

Joint Venture Exclusion for Covered Funds

15. May an issuer that would be a covered fund rely on the joint venture exclusion from the definition of covered fund under § 351.10(c)(3) of the final rule?

Posted: 6/12/2015

Section 351.10(c)(3) of the final rule provides that a covered fund does not include a joint venture between a banking entity or any of its affiliates and one or more unaffiliated persons, provided that the joint venture:

- Is comprised of no more than 10 unaffiliated co-venturers;
- Is in the business of engaging in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and
- Is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

As explained in the preamble to the final rule, one of the purposes of section 13 of the Bank Holding Company Act (“BHC Act”) is to limit investment and sponsorship activities of banking entities in hedge funds and private equity funds, which section 13 of the BHC Act generally defines as entities that rely on certain specified exclusions in the Investment Company Act of 1940.¹ The final rule defines hedge funds and private equity funds collectively as “covered funds.”² The preamble to the final rule explains that the definition of covered fund focuses on the types of entities formed for the purpose of investing in securities or derivatives for resale or other trading activity that are not subject to all of the securities law protections applicable to funds that are registered with the SEC as investment companies. A joint venture that qualifies for the joint venture exclusion in the final rule, however, is excluded from the definition of covered fund.

The conditions to the joint venture exclusion reflect that the exclusion is designed to be used by a banking entity to conduct businesses and operations in conjunction with a limited number of co-venturers and that the exclusion is not intended to include entities that invest in securities for resale or other disposition. Similarly, the exclusion would not apply to entities or arrangements that raise money from investors primarily for the purpose of investing in securities for the benefit of one or more investors and sharing the income, gain or losses on securities acquired by that entity. The limitations in the joint venture exclusion are meant to ensure that the joint venture is not an investment vehicle and that the joint venture exclusion is not used as a means to evade the limitations in the BHC Act on investing in covered funds.³

This exclusion is not met by an issuer that raises money from a small number of investors primarily for the purpose of investing in securities, whether the securities are intended to be traded frequently, held for a longer duration, held to maturity, or held until the dissolution of the entity. The exclusion also is not met by an entity that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities merely because one of the purposes for establishing the vehicle may be to provide financing to an entity to obtain and hold securities. As the preamble explains, the exclusion is designed to allow a banking entity to more efficiently manage the risks of its banking operations by, for example, seeking to obtain or share complementary business expertise. The conditions imposed on the exclusion are specifically intended to prevent the exclusion from being used as a vehicle to raise funds from investors primarily for the purpose of profiting from investment activity in securities for resale or other disposition or otherwise trading in securities.⁴ Thus, for example, a vehicle that raises funds from investors primarily for the purpose of sharing in the benefits, income, gains or losses from ownership of securities – as opposed to conducting a business or engaging in operations or other non-investment activities – would be raising money from investors primarily for the purpose of “investing in securities,” even if the vehicle may have other purposes.⁵

¹ See, e.g., *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 FR 5536 (Jan. 31, 2014) at 5670-5671.

² The final rule generally defines the term “covered fund” to include certain funds that rely on § 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940; certain commodity pools as defined in section 1a(10) of the Commodity Exchange Act; and certain foreign funds. See § 351.10(b)(1) of the final rule.

³ The joint venture exclusion is subject to conditions, as noted above. As an initial matter, the entity seeking to rely on the exclusion must be a joint venture. While the term “joint venture” is not defined separately in the final rule, the Agencies’ staffs note that the basic elements of a joint venture are well recognized, including under state law. Although any determination of whether an arrangement is a joint venture will depend on the facts and circumstances, the Agencies’ staffs generally would not expect that a person that does not have some degree of control over the business of an entity would be considered to be participating in “a joint venture between a banking entity or any of its affiliates and one or more unaffiliated persons” as specified in § 351.10(c)(3) of the final rule.

⁴ See 79 FR 5536 at 5680-82.

⁵ See, e.g., 79 FR 5536 at 5681 (stating that the limit on the number of co-venturers “allows flexibility in structuring larger business ventures without involving such a large number of partners as to suggest the venture is in reality a hedge fund or private equity fund established for investment purposes” and that “[t]he Agencies will monitor joint ventures—and other excluded entities—to ensure that they are not used by banking entities to evade the provisions of section 13”; also stating that “[t]he final rule’s requirement that a joint venture not be an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities prevents a banking entity from relying on this exclusion to evade section 13 of the BHC Act by owning or sponsoring what is or will become a covered fund”).