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DODD-FRANK 2.0: AGENCIES PROPOSE SUBSTANTIAL REVISIONS TO THE COVERED FUNDS PROVISIONS OF THE VOLCKER RULE

To Our Clients and Friends:

On January 30, 2020, the five regulatory agencies (Agencies) responsible for implementing the Dodd-Frank Act's Volcker Rule issued, in some cases with dissent, a proposed rule (Funds Proposal) that would make substantial revisions to the "covered funds" provisions of their Volcker regulations. The proposal would loosen a number of the restrictions imposed by the original 2013 regulation (Original Rule) and add new exclusions from the Rule's prohibitions.

Of particular significance, the Funds Proposal would:

- Exclude "credit funds" from the Volcker Rule, which would allow banking entities to invest their own money in such funds without limitation
- Exclude "venture capital funds" from the Volcker Rule, which would allow banking entities to invest their own money in such funds without limitation
- Eliminate restrictions on banking entities' directly investing their own money in parallel with investments by covered funds
- Permit certain exceptions to the so-called "Super 23A" provisions, which limit transactions between banking entities and covered funds that they advise or sponsor
- Exclude so-called "foreign excluded funds" from the Volcker Rule's prohibitions on proprietary trading and fund investments
- Permit exempt loan securitization vehicles to hold up to 5% of their assets in previously impermissible investments

In each of the above cases, the Agencies made considerable use of their exemptive authority in clear contrast to their approach in the Original Rule.

Comments on the Funds Proposal are due on April 1, 2020.

I. Proposed New Exclusion for Credit Funds

The Funds Proposal would provide a new exclusion from the definition of Volcker "covered fund" for "credit funds." The effect of the exclusion would be that banking entities could invest in up to 100% of the interests of such funds. Although the Agencies had rejected such an exclusion in the Original Rule, they stated that time had shown that credit funds had 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 Funds Proposal defines a "credit fund" as an issuer whose assets solely consist of: (1) loans; (2) debt instruments; (3) 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 (4) certain interest rate and foreign exchange derivatives. Permissible related rights and derivatives would be similar to those allowed in the regulations' loan securitization exclusion. With respect to warrants and equity kickers, the Agencies stated that they were considering imposing a quantitative limit on the amount of equity a credit fund could hold and sought comment on the issue.

Although the exclusion would mean that a banking entity could 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 Funds Proposal 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) would apply to transactions between a sponsoring or advising banking entity and a credit fund
- The prohibition on material conflicts of interest and high-risk trading strategies would apply to a credit fund
- 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. Proposed New Exclusion for Venture Capital Funds

The Funds Proposal also contains a new exclusion for qualifying venture capital funds. As with credit funds, the Original Rule declined to provide such an exclusion. The Funds Proposal quotes at length from the legislative history of the Dodd-Frank Act, in particular, floor statements from members of Congress, as justification for the new exclusion.

A "qualifying venture capital 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 prohibition on issuing asset-backed securities and 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 (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. The Agencies stated that they were further considering imposing a limitation on the amount of annual revenues that could be generated by portfolio companies in which a qualifying venture capital fund invests (for example, $50 million in annual revenues) and sought comment on that issue.

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

In a substantial change relating to bank investments, the Funds Proposal would permit 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. The preamble to the Funds Proposal states further that banking entities could market sponsored funds by referring to a direct co-investment strategy.

In addition, the loosening of restrictions on parallel investments would apply to director and employee investments. Such investments would not be attributed to the 3% per-fund and 3% of Tier 1 capital limits, and could be made by bank directors and employees that provided 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 places 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, should apply. In the Original Rule, the Agencies declined to import the Federal Reserve Act Section 23A exemptions by administrative action.

The Funds Proposal 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 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 proposed exemption is for an 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 Original Rule created a substantial issue for non-U.S. banking organizations. The statutory 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 Original Rule exempted "covered funds" 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 Original Rule, however, did not cover many funds sponsored by non-U.S. banks, *i.e,* those that had no U.S. investors. Because they were sponsored by non-U.S. banks, these "foreign excluded funds" were controlled companies and thus "banking entities" that were technically prohibited from proprietary trading and investing in private funds. The Volcker Agencies did not attempt to revise their regulations when this became apparent; rather, once the Volcker Rule conformance period finally ended in July 2017, the federal banking agencies issued annual orders that they would not take any action with respect to foreign excluded funds – essentially deferring the issue.

In what, if finalized, would be a substantial victory for non-U.S. banks, the Covered Funds Proposal would exempt 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, a fund 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 foreign 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.

If finalized as proposed, this exemption will significantly reduce compliance costs for non-U.S. banks.

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 Original Rule 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 Funds Proposal reverses this position. Reasoning that authorizing loan securitizations to hold small amounts of non-loan assets could "permit loan securitizations to respond to market demand and reduce compliance costs" without "significantly increasing risk to banking entities and the financial system" and also "increase a banking entity's capacity to provide financing and lending," the Funds Proposal would allow a loan securitization vehicle to hold up to five percent of assets in otherwise impermissible assets.

VII. Other Proposed Changes

Family Wealth Management Vehicles. The Funds Proposal would include a new exclusion from the definition of covered fund for "family wealth management vehicles." Such vehicles would not hold themselves out as raising money from investors generally; they could be either trusts, where all the grantors were family customers, or non-trust vehicles, where a majority of the voting interests were owned by family customers, and the entity was owned only by family customers and up to 3 closely related persons of those family customers. A "family customer" would mean "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."

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

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

Customer Facilitation Vehicles. The last new exclusion from the definition of covered fund would be 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 would be subject to the same conditions as family wealth management vehicles.

Definition of Ownership Interest. The Funds Proposal would eliminate an inconsistency in the manner in which the 3% limits and the regulations' capital deduction are calculated, by requiring banking entities to include employee/director payments in connection with a "restricted profits interest" (carried interest) only when the banking entity had financed such payments. This would result in a uniform approach to insider investments.

The Agencies also included clarifications to the definition of "ownership interest" so that a debt relationship with a covered fund would typically not constitute an ownership interest.

Foreign Public Funds. The Funds Proposal would loosen some of the conditions for the exclusion from the covered fund definition for "foreign public funds," namely, that the fund be authorized to be offered and sold to retail investors in the fund's home jurisdiction, and that the fund be sold "predominantly" through one or more public offerings. In addition, it would eliminate the limitation on selling ownership interests in the fund to employees, other than senior executive officers and directors, of the sponsoring banking entity, the fund, or their affiliates. The Agencies stated that these changes would align the treatment of foreign public funds more closely with exempt U.S. registered investment companies.

Public Welfare Funds. The Agencies sought comment on whether the exclusion from the definition of covered fund should cover "all permissible public welfare investments," under any banking agency's regulation, as well as comment on how the exclusion should apply to Rural Business Investment Companies and Qualified Opportunity Funds.

Small Business Investment Companies. The Funds Proposal would permit a small business investment company that had surrendered its license to continue to benefit from the SBIC exclusion from the definition of covered fund as long as it did not make any further portfolio investments.

Conclusion

The Funds Proposal would result in a material revision to the Volcker Rule. It shows significant flexibility on the part of the Agency staffs in revisting their prior positions in the Original Rule, flexibility that is not generally associated with regulators. Indeed, there is some irony that the Funds Proposal was issued on the same day that the Federal Reserve finalized its revised framework for "control" under the Bank Holding Company Act, which made rather restrained amendments to prior practice. The Volcker Agencies seem to have determined, after a little over six years' experience, that bank fund activities may be broadened, in some cases, substantially, without creating issues of undue risk taking.

[1] 12 U.S.C. § 1851(g)(2).

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:

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