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Dodd-Frank 2.0: Agencies Finalize Substantial Revisions to the Covered Funds Provisions of the Volcker Rule

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On June 25, 2020, the five regulatory agencies (Agencies) responsible for implementing the Dodd-Frank Act's Volcker Rule finalized their rulemaking (2020 Rule), substantially revising the "covered funds" provisions of the regulation. Of particular significance, the 2020 Rule:

- Excludes "credit funds" and "venture capital funds" from the definition of a "covered fund," thus allowing banking entities to invest their own money in such funds without limitation
- Eliminates restrictions on banking entities' directly investing their own money in portfolio companies in parallel with investments by covered funds they sponsor
- Permits certain exemptions from the so-called "Super 23A" provisions, which limit transactions between banking entities and covered funds that they advise or sponsor
- Excludes so-called "foreign excluded funds" from the Volcker Rule's prohibitions on proprietary trading and fund investments
- Permits exempt loan securitization vehicles to hold up to 5% of their assets in certain previously impermissible debt securities

The 2020 Rule becomes effective on October 1, 2020.

I. New Exclusion for Credit Funds

The 2020 Rule provides a new exclusion from the definition of Volcker "covered fund" for "credit funds." The effect of this is banking entities may now invest balance sheet moneys in up to 100% of the interests of such funds. Although the Agencies had rejected such an exclusion in their 2013 Volcker regulation, they stated that the time since then had shown that credit funds had difficulty fitting within any other exclusions, and that allowing the exclusion would be consistent with Congress's intent that the Volcker Rule not restrict banks' ability to sell loans.

The 2020 Rule defines a "credit fund" as an issuer whose assets solely consist of:

- loans;
- debt instruments;
- related rights, and other assets that are related to or incidental to acquiring, holding, servicing, or selling loans or debt instruments – including warrants and other "equity kickers;" and
- certain interest rate and foreign exchange derivatives, similar to those allowed in the regulation's loan securitization exemption.

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Although the new exclusion means that a banking entity can invest in up to 100% of the interests of a credit fund, regardless of whether the banking entity or a third party was the fund sponsor, the 2020 Rule does place certain limitations on a credit fund:

- A credit fund is not permitted to engage in proprietary trading
- If a banking entity sponsors or serves as an investment adviser to a credit fund, it must provide the type of disclosures to investors that it would provide for a covered fund
- A banking entity cannot guarantee the performance of a credit fund
- Super 23A, as modified by the revisions, applies to transactions between a banking entity that sponsors or advises a credit fund and the fund
- The Volcker Rule prohibition on material conflicts of interest and high-risk trading strategies applies
- A credit fund may hold only those assets that a bank can hold directly, and thus may hold equity only as a "kicker" to a loan, not equity generally
- A credit fund is not permitted to issue asset-backed securities

II. New Exclusion for Venture Capital Funds

The 2020 Rule also contains a new exclusion for qualifying venture capital funds. Such a fund is an issuer that meets the requirements set forth in the definition of "venture capital fund" contained in Rule 203(l)-1 under the Investment Advisers Act and meets the additional conditions for credit funds listed above, other than the limitation of fund assets to those assets that a bank can hold directly.

Under Rule 203(l)-1, a "venture capital fund" is limited in the types of companies in which it can invest, namely private portfolio companies; the types of assets it may hold, principally equity of qualifying portfolio companies and short-term assets; and the amount of leverage that it may incur.

III. Eliminating Restrictions on Direct Investments by Banking Entities and Their Officers and Directors

In a substantial change relating to bank investments, the 2020 Rule permits banking entities to make parallel direct investments in portfolio companies alongside investments by sponsored covered funds, without counting the direct investments towards the 3% per-fund and 3% of Tier 1 capital investment limits. Such parallel direct investments – in reliance on available legal authorities such as the Merchant Banking Rule – are subject to no quantitative Volcker Rule limitations. The preamble to the 2020 Rule further states that banking entities will also be permitted to market sponsored funds by referring to a direct co-investment strategy.

In addition, the loosening of restrictions on parallel investments applies to director and employee investments. Such investments are no longer attributed to the 3% per-fund and 3% of Tier 1 capital limits, and can be made by bank directors and employees that provide no services to the fund.

IV. Revisions to Super 23A Provisions

One of the more limiting aspects of the Volcker Rule is its so-called "Super 23A" provision, which placed outright prohibitions on certain transactions between banking entities and covered funds that they sponsor or advise – extensions of credit, guarantees issued on behalf of the fund, and purchases of assets or securities from the fund. One of the reasons the provision is called "Super 23A" is that the Volcker statute did not include any language stating that the exemptions in Section 23A of the Federal Reserve Act, on which Super 23A is based, apply. In their 2013 regulation, the Agencies declined to import the Federal Reserve Act Section 23A exemptions by administrative action.

The 2020 Rule changes course on this issue as well. It includes, moreover, not simply the historical Section 23A exemptions, but an additional exemption as well. The principal Section 23A exemptions are for: (i) extensions of credit secured by government securities or cash in a segregated, earmarked deposit account; (ii) purchases of certain assets having a publicly available and readily identifiable market quotation and purchased at that quotation; (iii) purchases of certain marketable securities; (iv) purchasing certain municipal securities; and (v) intraday extensions of credit.

The additional exemption is for an affiliated banking entity's extension of credit to, or purchase of asset from, a covered fund, as long as:

- The transaction is in the ordinary course of business in connection with payment transactions; settlement services; or futures, derivatives, and securities clearing
- Each extension of credit is repaid, sold or terminated by the end of five business days, and
- The banking entity making each extension of credit has established and maintains policies and procedures reasonably designed to manage the credit exposure arising from the extension of credit in a safe and sound manner and ensure that it is on market terms, and has no reason to believe that the covered fund will have difficulty repaying the extension of credit in accordance with its terms.

V. "Foreign Covered Funds" and the "Banking Entity" Problem

The 2013 regulation created a substantial issue for non-U.S. banking organizations. The Volcker statute's prohibitions on proprietary trading and investing in hedge funds and private equity funds apply broadly to every subsidiary in a bank holding company structure, because those subsidiaries are "banking entities" subject to the prohibitions. The 2013 regulation exempted "covered funds," as defined in the regulation, from the banking entity definition, since the statute permitted banking entities to sponsor hedge funds and funds of funds, which by definition engage in proprietary trading and fund investing.

The "covered fund" definition in the 2013 regulation, however, did not cover many funds sponsored by non-U.S. banks, *i.e,* those that had no U.S. investors, because it focused on Section 3(c)(1)/3(c)(7) funds. As a result, these funds, which were controlled companies within the meaning of the Bank Holding Company Act, were "banking entities" that were prohibited from proprietary trading and investing in private funds. The Agencies did not attempt to revise their regulations when this became apparent; rather, once the Volcker Rule conformance period finally ended in July 2017, annual orders were issued to the effect that no enforcement action would be taken with respect to these funds – essentially deferring the issue.

The 2020 Rule exempts so-called qualifying "foreign excluded funds" from the prohibitions on proprietary trading and sponsoring and investing in hedge funds and private equity funds. To qualify for the exemption, an entity must meet these requirements:

- Be organized and established outside the United States, with all ownership interests offered and sold solely outside the United States
- Would be a covered fund if the entity were organized or established in the U.S., ***or*** is or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments

- Would not otherwise be a banking entity except by virtue of a non-U.S. banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the entity
- Be established and operated as part of a bona fide asset management business
- Not be operated in a manner that enables evasion of the requirements of the Volcker Rule.

In addition, the 2020 Rule makes clear that non-U.S. banks are not required to have a formal Volcker compliance regime in place with respect to these funds.

VI. Broadening the Types of Assets That Can Be Held by Loan Securitizations

The Volcker statute provided that "[n]othing [herein] 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."[1] Based on this legal authority, the 2013 regulation contained an exemption from the definition of "covered fund" for loan securitization vehicles; those vehicles, however, were significantly limited in the types of assets they could hold. For example, as a general matter, debt securities were impermissible assets.

The 2020 Rule reverses this position in part. It permits a loan securitization vehicle to hold up to five percent of assets in otherwise impermissible debt securities, if those debt securities are not asset-backed securities or convertible debt obligations.

VII. Other Proposed Changes

Family Wealth Management Vehicles. The 2020 Rule includes a new exclusion from the definition of covered fund for "family wealth management vehicles." Such vehicles cannot hold themselves out as raising money from investors generally; they can be either trusts, where all the grantors are family customers, or non-trust vehicles, where a majority of the voting and total interests are owned by family customers, and the entity is owned only by family customers and up to 5 closely related persons of those family customers. A "family customer" is defined as "a family client, as defined in Rule 202(a)(11)(G)-1(d)(4) of the Advisers Act; 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, spouse or spousal equivalent of any of the foregoing."

Super 23A, as modified, does not apply to transactions between a banking entity and a sponsored or advised "family wealth management vehicle," but the Agencies did impose the limitation that a banking entity cannot purchase a low-quality asset from such vehicles. Such vehicles are subject to the following additional requirements and limitations:

- Banking entity transactions with the vehicles must be on market terms
- Banking entity ownership is limited to 0.5% and only when necessary for establishing corporate separateness or to address bankruptcy/insolvency concerns
- Banking entities are required to provide the same type of disclosures to vehicle investors as they would covered funds
- Banking entities may not guarantee the obligations or performance of the vehicles
- The Volcker prohibitions against material conflicts of interest and high-risk trading strategies apply

Customer Facilitation Vehicles. The 2020 Rule also contains an exclusion from the definition of covered fund for "customer facilitation vehicles." This exclusion would cover any issuer that is formed "by or at the request of" a customer of a banking entity for the purpose of providing the customer or its affiliates with exposure to a transaction, investment strategy or other service provided by the banking entity. A banking entity could market its services through the use of customer facilitation vehicles and discuss with customers prior to formation of the vehicle the potential benefits of using such a vehicle. Such vehicles are subject to the same prudential conditions as family wealth management vehicles.

Definition of Ownership Interest. The 2020 Rule eliminates an inconsistency in the manner in which the 3% limits and the regulations' capital deduction were calculated, by requiring, in all such calculations, banking entities to include employee/director payments in connection with a "restricted profits interest" (carried interest) only when the banking entity finances such payments.

Conclusion

The 2020 Rule should be seen as a material relaxation of the covered funds provisions. In addition, it shows significant flexibility on the part of the Agency staffs in revisiting their prior positions. The Agencies seem to have determined, after over six years' experience, that bank fund activities may be broadened, in some cases, substantially, without creating issues of undue risk taking, and that such broadened activities may benefit the overall economy at a particularly challenging time.

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[1] 12 U.S.C. § 1851(g)(2).

The following Gibson Dunn lawyers assisted in preparing this client update: Arthur Long and James Springer.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions or Investment Funds practice groups, or the following:

Financial Institutions Group:
Arthur S. Long – New York (+1 212-351-2426, along@gibsondunn.com)
Matthew L. Biben – New York (+1 212-351-6300, mbiben@gibsondunn.com)
Michael D. Bopp – Washington, D.C. (+1 202-955-8256, mbopp@gibsondunn.com)
Stephanie Brooker – Washington, D.C. (+1 202-887-3502, sbrooker@gibsondunn.com)
M. Kendall Day – Washington, D.C. (+1 202-955-8220, kday@gibsondunn.com)
Michelle M. Kirschner – London (+44 20 7071 4212, mkirschner@gibsondunn.com)
Jeffrey L. Steiner – Washington, D.C. (+1 202-887-3632, jsteiner@gibsondunn.com)
James O. Springer – New York (+1 202-887-3516, jspringer@gibsondunn.com)

Investment Funds Group:
Chézard F. Ameer – Dubai and London (+971 (0)4 318 4614, cameer@gibsondunn.com)
Albert S. Cho – Hong Kong (+852 2214 3811, acho@gibsondunn.com)
John Fadely – Hong Kong (+852 2214 3810, jfadely@gibsondunn.com)
Jennifer Bellah Maguire – Los Angeles (+1 213-229-7986, jbellah@gibsondunn.com)
Y. Shukie Grossman – New York (+1 212-351-2369, sgrossman@gibsondunn.com)
Edward D. Sopher – New York (+1 212-351-3918, esopher@gibsondunn.com)
C. William Thomas, Jr. – Washington, D.C. (+1 202-887-3735, wthomas@gibsondunn.com)

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