Statement by Martin J. Gruenberg

Member, FDIC Board of Directors

Final Rule: Volcker Rule Prohibition on Hedge Funds and Private Equity Funds

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Introduction

The Final Rule 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.

Today's Final Rule 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] Weakening this important prudential protection at the present time, given the economic and financial uncertainty caused by COVID-19, risks repeating the mistakes of the last crisis.

For that reason, I will vote against this Final 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,

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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.

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

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 certain debt securities. 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.

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[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.)

[4] Sen. Rep. at 92.

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 Final Rule would fundamentally weaken the prohibitions under Super 23A.

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 Final Rule 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

[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).

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 change would significantly undermine that objective.

Parallel Investments

In a similar vein, this rulemaking 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

[9] Preamble to the Final Rule at 17, 130-145; section 351.14 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.

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 Final Rule 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]

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 Final 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 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 changes to Section 23A and parallel investments, the value of these presumed protections is highly questionable.

[11] 79 Fed. Reg. 5535, 5734 (Jan. 31, 2014).
[12] Preamble to the Final Rule at 164-165.

Certain Debt Securities in Securitizations

It is also worth noting that the 2013 final Volcker Rule regulation allowed a covered fund exclusion for loan securitizations. Today's Final Rule, however, would allow loan securitization vehicles to hold up to five percent in debt securities that are not asset-backed or convertible. 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]

Venture Capital Funds

The 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 change, the preamble to today's Final Rule relies on a 2011 Securities and Exchange Commission rulemaking defining venture capital fund for

[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.
[16] Id. at 5704.

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 statutory language has not changed in the intervening years. It is consistent with the purpose of the Volcker Rule to limit high risk investments by banks and the extension of the safety net. It should be left to Congress to address how venture capital funds should be treated under the Volcker Rule.

Conclusion

Today's Final Rule goes far beyond streamlining or clarifying the covered fund provisions of the Volcker Rule as asserted in the preamble.[19] It would severely weaken the restrictions on relationships between banks and covered funds. It would reintroduce the types of high-risk investments and activities that contributed to the 2008 financial crisis, and risk repeating those mistakes in the current uncertain environment created by COVID-19. For this reason, I will vote against the Final Rule.

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[17] Preamble to the Final Rule at 91-95. (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, 76 Fed. Reg. 39646 (July 6, 2011)).
[18] Preamble to the 2013 final regulation, 79 Fed. Reg. at 5704.
[19] Preamble to the Final Rule at 1-2, 7.