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# Client**Alert**

## Bank Advisory

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# Key Provisions of the Volcker Rule Final Regulations for Non-US Banking Entities

The five US financial agencies ("Agencies") have approved jointly prepared final regulations ("Final Rules") to implement the prohibitions on engaging in proprietary trading and investment in or sponsorship of a private equity fund or hedge fund that apply to "banking entities" as defined in the Final Rules.[1] These prohibitions are referred to as the Volcker Rule.[2] The Board of Governors of the Federal Reserve System ("Board"), the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Securities and Exchange Commission ("SEC") and the Commodities Futures Trading Commission approved virtually identical Final Rules on December 10, 2013.

This Alert offers an overview of the key provisions of the Final Rules that relate to non-US banking entities subject to the Volcker Rule and, in particular, how the Final Rules differ from the rules originally proposed by the Agencies ("Proposed Rules"). The overview is presented in a question-and-answer format to provide easy access to the issues of most interest to non-US banking entities subject to the Volcker Rule. More detailed analyses of the Final Rules will be prepared in due course.

### Is there any change to when compliance with the Volcker Rule will be required?

Yes. The Board has extended the conformance period for an additional year to July 21, 2015.[3] The Agencies expect this additional year to be sufficient for banking entities to bring their activities into compliance with the Volcker Rule and the Final Rules, which become effective on April 1, 2014. The Board reiterates in a separate conformance order its earlier guidance that a banking entity is expected during the conformance period to use "good faith efforts," including having a conformance plan in place, to conform all activities and investments by the end of the conformance period.


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1 Agency Joint Release on Final Rules on Prohibition and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds (December 10, 2013) ("Release").

2 The Volcker Rule is codified as Section 13 of the Bank Holding Company Act of 1956, as amended ("BHC Act"). 12 U.S.C. §1851.

3 Federal Reserve Board, Order Approving Extension of Conformance Period (Dec.10, 2013).


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### Are there changes in the banking entities covered by the Final Rules?

No. The banking organizations included in the definition of "banking entity" remain unchanged, but the Final Rules exclude from the definition any "covered fund" that is not itself a banking entity, i.e., a US insured depository institution, a bank holding company or a foreign bank treated as a bank holding company.[4] A banking entity may only engage in proprietary trading or invest in or sponsor a covered fund in accordance with the Final Rules. A covered fund, however, even if a subsidiary or affiliate of a banking entity, would not be subject to the proprietary trading and fund investment and sponsorship prohibitions of the Final Rules if it is not itself a banking entity.

### Do the Final Rules modify the SOTUS exemption for non-US proprietary trading by a non-US banking entity?

Yes. The Final Rules take a new approach to determining whether non-US proprietary trading activities of non-US banking entities are conducted "solely outside of the United States" ("SOTUS") for purposes of complying with the Volcker Rule. The new approach provides greater clarity.

The Agencies have concluded that "allowing foreign banking entities to use US infrastructure and trade with certain US counterparties in certain circumstances does not contravene the overall purpose of the Volcker Rule."[5] The Final Rules, therefore, abandon the requirement that "no party to the purchase or sale is a resident of the United States."

Under the Final Rules, the SOTUS trading exemption is available for the non-US proprietary trading activities of a non-US banking entity if the non-US banking entity and the purchase or sale meet the following conditions.[6] The non-US banking entity:

- Is not controlled, directly or indirectly, by a US banking entity and
- Meets either the qualified foreign banking organization requirements of the Board's Regulation K or the similar requirements of the Final Rules in respect of conducting the majority of its business outside of the United States.

The purchase or sale meets each of the following requirements:

- The banking entity engaging in the purchase or sale as principal is not located in the United States and no personnel of the banking entity or any affiliate that is involved in *arranging, negotiating or executing* the purchase or sale is located in the United States.
- The banking entity that makes the decision to purchase or sell and any personnel involved in making that decision are not located in the United States.
- The purchase or sale and any related hedging transactions are not booked by or accounted for, as principal, by any US branch or US subsidiary of the non-US banking entity on either a stand-alone or consolidated basis.
- The purchase or sale is not conducted with or through any US entity other than:
  - An unaffiliated US securities broker/dealer, swap dealer, security-based swap dealer or futures commission merchant acting as principal, provided that the purchase or sale is cleared promptly and settled through a clearing agency or derivatives clearing organization acting as central counterparty
  - An unaffiliated US securities broker/dealer, swap dealer, security-based swap dealer or futures commission merchant acting as agent, provided that the purchase or sale is conducted anonymously on an exchange or other trading facility, is cleared promptly and is settled through a clearing agency or derivatives clearing organization acting as central counterparty or
  - The foreign operations of a US entity provided that none of its US personnel is involved in arranging, negotiating or executing the purchase or sale
- The purchase or sale does not involve any financing from any US branch or subsidiary of the non-US banking entity

The Final Rules change the focus of the proprietary trading prohibition, and the fund prohibition discussed below, from where the activity occurs to whether the activity, wherever it occurs, presents any risk to the safety and soundness of US banking entities or the US financial system.

4 Final Rules §__.2(c).

5 Release at 418.

6 Final Rules §__.6(e)(1) and __.6(e)(3).

## Is proprietary trading permitted in foreign government obligations?

Yes. Proprietary trading by non-US banking entities in foreign government obligations outside the United States was not prohibited by the Proposed Rules and is not prohibited by the Final Rules.

The Final Rules add an exemption not included in the Proposed Rules to permit, within separate prescribed limits, proprietary trading in foreign government obligations by (a) US affiliates of non-US banking entities and (b) non-US affiliates of US banking entities. The exemption is in response to objections that the Proposed Rules provided such an exemption only for trading in US government obligations.

For the US branches and non-bank subsidiaries of a non-US banking entity, the exemption applies to the purchase or sale of an obligation that is issued or guaranteed by the government of the non-US banking entity's home country or any of its agencies or subdivisions and includes any multinational central bank of which the foreign sovereign is a member.[7] The exemption, however, is not available for purchases or sales, as principal, by any US bank subsidiary of a non-US banking entity.

For the non-US subsidiaries of a US banking entity, the exemption applies to the obligations of the foreign sovereign under whose laws the subsidiary is organized.[8]

The Agencies point out in the Release that purchase and sale of the obligations of any foreign government may also be made under the underwriting, market-making and hedging exemptions from the proprietary trading prohibition.

## Are non-US mutual fund equivalents, such as open-end investment companies, excluded from the definition of covered fund?

Yes. US mutual funds are not covered by the Volcker Rule, and the Final Rules exclude a "foreign public fund" from the definition of covered fund.[9] A foreign public fund is a fund organized and offered outside of the United States that is authorized to offer and sell ownership interests to retail investors in the fund's home jurisdiction and that sells ownership interests predominantly through public offerings outside of the United States. The Agencies generally expect that an offering is made predominantly outside the United States if 85 percent or more of the fund's interests are sold to investors that are not US residents.[10] A public offering, for this purpose, means a distribution outside of the United States that is filed with the appropriate regulatory authorities and that does not set any minimum net worth requirements for investor participation.[11]

An exempt foreign public fund may be sponsored, directly or indirectly, by a non-US banking entity or a US banking entity, but, if sponsored by the latter, the ownership interests in the fund cannot be sold *predominantly* to the sponsoring banking entity, the fund itself, any of their affiliates or to any directors or employees of the sponsoring banking entity, the fund or their affiliates. Consistent with the Agencies' view for funds sold "predominantly" outside of the United States, the Agencies generally expect that this condition will be satisfied if 85 percent or more of the interests in a foreign public fund sponsored by a US banking entity are sold to persons other than the sponsoring US banking entity and persons connected to that banking entity.[12]

## What are the permissible US activities within the SOTUS fund exemption?

The Final Rules also provide greater clarity on the permissible US activities within the SOTUS fund exemption. The prohibition on the offer or sale of ownership interests in a covered fund to US residents is limited to offers or sales in an offering that "targets" US residents.[13] Whether an offering targets US residents would be a fact-and-circumstances–based determination but, if *reasonable* procedures are used to restrict a US resident from acquiring a fund interest, an offering would not be considered to be "targeting" US resident investors.[14]

As with the SOTUS trading exemption, the SOTUS fund exemption requires that the non-US banking entity and the fund investment or sponsorship activity meet certain conditions. The non-US banking entity must meet the same two conditions as required under the SOTUS trading exemption. The investment in or sponsorship of the covered fund must meet each of the following conditions:[15]

- No ownership interest in the covered fund is offered or sold to a US resident in an offering that targets US residents as noted above.

7 Final Rules §__.6(b)(1).

8 Final Rules §__.6(b)(2).

9 Final Rules §__.10(c)(1).

10 Release at 506.

11 Final Rules §__.10(c)(1)(iii).

12 Release at 507.

13 Final Rules §__.13(b)(3).

14 Release at 742 – 743.

15 Final Rules §__.13(b)(1).

- The banking entity that makes the decision to acquire or retain an ownership interest in a covered fund or to act as sponsor to a covered fund and any personnel involved in making that decision are not located in the United States. The Agencies in their commentary specify that making the investment or sponsorship decision does not include providing "back office" or administrative services to the covered fund, including clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data, or providing clerical support for the fund.[16] Those activities, therefore, could be conducted in the United States without regard to the limitations of the SOTUS fund exemption.
- The investment in the covered fund and any related hedging transactions are not booked by or accounted for, as principal, by any US branch or US subsidiary of the non-US banking entity on either a stand-alone or consolidated basis.
- The investment in or sponsorship of the covered fund does not involve any financing from any US branch or subsidiary of the non-US banking entity.

### Is the definition of "resident of the United States" aligned with the Regulation S definition of "US person"?

Yes. The Final Rules abandoned the proposed "similar, but not identical" definition of "resident of the United States" in favor of defining US resident by reference to the definition of "US person" in the SEC's Regulation S.[17] The alignment means that a US resident for purposes of the Final Rules excludes discretionary accounts held by a US person for the benefit of a non-US person and trusts and discretionary accounts held by a non-US person for the benefit of a US person, both of which were not excluded in the Proposed Rules definition.

The US resident definition of the Final Rules does not expressly refer to the status of a person that is a non-US resident at the time of the purchase of a fund interest but that subsequently becomes a US resident. However, such a subsequent change in status would appear to be permissible under the "targeting" limits of the Final Rules.

### What are the restrictions for compensating employees engaged in permissible trading activities?

The Agencies included a requirement in the Proposed Rules that the compensation arrangements of any persons performing permissible underwriting, market-making or hedging activities be "designed not to reward proprietary risk-taking." In response to commenters' concerns over the undefined term "proprietary risk-taking," the Agencies reworded this provision to specify that compensation should not "reward or incentivize proprietary trading."[18] While the Agencies note that compensation arrangements may take into account price movements or spreads in principal positions, the Agencies emphasize that compensation should primarily incent and reward client revenues and effective client services, not prohibited proprietary trading.[19] The provisions do not establish any holdback or clawback provisions for permissible incentive compensation.

### Does Super 23A prohibit a non-US banking entity from entering into a covered transaction with a non-US covered fund with no connection to the United States?

The Agencies acknowledge in the Release that commenters expressed concern that having Super 23A as proposed in the Proposed Rules include any transactions with any covered funds would represent an extraterritorial application of the BHC Act if applied in the circumstances covered by this question. The Agencies did not modify the Super 23A provisions of the Final Rules to accommodate this concern, but state that the more limited focus of the final definition of "covered fund," notably the exclusion of foreign public funds, substantially addresses the extraterritorial issues raised.[20]

### Do the Final Rules include any certification requirement by management of a banking entity?

Yes. The Final Rules include in the requirements for responsibility and accountability of the compliance program a requirement that the CEO of a non-US banking entity with US$50 billion or more in total US branch and subsidiary assets must attest annually to the appropriate Agency that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the banking entity's compliance program that are reasonably designed to achieve compliance with the Volcker Rule and the Final Rules.[21] A senior management officer of the US operations of a non-US banking entity may provide the attestation on behalf of the US branch or agency of the non-US banking entity.

16 Adopting Release at 735 – 736.

17 Final Rules §__.10(d)(8).

18 Final Rules §__.4(a)(2)(iv), __.4(b)(2)(v) and __.5(b)(3).

19 Release at 132.

20 Release at 751.

21 Final Rules, Appendix B, section III.

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