

Joint Press Release

June 25, 2020

Statement by Governor Brainard

As a result of financial reform mandated by the Dodd-Frank Act, the U.S. banking system is more resilient and is able to play a constructive role during the COVID-19 pandemic. Given that they are currently serving the country well, I see no reason for the rush to weaken these protections, particularly in the midst of COVID-19 disruptions.

With the Volcker rule, Congress put in place strong protections to limit banks' exposure to speculative trading activity directly and indirectly through risky funds, so these activities do not again put taxpayer money and the financial system at risk. Specifically, the covered fund provisions of the Volcker rule restrict banking entities' investment in risky, complex investment funds and limit how a banking entity can sponsor such funds as well as the transactions between a banking entity and the funds it sponsors. These protections serve an important purpose. They reduce risk-taking by banking entities and banks' incentives to bail out funds in times of stress. They also constrain indirect proprietary trading. The covered fund provisions decrease risks to the large banks at the core of our financial system, to taxpayers, and to the federal safety net.

I supported exempting community banks from the Volcker rule, and I support addressing the unintended application of the Volcker rule to certain funds organized outside of the United States and offered to foreign investors, known as foreign excluded funds. However, I am concerned key changes in the final rule weaken core protections in the Volcker rule and will permit banking entities to return to risky activities seen in the 2008 financial crisis.

Specifically, the final rule would open the door for firms to invest in a broad set of venture capital funds without limit. The test used to define venture capital funds imposes no size restrictions on the companies in which a venture capital fund may invest and permits 20 percent of a fund to be invested in any portfolio company. The test relies on a 2011 Securities and Exchange Commission definition of venture capital funds related to the Investment Advisers Act of 1940. This definition was rejected in the 2013 Volcker rule. Under the proposed definition, venture capital funds are indistinguishable from private equity funds. In the preamble to the 2013 rule, the agencies stated that the statutory language does not support excluding venture capital funds from the definition of covered fund, and there have been no changes to the statutory language that would provide a basis for excluding them now.

The final rule also would open the door for firms to invest without limit in credit funds. Some

credit funds played a material role in the financial crisis. These funds were not transparent in their activities, misled investors, and contributed to the financial abuses Congress intended to address in the Dodd-Frank Act.

In connection with the 2013 rule, the agencies were clear that a banking entity could not evade the Volcker rule's fund investments limits by making a parallel investment with a sponsored covered fund. This was intended to address the risk that a bank would "bail out" a sponsored fund if it got into trouble. In contrast, the final rule would expressly allow parallel investments that are economically identical to fund investments but exceed all statutory limits. These types of investments could create incentives to bail out these sponsored covered funds. The final rule does not provide evidence of changes to the statute or the associated risks that would justify permitting banks to make such investments.

Many of the changes that will be finalized today were considered and rejected in the 2013 rule. The rulemaking does not present compelling analysis that would warrant their reversal. When Congress amended the Volcker rule two years ago, it did not choose to make any of the changes reflected in the final rule. Congress chose not to add any new exclusions to the definition of covered fund or to expand any of the existing exclusions. Moreover, the covered fund provisions of the Volcker rule have been in place for seven years and the market has adapted well to them. During that time, U.S. banks have been very profitable and have remained competitive with their foreign counterparts. For these reasons, I do not support the final rule.

Last Update: June 25, 2020