

The ‘covered funds’ side of volcker: is there a benefit for international banks?

By **Kathleen A. Scott** | March 20, 2020

On Feb. 28, 2020, the Federal Reserve Board, the Securities and Exchange Commission, the Office of the Comptroller of the Currency and the Commodity Futures Trading Commission published a Notice of Proposed Rulemaking proposing changes to the “covered funds” prong of the Volcker Rule. In this edition of her International Banking column, Kathleen A. Scott discusses proposals focused on non-U.S. banks with U.S. banking operations.

In August 2019, the financial services regulators responsible for the Volcker Rule regulations (the Federal Reserve Board, the Securities and Exchange Commission, the Office of the Comptroller of the Currency and the Commodity Futures Trading Commission, collectively, the Agencies) issued final rules revising the proprietary trading restrictions the Volcker Rule places on certain banking entities (the 2019 Rule). See [“How Will Latest Changes to Volcker Rule Affect Non-US Banks?”](#) NYLJ (Sept. 9, 2019).

On Feb. 28, 2020, the Agencies published a Notice of Proposed Rulemaking (NPRM) proposing changes to the “covered funds” prong of the Volcker Rule. This month’s column will touch on proposals focused on non-U.S. banks with U.S. banking operations.

Some Background

As most readers will know, one provision of the 2010 Dodd-Frank Wall Street Regulatory Reform and Consumer Protection Act (Dodd-Frank) is referred to as the “Volcker Rule” (§13 of the Bank Holding Company (BHC) Act). The Volcker Rule and its implementing regulations prohibit “banking entities” (generally, insured banks and their affiliates, and non-U.S. banks with U.S. banking operations) from engaging in proprietary trading or

sponsoring or investing in private equity funds (covered funds). The covered funds subject to the Volcker Rule are funds that fall within the definition of “investment company” in the Investment Company Act, but that meet no exception from registration under that Act other than §3(c)(1) (100 or fewer investors, 250 or fewer investors in certain venture capital funds) or §3(c)(7) (consisting of “qualified purchasers” as defined) of the Act.

The Volcker Rule contains several exceptions to the covered funds restrictions, but the affected banking entities have been seeking revisions and more clarity with respect to what activities are permissible with respect to covered funds. Non-U.S. banks with U.S. banking operations (“non-U.S. banking entities”) also wanted the Agencies to address certain issues unique to them.

The 2019 Rule

Even though the 2019 Rule focused on the proprietary trading prong of the Volcker Rule, it did address an important exception for non-U.S. banks: the “Solely Outside the United States” (SOTUS) exemption from the Volcker Rule’s restrictions on both proprietary trading and covered funds. The SOTUS exemption allows non-U.S. banks to conduct certain activity outside the United States that otherwise could be subject to the Volcker Rule.

With respect to the covered funds SOTUS exemption, a revision was made that eliminated the so-called Financing Prohibition, under which no financing for the banking entity's purchase or sale of a covered fund could be provided by any U.S. branch or affiliate of the banking entity. In addition, the marketing prohibition on a non-U.S. covered fund being offered or sold to U.S. residents is clarified to apply only if the offering actually is targeted at U.S. residents. This latter amendment formally incorporated into the Volcker rule a 2015 Agencies interpretation on the issue.

The NPRM

In developing the NPRM, as with the 2019 Rule, the Agencies wanted to "improve and streamline" the Volcker Rule's covered fund provisions consistent with the Rule's statutory purpose.

'Qualifying Foreign Excluded Funds.' The Volcker Rule does not apply to a non-U.S. banking entity's investment in or sponsorship of non-U.S. funds organized and offered only outside the United States. However, the definition of "affiliate" in the Volcker Rule, which is tied to the definition of "control" in the BHC Act, could result in a non-U.S. banking entity being deemed to "control" the non-U.S. fund because of a large ownership in the fund, or because the non-U.S. banking entity selects the board of directors of the fund or acts as a general partner or trustee of the fund.

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If the non-U.S. banking entity is deemed to "control" the non-U.S. fund, that would make the non-U.S. banking entity an affiliate of the fund (a non-U.S. affiliated fund). As a consequence, the non-U.S. affiliated fund would be considered to be a "banking entity" for purposes of the Volcker Rule and thus subject to all the restrictions of the Rule, including those placed on proprietary trading. Non-U.S. banking entities had asked for relief from this result, citing the issue as unique to non-U.S. banking entities that are subject to the Volcker Rule.

Taking action to correct what the Agencies themselves noted was an inadvertent extraterritorial consequence, the Agencies are proposing to incorporate into the regulations a 2017 Joint Statement issued by the federal banking agencies that provided

a temporary exemption from the Volcker Rule for these non-U.S. affiliated funds. Expiration of the temporary exemption was extended in 2018 and 2019, and later to 2021.

Under the NPRM, similar to the temporary exemption, these non-U.S. affiliated funds would not be subject to the Volcker Rule's prohibition on proprietary trading if the fund meets the definition of a "qualifying foreign excluded fund" which is defined as a banking 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)(i) Would be a covered fund if the entity were organized or established in the United States, or (ii) 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 acquisition or retention of an ownership interest in, sponsorship of, or relationship with the entity, by another banking entity that meets the following: (i) the banking entity is not organized, or directly or indirectly controlled by a banking entity that is organized, under the laws of the United States or of any State; and (ii) the banking entity's acquisition or retention of an ownership interest in or sponsorship of the fund meets the SOTUS covered fund requirements

(4) Is established and operated as part of a bona fide asset management business; and

(5) Is not operated in a manner that enables any other banking entity to evade the requirements of the Volcker Rule statute or regulations.

Foreign Public Funds. The NPRM also would revise the current exclusion from the definition of "covered funds" for foreign public funds to be more in alignment with the similar exemption for U.S. mutual funds, which was the Agencies' intention when the exclusion was originally adopted. However, banking entities wishing to take advantage of the exclusion have found that some of the conditions required to qualify for the foreign public funds exclusion are limiting its usefulness.

Currently under the Volcker Rule, the definition of "covered fund" excludes a fund that (i) is organized or established outside the United States, (ii) is authorized to offer and sell ownership

interests to retail investors in the issuer's home jurisdiction and (iii) sells its ownership interests predominantly through one or more public offerings outside of the United States.

The Agencies have said that 85% or more of the funds interests have to be sold to investors that are not residents of the United States in order to meet the quantitative threshold for ownership interests being sold "predominantly" through public offerings outside the United States.

In addition, a "public offering" is defined as a distribution of securities outside the United States to investors, including retail investors, provided that the distribution complies with applicable requirements in the jurisdiction in which the securities are offered, the distribution does not restrict availability to investors with a certain minimum amount of net worth or assets, and the issuer has made appropriate filings with the relevant regulators of publicly available disclosure documents. These conditions were meant to have these funds more closely correlate with the manner in which U.S. registered mutual funds are sold.

There was one additional condition if a U.S. banking entity wishes to sponsor a foreign public fund that would qualify for the exclusion: the fund's ownership interests must be sold predominantly to persons other than the sponsoring U.S. banking entity, the issuer, its affiliates and their employees and directors. The Agencies would impose the same 85% minimum threshold on sales to people other than the sponsoring U.S. banking entity and those specified connected persons and entities in order to meet the "predominantly" condition. The Agencies' reason for this additional condition was designed to treat these funds consistently with similarly situated U.S. funds.

In the NPRM's commentary on the proposal, the Agencies note that some of the current conditions might not be necessary to achieve the desired alignment between U.S. mutual funds and foreign public funds, and may make it more difficult to be able to qualify for the exclusion. For example, it is not unusual for a foreign public fund to be formed in one jurisdiction and offered for sale exclusively in another jurisdiction, thus making the non-U.S. banking entity unable to meet the condition for sales to retail investors in the issuer's home jurisdiction.

In the NPRM, the Agencies propose to lift the jurisdictional restriction on the funds needing to be sold in the issuer's home jurisdiction, and replace it with a more general requirement that the fund is authorized merely to offer and sell ownership interests through one or more public offerings.

The definition of "public offering" would be revised to require that the distribution be subject to the applicable substantive disclosure and retail investor protection laws or regulations. The other distribution requirements noted above remain, but the requirement that the distribution comply with all applicable requirements in the jurisdiction in which such distribution is being made is applicable to an issuer that serves as the investment manager, investment advisor, commodity trading advisor and commodity pool operator.

For U.S. banking entities to take advantage of the exclusion, there still would be restrictions on sales to the banking entity's related parties and persons, but only sales to senior executive officers of the banking entity and its affiliates, not all employees, would be restricted.

Other changes. There are several other proposed changes, including modifications to the exclusions for loan securitizations and public welfare funds, and additional exclusions to the definition of "covered funds" for credit funds, certain venture capital funds and family wealth management vehicles. The NPRM also proposes a limited exception to the current restrictions on a banking entity's relationship with any fund for which it acts as investment manager, investment advisor, or sponsor, to allow a banking entity acting in those capacities to nevertheless enter into transactions otherwise permissible without limit for a state member bank with an affiliate under §23A of the Federal Reserve Act, the statute that places quantitative and qualitative restrictions on a bank's transactions with its affiliate. It also would allow the banking entity to enter into short-term extensions of credit with, and purchase assets from, a related covered fund in connection with payment, clearing, and settlement activities.

Conclusion

In this NPRM, the Agencies are working to clarify and simplify many of the Volcker Rule's covered funds provisions in the same way that it handled the proprietary trading prong's revisions to the Volcker Rule in 2019. Non-U.S. banks should consider whether making these changes will work for them. The due date for comments is April 1. Comments are welcome on any aspects of the NPRM, but the Agencies propose over 85 questions for commenters to consider in formulating their own comments.

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