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Financial Institutions Regulation Group Client Alert:

Joint Ventures under the Volcker Rule: A modest attempt to bring the Joint Venture exclusion out of the regulatory wilderness

This is a piece in our continuing series exploring the effects of the Volcker Rule; for previous alerts please click here.

BRIEF BACKGROUND

It is an axiom of statutory and regulatory construction that words adopted as law must have some meaning capable of being applied.[1] But what in the world does the joint venture exclusion to the Volcker Rule's covered fund restrictions mean?

The Volcker Rule, codified as Chapter 13 of the Bank Holding Company Act of 1956,[2] as amended (the "BHC Act"), generally prohibits banking entities[3] from engaging in proprietary trading or in making certain investments in (or having certain relationships with) so-called "covered funds."[4] The purported purpose of the latter prohibition is to ensure that banks do not engage indirectly in activities that they would

[1] *See, e.g.*, 1A Norman Singer & Shambie Singer, *Sutherland Statutes and Statutory Construction* § 21.1 (7th ed. 2015).

[2] Chapter 13 of the BHC Act was added by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, *Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds*, Public Law 111–203, 124 Stat. 1. (2010). Final rules implementing the statute were published in the Federal Register in early 2014. *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014).

[3] The final rule defines covered "banking entities" to include any of the following, unless otherwise exempted:

(i) Any insured depository institution;

(ii) Any company that controls an insured depository institution;

(iii) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and

(iv) Any affiliate or subsidiary of an entity described above.

[4] The final rulemaking generally defines "covered fund" to include any issuer that would be an Investment Company within the meaning of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act.

be prohibited under the Volcker Rule from engaging in directly. Many observers assume that the Volcker Rule essentially represents a blanket prohibition on bank investment activity, but as we analyzed in a prior Client Alert, this is incorrect.[5]

Nevertheless, there is an inherent tension between the ability of a banking entity to exercise its otherwise permissible bank investment powers and the broad sweep of the Volcker Rule's prohibitions. In promulgating the final Volcker Rule, the five issuing agencies (the "Agencies")[6] appeared to recognize this tension. Rather than imposing a blanket prohibition on covered fund activities, the Agencies acknowledged that certain entities and arrangements should be carved out of the general prohibition on covered fund activities, whether by virtue of an exemption from the general ban or through an exclusion from the definition of covered fund.[7] One such excluded entity is a "joint venture."[8]

From the moment the Volcker Rule was promulgated, however, practitioners have struggled to determine what investments, if any, would meet the standards to qualify as an excluded joint venture. On June 12, 2015, the Agencies issued a response to a "Frequently Asked Question" directed at providing additional guidance on this point ("FAQ 15").[9] Unfortunately, FAQ 15 raised as many questions as it purported to answer.

Below, we attempt to discern what structures are eligible for the joint venture exclusion. We have no magic answers; we merely believe that the market's understanding of this exclusion can be meaningfully furthered by having a more rigorous discussion than has to this point taken place.

WHAT IS A JOINT VENTURE AND WHY IS IT EXCLUDED FROM THE VOLCKER RULE?

Section _.10(c)(3) of the final rule provides that a joint venture will be excluded from the definition of a covered fund (and therefore the prohibitions under the Volcker Rule) if it "(i) is composed of no more than ten unaffiliated co-venturers, (ii) is in the business of engaging in activities that are permissible for the bank, other than investing in securities for resale or other disposition; and (iii) is not, and does not hold itself out

[5] *Things the Media believes the Volcker Rule says…but it actually doesn't* (Feb. 5, 2015), available at https://www.milbank.com/images/content/1/9/19707/NYT-Volcker-Alert.pdf.

[6] The five Agencies are the Office of the Comptroller of the Currency ("OCC"); Board of Governors of the Federal Reserve System ("Board"); Federal Deposit Insurance Corporation ("FDIC"); Securities and Exchange Commission ("SEC"); and the Commodity Futures Trading Commission ("CFTC"). The Federal Reserve, OCC, FDIC, and SEC issued a joint rulemaking; the CFTC separately issued a virtually identical rulemaking. The citations to the final regulations in this client alert refer to version codified by the Federal Reserve at 12 C.F.R. Part 248.

[7] Exclusions from the definition of covered fund are listed in 12 C.F.R. § 248.10(c). Exemptions from the general prohibition on covered fund activity are found in 12 C.F.R. §§ 248.11-13.

[8] 12 C.F.R. § 248.10(c)(3).

[9] *See* http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#15.

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."[10]

The preamble to the Volcker Rule provides background to the Agencies' decision to exclude qualifying joint ventures from the prohibition on covered fund activities.[11] The proposed rule would have limited the joint venture exclusion to "operating companies" that did not engage in activities prohibited under the Volcker Rule.[12] Commenters requested that this limitation be broadened so as to permit routine corporate structures and risk sharing that may not meet the definition of an operating company. The Agencies decided to adopt some, but not all, of these suggestions; as stated by the Agencies, "[banks] will continue to be able to share the risk and cost of financing their banking activities through these types of entities which, as noted by commenters …, may allow banking entities to more efficiently manage the risk of their operations."[13] In FAQ 15, the Agencies followed the preamble in noting that 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."[14]

The three prongs of the joint venture exclusion may be described as one quantitative prong and two prudential prongs. The quantitative limitation—no more than ten co-venturers—is random and without statistical justification, but largely simple to apply. The Agencies further explained this point in FAQ 15 when they noted "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."[15]

The prudential ones are more tricky to apply. The Agencies' underlying concern is easy enough to understand: banks should not be able to use the joint venture exclusion to engage in the types of activities that the Volcker Rule otherwise prohibits. Hence, "the exclusion is not intended to include entities that invest in securities for resale or other disposition."[16] The Agencies describe this limitation as preventing "a banking entity from relying on this exclusion to evade section 13 of the BHC Act …," and state that the

[10] 12 C.F.R. § 248.10(c)(3). As the Agencies note in the preamble to the final regulations, however, if a banking entity owns 25 percent or more of the voting securities of the joint venture or otherwise controls an entity that qualifies for the joint venture exclusion, the joint venture would then itself be a banking entity subject to the restrictions of the Volcker Rule. *See* 79 Fed. Reg. 5536, 5681.

[11] *See* 79 Fed. Reg. 5536, 5680-81.

[12] *Id.*, at 5680.

[13] *Id.*, at 5681.

[14] *See* FAQ 15 at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#1.5

[15] *Id.*

[16] *Id.*

"Agencies will monitor joint ventures … to ensure that they are not used by banking entities to evade the provisions of section 13."[17]

However, the Agencies struggle to translate that underlying concern into clear, easily applicable prudential limitations. On the one hand, they identify a banking power that may not be used in conjunction with the joint venture exclusion: "a banking entity may not use a joint venture to engage in merchant banking activities because that involves acquiring or retaining shares, assets, or ownership interests for the purpose of ultimate resale or disposition of the investment."[18] On the other hand, they fail to identify any entities or arrangements that would qualify for the joint venture exclusion, outside of operating companies that are unlikely to be considered covered funds in the first place.

Ultimately, therefore, these prudential limitations may be redundant. As the Volcker Rule defines a "covered fund" largely by reference to the exemptions under 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act"), it is unclear what set of entities could both (x) meet the prudential limitations of the joint venture exclusion and also (y) need to rely upon the exemptions for registrations set forth in 3(c)(1) and 3(c)(7).[19] It is only to such entities—a hazy group of structures that might, for one reason or other, inadvertently be considered covered funds but which do not primarily invest in securities for resale or other disposition—that the joint venture exclusion could possibly apply.

WHAT TYPES OF INVESTMENTS CAN A BANKING ENTITY MAKE?

In order to further illustrate the tension between the Volcker Rule and traditional bank investment powers, this section provides an overview of a few of the more commonly employed powers.

Under the BHC Act, bank holding companies ("BHCs") are largely restricted from making investments in companies engaged in activities that are not closely related to banking. However, a BHC, including a BHC that has elected to become a financial holding company ("FHC"), has numerous exceptions to this general prohibition under which it may make all manner of non-bank investments.

As an illustration, section 4(k)(4)(H) of the BHC Act permits an FHC to acquire up to 100 percent of the shares of any entity engaged in activities not otherwise authorized to

[17] 79 Fed. Reg. 5536, 5681. Of course, the Volcker Rule itself contains an anti-evasion clause that would prohibit use of the joint venture exclusion (or any exclusion or exemption) to evade the purposes of the Volcker Rule. See 12 C.F.R. § 248.21(a).

[18] 79 Fed. Reg. 5536, 5681 n. 1790 and accompanying discussion. As we note later in this client alert, however, many banking entities have used their merchant banking powers to make investments that they could otherwise hold indefinitely under other sources of authority, but have chosen to hold such investments under their merchant banking authority for convenience.

[19] 15 U.S.C. § 80a-3(c).

FHCs. This exception, known as an FHC's "merchant banking" authority, generally requires that the FHC refrain from routinely managing or operating the entity and dispose of its investment within a defined period (which usually is ten years).[20] Under section 4(c)(6) of the BHC Act and the Board's associated interpretations, a BHC may generally acquire and retain forever up to 4.9 percent of the voting equity or 24.9 percent of the total equity, of any entity, so long as the BHC is a passive investor that does not have "control" of that entity.[21]

Pursuant to section 4(k)(1) of the BHC Act, an FHC may acquire and retain forever up to 100 percent of the shares of any entity that engages in activities that are financial in nature, incidental to such financial activity or complementary to a financial activity.[22] A BHC under section 4(c)(8) of the BHC Act may acquire and retain forever up to 100 percent of the shares of any entity that engages in activities that are closely related to banking.[23] Provided that a BHC or FHC holds more than 25 percent of any class of voting securities of such an entity, that entity would be considered a subsidiary of the BHC or FHC and therefore a "banking entity."

The Volcker Rule adds an additional, complex overlay to the bank regulatory authorities above. Where investments in funds or fund-like structures are concerned, these authorities must now be analyzed alongside (and sometimes, in conjunction with) the question of whether an investment would be permissible under an exemption or exclusion from the Volcker Rule. For example, as a banking entity "may not use a joint venture to engage in merchant banking activities,"[24] we turn to the discussion below.

HOW DOES THE JOINT VENTURE EXCLUSION APPLY TO NON-MERCHANT BANKING INVESTMENTS?

"…IS IN THE BUSINESS OF ENGAGING IN ACTIVITIES THAT ARE PERMISSIBLE FOR THE BANKING ENTITY (OTHER THAN INVESTING IN SECURITIES FOR RESALE OR OTHER DISPOSITION)"

The first part of this prong is clear: an entity held pursuant to the joint venture exclusion must be engaged in activities otherwise permissible to the banking entity under applicable law. Consequently, the joint venture exclusion does not expand the

[20] 12 U.S.C. § 1843(k)(4)(H). We have noted previously the incongruity found when applying the Volcker Rule that a banking entity may own 100 percent of a company when investing by itself but may be limited to owning three percent of the same company when investing through a covered fund. *See Inequitable: Investments in Non-Financial Companies Under the Volcker Rule* (Feb. 7, 2014), available at http://digital.milbank.com/i/280360-inequitable-investments-in-non-financial-companies-under-the-volcker-rule.

[21] 12 U.S.C. § 1843(c)(6). The Board's Regulation Y defines "control" to include the direct or indirect ownership of 25 percent or more of the voting shares of a company. 12 C.F.R. § 225.2(e).

[22] 12 U.S.C. § 1843(k)(1); 12 C.F.R. § 225.85.

[23] 12 U.S.C. § 1843(c)(8); 12 C.F.R. § 225.28.

[24] 79 Fed. Reg. 5536, 5681 n. 1790 and accompanying discussion.

investment powers of the entity making the investment. As described above, FHCs and BHCs have a number of existing authorities, other than merchant banking authority, under which they may make such investments.[25]

However, the parenthetical (and the language in the preamble to the final rule, discussed above) appears to essentially equate the merchant banking authority with the making of investments in securities for resale or deposition.[26] We believe that the Agencies used this language as a short-handed method of capturing those investments that are made and held "for resale," as merchant banking investments are time limited under their terms. One problem with this approach, however, is that not all investments held under an FHC's merchant banking authority are necessarily investments in securities "held for resale or other disposition" in practice. While the BHC Act does state that merchant banking activities may be "engaged in for the purpose of appreciation and ultimate resale or disposition of the investment,"[27] it is also true that FHCs may choose to designate certain holdings as merchant banking investments even if those investments would be eligible to be held under some other available authority, such as Sections 4(c)(6) and 4(c)(8) of the BHC Act. FHCs do this for convenience of reporting and to avoid other regulatory restrictions applicable to those provisions. If they continue to hold such investments when the time periods for dispositions under merchant banking approach, they merely shift the designation of legal authority under which they hold the investment. Therefore, it is untrue that every investment held by a banking entity pursuant to its merchant banking authority is held for resale or other disposition.

Given the above, we believe that a banking entity that uses a non-merchant banking authority to hold its interest in the joint venture (and its interest in any investments held indirectly through the joint venture) should satisfy this prong. If a banking entity structured its interest in a joint venture to control the joint venture and require it to only make investments that satisfied the requirements of either section 4(c)(6) or section 4(c)(8) of the BHC Act (as described above), then the investment should satisfy the joint venture exclusion (so long as the other two prong criteria were met).[28]

[25] This portion is oddly worded. First, "is in the business" – does this phrase require that everything that the joint venture does or invests in is a permissible activity? Or just that the predominance of activities and investments are permissible? If it were the former, wouldn't a more concise provision say that the joint venture "may only engage in activities that are permissible …" This is not a phrase commonly used in banking regulation; however, when used colloquially in speeches, Federal Reserve Governors have used it to reference an activity being done, not that the actor is doing only that activity. See e.g. http://www.federalreserve.gov/newsevents/speech/warsh20071005a.htm

[26] 12 U.S.C. § 1843(k)(4)(H).

[27] 12 U.S.C. § 1843(k)(4)(H).

[28] If a banking entity were to structure its interest in a joint venture to be non-controlling and therefore satisfy the requirements of section 4(c)(6) of the BHC Act, then the investment would satisfy the joint venture exclusion (so long as the other two prong criteria were met). We believe that this analysis could potentially remain true even if the banking entity invested in (and had a degree of control under applicable state law, but did not "control" for BHC Act purposes) a joint venture engaged in, but not *primarily* engaged in, proprietary

"…IS NOT, AND DOES NOT HOLD ITSELF OUT AS BEING, AN ENTITY OR ARRANGEMENT THAT RAISES MONEY FROM INVESTORS PRIMARILY FOR THE PURPOSES OF INVESTING IN SECURITIES FOR RESALE OR OTHER DISPOSITION OR OTHERWISE TRADING IN SECURITIES."

The third prong seems to have two main components. First, a joint venture may not be an entity that raises money from investors *primarily* for any of the three listed improper purposes. FAQ 15 appears to add a fourth improper purpose not included in the text of the rule—investing to share in the income from securities even if no trading or disposition occurs or is contemplated.[29] Second, whether or not it actually does so, a joint venture may not hold itself out (to the markets? the public?) as being an entity that raises money to engage in any one of these improper purposes.

As described above, we believe that the intention of this prong is to ensure that the joint venture will not be a "true" investment company—i.e., an entity engaged primarily in traditional securities investing activities; such entities are generally investment companies under the first prong of the 1940 Act definition.[30] (FAQ 15 appears to support this conclusion by stating that "[t]he limitations in the joint venture exclusion are meant to ensure that the joint venture is not an investment vehicle … ."[31]) But an entity that is not engaged primarily in investing in securities is unlikely to be an investment company, or a covered fund, in the first place; true, such an entity may be an "inadvertent investment company" that holds a significant concentration of securities even though investing is not its main activity,[32] but such companies can generally qualify for an exemption under the 1940 Act if they can demonstrate that despite their securities holdings their primary business is something other than investing in securities.[33] The third prong therefore renders the joint venture exclusion therefore largely irrelevant to all but those entities that are neither primarily engaged in investing in securities nor primarily engaged in a business other than investing in securities.

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trading that would be prohibited under the Volcker Rule (FAQ 15, when discussing investing in securities, in some places uses primarily and at other times just refers to investing in securities).

[29] *See* FAQ 15, available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#15 ("[T]he exclusion is not intended to include entities or arrangements that raise money from investors 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."

[30] Under Section 3(a)(1)(A) of the 1940 Act (the "subjective test" of investment company status), any issuer that "is or holds itself out as being engaged primarily . . . in investing in the business of investing, reinvesting, or trading in securities" is an investment company unless an exception applies.

[31] *See* FAQ 15, available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#15.

[32] An issuer that is not primarily engaged in investing in securities under the subjective test will still be a *prima facie* investment company under the "objective test" (Section 3(a)(1)(C)) if, generally, its holdings of securities exceed 40% of its total asset value.

[33] For example, Section 3(b)(1) provides that the objective test does not include "[a]ny issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."

CONCLUSION

Having reviewed the proposed rules implementing Volcker Rule, the final rules, the preamble to the final rules, FAQ 15 and market commentary on the joint venture exclusion, we do not find that the joint venture exclusion has been meaningfully broadened from its original incarnation in the proposed rule, notwithstanding the Agencies' claims to the contrary.

In trying to bring the joint venture exclusion out of the regulatory wilderness, we can offer two relatively concrete suggestions. First, joint venture entities with true operating businesses that are not engaged primarily in the business of investing in securities should qualify. However, most of these entities would likely not be investment companies anyway, and would likely not be covered funds subject to the Volcker Rule.

Second, the joint venture exclusion may assist banking entities investing in inadvertent investment companies, that is, companies not primary engaged in investing in securities but otherwise captured under the definition of investment companies and therefore as covered funds.[34] Such inadvertent entities may potentially squeak through the tightened criteria and make use of the exclusion.

[34] *See* The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act, Edmund H. Kerr, 12 Stan. L. Rev. 29 (1959-60).

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