

FUND FINANCE FRIDAY

Regulators OK Fund-Linked Products Under the Volcker Rule

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The recently adopted changes to the Volcker Rule regulations add an exemption for risk-mitigating hedging in the context of covered fund activities. The exemption allows a banking entity to hold ownership interests in covered funds, including hedge funds and private equity funds, to facilitate the exposure by its customers to the profits and losses of such covered funds. The ownership of the covered fund interests must be designed to reduce or mitigate specific identifiable risks arising out of customer requests.

Many practitioners will remember that such an exemption was included in the 2011 proposed Volcker Rule regulations, but was unexpectedly left out of the final regulations adopted in 2013. The final regulations retained only a narrowed hedging exemption with respect to covered funds, limiting banking entities to risk-mitigating hedges related to employee compensation arrangements. As a result, following the 2013 rulemaking, many existing fund-linked products that involved the banking entity offering a customer an instrument referencing the performance of a covered fund (including total return swaps, structured notes, warrants and call options) had to be restructured or terminated because the banking entity was no longer permitted to retain the necessary hedge to its exposure. Such products were used to provide customers exposure to covered funds in a manner that was tailored to specific tax, accounting and/or leverage objectives. U.S. banks ceased to offer such products after the final Volcker Rule regulations became effective in 2017, and non-U.S. banks were forced to move their fund-linked derivatives businesses outside the United States.

The restoration of the risk-mitigating hedging exemption has been anticipated for some time, and has raised expectations for a revival of fund-linked products in the U.S. market.