Volcker Rule's VC Changes Will Support Underserved Regions

By **Lindsay Karas Stencel** (October 29, 2020)

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For nearly a decade, the Bank Holding Company Act, specifically the Volcker Rule, severely restricted banks and banking entities from investing in venture capital funds, effectively preventing them from backing the very types of investments the BHCA originally sought to promote: small businesses, regional businesses and startups that create jobs and spur innovation.

Implemented following the Great Recession, the Volcker Rule sought to curtail banks' investments in perceived high-risk assets and investment classes, like alternative investment vehicles, with the goal of reducing systemic risk in the banking system.

While the Volcker Rule never specifically called out venture capital funds in its definition of covered funds, its practical application treated hedge funds, private equity funds and venture funds alike, permitting investments only in the instance of a statutory exclusion made pursuant to various implementing regulations, which were often punitively expensive or time-consuming for smaller or emerging venture capital fund managers, making them nearly impossible to implement in reality.

The result was a prohibition on venture capital investing for banks and bank entities that did little or nothing to improve the banking system's overall health and created unnecessary roadblocks in traditionally underserved regions where raising venture funds is typically more challenging.

Adding venture capital to the rule's covered fund definition eliminated hundreds of millions of dollars of available capital annually for smaller and emerging regional funds. These smaller funds normally relied on institutional investors, such as banks and bank entities, to serve as larger limited partners, which not only increased capital investment in the region, but often attracted additional capital sources from outside the region, created new industries and spurred economic development, particularly with regard to new net job creation.

In many regions across the country, it was difficult to raise early or smaller-sized venture funds because the cost of obtaining a permitted statutory exclusion, such as a small business investment company license, was often too burdensome, time-consuming and costly for smaller or newer organizations.

A chilling of venture capital investment in smaller, regional funds occurred outside the large venture capital hubs of New York, Boston and Palo Alto, California. This in turn created a strain on capital access for startups and small businesses outside of those hubs, leading to reduced innovation, limited new industry development and stunted job creation across many of the impacted areas.

On June 25, however, banks learned that with the finalization of the revised regulations in October, they could reenter the realm of venture capital investing with funds that meet certain reduced requirements. In an unusual collective action, the Federal Reserve System, U.S. Department of the Treasury, Federal Deposit Insurance Corporation, Commodity Futures Trading Commission and U.S. Securities and Exchange

Commission created a new exclusion to the previously limited covered funds definition for qualifying venture capital funds.

The new definition excludes funds defined in Rule 203(l)-1 and funds that do not engage in any activity that would constitute proprietary trading, as if they are banking entities, meaning most traditional venture capital firms are once again eligible for bank investment.

The five agencies concluded that by permitting banks and bank entities to invest in qualifying venture capital funds, they could once again serve as foundational investors to support capital formation, job creation and economic development, particularly for small businesses and startups in regions outside the major investment hubs. They surmised that the broader financial system would improve if more capital was permitted to flow to small businesses and innovation.

As such, pending the release of the final regulations, venture capital will see the return of banks and banking entities as potential investors, opening up new sources of capital and turning the heat back on for innovation, economic development and job creation across the previously chilled regions of the country.

Some of the more significantly impacted venture ecosystems that should benefit from this relaxing of the Volcker Rule are those normally classified as second- or third-tier ecosystems, such as areas of the Midwest — Columbus and Cincinnati, Ohio; Omaha, Nebraska; Nashville, Tennessee — where, prior to the Volcker Rule's initial implementation, local banks were some of the largest funders, particularly in early-stage venture capital.

Early-stage venture capital is traditionally lacking in many developing ecosystems, and banks and bank entities were typically the anchor investors in the venture funds that invested in the early-stage spaces. The Volcker Rule's prior prohibition on investing in venture absent an exception or exclusion severely damaged these regions' ability to attract capital and in turn stunted the growth and build-out of these ecosystems, as they lacked large institutional anchor investors for their funds.

So the combination of a pinch on the available capital from more traditional investors and the lack of early-stage investment capital caused catastrophic harm to the development and growth of some of these developing ecosystems, which in turn resulted in a further concentration of venture capital in the major hubs.

Now, however, with the loosening of the Volcker Rule, banks and bank entities can again participate in financing the regions in which they have a footprint, allowing a renaissance of venture capital fund formation for smaller or emerging funds that were previously unintentionally excluded from raising capital to develop the next generation of high-growth businesses in their respective ecosystems.

Permitting the banks and bank entities to once again invest in the smaller or emerging funds could be the turning point many of these regions need to launch them to first-tier ecosystem status and assist in closing the gap in early-stage venture fund formation and startup financing.

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