Financial institutions
Energy
Infrastructure, mining and commodities
Transport
Technology and innovation
Life sciences and healthcare

NORTON ROSE FULBRIGHT

How will latest changes to Volcker Rule affect non-US banks?

Kathleen A. Scott, *New York Law Journal – September 9, 2019*

In her International Banking column, Kathleen A. Scott discusses the final Volcker Rule, focusing on some of the issues raised by non-US banks in their comments.

In my July 2018 column, I discussed proposed changes to the Volcker Rule regulations issued for comment by the federal banking, commodities and securities regulators (collectively, the Agencies). As most readers will know, the Volcker Rule (§13 of the Bank Holding Company (BHC) Act) and its implementing regulations (jointly with §13 of the BHC Act, the Volcker Rule) prohibit "banking entities" (generally, insured banks and their affiliates, and non-US banks with US banking operations) from engaging in proprietary trading or sponsoring or investing in private equity funds (covered funds).

In my January 2019 column, I discussed some comments on the proposal that had been submitted by non-US banks on issues of particular importance to them.

On Aug. 20, 2019, the Agencies' agreed-upon text of the final rule was released by the Federal Deposit Insurance Corporation (FDIC) when the FDIC board meeting voted to approve it. That same day, the Comptroller of the Currency (OCC) also signed off on the final rule text. As of Sept. 5, 2019, the Federal Reserve Board, the Securities and Exchange Commission and the Commodity Futures Trading Commission (together with the FDIC and OCC, the Agencies) had not yet approved the final rule.

This month's column will discuss the final rule, focusing on some of the issues raised by non-US banks in their comments (Commenters).

The final rule focuses mostly on the proprietary trading part of the Volcker Rule. Only those provisions in the covered funds part of the proposal that suggested specific language were finalized in the final rule. The Agencies noted in the commentary to the final rule that they intend this fall to issue a more detailed proposal on changes to the covered funds part of the Volcker Rule.

SOTUS Changes

As noted in previous columns discussing the Volcker Rule, many non-US banks rely on the "Solely Outside the United States" (SOTUS) exemption from the Volcker Rule's restrictions on both proprietary trading and covered funds. Proposed revisions to the SOTUS exemption for proprietary trading included elimination of the prohibition that no financing for the banking entity's purchase or sale be provided by any US branch or affiliate of the banking entity (the Financing Prohibition) and a narrowing of the restrictions on trading with US counterparties (the Counterparty Restriction). In addition, the requirement that no banking entity personnel who arrange, negotiate, or execute such purchase or sale can be located in the United States was narrowed to a

Kathleen A. Scott is a senior counsel in the New York office of Norton Rose Fulbright US LLP.

restriction that only "relevant" personnel engaged in the banking entity's decision in the purchase or sale cannot be located in the United States (the Personnel Restriction).

In the final rule, the Financing Prohibition and the Counterparty Restriction were eliminated from the SOTUS proprietary trading exemption requirements. The Personnel Restriction was retained as proposed. Responding to comments requesting more discussion of what constituted "relevant personnel," the Agencies in the commentary to the final rule note only that "[t]he proposed modifications recognized that some limited involvement by US personnel (e.g., arranging or negotiating) would be consistent with this exemption so long as the principal risk and actions of the purchase or sale do not take place in the United States for purposes of section 13 of the BHC Act and the implementing regulations."

With respect to the SOTUS covered fund exemption, for which specific language had been proposed, the final rule eliminates the Financing Prohibition. In addition, the marketing prohibition on a non-US covered fund being offered or sold to US residents is clarified to apply only if the offering actually is targeted at US residents. This particular amendment incorporates into the Volcker Rule regulation an interpretation on this issue that had been released by the Agencies back in 2015.

Compliance Programs

The original Volcker Rule regulations adopted in 2013 imposed detailed compliance obligations on banking entities. Under the proposal, Volcker Rule compliance program requirements would vary depending upon a banking entity's average gross sum of trading assets and liabilities on a worldwide consolidated basis over the previous consecutive four quarters (trading assets and liabilities).

Commenters generally approved of the tiered approach to Volcker Rule compliance obligations, but also suggested revisions to the method of calculation of the trading assets and liabilities, including (1) excluding all US and non-US government obligations in which a banking entity is authorized to trade under the current regulations from the calculation of a banking entity's trading assets and liabilities (under the proposal, only US government, or US government-guaranteed, obligations would be excluded) and (2) clarifying that the only "trading assets and liabilities" that should be counted are those that are defined as "financial instruments" in the Volcker Rule regulation.

The final rule retains the three-tiered approach to compliance requirements (based on significant, moderate and limited amounts of trading assets and liabilities), but the threshold level for those banking entities engaging in significant trading activity (and thus subject to the most detailed compliance obligations) was raised to $20 billion from $10 billion.

In the final rule, the Agencies amended the calculation of trading assets and liabilities to exclude all US and non-US government obligations in which a banking entity is authorized to trade under the current Volcker Rule regulations, not just US government or US government-guaranteed obligations. The calculation also was amended to limit the assets and liabilities counted toward the compliance threshold to those defined as "financial instruments" in the regulation.

In addition, non-US banks with US banking operations will need to look only to their combined US operations in calculating the appropriate compliance tier. The proposal had put forward another test to determine whether such non-US bank met the "limited" compliance tier.

Foreign Excluded Funds

One of the most significant issues raised by the Commenters deals with "foreign excluded funds." The Volcker Rule does not apply to a non-US bank's investment in or sponsorship of non-US funds organized and offered only outside the United States. However, given the definition of "affiliate" in the Volcker Rule itself (such as owning 25% of any class of voting shares), if a non-US banking entity has a large ownership in the non-US fund, or selects the board of directors of the fund, or acts as a general partner or trustee of the fund, it may be deemed to "control" the fund, making it an affiliate of the fund (a non-US affiliated fund). Affiliates of banking entities also are considered to be banking entities, and as a result, the non-US affiliated fund would be considered to be a banking entity itself and subject to all the Volcker Rule restrictions. While other types of investment funds are not considered to be banking entities, currently this category of fund is not addressed.

Since July 21, 2017, the OCC, FDIC and Federal Reserve Board (the Banking Regulators) have postponed taking any action against those non-US banking entities that could be deemed to control these non-US affiliated funds, provided certain conditions were met, while they finalize their joint position on the issue. The original no-action position was due to expire on July 21, 2018, and in the proposed rule, the Agencies extended it to July 21, 2019, and requested comments on possible solutions. On July 17, 2019, the Banking Regulators issued another statement extending their no-action position to July 21, 2021, subject to the same conditions:

(I) The non-US banking entity's acquisition or retention of any ownership interest in or sponsorship of a non-US affiliated fund would meet the requirements of the SOTUS exemption if the non-US affiliated fund were subject to the Volcker Rule; and

(II) the fund in question qualifies as a "qualifying foreign excluded fund" (QFEF) which is defined as an entity that:

(1) is organized or established outside the United States and its ownership interests are offered and sold solely outside the United States;

(2) would be a "covered fund" for Volcker Rule purposes 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" for Volcker Rule purposes except by virtue of the non-US 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 non-US banking entity to evade the requirements of the Volcker Rule or its implementing regulations.

While extension of the temporary no-action position was appreciated, commenters were looking for a permanent solution and put forward various proposed solutions, such as incorporating these no-action conditions into the definition of "banking entity." Commenters will have to wait longer for a permanent solution. In the commentary to the final rule, the Agencies note that they intend to address the treatment of foreign excluded funds as part of its forthcoming proposal on the covered funds portion of the Volcker Rule.

Trading Account

While not mentioned in my column on the proposed rule, but which was of interest to all banks, was how the Agencies proposed to revise the ways a banking entity can determine whether a financial instrument is in its trading account for purposes of the proprietary trading restrictions. Currently, one of the tests for determining whether a financial instrument is to be considered in the trading account is a rebuttable presumption that if the banking entity holds the instrument for fewer than 60 days or substantially transfers the risk of the position within 60 days. Probably the most controversial proposal was to eliminate that rebuttable presumption regarding what financial instruments would be seen to be in the trading account. The Agencies proposed a new test based on the accounting treatment of the purchase or sale of the financial instrument.

In reaction to the strong opposition by commenters to the proposed accounting test, the accounting test was dropped from the final rule. In the commentary to the final rule, however, the Agencies state that they "recognize the utility for both the agencies and the subject banking entities of an objective time-based standard." The current rebuttable presumption is replaced with a new rebuttable presumption that the purchase or sale of a financial instrument is presumed not to be for the banking entity's trading account if it holds the financial instrument for 60 days or longer and does not transfer substantially all of the risk within 60 days of the purchase or sale.

In the commentary to the final rule, the Agencies note that they "agree with commenters that a banking entity subject to the short-term intent prong that holds an instrument for at least 60 days should receive the benefit of a presumption that the trade was not entered into for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements."

Conclusion

The revisions to the Volcker Rule address several of the non-US banks' concerns about the proposal. However, some significant issues still remain, such as with respect to the "foreign excluded funds" discussed above. It will be interesting to see whether, and how, the proposal on covered funds being planned for release by the Agencies this fall will address that issue as well as the other pending covered fund questions.

Norton Rose Fulbright

Norton Rose Fulbright is a global law firm. We provide the world's preeminent corporations and financial institutions with a full business law service. We have more than 4000 lawyers and other legal staff based in more than 50 cities across Europe, the United States, Canada, Latin America, Asia, Australia, Africa, the Middle East and Central Asia.

Recognized for our industry focus, we are strong across all the key industry sectors: financial institutions; energy; infrastructure, mining and commodities; transport; technology and innovation; and life sciences and healthcare. Through our global risk advisory group, we leverage our industry experience with our knowledge of legal, regulatory, compliance and governance issues to provide our clients with practical solutions to the legal and regulatory risks facing their businesses.

Wherever we are, we operate in accordance with our global business principles of quality, unity and integrity. We aim to provide the highest possible standard of legal service in each of our offices and to maintain that level of quality at every point of contact.