



# Commodity Futures Trading Commission

## Office of Public Affairs

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### **CFTC Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions Regarding Certain Requirements under Section 13 of the Bank Holding Company Act of 1956 and Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds**

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new section 13 to the Bank Holding Company Act of 1956 ("BHC Act"), commonly referred to as the Volcker rule, that generally prohibits insured depository institutions and any company affiliated with an insured depository institution from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund. These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions.

The Commodity Futures Trading Commission ("CFTC") is working closely with the other agencies charged with implementing the requirements of section 13, including the Federal Reserve Board, Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (each an "Agency" and collectively with the CFTC "the Agencies"). While these frequently asked questions ("FAQs") apply to banking entities for which the CFTC has jurisdiction under section 13 of the BHC Act, they have been developed by staffs of the Agencies and substantively identical versions will appear on the public websites of each Agency.

#### **Joint Venture Exclusion for Covered Funds**

##### **1. May an issuer that would be a covered fund rely on the joint venture exclusion from the definition of covered fund under § 75.10(c)(3) of the final rule?**

Section 75.10(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.<sup>1</sup> The final rule defines hedge funds and private equity

<sup>1</sup> See, e.g., *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 FR 5808 (Jan. 31, 2014) at 5943.

funds collectively as “covered funds.”<sup>2</sup> 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.<sup>3</sup>

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.<sup>4</sup> 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.<sup>5</sup>

<sup>2</sup> The final rule generally defines the term “covered fund” to include certain funds that rely on section 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 section 75.10(b)(1) of the final rule.

<sup>3</sup> 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 § 75.10(c)(3) of the final rule.

<sup>4</sup> See 79 FR 5808 at 5952-54.

<sup>5</sup> See, e.g., 79 FR 5808 at 5953 (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”).

## Foreign Public Funds Sponsored by Banking Entities

### 2. How does the final rule apply to a foreign public fund sponsored by a banking entity?

The final rule excludes foreign public funds from the definition of covered fund.<sup>6</sup> To qualify for this exclusion, these funds must, among other conditions, be authorized to offer and sell ownership interests to retail investors in the foreign public fund's home jurisdiction and must sell ownership interests predominantly in public offerings outside of the United States.<sup>7</sup> The Agencies stated that this exclusion was "designed to prevent . . . the definition of covered fund from including foreign funds that are similar to U.S. registered investment companies, which are by statute not covered by section 13."<sup>8</sup> The Agencies also stated that the "foreign public fund exclusion is designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of section 13 of the BHC Act, including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States."<sup>9</sup>

Staffs of the Agencies understand that, unlike in the case of U.S. registered investment companies,<sup>10</sup> sponsors of foreign public funds in some foreign jurisdictions select the majority of the fund's directors or trustees, or otherwise control the fund for purposes of the BHC Act by contract or through a controlled corporate director. These and other corporate governance structures abroad therefore have raised questions regarding whether foreign public funds that are sponsored and distributed outside the U.S. and in accordance with foreign laws are banking entities by virtue of their relationships with a banking entity.

As noted by the Agencies in the preamble to the final rule, the definition of private equity fund and hedge fund in section 619 of the Dodd-Frank Act appears to reflect Congressional concerns regarding less regulated private funds as well as an intention not to disrupt registered investment companies, such as U.S. mutual funds.<sup>11</sup> The final implementing regulations issued by the Agencies adopted the same approach toward foreign public funds in order to make clear that U.S. banking entities and their foreign affiliates, as well as foreign banking organizations, could continue to carry on their traditional asset management businesses involving foreign public funds outside of the United States.<sup>12</sup> The final rule imposes conditions to ensure that

<sup>6</sup> See § 75.10(c)(1). The final rule defines the term "covered fund" to include certain funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act; certain commodity pools as defined in section 1a(10) of the Commodity Exchange Act; and certain foreign funds. See § 75.10(b)(1).

<sup>7</sup> See § 75.10(c)(1).

<sup>8</sup> 79 FR at 5945. The Agencies also noted more generally that the exclusions from the covered fund definition were designed, among other purposes, "to address the potential over-breadth of the covered fund definition and related requirements without such exclusions by permitting banking entities to invest in and have other relationships with entities that do not relate to the statutory purpose of section 13." 79 FR at 5949.

<sup>9</sup> 79 FR at 5951. The Agencies explained in the preamble that they "tailored the final definition [of covered fund] to include entities of the type that the Agencies believe Congress intended to capture in its definition of private equity fund and hedge fund in section 13(h)(2) of the BHC Act by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act. Thus, the final definition focuses on the types of entities formed for the purpose of investing in securities or derivatives for resale or otherwise trading in securities or derivatives, and that are offered and sold in offerings that do not involve a public offering, but typically involve offerings to institutional investors and high-net worth individuals (rather than to retail investors)." See also e.g., 79 FR at 5938-39.

<sup>10</sup> See 79 FR at 5948 (recognizing that the Federal Reserve Board's regulations and orders have long recognized that a bank holding company may organize, sponsor, and manage a registered investment company, including by serving as investment adviser to the registered investment company, without controlling the registered investment company for purposes of the BHC Act).

<sup>11</sup> See, e.g., 79 FR at 5948 ("Section 13's definition of private equity fund and hedge fund by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act appears to reflect Congress' concerns about banking entities' exposure to and relationships with investment funds that explicitly are excluded from SEC regulation as investment companies."). (emphasis in original) See also e.g., 79 FR at 5938.

<sup>12</sup> 79 FR at 5951 (stating "the Agencies' view that the foreign public fund exclusion is designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of section 13 of the BHC Act, including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States").

the foreign public fund is distributed predominantly through public offerings outside the United States, is offered to retail investors in the issuer's home jurisdiction, is distributed in accordance with all applicable requirements for distributing public funds in the jurisdiction in which the distribution is being made, and includes publicly available offering disclosure documents. These requirements were designed to mirror the characteristics of U.S. mutual funds that are outside the applicability of section 619 of the Dodd-Frank Act.<sup>13</sup>

By referring to characteristics common to publicly distributed foreign funds rather than requiring that foreign public funds organize themselves identically to U.S. mutual funds or other types of U.S. regulated investment companies, the final rule recognized that foreign jurisdictions have established their own frameworks governing the details for the operation and distribution of foreign public funds.

Section 255.12 of the final rule further provides that, for purposes of complying with the covered fund investment limits, a U.S. registered investment company, SEC-regulated business development company, or foreign public fund will not be considered to be an affiliate of the banking entity so long as the banking entity: (i) does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the fund; and (ii) provides investment advisory, commodity trading advisory, administrative, and other services to the fund in compliance with the limitations under applicable regulation, order, or other authority. The staffs of the Agencies note that these limitations would include those imposed by an authority in the relevant foreign jurisdiction.<sup>14</sup>

Staffs of the Agencies would not advise that the activities and investments of a foreign public fund that meets the requirements in section 75.10(c)(1) and section 75.12(b)(1) of the final rule be attributed to the banking entity for purposes of section 619 of the Dodd-Frank Act or the final rule where, consistent with section 75.12(b)(1) of the final rule, the banking entity does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the foreign public fund (after the seeding period),<sup>15</sup> and provides investment advisory, commodity trading advisory, administrative, and other services to the fund in compliance with applicable limitations in the relevant foreign jurisdiction. Nor would the staffs advise that a foreign public fund be deemed a banking entity under the final rule solely by virtue of its relationship with the sponsoring banking entity where the foreign public fund meets the requirements of section 75.10(c)(1) of the final rule and the sponsoring banking entity's relationship with the foreign public fund meets the requirements of section 75.12(b)(1) of the final rule, including the requirement that the sponsoring banking entity's relationship with the fund is in compliance with applicable limitations in the foreign jurisdiction in which the foreign public fund operates.

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<sup>13</sup> 79 FR at 5951.

<sup>14</sup> See § 75.12(b)(1)(ii). See also 79 FR at 6004 ("[F]or purposes of section 13 of the BHC Act and the final rule, a registered investment company, SEC-regulated business development company, and a foreign public fund as described in §75.10(c)(1) of the final rule will not be considered to be an affiliate of the banking entity if the banking entity owns, controls, or holds with the power to vote less than 25 percent of the voting shares of the company or fund, and provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund only in a manner that complies with other limitations under applicable regulation, order, or other authority.")

<sup>15</sup> See §§ 75.10(c)(12) and 75.20(e). The preamble to the final rule makes clear that, consistent with the Board's precedent regarding bank holding company control of and relationships with funds, a seeding vehicle that will become a registered investment company would not itself be viewed as violating the requirements of section 13 during the seeding period so long as the banking entity that establishes the seeding vehicle operates the vehicle pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company within the time period provided for seeding a covered fund. See 79 FR at 5949. The staffs of the Agencies have explained that an issuer that will become a foreign public fund would be treated during its seeding period in the same manner as an issuer that will become an excluded registered investment company.