customer (and one or more of its affiliates) with exposure to a transaction, investment strategy, or other service provided by the banking entity. All of the ownership interests of the vehicle must be owned by the customer, other than a *de minimis* interest that may be held by the banking entity. Additional conditions would apply, including documentation requirements, anti-bail out provisions, Super 23B and the prudential backstops. Although Super 23A would not apply, a banking entity and its affiliates would be subject to the prohibition in Regulation W on purchasing low-quality assets, as if such banking entity and its affiliates were a member bank and the vehicle were an affiliate thereof.
- **Family Wealth Management Vehicles.** The Proposal would provide a new exclusion for family wealth management vehicles—including trusts and other entities to which the banking entity provides trust, fiduciary or advisory services—that are owned by "family customers" and up to three "closely related persons." "Family customer" means a "family client" as defined in the Investment Advisers Act's "family office exclusion," or certain in-laws of a family client, and "closely related person" means a natural person who has longstanding business or personal

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relationships with any family customer. A banking entity would be permitted to own only a *de minimis* interest in the vehicle. Additional conditions would apply, including anti-bail out provisions, Super 23B and the prudential backstops. Although Super 23A would not apply, a banking entity and its affiliates would be subject to the prohibition in Regulation W on purchasing low-quality assets, as if such banking entity and its affiliates were a member bank and the vehicle were an affiliate thereof.

- **Loan Securitizations.** The Proposal would permit a loan securitization vehicle to hold up to five percent of its assets in non-loan assets and would codify the agencies' FAQ regarding loan securitizations with respect to the treatment of certain servicing assets and cash equivalents.
- **Public Welfare Investments.** The Proposal would expand the exclusion for small business investment companies ("SBICs") to capture SBICs that are being wound down. The agencies also request comment on whether funds that qualify for Community Reinvestment Act credit should *per se* fall within the exclusion and whether additional exclusions should be available for rural business investment companies ("RBICs") and qualified opportunity funds ("QOFs").

#### **Qualifying Foreign Excluded Funds.**

The Proposal would exempt the activities of qualifying foreign excluded funds ("QFEFs") from the Volcker Rule's proprietary trading and covered fund prohibitions. The agencies state that a QFEF would be defined in the same way as in the agencies' 2017 (see our analysis [here](#)) and 2019 policy statements (see our analysis [here](#)).

#### **Parallel Investments**

The Proposal effectively would rescind the preamble discussion in the 2013 final rule regarding limits on parallel investments and co-investments with sponsored covered funds. Under the Proposal, banking entities would not be required to treat a direct investment made alongside a sponsored covered fund as an investment in the covered fund, as long as the investment is made in compliance with applicable laws and regulations, including safety and soundness standards. The agencies indicate that directors and employees also may invest alongside a sponsored covered fund and may receive financing from the sponsoring banking entity, without those investments being attributed to the banking entity.

#### **Super 23A**

The Proposal would permit a banking entity to engage in 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

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Reserve Act.<sup>1</sup> The Proposal also would allow a banking entity to enter into short-term (no more than five business days) extensions of credit with, and purchase assets from, a related covered fund in connection with payment, clearing and settlement activities. The prudential backstops would apply to any such transactions.

#### **“Ownership Interest” Definition**

The Proposal would provide that senior loan or other senior debt interests that do not have equity-like features would not be ownership interests and would clarify that a creditor’s right to participate in the removal for cause or replacement of an investment manager upon the manager’s resignation or removal would not be treated as an “other similar interest.” The Proposal also would revise the calculation methodology for the aggregate fund limit and tier 1 capital deduction to be consistent with the per-fund limit calculation by providing that an employee or director’s restricted profit interest in a covered fund organized or offered by the banking entity would only be attributed to the banking entity’s ownership interest if the banking entity directly or indirectly financed the employee or director’s acquisition of the restricted profit interest.

#### **Seeding FAQs and Banking Entity Status**

Although the Proposal would not codify the registered fund seeding FAQs (Nos. 14 and 16), the preamble states that the Proposal would not modify or revoke any previously issued agency FAQs, unless otherwise specified. The preamble discussion to Federal Reserve Board’s final control rules, also issued yesterday, indicates that the one-year seeding period in the final control rules does not alter the rules applicable to fund investments under the Volcker Rule, including the rules addressing permissible seeding periods for such funds.

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Please do not hesitate to contact us with any questions.

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<sup>1</sup> The exemptions that would be included are those covered by 12 U.S.C. § 371c(d) or section 223.42 of Regulation W.

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