The Final Volcker Rule: Implications for Venture Capital

Timothy R. Lavender

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Introduction

As we approach the final quarter of 2020, we thought it would be helpful to recap one of the significant rule changes of the past few months that is likely to benefit venture capital funds and startup companies.

The Final Volcker Rule[1], which goes into effect October 1, 2020, makes a number of significant modifications that are encouraging for venture capital funds. Most notably, the rule change permits banks to take stakes in venture capital funds that were previously banned, meaning that Wall Street and other banks will soon be able to boost investments in these funds.

The Final Rule creates a new exclusion from the "covered funds" definition for venture capital funds and adopts the definition of "venture capital fund" from regulations under the Investment Advisers Act, Rule 203(l)-1 under the Advisers Act, 17 C.F.R. § 275.203(l)-1. In order to qualify for the exclusion, such a venture capital fund must refrain from engaging in proprietary trading.

As we describe in this Client Advisory, while banking entities will be subject to certain limitations and requirements with respect to their investment in or sponsorship of a venture capital fund, they will now, nevertheless, be permitted to sponsor a venture capital fund, and they will not be subject to the current 3% limit (or any other limit) on the percentage of such a fund's ownership interests they can hold.

This rule change could permit venture capital funds to tap previously unavailable pools of capital, and make it easier for banks to invest in startups and other early-stage ventures.

The Genesis of The Volcker Rule

Following the 2008 financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("The Dodd-Frank Act").[2] Section 619 of the Act, more commonly known as the "Volcker Rule" (the "Volcker Rule" or "the Rule"), codified as section 13 to the Bank Holding Company Act of 1956 ("BHC Act").[3] The Rule sought to end certain banking practices that many felt were a major contributing factor to the global financial crisis.[4]

The Volcker Rule had prohibited banks from engaging in proprietary trading, acquiring ownership interest in, sponsoring, or having relationship with certain hedge funds and other private investment funds referred to as "covered funds" ("Covered Funds").[5] For example, regulations restricted banking entities from engaging in relationships with some venture capital funds that primarily

invested in small businesses and startups, as well as private equity funds and hedge funds.

Covered Funds Under the Volcker Rule

The current Volcker Rule defines a covered fund as any entity that:

1. relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act (ICA) (i.e., the private fund exemptions that most hedge funds, private equity funds, and venture capital funds rely upon);
2. is a commodity pool whose operator relies on CFTC Rule 4.7; or
3. a foreign fund that either relies on section 3(c)(1) or 3(c)(7) of the ICA with respect to U.S. investors or satisfies other criteria.

Accordingly, the original Volcker Rule deems most private funds not considered an investment company under the ICA to be covered funds, thus, significantly limiting banks' investments.

On June 25, 2020, the Federal Reserve ("Board"), Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission ("CFTC"), Federal Deposit Insurance Corporation ("FDIC"), and Office of the Comptroller of the Currency ("OCC"), adopted regulations implementing section 13 of the BHC Act, revising the restrictions of a banking entity or nonbank financial company supervised by the Board to engage in proprietary trading, and permitting them to have certain interests in, or relationships with, hedge fund and private equity funds (the "Final Amendments"). The Final Amendments, along with the Final Rule, that will be effective October 1, 2020, will ease prior restrictions on banking entities by adding four new types of funds to the Volcker Rule's list of exclusions. Thus, some funds that regulators had categorized as covered funds (and not able to have a relationship with a banking entity), will now be excluded from the Volcker Rule's prohibitions.

While the Final Amendments and Final Rule also add exclusions for qualifying credit funds, qualifying family wealth management vehicles, and customer facilitation vehicles, this Client Advisory focuses on qualifying venture capital funds.

The Final Amendments allow "banking entities to acquire or retain ownership interests in, or sponsor, certain venture capital funds, to the extent the banking entity is permitted to engage in such activities under applicable law. These changes will give banks the ability to invest in VC funds, though only "venture capital funds" as defined by the SEC regulations qualify for the exclusion.

There are two gating questions to determine whether a banking entity can invest in a VC fund:

1. Is the fund a "venture capital" fund under SEC regulations? and
2. If so, what rules and regulations does the fund and the banking entity have to abide by in order to maintain a legal relationship? In other words, how does the fund avoid the Volcker Rule's definition of those covered funds that cannot have a relationship with banking entities?

Who Fits The Definition of a Venture Capital Fund Under The SEC Regulations?

A private fund must meet all of the following requirements to qualify as a venture capital fund under SEC regulations:

1. Represents to its investors that it pursues a venture capital strategy;
2. Holds **no more** than 20% of the amount of its aggregate capital contributions (plus uncalled capital commitments) in assets that are not "qualifying investments";
3. Will **not** incur leverage, including guarantees, of more than 15% of aggregate capital contributions or incur leverage for a term exceeding 120 days;
4. Only issue securities that **do not** provide holders withdrawal rights;
5. Is **not** registered as an investment company under the ICA; and
6. Has **not** elected to be treated as a business development company.

How Can a VC Fund Qualify for the Volcker Rule Exclusion?

The Final Rule exempts an issuer that meets the definition of venture capital fund in 17 C.F.R. 275.203(l)- 1 and does not engage in proprietary trading (as defined under the Current Rule).

If a fund complies with the below, it probably meets these requirements and banking entities may likely invest.

1. The fund does **not** engage in proprietary trading.[6]
2. If a banking entity takes an ownership interest in the fund:
    a.
    b. It will **not** lead to a conflict of interest between the banking entity its clients;
    c. It will **not** expose the banking entity to a high risk asset or trading strategy;
    d. It will **not** threaten the safety of the banking entity or threaten US financial stability; and
    e. It will comply with all applicable banking regulations and laws.
3. The banking entity does/will not guarantee, assume, or insure the fund's performance.
4. If the banking entity acts as a sponsor/advisor:
    a.
    b. It will provide investors, current or prospective, with written disclosures required by the Volcker Rule;
    c. It will ensure that the fund's activities follow the safety and soundness standards; and
    d. It will comply with Section 23A[7] as if the fund were a covered fund.

We would caution, as mentioned above, that a banking entity that sponsors or serves as an investment adviser or commodity trading advisor to the venture capital fund **may not rely on the qualifying venture capital fund exclusion** unless the banking entity:

1. provides prospective and actual investors in the venture capital fund with the written

disclosures required under the asset management exemption;

2. ensures that the activities of the venture capital fund are consistent with safety and soundness standards;

3. complies with Super 23A[8] with respect to the venture capital fund; and

4. complies with the anti-guarantee requirement of the asset management exemption.

Conclusion

The Final Volcker Rule will allow banks to invest in certain covered funds — including venture capital funds, credit funds, customer facilitation funds, and family wealth management vehicles. This change may increase the funds available for investment in startups, thus encouraging capital formation.

Funds that seek to raise capital from banking entities should ensure that they in fact qualify as venture capital funds under applicable SEC regulations to meet the Volcker Rule Exclusion, as banks will likely be performing careful diligence before they make investments in such funds. One critical consideration is the limitation on venture capital funds incurring leverage. Funds may want to consider including restrictions in their governing documents and/or other safeguards to avoid crossing the permitted leverage threshold.

For more information, please contact Kelley Drye partner Timothy R. Lavender.

(This Client Advisory was written with the assistance of summer associate Tal Ben-Moshe.)

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[1] Five federal regulatory agencies on June 25, 2020 finalized a rule modifying the Volcker rule's prohibition on banking entities investing in or sponsoring covered funds. With the adoption of the final rule, the agencies are creating four new exclusions from the definition of "covered fund" for venture capital funds, credit funds, family wealth management vehicles, and customer facilitation vehicles.

[2] The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173, commonly referred to as Dodd–Frank) (July 21, 2010).

[3] P.L. 111-203§ 1855; 124 Stat. 1375.

[4] Legislators and regulators have long grappled with whether restricting the types of activities banks can engage in, or reforming banks' structures, might reduce the risk of large bank failures and the risk of systemic instability, such as that seen in the 2008 financial crisis. The Volcker Rule is an example of a means of addressing this issue. See, *Financial Reform: An Overview of The Volcker Rule, In Focus* (Congressional Research Service, July 9, 2018).

Each of the Volcker Rule regulations as codified in different sections of the Code of Federal Regulations (C.F.R.)
12 C.F.R. Part 44 (Office of the Comptroller of the Currency)(OCC); 12 C.F.R. Part 248 (Board of Governors of the Federal Reserve System) (FRB); 12 C.F.R. Part 351 (Federal Deposit Insurance Corporation)(FDIC); 17 C.F.R. Part 255 (Securities and Exchange Commission) (SEC); and, 15 C.F.R. Part 75 (CFTC).

[5] The base definition of "covered fund" is broad, covering any issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the Investment Company Act) but for

the application of Section 3(c)(1) or 3(c)(7) of the Investment Company Act. The Original Rule included 14 exclusions from the definition of “covered fund.” The 2020 Revisions will add four new exclusions:

- credit funds
- venture capital funds
- family wealth management vehicles
- customer facilitation vehicles.

[6] The original Volcker Rule consisted of Subparts A through D. Subpart B defined Proprietary Trading as engaging as principal for the trading account of a banking entity in the purchase or sale of a financial instrument. Thus, compliance with the Rule by a banking entity depends on whether the account for which the trade is placed satisfies the definition of “trading account” and whether the trade involves a financial instrument. Financial instrument includes a security, a derivative, and a contract of sales of a commodity for future delivery, or an option on any of the foregoing. The term security includes any note, stock, security future, bond, debenture, certificate of interest, o participation in any profit-sharing agreement, any collateral trust certificate, certificate of deposit for a security, any put, call, straddle, option or privilege entered into on a national securities exchange related to foreign currency, or, in general, any instrument commonly known as a “security.”
[7] This is a reference to Section 23A of the Federal Reserve Act. The Final Rule revises the so-called Super 23A prohibition to permit banking entities to engage in a limited set of low-risk covered transactions with covered funds that the banking entity sponsors, advises or organizes and offers. Specifically, the Final Rule allows banking entities to enter into transactions that would be exempt from the qualitative limits, collateral requirements and low-quality asset prohibition in Section 23A of the Federal Reserve Act and Regulation W, provided they comply with the limits and conditions imposed in Regulation W (12 C.F.R. 223.42).
[8] See Footnote 7.