Final Volcker Rule 2.1 – Covered Funds

June 26, 2020

Overview

- The Federal Reserve, OCC, FDIC, SEC and CFTC (**Agencies**) have approved **final amendments** to the covered funds portion of the regulations implementing the Volcker Rule (**Final Amendments**).
- The Final Amendments largely adopt the amendments as proposed, with a few key differences, including the following:
  - The new exclusion for family wealth management vehicles (**FWMVs**) permits an FWMV that is not organized as a trust to be owned by up to five closely related persons of the family customers (rather than three, as proposed).
  - A U.S. banking entity and its associated parties may own up to 24.9% of the ownership interests in a foreign public fund that is sponsored by the U.S. banking entity, instead of up to only 14.9%.
  - A loan securitization vehicle may hold certain debt securities that represent up to 5% of the aggregate value of the securitization vehicle's assets.
  - A qualifying foreign excluded fund (**QFEF**) is not subject to the Volcker Rule compliance program requirements that are otherwise applicable to banking entities.
  - A banking entity may enter into riskless principal transactions with a related covered fund, regardless of whether that covered fund is a "securities affiliate" as defined in Regulation W.
  - The types of events that qualify as "cause" for removal of an investment manager for purposes of the ownership interest definition are clarified.
- The Agencies made no substantive amendments to the proprietary trading provisions or the compliance program requirements of the Volcker Rule other than to provide exemptions for QFEFs. The Agencies also confirmed in the preamble that the Final Amendments do not modify or revoke any of the Volcker Rule FAQs previously issued by staff of the Agencies, unless otherwise specified.
- We have prepared blacklines of the Final Amendments **marked against the proposed amendments** and **marked against the current Volcker Rule regulations**. We will be publishing updated versions of the Davis Polk Volcker Rule flowcharts to reflect the Final Amendments.
- The effective date of the Final Amendments is October 1, 2020.

Covered Funds Exclusions

- **New Covered Fund Exclusions.** The Agencies adopted largely as proposed **four new exclusions** to the definition of covered fund. The Agencies declined to adopt any other new exclusions, including an exclusion for long-term investment funds.
  - **Family Wealth Management Vehicles.** The Final Amendments include a new exclusion for an FWMV that meets the following conditions, largely as proposed.
    - The FWMV must not, and must not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

- If the FWMV is organized as a trust, the grantor(s) of the entity must all be **family customers**, meaning:
    - a family client as defined in Investment Advisers Act Rule 202(a)(11)(G)-1(d)(4). It includes, among others, family members, i.e., lineal descendants, including by adoption, stepchildren, foster children, and individuals that were a minor when another family member became a legal guardian of that individual, of a common ancestor, who may be living or deceased, and such lineal descendants' spouses or spousal equivalents, provided that the common ancestor is no more than 10 generations removed from the youngest generation of family members; former family members; and current and certain former key employees; and
    - a natural person who is a father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law, or daughter-in-law of a family client, or a spouse or a spousal equivalent of any family client.
- If the FWMV is not organized as a trust, (1) a majority of the voting interests in the entity must be owned, directly or indirectly, by family customers, (2) a majority of the interests in the entity must be owned, directly or indirectly, by family customers, and (3) up to **five closely related persons** of the family customers are permitted to own interests in the FWMV.
    - "Closely related person" is defined as a natural person, including the estate and estate planning vehicles of such person, who has longstanding business or personal relationships with any family customer.
    - The proposed amendments would have required that a majority of the *voting interests* in an FWMV be owned by family customers, but not that a majority of the *interests* in an FWMV be owned by family customers.
    - The limit on the number of closely related persons who may hold ownership interests in an FWMV was increased from three to five.
- One or more entities that are not family customers or closely related persons may acquire or retain, as principal, up to an aggregate of 0.5% of the FWMV's outstanding ownership interests if the ownership interest is acquired or retained by such parties for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.
    - This provision permits *de minimis* ownership of an FWMV by both banking entity and non-banking entity third parties. The proposed amendments would have permitted *de minimis* ownership of an FWMV solely by banking entities.
- A banking entity may not rely on the FWMV exclusion unless it or an affiliate:
    (1) provides *bona fide* trust, fiduciary, or advisory services to the FWMV;
    (2) complies with the anti-guarantee requirement of the asset management exemption;
    (3) complies with the disclosure requirement of the asset management exemption, provided that the content may be modified to prevent the disclosure from being misleading and the manner of disclosure may be modified to accommodate the specific circumstances of the FWMV;
        - The proviso permitting certain modifications to the disclosures was not included in the proposed amendments.

(4) does not acquire or retain, as principal, an ownership interest in the FWMV, other than as permitted under the *de minimis* ownership provision described above;

(5) complies with the Section 23B requirement in § __.14(b) of the Volcker Rule regulations (but compliance with Super 23A is not required);

(6) complies with the covered funds backstop provisions; and

(7) except for riskless principal transactions, complies with restrictions on the purchase of low-quality assets in Regulation W (12 C.F.R. § 223.15) as if the banking entity were a bank and the FWMV were an affiliate of the banking entity.

- "Riskless principal transaction" is defined in a manner consistent with federal banking law as a transaction in which a banking entity, after receiving an order from a customer to buy or sell a security, purchases or sells the security in the secondary market for its own account to offset a contemporaneous sale to or purchase from the customer.
- The proposed amendments did not include an exception for riskless principal transactions.

- **Customer Facilitation Vehicles.** The Final Amendments also include a new exclusion for a customer facilitation vehicle formed by, or at the request of, a customer of a banking entity for the purpose of providing the customer or its affiliates with exposure to a transaction, investment strategy, or other service provided by the banking entity.
  - A banking entity may not rely on the exclusion for customer facilitation vehicles unless:
    - all of the ownership interests of the customer facilitation vehicle are owned by the customer, which may include one or more of its affiliates, for which the vehicle was created, except that one or more entities that are not customers are permitted to acquire or retain, as principal, up to an aggregate of 0.5% of the vehicle's outstanding ownership interests if the ownership interest is acquired or retained by such parties for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns;
    - the banking entity and its affiliates maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction investment strategy, or service; and
    - the banking entity and its affiliates comply with conditions (2) to (7) noted above for the FWMV exclusion as if the customer facilitation vehicle were an FWMV.
- **Qualifying Venture Capital Funds.** The Final Amendments also include a new exclusion for venture capital funds, as defined in Rule 203(l)-1 under the Investment Advisers Act, largely as proposed.
  - Under Investment Advisers Act Rule 203(l)-1, the term "venture capital fund" includes any private fund that:
    - represents to investors and potential investors that it pursues a venture capital strategy, a term that is not defined in Investment Advisers Act Rule 203(l)-1;
    - immediately after the acquisition of any asset, other than a "qualifying investment," as defined in Investment Advisers Act Rule 203(l)-1(c)(3), or short-

term holdings, holds no more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;

- does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the fund of obligations of a qualifying portfolio company, as defined in Investment Advisers Act Rule 203(l)-1(c)(4), up to the amount of the value of the fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit;
- only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and
- is not registered under section 8 of the Investment Company Act of 1940, and has not elected to be treated as a business development company pursuant to section 54 of that Act.

- The qualifying venture capital fund must not engage in proprietary trading under the purpose test of the proprietary trading definition (**purpose test**).
- A banking entity that sponsors or serves as an investment adviser or commodity trading advisor to the venture capital fund may not rely on the qualifying venture capital fund exclusion unless the banking entity:

(1) provides prospective and actual investors in the venture capital fund with the written disclosures required under the asset management exemption;

(2) ensures that the activities of the venture capital fund are consistent with safety and soundness standards;

(3) complies with Super 23A with respect to the venture capital fund; and

- The Final Amendments clarify that Super 23A only applies to a banking entity that acts as a sponsor or adviser to a qualifying venture capital fund, and not a banking that merely invests in a qualifying venture capital fund.

(4) complies with the anti-guarantee requirement of the asset management exemption.

- A banking entity's ownership interest in or relationship with a qualifying venture capital fund must:

(5) comply with the covered funds backstop provisions; and

(6) be conducted in compliance with, and subject to, applicable banking laws and regulations, including applicable safety and soundness standards.

- **Credit Funds.** The Final Amendments also include a new exclusion for a credit fund that meets the following conditions, largely as proposed.

- The assets of the credit fund must consist solely of (1) loans, (2) debt instruments, including debt securities, (3) certain rights and other assets that are related or incidental to acquiring, holding, servicing, or selling such loans or debt instruments (although unlike the proposed amendments, the Final Amendments explicitly state that these rights may not include commodity forward contracts or any derivative), and (4) certain interest rate or foreign exchange derivatives.
    - The exclusion permits a credit fund to receive and hold a limited amount of equity securities or rights to acquire equity securities such as options or warrants that are received on customary terms in connection with the credit fund's loans or debt instruments.
    - Consistent with the proposed amendments, there is no quantitative limit on the amount of equity securities or rights to acquire equity securities that may be held by an excluded credit fund, but the Agencies stated in the preamble to the Final Amendments that they "generally expect that the equity securities or rights satisfying [the applicable] criteria in connection with an investment in loans or debt instruments of a borrower (or affiliated borrowers) would not exceed five percent of the value of the fund's total investment in the borrower (or affiliated borrowers) at the time the investment is made."
- The credit fund must not (1) engage in proprietary trading under the purpose test or (2) issue asset-backed securities.
- A banking entity may not rely on the credit fund exclusion unless:
    - any debt instruments or equity securities or rights to acquire an equity security that the credit fund holds would be permissible for the banking entity to acquire and hold directly under applicable federal banking laws and regulations; and
        - The Final Amendments clarify that this limitation only relates to federal banking laws and regulations, not state or foreign laws.
    - the banking entity complies with conditions (1) to (6) noted above for the qualifying venture capital fund exclusion as if the credit fund were a qualifying venture capital fund.

- **Modifications to Existing Covered Fund Exclusions.** The Final Amendments also include several modifications to existing exclusions from the definition of covered fund to provide clarity and simplify compliance.
    - **Foreign Public Funds.**
        - The existing requirements that the fund be authorized to be sold in its home jurisdiction and that it be sold predominantly through public offerings are eliminated. These two requirements are replaced with a requirement that the fund be authorized to offer and sell ownership interests, and such interests be offered and sold, through one or more public offerings.
        - The definition of public offering is modified by adding a requirement that a distribution must be subject to substantive disclosure and retail investor protection laws or regulations.
        - The existing requirement that the distribution of the fund comply with local law applies only where a banking entity acts as the sponsor of, or investment adviser, commodity trading advisor, or commodity pool operator to, the fund.

  - A U.S. banking entity and its associated parties are permitted to own up to 24.9% of the ownership interests in a foreign public fund that is sponsored by the U.S. banking entity, instead of up to only 14.9%. Like the proposed amendments, the Final Amendments permit sales to employees of the banking entity or fund, other than senior executive officers and directors, without such sales being attributed to an affiliated party of the banking entity or fund.

- **Loan Securitizations.**
  - A loan securitization vehicle is permitted to hold debt securities, excluding asset-backed securities and convertible securities, that represent up to 5% of the aggregate value of the securitization vehicle's assets. The proposed amendments would have allowed these holdings to be in any non-loan assets. The calculation of the percentage of debt securities must be based on par value, subject to a limited exception permitting fair market value, and occur at the time of the most recent acquisition of any debt security.
  - As proposed, the Final Amendments also codify the Loan Securitization Servicing FAQ issued in 2014. Accordingly, a loan securitization may hold securities, other than debt securities subject to the 5% limit, that are servicing assets if they are cash equivalents or securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities. Cash equivalents, for purposes of the rule, include "high quality, highly liquid investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities."
- **Small Business Investment Companies (SBICs).** The Final Amendments expand the exclusion for SBICs, as proposed, to cover the full life cycle of an SBIC, including an SBIC that (1) has voluntarily surrendered its license and operates in accordance with the Small Business Investment Act's implementing regulations and (2) does not make new investments, other than investments in cash equivalents, after such voluntary surrender.
- **Public Welfare Investment Funds.** The Final Amendments expand the exclusion for public welfare investment funds to explicitly include funds whose business is to make investments that qualify for consideration under the regulations implementing the Community Reinvestment Act, rural business investment companies, and "qualified opportunity funds" under the Tax Cuts and Jobs Act.

Qualifying Foreign Excluded Funds (QFEFs)

- The Final Amendments include new exemptions for the activities and investments of QFEFs. The exemptions are largely as proposed and generally consistent with the 2017 and 2019 policy statements that provide time-limited relief for the activities and investments of QFEFs.
- The Final Amendments define QFEF to mean a banking entity that:
  - is organized or established outside the United States, the ownership interests of which are offered and sold solely outside the United States;
  - would be a covered fund if the entity were organized or established in the United States, or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;
  - would not otherwise be a banking entity except by virtue of the acquisition or retention of an ownership interest in, sponsorship of, or relationship with the entity, by another banking entity that meets the following:

    - the banking entity is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or of any State; and
    - the banking entity's acquisition of an ownership interest in or sponsorship of the fund by the foreign banking entity meets the requirements for permitted covered fund activities and investments solely outside the United States, as provided in the SOTUS exemption;
  - is established and operated as part of a bona fide asset management business; and
  - is not operated in a manner that enables the banking entity that sponsors or controls the QFEF, or any of its affiliates, to evade the requirements of the Volcker Rule or the implementing regulations.
- Unlike the proposed amendments, the Final Amendments clarify that a QFEF is not subject to the Volcker Rule compliance program requirements that are otherwise applicable to banking entities. Therefore, although the Final Amendments do not exclude QFEFs from the definition of banking entity, the Final Amendments effectively align the practical Volcker Rule compliance requirements for QFEFs to the 2017 and 2019 policy statements.

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

- **Exempt Transactions under 23A and Regulation W.** The Agencies, using their authority under section 13(d)(1)(J) of the Volcker Rule statute, adopted the amendments to Super 23A largely as proposed. The Final Amendments permit a banking entity to enter into covered transactions with a related covered fund where the transaction would be exempt pursuant to section 223.42 of Regulation W. This change permits a banking entity to, among other transactions, provide intraday extensions of credit to a related covered fund. Even with the exemptions, Super 23A continues to be more restrictive than Section 23A of the Federal Reserve Act because it applies to both insured depository institution (**IDI**) and non-IDI affiliates and remains a flat prohibition (subject to the exemptions), rather than the numerical limits on covered transactions, and the prohibition on extensions of credit cannot be avoided by collateralizing them.
- **Riskless Principal Transactions.** The Final Amendments include a new, standalone exception from the Super 23A prohibition that permits a banking entity to enter into riskless principal transactions with a related covered fund. The definition of riskless principal transaction for purposes of the Volcker Rule is consistent with the definition in Regulation W, except that the related covered fund is not required to be a securities affiliate of the banking entity for the exception to be available. The Agencies clarified, however, that other types of covered transactions that must be with a securities affiliate to be exempt pursuant to section 223.42 of Regulation W must still satisfy that condition to be exempt for purposes of Super 23A.
- **Permissible Transactions in Connection with Payment, Clearing and Settlement Activities.** As proposed, the Final Amendments permit a banking entity to provide short-term extensions of credit to, and purchase assets from, a related covered fund in connection with ordinary course of business payment, clearing and settlement activities, provided that:
  - each extension of credit must be repaid, sold or terminated no later than five business days after it was originated; and
  - the banking entity making an extension of credit must comply with the requirements for exempt intraday extensions of credit under Regulation W, as if it were making an exempt intraday extension of credit.

Ownership Interest

- **Treatment of For-Cause Removal Rights.** As proposed, the Final Amendments clarify that an interest that allows its holder to remove an investment manager for cause or upon the occurrence of an event of default or acceleration event, or to participate in the selection of a replacement manager upon an investment manager's resignation or removal, would not be considered an ownership interest for that reason alone. The Final Amendments clarify that "cause" for removal of an investment manager means one or more of the following events:
  - the bankruptcy, insolvency, conservatorship or receivership of the investment manager;
  - the breach by the investment manager of material representations or warranties or any material provision of the covered fund's transaction agreements applicable to the investment manager;
  - fraud or criminal activity in the performance of the investment manager's obligations under the covered fund's transaction agreements;
  - the indictment of the investment manager for a criminal offense, or the indictment of any officer, member, partner or other principal of the investment manager for a criminal offense materially related to his or her investment management activities;
  - a change in control with respect to the investment manager;
  - the loss, separation or incapacitation of an individual critical to the operation of the investment manager or primarily responsible for the management of the covered fund's assets; or
  - other similar events that constitute "cause" for removal of an investment manager, provided that such events are not solely related to the performance of the covered fund or the investment manager's exercise of investment discretion under the covered fund's transaction agreements.
- **Senior Loan/Debt Interest Safe Harbor.** The Final Amendments include a safe harbor from the definition of ownership interest for senior loans or senior debt interests that meet the three criteria set out below. These criteria are designed to ensure that debt interests that do not have equity-like characteristics are not considered ownership interests. They are that:
  - the holders of the senior loan or senior debt interest do not receive any profits of the covered fund but may only receive (1) interest payments which are not determined by reference to the performance of the underlying assets of the covered fund, and (2) repayments of a fixed principal amount on or before a maturity date, in a contractually-determined matter;
  - the entitlement to payments on the senior loan or senior debt interest is absolute and may not be reduced because of losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the principal and interest payable; and
  - the holders of the senior loan or senior debt interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event).

  With respect to the first criteria, the Final Amendments clarify that the senior loan or senior debt interest must involve, among other things, repayment of a fixed principal amount, on or before a maturity date, in a contractually determined manner. This modification is intended to provide additional clarity that the safe harbor is available to senior loan and senior debt interests where contractual principal payments vary over the life of a senior loan or senior debt interest for reasons such as amortization and acceleration, provided that the total amount of principal required to be repaid over the life of the instrument does not change. The Agencies also clarified that a debt interest

in a covered fund would not be considered an ownership interest solely because the interest is entitled to receive an allocation of collections from the covered fund's underlying financial assets in accordance with a contractual priority of payments.

Parallel Banking Entity and Employee Investments

- **Parallel Banking Entity Investments.** The Final Amendments include a rule of construction that addresses investments made by a banking entity alongside a covered fund. This rule clarifies that a banking entity is *not* required to include in the calculation of the investment limits applicable to a covered fund that is organized and offered or sponsored by the banking entity any direct investment that the banking entity makes in a portfolio company alongside the covered fund. This rule of construction applies so long as the direct investment complies with applicable laws and regulations, including applicable safety and soundness standards.
  - The Agencies clarified in the Final Amendments that the Volcker Rule would not prohibit a banking entity from investing alongside a covered fund, including a covered fund organized and offered by the banking entity, in all or substantially all of the investments made by the covered fund, or to fund all or any portion of the investment opportunities made available by the covered fund to other investors, subject to applicable banking law.
- **Director and Employee Investments.** For investments by employees of a banking entity in a covered fund organized or offered or sponsored by the banking entity, the Final Amendments align the manner in which a banking entity calculates its aggregate investment limit and Volcker Rule-specific capital deduction consistent with the manner in which a banking entity calculates its per-fund investment limit.
  - **Parallel Employee Investments.** The preamble to the Final Amendments states that the Agencies would not expect that a direct investment by a director or employee of a banking entity in a portfolio company alongside a covered fund's investment in the same portfolio company would be treated as an investment by the director or employee in the covered fund, even if the banking entity arranged the transaction on behalf of the director or employee or provided financing for the investment or the director or employee provided no services to the covered fund. This would be true so long as the investment by the director or employee complies with applicable laws and regulations, including applicable safety and soundness standards.
  - **Restricted Profit Interest.** In contrast, the Final Amendments attribute to a banking entity amounts paid by an employee or director to acquire a restricted profit interest in a covered fund that is organized and offered or sponsored by the banking entity when the banking entity has financed the acquisition of the interest.

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