Schulte Roth&Zabel

Memorandum

Summary of Final Volcker 2.0 for Fund Activities

June 26, 2020

On June 25, 2020, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission (collectively, the "Agencies") approved a new final rule ("Final Rule") to simplify and tailor the "covered fund" provisions of the regulations implementing section 13 of the Bank Holding Company Act, commonly known as the "Volcker Rule."[1] A copy of the Final Rule is available at https://www.fdic.gov/news/board/2020/2020-06-25-notice-dis-a-fr.pdf. It will become effective Oct. 1, 2020.

On the day the Final Rule was approved, we published an *Alert* that provided an executive summary.[2] This *Memorandum* supplements that *Alert* by examining each of the Final Rule's provisions in detail.

Background

Under the Volcker Rule, a banking entity[3] is generally barred from acquiring or retaining, as principal, an ownership interest in a "covered fund," subject to certain exceptions. Further, a banking entity generally cannot sponsor a covered fund unless (i) it abides by a series of requirements or (ii) the sponsorship falls within an exception for non-U.S. activities.

In November 2019, the Agencies finalized numerous amendments to the "proprietary trading" provisions of the Volcker Rule regulations, but only relatively minor changes to the "covered fund" provisions.[4] The Agencies, however, stated that they would propose a separate rulemaking regarding

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[1] The Volcker Rule was part of the Dodd-Frank Wall Street Reform and Consumer Protection Act and restricts the proprietary trading and private investment fund activities of U.S. banks and their worldwide affiliates, as well as foreign banks with banking operations in the United States and their worldwide affiliates. Regulations implementing the Volcker Rule were initially finalized and jointly promulgated by the Agencies in December 2013. In July 2019, the Agencies adopted certain amendments to the regulations to reflect changes made to the statutory language of the Volcker Rule in May 2018. Those changes excluded certain community banks and their affiliates from the Volcker Rule and permitted an investment adviser that is a banking entity to share its name with any covered fund that it organizes and offers. In November 2019, the Agencies adopted more substantive amendments, effective Jan. 1, 2020, mostly to the "proprietary trading" provisions of the Volcker Rule. *See infra* note 4 and accompanying text.

[2] *See SRZ Alert* "Agencies Approve Volcker 2.0 for Fund Activities," June 25, 2020, available here: https://www.srz.com/resources/agencies-approve-volcker-2-0-for-fund-activities.html.

[3] Banking entities are U.S. banks and their affiliates, as well as foreign banks with a branch or agency office in the United States and their affiliates.

[4] *See* FDIC and OCC Approve Volcker 2.0 — Summary of Amendments to Fund Activity Provisions (Aug. 23, 2019), available here: https://www.srz.com/resources/fdic-and-occ-approve-volcker-2-0-summary-of-amendments-to-fund.html. These amendments affected covered fund activities in several ways: (i) provided greater capacity for banking entities to engage in underwriting and marketing making of third-party covered funds; (ii) provided greater flexibility for a banking entity to invest in a covered fund as a hedge; (iii) removed the "financing prong" from the "SOTUS" exemption to permit financing from U.S. affiliates for certain non-U.S. fund activity by non-U.S. banks; (iv) codified prior Agency guidance giving non-U.S. banks greater flexibility for "SOTUS" activity; (v) codified prior Agency guidance on the deadline for the

the "covered fund" provisions and released such proposed rules for comment on Jan. 30, 2020 ("Proposed Rule"). With certain limited exceptions, the Final Rule is nearly identical to the Proposed Rule.

While the Final Rule does not offer sweeping changes, as many in the banking and fund industries would have preferred, it does make several important changes designed to eliminate aspects of the current Volcker Rule regulations ("Current Rule") that were deemed to be unduly complex or burdensome, unnecessarily broad or the cause of unintended consequences.

While the Final Rule retains the basic structure and principles of the Current Rule's covered fund provisions, it (1) adds new exclusions for certain types of funds; (2) adds additional flexibility for certain existing exclusions; (3) eliminates certain extraterritorial outcomes; (4) permits low-risk transactions with sponsored covered funds; (5) provides greater flexibility for debt relationships with covered funds; and (6) increases the ability to co-invest with sponsored covered funds.

New Categories of Funds Are Made Exempt

The Final Rule adds four new exclusions to the definition of "covered fund" — credit funds, venture capital funds, family wealth management vehicles and customer facilitation vehicles — thereby exempting them from the scope of the Volcker Rule.

Credit Funds

The Final Rule exempts a fund whose assets consist solely of (1) loans; (2) debt instruments; (3) rights and other assets that are related or incidental to acquiring, holding, servicing or selling such loans or debt instruments[5]; and (4) certain interest rate or foreign exchange derivatives.[6] Qualifying credit funds are not permitted to engage in proprietary trading (as defined under the Current Rule) or issue asset-backed securities. The following criteria must also be satisfied for a banking entity to rely on the credit fund exclusion:

- The banking entity must not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the fund or of any entity to which the fund extends credit or in which such fund invests ("Anti-Guarantee Requirement");
- Any debt instruments or equity securities (or rights to acquire equity securities) that the fund holds must be among those the banking entity would be permitted to acquire and hold directly;
- The banking entity's investment in, and relationship with, the fund must comply with the rules regarding material conflicts of interest, high-risk investments, safety and soundness and financial stability as if the fund were a covered fund ("Prudential Backstop Requirement") and

annual CEO certification for the prime brokerage exception to "Super 23A"; and (vi) eliminated special documentation obligations for banking entities without significant trading activities.

[5] "Rights or other assets" would not include commodity forward contracts. Moreover, each right or asset that is a security must be either (i) a cash equivalent; (ii) a security received in lieu of debts previously contracted with respect to such loans or debt instruments; or (iii) an equity security (or right to acquire an equity security) received on customary terms in connection with such loans or debt instruments.

[6] The written terms of the derivative must directly relate to the loans, debt instruments or other rights or assets and must reduce the interest rate and/or foreign exchange risks related to the loans, debt instruments or other rights or assets.

be conducted in compliance with, and subject to, applicable banking laws and regulations, including applicable safety and soundness standards; and

- If the banking entity sponsors or serves as investment manager or commodity trading advisor to the fund, the banking entity must:
    - Provide certain disclosures to prospective and actual investors as if the fund were a covered fund ("Disclosure Requirement");
    - Ensure that the activities of the fund are consistent with safety and soundness standards; and
    - Comply with (i) the "Super 23A" prohibitions of the Current Rule and (ii) the requirements of Section 23B of the Federal Reserve Act as if the fund were a covered fund ("Transaction Restrictions").

Venture Capital Funds

The Final Rule exempts an issuer that meets the definition of venture capital fund in 17 CFR § 275.203(*l*)-1[7] and does not engage in proprietary trading (as defined under the Current Rule). A banking entity is only able to invest in such funds to the extent the banking entity is permitted to engage in such activities under applicable law.[8] The following criteria must also be satisfied for a banking entity to rely on the venture capital fund exclusion:

- The banking entity must satisfy the Anti-Guarantee Requirement;
- The banking entity's investment in, and relationship with, the fund must satisfy the Prudential Backstop Requirement and applicable banking laws and regulations, including applicable safety and soundness standards; and

[7] Under 17 CFR § 275.203(*l*)-1, a "venture capital fund" is any private fund that (1) represents to investors and potential investors that it pursues a venture capital strategy; (2) immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund; (3) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15% of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit; (4) only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata; and (5) is not registered under section 8 of the Investment Company Act of 1940 and has not elected to be treated as a business development company pursuant to section 54 of the Investment Company Act of 1940.

A "qualifying investment" is defined as (i) an equity security issued by a qualifying portfolio company 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 (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, or a predecessor, and is acquired by the private fund in exchange for an equity security described in (i) or (ii). Further, a "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 17 CFR § 270.3a-7 or a commodity pool.

[8] 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.

- If the banking entity sponsors or serves as investment manager or commodity trading advisor to the fund, the banking entity must (i) satisfy the Disclosure Requirement; (ii) comply with the Transaction Restrictions; and (iii) ensure that the activities of the fund are consistent with safety and soundness standards.

Family Wealth Management Vehicles

The Final Rule exempts an entity that 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 entity is organized as a trust, the grantor(s) of the entity must all be family customers.[9] If the entity is not organized as a trust, (1) a majority of the interests and voting interests in the entity must be owned (directly or indirectly) by family customers; and (2) the entity must be owned only by family customers and up to five closely related persons[10] of the family customers, except that up to 0.5% of the entity's outstanding ownership interests may be held by other entities for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns.

In addition, to rely on the family wealth management vehicle exclusion, a banking entity (or any affiliate of the banking entity) must:

- Provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services to the entity;
- Satisfy the Anti-Guarantee Requirement;
- Satisfy the Disclosure Requirement (subject to any necessary modification to fit the context);
- Not acquire or retain, as principal, an ownership interest in the entity, other than up to 0.5% of the entity's outstanding ownership interests for the purposes discussed above;
- Comply with the requirements of section 23B of the Federal Reserve Act as if the entity were a covered fund;
- *Except for riskless principal transactions*,[11] comply with the requirements of section 23A of the Federal Reserve Act regarding the prohibition on purchases of low-quality assets as if such banking entity and its affiliates were a member bank and the entity were an affiliate thereof (but not the requirements of Super 23A of the Current Rule); and
- Satisfy the Prudential Backstop Requirement.

[9] "Family customer" means (i) a family client, as defined in 17 CFR § 275.202(a)(11)(G)-1(d)(4); or (ii) any natural person who is father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law or daughter-in-law of a family client, spouse or spousal equivalent of any of the foregoing.

[10] "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.

[11] "Riskless principal transaction" means a transaction in which a banking entity, after receiving an order to buy (or sell) a security from a customer, purchases (or sells) the security in the secondary market for its own account to offset a contemporaneous sale to (or purchase from) the customer.

Customer Facilitation Vehicles

The Final Rule exempts an issuer that is formed by or at the request of a customer of a banking entity for the purpose of providing such customer (which may include one or more affiliates of such customer) with exposure to a transaction, investment strategy or other services provided by the banking entity. All of the ownership interests of the issuer must be owned by such customer (or affiliates), except that up to 0.5% of the issuer's outstanding ownership interests may be held by other entities for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency or similar concerns.

In order to rely on the customer facilitation vehicle exclusion, a banking entity (or any affiliate of the banking entity) must also (1) satisfy each of the bullet points listed above for family wealth management vehicles, except the requirement to provide bona fide trust, fiduciary, investment advisory or commodity trading advisory services; and (2) maintain documentation outlining how it intends to facilitate the customer's exposure to such transaction, investment strategy or service.

Certain Existing Exemptions Are Made More Available

The Final Rule contains modifications to three existing covered fund exclusions — foreign public funds, loan securitizations and public welfare and small business funds — to simplify the eligibility criteria and make it easier for banking entities to use and confirm compliance with these exclusions.

Foreign Public Funds

Under the Final Rule, the foreign public fund exclusion is modified to provide more consistent treatment between U.S. registered investment companies (which are not covered funds) and their foreign equivalents.

Current Rule	**Final Rule**
A foreign public fund is a public fund organized and established outside the United States, provided that: (a) It is authorized to offer and sell ownership interests to retail investors in its home jurisdiction; and (b) It sells such interests "predominantly" through one or more public offerings outside the United States. (c) For any U.S. banking entity (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity) to rely on this exemption to sponsor a non-U.S. public fund, the fund's ownership interests must be sold "predominantly" to persons other than (i) the banking entity; (ii) the issuer; (iii) their	The home jurisdiction requirement in (a) is removed. Authorization in any non-U.S. jurisdiction will suffice. Moreover, the "predominantly" requirement in (b) is removed. While the fund's interests still must be offered and sold, through one or more public offerings, there is no outcome test. For U.S. banking entities (or any non-U.S. banking entity that is directly or indirectly controlled by a U.S. banking entity) that sponsor the fund, the "predominantly" requirement remains in (c). However, "predominantly" now means only 75% or more of the fund's ownership interests and (iv) is amended to only count interests held by senior executive officers and directors, instead of all employees and directors.

affiliates or (iv) employees or directors of such entities. "Predominantly" means 85% or more of the fund's ownership interests. A "public offering" is any distribution of securities in any jurisdiction outside the United States to investors, including retail investors, provided that the public offering must (i) comply with all applicable requirements in the applicable jurisdiction; (ii) not be restricted based on investor net worth; and (iii) include the filing of publicly available disclosure documents.	The definition of "public offering" is modified to: • Add a new requirement that the distribution be subject to substantive disclosure and retail protection laws or regulations; and • Restrict the requirement that the distribution comply with all applicable requirements in the applicable jurisdiction only to an issuer for which the banking entity serves as investment manager, commodity trading advisor, commodity pool operator or sponsor.

Loan Securitizations

The Final Rule would amend two requirements of this exclusion, one of which would codify prior Agency guidance.

Current Rule	**Final Rule**
A loan securitization is an issuer of asset-backed securities provided that it holds only loans, certain rights and assets ("servicing assets"), and a small set of other financial instruments.	Also permits a loan securitization to hold debt securities (excluding asset-backed securities and convertible securities), provided that such debt securities do not exceed 5% of the value of its total assets, calculated at the most recent time of acquisition of such assets. Clarifies that servicing assets may include assets other than securities, but any servicing assets that are securities must meet additional eligibility requirements.[12]

Small Business Investment Companies

The Final Rule clarifies how the exclusion for small business investment companies ("SBICs") would apply to SBICs that surrender their licenses as part of wind-downs.

Current Rule	**Final Rule**
An SBIC is an issuer that holds a SBIC license from the Small Business Administration or has received a notice therefrom to proceed to qualify for a	Clarifies that the exclusion is still available if the SBIC voluntarily surrendered its license in accordance with 13 CFR § 107.1900 and does not

[12] This modification in the Final Rule regarding "servicing assets" codifies the "Loan Securitization Servicing Assets" FAQ. *See,* e.g., FAQ 4, Frequently Asked Questions, https://www.federalreserve.gov/supervisionreg/faq.htm#4. Permitted securities include cash equivalents. The Final Rule also codifies the meaning of "cash equivalents" as set forth in the FAQ.

license, which notice or license has not been revoked.	make new investments (other than investments in cash equivalents) after such voluntary surrender.

Public Welfare Investment Funds

The Final Rule provides a clarification and two expansions of the exclusion for public welfare investment funds ("PWIFs").

Current Rule	**Final Rule**
A PWIF is an issuer that is (a) "designed primarily to promote the public welfare" under section 24(Eleventh) of the National Bank Act; or (b) "qualified rehabilitation expenditures" with respect to a qualified rehabilitation building or certified historic structure under section 47 of the Internal Revenue Code of 1986.	Clarifies that investments that qualify for consideration under the regulations implementing the Community Reinvestment Act qualify for the exclusion. Expands the exclusion to also cover: • Rural business investment companies, as described in 15 U.S.C. § 80b-3(b)(8)(A) or (B), or entities that have terminated their participation as such in accordance with 7 CFR § 4290.1900 and do not make new investments (other than investments in cash equivalents) after such voluntary termination; and • Qualified opportunity funds, as defined in 26 U.S.C. § 1400Z-2(d).

Foreign Excluded Funds Are Granted Permanent Relief from Potential Extraterritoriality

Under the Current Rule, certain foreign funds that are organized and offered outside the United States are excluded from the definition of a covered fund. The Current Rule, however, has the unintended consequence of treating certain qualifying foreign excluded funds as "banking entities" if they are affiliates or subsidiaries of a foreign banking entity. As such, the funds themselves would be subject to the Volcker Rule, including its restrictions on proprietary trading and investing in covered funds. To address this issue, the Agencies issued a moratorium on enforcement against a foreign banking entity if the qualifying foreign excluded fund met certain criteria.[13] The Final Rule codifies this moratorium by exempting a foreign fund from the proprietary trading prohibition and restrictions on investments in the

[13] *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; see also Volcker Rule Update: Agencies Announce They Will Not Enforce Rule for Foreign Funds Until July 2021 (July 18, 2019), https://www.srz.com/resources/volcker-rule-update-agencies-announce-they-will-not-enforce-rule.

sponsorship of covered funds (and does not attribute the foreign fund's activities to a foreign banking entity that invests in or sponsors the fund), so long as the fund is:

- Organized or established outside of the United States and does not offer or sell its ownership interests in the United States;
- Structured such that it (i) would be a covered fund if it were organized or established in the United States or (ii) raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;
- Only a banking entity on account of the foreign banking entity's ownership interest in, or sponsorship of, the fund;
- Established and operated as part of a "bona fide asset management business"; and
- Not operated in a way that allows the foreign banking entity (or any affiliate) to evade the requirements of the Volcker Rule.

Further, to qualify for this exemption, a foreign banking entity's acquisition or retention of any ownership interest in, or sponsorship of, the qualifying foreign excluded fund must meet the requirements for permitted covered fund activities and investments outside the United States (commonly referred to as the "SOTUS" exemption).

The Limits on a Banking Entity's Transactions with Related Covered Funds Are Relaxed

The Final Rule permits a banking entity to enter into certain limited, low-risk transactions (currently prohibited by Super 23A) with covered funds it sponsors, manages or advises (or third-party covered funds, in which such related funds hold a "controlling" investment).

Current Rule	**Final Rule**
Banking entities generally are prohibited from entering into a transaction with a covered fund for which it serves as sponsor, investment manager, investment adviser, commodity trading advisor or which it otherwise organizes or offers (or any other covered fund, in which such fund holds a "controlling" investment) if such transaction would be a "covered transaction" under Section 23A of the Federal Reserve Act, without regard to whether such transactions would generally be exempt from the limits, requirements or prohibitions under Section 23A by its own terms or by Regulation W, its implementing regulation. (These provisions of the Current Rule are commonly referred to as "Super 23A.")	Exempts from Super 23A: (i) covered transactions that would be permissible without limit for a state member bank to enter into with an affiliate under Section 23A of the Federal Reserve Act or Regulation W; (ii) riskless principal transactions; and (iii) short-term extensions of credit (or asset purchases) in connection with payment, clearing and settlement transactions. Any transaction or activity permitted by these exemptions in the Final Rule must comply with the Prudential Backstop Requirement.

The 'Ownership Interest' Definition Is Modified to Exclude Certain Debt Relationships

The Final Rule clarifies that a debt relationship with a covered fund typically does not constitute an "ownership interest" and, therefore, is not subject to the Volcker Rule.[14]

Current Rule	Final Rule
An "ownership interest" is any equity or partnership interest, or any other interest, that exhibits certain features or characteristics on a current, future or contingent basis (such as the right to participate in the selection or removal of a fund's general partner, managing member, directors, investment manager, etc.). A debt interest in a covered fund can be an ownership interest if it has the same characteristics as an equity or other ownership interest.	Rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event, or 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, is not, by itself, an ownership interest. Any senior loan or other senior debt interest that meets all of the following characteristics is not an ownership interest: • The holders of such interest do not receive any income, gain or profits of the covered fund but may only receive (i) interest payments which are not dependent on the performance of the covered fund; and (ii) fixed principal payments on or before a maturity date in a contractually determined manner (which may include prepayment premiums intended solely to compensate for forgone income resulting from early repayment); • The entitlement to payments on the interest is absolute and may not be reduced because of the losses arising from the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reduction in the principal and interest payable; and • The holders of the interest are not entitled to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon

[14] Additionally, in the Final Rule the Agencies modified the manner in which a banking entity calculates its ownership interest for purposes of complying with the per fund limit, the aggregate fund limit and the covered fund deduction with respect to the attribution of an employee or director's restricted profit interest in a covered fund organized or sponsored by the banking entity.

	the occurrence of an event of default or an acceleration event).

Parallel and Co-Investments Excluded from Per Fund and Aggregate Ownership Limits

The Final Rule adds a new rule of construction to clarify that certain direct investments made by a banking entity alongside a covered fund should not be treated as an investment in the covered fund as long as certain conditions are met.

Current Rule	**Final Rule**
For any covered fund that a banking entity organizes and offers, (i) the aggregate investments of the banking entity and its affiliates cannot exceed 3% of the total number or value of that fund's outstanding ownership interests (i.e., the "per-fund limit"); and (ii) the aggregate value of all covered fund ownership interests held by the banking entity and its subsidiaries cannot exceed 3% of the tier 1 capital of the banking entity (i.e., the "aggregate limit"). The preamble to the Current Rule provides 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. Further, the preamble notes that a banking entity that sponsored 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.	A banking entity is not required to include in the calculations for the per-fund limit and the aggregate limit any investment the banking entity makes alongside a covered fund (and is not restricted in the amount of any such investment) as long as the investment is made in compliance with applicable laws and regulations, including applicable safety and soundness standards.

If you have any questions concerning this *Memorandum*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Authored by Joseph P. Vitale and Nicholas A. Wilson.