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ALERTS

FDIC and OCC Approve Volcker 2.0 — Summary of Amendments to Fund Activity Provisions

August 23, 2019

On Aug. 20, 2019, the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC") approved a final rule ("Final Rule") to amend the regulations adopted in 2013 ("2013 Rule") implementing Section 13 of the Bank Holding Company Act, commonly referred to as the "Volcker Rule."[1] While the Final Rule is largely similar to the Notice of Proposed Rulemaking issued by the agencies on May 30, 2019 ("Proposed Rule"), it does contain important modifications from the Proposed Rule. The other three agencies charged with implementing the Volcker Rule — the Commodity Futures Trading Commission ("CFTC"), Federal Reserve Board ("Board") and the Securities and Exchange Commission ("SEC" together with the FDIC, OCC, CFTC and Board, "Agencies") — are expected to approve the Final Rule in the coming days. A copy of the Final Rule is available here.[2]

This *Alert*[3] analyzes the Final Rule as it would affect a banking entity's investments in, or sponsorship of, private investment funds.[4] While nearly all of the Final Rule concerns the Volcker Rule's restrictions on a banking entity's proprietary trading and its compliance program requirements, it does affect "covered fund"[5] activities in several ways. As discussed in further detail below, each of these changes provides more flexibility with regard to the relevant activity. *Perhaps more importantly, however, the Agencies have indicated that they intend to make further (and likely more impactful) changes to the covered fund provisions. To that end, the Agencies intend to issue a separate proposed rulemaking to that effect shortly.[6]*

Greater Capacity for Underwriting and Market Making of Third-Party Covered Funds

The 2013 Rule allows banking entities to hold ownership interests in covered funds when the entity is engaged in underwriting and market making-related activities so long as certain requirements are met, including that any fund ownership interests held, directly or indirectly, by the banking entity and its affiliates pursuant to this exemption (i) are deducted from tier 1 capital (for all regulatory purposes); and (ii) do not exceed 3% of the resulting tier 1 capital ("aggregate limit") (together with any other investments that are subject to the aggregate limit). The Final Rule eliminates the tier 1 capital deduction and aggregate limit requirement for the value of ownership interests in *third-party covered funds* acquired or retained in accordance with the underwriting or market-making exemption, giving banking entities greater capacity to engage in underwriting and market making of such funds. The Final Rule does not eliminate the tier 1 capital deduction and aggregate limit for covered funds advised by the banking entity or covered funds that the banking entity organizes and offers. In implementing this change, the Agencies believed that the change would better align the compliance requirements for underwriting and market making involving covered funds with the risks those activities entail.

More Flexibility for Investing in a Covered Fund as a Hedge

Hedging Risk Associated with a Specific Customer Request Permitted

The 2013 Rule permits a banking entity to hold an ownership interest in a covered fund in order to "demonstrably reduce" or "significantly mitigate" the "specific, identifiable" risks to the banking entity from a compensation arrangement with an employee (or an employee of an affiliate) that directly provides investment advisory or other services to that fund. The Final Rule extends this exemption to allow a banking entity to acquire or retain an ownership interest in a covered fund as a hedge when acting as an intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund. The banking entity's acquisition or retention of the ownership interest as a hedge must be designed to reduce or otherwise significantly mitigate one or more specific, identifiable risks arising out of a transaction conducted *solely to accommodate a specific customer* *request* with respect to the covered fund (i.e., the transaction must be customer-driven and the banking entity cannot rely on this exemption to facilitate the banking entity's own exposure to a covered fund).

To avail itself of this customer-driven transaction exemption, like the employee compensation arrangement exemption, a banking entity must have internal written policies and controls to ensure compliance with the requirements associated with such hedging activity. Further, to the extent such activity significantly increases 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, it would not be permissible.

A Reasonably Designed Hedge Permitted, Even If Ultimately Unsuccessful

The Final Rule also eliminates the requirement that a permissible hedging transaction "demonstrably reduces or otherwise significantly mitigates" the relevant risks for both the employee compensation arrangement and the customer-driven transaction exemption. Instead the activity will be permissible so long as it was *designed* to reduce or otherwise significantly mitigate the specific, identifiable risk. The Agencies noted that it appears that the requirement to show that hedging activity demonstrably reduces a specific, identifiable risk that develops over time can be complex and could potentially reduce bona fide risk-mitigating hedging activity. For example, a banking entity may determine not to enter into what would otherwise be a reasonably designed hedge of foreseeable risks out of concern that the banking entity may not be able to effectively comply with the requirement that such a hedge demonstrably reduces such risks due to the possibility that unforeseen risks occur. This change is consistent with the statutory language of the Volcker Rule, which does not contain a similar requirement.

Financing from U.S. Affiliates Permitted for Certain Non-U.S. Fund Activity by Non-U.S. Banks

Under the Volcker Rule, certain eligible non-U.S. banking entities[7] are permitted to sponsor or hold ownership interests in certain eligible covered funds,[8] so long as such activity occurs "solely outside the United States" (commonly referred to as "SOTUS" exemption). Under the 2013 Rule, for such activity to occur "solely outside the United States" certain criteria need to be met, including that no financing is provided, directly or indirectly, by a branch or affiliate organized or located in the United States ("financing prong").[9] The Final Rule removes this financing prohibition from the list of "solely outside the United States" requirements. Removing the financing prohibition is intended to streamline the requirements of this exemption with the intention of improving the implementation of the statutory exemption. The Agencies indicated that removing this prohibition addresses concerns that the fungibility of financing has made the prohibition difficult to apply in practice.

Agency Guidance Giving Non-U.S. Banks Greater Flexibility for SOTUS Activity Codified

Prior Agency Guidance on SOTUS Marketing Restriction Codified

For eligible non-U.S. banking entities to hold ownership interests in covered funds under the SOTUS exemption, no ownership interest in such fund can be offered for sale or sold to a resident of the United States. The Final Rule codifies existing staff guidance on this issue,[10] by explicitly providing that the foregoing restriction is satisfied even if the relevant fund offers or sells its ownership interests to U.S. persons, so long as the banking entity or any of its affiliates do not participate in such marketing or sales. Absent this prior Agency guidance, the 2013 Rule would have drastically reduced the scope of funds in which a non-U.S. banking entity could invest pursuant to the SOTUS exemption.

The Final Rule also explicitly clarifies that if the banking entity or an affiliate sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund, then the banking entity or affiliate will be deemed for purposes of this restriction to participate in any offer or sale of the fund's ownership interests. This restriction constrains the non-U.S. banking entity in connection with its own activities with respect to covered funds rather than the activities of unaffiliated third parties.

Prior Agency Guidance on SOTUS Sponsorship Restrictions Codified

Under the SOTUS exemption, eligible non-U.S. banking entities[11] may sponsor an eligible covered fund,[12] without regard to the Volcker Rule's sponsorship requirements, provided certain criteria are satisfied. For purposes of this exemption, the Agencies previously indicated that the

U.S. personnel of a non-U.S. banking entity may provide investment advice and recommendations to the manager or general partner of a covered fund so long as that investment advisory activity in the United States does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States. Under the Final Rule, the Agencies have removed language from the SOTUS exemption that could be read as prohibiting any involvement by individuals in the United States. In doing so, they further confirmed that the SOTUS exemption does not preclude a non-U.S. banking entity from engaging a non-affiliated U.S. investment adviser, so long as the actions and decisions of the banking entity as principal occur outside the United States.

Deadline for Annual CEO Certification for Prime Brokerage Exception to “Super 23A” Codified

The Volcker Rule provides that a banking entity may not enter into any transaction with any covered fund for which such entity serves as sponsor, investment manager, investment adviser or commodity trading advisor, or which it otherwise organizes and offers, if the transaction would constitute a “covered transaction” as defined in Section 23A of the Federal Reserve Act (“Section 23A”) (such prohibition commonly referred to as, “Super 23A”[13]). Super 23A does not apply to prime brokerage transactions with a covered fund in which a covered fund sponsored, managed or advised by the banking entity (or an affiliate thereof) invests.[14] This exemption is available so long as certain enumerated conditions are satisfied, including that the chief executive officer (or equivalent officer) of the banking entity certifies annually that the banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the covered fund or any covered fund in which such fund invests. The 2013 Rule provided no timeframe when such a certification was to be provided. Agency staff issued guidance as to when a banking entity was required to provide the certification during the conformance period.[15] The Final Rule codified such Agency staff guidance and requires that the certification be provided no later than March 31 of the relevant year. The CEO (or equivalent officer) has a duty to update the certification if the information in the certification materially changes at any time during the year when he or she becomes aware of the material change.

Special Documentation Obligations Eliminated for Banking Entities Without Significant Trading Activities

The Final Rule significantly amends the compliance program requirements of the 2013 Rule, providing banking entities with certain relief (with such relief increasing inversely to the size of the banking entities' trading activities). Among the more general changes, the Final Rule significantly reduces the documentation burden resulting from covered fund activities for most banking entities. Under the 2013 Rule, a banking entity with greater than $10 billion in consolidated assets must maintain certain detailed documentation regarding its covered fund activities. Under the Final Rule this requirement now only applies to banking entities with "significant trading assets and liabilities," which under the Final Rule defines those banking entities with $20 billion or more of trading assets and liabilities.[16]

Authored by Joseph P. Vitale and Jessica Romano.

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

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[1] 12 U.S.C. § 1851. The Volcker Rule generally restricts the proprietary trading and private investment fund activities of U.S. banks and their affiliates, as well as non-U.S. banks with a branch or agency office in the U.S. and their affiliates (collectively, "banking entities").

[2] The effective date for the Final Rule is Jan. 1, 2020. However, banking entities have until Jan. 1, 2021 to comply with the Final Rule. The 2013 Rule will remain in effect until that compliance date. Alternatively, a banking entity may voluntarily comply, in whole or in part, with the Final Rule prior to the compliance date, subject to the Agencies' completion of necessary technological changes.

[3] Upcoming *Alerts* will summarize the Final Rule's effect on proprietary trading and compliance programs.

[4] Under the 2013 Rule, a banking entity is generally barred from acquiring or retaining, as principal, an ownership interest in a covered fund, subject to certain exceptions. Further, a banking entity may not sponsor any

covered fund, unless it abides by a series of requirements (or the sponsorship falls within an exception for non-U.S. activity).

[5] Under the 2013 Rule, “covered funds” generally include “3(c)(1)” and “3(c)(7)” funds or their commodity pool or non-U.S. fund equivalents, subject to certain exceptions. The “covered fund” definition has not been changed as a result of the Final Rule.

[6] While the Proposed Rule sought comments on numerous aspects of the covered fund provisions (including the defined term “covered fund”), the Agencies did not propose any actual changes at that time. Accordingly, including such changes, for the first time, in the Final Rule arguably would not have been appropriate under the Administrative Procedures Act, because it would not have afforded interested parties the opportunity to review such proposals and, potentially, submit comments prior to the Agencies’ final action.

[7] For a banking entity to use this exemption, the following criteria must be satisfied: (i) the banking entity is not organized, or directly or indirectly controlled, by a banking entity organized in a U.S. jurisdiction (including any U.S. territory or commonwealth); (ii) if the entity is a “foreign banking organization” under the Board’s Regulation K, it qualifies for the exemption; (iii) if the entity is not a “foreign banking organization” under the Board’s Regulation K, it must satisfy at least two of the following: (x) its total assets outside the United States exceed those held in the United States; (y) its total revenues from its non-U.S. business exceed those from its U.S. business; or (z) its total net income from its non-U.S. business exceed that from its U.S. business.

[8] For an eligible non-U.S. banking entity to invest in a covered fund under this exemption, the fund must not sell its ownership interests in any offering that targets “U.S. persons.”

[9] Other criteria that must be satisfied for the exemption to apply are the following: (i) the eligible banking entity (or office thereof) acting as principal (and that makes the decision to engage in the activity, if different) is not organized or located in the United States; (ii) no relevant personnel of the entity responsible for the decision to engage in the activity is located in the United States (excluding “back office” personnel); and (iii) the activity is not accounted for as principal, directly or indirectly, on a consolidated basis by a branch or affiliate organized or located in the United States.

[10] *See,* e.g., FAQ 13, Frequently Asked Questions.

[11] *See supra* note 6.

[12] *See supra* note 7.

[13] Because, for its purposes, the Volcker Rule both (i) expands the scope of entities to which Section 23A applies and (ii) replaces its requirements/limits with a prohibition.

[14] These transactions, however, are subject to Section 23B of the Federal Reserve Act (i.e., the market terms requirement).

[15] *See,* e.g., FAQ 18, Frequently Asked Questions.

[16] Which for a United States banking entity is measured by the average gross sum of trading assets and liabilities (excluding those involving obligations of the U.S. or any U.S. agency), on a worldwide consolidated basis at the end of each of the previous consecutive four quarters. A non-U.S. banking entity need only include its combined U.S. operations (including all its affiliates or offices operating, located or organized in the U.S.) in its calculation.

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