PitchBook

The Revised Volcker Rule

The 2020 revisions and their implications for private market strategies

PitchBook is a Morningstar company. Comprehensive, accurate and hard-to-find data for professionals doing business in the private markets.

Credits & contact

Analysts

JAMES GELFER Senior Strategist
james.gelfer@pitchbook.com

DYLAN COX Lead Analyst, PE
dylan.cox@pitchbook.com

HILARY WIEK, CFA, CAIA Senior Analyst
hilary.wiek@pitchbook.com

Data Analyst

VAN LE Senior Data Analyst

Design

JULIA MIDKIFF Junior Graphic Designer

Contact PitchBook

pitchbook.com

RESEARCH

reports@pitchbook.com

Contents

Key takeaways	1
Background	2
The Volcker Rule	3-5
2020 Volcker Rule Revisions for Covered Funds	5-7
Analysis	8-11

Key takeaways

- Changing economic events and administrations have led to pendulum swings in the regulation of banks' involvement in private market funds, with many large banks shifting their operations following the passage of Dodd-Frank and the original Volcker Rule.

- The SEC is implementing revisions to the Volcker Rule, with the main change for private markets pertaining to the covered fund rule. Specifically, the revisions offer some scope for additional bank investment into venture and debt funds as both an LP and a GP, while also loosening restrictions on certain other activities.

- Banks are now allowed to commit to credit funds that make similar loans or investments to the bank itself. We believe more capital in the mid-market loan space could put further pricing pressure on an already crowded market.

- We do not see a need for additional large-scale VC funds in the market but believe the revisions will embolden large banks to raise new vehicles. Smaller, less capitalized VC ecosystems stand to benefit the most from the rule changes.

In October 2020, modifications will be made to the Volcker Rule that will impact numerous players in private markets, particularly banking institutions and managers of certain private-market fund strategies. Many market participants only have a vague sense of what the Volcker Rule is and why it exists, so we will endeavor to catch readers up on the timeline of events and then dive into the details and expected impacts of the new rule changes.

Published on September 15, 2020

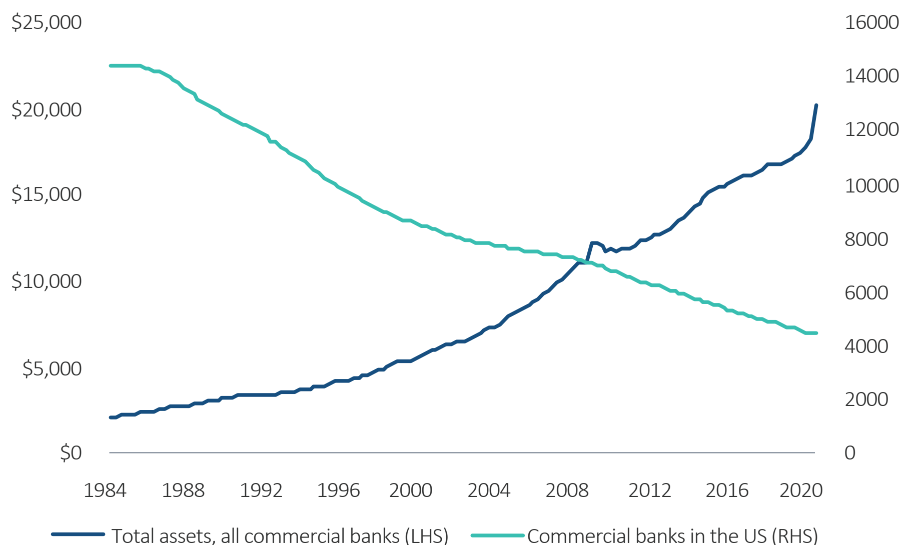
COPYRIGHT © 2020 by PitchBook Data, Inc. All rights reserved. No part of this publication may be reproduced in any form or by any means—graphic, electronic, or mechanical, including photocopying, recording, taping, and information storage and retrieval systems—without the express written permission of PitchBook Data, Inc. Contents are based on information from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Nothing herein should be construed as investment advice, a past, current or future recommendation to buy or sell any security or an offer to sell, or a solicitation of an offer to buy any security. This material does not purport to contain all of the information that a prospective investor may wish to consider and is not to be relied upon as such or used in substitution for the exercise of independent judgment.

HILARY WIEK, CFA, CAIA Senior Analyst
hilary.wiek@pitchbook.com

Background

From 1933 until its dissolution in November 1999, the Glass-Steagall Act mandated a separation of commercial and investment banking.[1] Responding to lobbying efforts dating back to the 1980s, the Financial Services Modernization Act of 1999 (aka the Gramm-Leach-Bliley Act) overturned portions of Glass-Steagall that had limited certain banking activities. While the new rules caused some firms to create new business lines in-house, a wave of mergers took place as the barriers were lifted that previously prevented commercial banking, investment banking, and insurance companies from being housed under one roof.

Number of commercial banks and total assets ($B)



Source: Federal Financial Institutions Examination Council (US); Board of Governors of the Federal Reserve System (US). Retrieved from FRED, Federal Reserve Bank of St. Louis, August 31, 2020 | **Geography:** US

The result of this widespread consolidation was that many institutions became in effect "too big to fail." So, when some did fail in 2008, government intervention—either through shotgun marriages like with Bear Stearns and Washington Mutual, or through shouldering banks' riskiest assets such as happened with Citigroup[2]—was required to ensure the US financial system did not collapse.

In the wake of the Global Financial Crisis (GFC) and this government intervention in the banking sector, sentiment swung back in favor of separating traditional banking activities from proprietary trading and the ability to create, buy, and sell risky assets and securities. This is overly simplistic, but suffice it to say that while Glass-Steagall was not reinstated, the Dodd-Frank Wall Street Reform Act, which passed in 2010, attempted to put more guardrails around banks to avoid re-encountering the circumstances that caused the GFC.

1: "Glass Steagall Act of 1933, Its Purpose and Repeal," The Balance, Kimberly Amadeo, April 24, 2020.
2: "Citigroup Gets Massive Government Bailout," Reuters, Dan Wilchins and Jonathan Stempel, November 25, 2008.

The Volcker Rule

As part of the effort to reduce the risks to taxpayers and the world economy, former US Federal Reserve Chairman Paul Volcker proposed in 2009 that federally insured banks be banned from many forms of short-term trading. His initial recommendation was a modest paragraph that led to Section 619 of the Dodd-Frank Act, titled "Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds." Section 619 mandated a long list of changes, but it left the responsibility to study and make implementation recommendations to the newly formed Financial Stability Oversight Council (FSOC).

Key elements of the Volcker Rule:

- Banks were prohibited from engaging in proprietary trading.[3]
- Banks were prohibited from owning or investing in a hedge fund or private equity fund.
- The rule limited the liabilities that the largest banks could hold.

After three years of attempting to define every possible situation, the FSOC came out with its rules in 2013, which were housed in a new Section 13 of the Bank Holding Company Act of 1956, now colloquially referred to as the "Volcker Rule." Through Section 13, Volcker's single paragraph recommendation had turned into 271 pages of rules and exemptions to the rules.[4] Banks lobbied intensely to limit the scope of the new rules and prolong implementation requirements as long as possible, and in some ways they were successful.[5] For one, the original timeline for this rule to take effect stretched from two years after the date of the law's enactment (July 21, 2010) to nearly four years later on April 1, 2014. Banks with $50 billion or more in consolidated trading assets and liabilities were not required to be in full compliance until 2015, while smaller banks had until 2016.

A key aspect of the original language in the Volcker Rule was to regulate banks' exposure to so-called "covered funds," defined broadly in the rule as "hedge funds and private equity funds." It generally "prohibited any banking entity 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."[6] Banks were also limited to investing a maximum 3% of their Tier 1 capital into private equity funds; for reference, Goldman Sachs' private equity assets represented 19% of its Tier 1 capital at the end of 2012.[7] Banks could still offer private

3: For more on prop trading: "What Is Proprietary Trading?" SmartAsset, Ashley Chorpenning, November 7, 2019. https://smartasset.com/investing/proprietary-trading
4: For the actual language of the Volcker Rule regulations: "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," US Department of the Treasury, January 31, 2014.
5: "Dodd-Frank Bill's Volcker Rule a Win for Big Banks," The Atlantic, Daniel Indiviglio, June 25, 2010.
6: "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," US Department of the Treasury, January 31, 2014.
7: "Goldman Sachs Has Already Figured a Way Around Regulation to Some of The Riskiest Investments on Wall Street," Business Insider, Jessica Toonkel and Lauren Tara LaCapra, March 4, 2013.

partnership investments to clients, but were severely limited in how much they could invest in these formal fund structures themselves. Some institutions found creative ways to circumvent the rules by finding what could be done outside of a formal fund structure, as a 2013 article about Goldman Sachs described: "Under the new plan, Goldman would then make investments in a syndicate fashion, contributing investor money, along with its own capital and partner dollars . . . . That would be different from a traditional private equity fund, where money from various investors has already been pooled together in a formal fund structure."[8]

The Volcker regulations prevent banks from using their name on private equity funds, for example, so Goldman has instead marketed its recent buyout funds under the "West Street Capital Partners" name. Many banks, including Goldman, also took advantage the rule's exemption for "merchant banking" activities, raising and operating funds through those divisions. Wells Fargo also doubled down on merchant banking, investing in buyouts and VC deals with its own funds instead of seeking external investors, which they believed was beyond the scope of the Volcker Rule.[9]

Citigroup, on the other hand, spun out its hedge fund business into Napier Park Global Capital in 2013 as a direct result of the Volcker Rule. Bank of America also took a more conservative approach, shedding selected businesses before the rules were final. JP Morgan announced in 2013 that it would spin out a private equity group into One Equity Partners; this may not have been entirely about the Volcker Rule, however, as the J.P. Morgan Private Equity Group did stay in-house, and in 2018 JPMorgan was named by Business Insider as the fourth largest hedge fund manager in the US.[10] As of 2016, Morgan Stanley still held $2.3 billion subject to the Volcker Rule,[11] but it was not clear if that included the $1 billion to $2 billion of private equity, real estate, and infrastructure funds that it was trying to sell through the secondaries market.

Teams of lawyers and lobbyists were hired by the banking sector to influence the rule making. Even after the deadline for compliance passed, banks continued to lobby for relief from the conditions of the Volcker Rule, and they were rewarded for the effort. The Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA, also known as the Crapo bill) passed in May 2018, the main Volcker-related effect being that banks under $50 billion in total consolidated assets were no longer going to be asked about compliance with the Dodd-Frank rules that had been designed for large banks.

8: "Exclusive: Goldman Finds New Way to Do Buyouts in Face of Volcker," Reuters, Jessica Toonkel and Lauren Tara LaCapra, March 4, 2013.
9: "Wells Fargo Ramps Up Private Equity Despite Volcker Rule," Reuters, Rick Rothacker, February 20, 2013.
10: "RANKED: The 10 Biggest Hedge Funds in the US," Business Insider, Michael Selby-Green, May 18, 2018.
11: "Morgan Stanley Carries $2.3bn Subject to Volcker Rule," Private Equity International, Annabelle Ju, October 27, 2016.

Amendments in 2019 built off the EGRRCPA's intent to provide regulatory relief to smaller banks by setting up bands for compliance: Banking entities with total consolidated trading assets and liabilities of at least $20 billion faced the most stringent compliance requirements, banks between $1 billion and $20 billion had a simplified compliance program, and banks under $1 billion would not be required to demonstrate compliance. This round of rules was largely about proprietary trading, but it did set up the concept of different levels of treatment for regulatory purposes, and there was mention that more rules surrounding covered funds were coming.

JAMES GELFER Senior Strategist
james.gelfer@pitchbook.com

2020 Volcker Rule Revisions for Covered Funds

In January 2020, the SEC issued a proposal for additional changes to the Volcker Rule, many of which concerned the treatment of covered funds. Following a comment period, the SEC announced in June 2020 that new amendments would be adopted, with the final rule taking effect on October 1, 2020. Since the revisions primarily remove regulations, rather than increasing compliance burdens, the agencies do not expect to need a transition period. The new 2020 rule outlines three explicit objectives related to covered funds, stating that it: i) "clarifies and simplifies compliance with the implementing regulations," ii) "refines the extraterritorial application of section 13 of the BHC Act," and iii) "permits additional fund activities that do not present the risk Section 13 was intended to address."[12]

Regarding "extraterritorial application," the rule exempts certain foreign investors and funds domiciled outside the US. The rule also includes exclusions for family wealth management and customer facilitation vehicles, which should allow banks more access to single-family offices and special-purpose-vehicle (SPV) fund structures. Additionally, the 2020 rule made some additional adjustments to the rules governing the relationships between banking entities and covered funds, but, as noted in the National Law Review, many of these amendments simply serve to "codify positions that the agencies already had been taking."[13] To that end, the parts most asset managers and investors will find pertinent will be the areas pertaining to changes to the definition of "covered funds."

Those familiar with alternative investments will appreciate that what exactly constitutes a hedge fund or private equity fund is often open for debate. As implemented under the 2013 version of the rule, "covered fund" included a variety of private market fund strategies beyond what PitchBook (and many other industry professionals) would define as "private equity," including VC and private debt funds.

12: "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," US Department of the Treasury, June 25, 2020.
13: "Volcker Rule Amended to Permit Venture Fund, Credit Fund and Other New Investments," National Law Review, Daniel L. McAvoy and Caroline C. Steck, July 2, 2020.

The 2020 rule includes specific exclusions from the covered fund definition for both "funds that extend credit to permit the same credit-related activities that banking entities can engage in directly" (i.e., direct lending funds) and VC funds.

Venture Funds

VC funds are often lumped under the broader category of "private equity," but there are fundamental differences between a minority equity investment (i.e., venture) and the acquisition of a mature company using debt (i.e., leveraged buyout). This distinction serves as a primary justification for why VC funds should be excluded from the Volcker Rule, with the 2020 rule stating that "The agencies believe [venture capital funds] may pose less potential risk to a banking entity sponsoring or investing in venture capital funds and to the financial system—specifically, the smaller role of leverage financing and a lesser degree of interconnectedness with the public markets."[14] To that end, the recent revisions explicitly cite definitional confusion as a rationale for changing the rules: ". . . Congress mandated specific treatment for venture capital funds for . . . registration requirements . . . . This provision suggests that Congress knew how to accord specific treatment for venture capital funds. Yet, Congress did not list venture capital funds among the types of funds that were restricted . . . .[15]

Example of fund classifications in government filing*

4. Industry Group

- [ ] Agriculture
- Banking & Financial Services
  - [ ] Commercial Banking
  - [ ] Insurance
  - [ ] Investing
  - [ ] Investment Banking
  - [X] Pooled Investment Fund
    - [ ] Hedge Fund
    - [ ] Private Equity Fund
    - [X] Venture Capital Fund
    - [ ] Other Investment Fund
  - Is the issuer registered as an investment company under the Investment Company Act of 1940?
    - [ ] Yes
    - [X] No
  - [ ] Other Banking & Financial Services
- Health Care
  - [ ] Biotechnology
  - [ ] Health Insurance
  - [ ] Hospitals & Physicians
  - [ ] Pharmaceuticals
  - [ ] Other Health Care
- [ ] Manufacturing
- Real Estate
  - [ ] Commercial
  - [ ] Construction
  - [ ] REITS & Finance
  - [ ] Residential
  - [ ] Other Real Estate
- [ ] Retailing
- [ ] Restaurants
- Technology
  - [ ] Computers
  - [ ] Telecommunications
  - [ ] Other Technology
- Travel
  - [ ] Airlines & Airports
  - [ ] Lodging & Conventions
  - [ ] Tourism & Travel Services
  - [ ] Other Travel
- [ ] Other

Source: Securities and Exchange Commission | **Geography:** US
*For illustrative purposes only

14: "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," US Department of the Treasury, June 25, 2020.
15: Ibid.

DYLAN COX Lead Analyst
dylan.cox@pitchbook.com

Indeed, VC funds have already been explicitly defined under Rule 203*(l)*-1 of the 1940 Act, which has several specific requirements pertaining to potential investors, qualifying investments, leverage, and qualifying investors. Specifically, leverage is capped at 15% of the fund's capital contributions, and uncalled capital and investments are not allowed redemption or liquidity rights. Furthermore, the qualifying investment criteria restricts holdings to equity securities in private companies, with a threshold of 20% for non-qualifying investments; this effectively prohibits activities typically associated with hedge funds or buyout funds. The Volcker Rule revisions also specify that the funds cannot be engaged in any activity that would constitute proprietary trading, effectively prohibiting banks from using a VC fund as a means to circumvent the proprietary trading rules that remain in effect.

Credit Funds

Under the 2013 rule, credit funds were included under the definition of covered funds due to concerns about regulators' ability to distinguish credit funds from private equity or hedge funds. With the 2020 changes, banks will be allowed to invest in funds that "make loans, invest in debt, or otherwise extend the type of credit that banking entities may provide directly under applicable law."[16] More specifically, credit funds will be excluded from the definition of covered funds if they consist solely of:

- "Loans
- Debt instruments
- Related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments
- Certain interest rate or foreign exchange derivatives"[17]

The exclusion is subject to a few additional requirements, but the broad intent is to expand banks' ability to extend credit, while minimizing potential loopholes when it comes to their involvement with private equity or hedge funds. Banks are also allowed to hold equity and equity-linked features, such as warrants, if they are "received on customary terms in connection with the credit fund's loans or debt instruments."[18] There is no upper limit to the value of these equity holdings, as the agencies explicitly recognized that these values often fluctuate materially with market changes over time. Finally, the agencies are keeping separate the definitions of credit funds from securitized loans, for which there was already an exemption in the original rule.

16: Ibid.
17: Ibid.
18: Ibid.

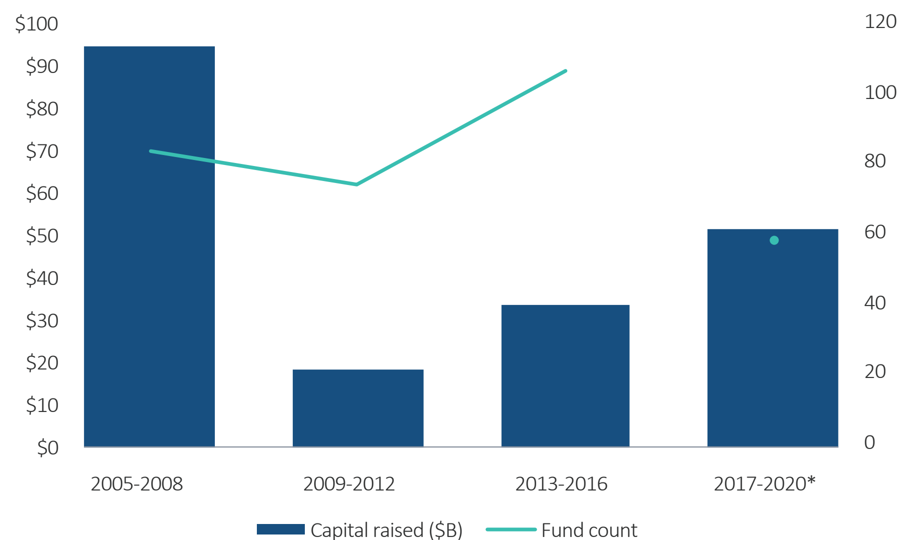
JAMES GELFER Senior Strategist
james.gelfer@pitchbook.com

Analysis

Impact on Banks

As noted previously, most of the large banks seem to have found ways to avoid full compliance with the Volcker Rule, continuing to hold investment funds and seeking extensions from requirements to sell them as recently as 2017, well after compliance was to have been mandatory.[19] That being said, the data shows a marked downturn in private market fundraising by banking institutions in the years following the GFC and the passage of the Dodd-Frank Act. Fundraising by banks reached an all-time high of more than $40 billion in 2007, but fundraising collapsed in the aftermath of the GFC, with less than $20 billion total raised from 2009 to 2012.

Private market fundraising by banking institutions



Source: PitchBook | **Geography:** US
*As of August 28, 2020

Fundraising by banks did not disappear entirely, however. A handful of notable funds have been raised by firms that were hesitant to come into compliance with the Volcker Rule, particularly Goldman Sachs, by raising fund vehicles mainly through their merchant banking divisions. Additionally, as mentioned earlier, many banks spun out their PE arms and/or continued to conduct large private market operations via funds-of-funds, secondaries, and advisory services. Because many banks were able to avoid the full scope of the original Volcker Rule, we believe they will be prepared to take advantage of the new revisions. Goldman has already announced plans for a new $2.0 billion venture and growth fund, and Citi launched an impact VC fund early in 2020.

19: "Fed Gives Extension on Complying with Part of Volcker Rule to Three Banks," Reuters, Kevin Lamarque, May 26, 2017.

The largest banks get called out because few smaller banks sponsored or had ownership interests in covered funds when the rules came into being. In fact, most community banks would have felt very little impact from the Volcker Rule, as the rules were focused on banks that had become too big to fail. Some have even presented evidence that the rules have decreased some of the disadvantage smaller banks have had in relation to the larger banks [20]

Impact on Venture Capital

We agree that VC funds pose little to no systemic risk to the financial system and that there appears to be limited rationale for including them under the broader covered fund definition. VC funds are often promoted as an engine for fueling innovation, and that sentiment was explicit in the revisions: "The agencies believe the exclusion for qualifying venture capital funds will support capital formation, job creation, and economic growth, particularly with respect to small businesses and start-up companies."[21] A section from the Comments portion is worth citing in its entirety as well:

> "Several commenters said an exclusion for venture capital funds would benefit underserved regions where venture capital funding is not readily available currently. One commenter said venture capital fund sizes are often too small for institutional investors, and banks have historically served an important source of investment for small and regional venture capital funds. This commenter said the loss of banking entities as limited partners in venture capital funds has had a disproportionate impact on cities and regions with emerging entrepreneurial ecosystems areas outside of Silicon Valley and other traditional technology centers."[22]

We agree that the greatest impact of the 2020 revisions will be felt outside of major VC hubs, but we are skeptical about the potential size of the impact. While we observed a pullback in VC fundraising by banks after the Volcker Rule, smaller regional banks were never a particularly large portion of overall VC activity, whether raising funds themselves or committing capital to outside vehicles. We recognize an acute need for capital in certain startup ecosystems across the country, however, as is detailed in our prior research. In places with particularly low ratios of dry powder to startup activity, the ability of banks to serve as institutional capital could have a meaningful impact.

20: "The Impact of the Volcker Rule on Targeted Banks, Systemic Risk, Liquidity, and Financial Reporting Quality," Science Direct, Fayez A. Elayan et al., November 28, 2017.
21: "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," US Department of the Treasury, June 25, 2020.
22: Ibid.

VC ecosystems with lowest local capital ($M) per startup*

	Dry powder ($M)**	Active VC companies	Dry powder per active VC company ($M)
Minneapolis-St. Paul, MN-WI	$31.2	240	$0.1
Pittsburgh-New Castle-Weirton, PA-OH-WV	$321.4	154	$0.1
Portland-Vancouver-Salem, OR-WA	$50.5	236	$0.2
Dallas-Fort Worth, TX-OK	$77.8	272	$0.3
Miami-Port St. Lucie-Fort Lauderdale, FL	$87.5	291	$0.3

Source: PitchBook | **Geography:** US
*As of September 30, 2019
**December 31, 2018

Our data shows that aggregate VC fundraising has surpassed pre-GFC levels, but most of that capital has been concentrated in California, New York, and Massachusetts. The share of VC capital raised outside those three states has fallen from 22%-28% in the pre-GFC years to 11%-22% in the 2010s. We believe that the 2020 revisions will lead to greater activity from banks in regional VC ecosystems and close this gap somewhat, but we also think banks will continue to play a relatively small role in overall VC activity, both as managers of funds and as providers of capital as limited partners. We view other recent developments—such as the ongoing evolution of fund structures and updates to the accredited investor rule—as being more impactful to less capitalized regions where startups are often backed by local individual investors, especially at the earlier stages.

DYLAN COX Lead Analyst
dylan.cox@pitchbook.com

Impact on credit funds

We believe the new rules will present new fundraising opportunities and the potential for heightened competition in the private credit space, with the extent of its effects limited to direct lending funds. The current direct lending ecosystem largely resulted from post-GFC banking regulation limiting the lending activity of banks; most decision makers at these non-bank affiliated funds received their training at major banks. We expect a rekindling of those connections, potentially including announced partnerships or the seeding of new funds; however, established managers who now run their own firms will be reluctant to take on a larger regulatory burden by fully returning to the banks. In short, the direct lending ecosystem has become too developed to see a full reversal to the pre-GFC status quo.

With the new rules meant to expand banks' ability to extend credit through private fund structures, we expect to see more capital flowing into an already crowded market. Notwithstanding the current COVID environment, deal terms and pricing could tighten even further for mid-market direct lending opportunities due to the heightened capital

availability. However, banks already had some exposure to this space. For example, Goldman Sachs, via its merchant banking division, raised $4.4 billion for direct lending opportunities in 2019. Moreover, a 2017 ruling had already allowed banks to lend past the 6.0x debt/EBITDA threshold, allowing them to participate in riskier financings such as the leveraged buyouts that many direct lending funds target.

Impacts of the 2020 Volcker Rule revisions

Banks	Venture Funds	Private Debt Funds
The crux of the rules is a greater ability to participate in VC and private debt funds.	Smaller, less capitalized VC ecosystems stand to benefit the most.	Banks are now allowed to commit to credit funds that make similar loans or investments to the bank itself.
The rules create opportunities for large banks, although many have found ways to circumvent existing rules.	While smaller regional VC ecosystems stand to benefit, we see the 2020 revisions as having limited impact on the industry broadly.	The impact will be limited to direct lending funds, which now have more potential investors.
Small banks are cited as primary beneficiaries, but we are skeptical that we will see meaningful new activity from these institutions.	We do not see a need for additional large-scale VC funds in the market but believe the revisions will embolden large banks to raise new vehicles.	More capital in the mid-market loan space could put further pricing pressure on an already crowded market.

Source: PitchBook