ALERT MEMORANDUM

June 29, 2020

Volcker Agencies Finalize Covered Fund Amendments

On June 25, the five regulatory agencies responsible for implementing the Volcker Rule approved a Final Rule that makes significant revisions to the "covered funds" provisions of the current implementing regulations. The amendments in the Final Rule represent a significant narrowing of the covered funds prohibitions to better focus on the risks the Volcker Rule was intended to address, and should provide new flexibility for banking entities to engage in both fund investment and customer-driven asset management activities inside and outside the United States. Key elements include:

- New exclusions for credit funds, venture capital funds, family wealth management vehicles, and client facilitation vehicles, and an expanded scope for the public welfare fund exclusion.
- Revisions to address practical obstacles to reliance on the existing exclusions for loan securitizations, foreign public funds, and small business investment companies ("SBICs").
- Clarifications about when debt interests in covered funds could be characterized as "ownership interests", including the treatment of creditor rights upon default and "for cause" removal rights, and a safe harbor for senior loans and senior debt interests.
- Limitations on the rule's extraterritorial impact for the non-U.S. funds activities of foreign banks by codifying existing no-action relief related to controlled qualifying foreign excluded funds.
- Exclusions from the "Super 23A" prohibition for certain low-risk transactions, such as intraday extensions of credit, credit extended in connection with payment clearing and settlement activities, and riskless principal transactions.
- 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.

The Final Rule made only a few changes to the proposal released on January 30 (the "Proposal"). Most of those were helpful technical fixes, and the expansion of the public welfare funds exemption and clarification of permitted voting rights for debt securities are notable improvements. Still, there were a number of opportunities to provide additional flexibility suggested in comments that the Agencies declined to adopt, and in a few cases—including the definition of the permitted bond bucket for loan securitizations and in the conditions on some of the new exemptions from Super 23A—commenters are likely to be disappointed with the Agencies' narrow approach. This memorandum updates our February 12 memorandum summarizing the proposal, and highlights key changes in the Final Rule.

The Final Rule is effective October 1, 2020. A link to the Final Rule is available here, and blacklines against the current rule text and the January proposal are available here and here.

Summary of Major Changes between the 2013 Rule, the Proposal, and the Final Rule

Topic	2013 Rule	2020 Proposal	Final Rule
Credit Funds	N/A	New exemption proposed	Adopted largely as proposed—clarifies application of Super 23A
Venture Capital Fund	N/A	New exemption proposed	Adopted largely as proposed—clarifies application of Super 23A
Family Wealth Management Vehicles	N/A	New exemption proposed	Adopted largely as proposed—increases the number of closely related persons that may own the entity from 3 to 5, and clarifies that family customers must own a majority of the entity's interests (not just voting interests)
Customer Facilitation Vehicles	N/A	New exemption proposed	Adopted largely as proposed
Foreign Public Funds	Covered fund exclusion. Must be authorized to offer and sell ownership interests to retail investors in home jurisdiction; interests must be "predominantly" sold through one or more public offerings outside the U.S.	Proposed to remove "home jurisdiction" and "predominantly public offering" requirements; public offerings must be subject to substantive disclosure and retail investor protection laws	Adopted largely as proposed—reduces ownership interest limits applicable to U.S. banking entities so nonaffiliated persons must own more than 75%, rather than more than 85%
Loan Securitizations	Covered fund exclusion. Assets limited to loans, servicing and other assets related to the loans, certain interest rate and FX derivatives, and special units of beneficial interest and collateral certificates	Proposed to permit loan securitizations to hold up to 5% by value of "any other asset" (e.g., including debt and equity securities)	Limited proposal's 5% "other asset" bucket to debt securities, other than asset backed securities and convertible securities
SBICs	Covered fund exclusion.	Proposed to extend to SBICs in wind down	Adopted as proposed
Public Welfare Funds	Covered fund exclusion for public welfare funds and funds that make expenditures to rehabilitate buildings and historic structures	Asked whether definition of public welfare fund should be expanded	Expanded exclusion to funds that make CRA-qualifying investments, RBICs, and qualified opportunity funds
Treatment of Parallel Investments	Preamble guidance that parallel investments and co-investments alongside sponsored covered funds should be counted towards the 3% per fund limit	Proposed to add rules of construction that investments made by a banking entity alongside covered funds need not be counted against the 3% per-fund and aggregate limits, and a banking entity is not restricted in the amount of investment made alongside a covered fund	Adopted as proposed
Qualifying Foreign Excluded Funds	For foreign banking entities, non-U.S. funds not sold to U.S. persons are not covered funds, but could be banking entities (temporary relief provided in 2017 and 2019 policy statements)	Proposed to codify relief for foreign excluded funds that would themselves be "banking entities" subject to the rule's prohibitions	Adopted largely as proposed; clarified that foreign excluded funds are not subject to Volcker Rule compliance program obligations
Ownership Interests	Defined to include interests with the right to participate in selection or removal of manager	Proposed safe harbor for "senior loan or senior debt interests" from treatment as an ownership interest; clarified scope of manager removal rights	Safe harbor adopted largely as proposed—expanded permissible for "cause" termination of fund manager
Super 23A	Prohibits banking entities from engaging in covered transactions with covered funds they sponsor, advise, or organize and offer	Proposed to permit banking entities to engage in a limited set of low-risk covered transactions with related covered funds	Adopted largely as proposed—creates a stand-alone exemption for riskless principal transactions in securities with any related covered fund

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 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 has frequently been criticized as overly complex, and many commenters suggested that it ended up restricting activity that Congress had not intended to prohibit.

The Final Rule represents the culmination of several years of effort among the Agencies to solicit comment on, consider, and adopt amendments intended to simplify and tailor application of the rule.[1] Although it leaves the basic framework of the funds provisions intact, it provides important new exclusions from the covered funds definition to limit its scope, and clarifies and expands other exclusions to reflect practical concerns that have limited their utility. While some key exclusions and revisions advocated by commenters were not included (e.g., an exclusion for long-term investment funds from the definition of covered fund), the Final Rule responds to many of the practical difficulties faced by industry participants in complying with the Volcker Rule.

Two themes common to many elements of the Final Rule are changes designed to avoid (i) prohibiting banking entities from doing indirectly (through an investment vehicle) what they are permitted to do directly, and (ii) inadvertent interference with traditional banking activities that do not present the risks that the Volcker Rule was intended to address. Many of the changes are also intended to simplify and lessen compliance burdens.

The Final Rule also incorporates important limitations on the extraterritorial application of the rule to funds activities of non-U.S. banks outside the United States by codifying in permanent form temporary relief the Agencies previously provided in policy statements.

[1] 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 comments 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 largely deferred the covered funds changes to the Proposal.

New Covered Funds Exclusions

The Final Rule tailors the reach of the Volcker Rule's covered fund definition through 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 adopting 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 are a 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 funds that Congress intended to restrict. In the round of comments in 2018 and the comments on the Proposal, however, most industry commenters decided not to advocate for a new covered fund definition, and instead supported the Proposal's approach to add new exclusions to address this issue of overbreadth.

<u>Credit Funds</u>

The Final Rule establishes 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 are subject to restrictions on the assets they can hold. A credit fund is 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 (including 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 ("DPC"), and equity interests (or rights to acquire equity) received "on customary terms in connection with such loan or debt instrument", but not commodity forward contracts or derivatives; 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 may only 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 under applicable federal banking laws and regulations.

Activities Restrictions. Credit funds also are subject to restrictions on their activities. In particular, a credit fund is 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 must ensure that its investments in and relationship with the credit fund are conducted in compliance with applicable banking laws and regulations, including applicable safety and soundness standards. Reliance on the exclusion also is subject to certain other restrictions common to numerous other new and existing exclusions in the Final Rule, including that:

— the banking entity may not directly or indirectly guarantee, assume, or otherwise insure the obligations or performance of the credit fund; 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 relying on this exclusion to sponsor or invest in a credit fund acts as a sponsor, investment adviser, or commodity trading advisor to the credit fund, it will also be required to:

— 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);

— 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 exclusion is to permit banking entities to extend credit to customers indirectly (through a fund structure) that they could extend directly. The 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 are permitted to hold equity securities "received on customary terms in connection" with investments in loans and debt instruments.

Nevertheless, the permissible assets for a credit fund remain limited, and the preamble to the Final Rule makes clear that responsibility for determining whether a fund qualifies rests with the sponsoring or investing banking entity. The Agencies specifically declined to grant a safe harbor for a banking entity that relies in good faith on a representation from a credit fund that it only invests in permissible assets.

The Agencies did not impose any additional conditions on the types or amounts of equity securities a credit fund could hold, although they suggested and solicited comment upon several in the Proposal. However, the preamble notes that the Agencies generally expect equities would not exceed five percent of the value of a credit fund's investment in any borrower at the time of investment, and that over time exposure to equities "would be managed on a basis consistent with the fund's overall purpose".

The Final Rule applies the short-term purpose test to determine whether a credit fund was engaging in proprietary trading, even if the banking entity relying on the exemption applies another definition (such as the market risk capital rule test). The preamble clarifies that a credit fund would have the benefit of the 60-day rebuttable presumption and the various exclusions from the definition of proprietary trading in Section __.3(d) of the rule, and could, in theory, rely on the permitted trading activities (underwriting, market-making, hedging, etc.) set out in Sections __.4 through __.6 of the rule, although it acknowledges the practical challenges for a fund to satisfy all the requirements of those permitted activities.

<u>Venture Capital Funds</u>

The Final Rule establishes an 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 are prohibited from engaging in proprietary trading.

Additional Conditions. A banking entity relying on this exclusion is required to ensure that its investments in and relationship with the venture capital fund are conducted in compliance with applicable banking laws and regulations, 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 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 relying on this exclusion to sponsor or invest in a venture capital fund 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;

— 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; and

— treat the venture capital fund as a covered fund for purposes of Super 23A and Super 23B.

The 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 promotes safety and soundness through diversification and enhances financial stability and provides 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 an investment or relationship in a fund would result in the banking entity having a material exposure 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 Agencies declined to impose the additional conditions on which they had requested comment in the Proposal, such as an annual revenue cap for each portfolio company, or reducing the percentage of non-qualifying investments a fund can hold.

As with credit funds, the Final Rule would apply the short-term purpose test to determine whether a venture capital fund was engaging in proprietary trading, even if the banking entity relying on the exemption applies another definition (such as the market risk capital rule test), and the preamble again confirms that a venture capital fund would have the benefit of the 60-day rebuttable presumption and the various exclusions from the definition of proprietary trading in Section __.3(d) of the rule, and could, in theory, rely on the permitted trading activities (underwriting, market-making, hedging, etc.) set out in Sections __.4 through __.6 of the rule.

Although the Final Rule adopts the "venture capital fund" definition by reference to the SEC's rules, the Agencies have left unaddressed whether they intend to incorporate parallel SEC guidance permitting venture capital funds to use a variety of corporate structures and vehicles to accommodate special investor circumstances that do not always meet the technical criteria for the definition (e.g., parallel and feeder funds, side cars, alternative investment vehicles, co-investment vehicles, and intermediate holding companies). Providing flexibility for a venture capital fund sponsor to use alternative corporate structures to efficiently organize the fund's activities, however, would appear to be consistent with the Agencies' rationales for adopting the other new exclusions, particularly if the structure is adopted to accommodate customer demands.

Family Wealth Management Vehicles

The Final Rule creates a new exclusion for certain family wealth management vehicles.

Definition. This exclusion is 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 interests and voting interests are owned (directly or indirectly) by family customers and the entity is owned only by family customers and up to 5 closely related persons (other than a 0.5% ownership interest, which may be held by one or more other entities to establish corporate separateness or address 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 (which may be modified to prevent the disclosure from being misleading and in a manner to accommodate the specific circumstances of the vehicle);

— 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 (except for riskless principal transactions).

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 made several minor modifications to the Proposal intended to facilitate compliance with the exclusion, including (i) increasing from 3 to 5 the number of family customers and closely related persons who may own interests, (ii) permitting any entity—not only banking entities—to acquire a de minimis ownership interest, (iii) permitting the form and content of required disclosures to be tailored to the circumstances of the vehicle, and (iv) providing an exclusion from the low-quality asset purchase restriction for riskless principal transactions.

<u>Customer Facilitation Vehicles</u>

The Final Rule also establishes a new exclusion for customer facilitation vehicles.

Definition. This exclusion is 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 one or more entities that are not customers to establish corporate separateness or address 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 (which may be modified to prevent the disclosure from being misleading and in a manner to accommodate the specific circumstances of the vehicle);

— 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 (except for riskless principal transactions).

As with the exclusion for family wealth management vehicles, 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.

The Agencies made several minor modifications to the Proposal intended to facilitate compliance with the exclusion, including (i) permitting any entity—not only banking entities—to acquire a de minimis ownership interest, (ii) permitting the form and content of required disclosures to be tailored to the circumstances of the vehicle, and (iii) providing an exclusion from the low-quality asset purchase restriction for riskless principal transactions.

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 is 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 Agencies declined to make other modifications for which they solicited comment in the Proposal, such as specifying the types of transactions and services that can be provided through customer facilitation vehicles.

Modifications to Existing Exclusions

The Final Rule amends four existing exclusions from the definition of covered fund. The modifications for the exclusions for **foreign public funds ("FPFs")**, **loan securitizations**, and **SBICs** provide additional flexibility to banking entities and address practical impediments to relying on these exemptions. The exclusion for **public welfare funds** has been expanded to include additional classes of funds dedicated to promoting economic development in rural or low-income communities.

Foreign Public Funds

The FPF provisions of the Final Rule are largely unchanged from the Proposal. It addresses the most significant problems with the original FPF exclusion by removing two requirements that proved unreasonably limiting 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 Final Rule also modifies 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 are:

— 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.

In one change from the Proposal, the Final Rule relaxes the ownership interest restriction for U.S. banking entities in FPFs that they sponsor. Now, more than 75% of the ownership interests (rather than 85% under the 2013 rule and Proposal) must be sold 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. Consistent with the Proposal, the restriction on sales to employees has been replaced with a restriction on sales to senior executive officers.

Modified Public Offering Requirement. To qualify as a public offering, there must be 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 revisions in the Final Rule further align the treatment of FPFs with the treatment of U.S. registered investment companies ("RICs"). The Final Rule removes conditions that were identified by the industry as impractical, unnecessary, or posing particularly burdensome compliance obligations. The former 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 former 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 have been unable to verify how an FPF distributed by third parties was in fact been distributed. Increasing the percentage that a U.S. banking entity and its affiliates can own in a FPF from 14.9% to 24.9% also aligns FPF ownership limits with functionally equivalent ownership limits for a RIC (which would become a banking entity if a banking entity owned 25% or more of its voting securities).

Many industry commenters advocated eliminating the public offering requirement altogether in favor of a simple requirement that the fund be *authorized* to be sold to retail investors, whether or not they are in fact sold to retail investors, as is allowed for U.S. RICs. The Agencies rejected this approach, reasoning that differing foreign regulations could result in FPFs authorized to be sold in a public offering to retail investors but only sold in private offerings, thus potentially lacking substantive disclosure or retail investor protections. The Final Rule 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 Agencies declined to provide a list of common foreign funds presumed to qualify as FPFs, or to presumptively qualify foreign exchange traded funds listed on public, retail exchanges, on the grounds that it would require careful review and ongoing monitoring by the Agencies, but the preamble confirms that "many such funds" should qualify.

The Agencies also declined to codify several important FAQs relevant to FPF seeding and banking entity status, but affirmed that all FAQs remain effective unless otherwise specified, and the preamble reinforces an important principle from FAQ 16—that an FPF's seeding period may exceed 3 years under certain facts and circumstances.

<u>Loan Securitizations</u>

The 2013 rule exempted loan securitizations, but limited the assets such vehicles can hold to loans, servicing assets, interest rate or FX derivatives, special units of beneficial interest and collateral certificates, and securities if they are cash equivalents or received DPC.

The Final Rule expands the loan securitization exclusion to permit holding debt securities (other than asset-backed securities and convertible securities) in an amount not exceeding 5% of the aggregate value of the loans, cash and cash equivalents, and debt securities held by the fund, although this represents a more limited expansion than what was proposed. Values are to be calculated at par value at the most recent time of acquisition of debt securities, except that asset value may be determined at fair market value if the issuing entity is required to use fair market value for the asset for purposes of calculating compliance with concentration or other similar limitations and the entity's valuation methodology values similarly situated assets consistently.

The Final Rule 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 Proposal would have provided a 5% bucket for "any other asset", which could have included, for example, a small amount of equity securities. The Final Rule narrowed the scope of the 5% bucket to permit only debt securities, and to exclude ABS and convertible securities, reasoning that non-loan assets with materially different risk characteristics than loans could change the character and complexity of the issuer. The additional flexibility for sponsors to include a small amount of debt securities in loan securitizations is a welcome change from the 2013 rule, but the decision to limit the types of assets permitted in the bucket is disappointing, because it leaves in place a binary analysis where a single, non-conforming asset, even if de minimis in value, can disqualify a securitization from the exclusion.

The Final Rule provides a methodology for calculating the 5% limit for the bond bucket that was not previewed in the Proposal (and consequently not the subject of comment, although a number of commenters proposed methods for doing the calculation). Consistent with those comments, the calculation is a point-in-time measurement, rather than an obligation for ongoing monitoring, based on par value measured at the most recent time of acquisition of debt securities (although there is an allowance for using fair market value in certain circumstances). The denominator for the calculation is the value of loans, debt securities, and cash and cash equivalents held by the fund, again generally determined at par value, with fair market value permitted in certain circumstances. Other assets held by the fund, which could include servicing assets, interest rate or FX derivatives, special units of beneficial interest and collateral certifications, and securities or other assets acquired DPC, are excluded from the denominator. The preamble explains the purpose of limiting the denominator is to "ensure the investment pool of a loan securitization is composed of loans" and simplify the calculation methodology by excluding harder to value assets such as servicing and other incidental rights and derivatives.

The effect of the calculation is similar to a typical concentration limit, but in some cases may prove more challenging to administer. Concentration limits typically operate as a restriction on potential asset purchases (the limit must be satisfied or maintained or improved after giving effect to a transaction), but the Final Rule's 5% limit is a hard cap measured at the time of every new purchase of debt securities.

However, although the hard cap may limit future purchases of debt securities, because the calculation is only measured at the time of purchase of new debt securities, a fund is not at risk of failing to comply with the new bond bucket simply by virtue of underlying asset prepayments or amortization. This is a welcome development and reduces potential compliance burdens.

Small Business Investment Companies

The Final Rule makes 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 only qualifies for the exclusion if it surrenders its license voluntarily and with the prior written approval of the Small Business Administration.

Public Welfare Funds

The 2013 rule exempted public welfare investment funds, defined as issuers that make investments that are:

— designed primarily to promote the welfare of low- and moderate-income families, as permitted for national banks under the National Bank Act; and

— expenditures to rehabilitate buildings and historic structures (as defined in the Internal Revenue Code or under state law)

The Final Rule expands the exclusion for public welfare investment funds to include:

— funds, the business of which is to make investments that qualify under any federal banking agency's Community Reinvestment Act regulations;

— rural business investment companies ("RBICs") (as described in 15 U.S.C. 80b-3(b)(8)(A) or (B)) or RBICs that have terminated their participation and that do not make new investments (a RBIC in wind-down only qualifies for the exclusion if it surrenders its license with the prior written approval of the Department of Agriculture); and

— qualified opportunity funds (as defined in 26 U.S.C. 1400Z-2(d)) formed under the "opportunity zone" program established by the Tax Cuts and Jobs Act of 2017.

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 that suggested that under certain circumstances parallel and co-investments alongside sponsored covered funds should be counted towards the 3% per-fund limit.

Consistent with the Proposal, the Final Rule adopts new rules of construction in the rule text clarifying that investments made by a banking entity alongside covered funds 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 is 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 must 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 may 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 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 investments and co-investments alongside a covered fund by a banking entity's directors and employees are not subject to the same limits that would apply if they were made in the covered fund. Thus, a banking entity may 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 does not apply to director and employee investments made in parallel to the covered fund.

The new rules of construction in the Final Rule 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.

The rule nonetheless continues to pose 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 with employee investments, generally or in a particular portfolio company, problematic. In addition, the Final Rule does not address concerns related to the ability of controlled employee securities companies ("ESCs"), which may themselves be banking entities (e.g., where a banking entity serves as a general partner), to invest in a fund vehicle (a sponsored fund, a third-party fund, or a co-investment vehicle), an issue which may require those employee vehicles to make investments directly in parallel rather than permitting aggregation to simplify such investments.

Qualifying Foreign Excluded Funds

The Final Rule provides 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 arose 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 due to a banking entity holding a sizable equity stake in a third-party investment vehicle outside the United States. 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 Final Rule makes that relief permanent by exempting from the proprietary trading and covered fund restrictions, and compliance program requirements, 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 the banking entity that sponsors or controls the fund, or any of its affiliates, 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).

This change makes permanent the relief permitting 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.

The relief in the Final Rule 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.

The Final Rule made two adjustments in response to concerns raised by foreign banking organizations. First, although the Final Rule does not fully exempt qualifying foreign excluded funds from banking entity status, it confirmed that qualifying foreign excluded funds will not be subject to the Volcker Rule's compliance program requirements. Second, it modified the anti-evasion prong of the Proposal's qualifying foreign excluded fund definition to apply only to the sponsoring/controlling foreign banking entity and its affiliates, rather than "any banking entity" (i.e., potentially including unaffiliated banking entities), which clarifies that one banking entity relying on the relief does not need to assess whether other unaffiliated banking entities are using the fund to evade the Volcker Rule.

Ownership Interests

<u>Safe Harbor for Senior Loan and Debt Interests</u>

The Final Rule creates 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 excludes "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
  - repayment of a fixed principal amount on or before a maturity date in a contractually determined manner (including prepayment premiums intended solely to reflect and compensate for forgone 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 Final Rule does not define "senior" for purposes of the safe harbor.

The creation of the senior debt and loan safe harbor, and the changes to permissible voting rights set out below, are both intended to address long-standing concerns under the 2013 rule that certain typical covenants and rights associated with some loan and debt interests could cause them to be deemed ownership interests because of their right to "participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor" of a covered fund.

This safe harbor exclusion could provide flexibility in relation to CLO securities that have "manager" voting rights that do not satisfy the new criteria for permissible for "cause" removal rights described below and are issued by CLOs that do not qualify for the loan securitization exemption, or in relation to U.S. collateralized bond obligation ("CBO") structures. However, those seeking to rely on the safe harbor will still have to resolve what should qualify as "senior", as it is not clear how far down the capital stack of a CLO or CBO this safe harbor exclusion applies.

Clarification of Permitted Voting Rights

Under the 2013 rule, an ownership interest includes any "equity, partnership, or other similar interest", and includes a "similar interest" that "has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)".

The Proposal clarified that permitted creditors' rights upon default or acceleration would include "the right to participate in the removal of an investment manager for cause or to nominate or vote on a nominated replacement manager upon an investment manager's resignation or removal".

The Final Rule further expands and details the types of voting rights that debt holders may have with respect to a manager without causing the debt interest to be deemed an ownership interest.

Under the Final Rule, these permitted voting rights include the rights to:

— (i) exercise remedies upon the occurrence of an event of default or acceleration event, and

— (ii) participate in the removal of an investment manager for "cause" or to participate in the selection of a replacement manager following a manager's removal or resignation.

For purposes of (ii), "cause" is defined as one or more of the following events:

— the bankruptcy, insolvency, conservatorship or receivership of the manager;

— the breach by the manager of any material provision of the covered fund's transaction agreements applicable to the manager;

— the breach by the manager of material representations or warranties;

— the occurrence of an act that constitutes fraud or criminal activity in the performance of the manager's obligations under the covered fund's transaction agreements;

— the indictment of the manager for a criminal offense, or the indictment of any officer, member, partner, or other principal of the manager for a criminal offense materially related to his or her management activities;

— a change in control with respect to the manager;

— the loss, separation, or incapacitation of an individual critical to the operation of the manager or primarily responsible for the management of the covered fund's assets; or

— other similar events that constitute "cause" for removal of a manager, provided that such events are not solely related to the performance of the covered fund or the manager's exercise of investment discretion under the covered fund's transaction agreements.

This change in the Final Rule is a helpful expansion of the Proposal, which had continued to link for "cause" removal rights to the occurrence of an event of default or an acceleration event. The changes align the Final Rule with 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.

<u>Attribution Rules for Employee Retained Profit Interests</u>

The Final Rule adopts the Proposal's modifications to 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 Final Rule reverses this treatment and, consistent with the treatment of other employee investments, only attributes employee investments to acquire restricted profit interests to the banking entity if the investments are financed by the banking entity.

Super 23A

The Final Rule revises 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 Final Rule allows banking entities to enter into transactions that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition in Section 23A of the Federal Reserve Act and Regulation W, provided they comply with the limits and conditions imposed on those transactions in Regulation W (12 C.F.R. 223.42). Key Regulation W exemptions now available for banking entities under Super 23A include:

— intraday extensions of credit;

— credit transactions (including securities financing) fully secured by U.S. government securities or cash collateral; and

— purchases of certain liquid assets.

In addition, the Final Rule creates stand-alone exemptions, separate from the Regulation W exemptions, for:

— riskless principal transactions in securities with any related covered fund; and

— 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 (which must meet the requirements applicable to intraday extensions of credit under Regulation W).

All of the new exemptions are subject to the Volcker Rule's prudential backstops.

The Final Rule takes some steps to 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 will 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).

Commenters will likely be disappointed, however, that the Agencies' declined commenter requests not to import from Regulation W the requirement that purchases of marketable and municipal securities are only exempt if the member bank purchases the securities from a securities affiliate—e.g., an SEC-registered broker or dealer. In practice, this requirement is likely to render these two important Regulation W exemptions meaningless under Super 23A, as it is hard to imagine a scenario where a covered fund would register as a securities broker or dealer.

The Agencies did create a new standalone riskless principal exemption to ensure those transactions would be permitted under Super 23A, notwithstanding the Regulation W requirement that riskless principal transactions be conducted with a securities affiliate. The riskless principal exemption in the Final Rule is otherwise identical to the one in Regulation W.

What's Not in the Final Rule

Although the industry's comments generally were targeted to the specific exclusions and revisions in the Proposal, commenters also sought a number of additional exclusions and revisions that were not included in the Final Rule, including the following requests of particular note.

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. Although the Agencies solicited comment on whether to exclude investment funds that generally have these attributes, they ultimately declined to provide a standalone exemption. The Agencies determined that distinguishing long-term investment funds from private equity funds and hedge funds remained difficult, and so a general exclusion linked to a banking entity's holding period would be too broad of an approach. Even without a specific exclusion for long-term investment funds, the rules of construction for parallel investments should provide some additional flexibility for banking entities seeking to sponsor funds holding long-term investments while also investing in those funds' strategies. The Agencies also noted that they expect the new exclusions for credit funds and venture capital funds to permit long-term financing through those types of fund structures.

Other Fund Types and Situations

The Proposal also declined to grant requests for covered fund exclusions for various other fund types and situations, including (i) tender bond vehicles, (ii) certain real estate funds, and (iii) funds that would otherwise be covered funds during a temporary seeding period. The Agencies determined that adopting these suggested exclusions would have been outside the scope of the Proposal.

Banking Entity Exclusions

Although the Agencies solicited comment on exclusions from the definition of banking entity, the Final Rule ultimately did not include any such new exclusions, including for (i) controlled FPFs and RICs during a termination or temporary lifecycle event, and (ii) controlled ESCs.

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