Client Update

New Volcker Rule FAQs Clarify Foreign Public Fund "Control" Issues and Limit Use of "Joint Venture" Exemption but Leave Many Issues Unresolved

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On Friday, the Federal Reserve and other agencies charged with implementing the Volcker Rule issued two new Frequently Asked Questions ("FAQs") to clarify certain aspects of the final regulations interpreting the Volcker Rule ("Final Rule"). One of the new FAQs, number 14 in the list the agencies have issued, permits a banking entity to maintain governance, management, investment advisory, service and other relationships with a foreign public fund without the fund's activities being attributed to the banking entity for purposes of the Volcker Rule or the fund being deemed a banking entity itself, so long as the banking entity limits its ownership interests in the fund below certain levels. The second FAQ, number 15, clarifies limits on the use of the joint venture exemption to the Volcker Rule's covered fund prohibitions.

Below we describe the issues that led to the two FAQs and then discuss the two FAQs. We also highlight some of the outstanding issues the agencies have yet to resolve.

BACKGROUND

The prohibitions of the Final Rule apply to "banking entities," which term generally includes all "affiliates" of a bank with deposit insurance from the Federal Deposit Insurance Corporation and foreign banks with a U.S. banking presence (such as a branch). The term "affiliate" is defined by cross-reference to the Bank Holding Company Act's ("BHC Act") standards for "control." Generally, under the BHC Act, one entity is deemed to control another (and, therefore, the two are affiliates) if the first (a) controls 25% or more of any class of voting securities of the second, (b) has the power to elect a majority of

directors or similar persons of the second or (c) otherwise exercises a "controlling influence" over the second.

The banking entity definition in the Final Rule specifically excludes "covered funds" – generally, private funds with respect to which banking entities have a number of investment limits and other restrictions under the Volcker Rule. Thus, a covered fund, even if it is controlled by a banking entity investor or sponsor, is not subject to the Final Rule's prohibitions on proprietary trading and investing in, and sponsorship of, other covered funds. This exclusion allows covered funds in which a banking entity invests or which a banking entity advises and sponsors to engage in the normal business of trading and investing without regard to the Volcker Rule's restrictions.

As originally proposed, the covered fund definition was exceedingly broad and included investment vehicles that did not appear to be intended to be covered by the Volcker Rule's restrictions and prohibitions. The Agencies recognized this over-reach and tailored the covered fund definition by excluding, among other entities, foreign public funds[1] and certain joint ventures.[2]

As a result of this framework, a foreign public fund "controlled" by a banking entity (and therefore an affiliate) could be viewed as a banking entity and subject to the Final Rule's prohibitions on proprietary trading and covered fund investments and activities. This result, although antithetical to the business of any investment fund, would not be uncommon because many foreign public funds are structured with boards controlled by a banking entity sponsor or, as a result of contractual or other arrangements, are otherwise controlled by the banking entity sponsor under BHC Act standards. Absent guidance, therefore, such foreign public funds would be banking entities – and likely unable to continue operating.

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1 A foreign public fund generally is defined as a pooled investment vehicle organized outside the United States, the ownership interests of which are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and are sold predominantly through one or more public offerings outside of the United States.

2 Under the Final Rule, a joint venture is excluded from the definition of covered fund if the joint venture is between the banking entity and no more than 10 unaffiliated co-venturers, is in the business of engaging in activities permissible for the banking entity other than investing in securities for resale or other disposition, and does not hold itself out as being an entity that raises money from investors primarily for the purpose of investing in or trading in securities.

FOREIGN PUBLIC FUND GUIDANCE

The new foreign public funds FAQ lays out the view of the staffs of the Volcker Rule implementing agencies that foreign public funds controlled by banking entities under BHC Act standards as a result of management, contractual or other governance arrangements will not be viewed as banking entities or have their activities attributed, for purposes of the Volcker Rule, to a banking entity sponsor. To qualify for this treatment, any investment advisory, commodity trading advisory, administrative and other services the banking entity sponsor provides to the fund must be in compliance with the limitations imposed by the relevant foreign jurisdiction.

This FAQ does not provide any relief in the case of control arising out of ownership of a foreign public fund's shares. Accordingly, banking entities may not own or control 25% of the voting shares of the fund after a permitted seeding period – discussed in more detail below – to take advantage of this FAQ. Absent any future guidance, the 25% ownership limit remains an important binding constraint for many foreign public fund structures in which banking entities may wish to own significant positions for a variety of reasons (including relevant foreign market practices).

This FAQ also does not appear to alter the additional condition imposed on U.S. banking entities seeking to rely on the foreign public fund exclusion to sponsor such funds. In particular, the foreign public fund exclusion is only available to a U.S. banking entity if the fund's interests are sold "predominantly" to persons other than the sponsoring banking entity and certain persons and entities connected with that banking entity. In the preamble to the Final Rule, the agencies indicate that to meet this test a U.S. banking entity "generally" must sell 85% or more of the foreign public fund's interest to such unaffiliated persons and entities (presumably, after a seeding period).

JOINT VENTURE GUIDANCE

As noted above, the Final Rule permits banking entities to organize and invest in joint ventures that otherwise would be covered funds, so long as certain conditions are met. Among those conditions, the joint venture may not be, and may not hold itself out as being, an entity that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

This new FAQ emphasizes that a banking entity may not rely on the joint venture exemption if the banking entity raises money from investors to invest in securities, even if the securities are held for a longer duration, until maturity or

until the dissolution of the entity. More generally, the new FAQ appears to reflect the staffs' view that use of the joint venture exemption will be scrutinized and should be used only to invest in enterprises that would be "well recognized" as a joint venture (a concept the FAQ does not further define). In some sense, this FAQ seems to import the requirement from the proposed Volcker Rule regulations – not included in the Final Rule, and which was not defined in the proposed rule – that a joint venture be some type of "operating company."[3]

CERTAIN REMAINING OUTSTANDING ISSUES

Although the foreign public fund FAQ is helpful in clarifying that the foreign public funds described above will not be deemed banking entities or have their activities attributed to their banking entity sponsors for purposes of the Volcker Rule, a number of important interpretive and procedural issues remain.

- The agencies have not yet addressed the treatment under the Final Rule of certain foreign private funds (sometimes referred to as "foreign excluded funds") that may be controlled under BHC Act standards. This treatment remains a significant open issue for many non-U.S. banking entities, which are permitted to invest in and sponsor foreign private funds without regard to the Volcker Rule's restrictions.
- The foreign public funds FAQ also does not address the process and standards the Federal Reserve will use to consider and grant extensions to the 1-year "seeding period" for various types of funds, including covered funds, foreign public funds and registered investment companies.
- Further, this FAQ does not address control issues that could arise from ownership situations, as reflected in industry efforts to seek guidance on the circumstances under which a banking entity could hold 25% or more of the voting shares of a foreign public fund (after a seeding period) without the fund being deemed a banking entity or having its activities attributed to the banking entity owner.

[3] 79 Fed. Reg. 5536, 5680-5681 (Jan. 31, 2014) (explaining the agencies' determination to remove the operating company concept from the joint venture definition: "However, [commenters] expressed concern that joint ventures were defined too narrowly under the proposal because the exclusion was limited to joint ventures that were *operating companies*. Some commenters criticized the lack of guidance regarding the meaning of operating company.") (emphasis added).

- The Federal Reserve also has not indicated whether it anticipates providing any additional extensions of the July 21, 2015 conformance deadline for any additional funds, including foreign public funds that might fall outside of the clarification provided by the new FAQ.

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Please contact us with any questions you may have.