Proskauer

Volcker Rule Amendments: Implications for Asset Managers

July 16, 2020

On June 25, 2020, the Federal Reserve Board, the OCC, the FDIC, the SEC and the CFTC (collectively, the "Agencies") adopted amendments (the "Amendments") to the regulations implementing section 13 of the Bank Holding Company Act, known as the "Volcker Rule." The Amendments will be effective on October 1, 2020.

The Volcker Rule generally prohibits banking entities (*e.g.*, insured depository institutions and their affiliates) from investing in, sponsoring, or having certain relationships with private equity funds, hedge funds and other entities that are defined under the Volcker Rule as "covered funds," subject to certain exceptions.

Most importantly for asset managers, the Amendments will expand the types of private funds that banking entities will be able to invest in, sponsor and advise by excluding from the definition of "covered funds" a number of different types of fund products. In addition, the Amendments address certain issues in the current rules related to foreign public funds, limit the extraterritorial impact of the Volcker Rule on certain foreign funds ("qualifying foreign excluded funds") and clarify the treatment of parallel investments made by banking entities in the same underlying investments as a sponsored covered fund.

Additional Covered Fund Exclusions

One of the most significant aspects of the Amendments is the creation of four new exclusions from the definition of "covered fund" that will enable banking entities to invest in and sponsor several additional types of funds that the Agencies have concluded do not raise the concerns that the Volcker Rule was intended to address.

1. *Qualifying Venture Capital Funds*

The Amendments add a new exclusion for "venture capital funds" as defined in Investment Advisers Act Rule 203(l)-1 which meet certain additional criteria. Rule 203(l)-1 requires that the private fund (i) represents to investors that it pursues a venture capital strategy, (ii) holds no more than 20% of the amount of its aggregate contributions plus uncalled commitments in assets (other than short term holdings) that are not "qualifying investments,"[1] (iii) does not incur leverage (including guarantees) in excess of 15% of aggregate contributions plus uncalled commitments or, subject to certain exceptions, incur leverage for a term of longer than 120 days, (iv) only issues securities that do not provide a holder with withdrawal rights, except in extraordinary circumstances, and (v) is not registered as an investment company and has not elected to be treated as a business development company.

A venture capital fund as defined in Rule 203(l)-1 will be excluded from the Volcker Rule's "covered funds" definition when the following requirements are satisfied:

- The venture capital fund does not engage in proprietary trading.
- A banking entity's ownership interest in and relationship with the venture capital fund must:
    - not involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties (subject to certain exceptions requiring disclosure of conflicts or internal information barriers);
    - not result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset[2] or high-risk trading strategy[3];
    - not pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States; and
    - comply with applicable banking laws and regulations.
- The banking entity must not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the venture capital fund.
- If a banking entity is acting as sponsor or adviser (as opposed to only investing), the banking entity must:
    - provide prospective and actual investors with the written disclosures required by the Volcker Rule's "asset management exemption" as if the venture capital fund were a covered fund;
    - ensure that the venture capital fund's activities are consistent with applicable safety and soundness standards; and

- comply with Sections 23A and 23B as if the venture capital fund were a covered fund.

2. Qualifying Credit Funds

The Amendments add a new exclusion from the Volcker Rule's "covered funds" definition for "credit funds" that satisfy the following asset and activity requirements:

- The assets of the credit fund must be composed solely of (i) certain types of loans, (ii) debt instruments that would be permissible for the banking entity to acquire and hold directly under applicable federal banking laws and regulations, (iii) rights and other assets that are related or incidental to acquiring, holding, servicing, or selling such loans or debt instruments and that would be permissible for the banking entity to acquire and hold directly under applicable federal banking laws and regulations (provided that each such right or asset that is a security is either a cash equivalent, a security received in lieu of debts previously contracted with respect to such loans or debt instruments or an equity security (or right to acquire an equity security) received on customary terms in connection with such loan or debt instruments), but excluding commodity forward contracts and derivatives and (iv) certain interest rate or foreign exchange derivatives that directly relate to the items in (i)-(iii).
    - Note that while the Agencies did not adopt a quantitative limit on the amount of equity securities (or rights to acquire equity securities) that may be held by an excluded credit fund, they noted in the preamble to the Amendments that the Agencies generally expect that, with respect to a particular investment, equity securities or rights would not exceed 5% of the value of the credit fund's investment in the borrower at the time the investment is made.
- The credit fund must not engage in proprietary trading or issue asset-backed securities.
- A banking entity's ownership interest in and relationship with the credit fund must:
    - not involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties (subject to certain exceptions requiring disclosure of conflicts or internal information barriers);
    - not result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset[4] or high-risk trading strategy[5];
    - not pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States; and
    - comply with applicable banking laws and regulations.

- The banking entity must not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the credit fund or of any entity to which the credit fund extends credit or in which the credit fund invests.
- If a banking entity is acting as sponsor or adviser (as opposed to only investing), the banking entity must:
    - provide prospective and actual investors with the written disclosures required by the Volcker Rule's "asset management exemption" as if the credit fund were a covered fund;
    - ensure that the credit fund's activities are consistent with applicable safety and soundness standards; and
    - comply with Sections 23A and 23B as if the credit fund were a covered fund.

3. Qualifying Family Wealth Management Vehicles

The Amendments add a new exclusion from the Volcker Rule's "covered funds" definition for "family wealth management vehicles" (each, an "FWMV") when the following requirements are satisfied:

- The FWMV is not, and does 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 a trust, the grantors of the trust are all "family customers."[6]
- If the FWMV is not a trust, (i) a majority of the voting interests in the FWMV are owned, directly or indirectly, by family customers, (ii) a majority of the interests in the FWMV are owned, directly or indirectly, by family customers and (iii) the FWMV is owned only by family customers and up to five "closely related persons"[7] of the family customers.
- One or more entities (banking entities or otherwise) that are not family customers or closely related persons may acquire or retain up to 0.5% of the FWMV's ownership interests for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.
- The banking entity relying on the exclusion (or an affiliate thereof) must:
    - provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the FWMV;
    - not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the FWMV;

- comply with the written disclosures required by the Volcker Rule's "asset management exemption" as if the FMVW were a covered fund (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);
- not acquire or retain, as principal, an ownership interest in the FWMV (aside from the 0.5% investment described above);
- comply with Section 23B (requiring all transactions between the banking entity and the FWMV to be on an arm's length basis) as if the FWMV were a covered fund;
- assure that its ownership interest in and relationship with the FWMV does not:
  - involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties (subject to certain exceptions requiring disclosure of conflicts or internal information barriers);
  - result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset[8] or high-risk trading strategy[9]; or
  - pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States; and
- except for riskless principal transactions, comply with Regulation W's restrictions on the purchase of low-quality assets from an affiliate as if the banking entity were a member bank and the FWMV were an affiliate of the banking entity.

4. Qualifying Customer Facilitation Vehicles

The Amendments add a new exclusion from the Volcker Rule's "covered funds" definition for "customer facilitation vehicles" (each, a "CFV") when the following requirements are satisfied:

- The CFV is formed by, or at the request of, a banking entity's customer for the purpose of providing such customer and/or its affiliates with exposure to a transaction, investment strategy, or other service provided by the banking entity.
- All of the ownership interests of the CFV are owned by the customer and its affiliates, provided that one or more entities (banking entities or otherwise) that are not customers or affiliates thereof may acquire or retain up to 0.5% of the CFV's ownership interests 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;
  - do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the CFV;
  - comply with the written disclosures required by the Volcker Rule's "asset management exemption" as if the CFV were a covered fund (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 CFV);
  - do not acquire or retain, as principal, an ownership interest in the CFV (aside from the 0.5% investment described above);
  - comply with Section 23B as if the CFV were a covered fund (requiring all transactions between the banking entity and CFV to be on an arm's length basis);
  - assure that their ownership interest in and relationship with the CFV do not:
    - involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties (subject to certain exceptions requiring disclosure of conflicts or internal information barriers);
    - result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset[10] or high-risk trading strategy[11]; or
    - pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States; and
  - except for riskless principal transactions, comply with Regulation W's restrictions on the purchase of low-quality assets from an affiliate as if the banking entity were a member bank and the CFV were an affiliate of the banking entity.

Modifications to Certain Existing Covered Funds Exclusions

1. *Foreign Public Funds*

Reflecting the Agencies' desire to better align the Volcker Rule's approach to United States registered investment companies (which are not covered funds under the Volcker Rule) and their foreign equivalents, the Amendments adjust certain requirements of the covered fund exclusion for foreign public funds. A foreign public fund will be excluded from the definition of "covered fund" if it satisfies the following: (i) the fund is organized or established outside of the United States; (ii) the fund is authorized to offer and sell ownership interests, and such interests are offered and sold, through one or more public offerings outside the United States to investors, including retail investors, provided that (a) the distribution is subject to substantive disclosure and retail investor protection laws or regulations, (b) with respect to a fund for which the banking entity serves as the advisor or sponsor, the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made, (c) the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets, and (d) the fund has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available; and (iii) solely with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or any State and any fund for which such banking entity serves as sponsor, more than 75 percent of the ownership interests in the fund are sold to persons other than the sponsoring United States banking entity or the issuing fund (or affiliates of the sponsoring banking entity or issuing fund), and directors and senior executive officers of such entities.

2. Qualifying Foreign Excluded Funds

While the Volcker Rule excludes certain foreign funds organized and offered by a foreign banking entity outside of the United States from the definition of "covered fund," these funds could become subject to the Volcker Rule's restrictions and compliance requirements by virtue of affiliation with the foreign banking entity. This ambiguity has been addressed in agency policy statements declining to take enforcement action against foreign banking entities based on the activities and investments of foreign funds meeting certain criteria. The Amendments codify this position by adding a new exemption from these restrictions and requirements for "qualifying foreign excluded funds" that meet the following conditions: (i) the fund is organized or established outside the United States; (ii) the fund's ownership interests are offered and sold solely outside the United States; (iii) the fund either (a) would be a covered fund if organized or established in the United States or (b) 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; (iv) the fund 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 when (a) such banking entity is not organized, or directly or indirectly controlled by a banking entity organized, under the laws of the United States or any State and (b) such banking entity's acquisition or retention of an ownership interest in or sponsorship of the fund meets the Volcker Rule's requirements for permitted covered fund activities and investments "solely outside the United States" (commonly referred to as the "SOTUS" exemption); (v) the fund is established and operated as part of a bona fide asset management business; and (vi) the fund 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 requirements of the Volcker Rule or the implementing regulations.

Parallel Investments and Co-Investments by Banking Entities

While the preamble to the current version of the Volcker Rule can be read to suggest that parallel investments and co-investments made by a banking entity alongside a sponsored covered fund should be counted towards calculation of the 3% per-fund limit, the Amendments clarify that such parallel investments and co-investments are not required to be included in such calculation as long as the investment is made in compliance with all applicable law and regulation, including applicable safety and soundness standards.

While the foregoing discussion focuses on some of the Amendments' more significant changes to the Volcker Rule, the Amendments will have other impacts and changes relevant to asset managers. If you have questions about how the Amendments may apply to your business or industry, please contact your Proskauer attorney or one of the private investment funds attorneys listed on this alert.

---

[1] "Qualifying Investment" means "(i) an equity security issued by a "qualifying portfolio company" [(as defined below)] that has been acquired directly by the private fund from the qualifying portfolio company, (ii) any equity security issued by a qualifying portfolio company in exchange for an equity security issued by the qualifying portfolio company described in [the preceding clause (i)] or (iii) any equity security issued by a company of which a qualifying portfolio company is a majority-owned subsidiary, as defined in section 2(a)(24) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(24)), or a predecessor, and is acquired by the private fund in exchange for an equity security described in [the preceding clauses (i) or (ii)]."

"Qualifying Portfolio Company" means "any company that (i) at the time of any investment by the private fund, is not reporting or foreign traded and does not control, is not controlled by or under common control with another company, directly or indirectly, that is reporting or foreign traded, (ii) does not borrow or issue debt obligations in connection with the private fund's investment in such company and distribute to the private fund the proceeds of such borrowing or issuance in exchange for the private fund's investment and (iii) is not an investment company, a private fund, an issuer that would be an investment company but for the exemption provided by [Rule 3a-7 under the Investment Company Act concerning certain issuers of asset-backed securities], or a commodity pool."

[2] "High-Risk Asset" means "an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States."

[3] "High-Risk Trading Strategy" means "a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States."

[4] See en. 2.

[5] See en. 3.

[6] "Family Customer" means any "family client" as defined in Investment Advisers Act Rule 202(a)(11)(G)-1(d)(4), and any natural person who is a father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law or daughter-in-law of a family client, or a spouse or a spousal equivalent of any of the foregoing. "Family client" means (1) any family member; (2) any former family member; (3) any key employee; (4) certain former key employees; (5) any non-profit organization, charitable foundation, charitable trust (including charitable lead trusts and charitable remainder trusts whose only current beneficiaries are other family clients and charitable or non-profit organizations), or other charitable organization, in each case for which all the funding such foundation, trust or organization holds came exclusively from one or more other family clients; (6) any estate of a family member, former family member, key employee, or eligible former key employee; (7) any irrevocable trust in which one or more other family clients are the only current beneficiaries; (8) any irrevocable trust funded exclusively by one or more other family clients in which other family clients and non-profit organizations, charitable foundations, charitable trusts, or other charitable organizations are the only current beneficiaries; (9) any revocable trust of which one or more other family clients are the sole grantor; (10) certain other trusts; or (11) any company wholly owned (directly or indirectly) exclusively by, and operated for the sole benefit of, one or more other family clients; provided that if any such entity is a pooled investment vehicle, it is excepted from the definition of "investment company" under the Investment Company Act.

[7] "Closely Related Person" means "a natural person, including the estate and estate planning vehicles of such person, who has longstanding business or personal relationships with any family customer."

[8] See en. 2.

[9] See en. 3.

[10] See en. 2.

[11] See en. 3.

Related Professionals

- **Marc A. Persily**
  Partner
- **Bruce L. Lieb**