

## Summary: Volcker Funds 2.1 Proposal

February 3, 2020

### Overview

On January 30, 2020, the Agencies<sup>1</sup> proposed amendments to the covered fund provisions of the Volcker Rule. The proposed amendments address long-standing concerns with the over-broad definition of covered fund, the treatment of foreign funds (both public and private), and the Super 23A prohibition.

The proposal is relatively short and straight-forward. It reflects the approach of Federal Reserve Vice Chair Randal Quarles to simplify the Volcker Rule “in light of our experience with the rule over six years of implementation” and to allow banking entities to conduct “additional fund-related activities, which do not present the risks that the Volcker Rule was intended to address.”

The Agencies proposed no further meaningful changes to the proprietary trading provisions or the compliance program requirements of the Volcker Rule. Nor did they resolve every open question regarding covered funds; the proposal includes 87 questions for comment on a variety of covered fund issues. Unlike in the May 2018 proposal, however, those questions are accompanied by specific proposals to amend and streamline the existing final rule as largely adopted in December 2013 (Final Rule).

### Comments Due April 1, 2020

All five Agencies announced their approval of the proposal on January 30. Because the comment deadline for the proposal has been set for April 1, 2020 (without regard to the date of publication in the Federal Register), the five Agencies appear poised to move quickly to finalize these amendments after considering the public comments.

### Covered Funds Exclusions

#### *New Covered Fund Exclusions*

The Agencies propose to add **four new exclusions** to the definition of covered fund. This approach is consistent with industry comments that opposed the introduction of separate definitions for “hedge fund” and “private equity fund” based on a mythological agreement as to their fundamental characteristics.

- **Family Wealth Management Vehicles (FWMVs).** The Agencies propose a new exclusion for a FWMV that meets the following conditions.
  - The FWMV must not, 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:

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<sup>1</sup> The Federal Reserve Board, OCC, FDIC, SEC and CFTC.

(1) a family client as defined in Investment Advisers Act Rule 202(a)(11)(G)-1(d)(4). This includes, among others, family members (i.e., lineal descendants, including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual, of a common ancestor (who may be living or deceased), and such lineal descendants' spouses or spousal equivalents; provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members), former family members, and current and certain former key employees; and

(2) 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.
- A banking entity may not rely on the FWMV exclusion unless it:
  - (1) provides bona fide trust, fiduciary, or advisory services to the FWMV;
  - (2) complies with the anti-guarantee requirement of the asset management exemption;
  - (3) complies with the disclosure requirement of the asset management exemption;
  - (4) 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;
  - (5) complies with Super 23B (but not Super 23A);
  - (6) complies with the covered funds backstop provisions; and
  - (7) 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 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:
    - (1) 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 may acquire up to 0.5% of the vehicle's ownership interests as permitted for a non-affiliate under the wholly owned subsidiary exclusion; and

(2) the banking entity complies with conditions (2), (3), (5), (6) and (7) noted above for the FWMV exclusion as if the customer facilitation vehicle was an FWMV.

- **Qualifying Venture Capital Funds.** Consistent with the recommendation in the 2017 Treasury Report and statements of several Members of Congress when the Dodd-Frank Act was enacted, the Agencies propose a new exclusion for venture capital funds, as defined in Rule 203(l)-1 under the Investment Advisers Act, subject to the following definitions and conditions.
  - 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 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.
  - The venture capital fund must not engage in proprietary trading under the purpose test of the proprietary trading definition (**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 (1) provide prospective and actual investors in the venture capital fund with the written disclosures required under the asset management exemption and (2) ensure that the activities of the venture capital fund are consistent with safety and soundness standards.
  - A banking entity sponsor or adviser must also comply with Super 23A with respect to the venture capital fund and the anti-guarantee requirement of the asset management exemption.
- **Credit Funds.** The Agencies propose a new exclusion for a credit fund that meets the following conditions:
  - The assets of the credit fund must consist solely of (1) loans, (2) debt instruments (including debt securities), (3) certain rights and other assets that are related or incidental to acquiring,

holding, servicing, or selling such loans or debt instruments, and (4) certain interest rate or foreign exchange derivatives.

- The proposed exclusion would also permit a credit fund to receive and hold a limited amount of equity securities (or rights to acquire equity securities such as options or warrants) that are received on customary terms in connection with the credit fund's loans or debt instruments.
- The credit fund must not (1) engage in proprietary trading under the purpose test or (2) issue asset-backed securities.
- The exclusion would be subject to additional restrictions designed to ensure that the issuer is actually engaged in providing credit and credit intermediation and is not operated for the purpose of evading the provisions of the Final Rule. This includes that a banking entity sponsor or adviser must comply with requirements substantially similar to those imposed on a banking entity seeking to rely on the venture capital fund exclusion (e.g., the banking entity sponsor or adviser must comply with both Super 23A with respect to the credit fund and the anti-guarantee requirement of the asset management exemption, and the banking entity must make certain disclosures).

## ***Modifications to Existing Covered Fund Exclusions***

The Agencies also propose several modifications to existing exclusions from the definition of covered fund to provide clarity and simplify compliance with the requirements of the Final Rule.

- **Foreign Public Funds.**
  - The Agencies propose to eliminate the requirements that the fund be authorized to be sold in its home jurisdiction and that it be sold predominantly through public offerings. The proposal would replace these two requirements with a requirement that the fund be authorized to offer and sell ownership interests, and 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.
  - The existing requirement that the distribution of the fund comply with local law would apply only where a banking entity acts as the sponsor of or investment adviser, commodity trading advisor, or commodity pool operator to the fund.
  - For U.S. banking entities that sponsor 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 fund. The proposal would, however, permit sales to employees of the banking entity or fund (other than senior executive officers and directors) without such sales being attributed to an affiliated party of the banking entity or fund.
- **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 that cash equivalents, for purposes of the rule, 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).** The Agencies propose expanding the exclusion for SBICs to cover the full life cycle of an SBIC, including an SBIC that (1) has voluntarily surrendered its license and operates in accordance with the Small Business Investment Act's implementing regulations and (2) does not make new investments, other than investments in cash equivalents, after such voluntary surrender.

## Qualifying Foreign Excluded Funds (QFEFs)

Generally consistent with the 2017 and 2019 policy statements that provide time-limited relief for the activities and investments of QFEFs, the Agencies propose new exemptions for the activities and investments of QFEFs.

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.

The proposal provides an exemption for the activities and investments of QFEFs, rather than excluding QFEFs from the definition of banking entity, as was done in the 2017 and 2019 policy statements. The proposal, therefore, would make a QFEF subject to the compliance program, backstop provisions, and other requirements of the Final Rule that are applicable to a banking entity.

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

### *Exempt Transactions under 23A and Regulation W*

The Agencies propose, using their authority under section (d)(1)(J) of the Volcker Rule statute, 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 pursuant to 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. But even with the 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 and remain a flat prohibition (subject to the exemptions), rather than merely numerical limits on

covered transactions, and the prohibition on extensions of credit could not be avoided by collateralizing them.

## ***Permissible Transactions in Connection with Payment, Clearing and Settlement Activities***

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 connection with ordinary course of business 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**

### ***Treatment of For-Cause Removal Rights***

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.

### ***Senior Loan/Debt Interest Safe Harbor***

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 payments which are not dependent on the performance of the covered fund, and fixed principal payments on or before a maturity date;
- 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 and Employee Investments**

### ***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 applicable 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***

For investments by 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 and Volcker Rule-specific capital deduction consistent with the manner in which a banking entity calculates its per-fund investment limit.

- **Parallel Employee Investments.** 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.
- **Restricted Profit Interest.** In contrast, but consistent with this 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.

We will publish a visual memorandum describing the proposal and incorporating elements of Davis Polk's Volcker Rule flowcharts in the near future.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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