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A shift into neutral — Volcker agencies provide temporary relief while continuing to mull foreign excluded funds

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OCTOBER 19, 2017

July 21, 2017 marked the date that the last of several broad extensions to the Volcker Rule's conformance period — the two-year extension for grandfathered "legacy" covered funds — came to an end. It also marked the date that the agencies implementing the Volcker Rule (the "Agencies") took their first step of the year — closely followed by several others[1] — to ameliorate some of the rule's more frustrating anomalies. All five Agencies (the Federal Reserve, OCC, FDIC, SEC and CFTC) issued a joint press release (the "Press Release"), and the three banking supervisory agencies among the Agencies (the "Banking Agencies") issued a joint statement (the "Statement"), regarding the treatment of certain foreign excluded funds.[2]

Pursuant to the Statement, "the Banking Agencies would not propose to take action during the one-year period ending July 21, 2018, against a foreign banking entity based on attribution of the activities and investments of a qualifying foreign excluded fund," subject to certain conditions.[3] For many foreign banking entities subject to the Volcker Rule (and especially European banking entities), the Statement provides a temporary respite from years of uncertainty concerning the application of the Volcker Rule to controlled "foreign excluded funds" — funds outside the United States that would have been "covered funds" had they been organized or offered in the United States. However, as with prior attempts by the Agencies to clarify the application of the Volcker Rule, the scope of relief is limited and the conditions relatively complex, leaving a number of important questions unanswered.

BACKGROUND: THE FOREIGN EXCLUDED FUND PROBLEM

Banks and their affiliates that are subject to the Volcker Rule are generally prohibited from engaging in "proprietary trading" or holding certain investments in "covered funds" (as such terms are defined in the final regulations implementing the Volcker Rule (the "Final Regulations"[4])). These prohibitions apply to any "banking entity" — generally, any U.S. bank or foreign bank with a U.S. branch, agency or U.S. subsidiary bank, and any entity that is a "controlled" subsidiary or affiliate of such a bank within the meaning of the Bank Holding Company Act of 1956 (the "BHCA").

If an entity is a covered fund, it is excluded from the definition of "banking entity" in the Final Regulations.[5] This approach reflects the Agencies' intention to provide appropriate latitude for banking entities to engage in client-oriented financial activities, including asset management services provided through controlled vehicles that may engage in proprietary trading or investment in other private funds.[6]

As with prior attempts by the Agencies to clarify the application of the Volcker Rule, the scope of relief is limited and the conditions relatively complex, leaving a number of important questions unanswered.

The Agencies sought to provide further latitude for the private fund activities of foreign banking organizations ("FBOs"), consistent with the legislative policy to limit the extraterritorial application of the Volcker Rule except as necessary to prevent evasion or protect the rule's objectives.[7] To that end, they crafted the covered fund definition, as it applies to most FBOs that are subject to the Volcker Rule, to exclude "foreign excluded funds" that are not offered or sold in the United States. As a result, they do not benefit from the covered fund exclusion from the banking entity definition. This turned out to be an extreme case of good news and bad news for FBOs: an FBO is generally free to sponsor or invest in a foreign excluded fund, but if it "controls" the fund, the fund itself will be a banking entity and prohibited from engaging in the trading and investment activities that would be permitted to a covered fund. Members of the industry have been pressing for a solution to this presumably unintended consequence virtually since the Final Regulations were first adopted.

COORDINATION AMONG THE AGENCIES: REAL NEWS OR FAKE NEWS?

The title of the Press Release is *Federal regulatory agencies announce coordination of reviews for certain foreign funds under "Volcker Rule."*

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This seems like unlikely "news" — the Agencies have reportedly been meeting via the Volcker Working Group since at least January 2014[8] to coordinate their reviews of issues, as they are required to do under the DFA,[9] and the treatment of foreign excluded funds is believed to have been on their agenda for nearly as long. A more apt title might have been *Agencies still cannot agree on a long-term fix for the foreign excluded fund problem.*

Indeed, the requirement of coordination among the five Agencies has become a high-profile target of criticism for exacerbating the already onerous complexity of Volcker implementation.[10] Is the real news that the Statement — which preceded by less than two weeks the OCC's unilateral Notice Seeking Public Input on the Volcker Rule — marks a turning away from the unanimous five-Agency approach embodied by the FAQs?[11] As noted, only three of the five Agencies issued the Statement, although they "consulted with the staffs of the SEC and the CFTC" regarding the Statement's subject matter.[12] Going forward, perhaps the Banking Agencies will provide interpretive guidance and enforcement relief for entities they supervise (such as FBOs)[13] without full involvement of the other Agencies.

THE SCOPE OF FOREIGN EXCLUDED FUND RELIEF UNDER THE STATEMENT

A cautious first step toward providing certainty

The Statement provides a measure of certainty to FBOs at an opportune time. Controlled foreign excluded funds did not benefit from the extended conformance period for legacy covered funds and were technically subject to the Volcker Rule's prohibitions as of July 21, 2015. No enforcement action was taken in respect of such funds over the two-year period,[14] but FBOs had reason to wonder whether the Agencies would take a more aggressive posture once the extended conformance period came to an end and the Volcker Rule was fully in effect across all funds.

Still, the cautious scope of the Statement limits its usefulness in providing certainty. One-year relief gives FBOs little to rely on if they seek to structure new funds (which would commonly have terms of ten years or more) in the coming year.[15] And even during the one-year period, the Statement relates only to enforcement action and does not interpret the substantive requirements of the rule or provide explicit relief from the Volcker Rule's compliance program requirements. Does an FBO's compliance program satisfy the Volcker Rule if it does not treat controlled qualifying foreign excluded funds as banking entities? And if the answer is uncertain, will the Agencies permit FBO CEOs to include appropriate qualifications in their annual attestations?

Mixed messages regarding future steps

Perhaps more important than the temporary relief is the implicit message that the Agencies expect to adopt permanent relief prior to the end of the one-year non-enforcement period. Further, the Statement offers hope that permanent relief, when and if adopted, will not be subject to the limitations imposed by the Agencies in applying the banking entity definition to other types of non-covered fund asset management vehicles. Registered investment companies and qualifying foreign public funds, for example, are considered banking entities (after the initial seeding period) unless the sponsoring banking entity limits its ownership of the relevant fund to less than 25 percent.[16] The relief provided under the Statement includes no such ownership limit.

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The Statement suggests, however, that the Agencies may not consider it within their power to adopt full permanent relief in this form, noting that "[i]t may be the case that congressional action is necessary to fully address the issue."[17] The Agencies' concern likely derives from the definition of banking entity in the statutory Volcker Rule (found in Section 13 of the BHCA) and its implied incorporation of BHCA concepts of "control," which would generally deem control to exist where a banking entity holds 25 percent or more of a fund's voting securities.[18]

One might question why the Agencies would doubt their authority to fix an anomaly that arises from their own regulatory definitions. Such a reading would be difficult to reconcile with the Agencies' relatively unconditional exclusion from the banking entity definition for merchant banking portfolio companies,[19] as well as the exclusion for covered funds.[20] It would also overlook Congress' intent, as reflected in Section 13(d)(1)(I) of the BHCA, that the Volcker Rule not regulate foreign banking entities in their sponsorship and ownership of private funds offered solely outside the United States.[21]

Which entities qualify and which do not?

The Statement's definition of a Qualifying Foreign Excluded Fund ("QFEF") includes five requirements. A QFEF is 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 purposes of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments;

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(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 first two requirements define the foreign excluded fund universe — funds that require relief because their lack of a U.S. nexus deprives them of the covered fund banking entity exclusion.[22]

Requirement (3) tailors the scope of relief to match the covered fund exclusion under the Final Regulations, which applies only to covered funds that are not banking entities in their own right. Requirement (4) further tailors relief to apply only to funds established and operated as part of a bona fide asset management business. And Requirement (5), perhaps superfluous in view of the all-purpose anti-evasion provisions included in the Final Regulations, excludes from relief any entity that is operated in a manner that enables the FBO to evade the requirements of the Volcker Rule.

Banking entities should be aware that certain "near miss" funds do not benefit from the relief provided by the Statement. These include:

- **Funds that are not SOTUS-compliant.** It is not enough for a fund to meet the five QFEF requirements; to qualify for relief under the Statement, an FBO's investment or sponsorship must "occur" solely outside the United States and otherwise meet the requirements that would apply under the "SOTUS" activity exemption if the QFEF were a covered fund. Thus, for example, a QFEF is out of scope if any financing for the FBO's sponsorship of or investment in the QFEF is directly or indirectly provided by a U.S. branch or affiliate, or if personnel at a U.S. branch or affiliate make the decision for the FBO to sponsor or invest in the QFEF. Still not answered by the Agencies is how much involvement persons or entities within the United States may have without violating the SOTUS requirements. For example, does an investment occur solely outside the United States if U.S. payment functions (U.S. dollars, U.S. bank accounts and U.S. payment systems) are used to effect payment for fund interests?

- **Foreign excluded funds that are not asset management vehicles.** Entities that would have been covered funds in the United States, but are not operated as part of an asset management business of the FBO, are not eligible for relief because they do not satisfy the QFEF "bona fide asset management business" requirement. The latter term is not defined, but it seems likely the Banking Agencies intended a parallel to the "organized and offered" exemption, which contemplates a customer-facing business in which the banking entity or an affiliate provides bona fide investment advisory or related fiduciary services through a fund. Other types of FBO-controlled businesses with investment activities would appear ineligible for QFEF relief, although a number of such businesses (such as insurance companies and clearing company members) may benefit from other Volcker Rule exemptions.

Perhaps more important than the temporary relief is the implicit message that the Agencies expect to adopt permanent relief prior to the end of the one-year non-enforcement period.

- **Foreign excluded funds controlled by U.S. banking entities.** The Volcker Rule also permits U.S. banking entities (including their non-U.S. affiliates) to sponsor and invest in foreign funds that would be covered funds if organized or offered in the United States. Such funds are not covered funds with respect to a U.S. banking entity so long as they are not vehicles that invest in securities for resale or trading, as described in the third prong of the covered fund definition. For example, a largely static securities "repack" organized and offered solely outside the United States in which a non-U.S. affiliate of the banking entity owns 25 percent or more of the voting securities or serves as general partner would generally be a foreign excluded fund controlled by a U.S. banking entity. Such a fund will not qualify for relief under the Statement, even if it meets all five QFEF requirements, because relief is explicitly limited to FBO-affiliated QFEFs.

- **Funds that qualify for other exemptions.** In its focus on one type of disparity — that between the treatment of covered funds and foreign excluded funds under the banking entity definition — the Statement misses an opportunity to address a broader disparity — that between covered funds and non-covered funds generally. Many types of bona fide asset management vehicles, including qualifying loan securitizations, REITs and oil and gas funds, will not qualify as QFEFs because they qualify for exemptions from the covered fund or investment company definition and therefore would not be covered funds "were the entity organized or established in the United States" pursuant to QFEF Requirement (2). We hope that this anomaly will ultimately be addressed by the Agencies for U.S. as well as non-U.S. funds, but in the short term, the Banking Agencies could have ameliorated the problem for FBOs by simply omitting Requirement (2) of the QFEF definition. The remaining requirements limit relief to bona fide asset management funds with no U.S.

investors and no U.S. banking entity involvement; it is difficult to see how the further limitations of Requirement (2) advance any policies regarding safety and soundness of the U.S. banking system or competitive disadvantage to U.S. banking entities.

CONCLUSION

It appears that the Agencies (or at least the Banking Agencies) are at long last attempting to work through the outstanding difficult interpretive issues under the Volcker Rule. Making the rule easier to interpret can only help both banking entities and examiners in complying and reviewing compliance. The Statement, along with minutes of the FSOC meetings, the OCC Notice and other statements by regulators, offers the promise of further clarifications and guidance going forward. However, the cautious scope of the Statement and the complexity of the requirements for relief suggest that evasion concerns continue to hold sway. If the Statement is a model for future action, it appears the Banking Agencies may continue to allow suspicion of evasion to be the enemy of clear guidance.

NOTES

[1] On July 24, 2017, the Federal Reserve issued guidance to banking entities seeking an extension to conform certain "seeding" investments in covered funds to the Volcker Rule. See https://www.federalreserve.gov/supervisionreg/srletters/sr1705.htm. On August 2, the OCC issued a notice soliciting public comment regarding potential revisions to the Volcker Rule (the "OCC Notice"). See https://www.occ.gov/news-issuances/news-releases/2017/nr-occ-2017-89a.pdf.

[2] The Press Release is available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170721a.htm, while the Statement is available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf.

[3] Statement at 2 (footnote omitted). We note that the Banking Agencies have more clear authority to enforce the Volcker Rule than do the non-Banking Agencies, and that certain Banking Agencies have more clear authority to enforce the Volcker Rule than do others. See our prior Client Alert discussing enforcement of the Volcker Rule by the five Agencies, at https://www.milbank.com/images/content/2/1/v5/21066/Out-ofthe-Frying-Pan.pdf.

[4] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014).

[5] 12 C.F.R. § 248.2.

[6] See the preamble to the Final Regulations (the "Preamble"), at 5541 ("The Agencies have designed the final rule to achieve the purposes of section 13 of the BHC Act … while permitting banking entities to continue to provide, and to manage and limit the risks associated with providing, client-oriented financial services that are critical to capital generation for businesses of all sizes, households and individuals, and that facilitate liquid markets.") A banking entity may control a covered fund consistent with the Volcker Rule if its sponsorship of and/or ownership of interests in the fund complies with an activity exemption, such as the "organized and offered" or "SOTUS" exemption.

[7] See, e.g., Preamble notes 1516, 2394.

[8] See, e.g., https://www.fdic.gov/regulations/reform/volcker/coordination.html.

[9] DFA Section 619(b)(2) requires the five federal regulatory agencies to engage in "coordinated rulemaking," and Section 619(b)(2)(B)(ii) states that those agencies must "consult and coordinate" to "provide for consistent application and implementation" of the provisions of the Volcker Rule. The Preamble further describes this requirement at note 11.

[10] See, e.g., Minutes of the Financial Stability Oversight Council (May 8, 2017); Daniel K. Tarullo, Departing Thoughts (April 4, 2017) ("The joint or parallel rulemaking among multiple agencies required in various parts of the Dodd-Frank Act has advantages and disadvantages that differ across subject matter. Here, though, the disadvantages seem to dominate."); U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities (June 2017) ("The regulators' existing approach to coordination has not worked and, as a result, banks have had difficulty obtaining clear, consistent guidance."); Institute of International Bankers, U.S. Supervision and Regulation of International Banks: Recommendations for the Report of the Treasury Secretary (April 28, 2017).

[11] We note that, aside from the current drumbeat of momentum to revisit or change elements of the rule, the more hesitant or dissenting views of two senior persons at the Banking Agencies. See Federal Reserve Chair Yellen at https://www.federalreserve.gov/newsevents/speech/yellen20170825a.htm and "Volcker Rule rollback is not the kind of reg relief small banks need", Thomas Hoenig, FDIC Vice Chairman, American Banker (Aug. 25, 2017).

[12] Statement at 3.

[13] For example, the Volcker Rule's "Super 23A" provisions incorporate, by reference, Section 23A of the Federal Reserve Act. One would expect that questions regarding the extraterritorial application of Super 23A would most naturally be addressed by the Federal Reserve, which is generally responsible for determining the extraterritorial application of Section 23A (as implemented through the Federal Reserve's Regulation W).

[14] The one public enforcement action against a foreign bank for Volcker Rule violations related to its compliance with its permitted market-making activities. See https://www.federalreserve.gov/newsevents/pressreleases/enforcement20170420a.htm.

[15] According to the July 28, 2017 "Readout of Financial Stability Oversight Council ["FSOC"] Meeting", the agencies making up FSOC "discussed potential improvements to the Volcker Rule, including the recommendations regarding the Volcker Rule in the Treasury Department's June 2017 report …". See https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/7-28-17%20FSOC%20readout.pdf. Perhaps the one-year no-action period is related to these potential improvements and assumes permanent action under FSOC's aegis.

[16] 12 C.F.R. § 12(b)(1)(ii). See also the Agencies' "Frequently Asked Question" number 14, regarding the application of the Final Regulations to a foreign public fund sponsored by a banking entity, at https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#14; Preamble at notes 1734-1739.

[17] Statement at 2.

[18] In particular, Section 13(h)(1) of the BHCA defines "banking entities" to include any "affiliate or subsidiary" of a covered bank, bank holding company, or company treated as a bank holding company. An "affiliate" is defined under the BHCA as any company controlling, controlled by, or under common control with another company, while a "subsidiary" of a bank holding company refers to any company directly or indirectly controlled by the bank holding company. 12 U.S.C. § 1841.

[19] We discussed this issue in a previous Client Alert, available at https://www.milbank.com/images/content/1/5/15555/FHC-Volcker-Alert.pdf on pages 6-7.

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[20] Where US banking entities are concerned, the covered fund exclusion arguably contains an embedded ownership limitation, in that the permitted activity exclusion for "organized and offered" funds generally limits banking entity ownership to three percent, although there is no per se ownership limit for foreign banking entities that invest in covered funds under the SOTUS exception. See 12 C.F.R. § 248.12.

[21] "Permitted activities" under BHCA Section 13(d)(1), which describes activities that are intended to be permitted notwithstanding the general Volcker Rule prohibitions (subject to such limitations as the appropriate Agencies may determine) include investment in or sponsorship of a hedge fund or private equity fund by a qualifying FBO, provided no ownership interests in the fund are offered or sold to U.S. residents.

[22] Requirement (2) describes the two main types of funds that may be covered funds even though they are offered and sold solely outside the United States: (i) funds that are organized in the United States, and therefore must generally rely on Section 3(c)(1) or 3(c)(7) to avoid Investment Company Act registration and fall within the first prong of the covered fund definition, and (ii) funds that "raise[] money from investors primarily for the purpose of investing in financial instruments for resale or other disposition or otherwise trading in financial instruments," and therefore generally fall within the third prong of the covered fund definition, though only with respect to U.S. banking entities and not with respect to FBOs. The joint venture exemption under the Final Regulations uses similar language; we discussed the difficulties in applying this language in a prior Client Alert, available at https://www.milbank.com/images/content/2/3/v5/23493/Final-Volcker-client-alert-3.3.16.pdf.

This article appeared in the October 19, 2017, edition of Westlaw Journal Derivatives.

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