# Volcker Rule 2.0: A Detailed Summary of Final Rule, Round 2 on Covered Funds

**June 30, 2020**

On June 25, the Federal Reserve Board and the other implementing agencies finalized revisions (the "Final Rule")[1] to the regulations implementing section 13 of the Bank Holding Company Act (referred to as the "Volcker Rule"). The Final Rule 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. It also follows proposed revisions[2] introduced on January 30 (the "Proposal"), which we summarized here, and an initial proposal that was issued in July 2018 that requested comment on various proprietary trading and covered fund issues, which we summarized here. The Final Rule's effective date is October 1, 2020.

Below is our comprehensive summary of the Final Rule. A redline showing changes to the current regulatory text is available here.

## Table of Contents



[1] A link to the press release may be found here.

[2] 85 Fed. Reg. 12120 (Feb. 28, 2020).

## New Covered Fund Exclusions

The agencies adopted several new exclusions to the definition of covered fund "to more closely align the regulation with the purpose of the statute."[3] The new exclusions cover: credit funds; venture capital funds; customer facilitation vehicles; and family wealth management vehicles.

### Credit Funds

In the 2013 final rule, the agencies declined to adopt an exclusion from the definition of covered fund for credit funds. After soliciting comment on the issue in 2018 and then proposing a new exclusion from the definition of covered fund for credit funds in the 2020 Proposal, the agencies are now finalizing the new credit fund exclusion largely as proposed. As a result, the credit fund exclusion applies to a fund that invests in loans and other debt instruments and is permitted to hold certain related rights and other assets, including equity securities, options and warrants received on customary terms in connection with investing in a loan or debt instrument. The credit fund exclusion also incorporates certain additional criteria and restrictions on the banking entity's relationship with the credit fund.

#### Asset Requirements

The exclusion requires that the credit fund's assets be composed solely of: (1) loans; (2) debt instruments; (3) certain rights and other assets that are related or incidental to acquiring, holding, servicing, or selling such loans or debt instruments; and (4) interest rate or foreign exchange derivatives, provided the written terms of the derivative directly relate to the loans, debt instruments, or other rights or assets and the derivative reduces the interest rate and/or foreign exchange risks related to the loans, debt instruments, or other rights or assets.

[3] Final Rule Preamble ("Preamble") at 12.

Each related right or other asset that is a security may not include a commodity forward contract or any derivative[4] and must be:

- a cash equivalent (as defined in the revisions to the loan securitization exclusion, discussed further below);
- a security received in lieu of debts previously contracted with respect to the loan or debt instrument; or
- an equity security (or right to acquire an equity security) received on customary terms in connection with the loan or debt instrument.

The agencies had requested comment as to whether a quantitative limit should apply to the amount of equity securities (or rights to acquire equity securities) that may be held by an excluded credit fund and decided not to adopt any such limit. The agencies explained that "[a]ny such equity securities or rights are limited by the requirements that they be (a) received on customary terms in connection with the fund's loans or debt instruments and (b) related or incidental to acquiring, holding, servicing, or selling those loans or debt instruments."[5] However, the agencies also noted they expect that equity securities (or rights to acquire equity securities) held in connection with an investment in loans or debt instruments of a borrower generally would not exceed 5% of the value of the credit fund's total investment in the borrower at the time the investment is made. At the same time, the agencies acknowledge "that the value of those equity securities or other rights may change over time for a variety of reasons, including as a result of market conditions and business performance," for example, and note that they accordingly "can foresee various circumstances where the relative value of such equity securities or rights in a borrower (or affiliated borrowers) would over the life of the investment exceed five percent on a basis consistent with the requirements."[6]

**Activity Requirements**

The credit fund is not permitted to engage in any activity that would constitute proprietary trading under the short-term intent prong of the proprietary trading provisions of the implementing regulations. The agencies clarify that this prohibition does not expressly incorporate the permitted activity exemptions to the proprietary trading prohibition, such as the exemptions for market making-related activities and risk-mitigating hedging activities. Nevertheless, a credit fund could engage in the permitted activities if it does so in compliance with the requirements of the exemption.

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[4] The Final Rule explicitly excludes derivatives from permissible related rights or other assets, the purpose being "[t]o ensure that the credit fund exclusion does not inadvertently allow the holding of certain derivatives unrelated to interest rate and/or foreign exchange risks." Preamble at 72.

[5] Preamble at 70.

[6] Preamble at 70-71.

In addition, the agencies note that a credit fund could engage in activities explicitly excluded from the definition of proprietary trading.

The exclusion also prohibits a credit fund from issuing asset-backed securities.

#### Requirements for a Sponsor or Adviser

A banking entity that acts as sponsor or adviser to the credit fund is not permitted to rely on the exclusion unless the banking entity:

- provides the disclosures required under the asset management exemption of the implementing regulations (the "covered fund disclosures") to any prospective and actual investors;
- ensures that the activities of the credit fund 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 (the "safety and soundness standards"); and
- complies with Super 23A and Super 23B as if the credit fund were a covered fund.

#### Banking Entity Requirements

The exclusion contains additional restrictions on the banking entity and its relationship with the qualifying credit fund, as follows:

- The banking entity may not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the fund or any entity to which the fund extends credit or in which the fund invests.
- Any debt instruments or equity securities (or rights to acquire an equity security) held by the credit fund must be permissible for the banking entity to acquire and hold directly under applicable federal banking laws and regulations.
- The banking entity's investment in, and relationship with, the credit fund must comply with the Volcker Rule's so-called "prudential backstops," as if the credit fund were a covered fund and be conducted in compliance with applicable banking laws and regulations, including safety and soundness standards.

### Venture Capital Funds

The Final Rule provides a new exclusion for qualifying venture capital funds. The agencies note they believe such an exclusion "will support capital formation, job

creation, and economic growth, particularly with respect to small business and start-up companies."[7]

**Venture Capital Definition**

A qualifying venture capital fund must be an issuer that is a "venture capital fund" as defined in 17 CFR 275.203(*l*)-1 ("Rule 203(*l*)-1"), a rule issued by the Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940 ("Advisers Act") for purposes of qualifying for an exemption from registration as an investment adviser. The agencies note that in adopting Rule 203(*l*)-1, "the SEC explained that the definition's criteria distinguish venture capital funds from other types of funds, including private equity funds and hedge funds."[8] Rule 203(*l*)-1 defines a "venture capital fund" as a fund that relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act") that:

- represents to investors and potential investors that it pursues a venture capital strategy;

- holds at least 80% of its assets in "qualifying investments" or short-term holdings;

  - "Qualifying investments" are (1) equity securities issued by "qualifying portfolio companies" acquired by the venture capital fund directly from the portfolio company; (2) equity securities issued by "qualifying portfolio companies" to the venture capital fund in exchange for an equity security in (1) above; or (3) equity securities issued by a company of which a "qualifying portfolio company" is a majority-owned subsidiary and is acquired by a venture capital fund in exchange for an equity security described in (1) or (2) above;

  - A "qualifying portfolio company" is a company that (1) at the time of any investment by the venture capital fund, is not subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 or does not have a security listed or traded on any exchange or organized market operating in a foreign jurisdiction; (2) does not borrow or issue debt obligations in connection with the venture capital fund's investment in the company and distributes to the venture capital fund the proceeds of the borrowing or issuance in exchange for the venture capital fund's investment; and (3) is not an investment company as defined in the 1940 Act, an issuer that would be an investment company but for the exemptions provided by Section 3(c)(1) or Section 3(c)(7) of the 1940 Act or the exemption provided by Rule 3a-7 under the 1940 Act, or a commodity pool;

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[7] Preamble at 88.

[8] Preamble at 93; *see also* 85 Fed. Reg. at 12136.

- does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days (except that any guarantee by the fund of a qualifying portfolio company's obligations up to the amount of the value of the fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit);

- does not issue securities that are redeemable by the holder other than in extraordinary circumstances (redeemability for this purpose includes the right to withdraw or require the repurchase of such securities); and

- is not registered under the Advisers Act and is not a business development company.

The agencies declined to impose any additional restrictions on the qualifying venture capital fund, such as a minimum securities holding period, a portfolio company revenue cap or an additional quantitative limit on the use of leverage.

**Requirements for a Sponsor or Adviser**

Consistent with the exclusion for credit funds, a banking entity that acts as sponsor or adviser to the qualifying venture capital fund is not permitted to rely on the exclusion unless the banking entity:

- provides the covered fund disclosures to any prospective and actual investors;

- ensures that the activities of the venture capital fund are consistent with the safety and soundness standards; and

- complies with Super 23A and Super 23B as if the venture capital fund were a covered fund.

**Banking Entity and Activity Requirements**

As with the exclusion for credit funds, the agencies incorporated certain additional limiting criteria and restrictions on the banking entity's relationship with the venture capital fund:

- The qualifying venture capital fund is not permitted to engage in any activity that would constitute proprietary trading under the short-term intent prong of the proprietary trading provisions of the implementing regulations, subject to the same clarifications as noted above for credit funds.

- The banking entity may not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the qualifying venture capital fund.

- The banking entity's investment in, and relationship with, the qualifying venture capital fund must comply with the Volcker Rule's prudential backstops, as if the venture capital fund were a covered fund, and be conducted in compliance with applicable banking laws and regulations, including safety and soundness standards.

### Other Long-Term Investment Funds

The Proposal had requested comment on whether certain long-term investment funds that would not be qualifying venture capital funds should also be excluded from the definition of covered fund. The agencies determined not to include this exclusion on the basis that it remains difficult to distinguish effectively long-term investment funds from the type of funds the Volcker Rule was designed to restrict.

## Customer Facilitation Vehicles

The Final Rule provides a new exclusion for a customer facilitation vehicle. In adopting this new exclusion, the agencies explain that the exclusion will "appropriately allow banking entities to structure certain types of services or transactions for customers, or to otherwise provide traditional customer-facing banking and asset management services, through a vehicle, even though such a vehicle may rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act or would otherwise be a covered fund."[9]

### Issuer Requirements

The exclusion is available for an issuer that is formed by or at the request of a customer of the banking entity for the purpose of providing such customer (or its affiliates) with exposure to a transaction, investment strategy, or other service provided by the banking entity. In addition, all of the ownership interests of the customer facilitation vehicle must be owned by the customer (which may include one or more of the customer's affiliates) for whom the vehicle was created, other than up to an aggregate 0.5% of the outstanding ownership interest that may be held by one or more entities (including the banking entity or its affiliates) that are not customers for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns.

### Banking Entity Requirements

In addition, the exclusion incorporates certain conditions to "help to ensure that customer facilitation vehicles are used for customer-oriented financial services provided

[9] Preamble at 122.

on arms-length, market terms, and to prevent evasion of the requirements of the [Volcker Rule]."[10] Specifically, the banking entity and its affiliates must:

- maintain documentation describing how the banking entity or its affiliate intends to facilitate the customer's exposure to such transaction, investment strategy or other service;
- not directly or indirectly guarantee, assume or otherwise insure the obligations or performance of the customer facilitation vehicle;
- provide the covered fund disclosures to any prospective and actual investors (although the content may be modified to prevent the disclosure from being misleading and the manner of disclosure may be modified to accommodate the specific circumstances of the customer facilitation vehicle);
- not acquire or retain, as principal, an ownership interest in the customer facilitation vehicle, other than up to an aggregate of 0.5% as noted above;
- comply with Super 23B and the prudential backstop provisions, as if the customer facilitation vehicle were a covered fund; and
- comply with the low-quality asset restrictions of 12 CFR 223.15(a), as if such banking entity and its affiliates were a member bank and the customer facilitation vehicle were an affiliate thereof, except for riskless principal transactions. The Final Rule defines riskless principal transaction to mean a transaction in which a banking entity, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security in the secondary market for its own account to offset a contemporaneous sale to (or purchase from) the customer.

## Family Wealth Management Vehicles

After the agencies solicited comment on the topic in the 2018 proposal and the Proposal, the Final Rule provides a new exclusion for family wealth management vehicles to allow banking entities to "structure services or transactions for customers, or to otherwise provide traditional customer-facing banking and asset management services."[11] The agencies explain that an exclusion for family wealth management vehicles would "effectively tailor the definition of covered fund by permitting banking entities to

[10] Preamble at 130.

[11] Preamble at 108.

continue to provide traditional banking and asset management services that do not involve the types of risks [the Volcker Rule] was designed to address."[12]

**Issuer Requirements**

The exclusion is available to any entity that is not, and does not hold itself out as being, an entity 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 that:

- for family wealth management vehicles that are trusts, the grantor(s) of the entity are all family customers; and

- for non-trust family wealth management vehicles, family customers must own a majority of the voting interests (directly or indirectly) as well as a majority of interests in the entity, and ownership is limited to family customers and up to five closely related persons of the family customers.

However, up to an aggregate 0.5% of the outstanding ownership interest may be held by one or more entities (including the banking entity or its affiliates) that are not family customers or closely related persons for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns.

The exclusion defines family customer as a "family client" as defined in the Advisers Act's family office exclusion,[13] or 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 spousal equivalent of any of the foregoing. A "closely related person" is defined as a natural person (including the estate and estate planning vehicles of such person) who has longstanding business or personal relationships with any family customer.

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[12] Preamble at 109; *see also* 85 Fed. Reg. at 12139.

[13] *Family client* means: (1) any family member; (2) any former family member; (3) any key employee; (4) certain former key employees; (5) any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients; (6) any estate of a family member, former family member, key employee, or eligible former key employee; (7) any irrevocable trust in which one or more other family clients are the only current beneficiaries; (8) any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries; (9) any revocable trust of which one or more other family clients are the sole grantor; (10) certain other trusts; or (11) any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the 1940 Act. 17 CFR 275.202(a)(11)(G)-1(d)(4).

### Banking Entity Requirements

As with the exclusion for customer facilitation vehicles, the exclusion incorporates certain conditions to "ensure that family wealth management vehicles are used for client-oriented financial services provided on arms-length, market terms, and to prevent evasion of the requirements of [the Volcker Rule]."[14] Specifically, the banking entity (and their affiliates) must:

- provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the family wealth management vehicle;
- not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the family wealth management vehicle;
- provide the covered fund disclosures (although the content may be modified to prevent the disclosure from being misleading and the manner of disclosure may be modified to accommodate the specific circumstances of the family wealth management vehicle);
- not acquire or retain, as principal, an ownership interest in the family wealth management vehicle, other than up to an aggregate of 0.5% as noted above;
- comply with Super 23B and the prudential backstop provisions, as if the family wealth management vehicle were a covered fund; and
- comply with the low-quality asset restrictions of 12 CFR 223.15(a), as if such banking entity and its affiliates were a member bank and the family wealth management vehicle were an affiliate thereof, except for riskless principal transactions as in the exclusion for customer facilitation vehicles.

## Changes to Current Covered Fund Exclusions

### Foreign Public Funds

The implementing regulations provide an exclusion for foreign public funds ("FPFs") from the definition of covered fund, with the intent of providing consistent treatment between FPFs and U.S. registered investment companies ("RICs").[15] In 2018, the

[14] Preamble at 115.

[15] *See* 79 Fed. Reg. 5536, 5673 (Jan. 31, 2014).

agencies requested comment on whether the exclusion for FPFs was too narrowly tailored and whether to modify certain of the exclusion's conditions.[16]

The Final Rule modifies the exclusion. In doing so, the agencies noted "that some of the conditions of the 2013 rule's [FPF] exclusion may not be necessary to ensure consistent treatment of [FPFs] and U.S. [RICs]."[17]

**Foreign Public Fund Requirements**

Under the Final Rule, the FPF exclusion is available for a fund that:

- is organized or established outside of the United States; and
- is authorized to offer and sell ownership interests, and such interests are offered and sold through one or more public offerings.

The term "public offering" means a distribution of securities in any jurisdiction outside the United States to investors, including retail investors, that meets all of the following criteria:

- The distribution must be subject to substantive disclosure and retail investor protection laws or regulations.
- The distribution must not restrict availability to investors having a minimum level of net worth or net investment assets.
- The issuer must have filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.
- For an FPF for which the banking entity serves as the investment manager, adviser or sponsor, the distribution must comply with all applicable requirements in the jurisdiction in which such distribution is being made.

The Final Rule therefore eliminates the requirement that the fund's interests must be sold "predominantly" through one or more public offerings outside of the United States (which the agencies had explained meant 85% of the fund's interests would have to be sold in this way) and, instead, requires that the fund's interests be sold through at least one public offering where the distribution is subject to substantive disclosure and retail investor protection laws or regulations. In addition, instead of requiring the fund to be authorized to offer and sell ownership interests in its home jurisdiction, the Final Rule

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16 83 Fed. Reg. 33432, 33473 (Jul. 17, 2018).

17 Preamble at 25.

requires that the fund merely be authorized to offer and sell ownership interests (not necessarily in its home jurisdiction).

### Requirements for U.S. Banking Entity Sponsors

If a U.S. banking entity sponsors the fund, under the Final Rule, no more than 24.9% (rather than 14.9%) of the fund's interests may be sold to the U.S. banking entity and associated parties—that is, affiliates of the U.S. banking entity, the fund itself or affiliates of the fund, or directors and senior executive officers (but not all employees) of the U.S. banking entity, the fund, or any of their affiliates. In adopting this revision, the agencies explained that "the permitted ownership level of a [FPF] by a U.S. banking entity sponsor and associated parties should be aligned with the functionally equivalent threshold for banking entity investments in U.S. [RICs], which is 24.9 percent."[18]

### Related Revisions

Related to the FPF exclusion, the agencies also amended a provision that sets forth two conditions that, if satisfied, prevent an FPF (or a RIC or business development company) from being treated as a banking entity for purposes of calculating the investment limits. The Final Rule clarifies that the 25% voting share limit in this provision applies to the banking entity and its affiliates, in the aggregate, and the requirement that the banking entity provide advisory or other services to the fund can be satisfied by the banking entity or its affiliates.

## Loan Securitizations

The implementing regulations already exclude loan securitizations that hold certain permissible assets from the definition of covered fund to implement the statutory requirement that nothing in the Volcker Rule "shall be construed to limit or restrict the ability of a banking entity…to sell or securitize loans in a manner otherwise permitted by law."[19] In considering revisions to this exclusion, the agencies had requested comment on whether the exclusion works in practice and asked whether they should permit the loan securitization vehicle to hold a limited percentage of debt securities.[20]

The Final Rule expands the exclusion by permitting a loan securitization vehicle to hold a 5% bucket for debt securities (rather than the broader "any non-loan asset" as in the Proposal). Such debt securities cannot include asset-backed securities or convertible securities. The agencies explained that "limiting the assets to debt securities is more

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[18] Preamble at 33.

[19] 12 U.S.C. 1851(g)(2).

[20] 83 Fed. Reg. at 33480.

consistent with the activities of an issuer focused on securitizing loans, rather than engaging in other activities."[21]

In addition, the Final Rule clarifies the methodology for calculating the 5% limit in response to comments, specifying that the limit must be calculated at the most recent time any debt security is acquired. In addition, the calculation is based only on the aggregate value of loans, debt securities and cash equivalents, at par value, as opposed to the value of all the issuer's assets (such as derivatives). The Final Rule further provides that the loan securitization vehicle may instead determine the value of any such loan, cash equivalent, or debt security based on its fair market value (rather than par value) if (1) the loan securitization vehicle is required to use the fair market value of such assets for purposes of calculating compliance with concentration limitations or other similar calculations under its transaction agreements, and (2) the loan securitization vehicle's valuation methodology values similarly situated assets consistently.

Furthermore, the Final Rule codifies the agencies' FAQ No. 4 regarding the scope of the servicing asset provision. Specifically, the Final Rule clarifies that:

- assets other than permitted securities can be servicing assets for purposes of the loan securitization exclusion;
- "cash equivalents" means high quality, highly liquid 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;[22] and
- special units of beneficial interest and collateral certificates that are securities need not meet the "permitted securities" requirements in the loan securitization exclusion.

## Public Welfare Exclusion

The Final Rule expands the exclusion for small business investment companies ("SBICs") to capture an SBIC that has voluntarily surrendered its license to operate as an SBIC in accordance with 13 CFR 107.1900 and does not make any new investments (other than investments in cash equivalents) after such voluntary surrender. The Final Rule also revises the public welfare exclusion to explicitly capture investments that qualify for consideration under the regulations implementing the Community Reinvestment Act. In addition, the Final Rule expands the exclusion to explicitly cover rural business investment companies, including one that has terminated its participation as a rural business investment company in accordance with 7 CFR 4290.1900 and does not make

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[21] Preamble at 44.

[22] Unlike in FAQ No. 4, the agencies are not proposing to require cash equivalents to be "short term."

any new investments (other than investments in cash equivalents) after such termination), and qualified opportunity funds.

## Super 23A

In finalizing so-called "Super 23A" limitations on banking entities' relationships with certain "related" covered funds in 2013, the agencies declined to incorporate the exemptions contained in section 23A of the Federal Reserve Act or in Regulation W.[23] In the 2018 proposal, however, the agencies requested comment on Super 23A, including whether it should be modified to incorporate some or all of these exemptions.[24]

In response to comments received on the scope of Super 23A, the Proposal would have permitted, and the Final Rule permits, additional types of transactions under Super 23A pursuant to the agencies' authority under section 13(d)(1)(J) of the BHC Act,[25] which allows the agencies to permit activities that "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." Relying on section 13(d)(1)(J) is a different legal route than the route the agencies declined to adopt in 2013 to exempt transactions from Super 23A. Then, the agencies declined to read the Volcker Rule statute as incorporating the exemptions contained in section 23A or Regulation W.[26] Now, the agencies instead use the 13(d)(1)(J) exemptive authority, and note that the newly permitted activities meet the standard for this authority because they "promote and protect the safety and soundness of banking entities and U.S. financial stability by allowing banking entities to reduce operational risk."[27] The permitted transactions are subject to the implementing regulations' prudential backstop provisions. The newly permitted transactions are as follows.

- First, the Final Rule revises the Super 23A limitations to incorporate certain section 23A and Regulation W exemptions. In particular, the Final Rule permits a banking entity to enter into a covered transaction with a related covered fund that would be exempt from the quantitative limits, collateral requirements and low-quality asset prohibition under section 23A and Regulation W, as if the transaction had been entered into between a member bank and its affiliate. An example of such permitted transactions includes intraday extensions of credit, among others.[28]

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[23] *See* 79 Fed. Reg. at 5746.

[24] 83 Fed. Reg. at 33487.

[25] Preamble at 134.

[26] 79 Fed. Reg. at 5746.

[27] Preamble at 143.

[28] *See* 12 U.S.C. § 371c(d); 12 CFR § 223.42.

- Second, the Final Rule explicitly permits a banking entity to enter into riskless principal transactions (defined above) with a related covered fund. Although Regulation W permits riskless principal transactions and certain other transactions between a member bank and a securities affiliate, the agencies declined to eliminate for Super 23A purposes the eligibility criteria applicable to the section 23A and Regulation W exemptions. As a result, a related covered fund must also be a securities affiliate in order to rely on certain exemptions. To nonetheless permit a banking entity to enter into riskless principal transactions with a related covered fund that may not be a securities affiliate, the agencies adopted this standalone exemption. In making this change, the agencies noted that "[i]n permitting such transactions under Regulation W, the [Federal Reserve] Board previously found that there was no regulatory benefit to subjecting riskless principal transactions to section 23A of the Federal Reserve Act, because such transactions closely resemble securities brokerage transactions, and these transactions do not allow the affiliate to transfer risk to the affiliate acting as a riskless principal."[29]

- Third, the Final Rule allows a banking entity to enter into short-term extensions of credit with, and purchase assets from, a related covered fund in the ordinary course of business in connection with payment transactions, settlement services, or futures, derivatives and securities clearing. Each extension of credit must be repaid, sold, or terminated by the end of five business days, and the banking entity making each extension of credit must meet certain requirements of Regulation W's intraday extension of credit exemption, including the requirement to maintain policies and procedures regarding such extensions of credit, as if the extension of credit were an intraday extension of credit, regardless of its duration.

## Ownership Interest

### "Ownership Interest" Definition

#### Rights of Creditors as an "Other Similar Interest"

In the 2018 proposal, the agencies requested comment on whether there were any modifications that should be made to the definition of ownership interest in the context of securitizations.[30] They specifically asked whether the definition should be modified to provide that the "rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event," which would not cause the interest to be an ownership interest, should include the right to participate in the removal of an

[29] Preamble at 139.

[30] 83 Fed. Reg. at 33481.

investment manager for cause, or to nominate or vote on a replacement manager upon an investment manager's resignation or removal.

The Final Rule clarifies 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 does not alone cause an interest to be an "other similar interest" that would be treated as an ownership interest. In addition, the Final Rule clarifies that for cause removal of an investment manager means one or more of the following events: (1) the bankruptcy, insolvency, conservatorship or receivership of the investment manager; (2) the breach by the investment manager of any material provision of the covered fund's transaction agreements applicable to the investment manager; (3) the breach by the investment manager of material representations or warranties; (4) the occurrence of an act that constitutes fraud or criminal activity in the performance of the investment manager's obligations under the covered fund's transaction agreements; (5) the indictment of the investment manager for a criminal offense, or the indictment of any officer, member, partner or other principal of the investment manager for a criminal offense materially related to his or her investment management activities; (6) a change in control with respect to the investment manager; (7) the loss, separation or incapacitation of an individual critical to the operation of the investment manager or primarily responsible for the management of the covered fund's assets; or (8) other similar events that constitute "cause" for removal of an investment manager, provided that such events are not solely related to the performance of the covered fund or the investment manager's exercise of investment discretion under the covered fund's transaction agreements.

### Ordinary Debt Interests Safe Harbor

The Final Rule also provides a safe harbor from the definition of ownership interest for ordinary debt interests, which the agencies believe will "provide clarity and predictability to banking entities by enabling them to determine more readily whether an interest would be an ownership interest."[31] In particular, the Final Rule provides that a senior loan or senior debt interest would not be an ownership interest if it has the following characteristics:

- Under the terms of the interest the holders 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:
    - 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

[31] Preamble at 153.

- repayment of a fixed principal amount, on or before a maturity date, in a contractually determined manner (which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, forgone income resulting from an early prepayment);[32]

- 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

- 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).

### Aggregate Limit and Tier 1 Capital Deduction for Restricted Profit Interests

The Final Rule revises the calculation methodology for the aggregate fund limit and tier 1 capital deduction to be consistent with the per-fund limit calculation. Specifically, under the Final Rule, an employee or director's restricted profit interest in a covered fund organized or offered by the banking entity is only attributed to the banking entity if the banking entity directly or indirectly financed the employee or director's acquisition of the restricted profit interest. The agencies explain that this change "will simplify a banking entity's compliance with the aggregate fund limit and covered fund deduction provisions of the rule, and more fully recognize that employees and directors may use their own resources, not provided by the banking entity, to invest in ownership interests or restricted profit interests in a covered fund they advise."[33]

## Parallel Investments

The Final Rule adds a new rule of construction that provides that a banking entity is not required to include in the calculation of the investment limits any investment the banking entity makes alongside a covered fund and is not restricted in the amount of any investment the banking entity makes alongside a covered fund, as long as the investment is made in compliance with applicable laws and regulations, including applicable safety and soundness standards. The Final Rule effectively rescinds the

[32] The agencies note that the safe harbor is available to senior loans and senior debt interests where contractual principal payments vary over the life of the senior loan or senior debt interest, for reasons such as amortization and acceleration, provided the total amount of principal required to be repaid does not change.

[33] Preamble at 157.

preamble discussion in the 2013 final rule regarding limits on parallel investments and co-investments with sponsored covered funds.[34]

In addition, banking entities that rely on this rule of construction to invest alongside a sponsored covered fund are still required to comply with all of the conditions under the asset management exemption, including the prohibition on the banking entity guaranteeing, assuming, or otherwise insuring the obligations or performance of the covered fund. The agencies note that, as a result, a "banking entity would not be permitted to make a direct investment alongside a covered fund that the banking entity organizes and offers for the purpose of artificially maintaining or increasing the value of the fund's positions."[35]

The banking entity also must comply with prudential backstops for any direct investments alongside an organized and offered covered fund. For example, the agencies note that if the investment would result in a material conflict of interest between the banking entity and its clients (*e.g.*, because the banking entity may exit the position at a different time or on different terms than the covered fund),[36] the banking entity may be required to provide timely and effective disclosure prior to making the investment.

As in the preamble to the Proposal, the agencies in the preamble to the Final Rule explain that this new rule of construction permits a banking entity to market a covered fund it organizes and offers pursuant to the asset management exemption on the basis of the banking entity's expectation that it would invest in parallel with the covered fund in some or all of the same investments, or the expectation that the banking entity would fund one or more co-investment opportunities made available by the covered fund. However, the agencies caution that the banking entity should retain independent decision-making; that is, "the ability to evaluate each investment on a case-by-case basis to confirm that the banking entity does not make any investment unless the investment complies with applicable laws and regulations, including any applicable safety and soundness standards."[37]

The agencies also reiterate that directors and employees of a banking entity (or an affiliate thereof) also may invest alongside a sponsored covered fund (in compliance with applicable laws and regulations) and may receive financing from the sponsoring banking entity to do so, without those investments being attributed to the banking entity, regardless of whether the banking entity arranged the transaction on behalf of

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[34] 79 Fed. Reg. at 5734.

[35] Preamble at 162.

[36] Preamble at 162 n.479.

[37] Preamble at 164-65.

the director or employee or provided financing for the investment, and regardless of whether the employee provided specified services to the covered fund.

## Banking Entity Status Issues

### Qualifying Foreign Excluded Funds

The Final Rule exempts 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), except for a modification to the anti-evasion provision described below.

Accordingly, the Final Rule defines a QFEF, with respect to a foreign banking entity, as a banking 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 if the entity were 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, sponsorship of, or relationship with, 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 banking entity that sponsors or controls the QFEF, or any of its affiliates, to evade the requirements of the Volcker Rule. In addition, any acquisition or retention of an ownership interest in, or sponsorship of, the QFEF by a foreign banking entity must meet the requirements for permitted covered fund activities and investments outside the United States (the so-called "SOTUS" exemption).

In addition, under the Final Rule, QFEFs are not required to have compliance programs or comply with the reporting and documentation requirements in section __.20. Nevertheless, the Final Rule, as with the Proposal, would continue to subject QFEFs, as banking entities, to the requirements of Super 23A and 23B.

### Seeding FAQs

Since the implementing regulations were first finalized in 2013, the staffs of the agencies have issued various FAQs that, among other things, acknowledged the permissibility of a multi-year seeding period for certain funds that are excluded from the definition of covered fund, providing three years as an example (without setting any

maximum prescribed period). In 2018, the agencies further clarified that a flexible multi-year seeding period would be available for such funds.[38] Although the Final Rule does not codify the seeding FAQs (*e.g.*, Nos. 14 and 16), the preamble to the Final Rule states that the Final Rule does not modify or revoke any previously issued agency FAQs, unless otherwise specified.[39] In addition, consistent with our observation from approximately five years ago when FAQ No. 16 was first issued, the agencies confirmed in the preamble to the Final Rule that "depending on the facts and circumstances of a particular foreign public fund, the appropriate duration of its seeding period may vary and, under certain facts and circumstances, may exceed three years."[40]

* * *

Please do not hesitate to contact us with any questions.

[38] 83 Fed. Reg. at 33549 ("The FAQ recognizes that the length of a seeding period can vary and therefore provides an example of 3 years, the maximum period of time that could be permitted under certain conditions for seeding a covered fund under the 2013 final rule, without setting any maximum prescribed period for a RIC or FPF seeding period").

[39] Preamble at 13.

[40] Preamble at 35.

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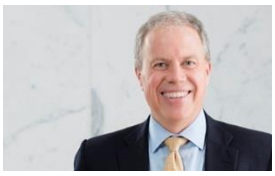

Gregory J. Lyons
gjlyons@debevoise.com


David L. Portilla
dlportilla@debevoise.com


Rebecca F. Silberstein
rfsilberstein@debevoise.com

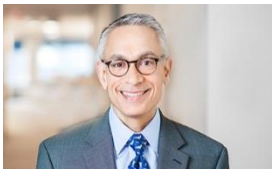

Alison M. Hashmall
ahashmall@debevoise.com


Sandeep S. Dhaliwal
ssdhaliwal@debevoise.com


Isabel Espinosa de los Reyes
iespinosa@debevoise.com


Chen Xu
cxu@debevoise.com

## WASHINGTON, D.C.


Satish M. Kini
smkini@debevoise.com


Marc Ponchione
mponchione@debevoise.com