Client Alert

July 24, 2017

Federal Banking Agencies Announce No-action Position on Certain Foreign Excluded Funds Under the Volcker Rule

Section 13 of the Bank Holding Company Act of 1956, as amended, and its implementing regulations[1] (the "Volcker Rule") generally prohibit a "banking entity" from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with "covered funds."

On July 21, 2017, the Board of Governors of the Federal Reserve System (the "Board"), the Office of the Comptroller of the Currency (the "OCC"), and the Federal Deposit Insurance Corporation (the "FDIC" and, together with the Board and the OCC, the "Banking Agencies") jointly released a Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (the "Statement").[2] In issuing the Statement, the Banking Agencies consulted with staffs of the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC").[3]

In short, the Banking Agencies will not enforce the prohibitions and restrictions of the Volcker Rule with respect to the activities of certain "qualifying foreign excluded funds" (as defined below) controlled by "foreign banking entities"[4] for a one-year period through July 21, 2018. During this enforcement moratorium, the staffs of the Banking Agencies and of the SEC and CFTC will consider ways in which the Volcker Rule implementing regulations 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. The no-action position is responsive to long-standing issues regarding treatment of foreign excluded funds raised by foreign banks and the Institute of International Bankers. As explained below, the no-action position is limited in scope and is effective for one year only, making it difficult for foreign banks to rely on it for more permanent organizational changes. Nonetheless, the Statement recognizes a problem in the implementing regulations that needs to be addressed and may foreshadow the Banking Agencies willingness to consider other changes to the implementing regulations.

ISSUES RELATED TO FOREIGN EXCLUDED FUNDS

A "foreign excluded fund" is generally understood to be a fund (i) in which a foreign banking entity invests or that it sponsors; (ii) organized under the laws of a foreign jurisdiction, the ownership interests of which are offered and sold solely outside the United States; and (iii) that 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.[5]

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[1] All citations to the regulations implementing the Volcker Rule are to the regulations as promulgated by the Board of Governors of the Federal Reserve System.

[2] A copy of the Statement is available at: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf. The Board of Governors of the Federal Reserve System's press release is available at: https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170721a.htm.

[3] The Banking Agencies, together with the SEC and CFTC, have promulgated implementing regulations under the Volcker Rule.

[4] A foreign banking entity is defined in the Statement as a banking entity that is not, and is not controlled by, a banking entity that is located in or organized under the laws of the United States or of any state.

[5] A foreign excluded fund arises by inference from the genesis in the rulemaking process of the third prong of the definition of "covered fund" contained in 12 C.F.R. § 248.10(b)(1)(iii). This third prong defines as a "covered fund" certain foreign funds controlled by U.S. banking entities. The third prong implies that a fund that meets the characteristics described above in the text but is sponsored or invested in by a foreign banking entity is not a covered fund.

Under the implementing regulations, a "foreign excluded fund" may itself be a banking entity, thereby making the foreign excluded fund subject to the prohibitions of the Volcker Rule. In the Statement, the Banking Agencies recognize that the application of the Volcker Rule's restrictions and limitations to foreign excluded funds may have certain unintended consequences. At the same time, the Banking Agencies expressed concerns that a foreign banking entity could use a controlled foreign excluded fund to avoid otherwise applicable requirements under the Volcker Rule. The no-action relief announced by the Banking Agencies in the Statement is designed to provide a temporary solution while other action is considered, including possible amendment to the regulation and/or congressional action.

NO-ACTION RELIEF

For one year, until July 21, 2018, the Banking Agencies will not 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 the qualifying foreign excluded fund as a banking entity.

A "qualifying foreign excluded fund" means an entity that:

1. is organized or established outside the United States, 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;[6] and
5. is not operated in a manner that enables the foreign banking entity to evade the requirements of the Volcker Rule.

For this no-action relief to apply, the foreign banking entity's investment in or sponsorship of the qualifying foreign excluded fund must meet the requirements under the exemption for activities solely outside the United States, as if the fund were a "covered fund" under the so-called "SOTUS" exemption—an acronym for fund activities taking place "solely outside of the United States."[7] The SOTUS exemption contains certain restrictions not applicable to the foreign fund exclusion. For example, the SOTUS exemption imposes certain geographic restrictions on fund activity to make sure that material fund activity and sponsorship take place solely outside of the United States.[8]

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[6] This requirement is not part of the SOTUS exemption and appears to be borrowed from the "asset-management exemption" contained in 12 C.F.R. § 248.11.

[7] 12 C.F.R. § 248.13(b).

[8] Based on the language of the Statement and its intention to grant relief, it does not appear that the Banking Agencies would require that a foreign banking entity adopt a formal compliance structure under 12 C.F.R. § 248.20 generally required for reliance on the SOTUS exemption (and other permitted covered fund activity), but foreign banking entities relying on the no-action position should expect to be able to demonstrate that they meet the conditions for the no-action position.

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