Client Update
Volcker Rule: Temporary Relief for Foreign Excluded Funds

On Friday, the Federal Reserve and other federal banking agencies (the "Agencies") issued interpretive relief from the Volcker Rule's requirements for "foreign excluded funds." In short, the relief provides that for a one-year period, until July 21, 2018, a non-U.S. banking entity subject to the Volcker Rule may control a qualifying foreign excluded fund without having the activities of the fund being subject to the Volcker Rule's prohibitions. The relief also resembles many aspects of an approach, referred to as "SOTUS opt-in," that we and our clients advocated that the Agencies adopt. The Agencies are continuing to consider a long-term approach to this issue, which may be implemented as a part of broader regulatory reform efforts.

Below we briefly explain the issue that this relief seeks to address and then summarize the relief. We have attached as an appendix the statement the Agencies issued.

BACKGROUND ON THE "BANKING ENTITY" ISSUE

The Volcker Rule's prohibitions apply to "banking entities," a term that includes, among other entities, non-U.S. banks with a U.S. banking presence plus all of the "affiliates" of such banks. The term "affiliate" is defined by cross-reference to the Bank Holding Company Act (the "BHC Act") and its standards for "control."[1]

There is an important carve out from the definition of banking entity for "covered funds." Thus, a banking entity may invest in, sponsor and otherwise control a covered fund (subject to various limits set forth in the Volcker Rule and its implementing regulations) without subjecting the investment activities of that covered fund to the Volcker Rule's prohibitions.

Funds that do not qualify as "covered funds" do not benefit from this carve out. For non-U.S. banking entities, funds that are organized and offered exclusively outside of the United States

[1] 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.

may not qualify as "covered funds" – these funds have come to be referred to as "foreign excluded funds."[2] As a result, a foreign excluded fund that is controlled by a non-U.S. banking entity is an affiliate, for BHC Act purposes, of the banking entity and is subject to all of the Volcker Rule's prohibitions. This result is untenable for many foreign excluded funds.

SOTUS OPT-IN RELIEF GRANTED

The guidance provides that, until July 21, 2018, the Agencies would not propose to take action against either a non-U.S. banking entity or a foreign excluded fund that is an affiliate of the non-U.S. banking entity based on the activities of that foreign fund. That is, the fund – despite being a BHC Act affiliate of a non-U.S. bank with a U.S. banking presence – may engage in trading and other activities that do not comply with the Volcker Rule's prohibitions. To qualify for this relief, the fund must meet enumerated requirements to be a "qualifying foreign excluded fund." These requirements are set out on the attached appendix.

Further, the non-U.S. banking entity's investment in or sponsorship of the foreign excluded fund must meet the requirements of the "solely outside the United States" (or "SOTUS") exemption, as if the foreign excluded fund were a covered fund. The SOTUS requirements include that the decision making for the investment in or sponsorship of the fund is made outside the United States, U.S. financing is not provided for the sponsorship or investment activity, and that the transaction is not accounted for by a U.S. entity. By taking this approach, the Agencies effectively have allowed non-U.S. banks to "opt-in" to the SOTUS exemption, an approach for which we and others advocated before the Agencies.

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Please do not hesitate to contact us with any questions.

[2] In June 2015, the Federal Reserve and other Volcker Rule-implementing agencies issued a Frequently Asked Question, which we discussed in a previous client update, which helped to address a highly similar issue for foreign *public* funds (e.g., mutual fund equivalents in a non-U.S. jurisdiction).

NEW YORK

Gregory J. Lyons
gjlyons@debevoise.com

David L. Portilla
dlportilla@debevoise.com

Sandeep S. Dhaliwal
ssdhaliwal@debevoise.com

WASHINGTON, D.C.

Satish M. Kini
smkini@debevoise.com

Appendix

See the following pages.

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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.