BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: January 23, 2020

To: Board of Governors

From: Vice Chair for Supervision Quarles

Subject: Proposed Rule Amending the Board's "Volcker Rule" Regulations

Attached are a memorandum to the Board and a *Federal Register* notice that would invite public comment on proposed revisions to the regulations implementing section 13 of the Bank Holding Company Act (the "Volcker Rule"). The draft proposed rule would be issued jointly by the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the "agencies").

In November 2019, the agencies finalized certain amendments to the Volcker Rule regulations and stated that they would propose a separate rulemaking regarding the "covered fund" provisions. The proposed rule is intended to clarify and streamline the covered fund-related provisions of the regulations by:

- Limiting the extraterritorial impact of the rule on foreign funds offered by foreign banks to foreign individuals;
- Permitting certain low-risk transactions (including intraday credit and payment, clearing, and settlement transactions) between a banking entity and covered funds for which the banking entity serves as investment adviser or sponsor;
- Simplifying existing provisions of the rule related to foreign public funds, loan securitizations, and small business investment companies;
- Permitting banking entities to invest in or sponsor certain types of funds that do not raise the concerns the Volcker Rule was intended to address, such as credit funds, venture capital funds, customer facilitation funds, and family wealth management vehicles;
- Clarifying that credit exposures to a covered fund would generally not constitute ownership interests under the Volcker Rule; and
- Clarifying that parallel direct investments made by a banking entity in the same underlying investments as a sponsored covered fund are not deemed to be investments in the fund itself.

I reviewed the package and believe it is ready for Board consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date:	January 23, 2020
To:	Board of Governors
From:	Staff[1]
Subject:	Draft Proposed Revisions to Rules Implementing the Hedge Fund and Private Equity Fund Restrictions of Section 13 of the Bank Holding Company Act

ACTION REQUESTED

Staff seeks approval to invite public comment on proposed revisions to the regulation implementing section 13 of the Bank Holding Company Act—commonly known as the Volcker Rule—regarding hedge fund and private equity fund (covered fund) restrictions.[2] The proposal has been developed jointly by staff from the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. Staff also requests authority to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register*.

EXECUTIVE SUMMARY

- In November 2019, the agencies finalized revisions to simplify and streamline the proprietary trading provisions of the Volcker Rule regulations. They also stated that they would invite public comment on a separate proposal to simplify the covered fund provisions.
- Based on their experience implementing the rule since 2013, the agencies believe that revisions to the rule would clarify and simplify compliance, address the extraterritorial

[1] Mr. Van Der Weide, Mss. Schaffer and Ahn, Messrs. Frischmann and Walsh, and Ms. Podrygula (Legal Division); and Mr. Gibson, Mss. Hewko, MacDonald, Boggs, and Holmes (Division of Supervision & Regulation).

[2] Section 13 of the Bank Holding Company Act (BHC Act) (12 U.S.C. § 1851).

application of the requirements, and permit additional fund activities that do not present the risks that the Volcker Rule was intended to address.

- Specifically, the proposed rule would:
    - Limit the extraterritorial impact of the rule on foreign funds offered by foreign banks to foreign individuals;
    - Permit certain low-risk transactions (including intraday credit and payment, settlement and clearing transactions) between a banking entity and covered funds for which the banking entity serves as investment adviser or sponsor;
    - Simplify existing provisions of the rule related to foreign public funds, loan securitizations, and small business investment companies;
    - Permit banking entities to invest in or sponsor certain types of funds that do not raise the concerns the Volcker Rule was intended to address, such as credit funds, venture capital funds, customer facilitation funds, and family wealth management vehicles;
    - Clarify that credit exposures to a covered fund would generally not constitute fund ownership interests under the Volcker Rule; and
    - Clarify an ambiguity from the 2013 rulemaking about the treatment of parallel investments made by a banking entity in the same underlying investments as a sponsored covered fund.
- Staffs of all five agencies have jointly developed the proposal, and public comment will be invited until April 1, 2020.

DISCUSSION

The Volcker Rule prohibits any banking entity from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a covered fund, subject to certain exemptions. The Volcker Rule defines a covered fund 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 by rule determine.

The regulations implementing the Volcker Rule define covered fund by including the statutory definition as well as certain additions (e.g., commodity pools that are not publicly

offered) and exclusions (e.g., foreign public funds). Since adoption of the implementing regulations in 2013, staff has identified opportunities, consistent with the statute, for revising the regulations to improve, streamline, and clarify the covered fund provisions.

A. Limit Extraterritorial Impact on Foreign Excluded Funds

The Volcker Rule has an unintended extraterritorial impact on foreign funds that imposes unnecessary regulatory burdens on such funds. While certain foreign funds that are organized and offered outside of the United States are excluded from the definition of covered fund under the agencies' rules, these foreign funds could become subject to the proprietary trading and other restrictions of the Volcker Rule because they are affiliated with a banking entity.[3]

To address this issue, the federal banking agencies announced[4] that they would not take enforcement action against a foreign banking entity based on the activities and investments of any of its foreign excluded funds that meet certain criteria, known as qualifying foreign excluded funds.[5]

The proposal would provide permanent regulatory relief by generally exempting qualifying foreign excluded funds from the proprietary trading prohibition and covered fund

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[3] The current rule excludes covered funds from the definition of "banking entity." 12 CFR 248.2(c)(2)(i). However, because qualifying foreign excluded funds are not covered funds, they can become banking entities through affiliation with other banking entities.

[4] *See* Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 21, 2017), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf; Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 17, 2019), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190717a1.pdf.

[5] The conditions are that the fund: (1) Is organized or established outside the United States and its ownership interests are offered and sold solely outside the United States; (2) Would be a covered fund were the entity 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; (3) 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 entity; (4) Is established and operated as part of a bona fide asset management business; and (5) Is not operated in a manner that enables the foreign banking entity to evade the requirements of section 13 or implementing regulations. *See supra* note 4.

provisions of the Volcker Rule. The proposal would define a qualifying foreign excluded fund using the same eligibility criteria set forth in the policy statements.

Staff believes that it would be appropriate for the agencies to exercise their statutory rulemaking authority to provide permanent relief for qualifying foreign excluded funds. The Volcker Rule permits foreign banking entities to conduct certain trading and investing activities outside of the United States.[6] Allowing the activities of qualifying foreign excluded funds would further limit the extraterritorial impact of the Volcker Rule on foreign asset management activities with little direct nexus to the U.S. financial system.

As described in the attached proposal, exempting qualifying foreign excluded funds from the Volcker Rule may promote safety and soundness by reducing the compliance burden on foreign banking entities in the conduct of foreign asset management activities that do not materially impact the United States. These banking entities would conduct such activities in accordance with the same laws and regulations applicable to their non-U.S. competitors. Also, by permitting qualifying foreign excluded funds to invest in U.S. companies, this exemption may promote U.S. financial stability by allowing such funds to provide capital and liquidity to U.S. financial markets.

B. Permit Limited, Low-Risk Transactions with Related Funds

The Volcker Rule generally prohibits a banking entity from entering into certain transactions with a covered fund for which the banking entity serves as an investment adviser or sponsor (related funds). Specifically, a banking entity is generally prohibited from entering into a transaction with a related fund of a type that would be covered by section 23A of the Federal Reserve Act (referred to as Super 23A).[7]

To facilitate the ability of banking entities to organize and offer funds, as expressly permitted by the Volcker Rule,[8] the proposal would allow a banking entity to enter into transactions with a related fund that would be permissible without limit under section 23A of the

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[6] *See, e.g.*, Section 13(d)(1)(H) and (I) of the BHC Act (12 U.S.C. § 1851(d)(1)(H), (I)).

[7] 12 U.S.C. § 1851(f)(1). The term "covered transaction" is defined in section 23A and includes, among other things, extensions of credit, asset purchases, and guarantees. *See* 12 U.S.C. § 371c.

[8] Section 13(d)(1)(G) of the BHC Act (12 U.S.C. § 1851(d)(1)(G)).

Federal Reserve Act.[9] This would include, for example, intraday extensions of credit and extensions of credit fully secured by U.S. Treasury securities. The proposal also would allow a banking entity to engage in certain transactions with a related fund in connection with payment, clearing, and settlement activities.

Allowing these types of transactions would provide the banking entity with greater flexibility to provide standard payment, clearing, and settlement services to a related fund, rather than requiring such services to be provided by an unaffiliated service provider. It would also reduce operational risks associated with the use of unaffiliated service providers, and therefore may reduce interconnectedness among financial institutions in the U.S. financial system.

C. Simplify Existing Covered Fund Exclusions

The proposal would simplify the eligibility criteria for certain exclusions from the definition of "covered fund," making it easier for banking entities to use and confirm compliance with these existing exclusions.

1. Foreign Public Funds

In order to provide consistent treatment between U.S. registered investment companies (which are not covered funds) and their foreign equivalents, the current rule excludes foreign public funds from the definition of covered fund, subject to certain eligibility requirements that do not apply to U.S. registered investment companies.

A foreign public fund is defined as any investment fund that is organized outside of the United States and the ownership interests of which are (1) authorized to be sold to retail investors in the fund's home jurisdiction and (2) sold predominantly through one or more public offerings outside of the United States.[10]

Some of the requirements are unnecessary to ensure consistency with the exclusion for U.S. registered investment companies and are difficult for banking entities to comply with. The home jurisdiction requirement disqualifies funds that are organized in one foreign jurisdiction but only authorized to be sold to retail investors in another foreign jurisdiction. Additionally, the

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[9] *See* 12 U.S.C. § 371c.

[10] The agencies stated in the preamble to the regulations implementing the Volcker Rule in 2013 that they generally expect that an offering is made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States. 79 FR 5678.

requirement that a fund be sold "predominantly" through one or more public offerings may cause compliance and monitoring difficulties because banking entities may have limited visibility into the fund's distribution history.

To remedy these concerns, the proposal would replace these requirements with a requirement that fund ownership interests be offered and sold through at least one public offering. To help ensure that these funds are sufficiently similar to U.S. registered investment companies, the proposal also would modify the definition of "public offering" to add a new requirement that the distribution be subject to substantive disclosure and retail investor protection laws or regulations in the jurisdiction where it is made.[11]

These changes would help ensure that qualifying foreign public funds are limited to those that are authorized to be sold to retail investors, while also more closely aligning the treatment of foreign public funds with that of U.S. registered investment companies.

2. Loan Securitizations

The Volcker Rule expressly permits banking entities to sell and securitize loans in a manner otherwise permitted by law.[12] As such, the current rule excludes loan securitizations from the definition of covered fund, provided such issuers meet various eligibility criteria, such as issuing asset-backed securities and only holding loans and certain other permitted assets.[13] The proposal would amend two key eligibility criteria required for a loan securitization to be excluded from the covered fund definition.

First, the proposal would expand the assets that a qualifying loan securitization could hold to allow such vehicles to hold non-loan assets equal to no more than five percent of the loan securitization's total assets. Permitting an issuer to hold a small pool of non-loan assets may provide banking entities with greater flexibility to sell and securitize loans.

Second, the proposal would clarify that servicing assets held by a loan securitization vehicle may include assets other than securities (for example, mortgage insurance policies supporting the mortgages in a loan securitization). The current rule provides that in addition to

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[11] Under the proposal, a banking entity that acts as an investment adviser or sponsor to a foreign public fund also would be required to ensure that the distribution complies with all applicable requirements in the jurisdiction where the fund is offered.

[12] Section 13(g)(2) of the BHC Act (12 U.S.C. § 1851(g)(2)).

[13] 12 CFR 248.10(c)(8).

loans, a loan securitization may hold servicing assets; however, the rule is unclear whether such assets may include assets other than securities. The proposal would codify staff guidance that servicing assets held by a loan securitization may include assets other than securities; servicing assets that are securities must meet additional eligibility criteria set forth in the regulations.[14]

3. Small Business Investment Companies

The Volcker Rule and the current regulation exclude from the definition of "covered fund" Small Business Investment Companies (SBICs), as long as the SBIC's license has not been revoked. In some cases, an SBIC may surrender its license during a wind-down period, which may call into question its eligibility for the SBIC exclusion.

The proposal would clarify that an SBIC could remain eligible for the exclusion from the covered fund provisions during a wind-down period provided it makes no new investments after surrendering its license. Allowing SBICs to retain their eligibility for the exclusion from the covered fund definition during their wind-down periods would help facilitate banking entities' investments in SBICs and give appropriate effect to the statutory exemption for SBIC investments.

D. Proposed Permitted Funds

The proposal would permit banking entities to own and sponsor several types of funds that do not raise the concerns that the Volcker Rule was intended to address.

1. Credit Funds

Although the Volcker Rule excludes loan securitizations from the definition of covered fund, the regulations implementing the Volcker Rule have limited the ability of banking entities to invest in or sponsor substantially similar funds that make loans, invest in debt securities, or otherwise extend credit (credit funds).[15] Moreover, the legislative history of the Volcker Rule indicates that Congress targeted the covered funds provisions at private equity funds and short-term-focused hedge funds, not private long-term debt funds. Therefore, the proposal would allow banking entities to invest in or sponsor credit funds that meet certain eligibility criteria.

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[14] *See* Volcker Rule Frequently Asked Questions, Question 4 (June 10, 2014), *available at* https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

[15] *See* Section 13(g)(2) of the BHC Act (12 U.S.C. § 1851(g)(2)) (providing that nothing in the Volcker Rule shall be construed to limit the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law).

A qualifying credit fund would be a fund whose assets consist solely of (1) loans; (2) debt instruments; (3) other assets that are related or incidental to acquiring, holding, servicing, or selling loans; and (4) certain interest rate or foreign exchange derivatives. A qualifying credit fund would be subject to certain restrictions, including a prohibition on proprietary trading by the fund. In addition, a banking entity investing in or sponsoring the qualifying credit fund would be prohibited from guaranteeing the performance of the fund and would be required to disclose this prohibition to investors. Moreover, a qualifying credit fund would be required to comply with the Super 23A restrictions as if the credit fund were a covered fund. Both the eligibility requirements and the limits would help to ensure that the fund is providing long-term credit and is not being used by the banking entity to evade the requirements of the Volcker Rule.

2. Venture Capital Funds

Under the current rule, venture capital funds that invest in small businesses and startup businesses may be covered funds subject to the restrictions of the Volcker Rule unless they otherwise qualify for an exclusion. To ensure that the restrictions of the Volcker Rule reflect Congressional intent, the agencies are proposing to allow banking entities to acquire or retain ownership interests in, or sponsor, certain venture capital funds, to the extent the banking entity is permitted to engage in such activities under applicable law.[16]

Only "venture capital funds" as defined in Securities and Exchange Commission regulations would qualify for the exclusion.[17] The proposal also would prohibit a qualifying venture capital fund from engaging in proprietary trading. Furthermore, a banking entity that acts as a sponsor or investment adviser to the fund would be prohibited from guaranteeing the fund's performance, must disclose this prohibition to fund investors, and would be required to comply with Super 23A limits as if the venture capital fund were a covered fund. The proposal would request comment on whether the agencies should further limit the scope of qualifying venture capital funds, for example, to funds that invest only in companies whose annual revenues are below a certain limit.

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[16] For example, a banking entity that has elected to be treated as a financial holding company may be permitted to make an investment in a venture capital fund pursuant to its merchant banking investment authority, provided the banking entity complies with applicable merchant banking investment requirements. *See* 12 CFR Part 225, Subpart J.

[17] 17 CFR 275.203(l)-1.

This element of the proposal would allow banking entities to invest in funds that serve an important role in providing financing for companies that do not have publicly traded securities at the time of the fund's investment, including smaller companies with fewer funding options.

During congressional consideration of the Volcker Rule, several members of Congress expressed support for excluding venture capital funds from the covered fund restrictions.[18] Staff notes that Congress expressed a favorable view of venture capital funds that invest in small companies by permitting investments in Small Business Investment Companies.[19] The proposed limitations on qualifying venture capital funds would help to address many of the critical issues about which Congress was concerned when enacting the Volcker Rule, including eliminating many of the incentives that a banking entity may have to guarantee the performance of a covered fund or bail out a covered fund during times of stress.

3. Family Wealth Management Vehicles

The proposal would allow banking entities more flexibility to provide traditional banking and asset management services to family wealth management vehicles, which are funds set up on behalf of a family. A fund would only qualify as a family wealth management vehicle under the proposal if it is owned only by members of a single family and no more than three closely related persons of the family customers.[20]

A banking entity that sets up a family wealth management vehicle would need to comply with a number of restrictions under the proposal. First, the banking entity must provide bona fide trust, fiduciary, or advisory services to the family wealth management vehicle. The banking entity also would be prohibited from guaranteeing the vehicle's performance (and must disclose this prohibition to fund investors), and would be required to comply with Super 23A limits with respect to such vehicles. Furthermore, the banking entity would be prohibited from having an

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[18] *See, e.g.*, 156 Cong. Rec. E1295 (daily ed. July 13, 2010) (statement of Rep. Eshoo); 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement of Sen. Boxer); 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (statement of Sen. Dodd); 156 Cong. Rec. S6242 (daily ed. July 26, 2010) (statement of Sen. Scott Brown).

[19] 12 U.S.C. § 1851(d)(1)(E).

[20] Under proposed rule § __.10(c)(15)(iii)(A), "closely related person" would mean "a natural person (including the estate and estate planning vehicles of such person) who has a longstanding business or personal relationship with any family customer."

ownership interest in the vehicle, other than up to 0.5 percent of the vehicle's outstanding ownership interests to the extent necessary for establishing corporate separateness of the vehicle. The banking entity also would generally be prohibited from acquiring low-quality assets from the family wealth management vehicle.[21]

This element of the proposal would give banking entities greater flexibility to structure services or transactions for families, and the additional limitations and requirements would help ensure that banking entities do not evade the requirements of the Volcker Rule.

4. Customer Facilitation Funds

In some circumstances, the current rule may constrain the manner in which a banking entity provides financial services to its customers. For example, a customer may obtain exposure to a financial product (e.g., a derivative) by entering into a contract directly with a banking entity, or by acquiring ownership interests in a standalone fund vehicle that has entered into a contract with the banking entity. Although each structure provides a customer with the same economic exposure to the underlying financial product, when financial products are provided through a fund, the fund may constitute a "covered fund" under the current rule. As a result, a banking entity may face obstacles to offering financial products to its customers through a fund structure.

The proposal would eliminate some of the covered fund restrictions for a fund designed to facilitate transactions between a banking entity and a single customer (customer facilitation fund). The change would provide banking entities with greater flexibility to provide banking and financial services to customers. The eligibility criteria described below would also help to ensure that banking entities do not evade the requirements of the Volcker Rule.

A banking entity would be prohibited from guaranteeing the fund's performance and would be required to disclose this prohibition to the customer. Furthermore, the banking entity would be prohibited from acquiring or retaining as principal an ownership interest in the fund, other than up to 0.5 percent of the entity's outstanding ownership interests to the extent necessary for establishing corporate separateness of the fund from the customer. The banking

[21] Specifically, a banking entity would be required to comply with the low-quality asset purchase requirements set forth in the Board's Regulation W (12 CFR 223.15(a)), as if such banking entity were a bank and the vehicle were an affiliate thereof.

entity also generally would be prohibited from acquiring low-quality assets from the customer facilitation fund.[22]

E. Clarify Ownership Interests and Fund Investment Limits

Under the Volcker Rule, a banking entity that organizes or offers a covered fund is subject to investment limits and a capital deduction with respect to its "ownership interests" in covered funds. The proposal would clarify both the definition of "ownership interest" and the manner in which a banking entity calculates its fund investment limits and capital deduction.

The current rule defines "ownership interest" to include any equity, partnership, or other "similar interest." The current rule defines a "similar interest" by reference to a list of characteristics, including 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 adviser of a covered fund. The proposal would amend this list of characteristics to clarify that a loan or debt interest with certain creditor rights would not be an ownership interest, and would provide an express safe harbor for senior loans and senior debt.

F. Clarify Ambiguity for Parallel and Co-Investments

The Volcker Rule does not impose any separate limits on direct investments by banking entities in the same assets invested in by a covered fund. However, the preamble to the current rule discusses the potential for evasion of the per-fund and aggregate funds ownership limitations in the current rule, and states that "if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund."[23] The preamble also states that "a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund in a privately negotiated investment unless the value of such co-investment is less than 3% of the value of the total amount co-invested by other investors in such investment."[24]

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[22] Specifically, a banking entity would be required to comply with the low-quality asset purchase requirements set forth in the Board's Regulation W (12 CFR 223.15(a)), as if such banking entity and its affiliates were a member bank and the issuer were an affiliate thereof.

[23] 79 FR 5734.

[24] *Id.*

This preamble language has created confusion as to whether the covered fund limits in the Volcker Rule apply to direct investments, and whether a banking entity has a legal obligation to track and monitor investments made directly by the banking entity in the same investments held by a covered fund organized and offered by the banking entity. The proposal would clarify that a banking entity need not include investments made alongside a covered fund in these limits to the extent that the investment is made in compliance with applicable laws and safety and soundness standards. This proposed amendment should help simplify compliance with the applicable covered fund limits, and would be consistent with the scope of the statute.

RECOMMENDATION

Staff recommends that the Board approve publication of the attached *Federal Register* notice. Staff also recommends that the Board authorize staff to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register*.