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NEWLY ADOPTED VOLCKER RULE AMENDMENTS EXPAND OPPORTUNITIES FOR BANKS TO SPONSOR AND INVEST IN PRIVATE CREDIT FUNDS

On June 25, 2020, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (collectively, the "**Agencies**") issued a final rule (the "**Final Rule**") adopting several amendments to the regulations implementing Section 13 of the Bank Holding Company Act of 1956, commonly known as the "**Volcker Rule**." Among the modifications to the Volcker Rule regulations included in the Final Rule was the exclusion of privately offered credit funds from the definition of "covered fund" (the "**Credit Funds Exclusion**") for purposes of the Volcker Rule's restrictions on a banking entity's interests and relationships with covered funds. The Final Rule will become effective on October 1, 2020.

This briefing provides background on the treatment of private credit funds under the Volcker Rule regulations, an explanation of the Credit Funds Exclusion, and examples of the various credit strategies potentially available under the Final Rule. We believe that the Final Rule will provide meaningful opportunities for nonbank sponsors of credit funds as well as for banking organizations. Specifically, we expect that the Credit Funds Exclusion will expand the universe of potential credit fund investors and attract substantial new credit fund commitments, as well as increase the ability of banks to engage in their core business of loan origination and extension of credit by sponsoring and/or investing in credit funds.

BACKGROUND

As enacted by Congress, the Volcker Rule generally prohibits any banking entity[1] from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with "a hedge fund or a private equity fund"[2]. While the apparent intent of the prohibition is only to cover relationships with "hedge funds" and "private equity funds," the statutory definition is far broader than the common understanding of these terms.[3] In the 2013 regulations implementing the statutory requirements of the Volcker Rule (the "**2013 Rule**"), the Agencies recognized that the breadth of the "hedge fund" and "private equity fund" definition—which the Agencies recast as a definition of "covered fund"—captured many kinds of entities that were outside the intent and purpose of the statute. The Agencies therefore excluded several types of entities from the general definition of "covered fund." The Agencies declined to exclude credit funds, however, on the rather implausible basis that the Agencies were "unable effectively to distinguish" such funds from private equity or hedge funds in a manner that would harmonize with the intent of the Volcker Rule and not raise concerns about the ability of banking entities to use such funds to evade the requirements of the Volcker Rule. Furthermore, the Agencies argued that credit funds would potentially be able to rely on the available exclusions for joint ventures or loan securitizations. In practice, however, these exclusions were able to accommodate only a few credit funds.

It was not until February 2020, when the Agencies originally proposed what became the Final Rule, that the restrictions on banking entities' relationships with credit funds were addressed. In the preamble to the Final Rule, the Agencies acknowledged that the 2013 Rule "inhibited" the ability of banking entities to originate loans and extend credit, in contravention of the intent of the Volcker Rule.[4] The Agencies specifically noted that fund structures present certain risk-mitigating features and "significant" cost efficiencies for banking entities that may result in an increased volume of credit intermediation.

Furthermore, the Credit Funds Exclusion addresses the fact that, as previously applied, the "covered fund" provisions prohibited banking entities from engaging indirectly in the traditional credit-related activities they were always permitted to engage in directly. The Credit Funds Exclusion now allows banking entities to engage in such activities regardless of the form of the transaction (*i.e.* interposing a fund between the banking entity and the loan recipient, even if the fund transacts primarily in loans and certain debt instruments, is no longer sufficient grounds to prohibit the banking entity participation). The Credit Funds Exclusion allows banking entities to share the risks of otherwise permissible banking activities with other investors.

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1 For purposes of the Volcker Rule, a "banking entity" means (i) any insured depository institution (as defined in 12 U.S.C. 1813), (ii) any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and (iii) any affiliate or subsidiary of any such entity. 12 U.S.C. 1851(h)(1).

2 12 U.S.C. 1851(a)(1)(B).

3 The statute defines both "hedge fund" and "private equity fund" to mean, in part, "an issuer that would be an investment company, as defined in the Investment Company Act of 1940 …, but for section 3(c)(1) or 3(c)(7) of that Act …." 12 U.S.C. 1851(h)(2).

4 The Agencies pointed to Section 13(g)(2) of the Bank Holding Company Act of 1956, which provides that "[n]othing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company .... to sell or securitize loans in a manner otherwise permitted by law." 12 U.S.C. 1851(g)(2).

The Agencies also recognized that the activities of a credit fund are insufficiently distinguishable from those permitted under the loan securitization exclusion to justify permitting the latter but not the former. The Agencies argued, in fact, that the concerns expressed about credit funds in the preamble to the 2013 Rule would be alleviated by the experiences of banking entities in using and complying with the loan securitization exclusion. Accordingly, the Credit Funds Exclusion is largely structured based on the framework provided by the loan securitization exclusion.

CREDIT FUNDS EXCLUSION

The Credit Funds Exclusion encompasses the following: (i) the types of assets that would allow an issuer to be a credit fund for purposes of the Credit Funds Exclusion; (ii) the types of activities permissible for credit funds and banking entities under the Credit Funds Exclusion; (iii) the requirements for a sponsor, investment adviser or commodity trading advisor to a credit fund; and (iv) certain investment and relationship limitations. Each of these will be discussed in turn.

At the outset, it is important to note the Agencies' explanation that reliance on the Credit Funds Exclusion by a banking entity is contingent on the permissible activities *of the banking entity*, including, for example, whether the relevant fund holds the types of debt instruments and allowable equity securities (as described below) that the applicable banking entity could hold directly. Therefore, it is conceivable that the same fund may qualify for the Credit Funds Exclusion in relation to one banking entity and still be a "covered fund" in relation to another. Banking entities are responsible for ensuring that their activities comply with the Credit Funds Exclusion.

Furthermore, the Agencies clarified that the Credit Funds Exclusion's requirements apply only to a sponsor, investment adviser or commodity trading advisor that relies on the Credit Funds Exclusion to sponsor or acquire an ownership interest in a credit fund, and *not* to an investment adviser or commodity trading advisor to a credit fund that *does not also* sponsor or acquire an ownership interest in the fund.

Asset Requirements

In deciding the types of assets that would qualify a fund for the Credit Funds Exclusion, the Agencies sought to limit permissible instruments only to those that would facilitate the extension of credit and directly related hedging activities.

Accordingly, a qualifying credit fund's assets must be composed *solely* of the following (*i.e.* there is no *de minimis* exception):

- Loans (any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative).
- Debt instruments, including any debt security (if the banking entity would be permitted to acquire and hold such instrument directly under applicable federal banking laws and regulations).
- Rights and other assets related or incidental to acquiring, holding, servicing or selling such loans or debt instruments if, to the extent such right or asset is a *security*, it is 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[5] (or right to acquire an equity security) received on customary terms in connection with such loans or debt instruments if the banking entity would be permitted to acquire and hold such security directly under applicable federal banking laws and regulations.

  - Such right or asset may *not* be a commodity forward contract or any derivative (except derivatives used to reduce interest rate and foreign exchange risks, as described below).

- Interest rate or foreign exchange derivatives if (i) the written terms of the derivative directly relate to the loans, debt instruments or other rights or assets related or incidental to acquiring, holding, servicing or selling such loans or debt instruments *and* (ii) the derivative reduces the interest rate and/or foreign exchange risks related to such loans, debt instruments or other rights or assets.

Notably, the Agencies specifically rejected revising or expanding on the definition of "debt instrument" with the assertion that the term "already has a general meaning that is used in the marketplace and by regulators."

No safe harbor will be available for banking entities that rely on the representation by a credit fund that the fund only invests in permissible assets. The banking entity itself must ensure that the applicable fund invests in compliance with the Credit Funds Exclusion prior to engaging in any newly authorized activities under the Volcker Rule.

Activity Requirements

In addition to complying with the asset requirements described above, a credit fund must also—

- refrain from engaging in any activity that would constitute proprietary trading under the Volcker Rule as if the credit fund were a banking entity[6]; and
- not issue asset-backed securities[7].

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5 The Agencies declined to adopt a quantitative limit on the amount of equity securities (or rights to acquire such securities) that may be held by the credit fund pursuant to the Credit Funds Exclusion. However, the Agencies stated their expectation that credit funds would hold not more than 5% of the value of the fund's total investment in a borrower (or affiliated borrowers) at the time the investment is made. Although the Agencies recognize that circumstances may cause a breach of this limit at certain times, the Agencies further expect that a fund's exposure to such assets, individually and collectively and viewed over time, would be "managed on a basis consistent with the fund's overall purpose."

6 The Agencies make it explicitly clear that a credit fund is prohibited from electing a different definition of proprietary trading than that under the Volcker Rule. Furthermore, although the Credit Funds Exclusion does not address a situation (because it would be fairly unexpected) in which a credit fund would be formed for the purpose of engaging in, or in the ordinary course would be engaged in, activities exempted under the Volcker Rule's prohibition on proprietary trading (such as certain underwriting and market-making related activities, risk-mitigating hedging activities and other specified permitted transactions) the Agencies provided that a credit fund would not be precluded from engaging in such activities under the Credit Funds Exclusion, as long as such activities were performed in compliance with the applicable exemption (which the Agencies note may be "inapt and/or highly impractical" in relation to credit funds).

7 For purposes of this limitation, an "asset-backed security" means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including (i) a collateralized mortgage obligation, (ii) a collateralized debt obligation, (iii) a collateralized bond obligation, (iv) a collateralized debt obligation of asset-backed securities, (v) a collateralized debt obligation of collateralized debt obligations; and (v) a security that the Securities and Exchange Commission, by rule, determines to be an asset-backed security. *See* 15 U.S.C. 78c(a)(79).

Furthermore, while engaging in otherwise permitted activities under the Credit Funds Exclusion, a credit fund must not—

- purchase or sell one or more financial instruments principally for the purpose of short-term resale;
- benefit from actual or expected short-term price movements;
- realize short-term arbitrage profits; or
- hedge one or more of the positions resulting from the purchases or sales of financial instruments.

With respect to activities of banking entities, a banking entity is prohibited, with respect to a credit fund, from directly or indirectly guaranteeing, assuming or otherwise insuring the obligations or performance of the credit fund or of any entity to which the credit fund extends credit or in which the credit fund invests.

The Agencies declined to permit banking entities that are insured depository institutions (or their operating subsidiaries) to invest in credit funds through a contribution to the fund of troubled loans and assets acquired in lieu of foreclosure *from the banking entity's portfolio* on the grounds that such activities would raise conflict-of-interest concerns of the type the Volcker Rule was intended to address.

Requirements Applicable to a Banking Entity Acting As Credit Fund Sponsor, Investment Adviser or Commodity Trading Advisor

A banking entity that acts as a sponsor, investment adviser or commodity trading advisor to (as opposed to merely investing in) an otherwise qualifying credit fund, may rely on the Credit Funds Exclusion only if the banking entity does the following:

- Clearly and conspicuously discloses, in writing (such as in the credit fund's offering documents), to any prospective or actual investor in the credit fund—
    - the statement that "any losses in [such fund] will be borne solely by investors in [the fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such fund] will be limited to losses attributable to the ownership interests in the fund held by [the banking entity] and any affiliate in its capacity as investor in [the fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate";
    - that such investor should read the credit fund's offering documents prior to investing in the fund;
    - the statement that the "ownership interests in the fund are not insured by the Federal Deposit Insurance Corporation, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity" (unless that happens to be the case with respect to the fund); and
    - the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the fund.

- If the banking entity sponsors or has an ownership interest in the credit fund *and* serves as an investment adviser or commodity trading advisor to the fund, ensures that the credit fund's activities are consistent with safety and soundness standards substantially similar to those that would apply if the banking entity engaged in such activities directly.
- Complies with certain limitations as if the credit fund were a "covered fund", including the Volcker Rule's "Super 23A" restrictions on transactions with the credit fund.

Investment and Relationship Limitations

Finally, the Credit Funds Exclusion requires that a banking entity's investment in, and relationship with, a credit fund must—

- not involve any transaction, class of transactions, or activity that would (i) involve or result in a material conflict of interest[8] between the banking entity and its clients, customers or counterparties, (ii) result, directly or directly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy (an asset or trading strategy of which the holding of or engaging in would "significantly increase 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), or (iii) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States; and
- be conducted in compliance with, and subject to, applicable banking laws and regulations, including applicable safety and soundness standards.
  - The Agencies noted, for example, that a banking entity that invests in or has a relationship with a credit fund is subject to capital charges and certain other applicable banking law requirements.

POTENTIAL STRATEGIES AVAILABLE UNDER THE CREDIT FUNDS EXCLUSION

The Credit Funds Exclusion provides valuable new opportunities for banking entities to sponsor and invest in certain credit funds, and for credit funds pursuing certain strategies to attract new investments from banks and their affiliates and/or subsidiaries.

Specifically, in light of the applicable requirements, we believe that the following types of credit funds potentially would be able to rely on the Credit Funds Exclusion:

[8] For purposes of the above, a "material conflict of interest" exists where (i) the transaction, class of transactions or activity would involve or result in the banking entity's interests being *materially adverse* to the interests of the client, customer or counterparty with respect to such transaction, class of transactions or activity and (ii) the banking entity, prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, has not (A) made timely and effective disclosure of the conflict of interest (in accordance with the requirements of 12 CFR 44.15(b)(2)) or (B) has established, maintained or enforced information barriers contained in written policies and procedures reasonably involved to prevent the conflict of interest (also in accordance with such requirements).

- All types of direct lending or loan origination funds (whether the loan is secured or unsecured, and including senior, second-lien, mezzanine and unitranche loans).
- Real estate debt funds.
- Opportunistic, special situations (but only if debt-focused) or distressed funds, including "rescue lending" funds.
- Funds investing in ABS and structured assets (including CLOs, RMBS, CMBS), including risk retention funds.
- Funds investing in esoteric structured assets, including life settlements, insurance-linked securities, and other structured securities.
- Funds focused on debt that have broad strategies permitting a variety of debt investments, including high-yield bonds, mezzanine securities and mezzanine debt.

CONCLUSION

Since the adoption of the 2013 Rule, the Agencies have clearly recognized that the scope of the Volcker Rule's "covered fund" prohibition, without furthering the goals that prompted the Volcker Rule's enactment, meaningfully restricted banking organizations from engaging indirectly in core banking activities that they were otherwise able to conduct directly.

The Credit Funds Exclusion presents a significant opportunity for nonbank sponsors of private credit funds and banking organizations to grow the market for private credit funds. As the October 1, 2020 effective date of the Final Rule approaches, participants in the market for private credit solutions should consider their investment strategies and gauge investor interest in light of these new possibilities.

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