

MEMO# 32565

June 29, 2020

US Agencies Adopt Final Revisions to Volcker Rule "Covered Fund" Regulations

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June 29, 2020 TO: ICI Members

Investment Company Directors

ICI Global Members

Bank-Affiliated Member Advisory Committee

ICI Global Regulated Funds Committee

SEC Rules Committee SUBJECTS: Bank Regulation

Financial Stability

International/Global RE: US Agencies Adopt Final Revisions to Volcker Rule "Covered Fund" Regulations

Last week, the five agencies ("Agencies")^[1] responsible for implementing Section 13 of the Bank Holding Company Act, known as the "Volcker Rule," adopted amendments ("Final Rule") to the "covered fund" provisions of the Volcker Rule implementing regulations.^[2] This memorandum provides brief background information and summarizes aspects of the Final Rule relevant to regulated funds (*i.e.*, US registered investment companies (RICs) and their foreign counterparts).

Background

Earlier this year, the Agencies issued proposed amendments to the implementing regulations concerning the restrictions on "covered fund" investments and activities and other issues related to the treatment of investment funds in the implementing regulations ("2020 Proposal").^[3] ICI filed a comment letter focusing on two areas of importance to regulated funds: the potential treatment of a regulated fund as a "banking entity" subject to the prohibitions and restrictions of the Volcker Rule, and the scope of the exclusion for "foreign public funds" ("FPFs") from the definition of "covered fund."^[4]

ICI's comment letter highlighted long-standing concerns that the implementing regulations' broad definition of "banking entity" and its interplay with the definition of "covered fund" create some uncertainty as to whether a regulated fund, particularly during its seeding period, could be treated as a banking entity—at odds with Congressional intent. Our letter expressed appreciation for previous efforts by the Agencies and their staffs to understand and address these concerns, including in staff FAQs issued in 2015, and observed that the

Agencies more recently appeared willing to adopt the staff positions as their own. We recommended that the Agencies affirmatively adopt the staff FAQs regarding regulated fund seeding practices through discussion in the preamble to any final rule. ICI's letter also expressed strong support for the proposed changes to the FPF exclusion and urged the Agencies to finalize them promptly.

The Final Rule—Aspects Relevant to Regulated Funds

The Final Rule includes many of the changes in the 2020 Proposal, with targeted revisions that generally are consistent with ICI's comments.

“Banking Entity” Issue/Fund Seeding

Similar to the 2020 Proposal, the preamble to the Final Rule states that “[t]he [Final Rule] does not modify or revoke any previously issued staff FAQs, unless otherwise specified.”^[5] In addition, in response to comments, the preamble addresses the seeding period for FPFs. It expresses the Agencies' belief that “depending on the facts and circumstances of a particular [FPF], the appropriate duration of its seeding period may vary and, under certain facts and circumstances, may exceed three years.” It further indicates that the Agencies “believe that this flexibility is appropriate and thus decline to further specify such a limit.”

FPF Exclusion

As the Agencies had proposed, the Final Rule revises the conditions in the FPF exclusion from the definition of “covered fund” to:

- Eliminate the requirements that a fund must be (1) authorized to be offered and sold to retail investors in the fund's “home jurisdiction,” and (2) sold “predominantly” through one or more public offerings;
- Replace those requirements with a requirement that the fund is authorized to offer and sell ownership interests, and such interests are offered and sold, through one or more public offerings;
- Modify the definition of “public offering” to add a requirement that the distribution is subject to substantive disclosure and retail investor protection laws or regulations;^[6]
- Limit application of the requirement that the distribution comply with all applicable requirements in the jurisdiction in which it is made to instances in which the banking entity acts as the investment manager, investment adviser, commodity trading advisor, commodity pool operator, or sponsor;^[7] and
- Limit the sale of ownership interests to directors and senior executive officers of the sponsoring banking entity, the fund, or their affiliates (rather than sales to directors and all employees of those entities, as the implementing regulations had required).

In addition, new rule text specifies that a US banking entity may not rely on the FPF exclusion unless more than 75 percent of the fund's interests are sold to persons other than the sponsor and associated parties. This change responds to a recommendation by some commenters that the Agencies modify their expectation of the level of ownership of an FPF that would satisfy the requirement that a fund be “predominantly” sold to persons other than its US banking entity sponsor and associated parties (currently, 85 percent or more). The Agencies agreed that the permitted ownership level “should be aligned with the functionally equivalent threshold” for banking entity investments in US RICs, which is 24.9

percent.

The preamble states that the Agencies “believe the revised requirements will make the [FPF] exclusion more effective by expanding its availability, providing clarity, and simplifying compliance with its requirements, while continuing to ensure that the funds that qualify are sufficiently similar to U.S. registered investment companies.”

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endnotes

[1] The Agencies are the Office of the Comptroller of the Currency, Federal Reserve Board, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Commodity Futures Trading Commission.

[2] See *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (as posted on Federal Reserve Board website), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200625a1.pdf>.

[3] See *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 85 Fed. Reg. 12120 (Feb. 28, 2020) available at <https://www.govinfo.gov/content/pkg/FR-2020-02-28/pdf/2020-02707.pdf>.

[4] The letter is available at <https://www.ici.org/pdf/31448a.pdf>

[5] The preamble mentions a commenter’s request that the Agencies codify certain staff FAQs relating to FPFs and RICs and states that the Agencies “decline to codify these FAQs at this time.”

[6] The preamble cites the statement in ICI’s comment letter that 95 percent of the world’s securities markets, including all major emerging markets, have substantive disclosure and retail investor protection rules that are guided by the International Organization of Securities Commissions’ common principles for retail funds and the detailed policy work that informs those principles.

[7] The Agencies acknowledged the difficulty that a banking entity investing in a third-party sponsored fund may have in determining whether the distribution of such fund complied with all the requirements in the jurisdiction where it was made.

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