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Volcker Rule covered funds revisions finalized: Impact on non-US banks

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In Kathleen A. Scott's International Banking Law column, she discusses some of the final rule's provisions that might be of most interest to non-U.S. banking organizations.

Last year, 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 The New York Law Journal, Sept. 9, 2019, "How will latest changes to Volcker Rule affect non-U.S. banks?).

On Feb. 28, the agencies published a Notice of Proposed Rulemaking (NPRM) proposing changes to the "covered funds" prong of the Volcker Rule. (See The New York Law Journal, March 20, 2020, "The "Covered Funds" Side of Volcker: Is there a benefit for international banks?"). On June 25, the agencies announced they had finalized the revisions. This month's column will discuss some of the final rule's provisions that might be of most interest to non-U.S. banking organizations.

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 sections 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.

While the Volcker Rule does contain several exceptions to the covered funds restrictions, affected banking entities, including non-U.S. banking entities, have long been seeking revisions and more clarity with respect to what activities are permissible

The 2019 Rule

Even though the 2019 Rule focused on the proprietary trading prong of the Volcker Rule, it did address an important exemption 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

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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 which 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. Additionally, the marketing prohibition on a non-U.S. covered fund being offered or sold to U.S. residents was clarified to apply only if the offering indeed targets U.S. residents. This latter amendment formally incorporated into the Volcker rule a 2015 Agencies interpretation on the issue.

The 2020 final rule

The Proposal: In the NPRM, the Agencies sought to correct what they admitted was an inadvertent extraterritorial extension of the Volcker Rule. While 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, the definition of "affiliate" in the regulation 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 by the non-U.S. banking entity, 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. 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 its restrictions.

The NPRM proposed to incorporate into the regulations a 2017 temporary exemption from the Volcker Rule for these non-U.S. funds.

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:

- Is organized or established outside the United States, and the ownership interests 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;
- 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
- Is established and operated as part of a bona fide asset management business; and
- Is not operated in a manner that enables any other banking entity to evade the requirements of the Volcker Rule statute or regulations.
- The Final Rule: This provision was adopted without change.

Foreign public funds

The Proposal: In the NPRM, the Agencies also proposed a revision to 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, but 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 had construed ownership interests being sold "predominantly" through public offerings outside the United States to mean that 85 percent or more of the funds interests have to be sold to investors that are not residents of the United States

A "public offering" currently is defined as a distribution of securities outside the United States to investors, including retail investors, provided that (i) the distribution complies with applicable requirements in the jurisdiction in which the securities are offered, (ii) the distribution does not restrict availability to investors with a certain minimum amount of net worth or assets and (iii) the issuer has made appropriate filings with the relevant regulators of publicly available disclosure documents.

In addition, if a U.S. banking entity wanted 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.

In the NPRM's commentary on the proposal, the Agencies noted that some of those conditions might not be necessary to achieve the desired alignment between U.S. mutual funds and foreign public fund; 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-US banking entity unable to meet the condition for sales to retail investors in the issuer's home jurisdiction.

In the NPRM, the agencies proposed 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 be 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, and the. requirement that the distribution comply with all applicable requirements in the jurisdiction in which such distribution is being made would be applicable to an issuer that serves as the investment manager, investment advisor, commodity trading advisor and commodity pool operator.

U.S. banking entities still would be able to take advantage of the exclusion, but the restrictions on sales would be limited to only sales to senior executive officers of the banking entity and its affiliates, not all employees.

Final Rule: The proposed language adopted in the Final Rule was substantially the same as in the NPRM, except that a U.S. banking entity that sponsors a foreign public fund would be able to own up to 24.9% of the fund.

"Super 23A"

The Proposal: Section 23A of the Federal Reserve Act places quantitative and qualitative restrictions on a bank's transactions with its affiliates. The original Volcker Rule regulations restricted a banking entity's relationship with any fund for which it acts as investment manager, investment advisor, or sponsor. The NPRM proposed a limited exception to those restrictions to allow a banking entity acting in those capacities to nevertheless enter into covered transactions under Super 23A that are permissible for banks without quantitative and other limitations with an affiliate under Section 23A, such as intraday extensions of credit, extensions of credit fully secured by a cash account at the bank, or U.S. Treasury securities. 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. The agencies considered these permitted transactions to be low-risk.

The Final Rule: The Final Rule adopted the changes substantially the same as proposed. The Agencies clarified that transactions entered into by a banking entity under Super 23A that are transactions permissible for banks without limitations under Section 23A still must comply with any requirements with which banks need to comply under the exception. A change also was made to allow a bank to enter into riskless principal transactions with a covered fund.

Other changes

The Final Rule also adopted other changes: (i) broadened the eligibility for funds currently excluded from definition of covered fund, (ii) added new exclusions from the definition of covered fund, subject to certain conditions, for certain credit funds that are not otherwise loan securitizations, (iii) expanded the exclusion from the definition of covered fund for certain venture capital covered funds, and (iv) added an exclusion from the covered fund for certain family wealth investment vehicles.

Conclusion

The Final Rule is substantially similar to the NPRM. The purpose behind the revisions to both the Volcker Rule proprietary trading and covered funds provisions was to clarify and simplify many of the Volcker Rule's covered funds provisions, and address inadvertent extraterritorial extension of the rule to non-U.S. activities involving non-U.S. persons. The Volcker Rule is not going away but perhaps the combined effect of all these changes will make the Rule more workable for the affected banking entities.

The Final Rule is effective Oct. 1.

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