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# Covered Funds Slightly Uncovered

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The federal regulatory agencies[1] charged with deriving and maintaining regulatory provisions pursuant to section 13 of the Bank Holding Company Act (commonly referred to as the Volcker Rule) have revised[2] the "covered fund" provisions under the Volcker Rule in substantially the manner initially proposed in February 2020.[3] These revisions implement relatively narrow changes to the Volcker Rule that are intended to (i) reduce regulatory overreach, (ii) create additional flexibility in areas where banking entities can directly provide similar services and (iii) resolve some definitional issues.

In particular these revisions:

- expand the scope of assets that may be held by issuers in loan securitizations;
- clarify the definition of "ownership interest";
- modify the requirements for foreign excluded fund status;
- make the definition of foreign public fund more realistic;
- expand the scope of the exclusions for public welfare and small business funds;
- create four new types of excluded funds, namely credit funds, venture capital funds, family wealth management vehicles and "customer facilitation vehicles";
- modify the limitations (i.e., Super 23A) on relationships with covered funds; and
- make the right to invest parallel to a covered fund slightly more robust.

The primary justification provided by the regulatory agencies for each revision is how the principal change is within the scope of section 13's purpose. In many cases a qualifying provision has been added by the regulatory agencies in order to prevent abuse that might arise as a result of the revision.

## LOAN SECURITIZATIONS

Loan securitization vehicles will now be allowed to hold up to 5% of their assets in the form of debt securities (other than asset-backed securities and convertible securities) in addition to the types of securities allowed to be held for cash management purposes. This limitation to the class of ordinary debt securities is intended to maintain a particular limited pattern of risk behavior while allowing some flexibility. The threshold for debt securities is set at 5% out of concern that a 10% threshold could affect the risk characteristics of a fund. Satisfaction of the 5% limitation is calculated each time a fund acquires such a security using the par value[4] of the relevant assets (debt securities, loans and cash and cash equivalents, but excluding derivatives and other assets).

## CLARIFYING THE DEFINITION OF "OWNERSHIP INTEREST"

The clarifications adopted regarding the definition of "ownership interest" are perhaps anticlimactic but perhaps for this very reason also very helpful, in that they essentially confirm the reasoned views of many attorneys about the original definition in the following respects: senior debt with certain straightforward payment terms should not be treated as creating an ownership interest; nor should the ability of a creditor to vote to replace an investment manager upon the occurrence of an event of default, an acceleration event or for cause (as defined in a substantial list). The Release, but not the amended regulation, also confirms that the existence of a waterfall does not result per se in the treatment of funds received pursuant to that waterfall as interests in the profits of the issuer.

The revisions also provide that an employee's or director's restricted profit interest in a fund organized or offered by a banking entity will not be attributed as an ownership interest to the banking entity unless the banking entity financed the acquisition of the profit interest.

## FOREIGN EXCLUDED FUNDS

Consistent with a July 21, 2017 policy statement, foreign excluded funds receive relief from the indirect Volcker Rule consequences that can arise from being controlled by a banking organization even when the funds themselves are not treated as covered funds.[5] Control arises because of the way funds are organized in some jurisdictions. The revisions provide this relief by further exempting already excluded funds[6] from the Volcker Rule restrictions on proprietary trading and on themselves sponsoring covered funds and from requirements that they maintain the kind of compliance program that is imposed by § __.20 of the Volcker Rule. The flexibility this offers is tempered by an anti-evasion requirement and by advice that the rest of the foreign banking organization must maintain an appropriate compliance program.

## FOREIGN PUBLIC FUNDS

Investment funds that are established, operated and publicly offered outside the US are excluded from treatment as covered funds because they strongly resemble registered investment companies in the US, which are also excluded. As proposed, the requirement is being dropped that such funds be sold to the public only in the jurisdiction of the fund's organization, since that requirement did not accord with typical structuring techniques outside the US. The requirement is also being dropped that interests in the fund be sold predominantly thorough public offerings, since tracking sales for this purpose seems complex and not particularly beneficial when third-party distributors are used. Adequate disclosure is required, as is protection of retail investors and, where the banking organization is actively involved in the sponsorship or operation of the fund, adherence to other applicable legal requirements. Limitations on sales to

employees have been eliminated, but those on sales to senior officers have not. The requirement of a public offering is retained out of concern that some jurisdiction may not impose requirements on non-publicly offered funds as those that are imposed on registered investment companies in the US even when they are not offered to the public. To prevent evasion, the current requirement is retained that US banking entities relying on this exclusion must make sure that interests in any applicable fund be sold predominantly to persons other than the US banking entity sponsor, affiliates of such sponsoring banking entity or fund, and the directors and senior executive officers of such entities; however, "predominantly" is now defined as more than 75% (instead of the current 85%).

## PUBLIC WELFARE FUNDS

Funds whose business consists in making investments that qualify under the federal banking regulations implementing the Community Reinvestment Act will be excluded from the definition of covered fund. Rural Business Development Companies and qualified opportunity funds (90% of whose assets are found in designated low-income areas) will also be expressly excluded because of their similarity to Small Business Investment Companies (SBICs) and public welfare investments, which are already within the scope of section 13. Public welfare funds are not, however, excluded from the definition of "banking entity," since the regulators do not perceive that classification to create much difficulty in structuring or compliance. SBICs themselves will be allowed to retain their excluded status when they voluntarily surrender their license and engage in no transactions thereafter.

## CREDIT FUNDS

Credit funds resemble loan securitizations but issue no asset-backed securities and tend to hold a wider range of debt instruments. Beginning October 1, 2020, they will be excluded from the definition of "covered fund" without regard to whether other exclusions might be available. To benefit from the new exclusion, credit funds will need to limit their holdings to loans; debt instruments that banking entities can hold directly; equity interests that banking entities can, subject to customary terms, receive in connection with extending credit; related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans or debt instruments; and derivatives that relate to interest rate or foreign exchange exposures created by the loan or debt security assets. Among the justifications for permitting funds to hold this range of assets are that fact that many banking entities can hold such assets directly instead of through loan securitization vehicles and that holding such asset types does not seem to render a fund a hedge fund or private equity fund of the type section 13 was designed to constrain. In addition, credit funds will be prohibited from engaging in proprietary trading and may not issue asset-backed securities.

Given the confirmation in the Release that ordinary senior debt securities do not create an ownership interest in the fund, the issuance of such a security could possibly create an interesting conundrum for a credit fund. If such a fund issues senior debt, it would have to determine whether the debt is an asset-backed security. Given the definition of "asset-backed security" in the Securities Exchange Act of 1934, it is conceivable that the credit fund would have to be actively managed (with proper attention to avoiding proprietary trading)[7] so that the payments on the debt do not depend primarily on the cash flow from the underlying assets; otherwise, because the credit fund would have issued an asset-backed security, it would have to be operated as a loan securitization, with correspondingly tighter limitations on the holding of non-loans. If the credit fund is not actively managed at all, potentially all of the securities it issues could be treated as asset-backed, which would again potentially require reliance on the loan securitization exclusion or on exemptions from investment company registration other than 3(c)(1) or 3(c)(7), such as Rule 3a-7.

To reduce the risk that is perceived to exist in the operation of a credit fund, particularly the possibility that investors will expect to be bailed out in the event of difficulty, the provisions of §__.14 (Super 23A) will apply to banking entities that serve as sponsors, investment advisers or commodity trading advisors to such funds. In addition, banking entities holding interests in credit funds will be subject to the conflict-of-interest and high-risk avoidance rules in §___.15 of the Volcker Rule as if the excluded fund were not excluded, as well as ordinary capital charges and safety-and-soundness rules generally applicable to such banking entities.

## VENTURE CAPITAL FUNDS

In order to allow banking entities to provide more financing in the relevant markets, funds will be excluded from the definition of "covered fund" if they satisfy the definition of "venture capital fund" in Rule 203(*l*)-1 under the Investment Advisers Act.[8] To limit the perceived risks arising from venture capital activities, such funds may not engage in proprietary trading (as defined in §__.3(b)(1)(i) [trading for short-term profit] of the Volcker Rule) except as permitted for banking entities. A banking entity that acts as sponsor of, investment adviser or commodity trading advisor to, or investor in, such a fund must provide specified types of disclosure to investors, adhere to the safety-and-soundness standards that would apply to a banking entity directly engaged in such activities, and observe the standards of Super 23A and Super 23B. It also may not guarantee or assume the obligations of the fund and must observe the conflict-of-interest and high-risk avoidance requirements found in §__.15 of the Volcker Rule as if the fund were a covered fund as well as other applicable banking laws and regulations.

## FAMILY WEALTH MANAGEMENT VEHICLES AND CUSTOMER FACILITATION VEHICLES

Family Wealth Management Vehicles and Customer Facilitation Vehicles are two new types of excluded funds that serve to provide a secure legal basis for what are essentially bank agency activities, as opposed to typical investment vehicles for sale to the general public.

The revisions recognize two types of family wealth management vehicles, trust and non-trust. The main difference between the two types of vehicles is largely the types of investors they are permitted to have. The majority of the voting and non-voting interests in a family trust must be held by family customers, while only five closely related persons can join family customers as holders of interests in non-trust vehicles.[9] However, for purposes of entity isolation or insolvency planning, others may hold interests totaling no more than 0.5% of the aggregate interests in the family vehicle. To underscore the agency aspects of the banking entity's role and reduce the potential risks of excluding family wealth management vehicles from the definition of "covered fund," the entity must provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services to the vehicle; abstain from guaranteeing or insuring the vehicle's obligations; provide disclosure; and comply with Super 23B and the conflict of interest and risky transaction provisions as if the vehicle were a covered fund. The banking entity is also prohibited from acquiring low-quality assets from the vehicle except when acting as a riskless principal, and the vehicle may not function as a device for raising money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

Customer facilitation vehicles have an even more pronounced customer orientation, since they are "formed by or at the request of a customer of the banking entity for the purpose of providing such customer (which may include one or more affiliates of such customer) with exposure to a transaction, investment strategy, or other service provided by the banking entity."[10] The other requirements that must be satisfied are essentially the same as those that must be satisfied

by family wealth management vehicles, except that all of the ownership interests of the customer facilitation vehicle must be owned by the customer (which may include one or more of its affiliates) for whom the vehicle was created, and the banking entity and its affiliates must maintain documentation outlining plans for how the vehicle is going to be used to provide transactional services.

## MAKING EXCEPTIONS TO SUPER 23A

Rather than amending the definition of "covered transaction," the Release adopts some exemptions to the prohibition on covered transactions with covered funds. Among these are exemptions for transactions "that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under section 23A of the Federal Reserve Act,"[11] provided they meet the eligibility requirements for such transactions set forth in Regulation W of the Federal Reserve Board, including the requirement that the transaction be carried out by a securities affiliate of the banking entity when purchases of marketable securities and municipal securities are involved. The banking entity may, however, enter into riskless principal transactions with the fund in question without using a securities affiliate. Banking entities may also rely on the separate exception for extending short-term credit and acquiring assets in connection with the provision of payment, clearing, and settlement services, subject to several detailed conditions common in this area. The adopting agencies spend an unusual amount of time justifying these changes as actually improving the safety and soundness of the financial system.

## PARALLEL INVESTMENTS

To eliminate the mismatch between the preamble to the Volcker Rule and the Rule itself with regard to whether investments made in parallel to those made by a covered fund would be attributed to the banking entity in question, parallel investments are now permitted (and are not included in covered fund ownership calculations) if the type of parallel investments are otherwise permissible for the investor under other applicable regulations and do not lead to the kinds of risky transactions or conflicts of interest[12] prohibited by §__.15 of the Volcker Rule. Instead of prohibiting parallel investments, the federal agencies now rely on the wording of section 13 to permit such investments and on other provisions of the law, including §__.15, to deal with the concerns that led to the original hint at prohibition. Consistent with this position, parallel investments by directors or employees of the applicable banking entity will not be attributed to the banking entity's interest in the covered fund, even if the banking entity financed those investments; nor will the limitations on which officers or directors are eligible to invest in a covered fund (which have not been amended) apply to a parallel investment.

## USEFULNESS

The theme of the revisions is one of enhanced usefulness of the Volker Rule rather than the rescue of a damaged financial system and some of the changes simply ratify reasoned steps already taken by practitioners in interpreting the Volcker Rule. The usefulness of the revisions, both in themselves and as a partial retelling of the story of what went wrong in 2008, will need to be tested by trial and error.

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[1] The Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission and Securities and Exchange Commission.
[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, June 2020 (the "Release")
[3] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 FR 12120 (Feb. 28, 2020).
[4] Fair value may be used instead under certain conditions.
[5] The Release notes in footnote 40 that a foreign excluded fund is excluded from treatment as a covered fund only with respect to the banking organization that is properly associated with it; the very same fund can at the same time be a covered fund with respect to a differently situated banking organization.
[6] Namely, those that satisfy the requirements contained in § __.13(b) of the Volcker Rule.
[7] The Release notes on p. 76 that "activities permitted under § __.10(c)(15) [i.e., the new provision excluding credit funds from the definition of "covered fund"] generally would not be considered proprietary trading, provided that an excluded credit fund does not purchase or sell one or more financial instruments principally for the purpose of resale, benefit from actual or expected short-term price movements, realize short-term arbitrage profits, or hedge one or more of the positions resulting from the purchases or sales of financial instruments." This phrasing would appear to increase the risk that active management could be thought to take place, since there is no discussion in the provision of the level of activity that might cause a security to become an asset-backed security. However, there is also no certainty that the ban on short-term profit seeking would render it impossible to operate a credit fund within the scope of the requirements. Nevertheless, a fair amount of care may need to be taken.
[8] The Release elaborates on why the agencies do not believe Congress intended to treat venture capital funds like hedge funds or private equity funds. The narrowness of the definition of "venture capital fund" is one of the reasons for this view, including, among other things, the investment limitations imposed on such a fund and the prohibition of both long-term debt and high levels of leverage.
[9] As pointed out in the Release: "…a 'family customer' is a 'family client,' as defined in Rule 202(a)(11)(G)-1(d)(4) of the [Investment] Advisers Act…; or any 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 spousal equivalent of any of the foregoing." A closely related person is "a natural person (including the estate and estate planning vehicle of such person) who has longstanding business or personal relationships with any family customer."
[10] Release, p. 121.
[11] Release, p. 136.
[12] Footnote 479 mentions the possibility of conflicts with clients if a banking entity exits a parallel investment at certain times or on different terms. This would call for pre-investment disclosure.