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Client Alert

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The Volcker Rule: Impact of the Final Rule on Foreign Banking Organizations

On December 10, 2013, the Federal Reserve, FDIC, OCC, SEC, and CFTC (the "Agencies") issued the long-awaited final rule ("Final Rule") construing the Volcker Rule.[1] The Volcker Rule generally prohibits banking entities — a broad term that includes banks, bank holding companies, foreign banks treated as bank holding companies, and their respective affiliates — from (i) engaging in proprietary trading and (ii) acquiring or retaining ownership interests in, or acting as sponsors to, certain hedge funds and private equity funds ("covered funds"). The Final Rule makes significant changes from the Proposed Rule that was published in the Federal Register on November 7, 2011 ("Proposed Rule"), in response to the large number of comments received on the Proposed Rule.

The purpose of this Client Alert is to summarize certain impacts of the Final Rule on foreign banking organizations ("FBOs") — in other words, foreign banks that own U.S. banks or Edge Corporations or operate branches or agencies in the United States, and companies that control such foreign banks. In other Client Alerts and Bulletins, we shall address other aspects of the Final Rule.

Exemption for Proprietary Trading by FBOs

Final Rule §__.6(e)

The Volcker Rule exempts FBOs (and their affiliates) from the prohibition against proprietary trading to the extent the activity is conducted solely outside the United States ("SOTUS Exemption"). In determining what constitutes activity conducted "solely outside the United States," the Proposed Rule took a transaction-based approach and required, among other things, that no counterparty to a trade could be a U.S. resident and each proprietary trade was required to be conducted "wholly outside" the United States. Based on comments received, the Agencies appear to have recognized that this approach was destined to have a significant anti-competitive effect on U.S. markets, U.S. exchanges and other U.S. market intermediaries and would not realistically provide the benefits of an exemption for FBOs engaged in proprietary trading outside the United States. The Final Rule takes a risk-based approach: in other words, it continues to seek to have the principal risks of proprietary trading under the SOTUS Exemption remain outside the United States, while mitigating potentially adverse competitive effects.

Under the Final Rule, FBOs are now permitted to rely on the SOTUS Exemption to engage in proprietary trading subject to the following requirements:

- The FBO may not be directly or indirectly controlled by a U.S. banking entity;

[1] The Volcker Rule was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July of 2010, and is codified as Section 13 of the Bank Holding Company Act, 12 U.S.C. § 1851.

- The FBO must be a qualified foreign banking organization, or "QFBO" — in other words, a majority of its business and banking activities must be outside the United States;[2]
- The FBO or any affiliate engaging in the trading activity (including any relevant personnel of the FBO or its affiliates that arrange, negotiate or execute the trades, but not those who clear or settle the trades) must be located outside the United States and must not be organized under U.S. law;
- The trading decisions must be made outside of the United States;
- The trades, including any related hedging transactions, must be booked, and the profit or loss must be accounted for as principal, outside of the United States in an entity that is not organized under the laws of the United States; and
- No financing of any trades may be provided by a U.S. branch or affiliate of the FBO.

Trades may not be conducted with or through a U.S. entity except:

- Trades with the foreign operations of a U.S. entity as long as no personnel of the U.S. entity located in the United States are involved in the arrangement, negotiation or execution of the trades;
- Trades through an unaffiliated intermediary acting as principal provided that the trades are promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or
- Trades through an unaffiliated market intermediary acting as agent if conducted anonymously on an exchange or similar trading facility and promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

Permitted Proprietary Trading in Foreign Government Obligations

Final Rule §__.6(b)

While containing an exemption for trading in U.S. government obligations, the Proposed Rule did not contain an exemption for proprietary trading in financial instruments issued or guaranteed by a foreign sovereign. Foreign governments and foreign banks objected to the lack of such an exemption.

The Final Rule contains a limited exemption. It permits a U.S. affiliate of an FBO to engage in proprietary trading in financial instruments issued or guaranteed by a foreign sovereign or any agency or political subdivision thereof (or a multinational central bank of which the foreign sovereign is a part), if:

- The U.S. affiliate is not controlled by a top-tier U.S. banking entity;
- The government obligations are issued or guaranteed by the foreign banking entity's home country government or any agency or political subdivision thereof (or a multinational central bank of which the foreign sovereign is a part); and
- The U.S. affiliate is not an insured depository institution.

[2] See Federal Reserve Regulation K, 12 C.F.R. § 211.23(a). Under the Final Rule, a "quasi-QFBO" also qualifies. 12 C.F.R. § 211.23(c).

It should be emphasized that an FBO can engage in trading of foreign sovereign debt (including sovereign debt of countries other than that of the FBO's home country) in compliance with the SOTUS Exemption discussed above.

The Final Rule also permits foreign affiliates of U.S. banking entities to engage in proprietary trading in obligations issued or guaranteed by the government where the foreign affiliate is organized (or such government's agencies or political subdivisions or a multinational central bank of which the foreign sovereign is a part), if the foreign affiliate is a foreign bank or is regulated by the foreign sovereign as a securities dealer. To avail itself of this exemption the foreign affiliate must own the financial instrument and the trade cannot be financed by a U.S. affiliate.

Fund Investment and Sponsorship by FBOs

Final Rule §__.13(b)

The Volcker Rule also exempts FBOs from the prohibition against investment in and sponsorship of covered funds to the extent the activity is conducted solely outside the United States. The exemption for FBOs under the Final Rule is subject to the following requirements (the first two of which are the same as for the proprietary trading SOTUS Exemption):

- The FBO may not be directly or indirectly controlled by a U.S. banking entity;
- The FBO must be a qualified foreign banking organization , or "QFBO" — in other words, a majority of its business and banking activities must be outside the United States;[3]
- Ownership interests in the covered fund in which the FBO invests have been sold only in an offering that does not target residents of the United States;
- Investment/sponsorship decisions must be made outside of the United States;
- The fund investment, including any related hedging transactions, must be booked outside of the United States in an entity that is not organized under the laws of the United States; and
- No financing of any fund investment may be provided by a U.S. affiliate of the FBO.

Under the Proposed Rule, this exemption was not available for investment in a fund if any ownership interests in the fund were offered or sold to a U.S. resident. The Final Rule appears to have somewhat mitigated this condition by explaining that the condition would be met if interests in the fund have been sold only in an offering that does not target U.S. residents. This leaves open the possibility that a U.S. resident could, at some later time, for example through a secondary trade, become an investor in a fund. The preamble to the Final Rule explains that, absent circumstances otherwise indicating a U.S. nexus, the sponsor of a foreign fund will not be viewed as targeting U.S. residents if it conducts an offering directed to residents of countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States. In the preamble, FBOs are cautioned not to send offering materials into the United States or conduct discussions with persons located in the United States (other than to or with a person known to be a dealer or other professional fiduciary acting on behalf of a discretionary account or similar account for a person who is not a resident of the United States). Sponsors of covered funds established outside of the United States are urged to examine the facts and circumstances of their

[3] See Federal Reserve Regulation K, 12 C.F.R. § 211.23(a). Under the Final Rule, a "quasi-QFBO" also qualifies. 12 C.F.R. § 211.23(c).

particular offerings and confirm that the offering does not target residents of the United States.[4] This same precaution would be appropriate for FBOs that invest in covered funds that they do not sponsor.

The Proposed Rule included within the definition of a covered fund any issuer organized or offered outside the United States that would be a covered fund if it were organized or offered in the United States. In the Final Rule, the Agencies narrowed the definition of such a covered foreign fund. Under the Final Rule, a covered fund includes a fund sponsored by a U.S. banking entity[5] or its affiliate, or in which such banking entity or its affiliate holds ownership interests, that meets the following criteria: (i) the fund must be, or hold itself out as, an entity that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; (ii) the fund must be organized abroad, and (iii) its ownership interests must be offered and sold solely outside the United States. Notwithstanding the foregoing, such an issuer would not be a covered fund if, were the issuer subject to U.S. securities laws, it would be exempt from the definition of "investment company" by reason of an exemption other than that provided by Sections 3(c)(1) and 3(c)(7) of the Investment Company Act.[6] The Agencies observed that such a fund may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.[7]

Also, foreign public funds (subject to certain conditions) sponsored by FBOs, or in which FBOs invest, are explicitly excluded from the definition of a covered fund.

Insurance Exemption for Foreign Insurance Companies

Final Rule §__.6(d); Final Rule §__.13(c)

Insurance company affiliates of banking entities (unless an exemption is available) are subject to the Volcker Rule to the same extent as other affiliates of banking entities.

The statute embodying the Volcker Rule exempts proprietary trading by a banking entity that is a regulated insurance company or an affiliate for the general account of the insurance company. The Final Rule clarifies that the exemption is also available for trading by an insurance company through a separate account of a customer — in other words, for an account in which the trading profits and losses accrue to the benefit/detriment of the customer. The trading must be conducted in compliance with applicable insurance company investment laws and regulations.

The Final Rule also provides an exemption for insurance companies, whether for the general account of the insurance company or a separate account, from the prohibition on investing in or sponsoring covered funds. Any investments under this exemption must be conducted in compliance with all applicable insurance company investment laws and regulations.

The Final Rule contains a new definition of "insurance company," which explicitly includes an insurance company subject to supervision by a foreign insurance regulator. Accordingly, foreign insurance company affiliates of FBOs can engage in proprietary trading or invest in or sponsor covered funds, subject to compliance with the applicable exemption.

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[4] Final Preamble to the Final Rule, pages 742 and 743.

[5] A U.S. banking entity, for these purposes, is a banking entity organized under the laws of the United States or any state of the United States, or any banking entity controlled, directly or indirectly, by such a banking entity. A U.S. branch or agency or U.S. subsidiary of a foreign bank would also qualify as a U.S. banking entity, but the foreign parent bank would not be a U.S. banking entity.

[6] Section 3(c)(1), in general, excludes from the definition of "investment company" any issuer whose securities are beneficially owned by not more than 100 persons, and Section 3(c)(7) excludes issuers the outstanding securities of which are owned exclusively by "qualified purchasers." *See* 15 U.S.C. §§ 80a-3(c)(1) and (c)(7).

[7] Final Preamble to the Final Rule, page 485.

Prudential Backstops

Final Rule §__.15

Under the Final Rule, as in the Proposed Rule, all the investments and activities permissible under the exemptions discussed above are subject to so-called "prudential backstops." These "backstops" prohibit an otherwise permitted transaction if the activity or investment would pose a threat to the safety and soundness of the banking entity or the financial stability of the United States or involve or would result in a material conflict of interest. A banking entity would have a material conflict of interest if its interests are materially adverse to the interests of its client, customer or counterparty, unless (i) the banking entity, before engaging in the transaction or activity, makes timely disclosure to the client, customer or counterparty of clear information regarding the conflict or (ii) uses information barriers, such as physical separation of personnel or functions, that addresses the conflict. The use of such barriers would not mitigate the conflict if the banking entity knows or should have known that such barriers would not be effective in mitigating the material adverse effect of the conflict of interest.

The Final Rule, as in the Proposed Rule, also prohibits a transaction or activity that would result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies.

The Final Rule contemplates that the Agencies will rely on the supervisory process to identify these conflicts, assets and strategies. It is not clear how the Agencies will address these "prudential backstop" issues when the trading or the investment or activity is made by the FBO outside of the United States in reliance on the SOTUS Exemption for proprietary trading or its counterpart for fund investment or sponsorship.

Compliance Program

Final Rule §__.20

The Final Rule requires banking entities, including FBOs, that are engaged in proprietary trading or covered fund investment or sponsorship to establish and maintain a compliance program that is (i) reasonably designed to ensure and monitor their compliance with the Volcker Rule and (ii) tailored to the size and complexity of the banking entity and its covered trading and fund activities.

Banking entities, including FBOs, that do not engage in proprietary trading or covered fund investment or sponsoring activities (other than trading in U.S. government obligations) are not required to establish a Volcker Rule-specific compliance program.

Banking entities with total consolidated assets of $10 billion or less that engage in covered proprietary trading or fund activities may satisfy the compliance program requirement by including appropriate Volcker Rule-specific references in their existing compliance policies and procedures.

Banking entities with $10 billion or more in total assets are required to establish and maintain a Volcker Rule compliance program including the following six elements:

- Policies and procedures that establish trading, exposure and investment limits and that are otherwise reasonably designed to ensure compliance with the Final Rule;
- Internal controls reasonably designed to monitor compliance with the Final Rule;
- A management framework that delineates responsibility and accountability for compliance and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters requiring attention;

- Independent testing and audit for the effectiveness of the compliance program;
- Training for trading personnel (and those involved in fund investment/sponsorship) to implement compliance; and
- Recordkeeping sufficient to document compliance, which a banking entity must promptly provide to the relevant Agency upon request and retain for five years (or such longer period as is required by the Agency).

FBOs are subject to a more stringent compliance regime if they have aggregate combined assets in the United States of $50 billion or more. The CEO of a banking entity subject to this more stringent compliance regime will have to attest on an annual basis in writing that the banking entity has in place processes reasonably designed to achieve compliance with the Volcker Rule. In the case of a U.S. branch or agency of an FBO, the attestation may be provided for the entire U.S. operations by the senior management officer of the FBO's U.S. operations who is located in the United States.

FBOs that are engaged in proprietary trading activities under the SOTUS Exemption or as otherwise permitted (market making, permitted hedging, etc.) are subject to specific reporting requirements if the average gross sum of the FBO's trading assets and liabilities of its combined U.S. operations (excluding trading assets and liabilities involving U.S. government or agency obligations) equals or exceeds $50 billion (as of June 30, 2014), $25 billion (as of April 30, 2016) or $10 billion (as of December 31, 2016).

Banking entities, including FBOs, with $10 billion or more in total consolidated assets are required to maintain records documenting the exclusions or exemptions on which they rely for their sponsorship of funds.

Conformance Period

The Federal Reserve Board has extended the conformance period for banking entities to be in compliance with the Volcker Rule for one year to July 21, 2015. The Federal Reserve, however, emphasized in its order approving the extension of the conformance period, that each banking entity is expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in conformance with the Volcker Rule not later than the end of the conformance period. Moreover, banking entities should not expand activities or make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted, and banking entities with stand-alone proprietary trading operations are expected to promptly terminate or divest such operations.

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