Volcker 2.1: Visual Memo on Proposed Amendments to Volcker Rule Covered Fund Provisions

VISUAL MEMORANDUM

February 13, 2020

Davis Polk

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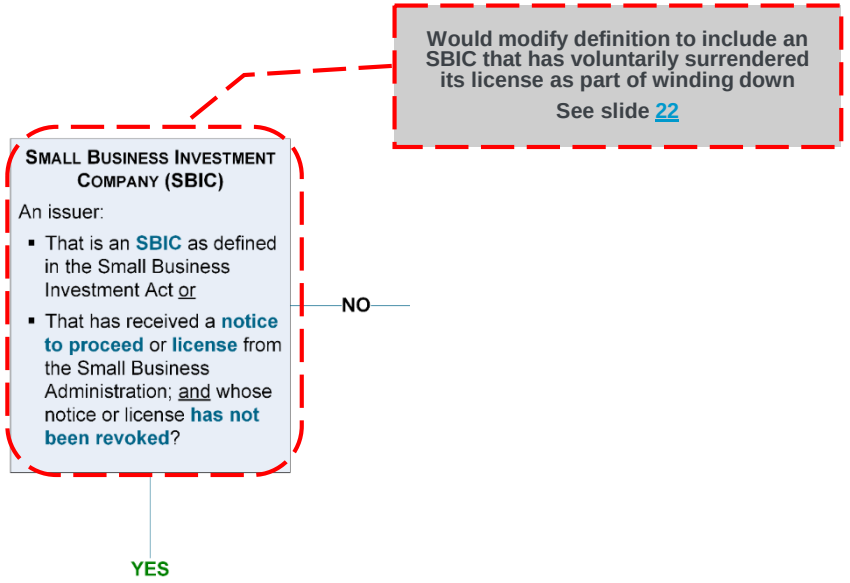
Introduction

- The Federal Reserve, FDIC, OCC, CFTC and SEC (the **Agencies**) **proposed changes** to the covered fund provisions of the Volcker Rule regulations (**covered fund provisions**) in late January 2020.
  - Comments are due **April 1, 2020**.
- The proposed amendments address several key aspects of the covered fund provisions:
  - exclusions from the definition of covered fund;
  - the treatment of foreign funds (both public and private); and
  - the Super 23A prohibition.
- The proposal includes 87 questions for public comment on a variety of covered fund issues. Unlike the **previous set of proposed rule amendments in May 2018**, however, these questions are accompanied by specific proposals to amend and streamline the covered fund provisions of the final rule as adopted in December 2013 (**Final Rule**).
- The Agencies proposed no meaningful changes to the proprietary trading provisions or the compliance program requirements of the Volcker Rule in this proposal.

Guide to this Visual Memorandum

- This visual memorandum incorporates elements of Davis Polk's widely read **flowcharts on the covered fund provisions** of the Final Rule.
- Visual depictions of the proposed changes to the Final Rule are shown by overlaying red dotted lines and grey boxes over our Final Rule flowcharts, as depicted in the example below.



- Following each visual depiction, we describe the proposed changes and requests for comment in a more detailed narrative.
- Topics covered by the Final Rule flowcharts that are not addressed in this visual memorandum would not be changed by the proposal.

New Covered Fund Exclusions

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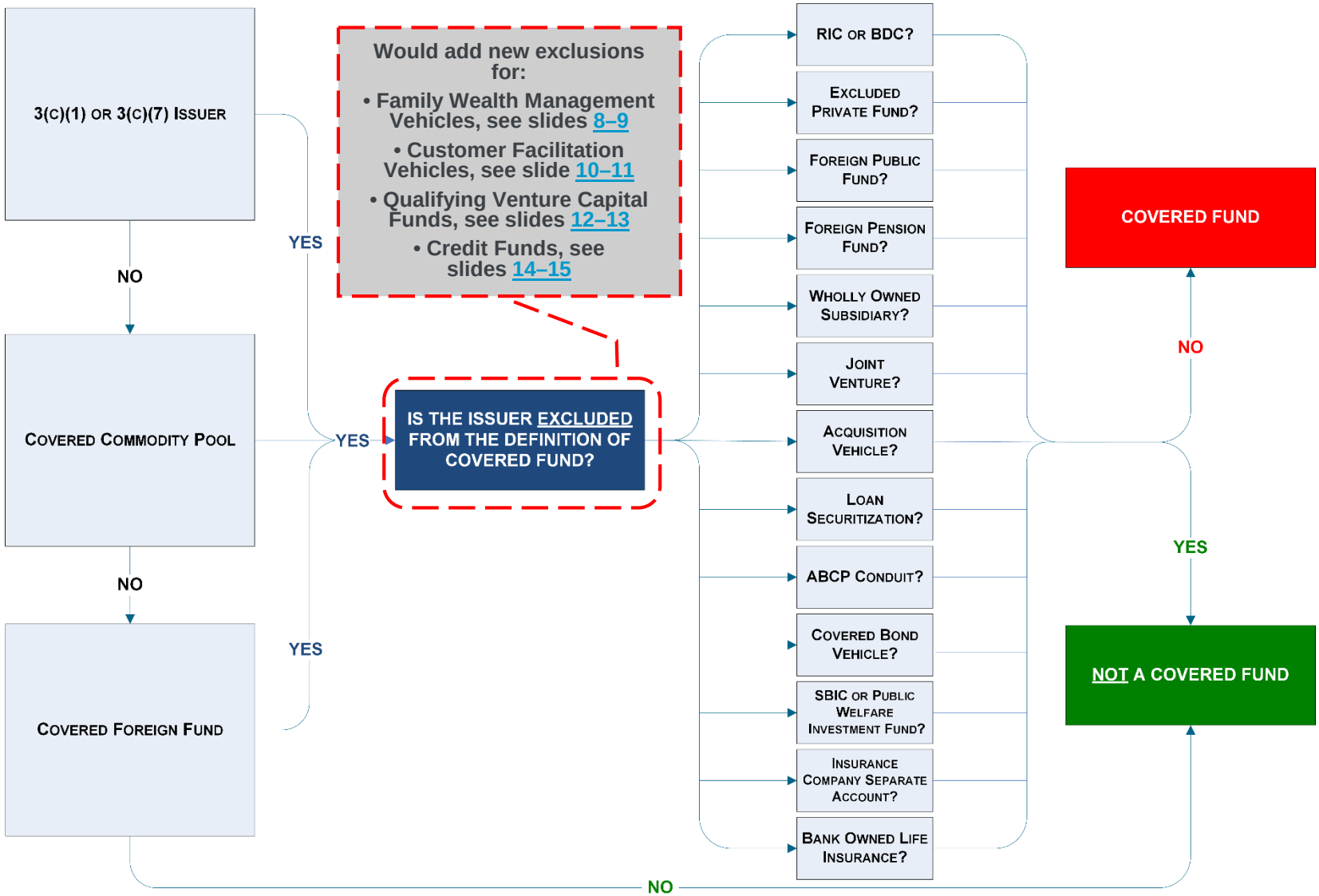
New Covered Fund Exclusions



NEW COVERED FUND EXCLUSIONS

Family Wealth Management Vehicles (FWMVs)

- The Agencies propose a new exclusion for family wealth management vehicles (**FWMVs**). This exclusion is designed to permit banking entities to "provide traditional services to customers through vehicles used to manage the wealth and other assets of those customers and their families."
- An FWMV would need to meet the following conditions to qualify for the exclusion:
  - The FWMV must not be, and must 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.
  - If the FWMV is organized as a trust, the grantor(s) of the entity must all be family customers, meaning:
    - a family client as defined in Investment Advisers Act Rule 202(a)(11)(G)-1(d)(4); or
    - a 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 a spousal equivalent of any family client.
  - If the FWMV is not organized as a trust, (1) a majority of the voting interests in the entity must be owned, directly or indirectly, by family customers and (2) the entity must be owned only by family customers and up to **three** closely related persons of the family customers.
    - 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.

Family Wealth Management Vehicles (FWMVs) (cont.)

- A banking entity may not rely on the FWMV exclusion unless it (or an affiliate):
  - provides bona fide trust, fiduciary, or advisory services to the FWMV;
  - does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such entity;
  - complies with the asset management exemption's disclosure requirement in § __.11(a)(8) of the Volcker Rule Regulations;
  - does not acquire or retain, as principal, an ownership interest in the FWMV, other than up to 0.5% of the FWMV's outstanding ownership interests as permitted for a non-affiliate under the wholly-owned subsidiary exclusion;
  - complies with the Section 23B requirement in § __.14(b) of the Volcker Rule regulations (but **not** Super 23A), as if the FWMV were a covered fund;
  - complies with the covered funds backstop provisions of § __.15 of the Volcker Rule regulations, as if the FWMV were a covered fund; and
  - complies with restrictions on the purchase of low-quality assets in Regulation W (12 C.F.R. § 223.15) as if the banking entity were a bank and the FWMV were an affiliate of the banking entity.

Customer Facilitation Vehicles

- The Agencies propose a new exclusion for a customer facilitation vehicle 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 may not rely on the customer facilitation vehicle exclusion unless:
  - all of the ownership interests of the customer facilitation vehicle are owned by the customer (which may include one or more of its affiliates) for which the vehicle was created, except that the banking entity and its affiliates may acquire up to 0.5% of the vehicle's ownership interests as permitted for a non-affiliate under the wholly-owned subsidiary exclusion;
  - the banking entity and its affiliates maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to the transaction, investment strategy, or service; and

Customer Facilitation Vehicles (cont.)

- the banking entity and its affiliates:
  - do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such entity;
  - comply with the asset management exemption's disclosure requirement in § __.11(a)(8) of the Volcker Rule Regulations;
  - comply with the Section 23B requirement in § __.14(b) of the Volcker Rule regulations (but **not** Super 23A), as if the customer facilitation vehicle were a covered fund;
  - comply with the covered funds backstop provisions of § __.15 of the Volcker Rule regulations, as if the customer facilitation vehicle were a covered fund; and
  - comply with restrictions on the purchase of low-quality assets in Regulation W (12 C.F.R. § 223.15) as if the banking entity were a bank and the customer facilitation vehicle were an affiliate of the banking entity.

NEW COVERED FUND EXCLUSIONS

Qualifying Venture Capital Funds

- The Agencies propose a new exclusion for venture capital funds, as defined in Rule 203(l)-1 under the Investment Advisers Act.
- Under Investment Advisers Act Rule 203(l)-1, the term venture capital fund includes any private fund that:
  - represents to investors and potential investors that it pursues a venture capital strategy, a term that is not defined in the U.S. securities laws or regulations, including Investment Advisers Act Rule 203(l)-1;
  - immediately after the acquisition of any asset, other than a “qualifying investment” (as defined in Investment Advisers Act Rule 203(l)-1(c)(3)) or short-term holdings, holds no more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;
  - 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 obligations of a qualifying portfolio company (as defined in Investment Advisers Act Rule 203(l)-1(c)(4)) 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;
  - only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and
  - is not registered under section 8 of the Investment Company Act of 1940, and has not elected to be treated as a business development company pursuant to section 54 of that Act.

Qualifying Venture Capital Funds (cont.)

- A venture capital fund must meet the following additional conditions to qualify for the exclusion:
  - The venture capital fund must not engage in proprietary trading under the purpose test of the proprietary trading definition in § __.3(b)(i) of the Volcker Rule regulations (**purpose test**).
  - If a banking entity sponsors or serves as an investment adviser or commodity trading advisor to the venture capital fund, the banking entity must:
    - provide prospective and actual investors in the venture capital fund with the written disclosures required under the asset management exemption; and
    - ensure that the activities of the venture capital 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.
  - A banking entity's ownership interest in or relationship with the venture capital fund must also:
    - comply with Super 23A (except the banking entity may acquire and retain any ownership interest in the venture capital fund), the covered funds backstop provisions, and the anti-bailout requirement of the asset management exemption as if the excluded venture capital fund were a covered fund; and
    - be conducted in compliance with, and subject to, applicable banking laws and regulations, including applicable safety and soundness standards.

Credit Funds

- The Agencies propose a new exclusion for credit funds, which the preamble to the proposed rule describes as funds that "make loans, invest in debt, or otherwise extend the type of credit that banking entities may provide directly under applicable banking law."
- To qualify for this proposed exclusion, the assets of the fund must be limited to:
  1) Loans;
  2) Debt instruments (including debt securities) that are permissible for a banking entity to invest in directly;
  3) Rights and other similar assets that are related or incidental to acquiring, holding, servicing, or selling permitted loans or debt instruments, including equity securities, or rights to an equity security, such as a warrant, received on customary terms in connection with a loan or debt instrument, subject to various conditions; or
  4) Interest rate or foreign exchange derivatives, if:
     - the written terms of the derivative directly relate to the loans, debt instruments, or other rights or assets permitted to be held by the fund; and
     - the derivative reduces the interest rate and/or foreign exchange risks related to the loans, debt instruments, or other rights or assets permitted to be held by the fund.
- In addition to the limitations on its investments, the credit fund must not:
  - engage in proprietary trading as defined under the purpose test; or
  - issue asset-backed securities.

Credit Funds (cont.)

- If a banking entity sponsors or serves as an investment adviser or commodity trading advisor to the credit fund, the banking entity must:
  - provide prospective and actual investors in the credit fund with the written disclosures required under the asset management exemption; and
  - ensure 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.
- A banking entity's investment in and relationship with the credit fund must also:
  - comply with Super 23A (except the banking entity may acquire and retain any ownership interest in the credit fund), the covered funds backstop provisions, and the anti-bailout requirement of the asset management exemption as if the credit fund were a covered fund; and
  - be conducted in compliance with, and subject to, applicable banking laws and regulations, including applicable safety and soundness standards.

Modifications to Existing Covered Fund Exclusions

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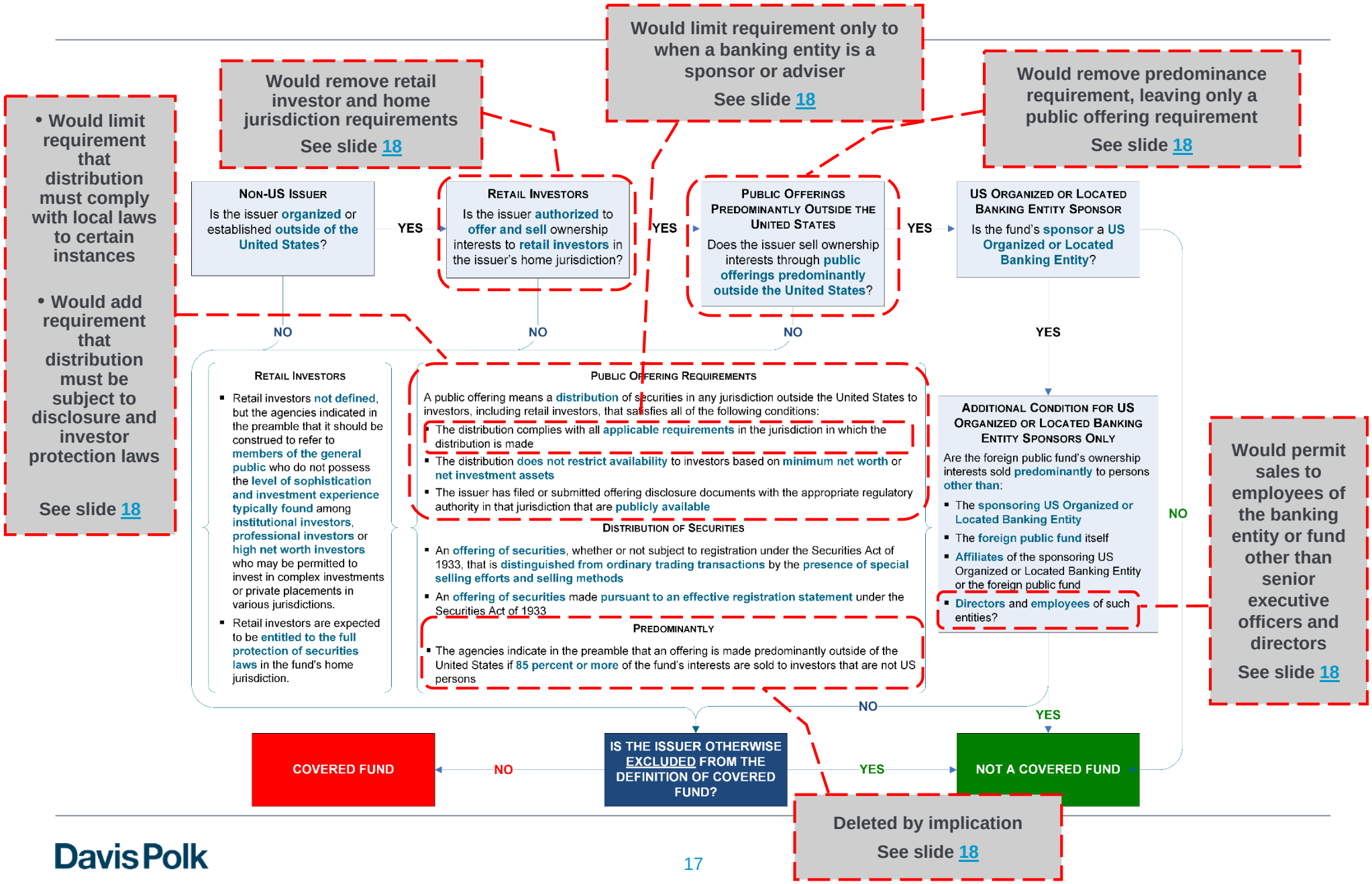
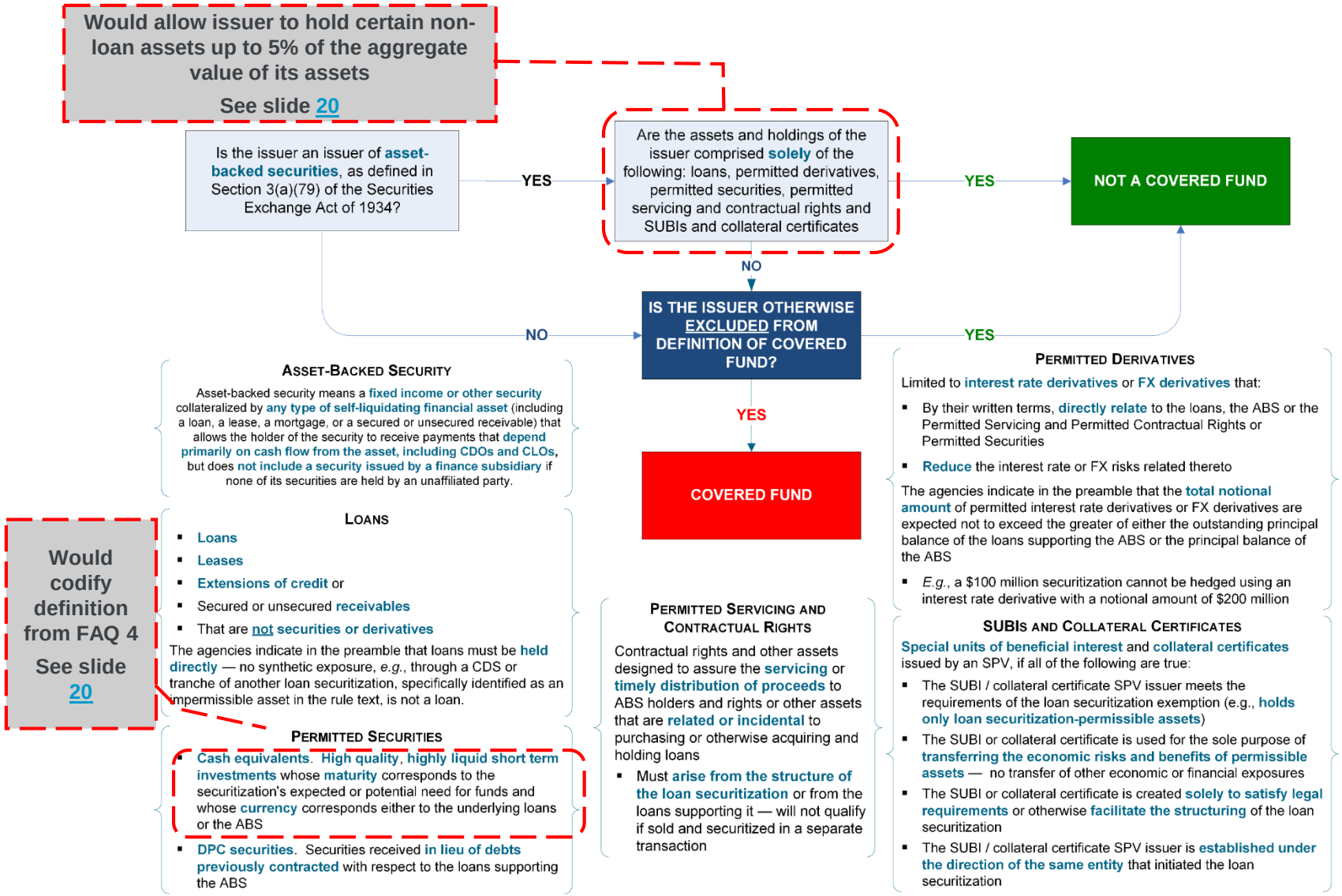
Foreign Public Funds



Foreign Public Funds

- The Agencies propose to eliminate the requirements that a foreign public fund (1) be authorized to offer and sell ownership interests to retail investors in its home jurisdiction and (2) sell ownership interests predominantly through public offerings outside of the United States.
- The proposal would replace these two requirements with a requirement that the fund be authorized to offer and sell ownership interests, and that such interests be offered and sold, through one or more public offerings.
- The proposal would modify the definition of public offering by:
  - adding a requirement that a distribution must be subject to substantive disclosure and retail investor protection laws or regulations; and
  - limiting the application of the existing requirement that the distribution of the fund comply with local law to circumstances where a banking entity acts as the sponsor of or investment adviser, commodity trading advisor, or commodity pool operator to the fund.
- For a U.S. banking entity that sponsors a foreign public fund, the proposal would retain the requirement that ownership interests in the fund be sold predominantly to parties other than the banking entity (or its affiliates) or the fund. The proposal would, however, permit sales to employees of the banking entity (or its affiliates) or the fund—other than senior executive officers and directors—without those sales being attributed to the banking entity or fund.

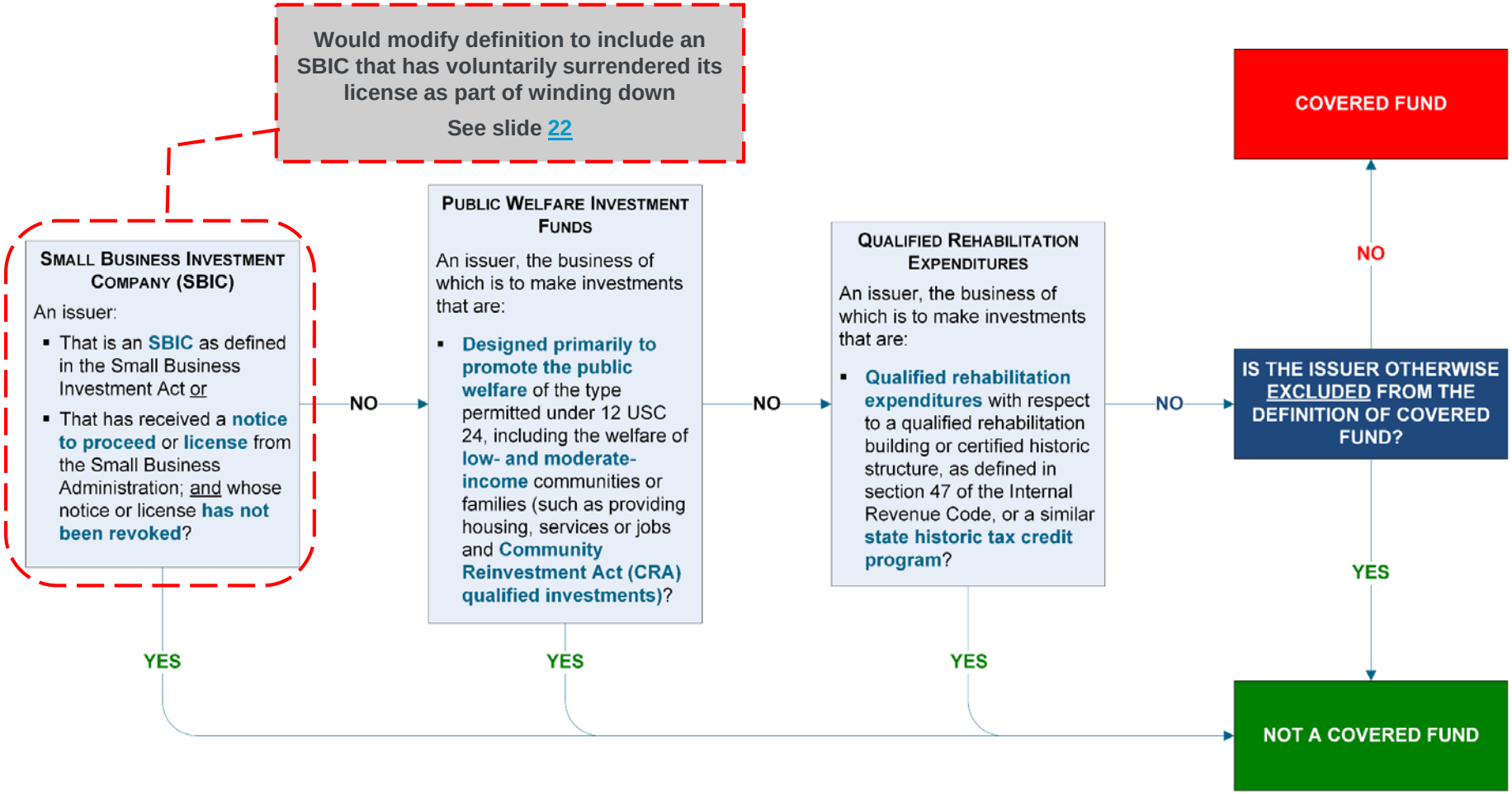
Loan Securitizations



Loan Securitizations

- The proposal would permit a loan securitization to hold debt securities or other non-loan assets that represent 5% or less of the aggregate value of the securitization's assets.
- The Agencies also propose to codify the Loan Securitization Servicing FAQ issued in 2014. This FAQ clarifies that:
  - a loan securitization may hold servicing assets other than permitted securities such as cash equivalents; and
  - cash equivalents, for purposes of the loan securitization exclusion, include "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."

Small Business Investment Companies (SBICs)



Small Business Investment Companies (SBICs)

- The Agencies propose expanding the exclusion for SBICs to cover the full life cycle of an SBIC, including an SBIC that both:
  - has voluntarily surrendered its license and operates in accordance with the Small Business Investment Act's implementing regulations; and
  - does not make new investments, other than investments in cash equivalents, after such voluntary surrender.

Qualifying Foreign Excluded Funds (QFEFs)

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Qualifying Foreign Excluded Funds (QFEFs)

- The Agencies propose new exemptions for the activities and investments of QFEFs (defined on the next slide).
- This proposal would result in similar treatment of QFEFs as under the 2017 and 2019 policy statements and would provide permanent relief for QFEFs.
  - However, the proposal would not exclude QFEFs from the definition of banking entity, as was done in the policy statements previously issued by the Banking Agencies in 2017 and 2019.
  - Instead, a QFEF would be exempt from the proprietary trading prohibition and the covered fund restrictions.
- The proposal would not change the definition of banking entity, meaning a QFEF would be subject to the compliance program, backstop provisions, and other requirements of the Final Rule that are applicable to a banking entity.

Qualifying Foreign Excluded Funds (QFEFs) (cont.)

- The proposal defines QFEF the same as in the 2017 and 2019 policy statements to mean a banking entity that:
  - is organized or established outside the United States, the ownership interests of which are offered and sold solely outside the United States;
  - 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;
  - would not otherwise be a banking entity except by virtue of the acquisition or retention of an ownership interest in, sponsorship of, or relationship with the entity, by another banking entity that meets the following:
    - the banking entity is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or of any State; and
    - the banking entity's acquisition of an ownership interest in or sponsorship of the fund by the foreign banking entity meets the requirements for permitted covered fund activities and investments solely outside the United States, as provided in the SOTUS exemption;
  - is established and operated as part of a bona fide asset management business; and
  - is not operated in a manner that enables any other banking entity to evade the requirements of the Volcker Rule or the implementing regulations.

Limitations on Relationships with a Covered Fund (Super 23A)

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Limitations on Relationships with a Covered Fund (Super 23A)

No banking entity **or its affiliate** that serves, directly or indirectly, as the **investment adviser**, **investment manager**, **commodity trading advisor**, or **sponsor** to a covered fund, or that **organizes and offers a covered fund under the asset management or ABS issuer exemption, or that retains an ownership interest under the ABS issuer exemption**, may enter into a transaction with the covered fund, or with any other covered fund **controlled** by such covered fund, that would be a covered transaction as defined in Section 23A of the Federal Reserve Act as if the banking entity were a member bank and the related covered fund were its affiliate

BANKING ENTITY RELATIONSHIP TO COVERED FUND

- Investment adviser
- Investment manager
- Commodity trading advisor
- Sponsor
- Organize and offer pursuant to asset management exemption
- Organize and offer or hold an interest under the ABS issuer exemption

Would incorporate exemptions of Section 23A of the Federal Reserve Act and Section 223.42 of Regulation W and add exemptions for certain transactions in connection with payment, clearing and settlement activities

See slide 28

Enter into covered transactions → **FIRST-TIER FUND**

Control

Enter into covered transactions → **SECOND-TIER FUND**

EXCEPTION FOR PRIME BROKERAGE TRANSACTIONS WITH ANY COVERED FUND IN WHICH A RELATED COVERED FUND HAS TAKEN AN OWNERSHIP INTEREST

subject to certain conditions

One or more products or services provided by a banking entity to a second-tier covered fund in connection with:

- Custody
- Clearance and settlement
- Securities borrowing and lending services
- Trade execution
- Financing
- Data, operational and portfolio management support

"COVERED TRANSACTIONS"

- **Loans** or other **extensions of credit** to the covered fund
- Purchases of or an **investment in securities issued by the covered fund, other than** ownership interests that are acquired or retained in accordance with the final rules implementing the Volcker Rule
- Acceptance of securities or other debt obligations issued by the related covered fund as collateral security for a loan or extension of credit to any person or company, **except** as provided by the agencies in the preamble
- **Purchases of assets**, including assets subject to a repurchase agreement, from a covered fund, except certain real estate assets
- Issuances of **guarantees**, acceptances or letters of credit, including an endorsement or standby letter of credit, on behalf of the covered fund
- Any **credit exposure** to the covered fund arising from a **derivative transaction**, **repurchase agreement**, **reverse repurchase agreement**, **securities lending transaction**, or **securities borrowing** transaction with the covered fund

NOT A COVERED TRANSACTION

- The agencies stated in the preamble that an **extension of credit to a third party secured by ownership interests** in a related covered fund is not a covered transaction under Super 23A, unless the third party is a related covered fund.

SECTION 23B

- Any banking entity that would be prohibited from entering into a covered transaction with a related covered fund pursuant to Super 23A is subject to Section 23B of the Federal Reserve Act with respect to any of the following transactions as if the banking entity were a member bank and the related covered fund were its affiliate:
  - Sale of securities or other assets to a related covered fund, including assets subject to an agreement to repurchase
  - Payment of money or the furnishing of services to a related covered fund under contract, lease or otherwise
  - Any transaction in which a related covered fund acts as an agent or broker or receives a fee for its services to the banking entity or any other person
  - Any transaction or series of transactions with a third party if a related covered fund has an interest in the third party or if a related covered fund is a participant in such transaction or series of transactions
- Any transaction that would be subject to Super 23A but for the exception for prime brokerage transactions is also subject to the requirements in Section 23B of the Federal Reserve Act as if the banking entity were a member bank and the related covered fund were its affiliate.

Limitations on Relationships with a Covered Fund (Super 23A)

- The Agencies propose to amend Super 23A to permit a banking entity to enter into covered transactions with a related covered fund where the transaction would be exempt under subsection (d) of Section 23A of the Federal Reserve Act or Section 223.42 of Regulation W.
  - This would permit a banking entity to, among other transactions, provide intraday extensions of credit to a related covered fund.
  - Even with the proposed exemptions, Super 23A would continue to be more restrictive than Section 23A of the Federal Reserve Act because:
    - it would apply to both insured depository institution (**IDI**) and non-IDI affiliates;
    - it would remain a flat prohibition (subject to the exemptions), rather than provide numerical limits on covered transactions; and
    - the prohibition on extensions of credit could not be avoided by collateralizing them.
- The Agencies also propose to permit a banking entity to provide short-term extensions of credit to, and purchase assets from, a related covered fund in the ordinary course of business in connection with payment, clearing and settlement activities, provided that:
  - each extension of credit must be repaid, sold or terminated no later than five business days after it was originated; and
  - the banking entity making an extension of credit must comply with the requirements for exempt intraday extensions of credit under Regulation W, as if it were making an exempt intraday extension of credit.

Ownership Interest

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Ownership Interest

Other than a **restricted profit interest (carried interest)**, is the interest in the **covered fund** acquired or retained by the **banking entity**:

An **equity** or **partnership** interest?

YES → **OWNERSHIP INTEREST**

NO

An **other similar interest**?

YES → **OWNERSHIP INTEREST**

NO → **NOT AN OWNERSHIP INTEREST**

Would clarify that removal rights triggered by an event of default or acceleration event are not, on their own, an ownership interest

See slide 31

Specified Characteristics of an "Other Similar Interest"

An "**other similar interest**" includes any interest in or security issued by a covered fund that exhibits any of the following characteristics on a current, future or contingent basis:

- **Selection or removal of manager**. The right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser or commodity trading advisor of the covered fund (excluding the rights of a creditor upon an event of default or acceleration)
- **Share in income, gains or profits**. The right under the terms of the interest to receive a share of the income, gains or profits of the covered fund, whether or not pro rata with other owners or holders of interests
- **Residual interest in assets**. The right 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 upon an event of default or acceleration)
- **Excess spread**. The right to receive all or a portion of excess spread (i.e., the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests)
- **Write-down of amounts payable due to losses**. Provides that, under the terms of the interest, the amounts payable by the covered fund with respect to the interest could 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
- **Return based on performance of assets**. Receives income on a pass-through basis or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund
- **Synthetic rights**. Synthetic right to have, receive or be allocated any of the rights above

Debt Securities as Potential Ownership Interests

- The agencies indicate in the preamble that an ownership interest does not generally cover **typical extensions of credit** the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate.
- However, a debt security or other interest in a covered fund that exhibits specified characteristics that are **similar to those of equity or other ownership interests would be an ownership interest.**

Would provide a safe harbor for certain senior loans and debt interests

See slide 31

Ownership Interest

- The proposal would clarify that an interest that allows its holder to remove an investment manager for cause upon the occurrence of an event of default or acceleration event, or to nominate or vote on a replacement manager upon an investment manager's resignation or removal, would not be considered an ownership interest for that reason alone.
- The Agencies propose to provide a safe harbor from the definition of ownership interest for senior loans or senior debt interests that meet the three criteria set out below. These criteria are designed to ensure that debt interests that do not have equity-like characteristics are not considered ownership interests. They are that:
  - the holders of the senior loan or senior debt interest do not receive any profits of the covered fund but may only receive:
    - 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
    - fixed principal payments on or before a maturity date, which may include prepayment premiums intended solely to reflect, and compensate holders of the interest for, foregone income resulting from an early prepayment;
  - the entitlement to payments on the senior loan or senior debt interest is absolute and may not be reduced because of 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 principal and interest payable; and
  - the holders of the senior loan or senior debt interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed and/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).

Parallel Banking Entity, Director and Employee Investments

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Parallel Banking Entity Investments

Fund of Funds Investments

- If a banking entity organizes and offers a covered fund **for the purpose of investing in other covered funds** (a **fund of funds**), and the fund of funds invests in **another covered fund** that the banking entity is permitted to own, then the banking entity's permitted investment in the **underlying fund** shall include both:
  - Any investment by the banking entity in the underlying fund, plus
  - The banking entity's **pro-rata share of any ownership interest** in the underlying fund that is held through the fund of funds.
- The agencies indicated in the preamble that the banking entity's investment in the fund of funds must "also meet the investment limitations contained in § __.12 of the rule text."

Master-Feeder Investments

- If the **principal investment strategy** of a covered fund (the **feeder fund**) organized and offered by a banking entity is to invest **substantially all of its assets** in another single covered fund (the **master fund**), then for purposes of the **per-fund investment limitations**, the banking entity's permitted investment in such funds shall be measured **only be reference** to the **value of the master fund**
- The banking entity's permitted investment in the **master fund** shall include both:
  - Any investment by the banking entity **in the master fund,** plus
  - The banking entity's **pro-rata share of any ownership interest** of the master fund that is held through the feeder fund.
- Although this attribution rule only applies by its terms to the per fund limit, it seems logical that it would also apply to the aggregate limit as a practical matter.

Parallel Investments

The agencies explained in the preamble that they had decided not to adopt a proposed rule that would have required banking entities to aggregate a wide range of parallel investments made with covered funds to prevent evasion of the investment limits because many investments made by banking entities in the same companies as related covered funds "are made for the purpose of serving the legitimate needs of customers and shareholders, and not for the purpose of circumventing the per-fund and aggregate fund limitations in [the Volcker Rule]."

Coordinated Investments. They nevertheless warned that "the potential for evasion of these limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors." They gave three examples when coordinated investments should be aggregated for purposes of the investment limits:

- **Co-Investments with Sponsored Covered Funds.** "[I]t is relatively common for the sponsor of a covered fund . . . to offer investors co-investment opportunities when the general partner or investment manager for the covered fund determines that the covered fund does not have sufficient capital available to make the entire investment in the target portfolio company or determines that it would not be suitable for the covered fund to take the entire available investment. In such circumstances, a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund . . . unless the value of such co-investments is less than 3% of the value of the total amount co-invested by other investors in such investment."
- **Co-Investment Vehicles.** "[I]f the co-investment is made through a co-investment vehicle that is itself a covered fund (a "co-investment fund"), the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed 3% of the sum of the ownership interests held by all investors in the co-investment fund and related covered fund."
- **Pattern of Parallel Investing.** "[I]f a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund."

Would add a new rule of construction addressing parallel investments by banking entities

See slide 34

Parallel Banking Entity Investments

- The Agencies propose to add a new rule of construction that would address investments made by a banking entity alongside a covered fund.
- This rule would clarify that a banking entity is not required to include in the calculation of the investment limits that apply to a covered fund that is organized and offered or sponsored by the banking entity any direct investment that the banking entity makes in a portfolio company alongside the covered fund.
- This rule of construction applies so long as the direct investment complies with applicable laws and regulations, including applicable safety and soundness standards.
  - The Agencies make clear that the Volcker Rule would not prohibit a banking entity from investing alongside a covered fund, including a covered fund organized and offered by the banking entity, in all or substantially all of the investments made by the covered fund, or to fund all or any portion of the investment opportunities made available by the covered fund to other investors, subject to applicable banking law.

Director and Employee Investments

General Approach to Attribution

- The agencies described their **general approach** to the **attribution** of ownership interests for purposes of the investment limits as follows:

"Under the final rule, a banking entity must account for an investment in a covered fund for purposes of the per-fund and aggregate funds limitations **only if the investment is made by the banking entity or another entity controlled by that banking entity.** Accordingly, the final rule does not generally require that a banking entity include the pro rata share of any ownership interest held by any entity that is not controlled by the banking entity, and thus reduces the potential compliance costs of the final rule. The Agencies believe that this concept of attribution is more consistent with how the [Federal Reserve] has historically applied the concept of 'control' under the BHC Act for purposes of determining whether a company subject to that Act is engaged in an activity or whether to attribute an investment to that company."

Preamble, pg. 704.

Core Banking Entity

- **A core banking entity.** An insured depository institution, bank holding company or other company that controls an insured depository institution, or a foreign bank with a U.S. commercial banking presence or a company that controls such a foreign bank.
- A "**U.S. commercial banking presence**" means having a U.S. branch, U.S. agency, U.S. commercial lending company or Edge Act subsidiary

Normal Covered Funds

A **normal covered fund** is a covered fund that is not itself a "**core banking entity**".

A normal covered fund is **excluded** from the term banking entity for the purposes of the Volcker Rule.

Consequently:

- A normal covered fund is **not** itself subject to the prohibitions or restrictions of the Volcker Rule, including the limits on acquiring or retaining ownership interests in another covered fund
- Subject to the **special attribution rules** for **master-feeder funds, funds-of-funds, and parallel funds**, ownership interests acquired or retained by a normal covered fund in another covered fund are **not** attributable to a banking entity that sponsors, advises or controls the normal covered fund

RICs, BDCs and Foreign Public Funds

For purposes of the investment limits, a registered investment company, business development company or foreign public fund is **not** treated as an affiliate of a banking entity, as long as the other banking entity satisfies **both** of the following conditions:

- Does not own, control or hold with the power to vote 25% or more the voting shares of the company or fund; and
- Any investment advisory, commodity trading advisory, administrative and other services provided by the banking entity or an affiliate to the RIC, BDC or foreign public fund is provided in compliance with any limitations under applicable regulation, order or other authority.

Consequently, **subject to the special attribution rules for master-feeder funds, funds-of-funds, and parallel funds**, ownership interests acquired or retained in a covered fund by a RIC, BDC or foreign public fund are **not** attributable to a banking entity for purposes of the investment limits, if the banking entity satisfi

Would modify the calculation methodologies related to employee and director investments

See slide 36

Employees and Directors

For purposes of the investment limits, ownership interests acquired or retained by a director or employee of a banking entity in a covered fund sponsored by the banking entity, **other than** ownership interests acquired and retained in connection with obtaining a restricted profit interest (carried interest), will **not** be attributed to the banking entity as long as **both** of the following conditions are satisfied:

- The director or employee acquires such ownership interests in his or her **personal capacity**
- The banking entity does **not, directly or indirectly, extend financing** for the purpose of enabling the director or employee to acquire the ownership interest in the fund **or** the financing is not used to acquire the ownership interests

In the preamble, the agencies:

- Clarified that a **guarantee** by the banking entity of the director or employee's obligations on financing obtained from a third party constitutes indirect financing by the banking entity
- Explained that so long as the investments are truly made with personal resources, and are not funded by the banking entity, they would not expose the banking entity to loss
- Stated that ownership interests **acquired and retained** by a director or employee of a banking entity in a covered fund sponsored by the banking entity in **connection with obtaining a restricted profit interest (carried interest)** will be attributed to the banking entity, **regardless** of whether the banking entity **finances** the acquisition or retention of such ownership interests
- Stated that they intend to **monitor** investments by directors and employees of banking entities to ensure that investments by directors or employees are not used by banking entities to circumvent the investment limits, and that they will consider the following factors in evaluating whether any **evasion** is taking place:
  - Whether the benefits of the acquisition and retention, such as dividends, inure to the benefit of the director or employee and not the banking entity
  - Whether the voting or control of the ownership interests is subject to the direction of, or otherwise controlled by, the banking entity
  - Whether the director or employee, rather than the banking entity, determines whether the director or employee should make the investment.

Director and Employee Investments

- For investments by directors or employees of a banking entity in a covered fund organized or offered or sponsored by the banking entity, the Agencies propose to align the manner in which a banking entity calculates its aggregate investment limit under § __.12(a)(2)(iii) and capital deduction under § __.12(d) consistent with the manner in which a banking entity calculates its per-fund investment limit under § __.12(a)(2)(ii).
  - The preamble, but not the proposed rule text, states that the Agencies would not expect that a direct investment by a director or employee of a banking entity in a portfolio company alongside a covered fund's investment in the same portfolio company would be treated as an investment by the director or employee in the covered fund, even if the banking entity arranged the transaction on behalf of the director or employee or provided financing for the investment or the director or employee provided no services to the covered fund.
    - This would be true so long as the investment by the director or employee complies with applicable laws and regulations, including applicable safety and soundness standards.
  - In contrast, but consistent with the alignment principle, the Agencies propose to attribute to a banking entity amounts paid by an employee or director to acquire a restricted profit interest in a covered fund that is organized and offered or sponsored by the banking entity when the banking entity has financed the acquisition of the interest.

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