

DATE: January 30, 2020
MEMORANDUM TO: Board of Directors
FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision
SUBJECT: Notice of Proposed Rulemaking: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Summary: Staff is presenting for the approval of the Federal Deposit Insurance Corporation (“FDIC”) Board of Directors (“FDIC Board”) a request to publish the attached interagency notice of proposed rulemaking (“proposal” or “NPR”) to amend the regulations adopted in 2013 (“2013 rule”) implementing section 13 of the Bank Holding Company Act (“BHC Act”), commonly referred to as the Volcker Rule. If approved, this NPR would be issued jointly by the FDIC, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission (“SEC”), and the Commodity Futures Trading Commission (collectively, the “agencies”). Section 13 of the BHC Act generally restricts banking entities, including FDIC-supervised institutions, from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (collectively, “covered funds”). On July 17, 2018, the agencies issued a notice of proposed rulemaking (“2018 proposal”) to improve supervision and implementation of section 13 of the BHC Act. The 2018 proposal focused primarily on amendments to the proprietary trading and compliance program provisions of the implementing regulations. Although rule text for certain targeted changes to the covered

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fund provisions of the implementing regulations was introduced as part of the 2018 proposal, the 2018 proposal requested comment on most aspects of the covered fund provisions without proposing specific rule text. On November 14, 2019, the agencies adopted as final the specific rule text amendments proposed in the 2018 proposal (“2019 amendments”),¹ and indicated that they intended to issue a separate proposed rulemaking to specifically address those aspects of the covered funds provisions on which comments were sought but for which no specific rule text was proposed.² This proposal would further advance the objective of improving supervision and implementation of section 13 of the BHC Act by proposing specific rule text to amend various aspects of the covered fund provisions of the implementing regulations.

Recommendation: Staff requests that the FDIC Board approve this NPR and authorize its publication in the *Federal Register* with a comment period ending April 1, 2020.

I. Introduction

Section 13 of the BHC Act generally prohibits banking entities from engaging in proprietary trading and from acquiring or retaining an ownership interest in, or sponsoring, or having certain relationships with, a covered fund. The agencies adopted the 2013 rule to implement section 13 of the BHC Act.³

Based on experience implementing the 2013 rule, the agencies published the 2018 proposal to propose certain revisions to the 2013 rule. The 2018 proposal sought to provide greater clarity and certainty about what activities section 13 of the BHC Act prohibits, and to better tailor the 2013 rule’s compliance requirements based on the risk of a banking entity’s activities. The 2018 proposal solicited comments on specific revisions to the 2013 rule, with an

¹ 83 Fed. Reg. 33471–87.

² 84 Fed. Reg. 62016.

³ 79 Fed. Reg. 5536 (January 31, 2014).

emphasis on the proprietary trading and compliance program provisions, and also requested comments related to the covered fund provisions of the 2013 rule. On November 14, 2019, the agencies published a final rule in the *Federal Register* that finalized certain specific proposals included in the 2018 proposal.⁴ The agencies received a wide range of comments in response to the 2018 proposal and are proposing specific amendments to the 2013 rule’s covered fund provisions in this NPR.

Since the issuance of the 2018 proposal, the agencies promulgated a final rule to amend the 2013 rule consistent with the Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA final rule”).⁵ The EGRRCPA final rule excludes certain community banks from the definition of insured depository institution for purposes of section 13 of the BHC Act.

On November 14, 2019, the agencies published a final rule in the *Federal Register* that implemented certain changes to the restrictions on proprietary trading and amendments to the compliance program requirements in the 2013 rule.

II. Discussion of the Proposal

A. Qualifying Foreign Excluded Funds

The proposal would exempt the activities of certain funds that are organized and offered outside of the United States and offered to foreign investors (“qualifying foreign excluded funds”) from the restrictions of the implementing regulations in cases where those funds meet the definition of banking entity. Because the definition of banking entity includes any entity that is an affiliate or subsidiary of a banking entity, a foreign fund that is controlled by a foreign banking entity may itself meet the definition of banking entity, thus causing the foreign fund to

⁴ See 84 Fed. Reg. 61974 (November 14, 2019).

⁵ See 84 Fed. Reg. 35008 (July 22, 2019).

be subject to the prohibitions and restrictions of the implementing regulations even if it has limited nexus to the United States.⁶

To better limit the extraterritorial impact of the implementing regulations, the proposal would exempt the activities of qualifying foreign excluded funds from the proprietary trading and covered fund restrictions of the implementing regulations. The proposal would define a qualifying foreign excluded fund to require, among other things, that the fund be organized or established outside the United States, that the fund's ownership interests be offered and sold solely outside of the United States, that the fund be established and operated as part of a bona fide asset management business, and to otherwise require that the fund have limited nexus to the United States. This exemption would codify an existing policy statement issued by the Federal banking agencies that addresses the potential attribution to a foreign banking entity of the activities and investments of qualifying foreign excluded funds,⁷ and would be adopted pursuant to the agencies' authority under section 13(d)(1)(J) of the BHC Act.⁸ The exemptions would promote and protect the safety of foreign banking entities by minimizing disruptions to their bona fide asset management business caused by the unintended extraterritorial application of the implementing regulations, and would promote and protect U.S. financial stability by ensuring that the risks of the investments made by these foreign funds would be booked to foreign entities in foreign jurisdictions.

⁶ See 84 Fed. Reg. 61974 (November 14, 2019).

⁷ Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 17, 2019), available at <https://www.fdic.gov/news/news/press/2019/pr19064a.pdf>.

⁸ Section 13(d)(1)(J) of the BHC Act gives the agencies rulemaking authority to exempt activities from the prohibitions of section 13, provided the agencies determine that the activity in question would promote and protect the safety and soundness of the banking entity and the financial stability of the United States. 12 U.S.C. § 1851(d)(1)(J).

B. Modifications to Existing Covered Fund Exclusions

1. Foreign Public Funds

In order to provide consistent treatment between U.S. registered investment companies and their foreign equivalents, the implementing regulations exclude foreign public funds from the definition of covered fund.⁹ Based on experience implementing the 2013 rule, as well as discussions with and comments received from regulated entities, it appears that some of the conditions of the foreign public fund exclusion may not be necessary to ensure consistent treatment of foreign public funds and registered investment companies and may make it difficult for a non-U.S. fund to qualify for the exclusion, or for a banking entity to validate whether a non-U.S. fund qualifies for the exclusion, resulting in certain non-U.S. funds that are similar to registered investment companies being treated as covered funds.

To address the concerns related to the requirement in the 2013 rule that a fund be authorized to be offered and sold to retail investors in the fund's home jurisdiction and the requirement that ownership interests be sold predominantly through public offerings, the proposal would replace those two requirements with a requirement that the fund is authorized to offer and sell ownership interests and such interests are offered and sold through one or more public offerings. The proposal also would modify the definition of "public offering" from the 2013 rule to add a new requirement that the distribution is subject to substantive disclosure and retail investor protection laws or regulations, to help ensure that funds qualifying for this

⁹ A foreign public fund is generally defined under the implementing regulations as any issuer that is organized or established outside of the United States and the ownership interests of which are (1) authorized to be offered and sold to retail investors in the issuer's home jurisdiction and (2) sold predominantly through one or more public offerings outside of the United States.

exclusion are similar to registered investment companies.¹⁰ Additionally, the proposal would only apply the condition that the distribution comply with all applicable requirements in the jurisdiction where it is made to instances in which the banking entity serves as the investment manager, investment adviser, commodity trading adviser, or sponsor.

To simplify the requirements of the exclusion and address concerns described by banking entities with the difficulty in tracking the sale of ownership interests to employees and their immediate family members, the proposal would eliminate the limitation on selling ownership interests of the issuer to employees (other than senior executive officers) of the sponsoring banking entity or the issuer (or affiliates of the banking entity or issuer). This change would also help to align the treatment of foreign public funds with that of registered investment companies, as the exclusion for registered investment companies has no such limitation. This proposal would continue to limit the sale of ownership interests to directors or senior executive officers of the sponsoring banking entity or the fund (or their affiliates), as the agencies view that such a requirement would not be difficult for a banking entity to track and enforce.

2. Loan Securitizations

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

¹⁰ The 2013 rule defines “public offering” for purposes of this exclusion to mean a “distribution” of securities in any jurisdiction outside the United States to investors, including retail investors, provided that the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made; the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and the issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.

¹¹ 12 U.S.C. § 1851(g)(2).

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

The 2013 rule defines “loan” to include leases and permits loan securitizations to hold rights or other assets (servicing assets) that arise from the structure of the loan securitization or from the loans supporting a loan securitization.¹³ Rights or other servicing assets are assets designed to facilitate the servicing of the assets underlying a loan securitization or the distribution of proceeds from those assets to holders of the asset-backed securities. In response to confusion regarding the types of assets that may be considered servicing assets, the staffs of the agencies released the Loan Securitization Servicing FAQ. Under this FAQ, a servicing asset may or may not be a security, but if the servicing asset is a security, it must be a permitted security under the rule. This proposal would codify the Loan Securitization Servicing FAQ to clarify the scope of the servicing asset provision.

This proposal would allow a loan securitization vehicle to hold up to five percent of assets in assets that do not meet the definition of “loan” (“non-loan assets”). Authorizing loan securitizations to hold small amounts of non-loan assets could, consistent with the statute, permit loan securitizations to respond to market demand and reduce compliance costs associated with the securitization process without significantly increasing risk to banking entities and the financial system. Moreover, loan securitizations provide an important avenue for banking entities to fund lending programs, and allowing loan securitizations to hold a small amount of non-loan assets in response to customer and market demand may increase a banking entity’s capacity to provide financing and lending. The proposed limits on the amount of non-loan assets

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

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

also would assuage potential concerns that allowing certain non-loan assets would lead to evasion, indirect proprietary trading, and other impermissible activities or excessive risk to the banking entity.

3. Public Welfare and Small Business Investment Funds

i. Public Welfare Funds

Section 13(d)(1)(E) of the BHC Act permits, among other things, for a banking entity to make and retain investments that are designed primarily to promote the public welfare of the type permitted under 12 U.S.C. 24(Eleventh). Consistent with the statute, the 2013 rule excludes from the definition of “covered fund” issuers whose business is to make investments that are designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24).

The OCC’s regulations implementing 12 U.S.C. 24(Eleventh) provide that investments that receive consideration as qualified investments under the regulations implementing the Community Reinvestment Act (“CRA”) would also meet the public welfare investment requirements.¹⁴ The 2013 rule did not expressly incorporate these implementing regulations into the exclusion for public welfare investments. The agencies are inviting comment on whether any change should be made to clarify that all permissible public welfare investments, under any agencies’ regulation, are excluded from the covered fund restrictions.

ii. Small Business Investment Companies (SBIC)

Consistent with section 13 of the BHC Act, the 2013 rule excludes from the definition of covered fund SBICs and issuers that have received notice from the Small Business

¹⁴ See 12 CFR 24.3 (stating that, for national banks, an investment that would receive consideration under 12 CFR 25.23 as a “qualified investment” is a public welfare investment); 12 CFR 25.23 (describing the investment test under the regulations implementing the CRA for national banks).

Administration to proceed to qualify for a license as a SBIC, which notice or license has not been revoked. The agencies propose to revise the exclusion for SBICs to clarify how the exclusion would apply to SBICs that surrender their licenses during wind-down phases. The proposed rule would specify that the exclusion for SBICs applies to an issuer that was a SBIC but that has voluntarily surrendered its license to operate as an SBIC and does not make new investments (other than investments in cash equivalents) after such voluntary surrender.

The agencies believe that continuing to apply the SBIC exclusion to an issuer that has surrendered its SBIC license is appropriate because, absent these revisions, banking entities may become discouraged from investing in SBICs due to concern that a SBIC may become a covered fund during its wind-down phase.

4. Parallel Investments

The 2013 rule requires that a banking entity hold no more than three percent of the total ownership interests of a covered fund that the banking entity organizes and offers pursuant to § 351.11 of the 2013 rule. Section 351.12(b)(1) of the 2013 rule requires that, for purposes of this requirement, “the amount and value of a banking entity’s permitted investment in any single covered fund shall include any ownership interest held under § 351.12 directly by the banking entity, including any affiliate of the banking entity.” In the preamble to the 2013 rule, the agencies stated “[I]f a banking entity makes investments side by side in substantially the same positions as a covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity’s investment in the covered fund.”¹⁵ The agencies also stated that a banking entity that sponsors a covered fund should not make any additional side-by-side co-investment with the covered fund in a privately negotiated investment unless the

¹⁵ 79 Fed. Reg. 5734.

value of such co-investment is less than 3 percent of the value of the total amount co-invested by other investors in such investment. Neither section 13(d)(4) of the BHC Act nor the text of the 2013 rule require that a banking entity treat an otherwise permissible investment the banking entity makes alongside a covered fund as an investment in the covered fund.

In light of the comments received for the 2018 proposal, the agencies are proposing to add a new rule of construction to § 351.12(b) that would address investments made by banking entities alongside covered funds. These provisions would clarify in the rule text that banking entities are not required to treat these types of direct investments alongside a covered fund as an investment in the covered fund as long as the investment is made in compliance with applicable laws and regulations, including applicable safety and soundness standards. The agencies recognize that banking entities rely on a number of investment authorities and structures to make investments and meet the needs of their clients. The proposal would provide clarity to banking entities that they may make such investments for the benefit of their clients, provided that those investments comply with applicable laws and regulations. Accordingly, banking entities would not be permitted to engage in prohibited proprietary trading alongside a covered fund. Moreover, banking entities would need to have authority to make any investment alongside a covered fund under applicable banking and other laws and regulations, and would need to ensure that the investment complies with applicable safety and soundness standards.

C. Proposed Additional Covered Fund Exclusions

1. Credit Funds

This proposal would create a new exclusion for credit funds that make loans, invest in debt, or otherwise extend the type of credit that banking entities may provide directly under applicable banking law. For the purposes of the proposed exclusion, a credit fund is an entity

whose assets consist solely of: (1) loans; (2) bank-permissible debt instruments; (3) related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments; and (4) certain interest rate or foreign exchange derivative that relate directly to and reduce the risks of such loans, debt instruments, or related rights.

To ease compliance burdens, several provisions of the exclusion are similar to and modeled on conditions in the loan securitization exclusion. For example, any related rights or other assets held that are securities must be cash equivalents, securities received in lieu of debts previously contracted with respect to loans held or, unique to the credit funds exclusion, certain equity securities (or rights to acquire equity securities) received on customary terms in connection with the credit fund's loans or debt instruments. Relatedly, any interest rate or foreign exchange derivatives held by the credit fund must relate to loans, bank-permissible debt instruments, or other rights or assets held and reduce the interest rate and/or foreign exchange risks related to these holdings.

The proposed exclusion would permit the credit fund to receive and hold a limited amount of equity securities (or rights to acquire equity securities) that are incidental to the loans held by the credit fund and that are received on customary terms in connection with the credit fund's loans or debt instruments. The agencies understand that some banking entities are permitted to take as consideration for a loan to a borrower a warrant or option issued by the borrower – which allows the creditor to share in the profits, income, or earning of the borrower – as an alternative or replacement to interest on an extension of credit. As noted below, the risks of holding such assets would be mitigated by the requirement that the credit fund not itself engage in proprietary trading, and that any assets held by the credit fund be permissible for the banking entity to acquire and hold directly.

The exclusion also would be subject to certain additional restrictions to ensure that the entity is actually engaged in providing credit and credit intermediation, and is not operated for the purpose of evading the provisions of section 13 of the BHC Act. Under the proposal, a credit fund would not be a covered fund, provided that:

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

2. Venture Capital Funds

The agencies are proposing to add an exclusion from the definition of “covered fund” under § 351.10(b) of the rule that would allow banking entities to acquire or retain an ownership interest in, or sponsor, certain venture capital funds to the extent the banking entity is permitted to engage in such activities under otherwise applicable law. The exclusion would be available

with respect to “qualifying venture capital funds,” which the proposal defines as an issuer that meets the definition in the Investment Advisers Act implementing regulations (17 CFR § 275.203(l)-1) and that meets several additional criteria. The SEC’s definition of “venture capital fund” in 17 CFR § 275.203(l)-1 contains, among other things, strategy guidelines, asset holding restrictions, leverage limitations, and redemption constraints.

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

Further, a banking entity’s investment in or relationship with a qualifying venture capital fund would be subject to the restrictions of § 351.14 (except the banking entity may acquire and retain any ownership interest in the fund in accordance with the terms of the exclusion) and § 351.15 of the implementing regulations regarding material conflicts of interest, high-risk

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

The agencies are considering an additional restriction for which they are seeking specific comment. Under this additional restriction, and notwithstanding 17 CFR § 275.203(1)-1(a)(2), the venture capital fund exclusion would be limited to funds that do not invest in companies that, at the time of the investment, have more than a limited dollar amount of total annual revenue, calculated as of the last day of the calendar year.¹⁶ The agencies are considering what specific threshold would be appropriate and are inviting comment through this proposal.

3. Family Wealth Management Vehicles

This proposal would exclude from the definition of “covered fund” under § 351.10(b) of the 2013 rule any entity that qualifies as a “family wealth management vehicle.” The proposed family wealth management vehicle exclusion would be available to an entity that: (1) if organized as a trust, the grantor(s) of the entity are all family customers and, (2) if not organized as a trust, a majority of the voting interests in the entity are owned (directly or indirectly) by family customers; and the entity is owned only by family customers and up to 3 closely related persons of the family customers.¹⁷

Section 13 and the implementing regulations were designed to permit banking entities to continue to provide client-oriented financial services, including asset management services.

Staff of the agencies believe that an exclusion for family wealth management vehicles is consistent with section 13(d)(1)(D), which permits banking entities to engage in transactions on

¹⁶ As noted in the preamble to this NPR, the agencies are specifically considering, for example, \$50 million as the annual revenue limit.

¹⁷ Under the proposed exclusion, a family customer would mean “a family client, as defined in Rule 202(a)(11)(G)-1(d)(4) of the Investment Advisers Act of 1940 . . . ; or... [any] natural person who is a father-in-law, mother-in-law, brother-in-law, sister-in-law, son-in-law or daughter-in-law of a family client, spouse or spousal equivalent of any of the foregoing.” Also, under the proposed exclusion, a “closely related person” would mean “a natural person (including the estate and estate planning vehicles of such person) who has a longstanding business or personal relationship with any family customer.”

behalf of customers, when those transactions would otherwise be prohibited under section 13. The proposed exclusion would similarly allow banking entities to provide traditional services to customers through vehicles used to manage the wealth and other assets of those customers and their families.

In addition, under the proposal, a banking entity would rely on the proposed exclusion only if the banking entity (or an affiliate): (i) provides bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the entity; (ii) does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of such entity; (iii) complies with the disclosure obligations under § 351.11(a)(8), as if such entity were a covered fund; (iv) does not acquire or retain, as principal, an ownership interest in the entity, other than up to 0.5 percent of the entity's outstanding ownership interests that may be held by the banking entity and its affiliates for the purpose of and to the extent necessary for establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns; (v) complies with the requirements of §§ 351.14(b) and 351.15, as if such issuer were a covered fund; and (vi) complies with the low quality asset purchase restrictions of 12 CFR 223.15(a), as if such banking entity and its affiliates were a member bank and the issuer were an affiliate thereof.

4. Customer Facilitation Funds

The proposal would exclude from the definition of “covered fund” under § 351.10(b) of the 2013 rule any issuer that acts as a “customer facilitation vehicle.” The proposed customer facilitation vehicle exclusion would be available for any issuer that is formed by or at the request of a customer of the banking entity for the purpose of providing such customer (which may include one or more affiliates of such customer) with exposure to a transaction, investment strategy, or other service provided by the banking entity.

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

Additional conditions for the proposed customer facilitation vehicle exclusion, similar to the proposed family wealth management vehicles exclusion, would include prohibitions on guarantees, disclosure requirements, restrictions on ownership to 0.5 percent for specified purposes, and compliance requirements with § 351.14(b), § 351.15, and the low quality asset purchase restrictions of 12 CFR 223.15(a), as if the customer facilitation vehicle were an affiliate of the banking entity.

D. Limitations on Relationships with a Covered Fund

This proposal would modify the regulations implementing section 13(f)(1) of the BHC Act to permit banking entities to engage in a limited set of covered transactions with covered funds for which the banking entity directly or indirectly serves as investment manager, investment adviser, or sponsor, or that the banking entity organizes and offers pursuant to section 13(d)(1)(G) of the BHC Act. The proposal would allow a banking entity to enter into covered transactions with a related covered fund that would be permissible without limit for a bank to enter into with an affiliate under section 23A of the Federal Reserve Act and the Federal Reserve Board's implementing Regulation W ("Regulation W"). This would include, for example, intraday extensions of credit. The proposal also would allow a banking entity to enter into short-

term extensions of credit with a related covered fund, provided each extension of credit is related to payment, clearing, and settlement activities.

Section 13(f)(1) of the BHC Act generally prohibits a banking entity from entering into a transaction with a related covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act.¹⁸ This proposal would permit a banking entity to engage in covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under section 23A of the Federal Reserve Act, as provided in § 223.42 of Regulation W.¹⁹

A member bank may enter into certain “exempt” covered transactions set forth in section 23A of the Federal Reserve Act and Regulation W, without regard to the quantitative limits, collateral requirements, and low-quality asset prohibition of section 23A and Regulation W.²⁰ Staff of the agencies believe that the same rationales that support the exemptions in section 23A of the Federal Reserve Act and Regulation W also support exempting such transactions from the prohibition on covered transactions between a banking entity and related covered funds under section 13(f)(1) of the BHC Act.

In addition, the proposal would permit a banking entity to provide short-term extensions of credit to an affiliated covered fund, subject to appropriate limits. First, any short-term extension of credit would have to be made in the ordinary course of business in connection with payment transactions, securities, derivatives, or futures clearing, or settlement services. Second, the extension of credit would be required to be repaid, sold, or terminated no later than five business days after it was originated. The provision of payment, clearing, and settlement

¹⁸ 12 U.S.C. § 1851(f)(1); *see* 12 U.S.C. § 371c.

¹⁹ *See* 12 U.S.C. § 371c(d); 12 CFR 223.42.

²⁰ *See id.*

services by a banking entity (or its affiliates) to a covered fund for which it serves investment manager, investment adviser, or sponsor, or that the banking entity organizes and offers, generally requires the ability to provide such short-term extensions of credit, and therefore is a necessary corollary to the exempt covered transactions that would allow banking entities to provide standard payment, clearing, and settlement services to affiliated covered funds.

E. Ownership Interest

The agencies are proposing changes to the definition of “ownership interest” to clarify that a debt relationship with a covered fund would typically not constitute an ownership interest under the regulations.²¹ In addition, the agencies are proposing amendments to the manner in which a banking entity must calculate its ownership interest for purposes of complying with the limits and conditions that apply to investments in covered funds organized and offered by a banking entity. Specifically, the proposed amendments are intended to better align the manner in which ownership limits are calculated for purposes of the quantitative limit on a banking entity’s investment in a single fund (the per fund limit), the quantitative limit on a banking entity’s investment in all covered funds (the aggregate fund limit), and the calculation of the applicable capital deductions for investments in covered funds (the covered fund deduction).²²

To provide clarity about the types of interests that would be considered within the scope of the definition of ownership interest, the proposal would specify that creditors’ remedies upon the occurrence of an event of default or an acceleration event include the right to participate in the removal of an investment manager for cause or to nominate or vote on a nominated replacement manager upon an investment manager’s resignation or removal. Accordingly, a

²¹ See 2013 rule § 351.10(d)(6) (defining “ownership interest” for purposes of subpart C of the rule).

²² See 12 U.S.C. § 1851(d)(4)(B)(ii)–(iii); 2013 rule §§ 351.10(d)(6); 351.12(a)(2)(ii)–(iii), (b)–(d).

banking entity's holding of a financial instrument that has these features would not necessary cause that instrument to be considered an "ownership interest."

The proposed rule also would provide a safe harbor from the definition of ownership interest, to address commenters' concerns that some ordinary debt interests could be construed as an ownership interest. Any senior loan or senior debt instrument that meets certain characteristics would not be considered to be an ownership interest under the proposed rule. These characteristics include that the debt holders do not have the right to receive a share of the income, gains, or profits of the covered fund, and may only receive interest at a stated interest rate, commitment fees or other fees, and fixed principal payments on or before a maturity date. The entitlements to such payments must be absolute and not reduced based on losses arising from the underlying assets of the fund, and the debt holders generally may not be entitled to receive the underlying assets of the fund after all other interests have been redeemed or paid in full.

The proposal also would modify the 2013 rule to better align the manner in which a banking entity calculates the aggregate fund limit and covered fund deduction with the manner in which it calculates the per fund limit. This proposal would limit the attribution of an employee or director's restricted profit interest in a covered fund organized or offered by the banking entity to only those circumstances when the banking entity has directly or indirectly financed the acquisition of the restricted profit interest.

III. Conclusion

Staff requests that the FDIC Board approve for publication in the *Federal Register* the attached interagency NPR to amend the 2013 rule with a comment period ending April 1, 2020.

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