Dissenting Views on the 2020 Volcker Rule Covered Funds Proposal

Dissenting Statement, 2020 Volcker Rule Covered Funds Proposal

SEC Commissioner Allison Herren Lee

January 30, 2020

Today we continue the march toward effective repeal of the Volcker Rule. The rule is premised on the common sense proposition that banks should not be allowed to gamble with taxpayer money and that taxpayers should never again be forced to rescue banks and their highly compensated executives from the consequences of their bad decisions.

The Volcker Rule seeks to protect taxpayers by prohibiting short-term, speculative trading by banks and restricting their investments in high-risk funds (referred to as "covered funds"). Last fall, we significantly weakened the former,[1] and today we propose to undermine the latter.[2]

Today's proposal would increase banks' ability to add risk to their balance sheets in two significant ways. It would broaden the categories of private funds in which banks can invest—most notably by including venture capital and credit funds. And, it would allow banks to evade certain investment restrictions by permitting a greater degree of "parallel investment" alongside covered funds, thus allowing exposure to these often high-risk holdings.

As with the rule last fall, this proposal replaces clear, common sense restrictions with just the hope that banks will self-police and remain diligent in identifying and mitigating their own risks—an expectation that flies in the face of experience. The structures of large financial institutions, including bankers' compensation, still strongly incentivize the kind of risk taking that led to the financial crisis. Hope will not protect investors from banks' appetite for risk in the pursuit of yield. I cannot support the proposal.[3]

Once again, the proposal has not provided evidence or analysis in support of the proposed changes.[4] The changes are, by and large, not correcting unforeseen complications or making adjustments to reflect changes in circumstances since the rule's adoption in 2013.[5] In fact, many of the changes proposed today were specifically considered and rejected by the agencies in adopting the final rule in 2013.[6] While I have numerous issues with the ways in which the proposal would erode the basic protections of the Volcker Rule[7], I want to highlight two of my more significant concerns.

Venture Capital Funds

The proposal states, without any supporting evidence, that permitting banks to invest in venture capital funds "could promote and protect the safety and soundness of banking entities and the financial stability of the United States."[8] The proposal, however, provides no meaningful analysis of the high-risk nature of venture capital. These funds are speculative by design, and yet the proposal illogically concludes that investing in them will make banks *safer*. The need for the changes is also unclear, especially in light of the historic growth in venture capital over the past two years.[9] In glossing over the risk—a consideration that should be central to any changes in the covered fund provisions—the proposal strays from

Congressional intent and ignores recent experience that illustrates the significant hazards in this part of the market.[10]

Prior to the adoption of the final rule in 2013, numerous industry commenters on the proposed rule requested a carve-out for venture capital funds.[11] The agencies determined, however, that the very changes we propose today are inconsistent with the statutory mandate of the Volcker Rule.[12] Specifically, the agencies stated that "the statutory language of [the Volcker Rule] does not support providing an exclusion for venture capital funds from the definition of covered fund."[13] Despite calls to differentiate venture capital funds from other forms of private equity, the agencies explained that "the activities and risk profiles for banking entities regarding sponsorship of, and investment in, venture capital funds and private equity funds are not readily distinguishable."[14]

Today, the agencies simply reverse course. The proposal would now adopt the Commission's definition of "venture capital fund" from an unrelated rule and use that to distinguish venture capital from private equity[15]—an argument that was *also* considered and rejected by the agencies in 2013.[16] The agencies determined at the time that Congress did not intend to permit banks to invest in speculative private funds, and the contours of the Commission's venture capital fund definition do not reasonably differentiate these funds for purposes of the Volcker Rule. Congress' intent in adopting the Volcker Rule in 2010, as interpreted by the agencies in 2013, does not change with the passage of time, nor does today's proposal support this fundamental reinterpretation.[17] Significantly, had Congress held the view that the 2013 interpretation was wrong or in need of adjustment, it could have addressed this in the legislative changes to the Volcker Rule that it adopted in 2018, but it did not.[18]

The proposal's reliance on the Commission's separate definition of "venture capital fund" also raises two additional concerns. First, by incorporating the Commission's definition into today's proposal, the agencies give the Commission substantial control over the degree of risk that is acceptable for banks to take with these types of investments. The Commission is not a prudential regulator; our mission is not anchored in principles of safety and soundness for banking institutions. However, to the extent that the Commission makes changes that broaden the current definition of "venture capital fund"—and we are receiving calls to do so[19]—we will concomitantly permit increased risk-taking by banks.

Second, the actions taken today have the potential to increase the level of risk that venture capital funds present to the financial system. When Congress adopted the Volcker Rule—which was intended to keep banks out of speculative private funds such as venture capital—it also adopted a provision relieving advisers to venture capital funds of the requirement to register with the Commission.[20] In providing this exemption, Congress relied heavily on the notion that venture capital funds, because of the nature of their operations, are less likely to present systemic risk than other types of private equity or hedge funds.[21] Congress believed that their "activities are not interconnected with the global financial system" and that the high level of risk inherent in these funds is borne by fund investors and not the broader economy.[22] Today's proposal, would allow banks greater flexibility to invest in venture capital funds. If this proposal is adopted, both Congress and the Commission should consider whether permitting banks to pursue speculative investments in venture capital funds calls into question the rationale for the registration exemption.[23]

Parallel Investments

The proposal would also lift certain restrictions on banks' investing alongside a covered fund, or "parallel investment," thus opening the door to evasion of the rule's investment prohibitions.

The 2013 Adopting Release limited banks' ability to engage in certain types of investment activity in parallel with covered funds. The agencies stated that if a bank invests 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."[24] The agencies took the same position with respect to commitments by a bank to co-invest with a covered fund in a privately negotiated transaction.[25] The rule limits the value of a bank's investments in any covered fund to a *de minimis* amount, and the agencies' position on these parallel investment activities was meant to ensure that such activity was counted toward that *de minimis* limitation.[26] After all, substantial investment alongside of a covered fund raises many of the same concerns as direct investments in the fund.

Today's proposal, however, reverses course and would specifically instruct banks that such parallel investments need not be counted toward the *de minimis* limitation.[27] Thus, parallel investments could be used to evade the prohibitions on investing in covered funds.[28]

Moreover, a bank may be motivated to make such investments in order to artificially maintain the value of a fund it has sponsored and the underlying assets to which the bank also has direct exposure. While the proposal asserts that banks still could not use parallel investments "for the purpose of artificially maintaining or increasing the value of the fund's positions,"[29] it goes on to explain that a bank may now "market a covered fund it organizes and offers . . . on the basis of the banking entity's expectation that it would invest in parallel with the covered funds in some or all of the same investments."[30] Thus, despite the assertion that banks still may not artificially maintain the value of sponsored covered funds, the proposal specifically suggests that banks pursue the very arrangements that could create market pressure and incentives for them to do just that. It is hard to imagine that this is what Congress intended in adopting the Volcker Rule.

Nothing in today's proposal would reduce the potential for systemic risk or subject banks to more meaningful oversight of high-risk investment activity. The proposal does not balance competing concerns; it does not seek to enhance protections in some areas while dialing them back because of new evidence in others. Rather, it uniformly allows banks to take on greater risk, especially in the form of investments in venture capital and credit funds, and increases opportunities for evasion of the restrictions that remain. In the case of venture capital funds, this not only imports the risks of such funds into the banking system, but, in doing so, undermines the rationale for exempting advisers to venture capital funds from registration with the Commission.

Although I cannot support the proposal in its current form, I look forward to receiving comment from the public about how the agencies can address the risks inherent in the proposed changes.

Footnotes

[1] *See* Final Rule: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Bank Holding Company Act Rel. No. 7 (Sept. 18, 2019).

[2] *See* Proposed Rule: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds [citation forthcoming] (Jan. 30, 2020) ("Proposing Release").

[3] While I am unable to support today's proposal, I want to thank the staff from the Division of Investment Management, Division of Trading and Markets, Division of Economic and Risk Analysis, and the Office of the General Counsel for their work on today's recommendation.

[4] The agencies state in today's release that the changes are "intended to improve and streamline the covered fund provisions and provide clarity to banking entities." *See* Proposing Release, *supra* note 2, at 14. Notably, all of the so-called improvements operate to provide more flexibility and reduce limitations on risk.

[5] *See* Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, Bank Holding Company Act Rel. No. 1 (Dec. 10, 2013) ("2013 Adopting Release").

[6] *Compare* 2013 Adopting Release, *supra* note 5, at 543 (adopting requirement for distribution "predominantly" through public offerings to avoid evasion of the rule's requirements) *with* Proposing Release, *supra* note 2, at 28-30 (discussing elimination of the requirement for distribution "predominantly" through public offerings); *compare* 2013 Adopting Release, *supra* note 5, at 580 (stating that "[t]he Agencies believe the purpose underlying section 13 is not to expand the scope of assets in an excluded loan securitization beyond loans") *with* Proposing Release, *supra note 2*, at 28-30 (stating that "the agencies are proposing to allow a loan securitization vehicle to hold up to five percent of assets in non-loan assets"); *compare* 2013 Adopting Release, *supra* note 5, at 648 (stating that the agencies were "unable effectively to distinguish credit funds from other types of private equity funds or hedge funds in a manner that would give effect to the language and purpose of section 13 and not raise concerns about banking entities being able to evade the requirements") *with* Proposing Release, *supra* note 2, at 46-52 (discussing a proposed exclusion for credit funds and claiming that such an exclusion is consistent with Congressional intent); *compare* 2013 Adopting Release*, supra* note 5, at 644 (stating that "the statutory language of section 13 does not support providing an exclusion for venture capital funds from the definition of covered fund") *with* Proposing Release, *supra* note 2, at 60 (stating that "the agencies are proposing to exclude from the definition of 'covered fund' qualifying venture capital funds"); *compare* 2013 Adopting Release*, supra* note 5, at 812-814 (referring to the plain language of the statute as prohibiting any "covered transaction, as defined in Section 23A" of the Federal Reserve Act) (emphasis in original) *with* Proposing Release, *supra* note 2, at 90-99 (claiming that the agencies have authority to permit certain covered transactions, as defined in Section 23A, notwithstanding the statute's plain prohibition on such transactions); c*ompare* 2013 Adopting Release, *supra* note 5, at 765 (requiring banks to count certain parallel investments toward *de minimis* limitations because the agencies "believe that the potential for evasion of these limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors") *with* Proposing Release, *supra* note 2, at 112-120 (describing a proposed rule of construction that would instruct banks that they are not required to count such parallel investments toward the *de minimis* exemptions).

[7] In addition to my concerns about how the proposed changes with respect to venture capital and parallel investments disregard Congressional intent and will increase risk in the banking sector, I note that the agencies' proposal contains a specific provision meant to facilitate greater access to investment services for billionaires. *See* Proposing Release, *supra* note 2, at 74-82 (discussing a new exclusion from the "covered funds" definition for "family wealth management vehicles"). While the provision of such services to billionaires may not present the same level of risk that is typical of certain other covered fund activities, the agencies might better serve the capital markets and the public at large by reallocating staff time and agency resources to facilitate greater access to investment services by Main Street investors and the middle class. Additionally, as my colleague from the Commodity Futures Trading Commission, Commissioner Dan Berkovitz, observed recently, "[t]he aggregate amount of wealth managed by family offices is staggering." *See* Dissenting Statement of Commissioner Dan M. Berkovitz, Rulemaking to Provide Exemptive Relief for Family Office CPOs: Customer Protection Should be More Important than Relief for Billionaires (Nov. 25, 2019). Exempting banks from Volcker Rule compliance with respect to their relationships with such funds creates a significant incentive for banks and their clients to restructure other types of funds in an attempt to fit into this new carve-out.

[8] Proposing Release, *supra* note 2, at 69. Of course, this is what the agencies *must* claim; after all, that is the high bar that Congress set for increasing the range of permissible activities under the Volcker Rule. *See* Section 13(d)(1)(J) of the Bank Holding Company Act, 12 U.S.C. § 1851 (stating that the agencies may expand the list of permissible activities for banking entities "as the [agencies] determine, by rule, . . . would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.").

[9] Interestingly, some industry commenters made apocalyptic predictions about the impact of the Volcker Rule's failure to exclude venture capital funds from the definition of "covered fund." *See, e.g.*, 2013 Adopting Release, *supra* note 5, at 643 ("One commenter argued, therefore that 'preventing banks from investing in venture thus could depress U.S. GDP by roughly 1.5% (or $215 billion annually) and eliminate nearly 1% of all U.S. private sector employment over the long term.'"). The same commenter also argued that the funding gap left by banks' exit from venture capital would not be filled by other market participants. *Id.* It seems, however, that venture capital funds have not suffered from a lack of capital, achieving record investment amounts in both 2018 and nearly matching those amounts in 2019. *See, e.g.*, Pitchbook, 18 Charts to Illustrate US VC in 2018 (Jan. 28, 2019) ("There's no contest for the biggest headline of the in VC: Capital invested surpassed $100 billion for the first time since 2000. The $130.9 billion invested . . . smashed the previous record [from 2000] of $105 billion."); Pitchbook and NVCA, Venture Monitor Q4 2019 (Jan. 13, 2020).

[10] *See, e.g.*, Yuliya Chernova, *WeWork Debacle Highlights the Risks of High Valuations Set by Existing Investors*, Wall St. J. (Oct. 14, 2019) ("SoftBank Group Corp. led WeWork's August 2017 fundraising round at a $20 billion valuation, then another valuing the provider of shared office space at $47 billion in January this year. Now, SoftBank is preparing a financing deal that could value We Co., WeWork's parent, at less than $10 billion, The Wall Street Journal reported, citing people familiar with the matter. The company needs funding to stave off a cash crunch in the wake of a failed effort to go public."); Robert Smith, *WeWork*

Could be the Venture Capital Boom's 'Burning Bed' Moment, Financial Times (Oct. 15, 2019) (In the 1980s, investment banks backed these dubious deals in the belief they could easily flip the debt on to bond investors. Today, venture capital funds chase companies with no immediate path to profitability, believing that public equity markets will buy them at even higher valuations.").

[11] *See, e.g.*, Comment Letter of SIFMA et al. (Feb. 13, 2012), Comment Letter of SVB Financial Group (Feb. 13, 2012); Comment Letter of National Venture Capital Association (Feb. 3, 2012).

[12] 2013 Adopting Release, *supra* note 5, at 642-647.

[13] *Id.* at 644.

[14] *Id.* at 645.

[15] *See* Proposing Release, *supra* note 2, at 65-68. *See also* 17 C.F.R. § 275.203(l)-1 ("Rule 203(l)-1"). Rule 203(l)-1 was adopted prior to the agencies' adoption of the current covered fund provisions in 2013. *See* Final Rule: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Rel. No. 3222 (June 22, 2011) ("VCF Adopting Release"). It is not as though the definition represents new information or a change in circumstances that might warrant revisiting the agencies' determination from 2013.

[16] *See, e.g.*, 2013 Adopting Release, *supra* note 5, at fn. 2066. Interestingly, some industry commenters also made apocalyptic predictions about the impact of the Volcker Rule's failure to exclude venture capital funds from the definition of "covered fund." *See, e.g.*, *id.* at 643 ("One commenter argued, therefore that 'preventing banks from investing in venture thus could depress U.S. GDP by roughly 1.5% (or $215 billion annually) and eliminate nearly 1% of all U.S. private sector employment over the long term.'"). The same commenter also argued that the funding gap left by banks' exit from venture capital would not be filled by other market participants. *Id.* It seems, however, that venture capital funds have not suffered from a lack of capital, achieving record investment amounts in both 2018 and nearly matching those amounts in 2019. *See, e.g.*, Pitchbook, 18 Charts to Illustrate US VC in 2018 (Jan. 28, 2019) ("There's no contest for the biggest headline of the in VC: Capital invested surpassed $100 billion for the first time since 2000. The $130.9 billion invested . . . smashed the previous record [from 2000] of $105 billion."); Pitchbook and NVCA, Venture Monitor Q4 2019 (Jan. 13, 2020).

[17] In an attempt to support today's reinterpretation of Congressional intent, the agencies cite the statements of a number of individual members of Congress. Again, these statements do not reflect new information that would warrant a reconsideration and reversal on the agencies' considered decisions from 2013. At the time of adoption in 2013, the agencies acknowledged those very same statements—*see, e.g.*, 2013 Adopting Release, *supra* note 5, at fn. 2060—in addition to contrary opinions of members of Congress that are notably absent from today's proposal. *See id.* at fn. 2068. *See also* Comment Letter of Senators Jeff Merkley and Carl Levin (Feb. 13, 2012) (responding to questions about whether venture capital should be excluded from the definition of covered funds: "It should not. The statute does not provide for these additional permitted activities. Recent studies have suggested that bank capital makes up only about seven percent of the capital presently in venture capital funds. Basic economics tells us that such capital can be made up from elsewhere in the economy, as capital flows to its most profitable use. In addition, investing in venture capital funds is a high risk activity with significant risk of loss. The vast majority of banks have not traditionally invested in venture capital funds and overall are not major players in the venture capital arena. Rather than investing in venture capital funds, banks can and should issue loans directly to new businesses which they judge creditworthy.").

[18] *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 (2018).

[19] *See, e.g.*, Letter to Dalia Blass, Director, Division of Investment Management, SEC from Bobby Franklin, President and CEO, National Venture Capital Association (Nov. 29, 2018) (calling for changes to the definition of "venture capital fund" include, among others: 1) permitting investment in a broader range of companies; 2) allowing investments in other venture capital funds; 3) flexibility to allow greater borrowing; and 4) investments in initial coin offerings, cryptocurrencies, and other digital assets). A proposal considered during the last Congress would have permitted venture capital funds to engage in more secondary investments, rather than the primary investments currently required under the definition. *See* Developing and Empowering our Aspiring Leaders (DEAL) Act of 2018, S. 3576, 115th Cong. (2018). The Commission has previously highlighted—and the agencies acknowledge in today's proposal—the "critical role this condition played in differentiating venture capital funds from other types of funds, such as leveraged buyout funds." *See* VCF Adopting Release, *supra* note 15, at 24; Proposing Release, *supra* note 2, at 69 and fn. 157. Expanding venture capital funds' ability to hold secondary investments would undermine a key benefit of venture capital funds; rather than providing capital directly to early-stage companies, venture capital funds would instead be providing liquidity to other investors.

[20] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, Section 407 (2010). *See also* Investment Advisers Act of 1940, Section 203(l), 15 U.S.C. § 80b-3.

[21] *See* S. Rep. No. 111-176, at 74-75 (2010) ("The Committee believes that venture capital funds, a subset of private investment funds specializing in long-term equity investment in small or start-up businesses, do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title. Their activities are not interconnected with the global financial system, and they generally rely on equity funding, so that losses that may occur do not ripple throughout world markets but are borne by fund investors alone.").

[22] *Id.* In fact, the agencies selectively quote from the VCF Adopting Release relating to the definition of "venture capital fund" to suggest that these funds will pose lower risks to banks. The Commission was not, however, suggesting that venture capital funds are not speculative or do not present a high level of investment risk. Rather, the Commission was explaining why these funds, on their own, might not present *systemic risk*.

[23] Investment by banks in venture capital funds creates a clear path for the risk of such funds to move into the banking sector and other parts of the public markets. Assuming that the agencies finalize today's proposal in its current form, we should consider whether we can continue to view venture capital funds as somehow disconnected from those markets such that it would justify exempting the advisers from registration.

[24] 2013 Adopting Release, *supra* note 5, at 766.

[25] See *id.* at 765-766.

[26] *See* Section 13(d)(4)(B)(ii) of the Bank Holding Company Act, 12 U.S.C. § 1851 ("[I]nvestments by a banking entity in a hedge fund or private equity fund shall: I) not later than one year after date of establishment of the fund, be reduced . . . to not more than 3 percent of the total ownership interests of the fund; and II) be immaterial to the banking entity . . . but in no case may the aggregate of all the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.").

[27] *See* Proposing Release, *supra* note 2, at 115-116.

[28] In fact, the release specifically acknowledges how today's proposal will aggravate this risk, but suggests that those risks are outweighed by helping banks make such investments on their own balance sheets and touting the quality of the funds alongside which the bank is investing. *See* Proposing Release, *supra* note 2, at 212-213 ("The SEC recognizes that the proposed approach may increase the risk that some banking entities may seek to use parallel investments for the purpose of artificially maintaining or increasing the value of the assets of a fund that is organized and offered by the banking entity. Supporting a fund in such a manner would increase these banking entities' exposures to the fund's assets and would generally be inconsistent with the 2013 rule's restriction on a banking entity guaranteeing, assuming, or otherwise insuring the obligations or performance of such a covered fund . . . In addition to removing impediments for banking entities' otherwise permissible investments, the proposed rule of construction may enable banking entities to make investments alongside a covered fund that will signal the quality of the investment(s) to the banking entities' clients and investors in the fund, and may also help align the incentives of banking entities, and their directors and employees, with those of the covered funds and their investors."). Of course, allowing this would align incentives between banks and their sponsored funds, but those aligned incentives could also exacerbate existing risks with respect to a bank's willingness to bail out such a fund.

[29] *See* Proposing Release, *supra* note 2, at 117. However the release also states that, with the proposed changes, a bank would not be prohibited from having "investment policies, arrangements or agreements to invest alongside a covered fund in all or substantially all of the investments made by the covered fund." *Id.* at 119. The proposal's over-reliance on an ability to determine a bank's "purpose" calls to mind the colorful quote from Jamie Dimon about the Volcker Rule's requirements relating to investment intent: "If you want to be trading, you have to have a lawyer and a psychiatrist sitting next to you determining what was your intent every time you did something." *See* Dan Fitzpatrick & Scott Patterson, *Dimon Applauds Certainty with Final Volcker Rule*, Wall St. J (Dec. 11, 2013). If today's proposal is ultimately adopted, both the industry and the agencies will lose the benefit of a clearer standard and we will instead need to confront how to evaluate a bank's intent.

[30] Proposing Release, *supra* note 2, at 119.

Dissenting Statement, 2020 Volcker Rule Covered Funds Proposal

CFTC Commissioner Rostin Benham

January 30, 2020

I respectfully dissent as to the Commission's decision to propose more revisions to the Volcker Rule. The Volcker Rule, in simple terms, contains two basic prohibitions for banking entities: (1) they may not engage in proprietary trading; and (2) they cannot have an ownership interest in, sponsor, or have certain relationships with a covered fund. Last September, the Commission, along with other Federal agencies[1], approved changes that significantly weakened the prohibition on propriety trading by narrowing the scope of financial instruments subject to the Volcker Rule.[2] Today, the Commission and the other agencies take aim at the second prohibition, and propose to significantly weaken the prohibition on ownership of covered funds. When the agencies approved the changes on proprietary trading in September, the late Paul Volcker himself sent a letter to the Chairman of the Federal Reserve stating that the amended rule "amplifies risk in the financial system, increases moral hazard and erodes protections against conflicts of interest that were so glaringly on display during the last crisis."[3] I can imagine that he would say something very similar about the further changes that we propose today, particularly the erosion of the existing protections regarding conflicts of interest. I fear that, if we continue to roll back the Volcker Rule, we will soon reach a stage where, sadly, there is nothing left.

Footnotes

[1] The Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System,; the Federal Deposit Insurance Corporation; and the Securities and Exchange Commission.

[2] 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).

[3] Jesse Hamilton and Yalman Onaran, "Vocker the Man Blasts Volcker the Rule in Letter to Fed Chair," Bloomberg (Sep. 10, 2019), https://www.bloomberg.com/news/articles/2019-09-10/volcker-the-man-blasts-volcker-the-rule-in-letter-to-fed-chair.

Dissenting Statement, 2020 Volcker Rule Covered Funds Proposal

CFTC Commissioner Dan M. Berkovitz

January 30, 2020

Let's start by calling the Volcker Covered Fund Proposal ("Proposal") what it is: a regulatory rollback.[1] Virtually every change in the Proposal creates a new exclusion from the rules, or eliminates or reduces existing requirements. The changes to the regulations run counter to the statutory purpose of prohibiting banks from owning hedge funds and private equity funds. The Proposal fails to analyze or discuss the risks inherent in the banking activities it would permit. It presents a thin veneer of a rationale for many of the changes that were precipitated by complaints from the banking industry. The agencies should be making reasoned decisions to improve the effectiveness of the regulations for the purposes mandated by Congress, not implementing industry-driven rollbacks. I therefore dissent.

The general purpose of the Volcker Rule is to eliminate excessive risk taking by banks that enjoy the benefits of U.S. taxpayer support while still preserving their ability to undertake banking activities that serve the public interest.[2] The covered fund provisions are intended to prevent banking entities from circumventing the proprietary trading prohibition in the Volcker rule through covered fund investments and limit bank involvement in covered funds so that the banks are not expected to bail out the funds if they lose money.[3]

While a few of the proposed changes are consistent with this statutory purpose because they correct unintended consequences from the original regulation, the Proposal goes much further than reasonably necessary and appears to create substantial loopholes without effectively analyzing the potential risks. There is no quantitative analysis of those risks. The rationales provided to support these rollbacks are qualitative, legalistic, and summary in nature. They purport to provide "clarity," allow banks to "diversify" investments, or improve bank competitiveness—none of which advance the goals articulated by Congress.

I am concerned that the proposed changes, along with the other regulatory reductions implemented in the proprietary trading provisions of the Volcker regulations in November 2019,[4] may together substantially reduce the safety measures instituted in the Dodd-Frank Act. Are the large banks that are subject to Volcker profitable? Definitely. Are the banks less competitive as compared to their international competitors? No.[5] Do we need to give them more rein to take on more risk? A case for that has not been made. I fear that we are putting the United States taxpayer at risk of once again bailing out the banks when we as regulators fail to take a reasoned, thoughtful approach; one that seeks to reach an appropriate balance of free markets with regulatory guard rails for risk-taking. After all, the banks that are subject to the Volcker regulations are insured by the FDIC and/or have access to Federal Reserve Bank support. We should have a say in the risks they take when the U.S. taxpayer is standing behind them.

Specific Changes of Concern

Much of the Proposal addresses regulations that will not impact, or will have only indirect impacts on, the CFTC's core mandate to regulate the derivatives markets. Nonetheless, I cannot vote in favor of proposed regulations that are presented to this agency for review that broadly fail to follow congressional intent—limiting risky behavior by banks connected with hedge funds and private equity funds.

The Proposal states: "The proposed rule is intended to improve and streamline the covered fund provisions and provide clarity to banking entities so that they can offer financial services and engage in other permissible activities in a manner that is consistent with the requirements of section 13 of the BHC Act."[6] This benign façade masks the true purpose and effect of the Proposal, which is a regulatory rollback. It adds five new, substantive exclusions from covered funds regulation;[7] expands three existing and significant exclusions; reduces what constitutes "ownership" in a covered fund in numerous ways; and significantly reduces limitations on banking relationships with covered funds.

The Volcker covered fund provisions could benefit from tailored revisions to fix some unintended consequences. The so called "super 23A" provisions restrict regular bank clearing activities for certain covered funds for which an affiliate provides services, such as investment management. Clearing services are not risk-taking activities. As another example, the existing regulations inadvertently convert some foreign covered funds into banking entities subject to the entire rule set when the statute intended to exclude those activities if they take place outside the United States. The Proposal would properly address these issues. Unfortunately, it also goes much further in proposing regulatory reductions without careful consideration of the risks involved.

I will discuss three particular provisions to illustrate my concerns. First, the Proposal would exclude "venture capital funds" from the covered funds definition with some minor limitations that are not based on the risks involved. The Proposal acknowledges that, as stated in the final release for the current Volcker regulations, venture capital funds are private equity funds. The Proposal states that the venture capital fund exclusion is based in part on several statements by members of Congress regarding venture capital funds. However, a close reading of the four statements cited in the Proposal shows that three of the four do not call for a complete exclusion of venture capital funds. Congress could have excluded venture capital funds if that were the intent. It did not.

The justification for the broad venture capital fund exclusion is flimsy. The Proposal asserts the exclusion could "promote and protect the safety and soundness of banking entities and the financial stability of the United States" by allowing banks to "diversify their permissible investment activities."[8] Unfortunately, virtually no analysis or information is provided as to whether such "diversification" is in fact a good thing. Allowing banks to invest in anything and everything would greatly increase diversification, but that absurd approach would not likely protect the safety and soundness of banks or our financial system.

A simple Google search reveals data indicating that venture capital investments historically have been high risk. One study found that about 75% of venture capital-backed firms in the United States did not return capital to investors.[9] A 2013 article in the Harvard Business Review noted that "VC funds haven't significantly outperformed the public markets since the late 1990s, and since 1997 less cash has been returned to VC investors than they have invested."[10] The author goes on to note that "[v]enture capital investments are generally perceived as high-risk and high-reward. The data in our report reveal that although investors in VC take on high fees, illiquidity, and risk, they rarely reap the reward of high returns." Although venture capital performs an important function in providing capital to new technologies, and has been critical in boosting our economy and global competitiveness, I do not think we should be permitting such investments by banks backed by U.S. taxpayers *without* analyzing the risks involved.

The Proposal would add another new exclusion from covered fund regulation for "customer facilitation vehicles." This exclusion is concerning because it is not well defined and could potentially become an end run around the Volcker rule. In effect, a bank could be the counterparty for the instruments in the vehicle sold to customers and thereby take on substantial risks permitted as a result of the exclusion. These risks are not addressed in the Proposal.

The Proposal states that such funds or "vehicles" would be used to facilitate customer needs. The brief example given is of accommodating a bank customer that wants to purchase structured notes issued through a vehicle, not the bank, "for certain legal, counterparty risk management, or accounting reasons specific to the customer."[11] However, unlike the "credit fund exclusion," which limits the assets that may be held in such funds, the Proposal has no restrictions as to what instruments can be in the vehicle and whether the banking entity can be the counterparty for those instruments. A portfolio of complex derivatives or synthetic "investments" could be placed in the vehicle with the bank taking the other side of the trades.

Furthermore, the Proposal acknowledges that the so called "customer facilitation" vehicles can in fact be ginned up by the banks themselves and that "marketing" the vehicles to the customers is not restricted. In effect, a bank could now create a fund of investments that it wants to hold, put the underlying instruments into a "vehicle" and then market the other side of the investments to customers in the form of security ownership in the vehicle. This exclusion has the potential to create a large loophole for creative bankers to exploit.

Finally, there is a special exclusion created for billionaires: the new "Family Wealth Management Vehicles" exclusion. This provision would exclude so called "family offices" from Volcker covered funds regulation. Unlike the prior two examples, this exclusion is not likely to materially increase undesirable risk taking by banks.[12] Rather, it is concerning because it allows banks and wealth vehicles to avoid Volcker compliance. In my view, wealth vehicles for ultra-wealthy individuals do not need special regulatory relief.

As I noted recently in a statement opposing family office exemptions from several CFTC rules, family offices are not used by ordinary families who may have a modest degree of wealth. Rather, the extraordinarily wealthy—including hedge fund operators, bankers, and super wealthy entrepreneurs—create these organizations to preserve, grow, and pass on their wealth to their descendants.[13] According to the Global Family Office Report 2019, "[t]he average family wealth of those surveyed for this report stands at USD 1.2 billion, while the average family office has USD 917 million in [assets under management]."[14] The aggregate amount of wealth managed by family offices is staggering. By one estimate, the total assets under management by family offices is over $4 trillion, and the number of family offices has grown ten-fold in the last decade.[15] A recent Forbes article noted that "[f]amily offices are now capable of making transactions that were traditionally reserved for big companies or private-equity firms and therefore are becoming a *disruptive force in the market-place*."[16]

Furthermore, there are indications that family offices for U.S. persons may be located in offshore tax havens to avoid paying U.S. taxes.[17] Financial regulators should not provide special and favorable regulatory treatment to benefit those who seek to avoid paying their fair share of U.S. taxes.

Conclusion

The Volcker Rule and related regulations are complicated. The regulations deserve careful, reasoned reassessment to maintain their effectiveness. Unfortunately, the Proposal is neither reasoned nor careful. It ignores the risk-reducing public policy for the Volcker rule and effectively acknowledges the fact that this rollback is driven by complaints from the very banks the rule is intended to make safer. No effort is made to assess the risks that the Proposal will now allow banks to assume. I cannot support the proposed changes to the Volcker rule because they do not conform to the statutory mandate for the rule and the Proposal does not carefully analyze the effect of the changes on the safety and soundness of our financial system. I therefore dissent.

Footnotes

[1] "Rollback" is defined as "reduc[ing] (something, such as a commodity price) to or toward a previous level on a national scale." https://www.merriam-webster.com/dictionary/rollback.

[2] *See* Statement of Sen. Dodd, 156 Cong. Rec. S6242 (July 26, 2010) ("The purpose of the Volcker rule is to eliminate excessive risk taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest.").

[3] The classic example of this risk is the collapse of two Bear Stearns-sponsored hedge funds in 2007. Bear Stearns provided loans intended to shore up two Cayman Islands hedge funds established by Bear Stearns. Bear Stearns was not legally obligated to back the funds financially, but as a business matter, it felt compelled to support them because of its sponsorship of the funds. Those actions were part of a chain of events that eventually led to the fire sale of Bear Stearns to J.P. Morgan in March 2008. To entice J.P. Morgan to buy a distressed Bear Stearns, the Federal Reserve System provided financial support for the purchase. *See* Reuters, *Timeline: A dozen key dates in the demise of Bear Stearns* (Mar. 17, 2008), available at https://www.reuters.com/article/us-bearstearns-chronology/timeline-a-dozen-key-dates-in-the-demise-of-bear-stearns-idUSN1724031920080317.

[4] 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).

[5] U.S. banks are the strongest in the world. The recent Global League Tables ranking global banks by amount of banking business activity shows that three or four U.S. banks are in the top five banks in almost every category, including for banking business in foreign markets. *See* GlobalCapital.com, Global League Tables, available at https://www.globalcapital.com/data/all-league-tables.

[6] Proposal, section II.

[7] While the Proposal lists four exclusions, the parallel investments permission is, in effect, an exclusion from regulation.

[8] Proposal, section III.C.2.

[9] Deborah Gage, *The Venture Capital Secret: 3 out of 4 Start-Ups Fail*, Wall Street Journal (Sept. 20, 2012), (citing research by Shikhar Ghosh, a senior lecturer at Harvard Business School), available at https://www.wsj.com/articles/SB10000872396390443720204578004980476429190.

[10] Diane Mulcahy, *Six Myths About Venture Capitalists*, Harvard Business Review (May 2013), available at https://hbr.org/2013/05/six-myths-about-venture-capitalists.

[11] Proposal, section III.C.4.

[12] The Proposal would only allow a de minimis investment in such vehicles by banking entities.

[13] Registration and Compliance Requirements for Commodity Pool Operators (CPOs) and Commodity Trading Advisors: Family Offices and Exempt CPOs, 84 FR 67355, 67369 (Dec. 10, 2019). According to one guide to family offices:
[T]he modern concept of the family office developed in the 19th century. In 1838, the family of financier and art collector J.P. Morgan founded the House of Morgan to manage the family assets. In 1882, the Rockefellers founded their own family office, which is still in existence and provides services to other families.
EY Family Office Guide, *Pathway to successful family and wealth management*, at 4, available at https://www.ey.com/en_us/tax/family-office-advisory-services.

[14] Campden Research and UBS, *The Global Family Office Report 2019*, at 10, available at https://www.ey.com/en_us/tax/family-office-advisory-services.

[15] Francois Botha, *The Rise of the Family Office: Where Do They Go Beyond 2019?*, Forbes (Dec. 17, 2018), available at https://www.forbes.com/sites/francoisbotha/2018/12/17/the-rise-of-the-family-office-where-do-they-go-beyond-2019/#426044f55795.

[16] *Id* (emphasis added).

[17] Kirby Rosplock, The Complete Family Office Handbook, A Guide for Affluent Families and the Advisors Who Serve Them, at 5 (Bloomberg Press 2014).

Dissenting Statement, 2020 Volcker Rule Covered Funds Proposal

Federal Reserve Board Governor Lael Brainard

January 30, 2020

The purpose of the Volcker rule is to limit banks' exposure to speculative trading activity and risky funds so they do not again put taxpayer funds at risk. I have previously supported exempting community banks from the Volcker rule, and I support today's proposal to address the inadvertent treatment of foreign funds as banking entities under the Volcker rule. However, I am concerned that several of the proposed changes will weaken core protections in the Volcker rule and enable banking firms again to engage in high-risk activities related to covered funds.

The proposal opens the door for firms to invest without limit in venture capital funds and credit funds.[1] The proposal suggests that these funds do not raise concerns about banks' involvement in risky activity that the Volcker rule was intended to address. To the contrary, it is clear why Congress legislated the Volcker rule to limit these activities.

Some credit funds played a material role in the financial crisis. These funds were not transparent in their activities, misled investors, and contributed to the financial abuses Congress intended to address in passing the Dodd-Frank Act.

Venture capital funds are a type of private equity fund. As such, they pose similar risks. The agencies determined in 2013 that excluding venture capital funds from the definition of covered funds is not supported by the statutory language. I don't see the basis for excluding venture capital funds. The proposal also asks whether to carve out from the Volcker rule's restrictions on private equity funds those private equity funds that pursue a long-term investment strategy. Such an exclusion would be inconsistent with the statute.

Congress put in place strong protections around these types of funds to mitigate the risks posed by hedge funds and private equity funds. I see no change in the statute or in the nature of these activities that would call for weakening those protections.

With regard to congressional intent, it is notable that Congress amended the Volcker rule two years ago and chose not to make any of today's proposed changes. Congress chose not to add an exclusion for venture capital funds, credit funds, family wealth funds, or customer facilitation funds or to expand any of the existing exclusions.

Finally, pursuant to the 2013 rule, the regulators were clear that a banking entity could not evade the Volcker rule's fund investment limits by creating a "synthetic" interest in a sponsored covered fund. This was intended to address the risk that a bank making side investments alongside a sponsored fund—and telling fund investors about this side investment—would have strong incentives to "bail out" the fund if it got into trouble. Today's proposal would reverse that restriction. Not only would today's proposal give banking firms the green light to exclude parallel investments from the statutory limits on covered fund investments, but it would also explicitly allow them to market the covered fund on the basis of the parallel investments.

For these reasons, I do not support the proposal.

I am supportive of the proposal to address the unintended application of the Volcker rule to certain funds organized outside of the United States and offered to foreign investors, known as foreign excluded funds. While these funds are not "covered funds" under the rule, if they are controlled by a foreign banking entity, they have been found to be subject to the rule as "banking entities" in certain circumstances. Given the limited nexus to the United States, it is appropriate to exempt them, consistent with the "no-action" relief currently provided by the banking agencies.

I appreciate all the work that has gone into today's proposal, and I look forward to public comments.

Footnotes

[1] These are funds that may be leveraged and invest in debt instruments.

Dissenting Statement, 2020 Volcker Rule Covered Funds Proposal

FDIC Board of Directors Member Martin J. Gruenberg

January 30, 2020

Introduction

The Notice of Proposed Rulemaking (NPR) before the FDIC Board today would severely weaken the Volcker Rule restrictions[1] on bank investments in, and relationships with, hedge funds and private equity funds -- typically referred to as "covered fund" activities in the Rule.

This is a highly technical proposal with serious consequences for the safety and soundness of the financial system. The proposal would allow the largest, most systemically important banks and bank holding companies once again to engage in investments and relationships with high risk funds that resulted in large losses, and contributed to the failure or near failure of large financial firms in the 2008-2009 financial crisis.[2] For that reason, I will vote against this proposed rule.

Paul Volcker explained the reason for a restriction on covered funds in the Dodd-Frank Act in Congressional testimony, "The basic point is that there has been, and remains, a strong public interest in providing a 'safety net' - in particular, deposit insurance and the provision of liquidity in emergencies - for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds - taxpayer funds - protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions."[3]

Then Deputy Treasury Secretary Neal Wollin also addressed this issue in Congressional testimony, "Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis.

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1 Section 13 of the Bank Holding Company Act of 1956 (12 U.S.C. 1851), added by section 619 of the Dodd-Frank Act.

2 Widely reported examples include Bear Stearns and Goldman Sachs. See *Bear Stearns in $3.2 billion bailout of fund, at* https://www.nytimes.com/2007/06/23/business/worldbusiness/23iht-bear.1.6295771.html; *$3.2 Billion Move by Bear Stearns to Rescue Fund,* https://www.nytimes.com/2007/06/23/business/23bond.html; *Goldman Sachs hedge fund gets $3 billion bailout,* USA Today, Aug. 14, 2007, at https://abcnews.go.com/Business/story?id=3475241&page=1; and Goldman and Investors to put $3 billion into fund, at https://www.nytimes.com/2007/08/13/business/13cnd-goldman.html. See also *Did Connected Hedge Funds Benefit from Bank Bailouts During the Financial Crisis?,* Journal of Banking and Finance (July 26, 2019), by Robert W. Faff, University of Queensland, Jerry T. Parwada, UNSW Australia Business School, School of Banking and Finance, and Eric K. M. Ta, University of Queensland - Business School, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1493004; and *The Financial Crisis Inquiry Report*, submitted by The Financial Crisis Inquiry Commission pursuant to Public Law 111-21 (January 2011), Chapters 12-13.

3 Sen. Rep. No. 111-176 (April 30, 2010) at 91 (in which the Committee on Banking, Housing, and Urban Affairs considered S. 3217, which incorporated the Volcker Rule and served as a basis for section 619 of the Dodd-Frank Act, and which cited the contribution made by former Federal Reserve Chairman Volcker.)

Some of these firms 'bailed out' their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most. The complexity of owning such entities has also made it more difficult for the market, investors, and regulators to understand risks in major financial firms, and for their managers to mitigate such risks."[4]

Last year, the Federal financial regulatory agencies responsible for the Volcker Rule adopted a final rule that effectively undid the restriction on proprietary trading in banks and bank holding companies.

Today's proposed rule would severely weaken the other major provision of the Volcker Rule restricting insured bank investments in, and relationships with, hedge funds and private equity funds in several ways.

First, it would weaken important safety and soundness constraints in the current rule imposed on covered fund activities through Section 23A of the Federal Reserve Act. Second, it would also weaken limitations on parallel investments by banks and their affiliates in the same assets as the covered fund. Third, it would allow permissible loan securitizations to include up to five percent of assets in risky non-loan assets. Finally, it would add two new exclusions to the prohibition on covered funds for credit funds and venture capital funds, both of which appear to be inconsistent with the purpose of the statute. I will discuss each of these weakening changes in turn.

Section 23A of the Federal Reserve Act

Section 23A of the Federal Reserve Act and its implementing regulation, Regulation W, permit certain defined covered transactions between a bank and its affiliates, such as loans, purchases of securities, or guarantees, subject to quantitative limits and other restrictions.[5] Section 23A and Regulation W also contain exemptions from those restrictions for banks and their affiliates.

In contrast, Section 13(f) of the Bank Holding Company Act, the Volcker Rule, expressly prohibits a bank or its affiliate from entering into a transaction with a related hedge fund or private equity fund that would be a covered transaction under Section 23A.[6] This statutory prohibition was implemented by the final 2013 Volcker Rule regulation.

In addition, the 2013 final Volcker Rule regulation did not make available to bank-related hedge funds or private equity funds exemptions from the Section 23A restrictions available to banks and their affiliates under the Federal Reserve Act and Regulation W.[7] [8] These additional restraints have come to be referred to as "Super 23A".

Its purpose is to carry out what is perhaps the central objective of the covered funds provision of the Volcker Rule -- to prevent bank bailouts of related hedge funds and private equity funds.

Today's proposed rule would fundamentally weaken the prohibitions under Super 23A.

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4 Sen. Rep.at 92.

5 12 U.S.C. 371c, which applies to insured State nonmember banks and thrifts to the same extent as if they were member banks under 12 U.S.C. 1828(j) and 12 U.S.C. 1468(a). 12 CFR Part 223.

6 12 U.S.C. 1851(f)(1) and 12 U.S.C. 371c(b)(7).

7 12 U.S.C. 371c(d); 12 CFR 223.42.

8 79 Fed. Reg. 5536, 5746 (Jan. 31, 2014).

First, banks and their affiliates would be allowed to enter into currently-prohibited covered transactions with a related hedge fund or private equity fund such as purchasing assets and engaging in intra-day extensions of credit.

Second, the NPR would add a new exemption for Volcker Rule purposes to allow banks and their affiliates to enter into short-term extensions of credit with a related hedge fund and private equity fund. Each extension of credit would have to be in the ordinary course of business in connection with payment transactions, settlement services, or futures, derivatives, and securities clearing.

These dealings would be free from the quantitative limits, collateral requirements, and low quality asset prohibitions under section 23A.[9]

This change to allow extensions of credit and asset purchases would provide an avenue for banks to support related covered funds in times of stress, despite the explicit statutory prohibition against a banking entity, directly or indirectly, guaranteeing, assuming, or otherwise insuring the obligations or performance of a related hedge fund or private equity fund.[10]

The covered funds provisions of the Volcker Rule were aimed at preventing the types of investments and relationships that, during the crisis, led banks to bail out their affiliated funds, caused large losses, and triggered unprecedented government support. This proposed change would significantly undermine that objective.

Parallel Investments

In a similar vein, this proposal would amend the 2013 final Volcker Rule regulation to expressly permit a bank to make an investment alongside an investment made by a related covered fund -- described as "parallel investments" or "co-investments."

The 2013 final regulation requires that a bank, including through any of its affiliates, hold no more than three percent of the total ownership interest of a covered fund organized and offered by that bank and, in the aggregate of all ownership interests of all covered funds, no more than three percent of tier 1 capital.

The preamble to the 2013 final regulation raised concerns about the potential for evasion of those limits and stated that, "if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investment shall be included for purposes of determining the value of the banking entity's investment in the covered fund."[11]

Today's proposal would reverse the approach from 2013 and would expressly provide that a bank and its affiliates would not be required to include any parallel investment in the calculation of the three percent investment limits, and would not be restricted in the amount of any parallel investment. Moreover, based on the discussion in the preamble, the bank would be permitted to market the covered fund based on its parallel investment.[12]

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9 Preamble to the NPR at 96-99; proposed section __.14 of the regulatory text.

10 12 U.S.C. 1851(d)(1)(G)(v). These activities would continue to be subject to the statutory limitations in the Volcker Rule relating to material conflicts of interest, material exposures to high-risk assets or trading strategies, safety and soundness, and U.S. financial stability. 12 U.S.C. 1851(d)(2). See also 12 CFR 351.15.

11 Preamble to the NPR at 112-114; see also 79 FR 5734.

12 Preamble to the NPR at 119.

This change would permit a major circumvention of the Volcker Rule's restrictions on bank ownership of hedge funds and private equity funds.

Credit Funds

The proposed rule also would exclude "credit funds" from the definition of covered funds.

This newly-defined fund would be permitted to hold a broad array of credit instruments, some of which played significant roles in the financial crisis. In addition to loans, the fund could hold debt instruments, certain rights and other assets related to acquiring, holding, servicing, or selling loans or debt interests (including equity securities); and interest rate or foreign exchange derivatives related to the foregoing. To be clear, these could include any related synthetic or derivative exposure, as well as collateralized debt obligations (CDOs), which were major contributors to the financial crisis.

To qualify for the exclusion, a credit fund issuer could not engage in proprietary trading or issue asset-backed securities, and could not guarantee the fund. In addition, a bank that acts as a sponsor, investment adviser, or commodity trading advisor would have to provide certain disclosures and comply with the statutory conflict of interest, high-risk strategy, safety and soundness, and financial stability provisions.

However, given the recent changes greatly weakening the proprietary trading rules, as well as the proposed changes to Section 23A and parallel investments, the value of these presumed protections is highly questionable.

Non-Loan Assets in Securitizations

It is also worth noting that the 2013 final Volcker Rule regulation allowed a covered fund exclusion for loan securitizations. Today's proposed rule, however, would allow loan securitization vehicles to hold up to five percent in non-loan assets. This is clearly inconsistent with the statute, which specifically addressed loan sales and securitizations in a rule of construction as follows, "Nothing in this section shall be construed to limit or restrict the ability of a banking entity … to sell or securitize **loans** in a manner permitted by law."[13]

In the preamble to the 2013 final regulation, the agencies declined to expand the definition of "loan" and explicitly excluded loans that are securities and derivatives because trading in those instruments is expressly included in the statute's definition of proprietary trading.[14] Moreover, the agencies expressed concerns about the potential for evasion and concluded that the definition of loan for securitization purposes in the 2013 final regulation "appropriately encompasses the financial instruments that result from lending money to customers."[15]

The proposal to expand beyond the current definition would also re-introduce the types of financial instruments and risks that contributed to the financial crisis.

Venture Capital Funds

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13 12 U.S.C. 1851(g)(2) (emphasis added).

14 Preamble to the 2013 final regulation, 79 Fed. Reg. at 5688.

15 Id. at 5689.

The proposed rule would establish an exclusion from the definition of "covered funds" for "qualifying venture capital funds". While some have argued in favor of such an exclusion since enactment of the Volcker Rule, the Agencies are constrained by the statute. As described in the preamble to the 2013 final Volcker Rule regulation, "The Agencies believe that the statutory language of section 13 does not support providing an exclusion for venture capital funds from the definition of covered fund."[16]

To justify the proposed change, the preamble to the proposed rule relies on a 2011 Securities and Exchange Commission rulemaking defining venture capital fund for purposes of the Investment Advisers Act of 1940, distinguishing it from private equity funds.[17]

However, this issue was explicitly addressed in the preamble to the 2013 Volcker Rule regulation:

> Congress explicitly recognized and treated venture capital funds as a subset of private equity funds in various parts of the Dodd-Frank Act and accorded distinct treatment for venture capital fund advisers by exempting them from registration requirements under the Investment Advisers Act. This indicates that Congress knew how to distinguish venture capital funds from other types of private equity funds when it desired to do so. No such distinction appears in section 13 of the BHC Act. Because Congress chose to distinguish between private equity and venture capital in one part of the Dodd-Frank Act, but chose not to do so for purposes of section 13, the Agencies believe it is appropriate to follow this Congressional determination.[18]

The preamble to today's proposed rule further cites section13(d)(1)(J) of the Bank Holding Company Act, which authorizes the agencies to permit under the Volcker Rule other activities that "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."[19]

An exclusion from the Volcker Rule based on an assumption that qualifying venture capital funds could allow banking entities to diversify their permissible investment activities and thereby "could promote and soundness of banking entities and the financial stability of the United States", as is asserted in the preamble,[20] is questionable. It ignores both the experience of the financial crisis and the purpose of the Volcker Rule to limit high-risk investments by banks and the extension of the safety net. It also could be a slippery slope to justify exclusions from other prudential protections.

The statutory language has not changed in the intervening years. It should be left to Congress to address how venture capital funds should be treated under the Volcker Rule.

Conclusion

The proposed rule goes far beyond streamlining or clarifying the covered fund provisions of the Volcker Rule as asserted in the preamble.[21] It would severely weaken the restrictions on relationships between

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16 Id. at 5704.

17 Preamble to the NPR at 60-66(referencing SEC Final Rule: Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets under Management, and Foreign Private Advisers, 76Fed. Reg. 39646 (July 6, 2011)).

18 Preamble to the 2013 final regulation, 79 Fed. Reg. at 5704.

19 12 U.S.C. 1851(d)(1)(J). See Preamble to the NPR at 69-70.

20 Preamble to the NPR at 69-70.

21 Preamble to the NPR at 14.

banks and covered funds. It would reintroduce the types of high-risk investments and activities that contributed to the financial crisis. For this reason, I will vote against the proposed rule.