CLEARY GOTTLIEB

ALERT MEMORANDUM

Observations on the Volcker Rule Funds Proposal

February 12, 2020

On January 30, the five regulatory agencies responsible for implementing the Volcker Rule approved a notice of proposed rulemaking that would make significant revisions to the "covered funds" provisions of the rule (the "Proposal"). The Proposal aims to revise aspects of the rule that have constrained banking activities that the rule was not intended to restrict, including certain activities outside the United States. The Proposal would also codify a number of interpretive clarifications. Key elements include:

- 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.
- Revisions to address practical obstacles to reliance on the existing exclusions for loan securitizations, foreign public funds and SBICs.
- Clarifications about when debt interests in covered funds could be characterized as "ownership interests", including the treatment of creditor rights upon default and a safe harbor for senior loans and senior debt interests.
- Limiting the rule's extraterritorial impact on the non-U.S. funds activities of foreign banks by codifying existing no-action relief.
- Exclusions from the "Super 23A" prohibition for certain low-risk transactions, such as intraday extensions of credit and clearing.
- Clarification that otherwise permissible direct investments alongside covered funds should not be counted towards the 3% limit on what a banking entity can hold in a sponsored covered fund.

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Comments are due April 1, 2020. A link to the Proposal is available here and a blackline against the current rule text is available here. Our highlights memo providing a summary overview of the Proposal is available here.

Background

The Volcker Rule, adopted as part of the Dodd-Frank Act as Section 13 of the Bank Holding Company Act (the "BHC Act"), generally prohibits banking entities from (i) engaging in proprietary trading or (ii) acquiring or retaining an interest in, sponsoring, or having certain relationships with a covered fund, subject to certain exceptions.

The statute charged five agencies with implementing the Volcker Rule—the Board of Governors of the Federal Reserve (the "FRB"), the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation, the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (together, the "Agencies").

Under the statute, a covered fund (a hedge fund or private equity fund in the statute) is defined as an issuer that would be an investment company as defined in the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the Agencies may determine.

The Agencies adopted the original final implementing regulation in December 2013 (the "2013 rule"). In the 2013 rule, the Agencies defined a covered fund to include certain funds beyond those specified by statute (e.g., certain commodity pools and certain foreign funds), and provided for a number of exclusions (e.g., for foreign public funds, joint ventures and loan securitization vehicles, among others).

The Volcker Rule as implemented was frequently criticized as overly complex, and many commenters suggested that it ended up restricting activity that Congress had not intended to prohibit.

In June 2017, the Treasury Department released a report in response to Executive Order 13772, in which it recommended significant statutory and regulatory changes to the Volcker Rule. In August 2017, the OCC released a request for information that solicited comments from the public on suggestions for revising and improving the rule's administration and implementing regulations. Revisions to the rule's covered funds prohibitions were a subject of recommendations and comment in connection with both initiatives.

In July 2018, the Agencies issued a notice of proposed rulemaking that included proposed amendments intended to simplify and tailor application of the rule. However, many of the concerns about the covered funds provisions of the rule were addressed only in questions soliciting comment, as opposed to specific proposed amendments.

In November 2019, the Agencies approved a final rule that simplified and clarified the proprietary trading and compliance program provisions of the rule, but deferred the covered funds changes to a new proposal.

If adopted, the Proposal would leave the basic framework of the funds provisions intact, but provide important new exclusions from the covered funds definition to limit its scope, and clarify other exclusions to reflect practical concerns that have limited their utility. Two themes common to many elements of the Proposal include (i) changes designed to avoid prohibiting banking entities from doing indirectly (through an investment vehicle) what they are permitted to do directly, and (ii) changes designed to avoid inadvertent interference with traditional banking activities that do not present the risks that the Volcker Rule was intended to address. Many of the proposed changes are also intended to simplify and lessen compliance burdens.

The Proposal would also incorporate into the rule important limitations on the extraterritorial application of the rule to funds activities of non-U.S. banks outside the United States by codifying temporary relief the Agencies previously provided in a policy statement, as well as interpretive guidance issued as an "FAQ".

New Covered Funds Exclusions

The Proposal would tailor the reach of the Volcker Rule's covered fund definition by adopting new exclusions from the definition of covered fund for **credit funds**, **venture capital funds**, **family wealth management vehicles** and **customer facilitation vehicles**. According to the Agencies, their practical goals for proposing new exclusions for credit funds and venture capital funds are facilitating capital formation for small businesses and permitting banking entities to engage in economically productive investment activities that do not give rise to the type of risks that the Volcker Rule was intended to address. The exclusions for customer facilitation vehicles and family wealth management vehicles were proposed in response to industry comments that the overly broad definition of covered fund interfered with banking entities' ability to provide ordinary course banking and financial services to customers through a special purpose vehicle that, as a technical matter, met the baseline definition of covered funds.

From the outset, practitioners, industry participants and even the Agencies have acknowledged that the baseline definition of covered fund is overbroad and poorly tailored to the types of risks the Volcker Rule was intended to address.

In prior rounds of comments, major industry trade associations argued that the Agencies should introduce a narrower, more focused definition based on the fundamental characteristics of hedge funds and private equity funds. In the most recent round of comments in 2018, however, most industry commenters decided not to advocate for a new covered fund definition, and instead favored the addition of new exclusions to address this issue of overbreadth.

One major trade association that had previously argued for a characteristics-based approach observed that making a change to the definition now would be unnecessarily disruptive and impose significant adjustment costs, given the length of time that has elapsed since the 2013 rule became effective, and the resources expended by banking entities to classify and conform covered fund activities under the 2013 rule's definition.

<u>Credit Funds</u>

The Proposal would establish an exclusion for credit funds that make loans, invest in debt or otherwise extend the type of credit a banking entity may provide directly.

Asset Restrictions. Credit funds would be subject to restrictions on the assets they can hold. A credit fund would be permitted to hold only:

— loans (any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative);

— debt instruments (apparently intended to include securities);

— rights and other assets related to acquiring, holding, servicing, or selling the above (including certain cash equivalents, securities received in lieu of debts previously contracted, and equity interests (or options on equity interests) received "on customary terms in connection with such loan or debt instrument"); and

— interest rate and FX derivatives directly relating to, or which reduce the interest rate or foreign exchange risk of, such loan, debt instrument, or right or other asset.

A banking entity would only be permitted to rely on this exclusion if the debt and equity securities held by the credit fund would be permissible for the banking entity to hold directly.

Activities Restrictions. Credit funds also would be subject to restrictions on their activities. In particular, a credit fund would be prohibited from:

— engaging in proprietary trading; or

— issuing asset-backed securities ("ABS") (in contrast to the loan securitization exclusion).

Additional Conditions. A banking entity relying on this exclusion would be required to ensure that its investments in and relationship with the credit fund are conducted in compliance with applicable banking laws, including safety and soundness standards. Reliance on the exclusion also would be subject to certain other restrictions common to numerous other new and existing exclusions in the rule, including that:

— the banking entity may not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the credit fund;

— the banking entity must treat the credit fund as a covered fund for purposes of Super 23A and Super 23B (which prohibit entering into extensions of credit and other covered transactions with covered funds advised or sponsored by the banking entity, and require all permitted transactions to be on arm's-length, market terms); and

— the banking entity must comply with the Volcker Rule's prudential backstops, which prohibit material conflicts of interest, material exposure to high risk assets and trading strategies and activities that threaten the banking entity's safety and soundness or U.S. financial stability (the "prudential backstops").

If the banking entity acts as a sponsor, investment adviser or commodity trading adviser to the credit fund, it would also be required to:

— provide certain required disclosure to any actual or prospective investor; and

— ensure 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.

The rationale for this proposed exclusion is to permit banking entities to extend credit to customers indirectly (through a fund structure) that they could extend directly. In the preamble to the 2013 rule, the Agencies had suggested that some credit funds might be able to rely on the loan securitization or joint venture exclusions. The preamble acknowledges that this expectation has not materialized, and cites industry comments asserting that most credit funds have not been able to rely on these exemptions.

The proposed credit fund exclusion is largely modeled on the loan securitization exclusion, but with greater flexibility to acquire a broader set of assets. Because traditional bank lending activities sometimes involve accepting warrants and options over equity securities in lieu of or as a supplement to interest—an activity long recognized as permissible by the OCC and other banking agencies (see, e.g., 12 C.F.R. 7.1006)—credit funds would be permitted to hold equity securities "received on customary terms in connection" with investments in loans and debt instruments.

The proposed exclusion would not impose additional conditions on the types or amounts of equity securities a credit fund could hold, but the preamble suggests the Agencies are considering further limits on non-debt and non-loan assets, and includes a question regarding whether equities should be permitted, and whether there should be a quantitative limit on the amount of non-debt and non-loan assets, such as 5% or 10%.

The proposed exclusion would prohibit credit funds from issuing ABS. This appears to be an attempt to distinguish credit funds from funds eligible for the loan securitization exemption, but the Agencies acknowledge the significant overlap between the two exemptions and ask whether the two exemptions should be combined.

<u>Venture Capital Funds</u>

The Proposal would establish a second exclusion for venture capital funds, as defined in SEC Rule 203(l)-1 (17 C.F.R. 275.203(l)-1).

Definition. SEC Rule 203(l)-1 defines a "venture capital fund" as a private fund that:

— holds no more than 20% of the fund's aggregate capital contributions and bona fide uncalled capital in non-"qualifying investments" (excluding cash and certain short-term holdings);

— does not borrow or otherwise incur leverage in excess of 15% of the fund's capital contributions and uncalled committed capital, and any such borrowing or leverage (excluding certain guarantees by the fund of qualifying portfolio company obligations) is for a non-renewable term of no longer than 120 calendar days;

— does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances;

— represents itself as pursuing a venture capital strategy to investors; and

— is not registered under the Investment Company Act and has not elected to be treated as a business development company.

A "qualifying investment" is an investment in equity securities issued by a "qualifying portfolio company", and acquired directly from the qualifying portfolio company or through certain exchanges (e.g., not in a secondary market transaction). A qualifying portfolio company is generally defined as an operating company that does not incur leverage in connection with the fund's investment in the company and is not a reporting or foreign traded company (i.e., is not subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934, and does not have any securities listed or traded on any exchange or organized market operating in a foreign jurisdiction) and does not control, is not under common control with, or is not controlled by any such company.

Activities Restrictions. Qualifying venture capital funds would be prohibited from engaging in proprietary trading.

Additional Conditions. A banking entity relying on this exclusion would be required to ensure that its investments in and relationship with the venture capital fund are conducted in compliance with applicable banking laws, including safety and soundness standards, and must also comply with backstop provisions similar to those for credit funds, including that:

— the banking entity may not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the venture capital fund;

— the banking entity must treat the venture capital fund as a covered fund for purposes of Super 23A and Super 23B; and

— the banking entity must comply with the prudential backstops prohibiting material conflicts of interest, material exposure to high risk assets and trading strategies, and activities posing a threat to the safety and soundness of the banking entity or U.S. financial stability.

If the banking entity acts as a sponsor, investment adviser, or commodity trading adviser to the venture capital fund, it would also be required to:

— provide certain required disclosure to any actual or prospective investor; and

— ensure 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.

The proposed exclusion for venture capital funds is grounded in statements in the record of Dodd-Frank Act deliberations suggesting that Congress did not intend for the Volcker Rule to restrict banking entities' investments in and relationships with venture capital funds, and in later reports by the Financial Stability Oversight Council (in 2011) and Treasury Department (in 2017) and numerous comment letters suggesting that venture capital funds should be distinguished from private equity and hedge funds.

The preamble distinguishes venture capital funds from private equity funds (which use leverage) and hedge funds (which engage in short-term speculative trading) based on venture capital funds' lesser reliance on leverage financing and lesser degree of interconnectedness with public markets. The preamble suggests these features reduce the risks that venture capital funds would pose to both banking entities and the financial system. The preamble also suggests the new exclusion could promote safety and soundness through diversification and could enhance financial stability and provide other economic benefits by facilitating capital formation and providing financing for small businesses.

The preamble highlights one implication of the decision to apply the prudential backstops to a banking entity's relationships with a venture capital fund: to the extent a fund would expose a banking entity to a high-risk asset or high risk trading strategy, the fund would not be a qualifying venture capital fund. It goes on to suggest that a banking entity should ensure a fund's investment mandate and strategy satisfy these requirements prior to making an investment, and have an ability to monitor the activities of the fund on an ongoing basis.

The preamble notes that the Agencies are considering whether to impose additional conditions on the portfolio investments of a qualifying venture capital fund, in the form of an annual revenue cap of $50 million for each portfolio company, and requests comment on this and other potential conditions (such as reducing the percentage of non-qualifying investments the fund can hold).

The definition in SEC Rule 203(l)-1 is used to provide an exemption from SEC registration as an investment adviser for entities that solely advise qualifying venture capital funds. In the past year, several large venture capital firms that formerly relied on the exemption have since registered with the SEC as investment advisers. These developments may indicate that the investment restrictions in the proposed venture capital fund definition have proven to be too constraining in practice, and may undermine the Agencies' capital formation goals.

Venture capital funds may use a variety of corporate structures and vehicles to structure investments or accommodate special investor circumstances (e.g., parallel and feeder funds, side cars, AIVs, co-investment vehicles and intermediate holding companies). These alternative vehicles and structures may not always meet the criteria for the venture capital fund definition, often because a technical issue prevents them from meeting the qualifying investment test (for example, because the vehicle acquires securities from another related fund vehicle in the complex, rather than directly from the portfolio company). The SEC has published guidance clarifying that an exempt venture capital adviser can provide advisory services to these types of vehicles in connection with advising a venture capital fund without tainting the adviser's exemption (SEC IM Guidance Update 2013-13, December 2013). The Proposal does not indicate whether this guidance might be incorporated into a final rule to provide flexibility for a venture capital fund sponsor to use alternative corporate structures to efficiently organize the fund's activities. If it is not, the ability of a venture capital fund complex to efficiently structure its operations without creating inadvertent covered funds is likely to be constrained.

<u>Family Wealth Management Vehicles</u>

The Proposal would create a new exclusion for certain family wealth management vehicles.

Definition. This exclusion would be available to a vehicle that:

— does not hold itself out as being an entity that raises money from investors primarily for the purpose of investing in securities for resale or disposition or otherwise trading in securities, and:

  - if the entity is a trust, the grantors are all family customers; or
  - if it is not a trust, a majority of the entity's voting interests are owned (directly or indirectly) by family customers and the entity is owned only by family customers and up to 3 closely related persons (other than a 0.5% ownership interest, which may be held by the banking entity for establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns).

"Family customer" includes the term "family client" as defined in Rule 202(a)(11)(G)-1 of the Investment Advisers Act of 1940 (17 C.F.R. 275.202(a)(11)(G)-1), but also adds various in-laws and their spouses.

Additional Conditions. A banking entity relying on this exclusion would be required to meet certain additional conditions, including that it:

— provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services to the vehicle;

— not directly or indirectly guarantee, assume or otherwise insure obligations or performance of the vehicle;

— provide certain required disclosures;

— not retain, as principal, an ownership interest in the vehicle (except up to 0.5% to establish corporate separateness or to address bankruptcy, insolvency or similar concerns);

— comply with Super 23B's arm's-length, market terms requirement and the prudential backstop provisions, each as if the vehicle was a covered fund (but Super 23A would not apply); and

— comply with the prohibition in Regulation W (12 C.F.R. 223.15(a)) on purchasing low-quality assets from the vehicle.

The preamble states that this exclusion is designed to address an unintended consequence of the Volcker Rule that results from an overly broad definition of covered fund, and to permit banking entities to provide the full range of traditional customer-facing banking and asset management services to family wealth management vehicles.

Industry commenters had raised concerns that the application of the Volcker Rule to family wealth management vehicles that technically qualify as covered funds, and in particular the Super 23A restriction against entering into covered transactions with sponsored or advised covered funds, interfered with banking entities' ability to provide ordinary course banking and asset management services to families through such vehicles, including investment advice, brokerage execution, financing and clearance and settlement.

The Agencies include several questions for comment, including how to define "closely related persons" (i.e., longstanding personal vs. business relationships) and whether to increase the number of these persons who may own voting interests from 3 to 10 in order to parallel the number of permitted co-venturers under the joint venture exclusion.

The Agencies did not address requests from some industry commenters that family wealth management vehicles also be excluded from the definition of banking entity. If such a vehicle is controlled by a banking entity for purposes of the BHC Act, e.g., by virtue of it acting as trustee or manager or general partner, the vehicle itself could be deemed a banking entity subject to the Volcker Rule's prohibitions. The Volcker Rule's exemptions for trading and investments undertaken by a banking entity as trustee or in a similar fiduciary capacity may be available in such circumstances to address that concern.

<u>Customer Facilitation Vehicles</u>

The Proposal would also establish a new exclusion for customer facilitation vehicles.

Definition. This exclusion would be available to a vehicle formed by or at the request of a banking entity's customer for the purpose of providing that customer (including one or more affiliates) with exposure to a transaction, investment strategy or other service provided by the banking entity.

All of the ownership interests of the vehicle must be owned by the customer (including one or more of its affiliates) by or for whom it was created (except that up to 0.5% of the vehicle's ownership interests may be held by the banking entity for establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns).

Additional Conditions. A banking entity relying on this exclusion would be required to meet certain additional conditions, including that it:

— maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to the transaction, investment strategy or service;

— not directly or indirectly guarantee, assume or otherwise insure the obligations or performance of the vehicle;

— provide certain required disclosures;

— not retain, as principal, an ownership interest in the entity (except up to 0.5% to establish corporate separateness or to address bankruptcy, insolvency or similar concerns);

— comply with Super 23B arm's-length, market terms requirement and the prudential backstop provisions, each as if the vehicle was a covered fund (but Super 23A would not apply); and

— comply with the prohibition in Regulation W (12 C.F.R. 223.15(a)) on purchasing low-quality assets from the vehicle.

As with the exclusion for family wealth management vehicles, the preamble states that this exclusion is designed to address an unintended consequence of the Volcker Rule that results from an overly broad definition of covered fund. The preamble takes note of the fact that customers have varying legal, counterparty risk management, accounting, and business needs that may favor the use of a fund structure for the services and transactions provided by a banking entity. Commenters noted in particular that customers in several non-U.S. markets may prefer to purchase structured notes issued by an independent vehicle for purposes of reducing credit exposure and providing for a segregated collateral pool specific to the transaction.

While the vehicle must be established by or at the direction of the customer, there would not be a strict "reverse inquiry only" requirement. The preamble confirms that a banking entity would be permitted to market its services through such a vehicle and discuss the potential benefits of structuring services through such a vehicle with a customer prior to its creation.

The Proposal asks several questions regarding the appropriate conditions for the exclusion, including whether the Agencies should specify the types of transactions and services that can be provided and whether services should only be provided at the initiation or request of a customer.

Modifications to Existing Exclusions

The Agencies propose to modify three exclusions from the definition of covered fund with the stated goal of providing clarity and simplifying compliance. The modifications proposed for the exclusions for **foreign public funds ("FPFs")**, **loan securitizations** and **small business investment companies ("SBICs")** would provide additional flexibility to banking entities and address practical impediments to relying on these exemptions.

<u>Foreign Public Funds</u>

The Proposal would address the two most significant problems with the original FPF exclusion by removing two requirements that proved impractical or unreasonably restrictive and burdensome in practice:

— the requirement that the FPF be authorized to offer and sell ownership interests to retail investors in its home jurisdiction (as opposed to, for example, the jurisdiction where the interests are actually sold); and

— the requirement that the interests in the fund be "predominantly" sold through one or more public offerings outside the United States.

The Proposal would also modify the definition of public offering to:

— require that the distribution be subject to substantive disclosure and retail investor protection laws or regulations; and

— limit the prong requiring that the distribution comply with all applicable requirements in the jurisdiction in which the distribution is made to apply only when a banking entity is acting as investment manager, investment adviser, commodity trading adviser, commodity pool operator or sponsor to the FPF (thereby eliminating the need to diligence this requirement when investing in third party FPFs).

Modified FPF Criteria. As modified, the requirements to qualify for an FPF would be:

— the FPF is organized or established outside of the United States; and

— the FPF is authorized to offer and sell ownership interests, and such interests are offered and sold, through one or more public offerings.

U.S. banking entities would continue to face the further restriction that ownership interests in FPFs that the U.S. banking entity sponsors must be sold predominantly to persons other than the sponsoring banking entity, the FPF itself, affiliates of the banking entity or FPF, and their directors and senior executive officers. These requirements remain unchanged, except that the original restriction referred to sales to "directors and employees" of the banking entity, FPF and their affiliates, which would be narrowed to "directors and senior executive officers" of such entities.

Modified Public Offering Requirement. As modified, the requirements to qualify as a public offering would require a distribution of securities in any jurisdiction outside the United States to investors, including retail investors, provided that:

— the distribution is subject to substantive disclosure and retail investor protection laws or regulations;

— if the banking entity serves as the investment manager, investment adviser, commodity trading adviser, commodity pool operator or sponsor, the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made;

— the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and

— the issuer has filed or submitted offering disclosure documents that are publicly available.

The proposed revisions are designed to align further the treatment of FPFs with the treatment of U.S. registered investment companies ("RICs"). The conditions that would be eliminated have been identified by the industry as impractical, unnecessary or posing particularly burdensome compliance obligations. The requirement that an FPF be authorized to be offered and sold to retail investors in the FPF's "home jurisdiction" had disqualified many foreign funds that are organized in one jurisdiction (e.g., Cayman Islands), but only sold in others (e.g., Europe). And the requirement that an FPF be "predominantly" sold through one or more public offerings outside the United States presented significant compliance and monitoring difficulties because banking entities may be unable to verify how an FPF distributed by third parties has in fact been distributed.

Many industry commenters had advocated for eliminating the public offering requirement altogether in favor of a simple requirement that the fund be authorized or qualified to sell to retail investors. U.S. RICs are exempted from the covered fund definition based on their registration status and *authorization* to be sold to retail investors, whether or not they are in fact sold to retail investors. But the Proposal would continue to require FPFs to be offered and sold in a public offering to qualify for the exclusion, albeit no longer with a quantitative inquiry into the number of interests that had been sold in a public offering versus other means of distribution. The Proposal does not address whether FPFs must in fact be sold to retail investors, or whether the offering of the fund to retail investors in a distribution would be sufficient.

The new proposed requirement that a public offering be a distribution that is subject to substantive disclosure and retail investor protection laws or regulations tracks suggestions in several industry comment letters. The preamble asks whether the proposed formulation is sufficiently clear, or if the Agencies should include further detail and/or examples.

The Agencies declined to adopt industry comments suggesting that foreign exchange traded funds listed on public, retail exchanges be automatically qualified as FPFs, although with the proposed modifications we expect it generally would be straightforward to determine that an exchange-listed fund satisfies the public offering requirement.

Loan Securitizations

The 2013 rule exempts loan securitizations, but limits the assets such vehicles can hold to loans, servicing assets, interest rate or FX derivatives, special units of beneficial interest and collateral certifications, and securities if they are cash equivalents or received in lieu of debts previously contracted for loans supporting the ABS issued by the vehicle.

The Proposal would expand the loan securitization exclusion to permit holding any other assets (including, e.g., debt and equity securities) in an amount not exceeding 5% of the aggregate value of the fund's assets.

The Proposal also codifies guidance previously provided by the Agencies in FAQs clarifying that:

— a servicing asset may or may not be a security (but if it is a security, then it must be a permitted security under the rule); and

— "cash equivalents" means high quality, highly liquid investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to the underlying loans or ABS (but not necessarily that they be short-term).

The lack of any "bond bucket" for debt securities has contributed to a bifurcated collateralized loan obligation ("CLO") market, with U.S.-based "pure loan" CLOs that qualify for the exclusion, and European-based mixed CLOs that continue to be treated as covered funds. The additional option of a small bucket for other assets in qualifying loan securitizations would provide welcome flexibility for sponsors seeking to create banking entity-eligible CLOs that also respond to market and customer demands.

While the Proposal would only provide a limited, 5% of net assets bucket for other assets, the Agencies have requested comment on whether to raise it to 10% (or some other threshold) as some commenters have previously sought.

The "other assets" bucket as proposed contemplates a broader range of assets than just debt securities, and the Agencies have sought comment on whether to limit permitted "other assets" only to debt securities or to make specific exclusions for derivatives, collateralized debt obligations or other particular assets. If equity securities remain included in the permitted basket, this may provide flexibility for CLOs to hold, e.g., warrants for which "in lieu of debt previously contracted" status may be unclear.

The Proposal does not specify how the numerator or denominator of the 5% would be calculated, nor does it specify the timing of the calculation, each of which we expect to be a significant focus area for commenters. For example, one potential area where a clarification may be welcome is whether to test the concentration limit for "other assets" only as at a specific purchase date for "other assets".

Small Business Investment Companies

The Proposal would make a technical adjustment to the exclusion for SBICs to extend the benefits of the exclusion to SBICs that surrender their licenses when winding down and that do not make new investments or engage in speculative activities. A SBIC in wind-down would only qualify for the exclusion if it surrenders its license voluntarily and with the prior written approval of the Small Business Administration.

Questions regarding Public Welfare Funds

The 2013 rule has an exclusion for public welfare investment funds, defined as issuers the business of which is to make investments that are:

— designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or

— qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

The Proposal does not include any modifications to this definition, but the preamble takes note of one comment suggesting the exclusion be expanded to account for community development investments made through investment vehicles, and solicits comment on whether the exclusion for funds should be expanded in a number of ways.

Treatment of Parallel Investments

The original 2011 notice of proposed rulemaking would have required certain direct investments made by a banking entity in parallel to a covered fund it organizes and offers to be treated as if they were investments in the fund itself, and subject to the 3% per fund investment limit under the asset management exemption. Although the Agencies decided not to include this provision in the 2013 rule, the accompanying preamble contained language suggesting that under certain circumstances parallel and co-investments alongside sponsored covered funds should be counted towards the 3% per fund limit.

The Proposal would include new rules of construction in the rule text that would clarify that investments made by a banking entity alongside covered funds generally do not need to be counted against the 3% per-fund and aggregate limits, and a banking entity is not restricted in the amount of any investment made alongside a covered fund.

The preamble notes that a banking entity would be permitted to have "investment policies, arrangements or agreements to invest alongside a covered fund in all or substantially all of the investments made by the covered fund" and to market a covered fund sponsored under the asset management exemption "on the basis of the banking entity's expectation that it would invest in parallel with the covered fund in some or all of the same investments", so long as the banking entity "has the ability to evaluate each investment on a case-by-case basis to confirm that the banking entity does not make any investment unless the investment complies with applicable laws and regulations".

The preamble emphasizes that any such parallel investments would have to be made in compliance with applicable laws and regulations, including safety and soundness regulations and the prohibition against proprietary trading. In addition,

— a parallel investment alongside a sponsored covered fund could not be made for the purpose of artificially maintaining the fund's value, given the prohibition on guaranteeing, assuming or otherwise insuring the obligations or performance of a covered fund; and

— the prudential backstops would continue to apply to the banking entity's covered fund organizing and offering activity, in particular the requirement to remedy any material conflicts of interest with timely and effective disclosure.

The preamble also addresses parallel investments made by directors and employees of a banking entity, confirming that direct parallel and co-investments alongside a covered fund by a banking entity's directors and employees would not be subject to the same limits that would apply if they were made in the covered fund. Thus, a banking entity could finance a director or employee's investment alongside a covered fund without such investment being deemed an investment in the covered fund and attributed to the banking entity. In addition, the prohibition in the asset management exemption limiting investments by directors and employees to only those who are directly engaged in providing services to the fund would not apply to directors and employee investments made in parallel to the covered fund.

These clarifications in the Proposal would restore significant flexibility for banking entities to make direct investments alongside covered funds they organize and offer and to demonstrate commitment to an investment strategy through co-investment arrangements. This would represent a step towards correcting what appears to be an unwarranted prohibition on permissible direct investments, given that the original intent appeared to be prohibiting proprietary trading and bailouts of sponsored funds, which are both separate prohibitions that would continue to apply.

The rule would nonetheless continue to create additional complexities for banking entity sponsors of funds as compared to their peers. For example, co-investment vehicles themselves may be "covered funds", which makes co-mingling the banking entity's co-investment in a particular portfolio company or with employee investments problematic. In addition, the Proposal did not address concerns related to either (i) the ability of controlled employee securities companies ("ESCs") to invest in a fund vehicle (a sponsored fund, a third-party fund, or a co-investment vehicle), an issue which if not resolved may also require those employee vehicles to make investments directly in parallel rather than permitting aggregation to simplify such investments, or (ii) the fact that an ESC controlled by a banking entity for purposes of the BHC Act (e.g., where a banking entity serves as a general partner) would itself be captured by the definition of banking entity.

The Agencies requested comment on what other modifications might be necessary to facilitate director and employee investments through ESCs, and more generally on what other limits or conditions should be considered for parallel investments by banking entities and their directors and employees.

Qualifying Foreign Excluded Funds

The Proposal would provide permanent relief on an issue of longstanding concern for foreign banking organizations that funds they control outside the United States would themselves be "banking entities" subject to the rule's prohibitions. This concern arises due to the fact that non-U.S. funds that are not offered or sold to U.S. investors ("foreign excluded funds") may be controlled due to governance arrangements (e.g., serving as general partner) or to a banking entity holding a sizable equity stake in a third-party investment vehicle. While covered funds are specifically excluded from the definition of banking entity, there is no comparable carveout for similar non-U.S. funds that are not covered funds because they have no U.S. investors. As a result, if controlled by a foreign banking organization, the foreign fund itself could be treated as a "banking entity" and subjected to the Volcker Rule's proprietary trading and covered fund restrictions.

The Agencies provided temporary relief to address this problem through a series of policy statements dating back to July 2017. The Proposal would effectively make that relief permanent by exempting from the proprietary trading and covered fund restrictions a "qualifying foreign excluded fund", defined as a banking entity that:

— is organized or established outside the United States and 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 foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the fund;

— 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 Volcker Rule.

In addition, the foreign banking entity's acquisition or retention of an ownership interest in or sponsorship of the foreign excluded fund must meet the conditions for permitted covered fund activities and investments solely outside the United States (the so-called SOTUS exemption).

The Proposal would make permanent temporary relief provided by an interagency policy statement in 2017 and extended in 2019. This relief permits foreign banking entities to conduct their non-U.S. investment and asset management businesses without having to apply the Volcker Rule's proprietary trading and covered funds restrictions to controlled qualifying foreign excluded funds. Many non-U.S. jurisdictions require sponsors of investment vehicles to have some form of controlling relationship, such as being the fund's general partner, and this requirement along with common market practices have contributed to the apparently unintended application of the Volcker Rule to thousands of non-U.S. vehicles that are offered to non-U.S. clients and sponsored by non-U.S. banking organizations.

In opening remarks at the meeting to issue the Proposal, FRB Governor Lael Brainard described the application of the Volcker Rule to foreign excluded funds as an "unintended application" of the rule and stated that providing permanent relief is appropriate given their limited nexus to the United States. The relief in the Proposal reflects an acknowledgement of the territorial limits of the Volcker Rule, as well as the Agencies' years of experience permitting foreign banking entities to offer and sell qualifying foreign excluded funds without implicating any supervisory concerns.

Ownership Interests

Safe Harbor for Senior Loan and Debt Interests

The Proposal would create a new safe harbor exclusion from the definition of ownership interest in order to clarify and limit the circumstances in which a debt interest could be characterized as an ownership interest under the "other similar interest" prong of the definition. The new safe harbor would exclude "senior loan or senior debt interests" that:

— do not have a right to receive a share of the income, gains, or profits of the covered fund;

— have an entitlement to receive only:

- interest at a stated rate, and fees, in each case not determined by reference to the performance of the fund's assets; and
- fixed principal payments on or before a maturity date (including prepayment premiums intended solely to reflect and compensate for foregone income resulting from early prepayment);

— have an entitlement to payments that is absolute and not subject to reduction based on losses from the fund's assets, 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; and

— do not have a right to receive the fund's assets after all other interests have been redeemed 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).

The Proposal does not define "senior" for purposes of the safe harbor.

This safe harbor exclusion could provide flexibility in relation to CLO securities that have "manager" voting rights and are issued by non-loan securitization compliant CLOs (such as certain European CLOs with bond buckets), or in relation to U.S. collateralized bond obligation ("CBO") structures. Without more clarity around what would qualify as "senior", it is unclear how far down the capital stack of a CLO or CBO this safe harbor exclusion should apply. This is expected to be the subject of comment on the Proposal, and the Agencies requested input on whether the safe harbor should be limited only to senior debt instruments, and how to distinguish them.

Clarification of Permitted Voting Rights

The Proposal would clarify that the right to participate in the removal of an asset manager for cause or to vote on a nominated replacement manager following a manager's removal or resignation does not make an interest an ownership interest, so long as such right arises upon the occurrence of an event of default or acceleration.

This is a helpful clarification, but does not seem to represent a material change, since the 2013 rule had already excluded "rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event". The exclusion would not appear to extend to the rights certain noteholders commonly have in CLO structures to remove or vote on a replacement manager prior to an event of default or acceleration under the indenture, but the Agencies asked whether the scope of this right should be extended to include, e.g., for-cause removal prior to default.

Attribution Rules for Employee Retained Profit Interests

The Proposal would modify the treatment of employee investments made to acquire restricted profit interests—the term used in the rule to describe carry entitlements. Under the 2013 rule, a "restricted profit interest" is not an ownership interest, but any capital investment to acquire the interest is deemed an ownership interest, and capital invested by an employee to acquire a restricted profit interest is attributed to the banking entity and counted towards the 3% and aggregate investment limits.

The Proposal would reverse this treatment and, consistent with the treatment of other employee investments, would only attribute employee investments to acquire restricted profit interests to the banking entity if the investments are financed by the banking entity.

Super 23A

The Proposal would revise the so-called Super 23A prohibition to permit banking entities to engage in a limited set of low-risk covered transactions with covered funds that the banking entity sponsors, advises, or organizes and offers. Specifically, the Proposal would allow banking entities to enter into transactions that would be exempt from the limits in Section 23A of the Federal Reserve Act and Regulation W. Key types of such transactions include:

— intraday extensions of credit;

— credit transactions fully secured by U.S. government securities or cash collateral;

— purchases of certain liquid assets and marketable securities;

— riskless principal transactions; and

— securities financing transactions.

In addition, the Proposal would permit 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. Such extensions of credit must meet the requirements applicable to intraday extensions of credit under Regulation W and are subject to the Volcker Rule's prudential backstops.

These changes address a significant industry criticism of the 2013 rule as taking an overly rigid view of the Super 23A statutory prohibition, extending the prohibition even to transactions between banking entities and covered funds that present little risk to a banking entity and which have therefore been exempted from the quantitative and other limits of "regular 23A"—Section 23A of the Federal Reserve Act and Regulation W. Commenters have advocated for many years that the exemptions for low-risk transactions in Regulation W be incorporated into Super 23A, particularly given that Super 23A represents a flat prohibition and not just a quantitative or other limit on covered transactions.

These revisions to Super 23A would enable banking entities to provide many ordinary course services to a covered fund, including payment, clearing and settlement services that frequently were impermissible under the 2013 rule because they created extensions of credit that were prohibited covered transactions (even if fully secured or intraday).

The ability to provide extensions of credit for up to five business days is intended to facilitate transactions between a U.S. covered fund and a non-U.S. affiliate that may last longer than a single day due to time zone differences.

The Agencies noted that they believe these exemptions generally do not present significant risk of loss and do not raise concerns that would implicate the federal safety net for banking entities. The Agencies also note that the exemptions may be stability enhancing by reducing interconnectedness and eliminating the need to rely on third parties that could transmit risks through the financial system.

Several questions in the Proposal request input on whether additional types of transactions or services should be permitted, and whether the Agencies should consider imposing quantitative limits on permitted covered transactions.

What's Not in the Proposal

The Agencies declined to propose some new exclusions and revisions that have been advocated by commenters, including the following selected requests.

Long-term Investment Funds

The most prominent omission was a requested exclusion for long-term investment funds that do not engage in any short-term proprietary trading, make investments that are permissible under banking laws and do not engage in any high-risk activities that would be prohibited by the Volcker Rule backstop provisions. The Agencies did, however, solicit comment on whether to exclude investment funds that generally have these attributes. We expect that this question will generate significant comments. Even without a specific exclusion for long-term investment funds, the proposed rules of construction for parallel investments should provide some additional flexibility for banking entities seeking to sponsor funds holding long-term investments and also to invest in those funds' strategies.

Banking Entity Exclusions

The Proposal also declined to grant certain requested exclusions from the definition of banking entity, including (i) controlled FPFs and RICs during a termination or temporary lifecycle event, and (ii) controlled ESCs.

Prime Brokerage Transactions

Commenters had requested that the Agencies clarify that the scope of "prime brokerage transactions" that are exempt from Super 23A with respect to certain "second tier" funds (i.e., covered funds in which a covered fund managed, sponsored or advised by a banking entity has taken an ownership interest) includes various specified banking services entered into as part of these activities. Commenters also requested that the required CEO certification required under the prime brokerage exemption be based on reasonable review by the CEO. While the Agencies declined to formalize these clarifications, the amendments to Super 23A discussed above should reduce any need to rely on the prime brokerage exemption, since the Proposal would permit a banking entity to enter into short-term extensions of credit and purchases of assets made in the ordinary course of payment, clearing and settlement activities without relying on that exemption.

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