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The Volcker Rule's Impact on Foreign Banking Organizations

The Volcker Rule, as embodied in the Dodd-Frank Act and reflected in proposed regulations, generally prohibits "banking entities" from engaging in proprietary trading and from investing in or sponsoring private equity and hedge funds.[1] These "banking entities" include foreign banks that maintain branches or agencies in the U.S. or that own U.S. banks or commercial lending companies in the United States. These banks, as well as their parent holding companies, are referred to in U.S. regulations as "foreign banking organizations," or "FBOs," and we will use this term throughout this paper.[2] This bulletin evaluates how Volcker, as construed by proposed regulations, impacts the proprietary trading and investment fund-related activities of FBOs outside the United States.

Generally, the Dodd-Frank Act exempts proprietary trading by FBOs that is conducted solely outside the United States, and, provided that no ownership interest in a fund is offered or sold in the United States, investment fund-related activities by FBOs conducted solely outside the United States. The exemptions are available under the Dodd-Frank Act for FBOs (or their affiliates) not controlled by U.S.-based banking entities as long as the activities in question are conducted consistent with the exemption accorded FBOs for activities conducted outside the United States pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act. Accordingly, the exemptions are not available for activities conducted by the U.S. branches or agencies of FBOs, or by U.S. banks or U.S. commercial lending companies owned by FBOs.

However, for FBOs, the non-U.S. exemptions do not apply automatically. In order to conduct otherwise forbidden trading or fund activity outside the United States, an FBO must satisfy several conditions, and it must adhere to several continuing requirements, some of which are so restrictive as to limit the utility of these non-U.S. exemptions. In particular, as discussed in more detail below, the non-U.S. exemptions are available under the proposed regulations only if (i) the activity has no U.S. contacts (including staff, facilities for the activity, and clients or counterparties) and (ii) the FBO establishes a compliance program through which it can demonstrate compliance with the conditions applicable to the non-U.S. exemptions.[3]

The extent to which U.S. regulators have authority to enforce the Rule directly with respect to activities outside the United States is uncertain, but compliance outside the U.S. is likely to become an issue when an FBO seeks U.S. regulatory approval to expand its U.S. banking operations, and may also become a matter of interest for the Federal Reserve during the exercise of its routine supervision of the U.S. banking or nonbanking activities of the FBO.

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[1] The Volcker Rule ("Volcker") originally is section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act") and is codified as section 13 of the Bank Holding Company Act, 12 U.S.C. § 1851. The implementing regulation (the "Rule") remains under development.

[2] Regulation K, 12 CFR § 211.21(o). FBOs do not include foreign banks that maintain only representative offices in the United States.

[3] For a full discussion of the Volcker compliance requirements, please see our user guide, "The Volcker Rule: Compliance Considerations," available on our website at http://www.mofo.com/files/Uploads/Images/120126-The-Volcker-Rule-Compliance-Considerations.pdf.

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An FBO that plans to continue its trading and fund-related businesses outside the United States should consider three questions:

(i) whether its activities are subject to the Volcker Rule;

(ii) what actions are necessary in order to take advantage of the outside-the-U.S. exemption; and

(iii) what its compliance obligations are, even if its non-U.S. activities are exempt from the Volcker Rule.

We also address briefly the enforceability of the extraterritorial provisions in the Rule.

1. Activities Subject to the Volcker Rule

The Volcker Rule prohibits both proprietary trading and the investment or sponsorship of a private equity fund or a hedge fund. The application of these concepts to foreign entities will be complex, particularly as to fund-related work.

A. *Proprietary Trading*

The ban on proprietary trading prohibits, with some exceptions, taking a position as principal in securities, derivatives, futures, options or any other financial instruments in any of three circumstances:[4]

- The position is held for the purpose of a short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more of these positions. “Short-term” is presumptively 60 days or less. The trading prohibition rests on the purpose of and intent behind a position, and U.S. regulators may take action on positions that exceed 60 days, if they determine that there is a purpose to trade in the short term. Alternatively, an entity may seek to rebut the presumption, particularly if the entity, for unforeseen reasons, disposes of a long-term position sooner than expected.

- The position is subject to the market risk capital rules, and the banking firm weights the position accordingly. These rules are part of the regulatory capital rules in the United States and allow assets that are reported as trading assets to be risk-weighted in accordance with their sensitivity to market prices. Under the language of the Rule and its preamble, it seems unlikely that this provision would reach any trading assets held outside the United States by an FBO, although the argument could be made that if the home country’s market risk capital rules treat the positions as trading assets, they should be similarly treated for Volcker Rule purposes.

- The entity taking the position is one of four types of dealers—or engages in trading of a type outside the United States that would require the entity to register as one of these types of dealers, if the trading occurred in the United States.

If the instrument being bought or sold is a covered financial instrument, the prohibition on proprietary trading is not based on the specific type of instrument but rather how it is held. Many of the same instruments can be held

[4] Positions in some instruments, such as spot foreign exchange and spot commodities, are not covered by the Volcker Rule. Of particular interest to non-U.S. banks may be the Volcker provision that exempts trading in U.S. government securities. Non-U.S. sovereign debt does not receive equal treatment, a point that was the subject of several comments on the proposal from foreign regulators and foreign banks.

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for investment, as well as in the trading book. Trading that a banking entity conducts solely as agent, broker, or custodian for an unaffiliated third party is not subject to Volcker.

B. *Investment in or Sponsorship of a Fund*

The ban on investments and sponsorships applies generally to funds that, but for one of two exceptions, would be required to register with the U.S. Securities and Exchange Commission as an investment company under the Investment Company Act ("ICA"). While the universe of companies subject to the ICA is complex, as a starting point, the definition of an investment company covers any company that is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities. The two exceptions that trigger the Rule are for funds owned by 100 or fewer investors (referred to as the 3(c)(1) exception) and for funds owned exclusively by "qualified purchasers" (referred to as the 3(c)(7) exception).[5] There are eleven other exceptions from the definition of investment company in the ICA; none of these triggers Volcker.

For FBOs, the Volcker Rule states that the ban reaches funds organized or offered outside the United States, but that would be exempt from registration under the ICA by either the 3(c)(1) or the 3(c)(7) exemption if they were offered or organized in the United States. The exemptions in the ICA are based on U.S. legal concepts, and the application to a particular non-U.S. fund requires careful analysis of at least three questions:

- First, would the non-U.S. fund hypothetically be subject to the ICA at all? The ICA would apply if the fund held itself out as making investments or if the fund has certain other characteristics. If the non-U.S. fund would not be an investment company if U.S. law applied, then it would not be subject to the Volcker prohibitions and restrictions. Alternatively, if the fund would be an investment company but could qualify for an exception other than 3(c)(1) or 3(c)(7), then it also would avoid the Volcker Rule.

- Second, is the fund organized such that it has 100 or fewer investors or is owned solely by investors who are qualified purchasers? If so, then it may be covered by Volcker.

- Third, if the fund has fewer than 100 investors or is owned by qualified purchasers, are there nevertheless other exemptions from the ICA that the fund could rely on? The eleven other exemptions in section 3(c) of the ICA cover various activities. It is unclear how the Rule would deal with non-U.S. funds that might serve similar purposes but that would not, of course, have been organized with (inapplicable) U.S. restrictions in mind.

This part of the Rule could have a substantial and adverse impact on some non-U.S. funds. FBOs and others that have commented on the proposal have identified European investment funds, such as Undertakings for Collective Investment in Transferable Securities ("UCITS"), as vehicles potentially subject to Volcker—even though economically similar U.S. vehicles may not. Further, many non-U.S. funds have an active public market and are listed on various exchanges, such as the Dublin or Luxembourg Stock Exchange, and therefore have all the substantive characteristics of U.S. public open-end or closed-end investment funds that are not covered by the Rule, but, in order to be offered and sold in the U.S., would have to rely on an ICA exemption.

Another area in which foreign funds are treated differently from domestic funds is with respect to "funds of funds." A banking entity may organize and sponsor a "customer fund," in other words, a fund organized, sponsored and managed by a banking entity in connection with its offering of trust, fiduciary, commodity trading or investment advisory services to its clients, and meeting certain conditions. Any fund in which such a customer fund invests is automatically exempt from the Volcker prohibition, thereby permitting banking entities to sponsor and manage a fund of funds under the "customer fund" exemption. However, if an FBO organizes and sponsors a fund under the non-U.S. exemption, any investments by that fund in further funds must, on their own merit, meet

[5] In very rough terms, a qualified purchaser is an individual or family company with more that $5 million in investments or an institution with more than $25 million in investments.

the non-U.S. exemption, the "customer fund" exemption or another applicable exemption from the Rule to be permitted.

Securitization transactions are something of a special case under Volcker, although the Rule does not distinguish between activity in the United States and abroad. The statute allows a banking entity to "sell or securitize loans" free from Volcker requirements and conditions. This full exemption does not, however, reach the organization or sponsorship of a securitization vehicle. The proposed regulation does so, but on a qualified basis. A banking entity may sponsor or invest in an issuer of asset-backed securities, provided that the assets consist solely of loans, contractual rights arising from the loans, and interest rate or foreign exchange derivatives materially related to the loans or contractual rights and that are used for hedging purposes. Ownership or sponsorship of a fund is subject to the prudential backstops and certain prohibitions on affiliate transactions that are discussed below. The banking entity also must establish a compliance program for its sponsorships or ownership interests.

Other investment vehicles may be forbidden or restricted by the Rule as well, even though they do not present the risks that private equity funds and hedge funds are perceived to present. These include covered bond structures and venture capital funds.

2. Conditions for Trading or Investing Outside the United States

An FBO (a term that includes any parent holding company) or any of its subsidiaries that either engages in proprietary trading or invests in or sponsors funds solely outside the United States is not, on that basis alone, automatically free from the Volcker prohibitions.[6] The exemptions for non-U.S. activities require such a banking entity to meet at least four conditions:

Banking Entity. The FBO or its subsidiary must have been organized outside the United States.

- If it is an FBO, then two requirements apply:
  - The entity must be a "qualifying" FBO, or "QFBO," meaning that:
    - More than half of its worldwide business is banking, as measured by assets (excluding banking assets in the United States), total revenue, or total net income. (Two of these three measurements are necessary.)
    - More than half of its banking business is outside the United States, also measured on the basis of assets, revenues, and net income (again, by two out of the three measures).[7]
  - The entity must conduct its trading or fund-related activity in compliance with the permission to conduct business outside of the United States provided under Section 4(c)(9) and 4(c)(13) of the Bank Holding Company Act. As reflected in Regulation K of the Federal Reserve Board (the "Board"), this essentially means conducting the activities outside the United States and, to the extent inside the United States, only as incidental to the foreign or international business of the entity.[8]
- If the FBO's subsidiary is not itself an FBO, then the banking entity must meet any two of three tests:

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[6] The Volcker Rule permits certain forms of trading and fund-related activity, including underwriting, market making and hedging (of other than short-term securities), as well as the sponsorship of customer funds. An FBO may invoke one of these provisions to support its activities, whether inside or outside the United States. This bulletin is limited, however, to activities permitted outside the United States.
[7] Regulation K, 12 CFR § 211.23(a).
[8] Regulation K, 12 CFR § 211.23(f).

  - o The entity's assets outside the United States exceed its assets inside the United States.
  - o The entity's total revenues derived from its business outside the United States exceed its total revenues derived from its business inside the United States.
  - o The entity's total net income derived from its business outside the United States exceeds its total net income derived from its business inside the Unites States.

Holding company. Any company that directly or indirectly controls the FBO or the FBO's subsidiary must be organized outside the United States.

Counterparty. Under the proposed regulations, no counterparty to a proprietary trade may be a "resident of the United States." The requirement that no counterparty to a proprietary trade be a U.S. resident is an onerous one, as the proprietary trading desk may have great difficulty in monitoring the residency of its counterparties. In addition, Volcker defines "resident of the United States" broadly—more broadly than a similar term that is used in Regulation S of the SEC, to which some FBOs may have become accustomed. For example, exclusions in the Regulation S definition that apply to (among other entities) dealers and fiduciaries acting on behalf of non-U.S. resident customers and employee benefit plans organized abroad are not replicated in the Rule and therefore these entities appear to be subject to Volcker.

Locus of the activity.

- As to proprietary trading, the statute requires that the trading must occur solely outside the United States. Under the proposed regulations, this requirement is interpreted to entail:
  - o No use of U.S. execution facilities.
  - o No personnel directly engaged in the trading may be physically located in the United States (other than back office, clerical or other mere administrative personnel). A trading decision could not be made in the United States and executed abroad.

  Foreign banks have broadly criticized these limitations. They argue that the statutory requirement that the trading occur solely outside the U.S. is met where the trade is booked outside the U.S., and that, in this regard, execution on a U.S. exchange or the involvement of U.S. personnel is not relevant. The Rule, they emphasize, is a prudential rule, seeking to safeguard institutions from unsafe and unsound practices. Transactions booked outside the U.S. are subject to the prudential regulation of the foreign bank's home country regulators and should not be regulated by host country regulators.

- As to fund-related activity:
  - o Under the statute, no interest in the fund may be offered or sold to a United States resident. The proposed regulations construe this requirement as prohibiting any co-investor to be a U.S. resident.[9] As noted by foreign banks and their trade groups that commented on the proposed regulations, the statutory exemption should be met as long as the FBO sponsoring the fund does not offer or sell interests in the fund to U.S. residents. However, the argument continues, the FBO should be permitted to invest in a fund which has U.S. co-investors (including pre-existing U.S. investors) as long as the FBO itself has not offered or sold the interest to the U.S. co-investors. Without such an interpretation, FBOs may be precluded from making passive

[9] Senators Carl Levin and Jeff Merkley have said that this condition goes too far, where an entity otherwise satisfies the outside-the-United States conditions.

investments in non-U.S. funds, which, incidentally, may have investors (including secondary investors) that are U.S. residents.

- The fund must have been organized outside the United States.

An FBO that satisfies these conditions and can rely on one of the non-U.S. exemptions is not subject to the limitations on other exempted activities. For example, a banking entity may establish a customer fund in (or outside of) the United States but only if, among other things, the entity and the fund do not share a similar name. This condition does not apply to fund activity eligible for the outside-the-United States exemption.

3. Continuing Obligations for Permissible Activities outside the United States

An entity must continue to comply with several obligations even after it is able to take advantage of the non-U.S. exemptions, including "prudential backstops" for both trading and fund-related work, prohibitions on certain transactions with funds, and a compliance program.

A. *Prudential Backstops for both Trading and Investment*

Even after an FBO has established that its trading or fund-related activity qualifies for the relevant non-U.S. exemption, the Volcker Rule imposes four continuing obligations, known as "prudential backstops."

- The activity may not involve any "material conflict of interest"—interests that are "materially adverse"—between an entity and its clients, customers, or counterparties. A banking entity may cure the conflict in one of two ways.
  - Disclosure and opportunity to negate or substantially mitigate. To qualify for this "cure," the entity must provide information and other materials
    - In sufficient detail and in a way that a reasonable client, customer, or counterparty can meaningfully understand the conflict; and
    - In a manner that provides the client, customer, or counterparty the opportunity to negate or substantially mitigate a materially adverse effect created by the conflict.
  - Information barriers. The entity creates barriers, memorialized in written policies and procedures that are reasonably designed, given the nature of the entity's business, to prevent a conflict of interest from having a materially adverse effect on a client, customer, or counterparty.
    - Note that an information barrier does not cure a conflict of interest if, for a specific class of transactions or activities, the entity should know or should reasonably know that the barriers will not protect against a materially adverse effect resulting from conflict.
- The activity cannot expose the entity to high-risk assets or high-risk strategies. An asset or a strategy is "high-risk" if it would "significantly increase the likelihood" either that
  - The entity would incur a substantial financial loss; or
  - The entity would fail.

Compliance with this condition may be especially difficult given the vagueness of the terms, particularly "high-risk" strategy and "substantial" loss. Would recent large and unsuccessful trades have violated this condition, had it been in effect?

- The activity cannot threaten the safety and soundness of the entity.
- The activity cannot threaten U.S. financial stability. The Volcker Rule does not explain this standard, but other Dodd-Frank provisions use the same standard.

Although required by the statute, the satisfaction of these "prudential backstops" as a condition to the continuing availability of the non-U.S. exemptions raises serious questions regarding the extraterritorial effect of the Volcker Rule and generally accepted international principles governing the division of responsibility between home country and host country regulators. In sum, the issues raised by the prudential backstops are those of the prudential conduct of offshore activities and, in principle, should not be supervised or regulated by host country regulators.[10]

B. *Additional Restrictions on Fund-Related Activity*

An additional set of restrictions applies when the role of an FBO or one of its affiliates with a fund goes beyond that of a non-controlling investor. Specifically, if an entity acts as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund then the restrictions are in effect. The two restrictions are:

- Neither the entity nor any other entity in the FBO structure may lend money to or purchase assets from the fund. (This prohibition is popularly knows as "Super 23A"—a reference to a U.S. statute limiting, but not prohibiting, similar transactions between a bank and its affiliates.) Super 23A does not apply to prime brokerage transactions, subject to certain limits.
- Any other transactions between the fund and any entity in the FBO organization must be on market terms. (Often known as "Super 23B"—a reference to a related U.S. statute on transactions between a bank and its affiliates.)

Under the statute, these restrictions come into play only if the banking entity relies on the customer fund exemption for managing, sponsoring, or advising the fund. However, under the proposed regulations, the Super 23A and Super 23B restrictions are triggered even where the FBO relies on the non-U.S. fund exemption for such fund activities.

C. *Compliance Program*

The Volcker Rule requires a program that, in the case of an FBO, will ensure both that trading or fund-related activities continue to qualify for the non-U.S. exemptions and that the FBO will adhere to the continuing prudential requirements. The contents of a plan will vary, depending on the size, nature, and scope of the entity's activities. The most critical factor is whether an entity has $1 billion or more in trading assets or liabilities or invests in or sponsors funds with total aggregate assets of $1 billion or more; if so, compliance obligations become significantly more stringent In any case, a compliance program must include six elements:

- Internal policies and procedures reasonably designed to document, describe, and monitor the activities;

[10] *See, e.g.*, Basle Committee, Minimum Standards for the Supervision of International Banking Groups and their Cross-order Establishments (July 28, 1992).

- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with the Rule;
- A management framework that clearly delineates responsibility and accountability for compliance;
- Independent testing for the effectiveness of the compliance program;
- Training for trading personnel and managers to implement and enforce the compliance program;
- Recordkeeping sufficient to document compliance.

4. Implementation and Enforcement

The application of the Volcker Rule, particularly the prudential backstops, to trading and fund-related activities of FBOs outside of the United States faces several challenges, including the fundamental principle that a U.S. government agency does not have the authority to exercise any regulatory powers in a foreign country. The Federal Reserve's examination powers over foreign banks are limited to branch and agency offices in the United States. Nevertheless, FBOs should bear in mind that, if they must file an application or notice with the Board, the Board might require information on their Volcker compliance activities abroad. A starting point on the part of a U.S. regulator would be a request for a compliance plan. Moreover, such a request may be made by the Federal Reserve in the normal course of its oversight of the FBO.

It is worth noting as well that the Dodd-Frank Act does not require that U.S. regulators reach into foreign jurisdictions to apply or enforce the Volcker Rule. Indeed, Dodd-Frank broadly embraces the principle of international comity and contemplates that U.S. regulators will coordinate with their foreign counterparts on major regulatory issues and, by implication, not act unilaterally on cross-border issues. This is, of course, the longstanding practice of the U.S. regulators. The Act authorizes the President to coordinate international policies relating to limits on, among other items, the nature and scale of financial companies. The Act requires the Financial Stability Oversight Council to "regularly consult" with foreign governments on matters relating to systemic risk—a term that, in these circumstances surely encompasses Volcker. Similarly, the Board and the Secretary of the Treasury must consult with their foreign counterparts and multilateral organizations on comprehensive supervision and regulation of "all highly leveraged and interconnected financial companies"—a description that would cover the Volcker policies. The Act does not purport to exempt the Rule from the matters that should be handled on a cooperative international basis.[11]

Overall, the requirements of the proposed Volcker regulations in their current form could be seen as a remarkable extension of U.S. regulatory jurisdiction over FBO activities around the world, and threaten to have a materially disruptive impact on FBO trading activities in particular. While it may be straightforward enough—albeit burdensome—for an FBO to limit its international fund customer base to non-U.S. residents, it is significantly more problematic for FBOs to engage in trading in U.S. securities or other financial instruments without the use of U.S. exchange trading, clearance, or settlement facilities. Moreover, the imposition and enforcement of an elaborate compliance and conflicts management regime, as the proposed regulations would require, could amount to an excessive application of U.S. regulatory jurisdiction to offshore trading and fund-related activities.

[11] Senators Levin and Merkley have observed that the Volcker Rule is to be implemented in accordance with international comity.

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Financial Services

Dwight Smith
(202) 887-1562
dsmith@mofo.com

Henry Fields
(213) 892-5275
hfields@mofo.com

Charles Horn
(202) 887-1555
charleshorn@mofo.com

Oliver Ireland
(202) 778-1614
oireland@mofo.com

Barbara Mendelson
(212) 468-8118
bmendelson@mofo.com

Capital Markets

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

James Tanenbaum
(212) 468-8163
jtanenbaum@mofo.com

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