Meeting Between Staff of the Federal Reserve Board and the Investment Company Institute
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Participants: Flora Ahn, Greg Frischmann, Amy Peterson, Kirin Walsh, Page Conkling, Kevin Tran, Amy Lorenc, David McArthur, and Dennis Mawhirter (Federal Reserve Board)

Frances Sadler and Rachel Graham (ICI); Ursula Pfeil (PNC); David Portilla and Satish Kini (Debevoise & Plimpton)

Summary: Staff of the Federal Reserve Board met with representatives of the Investment Company Institute (ICI) and one of its members to discuss the proposal to amend the regulation implementing section 13 of the Bank Holding Company Act of 1956 (commonly referred to as the "Volcker Rule"). Specifically, the ICI representatives discussed the proposed treatment of registered investment companies and foreign public funds under the Volcker Rule regulations.

Attachment

Investment Company Institute
Proposed Volcker Rule Regulatory Text and Explanation

Set out below are explanations of, and regulatory text for, (1) two possible solutions to the "banking entity" issue faced by U.S. registered investment companies ("RICs"), their foreign public fund ("FPF") analogs (FPFs, together with RICs, "regulated funds") and their sponsors under the Volcker Rule implementing regulations – *i.e.*, the treatment of regulated funds as banking entities under certain circumstances; and (2) a simplified exclusion for FPFs from the definition of "covered fund."

As described in more detail below, the first solution to the "banking entity" issue would carve out regulated funds from the banking entity definition. The second solution would provide a conditional carve out for regulated funds from the banking entity definition, during a seeding period and other temporary periods when a sponsor may be deemed to "control" a regulated fund under the standards of the Bank Holding Company Act ("BHC Act"). Finally, the simplified exclusion for FPFs would remove unnecessary restrictions in the current implementing regulations and put FPFs on even footing with RICs, which was the agencies' stated objective.

- ***Explanations***

"Banking entity" definition, solution one: carve out from the banking entity definition.

This solution would be the most comprehensive, carving out regulated funds from the banking entity definition in the same way as covered funds benefit from a carve out. The same statutory reasoning on which the agencies relied to carve out covered funds from the banking entity definition could be used for this approach. The benefit of this approach is that it would effectuate the original intent of Congress that the Volcker Rule should not apply to regulated funds.

We recognize that the agency staffs have been concerned about 'evasions' to the Volcker Rule prohibitions. We note, however, that there is no evidence of banking entities using regulated funds to evade the restrictions of the Volcker Rule (or other provisions of the BHC Act, which would remain in place notwithstanding the carve out proposed here). If individual cases of evasion arise, the agencies have ample tools to address these issues. Accordingly, we continue to believe that this approach is the best solution to the issue.

"Banking entity" definition, solution two: conditional carve out from the banking entity definition during seeding period and other temporary instances of BHC Act "control."

Under this solution, the agencies also would carve out regulated funds from the banking entity definition, but the carve out would be subject to certain conditions and be limited

to a seeding period and other temporary instances when a sponsor may be deemed to control a fund under BHC Act standards.[1]

This approach would codify the agencies' recognition in FAQ No. 16 that a regulated fund should not be treated as a banking entity during a seeding period. The language we propose tracks the description of the purpose of a seeding period in FAQ No. 16. The approach also would permit the multi-year seeding periods intended by FAQ No. 16. In addition, the approach would accommodate other temporary instances when, due to duties or obligations to the fund or its investors, a sponsor may own a substantial portion of a regulated fund for a temporary period of time. For example, a sponsor may need to hold 25% or more of a regulated fund at the end of a fund's life when it is liquidating or, at any point during a fund's life, because a large investor redeems. In both situations, the sponsor's temporary ownership of 25% or more of a fund avoids adverse effects on the other investors in the fund, a result that should not be demanded by the Volcker Rule (which was never intended to affect regulated fund activities and practices).

The proposed approach is analogous to the Federal Reserve Board's merchant banking regulations, which permit a financial holding company to exercise routine management or operation of a merchant banking portfolio company (which otherwise is prohibited) for a temporary period to allow the financial holding company to achieve a reasonable return on its investment (such investment returns are integral to the underlying purpose of merchant banking authority). *See* 12 CFR 225.171(e). Similarly, for regulated funds, allowing banking entity sponsors to own 25% or more of a fund for a temporary period would allow the sponsor to fulfill its duties or obligations to the fund and its investors.

Simplified exclusion for FPFs from the definition of "covered fund"

The preamble to the implementing regulations states that the foreign public fund exclusion "is designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of [the Volcker Rule], including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States." 79 Fed. Reg. 5536, 5678 (Jan. 31, 2014). The agencies expect that investors in foreign public funds will "be entitled to the full protection of securities laws in the home jurisdiction of the fund" and that "a fund authorized to sell ownership interests to . . . retail investors [would] be of a type that is more similar to a U.S. registered investment company than to a U.S. covered fund." *Id*.

[1] The same result also could be obtained by exempting the activities of regulated funds during a seeding period and other temporary instances of control from the proprietary trading definition and covered funds restrictions. The agencies could rely on the same statutory reasoning that was used to exclude other activities from the proprietary trading definition (*see* Section _.3(d)) and from the covered fund restrictions (*see* Section _.10(a)).

In three respects, the current exclusion is crafted more narrowly than necessary to achieve the agencies' stated goals.

1. First, the requirement that ownership interests be sold "predominantly" through one or more public offerings outside the United States is contrary to the objective of "treat[ing] foreign public funds consistent with similar U.S. funds" because the exclusion for RICs places no conditions on their distribution. This requirement creates compliance challenges and operational and other issues.

2. Second, a non-U.S. fund sponsored by a U.S. banking entity can qualify for the exclusion only if its ownership interests are sold "predominantly" to unaffiliated parties. This presents considerable compliance challenges for the fund sponsor, such as having to track – and possibly limit – investments in the fund by its directors and employees. Again, the exclusion for RICs places no conditions on their distribution.

3. Third, the requirement that a non-U.S. fund must be authorized for sale to retail investors in its "home jurisdiction" is unduly restrictive. There are valid business reasons for organizing a fund in one jurisdiction and then selling its shares primarily, or even exclusively, in other jurisdictions (*e.g.*, more favorable tax treatment, flexibility to distribute a single fund into multiple markets). In fact, this is common practice in many markets.

The proposed definition would achieve the agencies' regulatory goals without placing unnecessary constraints on the ability of U.S. banking entities to offer regulated funds in jurisdictions outside the United States. It modifies the conditions of the FPF exclusion to focus on the key distinctions – substantive regulation and transparency – between funds that are authorized for sale to retail investors and those that are not. Although the governing rules for regulated funds vary across jurisdictions, these rules reflect common principles developed by the International Organization of Securities Commissions ("IOSCO") for regulated funds (which IOSCO refers to as "collective investment schemes," or "CIS") as well as IOSCO's more detailed work on core areas of CIS regulation.[2] As well, the proposed definition accommodates legitimate business practices, such as organizing a fund in one jurisdiction for sale in another or selling shares of a regulated "public" fund to institutional or other non-retail investors.

Finally, the proposed definition addresses the agencies' concern (as stated in the preamble to the implementing regulations) that foreign public funds sponsored by U.S.

[2] For a brief discussion of many regulatory and structural characteristics common to regulated funds worldwide, see Letter to the Basel Committee on Banking Supervision from Dan Waters, Managing Director, ICI Global (March 17, 2016), at 4-11, available at https://www.ici.org/pdf/29778.pdf.

banking entities "may present heightened risks of evasion." Although we question the basis for this assertion, and are aware of no data to support it, we nevertheless seek to clarify that the FPF exclusion is not available to any fund formed for the purpose of investment by affiliated parties. Revising the exclusion in this way would not foreclose the agencies from exercising their broad supervisory authority to address any particular instances of evasion.

- ***Proposed regulatory text***

Below is regulatory text for each of the two possible solutions for the "banking entity" issue (together with a defined term used in each solution) and the simplified exclusion for FPFs from the definition of "covered fund."

<u>"Banking entity" definition, solution one</u>

Section _.2(c)(2) could be revised to add new paragraph (iv) as follows:

> Banking entity does not include:
>
> > …..
> >
> > (iv) A regulated fund that is not a banking entity itself under paragraphs (c)(1)(i), (ii), or (iii) of this section.

<u>"Banking entity" definition, solution two</u>

Section _.2(c)(2) could be revised to add new paragraph (iv) as follows:

> Banking entity does not include:
>
> > …..
> >
> > (iv) A regulated fund that is not a banking entity itself under paragraphs (c)(1)(i), (ii), or (iii) of this section, but only during the following circumstances:
> >
> > > (A) A seeding period during which a regulated fund is operated pursuant to a written plan to test the fund's investment strategy, establish a track record of the fund's performance for marketing purposes, and attempt to distribute the fund's shares; or
> > >
> > > (B) A temporary period of control by the regulated fund's banking entity sponsor or adviser, provided that the banking entity sponsor or adviser determines that maintaining such control is appropriate to satisfy its duties or obligations to the regulated fund or its

investors and the banking entity sponsor or adviser maintains documentation that describes the reasons for such control and the plan for disposing of control within a reasonable period of time.

Common definition

In addition, the following definition could be added to section _.2.

(1) *Regulated fund* means:

(A) Any investment company that is registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8); and

(B) Any foreign public fund as described in Section _.10(c)(1).

Simplified exclusion for FPFs from the definition of "covered fund"

The existing language in section _.10(c)(1) could be replaced with the following:

(1) *Foreign public fund.*

(i) Subject to paragraph (ii) below, an issuer that:

(A) Is organized or established outside of the United States;

(B) Is substantively regulated so that its ownership interests are eligible to be offered and sold to retail investors in one or more jurisdictions outside of the United States;

(C) Has filed or submitted any required offering disclosure documents with the appropriate regulatory authority in each such jurisdiction; and

(D) Sells ownership interests to investors as permitted by each such jurisdiction.

(ii) If an issuer's banking sponsor is located in or organized under the laws of the United States or of any other State, or is controlled directly or indirectly by such a banking entity, the issuer is not a *foreign public fund* if the issuer is formed for the purpose of investing for the benefit of the sponsoring banking entity, its affiliates, or directors and employees of such entities.

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