BETTER MARKETS

– FACT SHEET –

The Hastily Proposed Covered Funds Proposal Would Permit, If Not Invite, Indirect Speculative Proprietary Trading

On April 1, 2020, Better Markets filed a comment letter on a proposal relating to so-called "Covered Funds" investments under the Volcker Rule's prohibition on proprietary trading ("Covered Funds Proposal"). The Covered Funds Proposal was hastily issued by the Board of Governors for the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the "Agencies") on February 28, 2020. Our brief comment letter on the Covered Funds Proposal can be accessed here.

The Volcker Rule's Covered Funds provisions are intended to limit speculative investments in hedge funds and private equity funds, as well as similar types of private funds, and to prevent avoidance or evasion of banking entities' proprietary trading restrictions and prohibitions. **The Volcker Rule was designed to limit speculative investments and to prevent both direct, inside-of-the-bank proprietary trading and indirect, outside-of-the-bank proprietary trading accomplished through investments in Covered Funds**.

Several proposed provisions appear to disregard these fundamental purposes and to instead facilitate, if not invite, speculative investments through new exclusions (or expanded existing exclusions) and revised definitions and guidance. For example, the Agencies propose four new conditional exclusions for categories of private funds that otherwise would (or might) be considered Covered Funds subject to the Volcker Rule's restrictions and prohibitions on indirect proprietary trading:

- **Credit Funds Exclusion:** The proposal would exclude funds whose assets consist solely of loans, debt securities, rights or assets related to permissible loans or debt securities, and interest rate and foreign exchange derivatives if the written terms directly relate to and reduce risks related to permissible investments. While the Agencies condition this new proposed exclusion in these and other important ways, our comment letter questioned the need for any such new exclusion and recommended that the Agencies substantially narrow the potential scope of the new exclusion.

- **Venture Capital Funds:** The proposal would exclude certain funds that, among other things, (1) meet the definition of "venture capital funds" under SEC Rule 203(l)-1 and represent to investors that they pursue a venture capital strategy, (2) primarily invest in securities of qualifying portfolio companies, (3) limit investors' withdrawal rights, and (4) limit their use of leverage. Like the Credit Funds Exclusion, the Agencies condition this new proposed exclusion in important ways. However, we are not convinced that a new categorical exclusion for high risk, venture capital investments is necessary, and the Agencies provide little more than general, conclusory statements to support such an exclusion.

  In this regard, we encouraged the Agencies to review the often cited, and most often misleadingly cited, statement of U.S. Senator Chris Dodd relating to venture capital funds, which focused on eliminating excessive risk taking by banking entities, while "preserving safe, sound investment activities that serve the public interest" through "properly conducted" venture capital investments that would "not cause the harms at which the Volcker [R]ule is directed." The Agencies proposed to address some of Senator Dodd's concerns. However, the Agencies must (1) restrict all fund investments to "qualifying investments" or at least very significantly restrict investments in non-"qualifying investments" (e.g., limit them to no more than five percent of the fund's aggregate capital), (2) impose a minimum securities holding period and portfolio company revenue limitation of $35 million (or a similarly appropriate and low figure) to ensure the fund is truly focused on medium-to-long term venture (as opposed to growth stage) investments, and (3) quantitatively limit the use of leverage as a key means for distinguishing excluded venture capital funds from statutorily prohibited activities involving private equity funds.

- **Family Wealth Management Vehicles:** The proposal would conditionally exclude funds that do not hold themselves out as raising money from investors primarily for the purpose of investing in securities for resale or disposition or otherwise trading in securities. The proposed exclusion would further require a trust vehicles to have grantors that are all family customers and non-trust vehicles be owned solely by family customers and no more than three closely related persons of such family customers. We question the Agencies' use of scarce resources to prioritize special new regulatory exclusions for trusts and other investment vehicles used solely by a few of the very wealthiest American families in the middle of a pandemic and economic crisis causing massive losses of wealth, jobs, and lives.

- **Customer Facilitation Funds:** The proposal would exclude funds that facilitate transactions between a banking entity and a customer (including one or more affiliates of such customer). This proposed exclusion appears intended to permit banking entities to accept risk exposures through an expansive array of structured finance and synthetic special purpose vehicles providing customers exposures related to any "transaction, investment strategy, or other service provided by the banking entity." The new proposed exclusion would permit, if not encourage, banking entities to increase risk exposures through funds at a time when the Agencies should be most concerned about simplifying such exposures and ensuring responsible risk monitoring and risk management. Structured transactions facilitated through one-off "customer facilitation" vehicles contravene all of these goals. Moreover, the proposed exclusion appears to encourage banking entities to actively market structured transactions through such vehicles (with no limitation that customers initiate transactions, an extremely minimal formality applicable in other contexts). In these and other respects, the proposal apparently does far too little to address indirect proprietary trading and confine the exclusion.

Through these new proposed exclusions, the proposal opens a number of potential avenues for banking entities to avoid the Volcker Rule's statutory restrictions and prohibitions on investments in Covered Funds and indirect proprietary trading. Unfortunately, the above four new exclusions are just the tip of the iceberg. The new exclusions merely supplement additional and equally concerning elements of the proposed rulemaking, including revised and newly expanded guidance, definitions, and exclusions relating to foreign public funds, loan securitizations, small business investment companies, qualifying foreign excluded funds, ownership interests, Super 23A restrictions, and the so-called "parallel investment" exclusion. Each of these elements of the Agencies' proposal has significant implications for the effectiveness of the Covered Funds restrictions and prohibitions

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