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February 6, 2020

US Agencies Propose Revisions to Volcker Rule "Covered Fund" Regulations; ICI Plans to Comment

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February 6, 2020 TO: ICI Members
Investment Company Directors
ICI Global Members SUBJECTS: International/Global
Systemic Risk RE: US Agencies Propose Revisions to Volcker Rule "Covered Fund" Regulations; ICI Plans to Comment

Last week, the five agencies ("Agencies")[1] responsible for implementing Section 13 of the Bank Holding Company Act, known as the "Volcker Rule," jointly issued for public comment proposed amendments to the Volcker Rule implementing regulations ("2020 Proposal").[2] This memorandum provides background information and summarizes aspects of the 2020 Proposal relevant to regulated funds (*i.e.*, US registered investment companies (RICs) and their foreign counterparts).

ICI will prepare a comment letter, working in consultation with our Bank-Affiliated Member Advisory Committee. Comments are due by April 1.

Background

The 2020 Proposal follows up on a 2018 notice of proposed rulemaking in which the Agencies proposed specific revisions to the implementing regulations "to provide banking entities with clarity about what activities are prohibited and to improve supervision and implementation of" the Volcker Rule. The 2018 proposed revisions mainly related to the Volcker Rule's proprietary trading restrictions and did not address Volcker Rule issues of concern to regulated funds. The preamble to the 2018 proposal sought comment on regulated fund issues, however, through an extensive series of specific questions.

ICI filed a detailed comment letter in October 2018 focused on Volcker Rule concerns for regulated funds.[3] We recommended reforms in two areas:

1. *Reforms to avoid impeding the activities and investments of regulated funds.* We explained that the lack of sufficient exclusions for regulated funds and their activities (*e.g.*, fund seeding) leaves open the possibility that a fund could be deemed a "banking entity" and thus subject to the full panoply of Volcker Rule trading and investment restrictions—an untenable result.

2. *Reforms to eliminate unnecessary constraints on banking entities' ability to offer regulated funds in jurisdictions outside the United States.* We noted that the "foreign public fund" exclusion from the definition of "covered fund" requires foreign public funds (FPFs) to adhere to certain conditions that do not apply to RICs. We pointed out that the conditions are at odds with the agencies' intent to treat FPFs in a manner similar to RICs and to limit the extraterritorial application of the Volcker Rule.

Our 2018 letter strongly urged the agencies to resolve regulated fund issues through formal rule changes because, among other reasons, they provide greater certainty and permanence than agency or staff guidance.

In November 2019, the Agencies issued a final rule implementing, with targeted changes, the proprietary trading and certain other revisions contemplated by the 2018 proposal.[4] In the preamble to the final rule, the Agencies acknowledged the comments ICI and other stakeholders submitted concerning issues for RICs and FPFs. The Agencies expressed their intent "to issue an additional notice of proposed rulemaking that would propose additional, specific changes to the restrictions on covered fund investments and activities and other issues related to the treatment of investment funds under the regulations implementing" [the Volcker Rule]. The 2020 Proposal is the "additional notice of proposed rulemaking" the Agencies promised.

The 2020 Proposal—Aspects Relevant to Regulated Funds

The 2020 Proposal is silent on the "banking entity" issues for regulated funds. The preamble includes a general statement that "[t]he proposed rule would not modify or revoke any previously issued staff FAQs, unless otherwise specified."

The 2020 Proposal would revise the conditions in the FPF exclusion from the definition of "covered fund" in ways that appear to be consistent with ICI's 2018 recommendations. The proposed revisions include:

- Eliminating 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;
- Replacing 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;
- Modifying the definition of "public offering" to add a requirement that the distribution is subject to substantive disclosure and retail investor protection laws or regulations;
- Limiting 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;[5] and
- Limiting 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 now require).

The preamble to the 2020 Proposal poses detailed questions about the proposed modifications

to the FPF exclusion. More generally, the Agencies seek comment on “whether the exclusion is effective in identifying foreign funds that may be sufficiently similar to RICs and permitting US banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States, without creating opportunities for evasion of [the Volcker Rule].”

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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 Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (as posted on the SEC’s website), *available at* https://www.sec.gov/rules/proposed/2020/bhca-8.pdf.

[3] The letter is *available at* https://www.ici.org/pdf/31448a.pdf.

[4] *See Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 84 Fed. Reg. 61974 (November 14, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-11-14/pdf/2019-22695.pdf.

[5] The preamble states that this change is intended to address the potential 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.