ALERT MEMORANDUM

Banking Agencies Release Guidance Providing Temporary Relief for Foreign Excluded Funds

July 24, 2017

On Friday, the banking agencies responsible for implementing the Volcker Rule released guidance providing temporary relief with respect to foreign excluded funds that are controlled by a foreign bank and thus could be subjected to the Volcker Rule as a "banking entity." Prior to Friday's release, the banking agencies had not provided any public guidance on whether the activities of a foreign excluded fund that is controlled by a foreign bank within the meaning of the Bank Holding Company Act (due, e.g., to the bank's ownership of more than 25% of a class of the fund's voting securities, serving as general partner or trustee of the fund or selecting a majority of the fund's board) would be subject to the Volcker Rule's proprietary trading and covered funds restrictions.

The guidance provides foreign banks with a positive, if temporary (one year), resolution of an issue that had been a source of concern and focus of their advocacy efforts over the past several years.

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Key points of note:

— The guidance provides that for one year (until July 21, 2018), the agencies will not take action with respect to a "qualifying foreign excluded fund" ("QFEF") controlled by the foreign banking organization ("FBO") by virtue of the FBO's sponsorship of or level of ownership in the fund. In particular, the banking agencies stated that they would not attribute the activities or investments of a controlled QFEF to an FBO for purposes of determining compliance with the Volcker Rule.

— The guidance lays out certain criteria for a fund to be considered a QFEF, including:

  - The FBO's ownership interest in and/or sponsorship of a QFEF complies with the SOTUS conditions contained in Section ___.13(b) of the Final Rule;[1]
  - The fund is organized outside the United States and is not offered or sold to U.S. investors;
  - The fund would be a "covered fund" if it were organized or established in the United States, or otherwise is, or holds itself out as being, an entity 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;
  - The fund would not otherwise be a "banking entity" except by virtue of the FBO's sponsorship of, or ownership interest in, the fund;
  - The fund is established and operated as part of a bona fide asset management business; and
  - The fund is not operated in a manner that enables an FBO to evade the Volcker Rule.

— We do not read the bona fide asset management business condition to require that an investment in a QFEF be made only as part of the bank's asset management business, but rather that the fund itself is established and operated as part of an asset management business (whether the FBO's or a third party's).

  - This distinction is particularly relevant for FBO investments in third-party funds that are acquired in connection with customer-driven transactions such as hedges to fund-linked products entered into with customers. The scope of this requirement will likely be one of the areas of focus as the market moves to implement the guidance.

— The guidance does not require a specific percentage limit on ownership as to how much of the QFEF the FBO could own. This had been a subject of much discussion in the market, with concerns that a specific limit would raise new questions and problems. Instead of a specific limit, the agencies included an explicit anti-evasion provision, which will inform the permissibility of a given investment that otherwise qualifies. This should provide appropriate flexibility to address different facts and circumstances.

— The guidance incorporates the SOTUS requirements contained in Section ___.13(b) of the Final Rule without requiring an FBO to "opt in" to treating the fund as a covered fund, which could have raised questions regarding the extraterritorial application of Super 23A.

The agencies note that they are still considering ways in which to amend the Final Rule (or other appropriate action, including potential congressional action) to address the unintended consequences of applying the Volcker Rule's proprietary trading and covered fund

[1] The SOTUS conditions require, among other things, that: (i) the foreign banking entity sponsoring or investing in the fund not be controlled, directly or indirectly, by a U.S. banking entity; (ii) the banking entity and relevant personnel who make the decision to invest in or sponsor the fund are not located in the United States; (iii) the investment or sponsorship (including any related risk-mitigating hedging) is not accounted for as principal directly or indirectly on a consolidated basis by any U.S. branch or affiliate; and (iv) no financing for the banking entity's investment or sponsorship is provided, directly or indirectly, by any U.S. branch or affiliate.

restrictions to foreign excluded funds. In considering these approaches, the banking agencies note that they are mindful of concerns that some of the proposed solutions could provide FBOs with competitive advantages over their U.S. counterparts. Accordingly, advocacy by individual institutions, trade groups and foreign governments is likely to continue in order to fully address the issue.

The text of the guidance appears below.

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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

[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.

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 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) 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.

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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.

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.

The press release and guidance can be found here: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170721a.htm.

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