Covered Funds May Cover Less

FEBRUARY 10, 2020

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The federal agencies[1] responsible for the Volcker Rule[2] have proposed[3] to clarify some requirements for exclusion from the definition of "covered fund" and to increase the types of funds excluded from that definition. The proposals aim to achieve these results by modifying the existing restrictions without changing the fundamental aim and structure of the Rule. The modifications are justified on the basis that experience has revealed the lack of necessity for the current, stricter requirements.

LOAN SECURITIZATIONS AND CREDIT FUNDS

The number of funds that are not treated as covered would be increased. The ability to offer investments in pools of loans would be broadened in two ways: the loan securitization exclusion would be loosened, and credit funds would be added to the list of entities excluded from the definition of "covered fund." The principal change to the requirements for treatment as a loan securitization would be the addition of a 5% bucket for "any other assets." These other assets would be permitted, but not required, to be securities other than cash equivalents. In addition, the definition of "cash equivalents" would be made more precise, but in a manner that accords with existing understanding, and the treatment of servicing assets would be modified in line with a previous FAQ.[4]

Credit funds would be treated similarly to loan securitizations, except that they:

- Would not be required to issue (and would, in fact, be prohibited from issuing) asset-backed securities,[5]
- Could hold debt securities in addition to loans, so long as the debt securities are of a kind that a bank may hold directly, and
- Could hold equity securities or warrants that are eligible to be held directly by the banking entity relying on the credit fund exclusion and that are received on customary terms when the loans or debt securities held by the fund are made or issued, respectively.

Holding commodity forward contracts would not be permitted, and credit funds would be prohibited from engaging in proprietary trading as if they were banking entities. Banking entities that act as sponsors of, or investment advisers or commodity trading advisors to, a credit fund would be required to:

- Provide disclosure regarding the fund as if it were a covered fund,
- Ensure that the fund conducts its activities as if the banking entity were itself conducting those activities, and
- Avoid guaranteeing or insuring the performance of borrowers whose loans or debt securities are held by the fund.

Despite the exclusion of credit funds from the definition of “covered fund,” banking entities would be subject to so-called Super 23A restrictions[6] (other than the restrictions on fund ownership) on their relationships with such funds and to the limitations in common rule §__.15 on material conflicts of interest and high-risk transactions. The justification offered for this treatment is concern about banking entities’ potential temptation to bail credit funds out. The severity of applying Super 23A is mitigated somewhat by revisions to Super 23A contained in the proposal, which would allow some servicing relationships, but applying Super 23A and the other special restrictions mentioned in this paragraph essentially results (except for ownership and asset structure) in treating credit funds like covered funds, with respect to which some activities (offering, underwriting and market making) are permitted under common rule §__.11 in spite of their covered fund status.

VENTURE CAPITAL FUNDS

In addition, a form of venture capital fund would be added to the list of funds treated as uncovered. A fund that satisfies the definition of “venture capital fund” in 17 CFR § 275.203(l)-1, which is one of the rules adopted by the Securities and Exchange Commission under the Investment Advisers Act of 1940, and that does not engage in the type of proprietary trading which is impermissible for banking entities would be excluded from the definition of “covered fund.” Nevertheless, sponsors, investment advisers and commodity trading advisors may not rely on this exclusion unless they satisfy additional requirements, namely, those that must be satisfied by credit funds. The justification for and consequences of applying these various requirements are also the same as those described above for credit funds. Use of the Advisers Act definition imports requirements as to strategy, asset and debt limitations, the types of securities that may be issued, registration under the Investment Company Act or choosing to be regulated as a business development company and is justified in the proposal as reflecting what Congress had in mind when it considered venture capital funds while in the process of adopting Dodd-Frank.[7] The justification serves to distinguish this type of fund from private equity and hedge funds, to which Dodd-Frank literally applies. The Agencies also believe that venture capital funds as so defined have less risk than similar funds that are not so restricted and may diversify the funding available to smaller businesses.

ACCOMMODATION FUNDS

The Agencies also propose to exclude from treatment as covered funds two types of funds that might best be thought of as accommodating the needs of specific types of customers: family wealth management vehicles and customer facilitation vehicles. To be excluded, family wealth management vehicles would not be permitted to obtain funds from investors for use primarily in trading or in purchasing securities for resale and would be required to satisfy several organizational requirements relating to the type of structure used and the types of family and non-family participation. In its dealings with such vehicles, a banking entity could provide only certain types of services and would need to:

- Refrain from guaranteeing the performance of the vehicles,
- Make disclosures as if the vehicles were covered funds,
- Limit its interest in the vehicles to the level necessary for corporate separateness or bankruptcy remoteness (and no more than 0.5%),

- Comply with the market-terms provisions of Section 23B of the Federal Reserve Act and the riskiness restrictions in common rule §__.15, and
- Observe the prohibition in 12 CFR 223.15(a) against purchasing low-quality assets from the vehicles, as if the banking entity were a member bank and the vehicles were affiliates.

Customer facilitation vehicles resemble family wealth management vehicles in that they are a form of agency (as opposed to principal) activities by a banking entity. Dodd-Frank and the Volcker Rule expressly permit various kinds of agency activities. Facilitation vehicles must be formed at a customer's request to provide "exposure to a transaction, investment strategy, or other service provided by the banking entity,"[8] and the banking entity would need to keep records of any vehicle's purpose and of the services it provides to the vehicle. All ownership interests in the vehicle would have to be held by the customer or its affiliates, subject to the banking entity's limited ability to hold an interest as described in the bullet points immediately above, all of which bullet points would also apply to facilitation vehicles.

FOREIGN PUBLIC FUNDS

The requirements for excluding foreign public funds from the definition of "covered fund" would be revised to require:

- Substantive disclosure and the protection of retail investors and
- Compliance by any banking entity that is involved as an advisor or sponsor with the requirements of the jurisdiction(s) in which the offering is made.

The requirement that the foreign fund be authorized to sell to retail investors in its own jurisdiction would be dropped, as would the requirement that interests in the fund be sold predominantly through public offerings and the need to track sales to employees of the sponsor, the issuer or their affiliates (while continuing to in effect require the tracking of holdings by directors and senior executive officers).

OTHER PROPOSED REVISIONS

Revisions are also proposed that do not relate to specific types of funds. These include the elimination of some transactions from the prohibition of Super 23A, clarification of the meaning of "ownership interest," "affiliate," "parallel investment" and "co-investment," fixing the manner in which the capital requirements for investments in covered funds are calculated, and extension of the time allowed for divesting impermissible holdings.

Activities that are permissible without limit and without any collateral requirements or low-quality asset prohibitions for state member banks under section 23A of the Federal Reserve Act would be excluded from the prohibitions of Super 23A. These activities include asset purchases and extensions of credit (repayable within five business days) made in the ordinary course of business in connection with payment, clearing and settlement. Such transactions would remain subject to the general risk prohibitions in common rule §__.15.

Since the adoption of the Volcker Rule questions have frequently arisen as to whether terms commonly found in credit agreements create an "ownership interest," especially given the catch-all phrase "other similar interest" in the current definition. The Agencies propose to revise the definition of "ownership interest" to exclude participation in the removal or replacement of an investment manager upon the occurrence of a default. In addition, senior debt that has the following characteristics would be excluded from the definition: the creditor receives only interest payments that do not depend on fund performance and fixed principal payments (before maturity); interest is not reduced upon the occurrence of certain events; and the creditor is not entitled to receive the remainder interest except as part of the enforcement process.

The permissibility of parallel and co-investments has also been a matter of concern since the adoption of the Volcker Rule, both because such investments serve useful purposes and because they seemed to occasionally provide a means of evading the Rule's constraints, especially the ownership limits. The Agencies now propose to permit banking entities to make unrestricted investments "alongside" a covered fund and to exclude such investments from the calculation of their ownership interest in the covered fund, as long as those other investments are within the banking entity's powers, otherwise comply with regulation and do not create safety or soundness concerns. According to the supplementary material in the proposal, investing alongside a covered fund to increase the value of the fund would be treated as otherwise insuring the performance of the fund and might also create an impermissible conflict of interest under common rule §__.15. The proposal would also permit directors and employees of a banking organization to invest alongside a covered fund without that investment being treated as an investment by the director, employee or banking entity in the fund, regardless of whether the banking entity financed that investment.

Each of the proposals is accompanied by a set of questions that cover most aspects of the changes being considered. Responses to those questions and any other comments are due by April 1, 2020.

[1] The Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission and Securities and Exchange Commission (Agencies).
[2] In this article the term Volcker Rule refers to the regulations the agencies have adopted pursuant to section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which is codified as section 13 of the Bank Holding Company Act (12 USC 1851).
[3] On January 30, 2020. The text of the proposal is available on each agency's website.
[4] Loan Securitization Servicing FAQ, which is the fourth FAQ in the list at federalreserve.gov/supervisionreg/faq.htm.
[5] This would render risk retention inapplicable.
[6] Found in common rule §__.14.
[7] The Agencies are also considering a further restriction on the assets that may be held by a venture capital fund, one that would prohibit investments in funds with more than $50,000,000 in annual revenues.
[8] Proposed 12 CFR § 248.10(c)(18)(i).