DATE: June 25, 2020

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Interagency Final Rule: Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

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Summary: Staff is presenting for the approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") the attached interagency final rule ("final rule") to amend the regulations adopted in 2013 ("2013 rule") implementing section 13 of the Bank Holding Company Act ("BHC Act"), commonly referred to as the Volcker Rule. Section 13 of the BHC Act generally restricts banking entities, including FDIC-supervised institutions, from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with, a hedge fund or private equity fund (collectively, "covered funds"). The final rule is intended to improve and streamline the regulations implementing section 13 of the BHC Act by modifying and clarifying requirements related to the covered fund provisions of the 2013 rule.

If approved, this final rule would be issued jointly by the FDIC, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") (collectively, the "agencies").

Concur:

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Nicholas J. Podsiadly
General Counsel

Recommendation: Staff requests that the FDIC Board approve the final rule and authorize its publication in the *Federal Register* with an effective date of October 1, 2020.

I. Introduction

Section 13 of the BHC Act generally prohibits banking entities from engaging in proprietary trading and from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with, a covered fund. The agencies adopted the 2013 rule to implement section 13 of the BHC Act.[1]

Based on experience administering the 2013 rule, the agencies proposed certain revisions in 2018 ("2018 proposal").[2] The 2018 proposal sought to provide greater clarity and certainty about what activities section 13 of the BHC Act prohibits, and to better tailor the 2013 rule's compliance requirements based on the risk of a banking entity's trading activities. The agencies issued a final rule adopting amendments to the 2013 rule in November 2019 ("2019 amendments"), and those provisions became effective in January 2020.[3] As part of the 2018 proposal, the agencies proposed targeted changes to the provisions of the 2013 rule relating to acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a fund and sought comments on other aspects of the covered fund provisions beyond those changes for which specific rule text was proposed.[4] The 2019 amendments finalized those changes to the

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[1] 79 Fed. Reg. 5536 (January 31, 2014).

[2] 84 Fed. Reg. 33432 (July 17, 2018).

[3] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 84 FR 61974 (Nov. 14, 2019). The regulations implementing section 13 of the BHC Act, as amended through May 1, 2020, are referred throughout as the "implementing regulations."

[4] 83 FR 33471–87.

covered fund provisions for which specific rule text was proposed in the 2018 proposal.[5] The agencies indicated they would issue a separate proposal addressing and requesting comment on the covered fund provisions of the 2013 rule and other fund-related issues, and, in February 2020, the agencies issued a separate notice of proposed rulemaking that specifically addressed those areas (the "2020 proposal").[6]

In the 2020 proposal, the agencies proposed revisions to a number of the covered fund provisions as well as to other provisions of the regulations related to the treatment of covered funds. The proposed changes, which were informed by comments responsive to the agencies' questions in the 2018 proposal and the agencies' experience with the implementing regulations, were intended to reduce the extraterritorial impact of the implementing regulations, improve and streamline the covered fund provisions, and provide clarity to banking entities regarding the provision of financial services and the conduct of permissible activities in a manner that is consistent with the requirements of section 13 of the BHC Act.

The agencies invited comment on all aspects of the 2020 proposal. The agencies received approximately 40 unique comments from banking entities and industry groups, public interest groups, and other organizations and individuals. In addition, the agencies received six letters related to the 2020 proposal prior to the formal comment period.

[5] In response to the 2018 proposal, the agencies received numerous comments related to covered fund issues for which no specific rule text was proposed. However, in the preamble to the 2019 amendments, the agencies generally deferred public consideration of such comments to a future proposed rulemaking. 84 FR 62016.

[6] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 FR 12120 (Feb. 28, 2020).

II. The Final Rule

A. Qualifying Foreign Excluded Funds

To better limit the extraterritorial impact of the implementing regulations, the final rule would exempt the activities of certain funds that are organized outside of the United States and offered to foreign investors ("qualifying foreign excluded funds") from the restrictions of the implementing regulations. In certain circumstances, some foreign funds that are not "covered funds" may be subject to the implementing regulations as "banking entities" if they are controlled by a foreign banking entity, and thus could be subject to more onerous compliance obligations than are imposed on similarly-situated covered funds, even though the foreign funds have limited nexus to the United States.[7] This provision would codify an existing policy statement issued by the Federal banking agencies that addresses the potential attribution to a foreign banking entity of the activities and investments of qualifying foreign excluded funds.[8]

To provide greater clarity and certainty to banking entities and qualifying foreign excluded funds, and to respond to certain comments on the 2018 and 2020 proposals, the agencies would adopt an exemption pursuant to their authority under section 13(d)(1)(J) of the BHC Act to exempt the activities of qualifying foreign excluded funds.[9] Specifically, the final rule would exempt the purchase or sale of a financial instrument by a qualifying foreign

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[7] The 2013 rule excludes covered funds from the definition of "banking entity." However, because qualifying foreign excluded funds are not covered funds, they can become banking entities through affiliation with other banking entities.

[8] See 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.fdic.gov/news/news/press/2019/pr19064a.pdf.

[9] Section 13(d)(1)(J) of the BHC Act gives the agencies rulemaking authority to exempt activities from the prohibitions of section 13, provided the agencies determine that the activity in question would promote and protect the safety and soundness of the banking entity and the financial stability of the United States. 12 U.S.C. § 1851(d)(1)(J).

excluded fund and the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a qualifying foreign excluded fund, if any acquisition of an ownership interest in, or sponsorship of, the qualifying foreign excluded fund by the foreign banking entity meets the requirements for permitted covered fund activities and investments solely outside the United States, as provided in § 351.13(b) of the rule.

B. Modifications to Existing Covered Fund Exclusions

1. Foreign Public Funds

In order to provide consistent treatment between U.S. registered investment companies and their foreign equivalents, the implementing regulations exclude foreign public funds from the definition of covered fund.[10] Based on experience administering the 2013 rule, as well as feedback received from regulated entities, some of the conditions of the foreign public fund exclusion may not be necessary to ensure consistent treatment of foreign public funds and registered investment companies and may make it difficult for a non-U.S. fund to qualify for the exclusion, or for a banking entity to validate whether a non-U.S. fund qualifies for the exclusion. This could result in certain non-U.S. funds that are similar to registered investment companies ("RICs") being treated as covered funds.

To address the concerns related to the requirement in the 2013 rule that a fund be authorized to be offered and sold to retail investors in the fund's home jurisdiction and the requirement that ownership interests be sold predominantly through public offerings, the final rule would replace those two requirements with a requirement that the fund is authorized to offer

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

and sell ownership interests and such interests are offered and sold through one or more public offerings. The final rule also would modify the definition of "public offering" from the 2013 rule to add a new requirement that the distribution is subject to substantive disclosure and retail investor protection laws or regulations, to help ensure that funds qualifying for this exclusion are similar to RICs. Additionally, the final rule would only apply the condition that the distribution comply with all applicable requirements in the jurisdiction where it is made to instances in which the banking entity serves as the investment manager, investment adviser, commodity trading adviser, commodity pool operator, or sponsor.

To simplify the requirements of the exclusion and address concerns described by banking entities with the difficulty in tracking the sale of ownership interests to employees and their immediate family members, the final rule would eliminate the limitation on selling ownership interests of the issuer to employees (other than senior executive officers) of the sponsoring banking entity or the issuer (or affiliates of the banking entity or issuer). This change would also help to align the treatment of foreign public funds with that of RICs, as the exclusion for RICs has no such limitation.

2. Loan Securitizations

Section 13 of the BHC Act provides that "[n]othing in this section shall be construed to limit or restrict the ability of a banking entity… to sell or securitize loans in a manner otherwise permitted by law." [11] To effectuate this statutory requirement, the 2013 rule excludes from the definition of covered fund loan securitizations that issue asset-backed securities (ABS) and hold

[11] 12 U.S.C. § 1851(g)(2).

only loans, certain rights and assets, and a small set of other financial instruments (permissible assets).[12]

The 2013 rule permits loan securitizations to hold rights or other assets (servicing assets) that arise from the structure of the loan securitization or from the loans supporting a loan securitization.[13] Rights or other servicing assets are assets designed to facilitate the servicing of the assets underlying a loan securitization or the distribution of proceeds from those assets to holders of the ABS. In response to confusion regarding the scope of these provisions, the staffs of the agencies released the Loan Securitization Servicing FAQ. Under this FAQ, a servicing asset may or may not be a security, but if the servicing asset is a security, it must be a permitted security under the rule. Thie final rule would codify the Loan Securitization Servicing FAQ to clarify the scope of the servicing asset provision.

The final rule would allow a loan securitization vehicle to hold up to five percent of assets in debt securities (excluding ABS and convertible securities). Authorizing loan securitizations to hold small amounts of debt securities could, consistent with the statute, permit loan securitizations to respond to market demand and reduce compliance costs associated with the securitization process without significantly increasing risk to banking entities and the financial system. Moreover, loan securitizations provide an important avenue for banking entities to fund lending programs, and allowing loan securitizations to hold a small amount of debt securities may increase a banking entity's capacity to provide financing and lending.

[12] *See* § 351.10(c)(8). "Loan" is further defined as any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative. § 351.2(t).

[13] 2013 rule, §§ 351.2(s); 351.10(i)(D), (v).

3. Public Welfare Funds and Small Business Funds

Section 13(d)(1)(E) of the BHC Act permits, among other things, a banking entity to make and retain investments that are designed primarily to promote the public welfare of the type permitted under 12 U.S.C. 24(Eleventh). Consistent with the statute, the 2013 rule excludes from the definition of "covered fund" issuers that make investments that are designed primarily to promote the public welfare, of the type permitted under 12 U.S.C. 24 (Eleventh).

After carefully considering the comments received, the final rule revises the public welfare investment exclusion to explicitly incorporate funds, the business of which is to make investments that qualify for consideration under the Federal banking agencies' regulations implementing the Community Reinvestment Act.

The final rule also adopts explicit exclusions from the definition of covered fund for Rural Business Investment Companies ("RBICs") [14] and qualified opportunity funds ("QOFs") [15] in § 351.10(c)(11) of the final rule. These types of funds were created by Congress to encourage investment in rural areas, small enterprises, and low-income areas, and section 13 of the BHC Act was not intended to restrict their activities.

Consistent with section 13 of the BHC Act, the 2013 rule excludes from the definition of covered fund Small Business Investment Companies ("SBICs") and issuers that have received notice from the Small Business Administration to proceed to qualify for a license as a SBIC,

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[14] RBICs are companies licensed under the Rural Business Investment Program, a program designed to promote economic development and the creation of wealth and job opportunities among individuals living in rural areas and to help meet the equity capital investment needs primarily of smaller enterprises located in such areas. *See, e.g.,* Rural Business Investment Company (RBIC) Program, 85 FR 16519, 16520 (Mar. 24, 2020).

[15] QOFs were developed as part of a program to promote long-term investing in designated economically distressed communities and are required to have at least 90 percent of their assets in designated low-income zones. *See* 26 U.S.C. 1400Z-2(d).

which notice or license has not been revoked. The final rule clarifies how the exclusion for SBICs would apply to SBICs that surrender their licenses during wind-down phases. The final rule also specifies that the exclusion for SBICs applies to an issuer that was a SBIC but that has voluntarily surrendered its license and does not make new investments (other than investments in cash equivalents) thereafter.

C. Additional Covered Fund Exclusions

1. Credit Funds

Consistent with the 2020 proposal, the final rule would create a new exclusion for credit funds that make loans, invest in debt, or otherwise extend the type of credit that banking entities may provide directly under applicable banking law. Under the final rule, a credit fund is an entity whose assets consist solely of: (1) loans; (2) bank-permissible debt instruments; (3) related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments; and (4) certain interest rate or foreign exchange derivatives.

To ease compliance burdens, several provisions of the exclusion would be similar to and modeled on conditions in the loan securitization exclusion. For example, any derivatives held by the credit fund must relate to loans, permissible debt instruments, or other rights or assets held and reduce the interest rate and/or foreign exchange risks related to these holdings.[16] In addition, any related rights or other assets held that are securities must be cash equivalents, securities received in lieu of debts previously contracted with respect to loans held or, unique to the credit fund exclusion, equity securities (or rights to acquire equity securities) received on customary terms in connection with the credit fund's loans or debt instruments. The exclusion also would be subject to certain additional restrictions to ensure that the entity is actually engaged in providing

[16] Final rule § 351.10(c)(15)(i)(D).

credit and credit intermediation, and is not operated for the purpose of evading the provisions of section 13 of the BHC Act. Under the final rule, a credit fund would be excluded from the definition of covered fund, provided that:

- the fund does not engage in activities that would constitute proprietary trading, as defined in § 351.3(b)(1)(i) of the rule, as if the fund were a banking entity;
- the fund does not issue asset-backed securities;
- the banking entity does not guarantee the performance of the fund;
- if a banking entity sponsors or serves as an investment adviser or commodity trading advisor to a credit fund, the banking entity provides certain disclosures stating that it does not guarantee the performance of the fund, and ensures that the activities of the issuer are consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly;
- the banking entity complies with the limitations in § 351.14 ("Super 23A") (except the banking entity would be permitted to acquire and retain an ownership interest in the issuer); and
- the banking entity complies with the limitations in § 351.15 of the implementing regulations regarding material conflicts of interest, high-risk investments, and safety and soundness and financial stability, in each case as though the credit fund were a covered fund.

2. Venture Capital Funds

Consistent with the 2020 proposal, the final rule would add an exclusion from the definition of "covered fund" under § 351.10(b) of the rule that would allow banking entities to acquire or retain an ownership interest in, or sponsor, certain venture capital funds to the extent the banking entity is permitted to engage in such activities under otherwise applicable law. The

exclusion would be available with respect to "qualifying venture capital funds," which the final rule would define as an issuer that meets the definition in the Investment Advisers Act implementing regulations (17 CFR § 275.203(*l*)-1) and several additional criteria. The SEC's definition of "venture capital fund" in 17 CFR § 275.203(*l*)-1 contains, among other things, strategy guidelines, asset holding restrictions, leverage limitations, and redemption constraints.

While the definition in 17 CFR § 275.203(*l*)-1 would form the basis of the exclusion in the final rule for qualifying venture capital funds, this exclusion would include additional criteria that would help promote the specific purposes of section 13 of the BHC Act. In particular, a qualifying venture capital fund would not be permitted to engage in any activity that would constitute proprietary trading under § 351.3(b)(1)(i) as if the fund were a banking entity. A banking entity that serves as a sponsor, investment adviser, or commodity trading advisor to a qualifying venture capital fund would be required to provide the disclosures required under § 351.11(a)(8) to prospective and actual investors in the fund. In addition, any banking entity that relies on the exclusion would not be permitted to, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the qualifying venture capital fund. A banking entity that serves as a sponsor, investment adviser, or commodity trading advisor to a qualifying venture capital fund also would be required to ensure the fund's activities are consistent with safety and soundness standards substantially similar to those that would apply if the banking entity engaged in the activities directly.

Further, a banking entity's investment in or relationship with a qualifying venture capital fund would be subject to the restrictions of Super 23A (except the banking entity may acquire and retain an ownership interest in the fund in accordance with the terms of the exclusion) and § 351.15 of the implementing regulations regarding material conflicts of interest, high-risk

investments, and safety and soundness and financial stability, as if the fund were a covered fund.[17]

The requirements of the exclusion, including the definition of venture capital fund in 17 CFR 275.203(*l*)-(1), are intended to address the concerns expressed in the preamble to the 2013 rule that the activities and risk profiles for banking entities with sponsorship of, or investment in, venture capital funds are not readily distinguishable from those of funds that section 13 of the BHC Act was intended to capture. Accordingly, these requirements will give effect to the language and purpose of section 13 of the BHC Act without allowing banking entities to evade the requirements of section 13.

In the preamble to its regulation adopting the definition of venture capital fund in 17 CFR 275.203(*l*)-(1), the SEC explained that the definition's criteria distinguish venture capital funds from other types of funds, including private equity funds and hedge funds. For example, the SEC explained that it understood the criteria for "qualifying portfolio companies" to be characteristic of issuers of portfolio securities held by venture capital funds and, taken together, would operate to exclude most private equity funds and hedge funds from the venture capital fund definition.[18] The SEC also explained that the criteria for "qualifying investments" under the SEC's regulation would help to differentiate venture capital funds from other types of private

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[17] In the final rule, the requirement that the banking entity must comply with § 351.14 of the implementing regulations is moved to § 351.10(c)(16)(ii). This change clarifies that this requirement applies to a banking entity that acts as sponsor, investment adviser, or commodity trading adviser to the qualifying venture capital fund and does not apply to a banking entity that merely invests in a qualifying venture capital fund.

[18] 76 FR 39656.

funds, such as leveraged buyout funds.[19] The SEC further explained that its regulation's restriction on the amount of borrowing, debt obligations, guarantees or other incurrence of leverage was appropriate to differentiate venture capital funds from other types of private funds that may engage in trading strategies that use financial leverage and may contribute to systemic risk.[20]

3. Family Wealth Management Vehicles

The final rule would exclude from the definition of "covered fund" under § 351.10(b) of the implementing regulations any entity that qualifies as a "family wealth management vehicle." For family wealth management vehicles that are trusts, the grantor(s) must be family customers.[21] For non-trust family wealth management vehicles, family customers must own a majority of the voting interests (directly or indirectly) as well as a majority of interests in the entity. Ownership of non-trust family wealth management vehicles is generally limited to family customers and up to five closely related persons of the family customers.[22] However, there is a

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[19] *See, e.g.*, 76 FR 39653 (explaining that a limitation on secondary market purchases of a qualifying portfolio company's shares would recognize "the critical role this condition played in differentiating venture capital funds from other types of private funds").

[20] 76 FR 39662. *See also* 76 FR 39657 ("We proposed these elements of the qualifying portfolio company definition because of the focus on leverage in the Dodd-Frank Act as a potential contributor to systemic risk as discussed by the Senate Committee report, and the testimony before Congress that stressed the lack of leverage in venture capital investing.").

[21] Under § 351.10(c)(17)(iv)(B) of the final rule, a "family customer" is a "family client," as defined in Rule 202(a)(11)(G)-1(d)(4) of the Advisers Act (17 CFR 275.202(a)(11)(G)-1(d)(4)); or any natural person who is a 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. All terms defined in Rule 202(a)(11)(G)-1 of the Advisers Act (17 CFR 275.202(a)(11)(G)- 1) have the same meaning in the family wealth management vehicle exclusion.

[22] Under § 351.10(c)(17)(iv)(A) of the final rule, "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."

de minimis ownership allowance that permits one or more entities, including a banking entity, that are not family customers or closely related persons, to acquire or retain, as principal, up to an aggregate 0.5 percent of the family wealth management vehicle's outstanding ownership interests for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns. [23]

Section 13 and the implementing regulations were designed to permit banking entities to continue to provide client-oriented financial services, including asset management services. As such, an exclusion for family wealth management vehicles is consistent with section 13(d)(1)(D), which permits banking entities to engage in transactions on behalf of customers, when those transactions would otherwise be prohibited under section 13. The exclusion in the final rule would similarly allow banking entities to provide traditional services to customers through vehicles used to manage the wealth and other assets of those customers and their families.

In addition, under the final rule, a banking entity may rely on the exclusion only if the banking entity: (i) provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the entity; (ii) does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such entity; (iii) complies with the disclosure obligations under § 351.11(a)(8), as if such entity were a covered fund; (iv) does not acquire or retain, as principal, an ownership interest in the entity, other than up to an aggregate 0.5 percent of the family wealth management vehicle's outstanding ownership interests for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns; (v) complies with the requirements of §§ 351.14(b) and 351.15,

[23] This 0.5 percent ownership interest represents the aggregate amount of a family wealth management vehicle's ownership interests that may be acquired or retained by all entities that are neither a family customer nor a closely related person.

as if such issuer were a covered fund; and (vi) except for riskless principal transactions as defined in § 351.10(d)(11), complies with the low quality asset purchase restrictions of 12 CFR 223.15(a), as if such banking entity and its affiliates were a member bank and the issuer were an affiliate thereof.

The exclusion for family wealth management vehicles would allow banking entities to structure services or transactions for customers, or to otherwise provide traditional customer-facing banking and asset management services, through a vehicle, even though such a vehicle may rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act or would otherwise be a covered fund under the implementing regulations. As the agencies noted in the preamble to the 2013 rule, section 13 and the implementing regulations were designed in part to permit banking entities to continue to provide client-oriented financial services, including asset management services. Furthermore, the provisions of the exclusion are intended to work together to sufficiently reduce the likelihood that these vehicles could be used to evade the requirements of section 13 or the implementing regulations.

The final rule would allow up to five closely related persons to hold ownership interests in a family wealth management vehicle. Commenters to the 2020 proposal stated that many family wealth management vehicles currently include more than three closely related persons, which was the limit proposed in the 2020 proposal. The final rule will more closely align the exclusion with the current composition of family wealth management vehicles, thereby increasing the utility of the exclusion without allowing such a large number of non-family customer owners to suggest the entity is in reality a hedge fund or private equity fund. Additionally, requiring family customers to own a majority of the interests in the family wealth

management vehicle would serve as an additional safeguard against evasion of the provisions of section 13.

4. Customer Facilitation Funds

The final rule would exclude from the definition of "covered fund" under § 351.10(b) any issuer that acts as a "customer facilitation vehicle." The customer facilitation vehicle exclusion would be available for any issuer that is formed by or at the request of a customer of the 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 service provided by the banking entity.

A banking entity would be able to rely on the customer facilitation vehicle exclusion only under certain conditions, including that all of the ownership interests of the issuer are owned by such customer (which may include one or more of the customer's affiliates), other than a de minimis interest up to 0.5 percent that may be held by the banking entity establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns. A banking entity and its affiliates would have to maintain documentation outlining how the banking entity intends to facilitate the customer's exposure to such transaction, investment strategy, or service.

Additional conditions for the customer facilitation vehicle exclusion, similar to the family wealth management vehicles exclusion, would include prohibitions on guarantees, disclosure requirements, and compliance requirements with respect to §§ 351.14(b) and 351.15, and the low quality asset purchase restrictions of 12 CFR 223.15(a) (except for riskless principal transactions), as if the customer facilitation vehicle were an affiliate of the banking entity.

D. Limitations on Relationships with a Covered Fund

This final rule would modify the regulations implementing section 13(f)(1) of the BHC Act to permit banking entities to engage in a limited set of covered transactions with covered funds for which the banking entity directly or indirectly serves as investment manager, investment adviser, or sponsor, or that the banking entity organizes and offers pursuant to section 13(d)(1)(G) of the BHC Act. Consistent with paragraph (d)(1)(J) of section 13 of the BHC Act, the final rule would allow a banking entity to enter into covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under section 23A of the Federal Reserve Act and the Federal Reserve Board's implementing Regulation W. This would include, for example, intraday extensions of credit. The final rule also would allow a banking entity to enter into short-term extensions of credit with a related covered fund, provided each extension of credit is related to payment, clearing, and settlement activities.

The final rule permits banking entities to enter into riskless principal transactions with a related covered fund, including in circumstances where the covered fund is not a "securities affiliate." In a riskless principal transaction, the banking entity acting as riskless principal buys and sells the same security contemporaneously, and the asset risk passes promptly from the affiliate (the related covered fund) through the riskless principal to a third party. In permitting such transactions under Regulation W, the Federal Reserve Board previously found that there was no regulatory benefit to subjecting riskless principal transactions to section 23A of the Federal Reserve Act, because such transactions closely resemble securities brokerage transactions, and these transactions do not allow the affiliate to transfer risk to the affiliate acting as a riskless principal. Although the 2020 proposal would have permitted a banking entity to

enter into a riskless principal transaction with a covered fund provided it met the criteria in Regulation W, the final rule adopts a standalone exception to differentiate riskless principal transactions specifically from other transactions that would be exempt transactions under Regulation W.

E. Ownership Interest

The final rule would change the definition of "ownership interest" to clarify that a debt relationship with a covered fund would typically not constitute an ownership interest under the regulations.[24] In addition, the final rule would provide amendments to the manner in which a banking entity must calculate its ownership interest for purposes of complying with the limits and conditions that apply to investments in covered funds organized and offered by a banking entity. Specifically, these amendments are intended to better align the manner in which ownership limits are calculated for purposes of the quantitative limit on a banking entity's investment in a single fund (the per fund limit), the quantitative limit on a banking entity's investment in all covered funds (the aggregate fund limit), and the calculation of the applicable capital deductions for investments in covered funds (the covered fund deduction).[25]

To provide clarity about the types of interests that would be considered within the scope of the definition of ownership interest, the final rule would modify the scope of the definition of ownership interest to allow for certain additional rights of creditors to participate in the removal or replacement of an investment manager for cause that are not triggered exclusively by an event of default or acceleration. Accordingly, a banking entity's holding of a financial instrument that

[24] *See* 2013 rule § 351.10(d)(6) (defining "ownership interest" for purposes of subpart C of the rule).

[25] *See* 12 U.S.C. § 1851(d)(4)(B)(ii)–(iii); 2013 rule §§ 351.10(d)(6); 351.12(a)(2)(ii)–(iii), (b)–(d).

has these features would not necessarily cause that instrument to be considered an "ownership interest."

The final rule also would provide a safe harbor from the definition of ownership interest, to address commenters' concerns that some ordinary debt interests could be construed as an ownership interest. Any senior loan or senior debt instrument that meets certain characteristics would not be considered to be an ownership interest under the final rule.

The final rule amends the implementing regulations to limit the attribution of an employee's or director's restricted profit interest in a covered fund organized or offered by the banking entity to only those circumstances in which the banking entity has directly or indirectly financed the acquisition of the restricted profit interest. This amendment will simplify a banking entity's compliance with the aggregate fund limit and covered fund deduction provisions of the rule, and more fully recognize that employees and directors may use their own resources, not provided by the banking entity, to invest in ownership interests or restricted profit interests in a covered fund they advise (for example, to align their personal financial interests with those of other investors in the covered fund).

F. Parallel Investments

The 2013 rule requires that a banking entity hold no more than three percent of the total ownership interests of a covered fund that the banking entity organizes and offers pursuant to § 351.11 of the 2013 rule. Section 351.12(b)(1) of the 2013 rule requires that, for purposes of this requirement, "the amount and value of a banking entity's permitted investment in any single covered fund shall include any ownership interest held under § 351.12 directly by the banking entity, including any affiliate of the banking entity." In the preamble to the 2013 rule, the agencies stated "[I]f a banking entity makes investments side by side in substantially the same

positions as a 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."[26] The agencies also stated that a banking entity that sponsors a covered fund should not 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 percent of the value of the total amount co-invested by other investors in such investment. Neither section 13(d)(4) of the BHC Act nor the text of the 2013 rule require that a banking entity treat an otherwise permissible investment the banking entity makes alongside a covered fund as an investment in the covered fund.

The final rule would add a new rule of construction to § 351.12(b) that would address investments made by banking entities alongside covered funds. These provisions would clarify in the rule text that banking entities are not required to treat these types of direct investments alongside a covered fund as an investment in the covered fund as long as certain conditions are met. Banking entities rely on a number of investment authorities and structures to make investments and meet the needs of their clients and shareholders. The final rule would provide clarity to banking entities that they may make such investments for the benefit of their clients and shareholders, provided that those investments comply with applicable laws and regulations. Accordingly, banking entities would not be permitted to engage in prohibited proprietary trading alongside a covered fund. Moreover, banking entities would need to have authority to make any investment alongside a covered fund under applicable banking and other laws and regulations, and would need to ensure that the investment complies with applicable safety and soundness standards.

[26] 79 Fed. Reg. 5734.

G. Technical Amendments

The final rule would also finalize nonsubstantive, technical amendments identified in the 2020 proposal. The agencies received no comments on these technical amendments.

Conclusion: Staff requests that the FDIC Board approve for publication in the *Federal Register* the attached interagency final rule to amend the 2013 rule with an effective date of October 1, 2020.

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	Annmarie Boyd, Counsel (ext. 8-3714)