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Playing by the Volcker Rule: How Deregulation Threatens the Firewall Between Banks and Risk

ABSTRACT. The Volcker Rule's Covered Fund Provision, enacted under the Dodd-Frank Act in 2013, was designed to separate traditional banking from speculative investment activities to safeguard financial stability and delineate the roles of distinct segments within the financial system. In 2020, financial regulators compromised this regulatory firewall by excluding venture capital and credit funds from the provision's restrictions, allowing banks to serve as investors, sponsors, and working partners. This paper critiques the 2020 modification through a combination of legal and regulatory analysis. I will first examine the foundational purpose and structure of the original Volcker Rule. Then, I will interpret the statutory definitions, treatment, and risk profiles of venture capital and credit funds. Together, these analyses support the paper's primary contention that the 2020 modification failed on two core fronts: contradicting the original legislative intent of the Volcker Rule and reintroducing systemic vulnerabilities by enabling banks to invest in high-risk, illiquid, and speculative funds. Reinstating an uncompromising definition of covered funds and creating a clear separation of federally insured banks from speculative investments will be critical to maintaining systemic financial stability and preserving systemic resilience from future crises.

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INTRODUCTION

In the aftermath of the 2008 Global Financial Crisis (GFC), the implementation of the Volcker Rule's Covered Fund Provision, Section 619 of the Dodd-Frank Act, served as a core mechanism in restoring stability to the banking system. The provision aimed to insulate banks from high-risk investment entities by prohibiting sponsorship and limiting investment in speculative investment entities, referred to as covered funds. In 2020, bank regulators adopted a modification of the Volcker Rule's Covered Fund Provision by excluding specific investment entities, including venture capital (VC) and credit funds.

I argue that the exclusion of VC and credit funds from the Volcker Rule's covered fund restriction contradicts the original legislative intent of the post-GFC regulation, re-exposing the banking sector and broader economy to the same systemic regulatory loopholes that fueled the pre-crisis financial market instability. I approach this argument in two steps. First, I examine the trade-offs between capital formation as an instrument for economic growth and the need to preserve the stability of the banking sector, which plays a vital role in safeguarding depository funds, facilitating credit extension, and ensuring liquidity. The Volcker Rule's legislative authors and implementers favored stability over capital access, emphasizing that expanding investment opportunities must not come at the expense of federally insured banks' stability.

Second, I argue that the 2020 modification of the Covered Fund Provision erred in three key regulatory respects. One, legislators of the original Volcker Rule rejected statutory exemptions from covered fund definitions, including VC and credit funds. Two, proponents of the 2020 modification underestimated the risks in the structure and asset holdings of VC and credit funds, as concerns of liquidity mismatches and divergent risk tolerance between banks and covered funds prompted the Volcker Rule's separation of banks and high-risk investment institutions. Three, when banks are allowed to retain both investment and ownership interests in VC and credit funds, their relationship with these funds can be distorted from the intended purposes of the 2020 modification. In the case of VC funds, banks may influence the investment selection process to serve their prospective lending and strategic interests rather than committing to the industrial growth VC funds' claim. In the case of credit funds, banks can offshore high-risk assets or extend high-risk credit through fund structures, circumventing regulatory oversight and avoiding direct balance sheet exposure.

I. BACKGROUND

A. Rationale for Financial Regulation

Throughout financial history, policymakers and banks have debated the appropriate scope of banking regulation. While the banking industry argues that excessive oversight can stifle economic growth, policymakers view banking regulation as the fundamental safeguard against financial crises. This regulatory principle of insulating commercial banks from speculative activities has been embedded in major financial regulations, including the Great Depression Banking Act of 1933 (Glass Steagall)¹ and Dodd-Frank's Volcker Rule.

Following the 2008 GFC, when over \$245 billion in taxpayer funds were allocated to bank stabilizations,² it became clear that banks must be held to a higher standard of operation. Considering the banking industry's market interconnectedness and vital economic functions, federal regulators deemed the banks "too big to fail."³ In the event of a bank's collapse, the consequences extend far beyond its shareholders, triggering a cascading effect on the broader economic system by threatening small businesses' operations, household deposits, payment facilitation, and credit extension. Consequently, rescuing banks from their failures requires extraordinary government intervention. In exchange for the financial protection and unique privileges, such as federal deposit insurance and emergency liquidity guarantees from the public sector,⁴ insured banks are expected to operate under enhanced oversight with a clear separation of speculative investment activities that operate against the bank's maintenance of stability.

Advocacy for the protection of commercial banks from speculative and high-risk activities has garnered widespread support across all segments of financial regulation. On the legislative floor, Senator Elizabeth Warren and John McCain led bipartisan efforts to install a divide between commercial banking from riskier institutions within a

¹ Banking Act of 1933, Pub. L. No. 73-66, §§ 20-21, 48 Stat. 162, 174-175 (1933).

² U.S. Dep't of the Treasury, *Troubled Asset Relief Program (TARP)* (Under Troubled Asset Relief Program, more than \$250 billion was committed in programs to stabilize banking institutions).

³ Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Remarks before the 47th Annual Conference on Bank Structure and Competition (May 5, 2011).

⁴ See George French, *A Year in Bank Supervision: 2008 and a Few of Its Lessons*, FDIC, Jun. 6, 2023, <https://www.fdic.gov/bank-examinations/year-bank-supervision-2008-and-few-its-lessons#:~:text=On%20October%2013%2C%202008%2C%20the,%2C%202008%20>.

common ownership,⁵ often in the form of a bank holding company.⁶ At the central bank, former Federal Reserve Chair Paul Volcker was the chief architect of the Volcker Rule that discontinued commercial banks' ability to hold non-banking relations with designated investment entities.⁷

However, despite support for a strong regulatory presence in the banking industry, periods of economic calm have historically led to financial regulators adopting a looser regulatory philosophy. This included the expansion of banks' ability to venture into investment institutions and an extension of credit lending capabilities with a disregard for systemic risk and institutional conflicts of interest. Proposals to diminish the authoritative abilities of financial regulators have gone largely unnoticed by the public, and the economy is returning to a point of instability, fragility, and entanglement. The following section explains how the dismantling of post-Great Depression banking regulations contributed to the systemic instability that exacerbated the 2008 GFC shock.

B. Historical Context and Cycle of Deregulation and Its Consequences

In 1999, a period of strong economic growth,⁸ the Financial Service Modernization Act⁹ effectively repealed the Glass Steagall Act by enabling commercial banks to engage in proprietary trading and direct affiliation with investment banking activities. As a result, the nation's banking frenzy spiraled into the 2008 financial meltdown.

Major bank holding companies, many with large commercial banking subsidiaries, played a catalytic role in originating the subprime (loans to poor credit borrowers) and Alt-A (loans to borrowers with limited documentation) mortgages while simultaneously underwriting mortgage-backed securities with high-risk loan packages. Working directly with their investment banking partners, the issuance of securities made it possible for investors to take bets on the US housing market.¹⁰ Commercial banks took risky positions as their mortgages were lent out to bad credit under

⁵ 21st Century Glass Steagall Act of 2017, S.881, 115th Cong. (2017).

⁶ 12 U.S.C § 1841 (A)(i) (Any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter).

⁷ Dodd–Frank Wall Street Reform and Consumer Protection Act Pub. L. No. 111-203, § 619, 48 Stat. 1620 (2010).

⁸ Joseph Tracy and Henry Schneider, *Stocks in the Household Portfolio: A Look Back at the 1990s*, 7 Federal Reserve Bank of New York 4, 1 (Apr. 2001).

⁹ Gramm–Leach–Bliley Financial Modernization Act, Pub. L. No. 106-102 113 Stat. 1338 (1999).

¹⁰ See Fed. Deposit Ins. Corp., *Crisis and Response: An FDIC History, 2008-2013* 4 (2017).

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loosened lending standards. This deterioration of lending standards was caused by a growing market demand of high yield assets from investors, an underregulated securitization process (the process of bundling illiquid and nontradable assets, typically in the forms of loans or mortgages, used to issue tradable securities backed by the credit and cash flow of those underlying assets)¹¹, speculation surrounding the indefinite rise of housing prices, and commercial banks' ability to coordinate directly with their investment banking arms in both lending and securitization.¹² When widespread housing mortgage loans defaulted and housing prices plummeted, the effects rippled through the entire financial system. Financial instruments, such as mortgage-backed securities¹³ and credit default swaps,¹⁴ which were designed to insure and transfer risk from commercial banks' balance sheets to investment funds and entities, directly contributed to the mass failure of the banks due to their unregulated exposure to toxic assets. "Too big to fail" not only implies the size of the banking sector but also the entanglement between traditional banking functions with trading and investment banking activities that generate the highest risk of failure.

In response to the financial meltdown, Congress passed the Dodd-Frank Act in 2010.¹⁵ The act sought to enhance financial stability and insulate banks from non-bank-related risks. Amongst all provisions within Dodd-Frank, the Volcker Rule stands out as the most significant policy aimed at regulating financial institutions. The Volcker Rule epitomized the post-financial crisis effort to instill financial transparency of bank functions and enforce the separation of speculative investment activities from traditional commercial banking activities.

A decade after 2008, the regulatory guardrails implemented in the aftermath of the GFC have all experienced significant rollbacks, fueled in part by resurging market optimism, leading to a weakening of regulatory authority and efficacy. One significant

¹¹ James Chen, *Securitization: Definition, Pros & Cons, Example*, Investopedia (Jun. 14, 2024) <https://www.investopedia.com/terms/s/securitization.asp>.

¹² See Fed. Deposit Ins. Corp., *Crisis and Response: An FDIC History*, at 15.

¹³ *Mortgage-Backed Security (MBS)*, Investopedia, <https://www.investopedia.com/terms/m/mbs.asp> o4-mini-high (last visited Feb. 22, 2025) (A "mortgage-backed security" ("MBS") is an investment similar to a bond: each MBS consists of a bundle of home loans and other real estate debt bought from the banks that issued them).

¹⁴ *Credit Default Swap (CDS)*, Investopedia, <https://www.investopedia.com/terms/c/cds.asp> (last visited Feb. 22, 2025) (A "credit default swap" ("CDS") is a financial derivative that allows an investor to swap or offset their credit risk with that of another investor).

¹⁵ See Barack Obama, President, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act (Jul. 21, 2010).

rollback was the 2020 modification of the Volcker Rule and a partial repeal of the Dodd-Frank Act in 2018.¹⁶ Continuing deregulatory trends surrounding financial institutions will result in heightened systemic risks and growing vulnerability to future financial crises, likely requiring the leveraging of public funds to bail out institutions from the consequences of their bets. In the following section, I break down the structure of the Volcker Rule and its 2020 modification, setting the foundation for analyzing how regulators failed to account for systemic risks and the Rule's original intent.

II. THE VOLCKER RULE

Named after the former Federal Reserve Chairman Paul Volcker, the Volcker Rule echoes the immediate address to bank failures in the 2008 banking crisis and Volcker's commitment to financial stability and institutional reforms. During Volcker's tenure as Chairman (1979-1987), the Glass Steagall Act's Section 21 (1) and (2)¹⁷ forbade financial institutions from engaging in investment banking activities— underwriting, speculative trading, and issuing of financial products— and holding depository functions.¹⁸ When reflecting on Glass-Steagall, Volcker was an adamant proponent for the modernization of the act and a clear divide between banks and nonbank financial entities.¹⁹ In the aftermath of the GFC, Volcker served as chair of President Obama's Economic Recovery Advisory Board and was a key architect of the Dodd-Frank Act. His advocacy for disciplined banking practices and the end of proprietary and speculative trading for commercial banks was reflected in Section 619 of the Volcker Rule. In testimony before the Senate, Volcker warned of growing moral hazards from allowing public funds to serve as a safety net for proprietary and speculative activities. He argued that hedge funds, private equity funds, and trading activities unrelated to core banking functions should operate independently, without relying on implicit subsidies provided by public support for depository institutions.²⁰ This warning

¹⁶ See Joint Press Release, Bd. of Governors of the Fed. Rsrv., Financial regulators modify Volcker rule (Jun. 25, 2020).; Financial CHOICE Act of 2017, H.R.10, 115th Cong. (2017).

¹⁷ Glass Steagall Act, Pub. L. No. 44, §§ 21, 1-2, 72d Cong. (1932).

¹⁸ Banking Act § 21, 1-2, *supra* note 1.

¹⁹ See Mike Mayo, *Paul Volcker on Conflicts, Ethics, and the US Banking Industry*, CFA Institute, Feb. 25, 2019, <https://blogs.cfainstitute.org/investor/2019/02/25/paul-volcker-on-conflicts-ethics-and-the-us-banking-industry/>.

²⁰ Paul Volcker, Statement Before the S. Comm. on Banking, Housing, and Urban Affairs, 1 (2010).

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against Wall Street's entanglement with commercial banks reflects a broader banking principle: non-banking financial institutions should not depend on relationships with commercial banks to receive government-issued bailouts. Additionally, banks should stop speculative activities to reduce risk exposure and alleviate the financial burden of taxpayer funds in the event of another government rescue.

In addition to Volcker, five former Treasury secretaries— Michael Blumenthal, Nicholas Brady, Paul O'Neill, George Shultz, and John Snow— also endorsed the Volcker Rule proposal to Congress. In their collective letter to the Wall Street Journal, the former Treasury Secretaries stated the importance of allowing hedge funds and private equity funds to compete without the expectation of government protection from the funds' failure. Further, commercial banks should be confined to their essential lending and depository responsibilities rather than speculative and market betting activities.²¹ The Volcker Rule's co-authors from the Senate Banking Committee, Oregon Senator Jeff Merkley and Ohio Senator Sherrod Brown, also highlighted the importance of leaving speculative investing to hedge and private equity funds and keeping them out of depository institutions, so should covered funds fail, the broader economy would not be threatened.²² In a separate statement, Senator Jeff Merkley demanded stronger language in the Volcker Rule, as trusting financial institutions to self-regulate has consistently failed. This enforces the idea that regulators must retain a strong position on the separation of banks and non-bank related risks, as market confidence can only be restored through enforcing market transparency.²³ On December 10, 2013, the five financial regulatory agencies²⁴ issued the 2013 Final Rule of the Volcker Rule.²⁵ On April 1, 2014, the Volcker rule became

²¹ See Reuters, *Ex-Treasury secretaries back Volcker rule*, Reuters, Feb. 21, 2010, <https://www.reuters.com/article/world/us-politics/ex-treasury-secretaries-back-volcker-rule-idUSTRE61L0BB/>.

²² Jeff Merkley, Carl Levin, *Merkley and Levin Statement on Final Volcker Rule*, Jeff Merkley Senator for Oregon, Dec. 10, 2013, <https://www.merkley.senate.gov/merkley-and-levin-statement-on-final-volcker-rule/>.

²³ Jeff Merkley, *Defending a Strong Volcker Rule*, Harvard Law School Forum, Jan. 31, 2012, <https://corpgov.law.harvard.edu/2012/01/31/defending-a-strong-volcker-rule/>.

²⁴ The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the U.S. Securities and Exchange Commission (SEC), and the U.S. Commodity Futures Trading Commission.

²⁵ *Volcker Rule Implementation*, Off. of the Comptroller of the Currency, <https://www.occ.treas.gov/topics/supervision-and-examination/capital-markets/financial-markets/trading-volcker-rule/volcker-rule-implementation.html>.

effective.²⁶ Commercial banks, under the purview of the Office of the Comptroller of the Currency (OCC), were required to commit to regulatory standards by July 21, 2015.

A. Analyzing the Volcker Rule

The Volcker Rule serves as the cornerstone of Dodd-Frank's efforts to mitigate banking instability by requiring banking institutions to adhere to prudent banking practices and limit risk exposure from the investment banking segment of the financial system. This is accomplished through two key provisions: the prohibition of banking entities from proprietary trading, and restrictions on retaining any equity, sponsorship, or affiliation with hedge and private equity funds, subject to narrow exceptions.²⁷

The first provision banned proprietary trading functions from commercial banks. The Volcker Rule defines proprietary trading as a commercial banking entity acting as a principal, upon its account, to acquire financial instruments with the intent of profiting through near-term resale.²⁸ The ban ensures commercial banking institutions do not leverage depository funds in risky speculative trading. Additionally, it creates a clear separation between the institutional responsibilities of banking entities and investment companies. Under the Volcker Rule, commercial banks focus exclusively on lending and customer services while refraining from high-risk trading activities.²⁹ The ban reduced the conflict of interest between banks and their customers, as well as excessive risk-taking, endangering depository funds. It also limited financial market interconnectedness and discouraged banks from raising risk tolerance, both key contributors to the 2008 GFC.³⁰

B. Covered Fund Provision

²⁶ Off. of the Comptroller of the Currency, *supra* note 25 (final regulation published on Jan. 31, 2014. Effective date on Apr. 1, 2014).

²⁷ Dodd-Frank Act § 619, *supra* note 7 (defines the limited activities and circumstances where a banking entity is permitted to retain/attain previously defined relationships with investment companies).

²⁸ *Id.*

²⁹ *Id.*

³⁰ See Letter from David Arkush, Director, Pub. Citizen's Cong.; Watch, Bartlett Naylor, Financial Policy Advocate, Pub. Citizen's Cong.; Watch, to Robert Feldman, Executive Secretary, Fed. Deposit Ins. Corp. (Feb. 13, 2012), https://www.federalreserve.gov/secrs/2012/april/20120418/r-1432/r-1432_021312_104991_420900605035_1.pdf.

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Along with the prohibition of proprietary trading, the Covered Fund Provision³¹ defines and restricts the relationship between banking entities and investment companies. The provision prohibits banking entities from acquiring or retaining any equity, partnership, or other ownership interest and sponsorship of a covered fund. This restricts any banking entity from investing, sponsoring, transacting, owning, or having significant relationships with a specific set of investment entities. Under the 2013 implementation, the covered fund Provision extended regulation to any investment entities that rely on the exclusion from the definition of investment company under section 3(c)(1)³² or 3(c)(7)³³ of the Investment Company Act of 1940.³⁴ The Volcker Rule applies bank investment restrictions to most hedge, private equity, and VC funds, as these entities all avoid registration as traditional investment companies under the Investment Company Act. With respect to certain exceptions and permitted activities³⁵, the Covered Fund Provision also withholds any banking entity that serves as the investment manager, adviser, sponsor, and affiliate to a hedge or private equity fund to enter into a “covered transaction”³⁶ as defined in section 23A of the Federal Reserve Act.³⁷ These covered transactions include loans or extensions of credit, purchase of assets or securities issued by the covered fund, acceptance of securities or debt obligations as collateral security from the covered fund, and entering into a transaction involving the borrowing or lending of securities or derivatives. For banking entities seeking investment in any unaffiliated covered funds, the banking entity may retain up to 3 percent of the total ownership of the fund using their own

³¹ 12 U.S.C § 1851(H)(ii).

³² See Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789,(3)(c)(1)) (Covered Funds are beneficially owned by not more than 100 persons or whether the outstanding securities of the issuer excepted under this paragraph are owned by persons that are not qualified purchasers).

³³ See Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789,(3)(c)(7)) (qualified institutional investors).

³⁴ Prior to the passage of Dodd-Frank, covered funds were loosely defined and regulated. Regulatory guidance and definition derived from Great Depression Era legislations (i.e., Investment Company Act of 1940) had significant loopholes and lax exercise of banking affiliation with investment companies. However, in Volcker, the definition of a covered fund broadened to include any non-registered investment companies.

³⁵ Permitted activities include government bonds, market making activities on the basis of client service, hedging and risk mitigation, entering into rehabilitation funds, and investment into foreign funds that operate solely outside of the United States. (Can enter into a prime brokerage when satisfying § f(3)).

³⁶ Investment Company Act § 3(f)(1).

³⁷ 12 U.S.C. § 371c.

Tier 1 Capital.³⁸ Restrictions on banking entities' general investment and ownership of covered funds are in place to discourage banks from engaging in excessively risky activities such as proprietary trading with their capital, reducing the conflict of interest from their fiduciary responsibilities to their depositors and investment affiliates.³⁹

Since the Volcker Rule's implementation, high-risk activities have largely migrated from commercial banks to hedge funds, specialized proprietary firms, and other non-bank entities. This represents a successful effort to separate and compartmentalize financial markets by eliminating the opportunity for non-banking entities to be implicitly protected by banking institutions with depositor funds.⁴⁰ The 2013 Covered Fund Provision was implemented as a safeguard to sever ties between banking entities and high-risk investment firms, as well as reduce risk-taking ability from the banks' balance sheets. The division of the financial sector was not just a regulatory measure but also a necessary reform to ensure federally insured institutions remained focused on their core responsibilities rather than acting as a safety net for profit-driven speculative investment entities.

C. 2020 Final Rule, Volcker Rule Modification

However, in 2020, five federal financial regulators⁴¹ finalized a rule significantly altering the Covered Fund Provisions of the Volcker Rule. These modifications were intended to streamline the covered fund compliance, reduce banking entities' burden to engage in external activities, and address the treatment of certain foreign funds. Its most significant alteration was the removal of VC and credit funds from the Covered Fund restrictions. These funds, previously restricted due to their speculative investments, high leverage, and high risk exposure, are now allowed to engage in direct investments and covered transactions⁴² by banking entities with loosened supervision.

³⁸ 15 U.S.C. § 80a-3(c)(4).

³⁹ See *Study & Recommendations of Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, Financial Stability Oversight Council (Jan. 2011).

⁴⁰ In 2008, major banks took huge hedge fund losses due to high exposure of assets and investments (find sources on Citigroup, Morgan Stanley, Etc).

⁴¹ The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission.

⁴² Permit certain low-risk transactions (including intraday credit and payment, clearing, and settlement transactions) between a banking entity and covered funds for which the banking entity serves as investment advisor or sponsor (found within the register).

Proponents of the 2020 final rule stated that such funds operate with significantly lower risk than the intended targets of the 2013 Covered Fund Provision. The exclusion also responds to concerns that the original restrictions were overly broad, prohibiting banking entities from engaging in investment activities that do not endanger financial stability and encourage capital formation and economic growth. In particular, the Federal Reserve Board's Vice Chair for Supervision Randal Quarles stated in a press release that the expansion of capital investment into VC through a fund structure would simplify compliance with the Volcker Rule and allow banking entities to engage in activities under the purview of the Volcker Rule's original intent.⁴³ A comment made by the American Bank Association and State Street during the 2018 public hearing of the Volcker Rule's overbroad restriction has shuttered investment programs focusing on capital formation rather than high-risk investment activities. In a similar statement of support, the Securities Industry and Financial Markets Association (SIFMA), a financial industry association, defined the 2020 modification as a victory for the financial market and expected economic growth through the relaxation of the Covered Fund definition.⁴⁴

D. Risk Considerations of the 2020 Final Rule

Although arguments to simplify the Covered Fund Provision have practical appeal, financial regulators must consider the tradeoff between allowing depository institutions to invest in risk-seeking institutions while preserving institutional stability when confronted with a future financial crisis. The Volcker Rule's role in financial regulation extends beyond preventing another financial collapse, serving as a firewall between federally insured banks and the speculative risk traditionally associated with investment funds. When the government is confronted with future financial distress, the rule would ensure that the banking system and depository funds are insulated from the consequences of unchecked exposure to high-risk assets and affiliations with speculative investments.

The 2020 modification to the Volcker Rule, particularly the exemption of VC funds, credit funds, and FWMV, undermines the structural principle of separating financial entities with different economic functions and responsibilities. Intended to

⁴³ Bd. of Govs. of the Fed. Rsrv., Financial Regulators Modify Volcker Rule, *supra* note 16.

⁴⁴ Press Release, Securities Indus. & Fin. Mkts. Ass'n (SIFMA), SIFMA Supports Proposed Changes to the Volcker Rule (Mar. 11, 2020).

stimulate capital formation and reduce regulatory burdens, the finalized rule instead reintroduces systemic vulnerabilities when blurring the lines between commercial banking and speculative investment activities. By prioritizing short-term gains, the modification bypasses the absolute intent of the original Volcker Rule and creates new risks for regulators and the American financial system.

The following sections highlight two core vulnerabilities that the modification introduces. First, VC and credit funds are not nearly as risk-averse as industry advocates suggest. The threats to institutional stability outweigh the marginal benefits from allowing the exempted funds to tap into bank investments and sponsorships. Second, when banks serve as both lenders and investors, a conflict of interest arises, blurring the line between fiduciary duty and investment activities. The exemption creates the same moral hazards that prompted the implementation of the post-GFC regulatory frameworks.

III. EXCLUSION OF VENTURE CAPITAL FUNDS

VC funds are private equity vehicles driven by the strategy of investing in early-stage, high-growth companies. Before the 2020 modification, VC funds remained confined under the Covered Fund Provision due to its exemptions from Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940's definition of a traditional investment company.⁴⁵ During the implementation process of the 2013 Final Rule,⁴⁶ regulators rejected VC funds' exclusion due to a lack of distinguishability between VC funds and private equity funds. The regulators stated that both funds share the same sources of credit, the ability to invest in similar entities, and incentive-based compensation to their investors based on the price appreciation achieved on the investments.⁴⁷ Authors of the 2013 rule also intended the Volcker Rule, and its definition of a covered fund, to serve as a firm statutory protection that could not be weakened by discretionary exemptions. However, the 2020 rule adopted an exclusion

⁴⁵ Investment Company Act § 3(c)(1); Investment Company Act § 3(c)(7).

⁴⁶ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5704 (Jan. 31, 2014).

⁴⁷ *Id.* at 642–45.

for VC funds from the Covered Fund Provision with weakened restrictions.⁴⁸ The new exclusion applies to any VC fund that does not engage in proprietary trading.⁴⁹

Proponents of the 2020 modification argued that, different from private equity and hedge funds, VC funds support capital formation, foster job creation, and stimulate economic growth for start-ups and should qualify for the funds' exemption.⁵⁰ It was argued that VC funds have a significantly different risk profile compared to private equity and hedge funds, posing less risk to banks' balance sheets. VC funds have lower reliance on leverage and a smaller degree of interconnectedness with the public markets, which justifies their exclusion from the Covered Fund. In the following section, I respond to each of the proponents' claims and explain why VC funds are unsuitable for bank investment and sponsorship.

A. Risks of Venture Capital Fund Exclusion

While VC funds serve important market roles by fostering growth for start-up enterprises, efforts to exclude such funds by loosening their regulatory definition fail to account for their associated instability risks. The innate functions of a VC fund require investment in early-stage companies with a high-risk, high-reward philosophy. VC investments have low levels of asset liquidity, similar to most private equity funds. These investments are highly reliant on market valuations of companies, which revolve around high degrees of market speculation. When confronted with an economic downturn, VC-backed companies are extremely vulnerable to failure from a sharp valuation loss. Furthermore, Bank-Sponsored Venture Capital Funds (BVC) struggle to ignore their sponsor bank's strategic interests during the process of fostering small enterprise growth, creating conflict of interest concerns.

⁴⁸ Office of the Comptroller of the Currency et al., *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536, 642–45 (Jan. 31, 2014), <https://www.sec.gov/files/rules/final/2013/bhca-1.pdf> (Additional requirements to qualifying venture capital funds under the 2020 final rules).

⁴⁹ 17 CFR § 275.203(l)-1 (defines a VC fund as any entity that (1) represents to investors and potential investors that it pursues a VC strategy, (2) limited investment in any particular acquisition of asset, (3) does not borrow, issue debt obligations, provide guarantees over 15 percent of the fund's total contribution for no longer than across 120 days, (4) only issue specific forms of securities that do not generally withhold rights to withdraw, and (5) is exempted from section 8 of the investment Company Act of 1940).

⁵⁰ Office of the Comptroller of the Currency et al., *supra* note 48.

B. High-Risk, High-Return Portfolio Investments

VC and private equity funds share many structural and functional features, particularly in their fund source, profit structure, and high-risk appetite. Higher risk tolerance is driven by VC funds' preference for investing in small and medium-sized enterprises that lack immediate profitability but are expected to generate strong long-term growth. Contrary to a typical private equity investment towards an established business, VC fund investments are characterized as high-risk, high-return due to the form of equity investments.⁵¹ These businesses often lack traditional financing options and rely on early seed investments from private investors or VC funds. The process of selecting an investment opportunity, also known as portfolio company selection, requires reviewing hundreds of business plans. VC investors must also be aware of the high failure rate of portfolio companies, as fund managers make investment decisions based on expectations of the fund's growth.⁵² This process demands a high degree of market speculation and risk tolerance from the funds, given the high failure rate of venture-backed companies.

According to a 2012 study by Shikhar Ghosh, a senior lecturer at Harvard Business School, about three-quarters of VC-backed firms fail, surpassing the industry's self-reported claim of a 25 to 30 percent failure rate.⁵³ Similarly, Startup Genome, an innovation development organization, reported a 90 percent failure rate amongst all startups, with 1.5 percent of startups producing a successful exit of \$50 million or more since the 2019 COVID-19 pandemic.⁵⁴

Although different from the short-term, market-based trading activities of hedge funds, VC funds' acquisition, development, and eventual resale of high-risk companies and assets also involve a high degree of risk. The practice of portfolio selection and pricing the potential growth of companies hinges on volatility-prone evaluation. Rather than employing speculative trading, VC funds shift to other forms of calculated bets on companies' positions, valuations, and demand. The combination of the high failure rate of VC-backed companies and the funds' speculative nature is precisely the

⁵¹ Daniela Bumbac & Olga Stefaniuc, *Venture Capital Financing: Particularities and Opportunities*, International Journal of Innovative Technologies in Economy 1, 3 (2021).

⁵² *Id.*

⁵³ Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail*, The Wall Street Journal, Sept. 20, 2012, 12:01 AM,

<https://www.wsj.com/articles/SB10000872396390443720204578004980476429190>.

⁵⁴ Startup Genome, *The State of the Global Startup Economy*, The Global Startup Ecosystem Report, 2022, <https://startupgenome.com/article/the-state-of-the-global-startup-economy>.

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high-risk activity the Volcker Rule sought to protect federally insured banking entities from.

Under the 2013 Volcker Rule, banking entities are prohibited from retaining ownership or exceeding a 3 percent investment threshold in any covered funds without any exception.⁵⁵ Following the limitation on permitted activities in Section 13(d)(2)(A)(ii) of the 2013 Final Rule, banks are prohibited from transacting with covered funds if such activities would involve banking entities retaining high-risk assets and high-risk trading strategies.⁵⁶ Assets and trading strategies are defined as high-risk if held by a banking entity that would significantly increase the likelihood of substantial financial loss or pose a threat to the financial stability of the United States.⁵⁷ Abiding by this standard, VC's portfolio investment, which includes high-failure rate early-stage businesses that have yet to yield profitability, and speculative investment strategies based on the valuation of a company's potential worth, would reasonably qualify within the high-risk assets and trading strategies definition. Regulators purposefully included a broad definition of high-risk assets and trading strategies to maintain flexibility in insulating banking entities from any circumstances that would threaten their stability.⁵⁸

Although the definitions of high-risk assets and trading strategies are included in the 2020 Final Rule, legislators delegated compliance and oversight responsibilities to banks themselves.⁵⁹ The expectation that Wall Street would be self-compliant was a major failure that led up to the 2008 GFC. Furthermore, the Final Rule significantly weakened the statutory definition of high-risk assets and trading strategies to exclude VC speculative practices. First, regulators declined to establish a quantitative limit on the amount of "non-qualifying" investments.⁶⁰ These investments include secondary acquisition of portfolio company shares, which are more aligned with speculative trading. Second, regulators declined to establish a revenue limit on portfolio companies

⁵⁵ 12 U.S.C. § 1851 (13)(a)(1)(B) (2013) (prohibition of any ownership interests from banking entities to covered funds).

⁵⁶ 12 U.S.C. § 1851 (b)(2)(A)(ii) (2013).

⁵⁷ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 55130.

⁵⁸ *Id.* at 131.

⁵⁹ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46422, 46484 (Jul. 31, 2020) (to be codified at 12 C.F.R. pts. 44, 248, 351; 17 C.F.R. pts. 75, 255).

⁶⁰ *Id.* at 46485.

that VC funds invest in.⁶¹ Allowing VC funds to operate under banks' sponsorship without any regulatory oversight epitomizes the lack of risk consideration for banking entities. The 2020 Final Rule significantly weakens the legislative purpose of the original Volcker Rule by diluting definitions and guardrails. Consequently, bank sponsorship or ownership of VC funds directly contradicts the Volcker Rule's original legislative intent by exposing banks to high-failure-rate investment activities.

C. *Liquidity Mismatch between Banks and VC Funds*

A second major concern with reintroducing VC fund sponsorship onto banks' balance sheets is the issue of asset illiquidity. VC portfolio investments are characterized by long-term commitment, typically spanning five to six years, and rely on distinct exit events of a merger, acquisition, or Initial Public Offering (IPO).⁶² In addition, significant risk factors, such as limited marketability of unproven equity value, also make it difficult to assign a fair value to the underlying portfolio.⁶³ Without a strong secondary or public market, offloading portfolio investments is nearly impossible before the underlying companies reach maturity. Contrary to traditional secured debt financing, VC equity investments tend to be difficult to liquidate.

More notably, VC funds backed by banking entities (CBVC) tend to strategically invest in portfolio companies with lower liquidity than non-VC backed firms to create a stronger reliance on the capital loan services of parent banks.⁶⁴ Furthermore, capital investments into VC funds limit the routine withdrawal of capital as portfolio companies require time to mature in value. Generally, private equity and VC funds

⁶¹ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. at 46465.

⁶² Daniela Bumbac & Olga Stefaniuc, *Venture Capital Financing: Particularities and Opportunities*, International Journal of Innovative Technologies in Economy 1, 3 (2021).

⁶³ Giang Nguyen, *Asset Liquidity and Venture Capital Investment*, 69 Journal of Corporate Finance 1, 11 (2021).

⁶⁴ See Samuele Murtinu, *Bank-Affiliated Venture Capital Funds: Portfolio Selection, Strategic Objectives, Performance and Exit*, 4 Review of Corporate Finance 375, 375-416 (2024) (With a dataset on European VC funds and their investments, the study aimed to define the different selections of portfolio companies depending on the structure of the VC funds. In particular, commercial bank backed funds would purposefully select illiquid investment opportunities that would generate traditional capital loan or credit deals for the funds' parent bank. This creates an issue for long term illiquid assets that are costly for banks to carry on their balance sheet).

hold a lifetime of 10 years with a contractual bind to capital investors and partners.⁶⁵ The illiquidity concern was a primary factor in the implementation of the Covered Fund Provision, as illiquid investments expose a bank to heightened risk during economic recession or valuation meltdown— a contributing factor that led to the 2008 GFC, when credit and liquidity dried up.

Under the 2013 Volcker Rule,⁶⁶ banks are prohibited from sponsoring and investing in covered funds with illiquid assets, such as portfolio companies, real estate investments, and VC investments. This definition of an illiquid fund under the Covered Fund Provision indicates a fundamental concern for federally insured banks' exposure to long-term investments that can not be easily liquidated without losing significant market value. In the case of VC funds, portfolio companies and general VC investments fall within this definition due to assets' illiquid nature. The fund's limited withdrawal conditions also lock up capital investments for around ten years with a long-term commitment to portfolio companies that carry a five to six-year investment duration. The Volcker Rule was designed to exclude this specific form of illiquid investment from the banking system, which relies significantly on liquidity reserves. The original 2013 Final Rule demonstrates a clear legislative intent to prohibit bank involvement in VC funds based on the fundamental difference between a liquidity profile and the tolerance between depository banks and investor-driven VC funds.

D. Vulnerability to Economic Downturns and Dependency on Market Valuation

VC portfolio investments targeting high-growth potential companies are particularly vulnerable to sharp valuation drops and economic downturns. A common investment strategy employed by venture capitalists is known as discontinuity investing. The strategy, created by a VC fund known as Adams Capital Management (ACM) in 1994, involves exploiting market opportunities with breakthrough innovation when there is a discontinuity in industry, standards, regulations, technology convergence, and distribution. ACM was successful at identifying high-growth opportunities. By 2000, ACM's fund managers and investors were confronted with a difficult market and experienced significant liquidity struggles. If a downturn results in investment failures, the remaining companies must outperform

⁶⁵ See Josh Lerner et al., *Venture Capital and Private Equity: A Casebook*, Harvard Business School, 65 (5th ed., 2012).

⁶⁶ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg., at 55051.

their market value to compensate.⁶⁷ Venture capitalists also tend to reallocate resources and development services to high-performing portfolio companies, exacerbating the issue of failing portfolios. In the 1990s, when technology outpaced life science sectors, many VC funds abandoned their investments in associated portfolio companies. This raises the question of whether venture capitalists are truly beneficial to innovation and sectoral growth when profit maximization strategies involve prioritizing specific fields over others, leaving more vulnerable industries underfunded through uneven capital allocation.⁶⁸

When the economy faces a sharp downturn, VC-backed portfolio companies are prone to operational and financing difficulties as well as high failure rates. For example, the “Dot Com Crash”⁶⁹ during the early 2000s depleted the VC landscape⁷⁰ due to the oversaturation of investments without sufficient due diligence. Before the implementation of the Covered Fund Provision, VC funds with cheap and accessible capital invested heavily in the technological field, heavily influencing the sectoral boom. Venture capitalists artificially inflated valuations through premature IPOs and created “first-day pops” with the help of trigger-happy underwriters.⁷¹ Under the guidance of venture capitalists, more companies were pressured to go public to generate immediate exit profits for investors. The IPOs of these companies were largely premature as they had not yet demonstrated profitability, setting them up to fail.⁷² The internet boom introduced a discontinuity into the investment system, demonstrating the volatility of market valuations of VC-backed firms.⁷³ In addition to the failure of VC investments,

⁶⁷ Lerner et al., *supra* note 65.

⁶⁸ Lerner et al., *supra* note 65, at 157 (When ACM’s investment focus broadened, the fund had realized a sector’s underperformance may dramatically hinder the development and maturity of another, leaving the designated expert and team to be reduced and reallocated into more promising projects).

⁶⁹ Sebastien Canderle, *Venture Capital: Lessons from the Dot-Com Days*, CFA Institute, Mar. 1, 2024, <https://blogs.cfainstitute.org/investor/2024/03/01/venture-capital-lessons-from-the-dot-com-days/> (The Dot-Com Crash implicated a 77% fall for the NASDAQ 100 index in third fourth quarter 2002 from its all time high in second quarter 2000. An estimated loss of \$5 trillion in the stock market resulted in a 15 year recovery for the tech industry).

⁷⁰ Thomas Hellmann & Manju Puri, *Venture Capital and the Internet Bubble: Facts, Fundamentals and Food for Thought 2* (paper presented at the Financial Markets Conference, Sea Island, Ga., May 2-4, 2002) (unpublished manuscript) (on file with author) (Citing Federal Reserve of Atlanta Report, the venture capitalists investments in the fourth quarter of 2001 were at \$7.1B, which nearly equated to a third of the year before at \$20.9B).

⁷¹ Canderle, *supra* note 69.

⁷² See Hellmann, *supra* note 70, at 17.

⁷³ See Hellmann, *supra* note 70, at 18.

investment at the fund level also saw a sharp decrease. Between 2000 and 2002, Silicon Valley Bank (SVB) underwrote 95 percent of all venture debt deals from VC-backed companies and retained a 60 percent market share. SVB's warrant income (the financial gains of investors from underlying stock and loan performances) dropped from a peak of \$86 million to just \$1.7 million.⁷⁴ Similarly, following the 2008 GFC, start-ups experienced high failure rates due to the nature of early-stage companies and an inability to secure exits or growth financing options.

VC funds leading the valuation process on early-stage startups have proven to be highly fallible. When market valuations are unreasonably higher than realistic expectations, investments are likely to fail and default when confronted by a singular market-altering event. This concern is addressed by the original legislator of the 2013 Final Rule, which stated that products whose valuations are determined by an internal model can be more easily manipulated than observable public market prices.⁷⁵ The VC funds' dependency on speculation and growth prediction is precisely what the Volcker Rule aimed to address. Without transparent market data, volatile and market-contingent capital investments pose a greater risk to the financial system.

E. Material Conflict of Interest

The final factor is the conflict of interest between banking entities and the VC fund they sponsor. Proponents of the VC fund exemption argue that early-phase capital investments are essential to stimulating enterprise and innovation growth.⁷⁶ Allowing banks to sponsor and offer lines of credit to VC funds gives banks the ability to expand capital access, leading to broader economic growth. However, VC funds sponsored or owned by banking entities (BVC) become strategically opaque. In particular, CBVCs often prioritize their parent banks' lending business over lending

⁷⁴ Josh Lerner et al., *supra* note 65, at 121.; Flow Capital, *A Guide to Warrants in Venture Debt*, <https://www.flowcap.com/resources/a-guide-to-warrants-in-venture-debt> (Warrants are securities that provide debt holders the right to purchase company stock at a specified price within a specific period of time).

⁷⁵ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5551 (Trading illiquid product raises concern in rules).

⁷⁶ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. at 46443.

entrepreneurial support and fostering industrial growth.⁷⁷ A study by Samuele Murtinu reviewed a wide array of European-based VC funds and their respective portfolio investments, finding a categorical difference between non-bank affiliated and bank-sponsored VC funds. CBVC was found to select portfolio companies with lower liquidity, which would increase their reliance on operational debt.⁷⁸ Portfolio companies are not just selected for their promise of high growth potential or innovation, but rather for how reliant they are on debt financing. This steers the start-up industry towards over-reliance on debt financing offered by affiliated banks. When banking entities' investments influence VC funds' investment strategy, a conflict of interest arises as parent banks can directly leverage their relationship with VC funds to benefit their credit offerings and cultivate new borrowers. The primary purpose of excluding VC funds from bank investments contradicts the assumed goal of supporting early-stage enterprises and industry, shifting towards a debt dependency model.

F. Summary of VC Funds Exclusion from Covered Fund Provision

The exclusion of VC funds from the Covered Fund Provision compromises the post-GFC regulatory standards implemented to ensure economic stability and transparent market activities. Arguments for VC fund exemptions revolve around the funds' abilities to fuel innovation and entrepreneurship. However, factors of market growth should not come at the expense of economic stability and transparency. By allowing banks to integrate into the VC ecosystem, regulators overlook systemic risks that undermine the market protection intent of the Volcker Rule. A commercial bank's function is to provide stable credit extension while safeguarding depositor funds through the maintenance of a liquid reserve to meet withdrawal demands. In contrast, investment in a VC fund and the fund's portfolio are highly illiquid. The entanglement between two distinct institutions introduces risks of liquidity and maturity mismatch, contributing to credit market fragility. Considering liquidity issues and high-failure risks, investment and sponsorship of VC funds are misaligned with the fiduciary responsibilities banks hold for their depositors. Additionally, the Volcker Rule was originally intended to limit bank involvement in market speculation from

⁷⁷ Samuele Murtinu, *Bank-Affiliated Venture Capital Funds: Portfolio Selection, Strategic Objectives, Performance and Exit*, 4 *Review of Corporate Finance* 375, 375-416 (2024).

⁷⁸ Murtinu, *supra* note 77, at 378 (discusses CVBC's targeting portfolio companies that demonstrate demand for operational debt financing).

acquisitions and investments with VC funds. In the event of an economic downturn, market valuation drops affect VC funds and affiliated banks' balance sheets as a result of speculative risks. Finally, the opaque investor and sponsor relationship between banks and funds poses an unregulated area of moral hazards. Under the influence of the banks, funds can distort the portfolio selection process by focusing on the debt reliance of companies rather than their pure potential. Volcker's prohibition on banks' sponsorship and simultaneous investment in covered funds reflects a core objective of ensuring no banking entity becomes over-entangled with non-bank financial institutions due to two factors: fear of indirect control and interconnectedness of the financial system.⁷⁹

Regulators and legislators rejected the exclusion of VC funds from the Covered Fund Provision in 2013. Regulators intended the statutory application of the covered fund definition to be without any exemption or exclusion due to the demand for a clear separation from banks. VC funds are a subset of private equity funds, leading legislators to view VC and private equity fund activities in private asset holding and risk profiles as indistinguishable.⁸⁰ Assets invested in by VC funds could also be targeted by similar private equity funds. Excluding VC funds from the definition of covered funds allows banking entities, directly or indirectly, to engage in speculative activities that the Volcker Rule was designed to address. This final consideration divides the two segments of the financial systems with an uncompromising definition of covered funds. The exemption of VC funds from this definition tears down the regulatory insulation that protects banks from systemic spillover and market contagion. In the event of economic distress, regulators and legislators would again face the difficult task of deciding which non-bank financial institutions must be stabilized through public intervention.

IV. EXCLUSION OF CREDIT FUNDS

Under the final rule of the Covered Fund exclusion, a credit fund is classified as: an issuer whose assets consist solely of loans, debt instruments, related rights and assets related or incidental to acquiring, holding, servicing, or selling loans, or debt instruments, and certain interest rate or foreign exchange derivatives.⁸¹ Different from

⁷⁹ 12 U.S.C. § 1851 (2011).

⁸⁰ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5169 (Debates on VC exclusion).

⁸¹ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. at 46443.

equity and speculative investment entities, credit funds are investment vehicles that engage in credit-related activities through loans and leveraged instruments. Relying on private credit lending, credit funds offer alternative bank loans to mid-sized businesses, which are generally highly leveraged and cannot borrow in corporate bond markets.⁸²

Proponents of the credit fund exclusion emphasized the importance of enabling credit lending activities through a fund structure. Citing a demand to reduce compliance burden and support under-banked industries, proponents argued for greater banking flexibility to better facilitate capital formation and promote US economic growth.⁸³ In supporting the credit fund exclusion, sympathetic regulators argued that the credit funds' credit extension ability resembled traditional banking functions. While arguments for capital and credit formation remain valuable to policymakers, the Final Rule's exemption of credit funds overlooks significant regulatory concerns and leaves insufficient guardrails.⁸⁴

A. Risks of Credit Fund Exclusion

In combination with the exclusion of VC funds from the Covered Fund, the exclusion of credit funds reintroduces systemic risks to the financial system that played a role in the 2008 GFC. The proponents of the 2020 Final Rule drastically underestimated the risk profile of credit funds. The exclusion lacks consideration for underlying asset classes, their risk characteristics, and liquidity constraints that would expose banks' balance sheets to risk. Additionally, when excluded from the Covered Fund, banking entities may invest in credit funds while engaging in covered transactions, leading to a conflict of interest and regulatory exploitation. When banks

⁸² See Sam Boocker & David Wessel, *What Is Private Credit? Does It Pose Financial Stability Risks?*, Brookings Inst., Feb. 2, 2024, <https://www.brookings.edu/articles/what-is-private-credit-does-it-pose-financial-stability-risks/>; International Monetary Fund, *Global Financial Stability Report: The Last Mile: Financial Vulnerabilities and Risks* 53 (Apr. 2024) (Private credit provides long-term financing to firms too large or risky for banks and too small for public bond markets. However, “[C]redit migrating from national banks and relatively transparent public markets to the more opaque world of private credit creates potential risks...If the asset class remains opaque and continues to grow exponentially under limited prudential oversight, the vulnerabilities of the private credit industry could become systemic”).

⁸³ Press Release, Securities Indus. & Fin. Mkts. Ass'n (SIFMA), SIFMA Supports Proposed Changes to the Volcker Rule (Mar. 11, 2020).

⁸⁴ 79 Fed. Reg. 5705 (Jan. 31, 2014) (rejecting credit fund exclusion due to inability to differentiate with private equity activities).

are allowed to serve as both investors and sponsors, regulators lack substantive oversight authority. The following sections will explore these regulatory considerations.

B. Credit Fund Asset Risks

Arguments to exclude credit funds from covered funds significantly underestimate the risk profile of credit funds as well as the volatility of their underlying assets. According to a 2024 congressional study, the most common type of private credit is direct lending, where nonbank investors provide loans to businesses rather than intermediary structures employed by traditional banks.⁸⁵ Other categories of private credit include: distressed debt— loans to companies in or near bankruptcy— special situations debt— lending in event of mergers, acquisitions, and changes of control— venture debt— loans to early-staged companies with VC backing— and mezzanine debt— loans subordinate to other debt but senior to equity in bankruptcy repayment orders.⁸⁶ Through riskier loan instruments, credit funds move into the high-default, low-credit, but high-yield debt market that traditional banks are often unable to underwrite. With non-traditional loan yields outperforming bank loan yields, private credit continues to appeal to high net worth individuals or institutional investors despite its investment risk.⁸⁷ However, when banks serve as sponsors, investors, and partners, these high-risk assets held by credit funds pose an unregulated risk.

Credit fund-sponsored loans often involve leveraged loans to non-investment-grade companies with existing high leverage.⁸⁸ These borrowers, often with weak credit, rely on leveraged loans and are highly susceptible to default, which explains their inability to secure traditional bank loans. Furthermore, when interest rates and borrowing costs rise, leveraged loans, which generally carry floating rates, increase the likelihood for borrowers of distressed and venture debt to default.⁸⁹ At the end of 2024, Moody's predicted a four-year record high of 9.2 percent average probability of default between all US public companies and a high of 7.6 percent leveraged loan default rate.⁹⁰

⁸⁵ Eva Su, *Private Credit: Trends and Policy Issues*, Library of Congress (2025).

⁸⁶ *Id.*

⁸⁷ *Id.* at 2.

⁸⁸ Financial Stability Oversight Council, *Annual Report 37* (2024).

⁸⁹ *Id.* at 36.

⁹⁰ Moody's Analytics, *U.S. Firms' Default Risk Hits 9.2% of Post-Financial Crisis High*, Moody's, <https://www.moody.com/web/en/us/about/insights/data-stories/us-corporate-default-risk-in-2025.html> (Moody's estimates a post GFC high probability of default of 9.2% of all publicly listed U.S. companies correlated with a projected 7.6% of default rate).

Non-traditional bank loans offered by credit funds exhibit similar drawbacks to VC fund portfolio investments, such as liquidity risk and valuation volatility. While traditional credit funds employ a closed-end structure to lock up investor capital, new forms of private credit funds impose liquidity and maturity transformation (lending short-term deposits to long-term loans) back into the market. These semi-liquid and perpetual Business Development Companies (BDC), which have seen significant market growth, allow for more flexible redemptions and are marketed towards a broader investor base.⁹¹ During phases of liquidity tightening, BDC cannot sustain mass investor withdrawal, triggering fire sales, selling assets at a significantly reduced value. Similarly, during a market stress scenario, the lack of a secondary market for leveraged loans exacerbates the liquidity of the private fund. This may be caused by a lack of market transparency, as credit funds transact in private market negotiations, which indicates the valuation for illiquid assets does not keep pace with the actual value. When facing a credit stress market, sudden markdowns may occur and lead to a fire sale of illiquid assets. Estimates of bank commitment to BDC credit facilities surpassed \$117 billion by the end of the third quarter of 2024, nearly threefold from 2020.⁹² Excluding credit funds from the covered fund purview reintroduces the same fragilities seen before the 2008 financial crisis. When banks become entrenched in poor credit, high default, illiquid, and volatile segments of the financial market, a collapse in one industry extends the burden of recovery to the broader system.

During the implementation of the 2013 Final Rule, some commenters requested the exclusion of credit funds, arguing that credit funds, unlike VC or private equity, serve a credit extension function, primarily holding loan products.⁹³ Under the 2020 Final Rule, regulators accepted these arguments. However, they overlooked the original legislative concerns on the illiquid and highly concentrated asset holding and issuance style of credit funds. Under reasoning against VC fund exclusion, direct transaction and ownership of credit funds would alarm Section (d)(2)(A)(ii)'s prohibition of covered funds transactions that involve high-risk assets and trading strategies. Given the high default rate and reliance on high-leverage funds to poor credit borrowers, sponsorship and investment in credit funds pose systemic risk to banks' balance sheets. Furthermore, drafters of the 2013 Final Rule mentioned possible structural concerns

⁹¹ Financial Stability Oversight Council, *supra* note 88.

⁹² *Id.*

⁹³ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 5169 (comments on credit fund exclusion).

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due to excessive leverage reliance and high concentration of assets.⁹⁴ Without structural divides between banks and credit funds, banks become more market sensitive and vulnerable to liquidity spirals, a period of high liquidity that drives up asset prices and dependency on leverage, followed by a period of illiquidity and mass fire sales by market speculators.⁹⁵ Allowing banks to engage with credit funds without clear limitations undermines the very liquidity requirements designed to ensure banks' economic stability and market resilience.

C. Shadow Banking Concerns of Credit Funds

By excluding credit funds from covered funds, the 2020 Final Rule effectively creates a channel of interconnectedness between banks and investment institutions that contradicts market separation enforced by the Volcker Rule. When banks are permitted to serve as the investor, sponsor, partial owner, and lender to credit funds, banks can extend credit lending activities through credit fund intermediaries without regulation.⁹⁶ When non-depository entities, such as credit funds, reinvest short-term deposits to fund long-term investments, both the bank and the credit fund effectively engage in shadow banking.⁹⁷ Furthermore, credit funds hold loans originated from their sponsor bank, co-invest with sponsor banks on broadly syndicated loans, or employ synthetic risk transfers to offload high-risk assets from banks' balance sheets.⁹⁸ Each of these activities highlights either the core vulnerabilities of the financial system or directly contributes to its fragility by extending banking activities without regulatory constraint. Under the 2020 Final Rule, credit funds are accountable for following activity requirements, but covered transactions between banks and funds are not regulated.⁹⁹ This allows credit banks to purchase or hold loans originating from

⁹⁴ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. at 55131.

⁹⁵ *Id.* at 55044 (Comments on liquidity spirals).

⁹⁶ See David Beckworth, Morgan Ricks, *Morgan Ricks on the "Money Problem," Financial Regulation, and Shadow Banking*, Mercatus Original Podcasts, Sept. 26, 2016 <https://www.mercatus.org/macro-musings/morgan-ricks-money-problem-financial-regulation-and-shadow-banking>; See John Crawford, *A Better Way to Revive Glass-Steagall*, 70 Stan. L. Rev. (2017).

⁹⁷ Tobias Adrian & Hyun Song Shin, Fed. Reserve Bank of N.Y., Staff Rep. No. 382, *The Shadow Banking System: Implications for Financial Regulation* 8 (2009), http://www.newyorkfed.org/research/staff_reports/sr382.pdf.

⁹⁸ *Private Credit: Trends and Policy Issues*, Library of Congress, *supra* note 85.

⁹⁹ 85 Fed. Reg. 46440 (Jul. 31, 2020) (Under the 2020 Final Rule, credit funds are ensured to follow the below three main activity requirements: The fund does not engage in activities that would constitute

their sponsored banks through participation, securitizations, or fund structures. In turn, banks can transfer loans off their balance sheets to credit funds by avoiding regulatory constraints such as capital requirements. Banks can also provide leverage to credit funds through subscription lines, investor-backed capital commitments, and net asset-backed borrowings, credit from fund investments lent to high-risk borrowers without appearing on the banks' balance sheets.¹⁰⁰ When faced with market devaluation of assets, a credit fund failure could signal broader, unaccounted market losses due to reliance on bank-sponsored credit lines.

D. Summary of Exclusion of Credit Fund

The credit fund exclusion from the Covered Fund Provision fundamentally contradicts the legislative intent of the Volcker Rule to maintain a clear separation between high-risk financial activities and traditional banking functions. Credit funds, which operate in the distressed, illiquid, and volatile region of the financial market, rely on leveraging loans to those with poor credit and unconventional borrowers incapable of securing traditional bank financing. By allowing banks to sponsor and invest in credit funds, banking institutions inevitably become entangled with an uninsured region of the credit market. When banks incur large risk exposure, it leaves the financial market vulnerable to contagion effects, leading to a broader financial market failure. In addition to bank stability concerns, the weakening of the Volcker Rule introduces regulatory arbitrage for banks and credit funds to exploit. Banks can leverage credit funds through the transfer of risky assets off of banks' balance sheets and extend credit to distressed borrowers while avoiding regulatory oversight, liquidity requirements, and lending standards. Without necessary regulatory supervision, the opaque relationship between banks and their affiliated credit funds presents a significant vulnerability. During times of economic stress, credit fund failures will be felt by their sponsor banks and can result in a vicious cycle of mass withdrawal, illiquidity, fire sale, and market devaluation. The exclusion of credit funds from Covered Fund regulations significantly dismantles post-GFC guardrails, creating space for market manipulation, systemic risk, and cross-exposure within financial markets. A fundamental difference in

proprietary trading as if the fund were a banking entity; the fund does not issue asset-backed securities; banking entities must ensure activities of the credit fund are consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly).

¹⁰⁰ Financial Stability Oversight Council, *Annual Report 37* (2024).

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risk tolerance and economic responsibility is that banks and credit funds are not held to the same standard, let alone able to operate in conjunction with each other.

CONCLUSION

The 2020 modification of the Volcker Rule's Covered Fund Provision fundamentally contradicts the post-GFC regulatory principle of prioritizing banking system stability over short-term financial gain. It reflects a deregulatory shift influenced by the interests of a concentrated financial elite at the expense of systemic safeguards, leaving the financial system and regulators ill-equipped to confront another economic downturn. By exempting VC and credit funds, the 2020 Final Rule re-exposes federally insured banks to the high-risk, high-reward investment vehicles the original rule aimed to separate from banking. I argued that such exemptions reflect not only a legal divergence from the original legislative intent but also a structural threat that exacerbates institutional vulnerabilities. This paper leverages three key steps to support this claim.

First, I examined the trade-off between an increase in capital formation capabilities with systemic stability, underscoring how legislative drafters designed the Volcker Rule on the principle that economic growth can not come at the cost of institutional resilience. Furthermore, banks, which receive extraordinary government privileges and protections, are held to higher operating standards due to their vital public role.

Second, the analysis of VC and credit funds' risk profiles demonstrated their fundamental incompatibility with the operational requirements of bank stability mandates. This section breaks down the different assets and investment strategies employed by fund types. In the case of the VC-backed portfolio companies, long-term investments in high-failure-rate and illiquid portfolio companies can lead to liquidity and maturity mismatches that contradict the short-term funding and liquidity obligations of commercial banks. In the case of credit fund holdings of high-risk loans and financial instruments, similar concerns emerge, including high default risk, poor borrower credit, illiquidity, and sensitivity to market valuation fluctuations. I applied the regulatory definitions and statutory language of the 2013 Volcker Rule to demonstrate how the 2020 modifications reflect a failure to uphold the original rule's legislative intent. I relied heavily on the "high-risk assets, high-risk trading strategies" as well as the statutory definition of illiquid funds to reveal clear contradictions within the 2020 Final Rule that leave significant vulnerabilities to the broader banking regulatory framework.

Third, I argued that by allowing banks to retain ownership, sponsorship, and

working relationships with VC and credit funds, the 2020 Final Rule creates a conflicted and opaque institutional dynamic that allows both parties to circumvent regulatory oversight and supervision. In the case of VC funds, sponsoring banks may influence the investment selection process by skewing decisions towards highly illiquid and debt-reliant portfolio companies that would serve the bank's credit interest. In the case of credit funds, banks can offshore high-risk assets or extend credit lending functions through a fund structure. Under the 2020 Final Rule, both practices would be exempted from regulatory scrutiny, allowing banks to evade capital requirements and engage in shadow banking activities that further entangle the financial market.

These findings demonstrate that bank investment and sponsorship of VC and credit funds reflect an erosion of the structural firewall between banking and speculative investments. In the aftermath of the 2008 GFC, regulators intentionally designed the Volcker Rule to sever the entanglement between federally insured banks and investment entities, ensuring that public guarantees and government insurance would no longer subsidize private risk-taking. The 2020 Final Rule significantly undermines the economic stability principle of the Volcker Rule. To better prepare the economy for the possibility of another financial crisis, regulators must reinstate the original separation to ensure that the soundness and stability of core banking functions remain insulated from the consequences of private risk-taking. Preserving the authority of post-crisis reforms demands more than verbal commitments, it requires the reinforcement of legislative safeguards put in place to protect financial stability.