SULLIVAN & CROMWELL LLP

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Volcker Rule

Federal Banking Agencies Release New Guidance on the Treatment of "Foreign Excluded Funds" Under the Volcker Rule

SUMMARY

On Friday afternoon, the staffs of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC," and together with the Federal Reserve and the OCC, the "Banking Agencies") issued a joint statement (the "Joint Statement") relating to the implementation of section 13 of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), commonly known as the "Volcker Rule," with respect to foreign banking entities' investment in and sponsorship of certain foreign funds.[1]

A. EXISTING REGULATORY FRAMEWORK UNDER THE FINAL RULE

The Volcker Rule imposes broad prohibitions on proprietary trading and investing in and sponsoring hedge funds and private equity funds ("covered funds") by banking entities and their "affiliates" and "subsidiaries," as such terms are defined for purposes of the BHC Act. Under the final regulations issued by the Agencies to implement the Volcker Rule (the "Final Rule"), covered funds are generally excluded from the definition of "banking entity."[2] Accordingly, although a banking entity would not be permitted to invest in or sponsor a covered fund absent an exemption, the covered fund itself would generally not be restricted by the Volcker Rule from conducting its business activities (which could include proprietary trading and investing in other covered funds) if a banking entity were to invest in or sponsor the covered fund in reliance upon an applicable exemption.

In order to limit the extraterritorial application of the Volcker Rule, the Agencies provided in the Final Rule that, in the case of foreign banking entities, a "covered fund" generally does not include an entity that is

organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States (commonly referred to as a "foreign excluded fund").[3] As a result, a foreign banking entity is permitted under the Volcker Rule to invest in or sponsor foreign excluded funds without having to comply with another exemption. As the Joint Statement explains, "Section 13 [of the BHC Act] and the [Final Rule] do not apply to a foreign banking entity's investment in, or sponsorship of, foreign excluded funds organized and offered exclusively outside the United States."

However, if a foreign banking entity's investment in or sponsorship of a foreign excluded fund constitutes "control" (as defined for purposes of the BHC Act) of the fund, then the fund would be deemed a "subsidiary" of the foreign banking entity and would itself be a banking entity subject to the Volcker Rule.[4] This could arise, for example, where the foreign banking entity owns 25 percent or more of any class of voting shares of a foreign excluded fund, or where the foreign banking entity selects a majority of the board of directors of the fund or acts as general partner or trustee of the fund.

B. THE JOINT STATEMENT

As the Joint Statement acknowledges, the interaction of the Final Rule's definitions of "covered fund" and "banking entity," combined with the Federal Reserve's expansive definition of "control" under the BHC Act, gives rise to potential adverse consequences for foreign banking entities (including foreign funds deemed to be "banking entities") and has caused uncertainty among foreign banking entities, foreign government officials and other market participants.

The Joint Statement provides that the Banking Agencies will not, during the one-year period ending July 21, 2018, "propose to take action" against a foreign banking entity based on attribution of the activities and investments of a "qualifying foreign excluded fund" to the foreign banking entity, or against a qualifying foreign excluded fund that could be itself to be deemed a banking entity, provided that the foreign banking entity's investment or sponsorship complies with the Final Rule's exemption for certain covered fund activities conducted "solely outside of the United States" (commonly referred to as the "SOTUS" exemption).[5]

As defined in the Joint Statement, a "qualifying foreign excluded fund" means, with respect to a foreign banking entity, an entity that:

(1) Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;

(2) Would be a covered fund were the entity organized or established in the United States, or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;

(3) Would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the entity;

(4) Is established and operated as part of a *bona fide* asset management business; and

(5) Is not operated in a manner that enables the foreign banking entity to evade the requirements of the Volcker Rule or the Final Rule.

The foregoing definition of "qualifying foreign excluded fund" appears to be intended to apply to non-U.S. funds that are offered and sold solely outside of the United States—as required by clauses (1) and (2) of the definition—and that are captured by the "banking entity" definition solely by virtue of the fund's relationship with the investing or sponsoring foreign banking entity. While the language of clause (3) of the definition is somewhat ambiguous, it appears that an entity that is within the "banking entity" definition irrespective of any other banking entity's investment or sponsorship—for example, a non-U.S. company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978—would not be a "qualifying foreign excluded fund."[6]

The Joint Statement does not specify how foreign banking entities should determine that clauses (4) and (5) of the definition are satisfied, although it appears that these elements are designed to address the Banking Agencies' "concerns that a foreign banking entity could use a controlled foreign excluded fund to avoid otherwise applicable requirements under [the Volcker Rule] (for example, to engage in proprietary trading or to sponsor or invest in a covered fund in the United States in a manner that the foreign banking entity would otherwise be prohibited from doing directly)."

As noted above, the Joint Statement also requires that the foreign banking entity's investment in or sponsorship of a qualifying foreign excluded fund comply with the SOTUS exemption as though the fund were a covered fund. Under the Final Rule, the SOTUS exemption is available only to a foreign banking entity that is not controlled, directly or indirectly, by a U.S. banking entity. In addition, such a foreign banking entity could rely upon the SOTUS exemption to invest in or sponsor a covered fund only if, among other conditions: (i) the foreign banking entity's relevant personnel who make the decision to invest in or sponsor the fund are not located in the United States, (ii) the investment or sponsorship (including any related risk-mitigating hedging transaction) is not accounted for as principal directly or indirectly on a consolidated basis by any U.S. branch or affiliate of the foreign banking entity; and (iii) no financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any U.S. branch or affiliate of the foreign banking entity.

Because the Joint Statement applies solely during the one-year period ending July 21, 2018, as a practical matter, its relevance may be limited for qualifying foreign excluded funds that are not already in existence. The Joint Statement notes that the Agencies are considering ways to amend the Final Rule or other appropriate action to "address any unintended consequences of the Volcker Rule for foreign excluded funds in foreign jurisdictions," and further suggests that Congressional action may be necessary to fully address any unintended consequences.[7]

A copy of the Joint Statement is attached as Appendix A.

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ENDNOTES

[1] The Joint Statement is not a joint issuance of all five of the federal regulatory agencies responsible for implementation and enforcement of the Volcker Rule (collectively, the "Agencies"), which include the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC") in addition to the Banking Agencies, unlike prior guidance issued under the Volcker Rule such as the "Frequently Asked Questions." However, the Banking Agencies note that they have consulted with the SEC and CFTC regarding the subject matter of the Joint Statement.

[2] A banking entity generally includes any insured depository institution, any depository institution holding company, any foreign company treated as a bank holding company under the International Banking Act of 1978 and any affiliate or subsidiary of any of the foregoing. Final Rule § _.2(c). The Final Rule defines the terms "affiliate" and "subsidiary" to have the same meanings as under Section 2 of the BHC Act. Final Rule §§ _.2(a), _.2(dd). Under the BHC Act, "the term 'affiliate' means any company that controls, is controlled by, or is under common control with another company," and "[a]ny company has control over a bank or over any company if—(A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company; (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (C) the [Federal Reserve] determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company." BHC Act §§ 2(k), 2(a)(2). The BHC Act defines the term "subsidiary" similarly to mean "with respect to a specified bank holding company . . . (1) any company 25 per centum or more of whose voting shares (excluding shares owned by the United States or by any company wholly owned by the United States) is directly or indirectly owned or controlled by such bank holding company, or is held by it with power to vote; (2) any company the election of a majority of whose directors is controlled in any manner by such bank holding company; or (3) any company with respect to the management of policies of which such bank holding company has the power, directly or indirectly, to exercise a controlling influence, as determined by the [Federal Reserve], after notice and opportunity for hearing." BHC Act § 2(d).

[3] *See* Final Rule § _.10(b)(1)(iii).

[4] *See* note 2 above (defining "subsidiary" for purposes of the BHC Act).

[5] Final Rule § _.13(b). *See also* 12 U.S.C. § 1851(d)(1)(I). For additional discussion of the SOTUS covered fund exemption, including an FAQ released by the Agencies regarding the interpretation of that exemption, see our February 27, 2015 Memorandum to Clients titled "Agencies Release New Volcker Rule FAQ with Critical Guidance for Foreign Banking Entities and Fund Sponsors; Clarify That U.S. Marketing Restriction Under "SOTUS" Covered Fund Exemption Does Not Apply to Third Parties."

[6] *See* note 2 above (defining "banking entity" for purposes of the Volcker Rule).

[7] In the current Congress, several pieces of legislation have been introduced in the House of Representatives and Senate that would affect the Volcker Rule to varying degrees. Certain bills have sought to make targeted changes to the Volcker Rule statute, whereas others would repeal the Volcker Rule altogether. Most notably, the House of Representatives passed H.R. 10, the "Financial CHOICE Act of 2017," which would, among other measures, repeal the Volcker Rule entirely, as discussed in our June 9, 2017 Memorandum to Clients titled "Financial CHOICE Act of 2017."

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July 21, 2017

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), also known as the Volcker Rule, added a new section 13 to the Bank Holding Company Act of 1956 (the "BHC Act") (codified at 12 U.S.C. 1851) that generally prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund ("covered fund"). These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions. The Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC," and together with the Board and the OCC, the "Banking Agencies"), the Securities and Exchange Commission (the "SEC"), and the Commodity Futures Trading Commission (the "CFTC," and together with the Banking Agencies and the SEC, the "Agencies") issued final rules implementing section 13 in December 2013.[1]

A number of foreign banking entities, foreign government officials, and other market participants have expressed concern about the possible unintended consequences and extraterritorial impact of the Volcker Rule and implementing regulations for certain foreign funds ("foreign excluded funds") that are excluded from the definition of "covered fund" under section 13 and the Agencies' implementing rules with respect to a foreign banking entity. In particular, these parties have contended that certain foreign excluded funds may fall within the definition of "banking entity" under section 13 and implementing regulations if they are an affiliate or subsidiary of a foreign banking entity under the BHC Act by virtue of typical corporate governance structures for funds sponsored by a foreign banking entity in a foreign jurisdiction or by virtue of investment by the foreign banking entity in the fund.[2] Foreign banking entities and others have expressed concern that the application of the requirements of section 13 and implementing regulations to the activities of these foreign excluded funds could put foreign excluded funds affiliated with foreign banking entities at a disadvantage in competing with foreign excluded funds that are not affiliated with a banking entity and are not subject to the requirements and restrictions of section 13 applicable to banking entities. At the same time, the Banking Agencies are also mindful of concerns that a foreign banking entity could use a controlled foreign excluded fund to avoid otherwise applicable requirements under section 13 (for example, to engage in proprietary trading or to sponsor or invest in a covered fund in the United States in a manner that the foreign banking entity would otherwise be

[1] These final rules are codified at 12 CFR part 44 (OCC), 12 CFR part 248 (FRB), 12 CFR part 351 (FDIC), 17 CFR part 75 (CFTC), and 17 CFR part 255 (SEC).

[2] The term "banking entity" is defined by statute to include, with limited exceptions: (i) any insured depository institution ("IDI") (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); (ii) any company that controls an IDI; (iii) any company that is treated as a BHC for purposes of section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106); and (iv) any affiliate or subsidiary of any of the foregoing. 12 U.S.C. 1851(h)(1); section __.2(b) of the final rules.

prohibited from doing directly), which could provide the foreign banking entity with competitive advantages over U.S. banking entities. Market participants have urged the Agencies to consider various alternatives to clarify the treatment of foreign excluded funds under the Volcker Rule and implementing regulations.

Section 13 and the Agencies' final rules do not apply to a foreign banking entity's investment in, or sponsorship of, foreign excluded funds organized and offered exclusively outside the United States. However, where a foreign banking entity owns a large amount of the fund, selects the board of directors of the fund, or acts as general partner or trustee of the fund, the foreign bank may be deemed by law to control the foreign fund.[3] A foreign fund controlled by a foreign banking entity would be an affiliate of the foreign bank under the BHC Act, and the statute by its terms subjects an affiliate of a banking entity to the restrictions on covered fund and proprietary trading activities in the United States.

The staffs of the Agencies are considering ways in which the implementing regulation may be amended, or other appropriate action may be taken, to address any unintended consequences of the Volcker Rule for foreign excluded funds in foreign jurisdictions. It may also be the case that congressional action is necessary to fully address the issue. In order to provide additional time, the Banking Agencies would not propose to take action during the one-year period ending July 21, 2018, against a foreign banking entity[4] based on attribution of the activities and investments of a qualifying foreign excluded fund (as defined below) to the foreign banking entity, or against a qualifying foreign excluded fund as a banking entity, in each case where the foreign banking entity's acquisition or retention of any ownership interest in, or sponsorship of, the qualifying foreign excluded fund would meet the requirements for permitted covered fund activities and investments solely outside the United States, as provided in section 13(d)(1)(I) of the BHC Act and section __.13(b) of the Agencies' implementing rules, as if the qualifying foreign excluded fund were a covered fund.[5]

For purposes of this statement, a "qualifying foreign excluded fund" means, with respect to a foreign banking entity, an entity that:

(1) Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;

(2) Would be a covered fund were the entity organized or established in the United States, or is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;

[3] *See* 12 U.S.C. 1841(a)(2), (d), and (k).

[4] For purposes of this statement, "foreign banking entity" means a banking entity that is not, and is not controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or any State.

[5] "Covered fund" is defined in section __.10 of the Agencies' implementing rules, and "hedge fund" and "private equity fund" are defined in section 13(h)(2) of the BHC Act. Unless otherwise defined, terms used in this statement have the same meaning as under section 13 and implementing rules.

(3) Would not otherwise be a banking entity except by virtue of the foreign banking entity's acquisition or retention of an ownership interest in, or sponsorship of, the entity;

(4) Is established and operated as part of a bona fide asset management business; and

(5) Is not operated in a manner that enables the foreign banking entity to evade the requirements of section 13 or implementing regulations.

The Banking Agencies have consulted with the staffs of the SEC and CFTC regarding this matter.

Nothing in this statement restricts in any way the authority of any Agency to use its supervisory or other authority to limit any activity the Agency determines to be unsafe or unsound or otherwise in violation of law.