Financial Services Management

Volcker 2.0 Covered-Funds Rule

Cite
FRB, FDIC, OCC, SEC, CFTC; Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

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Websites:
https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200625a1.pdf

Impact Assessment

- This far-reaching rewrite of U.S. covered-funds regulation empowers innovative fund structures giving U.S. banks and those doing business in the U.S. increased competitiveness, fee-based revenue potential, and greater synergy between capital markets and banking activities along with posing new risk.
- Super 23A restrictions are eased, enhancing the ability of banks to make parallel or co-investments in permissible funds. The ability to market funds based on these bank investments may provide a competitive advantage to bank-sponsored hedge or VC funds along with loan securitizations and credit funds although restrictions on guarantees or rescue commitments are retained in the final rule.
- Banks may now provide services to permissible funds. U.S. custody banks gain significant new opportunities.
- U.S. rules are now far less extraterritorial, providing expansive investment-fund opportunities to FBOs.
- Funds focused on high-wealth families and client-directed investment are now permissible under the generally relaxed construct for permissible covered funds. These will enhance wealth-management and wholesale-finance offerings.
- Fund options to meet CRA goals and support targeted communities are now also possible under liberalized rules.

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Overview

The banking agencies, SEC, and CFTC have finalized a long-awaited, complex, and comprehensive proposal[1] rolling back many of the restrictions on covered funds imposed in the 2013 rules implementing the Volcker Rule provisions of the Dodd-Frank Act.[2] Strongly opposed by those who fear greater integration of banking and "speculative" finance or commerce, the rule liberalizes the "Super 23A" inter-affiliate transaction restrictions on excluded covered funds that limited their ability to benefit from funding and operational capacity within affiliated insured depositories. Foreign banking organizations (FBOs) also gain considerably through final codification and expansion of longstanding exemptions for certain covered-fund activities that conflict with home- or other host-country rules. Classes of newly-permissible funds include credit funds which integrate bank-credit functions with capital-markets and asset- management opportunities. Authorization for venture-capital (VC), family wealth, and customer facilitation funds also creates considerable competitive opportunity and, despite restrictions, risks some fear could lead to the bail-outs banks were forced to provide at great cost to structured investment vehicles and other funds during the great financial crisis. Advocates counter, however, that risks in these new funds are controlled due to continuing imposition of tough post-crisis capital rules and remaining Super 23A standards along with a ban on bank guarantees.

Impact

As enacted in 2010,[3] the Volcker Rule not only generally bars banks and BHCs from proprietary trading, but also from owning, sponsoring, or having certain relationships with investment funds, including hedge funds and private-equity (PE) funds, providing numerous exemptions to this prohibition to, for example, permit risk mitigation. The law and prior rules also allow banking entities to organize, sponsor, or offer covered funds subject to restrictions designed to ensure that banks do not evade proprietary-trading bans, rescue investors in such funds, or take no significant risk as a result of covered-fund activities. Various governance, marketing, and related restrictions also applied to permissible covered funds. Restrictions between insured depositories and covered funds known as "Super 23A" also tightened applicable inter-affiliate transaction restrictions to provide additional protection for these entities and the Deposit Insurance Fund.[4]

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[1] See **COVEREDFUNDS**, *Financial Services Managemen*t, February 6, 2020.

[2] See **PROPTRADE18**, *Financial Services Management*, December 10, 2013.

[3] See **PROPTRADE6**, *Financial Services Management*, August 5, 2010.

[4] See *Client Reports* in **REGW** series.

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These rules became generally effective in 2014, although the agencies in 2018 proposed a significant revision to the rule and have also provided a series of exemptions to the covered-funds provisions for foreign banks over the years. The 2018 proposal was finalized in late 2019 and principally implements provisions of EGRRCPA that exempt community banks from proprietary-trading restrictions.[5]

The additional 2020 proposal and this final rule are premised on the agencies' view now that they all have had sufficient experience with the covered-funds standards not only to finalize these foreign-bank exemptions, but also to "simplify and clarify" current standards. Many of the proposed changes were also recommended in a 2017 report from the U.S. Treasury,[6] with Treasury's goal and much in the new, final rule designed to reduce not just the extraterritorial impact of prior rules on FBOs, but also give U.S. banks significant new opportunities to compete with PE and other nonbank financial institutions and intermediaries.

Despite this background, opponents of the rule believe that it goes beyond simplifications and clarification also to provide undue relaxation. Concerns include the extent to which banks could be expected or even required to bail out funds organized by holding-company affiliates. Global bank regulators have been concerned enough about such risks that they in 2017 finalized capital standards to capture "step-in" risk – i.e., the risks that banks might find themselves compelled to sustain affiliates or entities in which they are involved to ensure market credibility no matter the absence of any legal obligation to do so.[7] Perhaps because this global construct also implies that banks will indeed bail out fund investors, this covered-funds rule includes no suggestion of any U.S. standards along these lines, instead frequently referencing post-crisis prudential standards and the extent to which they ensure bank resilience.

What's Next

The FDIC, FRB, CFTC, and SEC finalized this rule on June 25 by divided votes. The OCC finalized it on the same day. The rule is effective on October 1.

Congressional Democrats are strongly opposed to many aspects of this rule. Chairwoman Waters (D-CA) will likely launch an effort to use the Congressional Review Act to overturn it, but this will not be sustained in the

[5] See **REFORM149**, *Financial Services Management*, June 6, 2018.

[6] See *Client Report* **PROPTRADE22**, June 19, 2017.

[7] See **RECOURSE5**, *Financial Services Management*, March 22, 2017.

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Senate. As a result, the rule will stand unless or until the agencies choose to revisit it.

Analysis

This analysis addresses changes with strategic or policy impact. Clients are referred to the final rule for transactional considerations.

A. Foreign Banks and U.S. Offshore Activities

Funds owned or otherwise related to foreign banks that are solely offered to foreign investors have long been excluded from covered-fund constraints subject to certain limitations. The rule codifies prior policy statements related to foreign excluded funds and reduces these restrictions by:

- clarifying when a foreign bank's control over an excluded fund makes the fund a "banking entity" and relaxing the conditions when this is done;
- easing the restriction now requiring sale to retail investors in the bank's home jurisdiction to encompass other foreign jurisdictions;
- expanding the exclusions for foreign public funds. Changes include allowing larger U.S. banks and employees (but not executive officers and directors) to hold ownership stakes in foreign funds;
- establishing anti-evasion provisions;
- easing FBO compliance obligations for excluded funds; and
- liberalizing the restrictions on sale to certain U.S. bank affiliated persons.

B. Loan Securitization

The Dodd-Frank Act stipulates that nothing in it should impair loan securitization, leading to numerous exemptions in the prior rule and related FAQs (e.g., for funds that hold only asset-backed securities [ABS], loans, certain rights and assets, and additional permissible assets). The rule:

- codifies a 2014 statement clarifying that servicing assets are permissible; and
- adds more flexibility with regard to holding up to five percent of the fund in non-loan assets, which the final rule allows to include only debt securities. The NPR's definition would, for example, have allowed impermissible assets to include those related to mortgage insurance, but this would now not be allowed.

C. Public-Welfare and Small-Business Funds

The prior rule exempts public-welfare funds from the covered-fund restrictions, but only if limited investment classes are held. The final rule expands the definition of these asset classes to include any asset that counts for purposes of Community Reinvestment Act (CRA) rules of a federal banking agency. As a

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result, national banks will gain considerable additional flexibility under this provision due to the expanded asset classes eligible for CRA consideration under the OCC's new CRA rule.[8] The rule also expands the current exemption granted to Small Business Investment Companies (SBICs) to grant exemptions also to those that surrender their licenses as long as certain conditions are met. An express exemption for funds related to Rural Business Investment Companies and Qualified Opportunity Funds is also provided.

D. Additional Covered Funds

1. Credit Funds

A new exclusion from prohibited funds is created for "credit funds" that make loans, invest in debt, or extend bank-like credit. In 2013, the agencies declined to do so out of fears that credit funds would be indistinguishable from PE and hedge funds. Since then, the agencies have determined that other permissible options do not give sufficient scope for extending credit without at the same time issuing ABS as required for loan-securitization funds. Under the rule, a credit fund's permissible assets include:

- loans and debt instruments;
- an unlimited amount of related rights or assets incidental to acquiring, servicing, holding, or selling loans and debt instruments;
- equity and equity rights customarily received in connection with the fund's loans or debt investments or incidental to related loan/debt activities. No limit is set on these equity holdings, but the agencies expect them to stay within five percent of a fund's or affiliated bank's exposure to the borrower or affiliated borrowers. The agencies also express a general intent that equity positions be held and managed in a manner consistent with the credit-fund purpose. All equity and related rights must be permissible for the bank to hold directly under federal law;
- securities related to warrants or debt previously contracted (DPC) be measured in cash-equivalent terms as required for loan securitization; and
- certain interest-rate and foreign-currency derivatives that reduce fund risk and are expressly related to loan and debt instruments.

Conditions include:

- that any bank investments in the fund comply with rules governing conflicts of interest, high-risk investments, and safety and soundness;
- imposition of Super 23A restrictions if the bank acts as the fund's investment manager, investment adviser, commodity trading adviser, or sponsor;

[8] See *Client Report* **CRA28**, May 26, 2020.

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- no proprietary trading otherwise impermissible under the Volcker Rule;
- no ABS issuance;
- disclosures if the bank is the fund's investment or commodity-fund adviser or sponsor;
- safety-and-soundness standards akin to those directly covering the bank for like-kind assets if the bank invests in, sponsors or has ownership interests in a covered credit fund that also serves as investment adviser or commodity trading adviser to the fund;
- compliance with restrictions on permissible assets governing the bank and with all restrictions applicable to covered funds; and
- no affiliated-bank guarantee of credit funds to ensure banks do not bail them out. If the bank guarantees assets in the fund, then all exclusions pertinent to credit funds would cease to apply.

2. VC Funds

A class of qualifying VC funds is created in which banks may own, retain interests, or provide sponsorship as long as the banking organization may otherwise engage in the fund's activities through, for example, merchant-banking powers vested in the parent holding company. Congress in 2010 feared that the differences between VC and expressly prohibited funds was complex and has subsequently declined to revise the law. However, the agencies believe they have ample statutory scope for the proposed change. The rule includes a lengthy legislative history and rationale to demonstrate that VC funds are not the same as hedge or PE funds and to argue that VC provides essential public service through support for start-up and small enterprises. The rule also notes prudential benefits to banks from VC-fund activities (e.g., diversification). The agencies also believe that allowing banks to engage in VC permits banks to compete with nonbanks and thus brings this activity within the regulatory perimeter.

VC funds are defined as in applicable securities law and generally understood (i.e., encompassing early-stage, high-risk investments). To sponsor or act as investment- or commodity trading-adviser to a qualifying VC fund, a bank will need to:

- provide investor disclosures that deny any bailout prospects by the bank or the FDIC;
- ensure the fund complies with applicable SEC rules that the Commission believes clearly differentiate VC funds from PE and hedge funds. The SEC also believes that VC funds are less connected to public markets and thus pose less systemic risk;
- limit activities to those permissible for banking organizations;
- ensure that activities are safe and sound under standards substantially equivalent to those applied to direct bank like-kind activities;
- comply with Super 23A if the bank acts as sponsor or adviser to the VC fund; and

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- not engage in any activity principally for the purposes of short-term resale investors, benefiting from short-term price movements, realizing short-term arbitrage profits, or providing position hedging.

The final rule clarifies that market risk-based capital standards do not apply to VC funds.[9] However, banks must apply the rule's short-term intent prong to ensure that fund holdings are permissible.

3. Family Wealth-Management Vehicles

This status is available to entities that are organized solely for a single family's members. If a trust, then a majority of interests must be owned by no more than five closely-related family members or family customers. If not a trust, then the fund must be majority-owned by family customers, who also have majority voting rights. Five closely-related family members may also own interests in the fund.

Banks and other entities must provide only trust, fiduciary, investment-adviser, and commodity-future trading adviser services, but they may own up to a 0.5 percent ownership to the extent necessary for corporate separateness or other concerns. A modified prohibition also bars banks from acquiring low-quality assets from the family-wealth management entity if these purchases would be barred under inter-affiliate transaction rules unless the bank acts as riskless principal. Various disclosure rules are also slightly modified.

4. Customer Facilitation Vehicles

These are now excluded covered funds if the entity is formed by or at the request of a customer (which may not be another banking organization) to provide the customer with the banking organization's investment or other services. No express limits on investments, services, or other factors are provided, but numerous safeguards comparable to those discussed above apply. Marketing of these services is permitted, but numerous conditions apply that are generally similar to those for family-wealth management funds not specific to family issues.

D. Relationships with Covered Funds

1. Covered Transactions

The rule expands the scope of transactions otherwise barred under rules governing inter-affiliate transactions a bank may conduct with a covered fund subject to conflict, risk, and safety-and-soundness restrictions now also to short- (i.e., five-day) term extensions of credit and asset acquisition in connection with payment, settlement, and clearing activities or under certain other conditions. Riskless-principal transactions are now also permitted. The agencies believe that this change enhances bank safety and soundness by

[9] See **CAPITAL184**, *Financial Services Management*, June 26, 2012.

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reducing operational risk and inter-connectedness. Section 23B's arm's-length restrictions remain as before to exposures with new Super 23A relief, while remaining exposures not subject to these exemptions are flatly prohibited with no quantitative or other allowances.

2. Ownership Interests

The rule changes the definition of "ownership interest" to make it clear that a bank's debt relationship, no matter its covenants, in a covered fund would not usually constitute ownership unless a covenant, other than those related to default or an acceleration event, changes the attributes of the relationship to constitute meaningful ownership. A safe harbor for certain debt instruments is also provided, making it clear that the bank may receive interest payments or other revenue from senior-debt instruments held by the covered fund under limits designed to prevent backdoor ownership. The calculation method for measuring ownership in covered funds organized and offered by a banking entity is also redefined.

The rules also clarify that parallel or co-investments do not count towards otherwise-applicable capital limits if the investments are safe, permissible, and do not affect the value or other attributes of the covered fund. No related proprietary trading is permitted.

A new rule of construction to address parallel investments applies, clarifying matters such as the fact that a bank may invest alongside a covered fund and market the fund on this basis. Banks may also co-invest in covered funds under certain circumstances.

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