

January 31, 2020

Highlights of the Volcker Rule Funds Proposal

Yesterday, the five agencies responsible for implementing the Volcker Rule approved a notice of proposed rulemaking to revise the Rule's provisions relating to covered funds. The proposal is the latest step in the effort to simplify and streamline the Rule, following last year's adoption of final revisions to the Rule's proprietary trading and compliance program requirements, which largely deferred the principal issues related to the Rule's covered funds provisions to this proposal. If adopted, the proposal would leave the basic framework of the covered funds provisions intact, but provide important new exclusions from the covered funds definition and flexibility for banking entities to engage in funds activities.

Below is a brief summary of the key headlines and proposals from the release. A redline of the proposed changes can be found [here](#).

Headlines

- New covered fund exclusions for credit funds, venture capital funds, family wealth management vehicles and client facilitation vehicles, but no change to the baseline definition of covered fund.
- Additional flexibility in key exclusions for loan securitizations, foreign public funds and SBICs.
- Revised definition of ownership interest that provides clarity for debt interests in covered funds, including the treatment of creditor rights upon default and a safe harbor for senior loan and senior debt interests.
- Codification of the agencies' no-action relief for qualifying foreign excluded funds.
- Relaxation of the Super 23A prohibition on transactions with advised or sponsored covered funds to permit certain low-risk transactions.
- Permission for banking entities to make parallel investments alongside covered funds without counting such investments as investments in the covered fund for purposes of the 3% per fund limit.

New Covered Fund Exclusions and Expansion of Existing Exclusions

- *Venture capital funds (new)*. Venture capital funds that meet the definition in Rule 203(1)-1 under the Investment Advisers Act.
 - Prohibits fund from engaging in any activity that would constitute proprietary trading.
 - Applies limits to the banking entity, including a prohibition on guaranteeing the fund and application of Super 23A and B and the Rule's general backstop provisions. If a banking entity serves as sponsor or adviser to the fund, it must comply with disclosure requirements and ensure that the activities of the fund are "consistent with safety and soundness standards . . . substantially similar to those that would apply if the banking entity engaged in the activities directly."

- *Credit funds (new)*. Credit funds that invest in assets permitted for loan securitizations, as well as (i) “debt instruments” and (ii) equity securities “received on customary terms in connection with” loans and debt instruments in which the credit fund invests.
 - Prohibits fund from engaging in any activity that would constitute proprietary trading, issuing “asset-backed securities” or holding debt instruments or equity securities that would be impermissible for the banking entity to hold.
 - Applies limits to the banking entity, including a prohibition on guaranteeing the fund and any entity it invests in or lends to and application of Super 23A and B and the Rule’s general backstop provisions. If a banking entity serves as sponsor or adviser to the fund, it must comply with disclosure requirements and ensure that the activities of the fund are “consistent with safety and soundness standards . . . substantially similar to those that would apply if the banking entity engaged in the activities directly.”
- *Customer facilitation vehicles (new)*. A vehicle that is owned by a single customer (and its affiliates) and formed for the purpose of facilitating a customer’s exposure to a transaction, investment strategy, or other service provided by the banking entity.
 - Applies limits to the banking entity, including a prohibition on guaranteeing the vehicle, disclosure and documentation requirements, application of Super 23B (but not Super 23A) and the Rule’s general backstop provisions and a prohibition of purchases of low quality assets from the vehicle.
- *Family wealth management vehicles (new)*. Vehicles owned by a single family client and up to three closely related persons, where the banking entity provides bona fide trust, fiduciary or advisory services to the vehicle.
 - Applies limits to the banking entity, including a prohibition on guaranteeing the vehicle, disclosure requirements, application of Super 23B (but not Super 23A) and the Rule’s general backstop provisions and a prohibition of purchases of low quality assets from the vehicle.
- *Foreign public funds (revised)*. Removes criteria requiring that the fund (i) be authorized to sell to retail investors in its home jurisdiction and (ii) sell ownership interests “predominantly through one or more public offerings outside of the United States”.
 - Replaces these criteria with a new requirement that the fund “[i]s authorized to offer and sell ownership interests, and such interests are offered and sold, through one or more public offerings.”
 - Supplements existing definition of “public offering”, which requires distribution “in any jurisdiction outside the United States to investors, including retail investors”, to further require that the distribution be “subject to substantive disclosure and retail investor protection laws or regulations.”
- *Loan securitizations (revised)*. Adds a permitted basket for “any other assets, provided that the aggregate value of any such other assets . . . do not exceed 5% of the aggregate value of the issuing entity’s assets,” providing flexibility to securitizations such as CLOs that have previously had to exclude all securities from their asset pools to avoid covered fund treatment.
- *SBICs (revised)*. Expands exclusion to include SBICs in wind-down.

Changes to the Definition of Ownership Interest

- Adds safe harbor exclusion for senior loan or debt interests that have only specified absolute rights to principal, interest and fees not determined by reference to the fund’s performance, providing flexibility for banking entities to make straightforward debt investments in funds with terms that raise questions under the “other similar interest” prong of the definition (*e.g.*, consent rights).
- Clarifies the scope of voting rights that may bring an interest into the “other similar interest” element of the definition to exclude the right to participate in the removal of an investment manager for cause or vote on a replacement manager upon resignation or removal where such rights only arise as creditors’ remedies upon default or acceleration.

New Exemptions from Super 23A

- Amends Super 23A to permit banking entities to enter into transactions with related covered funds if the transaction would be exempted from the covered transaction limits in Section 23A of the Federal Reserve Act and Regulation W, and to permit certain other short-term extensions of credit and asset purchases.
 - Incorporates important Regulation W exemptions, including intraday extensions of credit, credit transactions fully secured by U.S. government securities or cash collateral, purchases of certain liquid assets and marketable securities, and riskless principal transactions.
 - Permits short-term (up to five business days) extensions of credit and purchases of assets if made in the ordinary course of payment, clearing and settlement activities.

Permanent Relief for Foreign Excluded Funds

- Exempts activities of qualifying foreign excluded funds from the prohibitions on proprietary trading and investing and sponsoring covered funds, effectively codifying the 2017 and 2019 policy statement temporary no-action relief and solving the “banking entity issue” for foreign excluded funds.

Elimination of Parallel Investment Attribution

- Reverses preamble statement from the 2013 adopting release that suggested banking entities should treat parallel investments alongside covered funds as included for purposes of the 3% per fund limit in certain circumstances, and provides a clear rule of construction that such investments should not be limited if they otherwise comply with applicable laws and regulations including safety and soundness standards.

Comments on the proposal are due April 1, 2020.

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