

# The Banking Law Journal

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**EDITOR'S NOTE: BANKING HISTORY IN THE MAKING**

Victoria Prussen Spears

**OFAC ISSUES SANCTIONS GUIDANCE TO VIRTUAL CURRENCY INDUSTRY**

Abena Mainoo, Chase D. Kaniecki, Michael G. Sanders, John Lightbourne and William S. Dawley

**FEDERAL BANK REGULATORS SET OUT REGULATORY ROADMAP FOR CRYPTO-ASSETS**

Clifford S. Stanford, Brian D. Frey, Brendan Clegg and Jessica Garcia Keenum

**U.S. FEDERAL BANKING AGENCIES ISSUE RULE REQUIRING BANKS TO NOTIFY REGULATORS OF CYBER INCIDENTS WITHIN 36 HOURS**

Daniel Silver, Megan Gordon, Celeste Koeleveld, Philip Angeloff, Brian Yin and Shannon O'Brien

**FINANCIAL INSTITUTIONS NEED TO KEEP UP WITH THE CHANGING BUSINESS OF RANSOMWARE**

Michael A. Mancusi, Kevin M. Toomey, Nancy L. Perkins, Anthony Raglani, Daniel E. Raymond and Kara Ramsey

**OCC ADVISES BANKS TO CAREFULLY EVALUATE VENTURE CAPITAL FUND INVESTMENTS**

David F. Freeman, Jr., Kevin M. Toomey and Anthony Raglani

**U.S. BANK REPORTING HANDBOOK UPDATED BY OCC**

Jeffrey P. Taft and Matthew Bisanz

**NAVIGATING FAIR LENDING AND REDLINING CONSIDERATIONS UNDER THE BIDEN ADMINISTRATION**

Abigail M. Lyle and Nicole Skolnekovich

**NEW YORK IMPOSES COMMUNITY REINVESTMENT ACT REQUIREMENTS ON MORTGAGE BANKERS**

Bob Jaworski

**FIFTH CIRCUIT HOLDS DIFFICULT ECONOMIC CIRCUMSTANCES INSUFFICIENT TO CLAIM DURESS; LENDERS ENTITLED TO THREATEN TO EXERCISE CONTRACTUAL RIGHTS AS NEGOTIATING LEVERAGE**

Gregory G. Hesse and Jennifer E. Wuebker

**CURRENT DEVELOPMENTS**

Steven A. Meyerowitz

# THE BANKING LAW JOURNAL

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VOLUME 139

NUMBER 3

March 2022

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<b>Editor's Note: Banking History in the Making</b> Victoria Prussen Spears	109
<b>OFAC Issues Sanctions Guidance to Virtual Currency Industry</b> Abena Mainoo, Chase D. Kaniecki, Michael G. Sanders, John Lightbourne and William S. Dawley	112
<b>Federal Bank Regulators Set Out Regulatory Roadmap for Crypto-Assets</b> Clifford S. Stanford, Brian D. Frey, Brendan Clegg and Jessica Garcia Keenum	118
<b>U.S. Federal Banking Agencies Issue Rule Requiring Banks to Notify Regulators of Cyber Incidents Within 36 Hours</b> Daniel Silver, Megan Gordon, Celeste Koeleveld, Philip Angeloff, Brian Yin and Shannon O'Brien	122
<b>Financial Institutions Need to Keep Up with the Changing Business of Ransomware</b> Michael A. Mancusi, Kevin M. Toomey, Nancy L. Perkins, Anthony Raglani, Daniel E. Raymond and Kara Ramsey	126
<b>OCC Advises Banks to Carefully Evaluate Venture Capital Fund Investments</b> David F. Freeman, Jr., Kevin M. Toomey and Anthony Raglani	130
<b>U.S. Bank Reporting Handbook Updated By OCC</b> Jeffrey P. Taft and Matthew Bisanz	134
<b>Navigating Fair Lending and Redlining Considerations Under the Biden Administration</b> Abigail M. Lyle and Nicole Skolnekovich	138
<b>New York Imposes Community Reinvestment Act Requirements on Mortgage Bankers</b> Bob Jaworski	143
<b>Fifth Circuit Holds Difficult Economic Circumstances Insufficient to Claim Duress; Lenders Entitled to Threaten to Exercise Contractual Rights as Negotiating Leverage</b> Gregory G. Hesse and Jennifer E. Wuebker	148
<b>Current Developments</b> Steven A. Meyerowitz	152

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# OCC Advises Banks to Carefully Evaluate Venture Capital Fund Investments

*By David F. Freeman, Jr., Kevin M. Toomey and Anthony Raglani\**

*The Office of the Comptroller of the Currency has published a bulletin advising national banks that many equity investments as principal in venture capital funds are not permissible for national banks. The authors of this article discuss the Bulletin, which serves as a reminder to banks to carefully evaluate any potential venture capital fund investment to ensure that the investment is legally permissible, consistent with supervisory expectations for banks' equity investments and their own risk appetites, and carried out in accordance with applicable risk management controls.*

The Office of the Comptroller of the Currency (“OCC”) published Bulletin 2021-54 (the “Bulletin”) advising national banks that many equity investments as principal in venture capital funds are not permissible for national banks.<sup>1</sup> The key points of the Bulletin, which is published amid a substantial increase in global venture capital investment activity,<sup>2</sup> are set forth below.

- Banks generally are not authorized to make passive equity investments in venture capital funds.
- Equity investments in venture capital funds may be permissible if they are public welfare investments or investments in small business investment companies that are specifically authorized by statute.<sup>3</sup>
- Qualifying for the Volcker Rule’s “covered fund” exclusion for “qualifying venture capital funds” does not make a fund a permissible investment for a bank.<sup>4</sup>
- Before a bank invests in a venture capital fund, the bank must determine whether the investment is legally permissible and appropriate for that institution. Impermissible and inappropriate investments

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<sup>1</sup> OCC Bulletin 2021-54, Investments: Venture Capital Funds (Nov. 23, 2021).

<sup>2</sup> See, e.g., Guarav Dogra and Patturaja Murugaboopathy, Global venture capital investments hit record high, REUTERS, July 21, 2021.

<sup>3</sup> See 12 USC § 24(Eleventh); 15 USC § 682(b); 12 CFR Part 24 & § 7.1015.

<sup>4</sup> See 12 USC § 1851(a)(1)(B); 12 CFR § \_\_\_\_.10(c)(16).

may expose the bank and its institution-affiliated parties to enforcement actions and civil money penalties. Further, national bank directors may be personally liable for impermissible investment losses.<sup>5</sup>

## RESTRICTIONS ON INVESTMENTS

Restrictions on investments by “banking entities” (as defined for Volcker Rule purposes as banks and companies controlling, controlled by, or under common control with, the bank—with certain exceptions) as principal in venture capital funds were relaxed in one respect in July 2020 when the federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission amended the regulations implementing the Volcker Rule to provide an exclusion from the Volcker Rule’s prohibition on banking entity “covered fund” investments for qualifying venture capital fund investments.

In adopting this exclusion, the agencies stated their views that the activities and risk profiles of venture capital funds are distinguishable from those of hedge funds and other private funds that Congress intended to fall within the “covered fund” investment prohibition of the Volcker Rule and that the exclusion would support capital formation, job creation and economic growth for small businesses and start-up companies.<sup>6</sup>

## VENTURE CAPITAL FUND

A venture capital fund is defined under applicable rules<sup>7</sup> as a private fund that:

- (a)(1) represents to existing and potential investors that it pursues a venture capital strategy;
- (2) immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20% of the amount of the fund’s aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund;

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<sup>5</sup> See 12 USC § 93(a).

<sup>6</sup> See Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46,422, 46,444 (July 31, 2020).

<sup>7</sup> 12 CFR § \_\_\_\_.10(c)(16)(i); 17 CFR § 275.203(l)-1(a).

(3) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage, in excess of 15% of the fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the fund of a qualifying portfolio company's obligations up to the amount of the value of the fund's investment in the qualifying portfolio company is not subject to the 120 calendar day limit;

(4) only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders pro rata;

(5) is not registered as an "investment company" under Section 8 of the Investment Company Act of 1940, and has not elected to be treated as a "business development company" pursuant to Section 54 of that Act; and

(b) does not engage in "proprietary trading" within the meaning given to that term by the Volcker Rule and its implementing regulations.<sup>8</sup>

Notwithstanding the Volcker Rule "covered fund" exclusion for banking entities' qualifying venture capital fund investments, that change to the Volcker Rule did not provide authority for banks and their operating subsidiaries to invest in venture capital funds or other equity investments. Banks must be able to identify independent authority establishing that such investments are bank permissible investments.

As noted in the Bulletin, in some cases, venture capital fund investments may fall within banks' public welfare or small business investment company investment powers; however, such investments may also be permissible under a national bank's powers to establish and invest in operating subsidiaries or to make non-controlling equity investments in entities that engage in bank permissible activities—provided, in each case, that such investments are convenient and useful to the bank's business and not mere passive investments, and other applicable conditions are satisfied.<sup>9</sup>

## EVALUATING BANK INVESTMENTS

The Bulletin also emphasizes the need for the senior management and boards of directors of national banks to evaluate every bank investment, including

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<sup>8</sup> See 12 USC § 1851(a)(1)(A); 12 CFR § \_\_\_\_3.

<sup>9</sup> See 12 CFR §§ 5.34 & 5.36.



venture capital fund investments, to ensure that investments are consistent with safety and soundness standards and the bank's risk profile and appetite. Such evaluation requires an understanding of the nature and structure of the investment, any specialized risks posed by the investment (e.g., interest rate risk, credit risk, liquidity risk, etc.), the practical reason(s) for the investment and, as discussed above, the legal authority that provides a basis for the bank to make the investment.

In sum, as the venture capital market continues to experience growth, the Bulletin serves as a reminder to national banks (and, in effect, all banking organizations) to carefully evaluate any potential venture capital fund investment to ensure that the investment is legally permissible, consistent with supervisory expectations for banks' equity investments and their own risk appetites, and carried out in accordance with applicable risk management controls.