ALLEN & OVERY

October 27, 2011

The Volcker Rule and Foreign Banks, Part II:

The "Foreign Funds Exemption" and the Outer Limits of Extraterritorial Reach

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Contents

Speed Read

In releasing proposed rules (**Proposed Rules**) to implement section 619 of the Dodd-Frank Act (**DFA**), the four federal agencies behind the Proposed Rules (the Securities and Exchange Commission, **SEC**, the Federal Deposit Insurance Corporation, **FDIC**, the Board of Governors of the Federal Reserve System, **Federal Reserve** and the Office of the Comptroller of the Currency, **OCC**, collectively the **Agencies**) have not spared from regulation foreign banks with US branches, agencies or subsidiaries and the affiliates of such foreign banks (**Covered Foreign Banks**). Section 619 would, if implemented as proposed, greatly expand the reach of US financial services regulation around the globe and in so doing limit the ability of Covered Foreign Banks to invest in or sponsor private funds that have any US investment or involvement.

While the Proposed Rules provide a measure of clarity on the boundaries of permissible activities for Covered Foreign Banks that wish to comply with the foreign funds exemption within section 619, in some points the Proposed Rules go beyond the text and purpose of section 619. This alert looks at the effects of the ban on sponsoring or investing in certain funds on Covered Foreign Banks and suggests how the Agencies could amend the Proposed Rules to ameliorate these concerns while remaining true to the spirit and text of section 619.

Proposed Rules and the Foreign Funds Exemption

Section 619 of the DFA (also commonly referred to as the "Volcker Rule") creates a new section 13 of the Bank Holding Company Act of 1956, as amended (**BHCA**).[1] In an effort to protect the US banking system from future shocks and minimize risky activities by federally insured banks, the new section will ban principal investments in hedge funds and private equity funds as well as certain forms of proprietary trading. In their Proposed Rules, the Agencies seek to implement the provisions of section 619. For a full review of the Proposed Rules, please see our recent alert, "Agencies release proposal to implement Volcker Rule and request comment." [2] For a more concentrated look at how the exemption for trading outside the US increases cost and compliance obligations for Covered Foreign Banks, please see our alert, "The Volcker Rule and Foreign Banks: The Incredible Shrinking Exemption for Trading Outside of the US" (**Part I**).[3]

The aim of this alert is to assess the effect of the foreign funds exemption for Covered Foreign Banks and the market at large. Generally speaking, the foreign funds exemption allows certain Covered Foreign Banks to continue investing in and sponsoring private funds provided that there are no US investors in the funds and that relevant actions take place outside of the US. Part I highlighted the tremendous compliance burden that the Proposed Rules will create for Covered Foreign Banks due to the narrow, unprecedented way in which they develop the proprietary trading exemption. As with the proprietary trading exemption, the foreign funds exemption focuses closely on whether actions are performed "solely outside the United States" and whether specified transactions involve US residents.

As detailed below, the compliance burden created by the foreign funds exemption overlaps in many instances with processes and procedures that many private funds and their sponsors already apply. While Covered Foreign Banks' compliance burden may increase incrementally as they seek to make sense of and comply with the foreign funds exemption, the market consequences will be significant including (as explored in further detail below):

- Covered Foreign Banks cannot not invest in or otherwise commit capital to covered funds sponsored by US banking entities, even where the covered funds are raised in accordance with the Volcker Rule once it is effective, depriving those funds of a potentially critical source of foreign capital;
- Covered Foreign Banks that sponsor investment funds may not offer their products to US investors, decreasing access for US institutional investors to opportunities in specific asset classes and global markets; and
- Covered Foreign Banks that sponsor investment funds in accordance with the foreign funds exemption will not be able to use US-based affiliates to find and communicate with non-US investors.

Part I set forth the purposes of section 619 of the DFA. The foreign funds exemption (as further developed by the Proposed Rules) imposes costs on the market while failing to serve these stated ends.[4]

The following table summarizes the integral concepts of the foreign funds exemption, providing a comparison of where each concept began in DFA section 619 and how each has been modified by the Proposed Rules. Following

the table we provide brief discussion of the issues raised by each concept:

Concept	Position under DFA section 619 (July 2010)	Position under Proposed Rules (October 2011)	Comment
Foreign fund exemption: eligibility for Covered Foreign Banks	"The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund *by a banking entity pursuant to paragraph (9) or (13) of section 4(c)* … provided that … *the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States.*" – BHCA section 13(d)(1)(I)	The Preamble notes that "Consistent with the statutory language, banking entities organized under the laws of the United States or of one or more States, or the subsidiaries or branches thereof (wherever organized or licensed), may not rely on the exemption. Similarly, the U.S. subsidiaries or U.S. branches of foreign banking entities would not qualify for the exemption." The proposed rules likewise apply BHCA 4(c)(9) – § __.13(c)(1)(i) and § __.13(c)(2)	Although section 619 also references entities eligible to use section 4(c)(13) of the BHCA (generally US entities that act almost entirely outside of the US) for inclusion as entities eligible for the foreign funds exemption, the Proposed Rules (which focus on section 4(c)(9) criteria) do not include such entities.
Foreign fund exemption: outside the US	"The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund … *solely outside of the United States*." – BHCA section 13(d)(1)(I)	"An activity will be considered to have occurred solely outside of the United States only if: I. The transaction or activity is conducted by a banking entity that is not organized under the laws of the United States or of one or more States; II. No subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States [but NB below exception for back-office activities]; and III. No ownership interest in such covered fund is offered for sale or sold to a resident of the United States." – § __.13(c)(3)	While sections __.13(c)(3)(i) and __.13(c)(3)(iii) implement suggestions otherwise set out in section 619, section __.13(c)(3)(ii) goes beyond the requirements set out there.

Concept	Position under DFA section 619 (July 2010)	Position under Proposed Rules (October 2011)	Comment
Foreign fund exemption: no offer or sale to a resident of the US	"The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund … provided that *no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States*." – BHCA section 13(d)(1)(I)	The Agencies define "resident of the United States" to include: "(i) any natural person resident in the United States; (ii) any partnership, corporation or other business entity organized or incorporated under the laws of the United States or any State; (iii) any estate of which any executor or administrator is a resident of the United States; (iv) any trust of which any trustee, beneficiary or, if the trust is revocable, settlor is a resident of the United States; (v) any agency or branch of a foreign entity located in the United States; (vi) any discretionary or non-discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary for the benefit or account of a resident of the United States; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary organized or incorporated in the United States, or (if an individual) a resident of the United States; or (viii) any partnership or corporation organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the United States principally for the purpose of" investing in or sponsoring a covered fund.	"Resident of the United States" is defined very broadly in a manner intended to reflect Regulation S under the US Securities Act of 1933, as amended.
Definition of "covered fund"	"The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine." – BHCA section 13(h)(2)	In addition to "hedge funds" and "private equity funds" under section 3(c)(1) or 3(c)(7), the Agencies have "proposed to include as 'similar funds' a commodity pool, as well as the foreign equivalent of any entity identified as a 'covered fund.'"	The addition of commodity pools and foreign equivalent funds broadens the notion of "covered fund" far beyond section 3(c)(1) and 3(c)(7) funds.

Only Certain Covered Foreign Banks Will Be Eligible for the Exemption

While every Covered Foreign Bank is subject to the prohibitions of section 619, the Proposed Rules make available the covered funds exemption solely to transactions conducted by those banks in compliance with Subpart B of Federal Reserve Regulation K.[5] As we noted in Part I, reference to Regulation K seems overbroad in this context and we think that perhaps the Agencies mean only to reference the qualifying foreign banking organization (**QFBO**) test of Subpart B in Regulation K.

The QFBO test measures a bank's assets and revenues and seeks to ensure that only banks whose activities are truly primarily outside the US are eligible to take advantage of the exemptions offered by Regulation K (or a similar test meant to apply to foreign commercial or industrial companies that control certain US thrifts or industrial banks). Assuming that the Agencies mean to reference the QFBO test in the context of the foreign funds exemption, we reiterate that the Agencies should clarify this provision to ensure that (i) the QFBO test alone is used as an eligibility criteria and (ii) the reference to Regulation K is not intended to require substantive compliance with Regulation K's established investment rules *in addition* to the "solely outside of the United States" criteria. As displayed in the table above, the Proposed Rules provide that a Covered Foreign Bank must not be directly or indirectly controlled by a US banking entity. This requirement seems consistent with the QFBO test.

Interpreting the Requirement for Actions to Take Place "Solely Outside of the United States"

Section 619 requires that a Covered Foreign Bank's purchase or sponsorship of a covered fund must take place "solely outside of the United States". The Proposed Rules expand on this for the foreign funds exemption to clarify that (i) activities must be conducted by a banking entity that is not organized under the laws of the United States or of one or more States, (ii) the Covered Foreign Bank cannot have any subsidiary, affiliate, or employee incorporated or physically located in the United States that takes part in offering a covered fund, and (iii) no covered fund can be offered for sale or sold to a US resident.

Requirement (ii) adds a dimension that is not found in section 619. To understand why this addition matters, consider the following scenario. Covered Foreign Bank X (**CFBX**) has a global asset management platform through

which it sponsors funds and operates a placement agent business that is key to its global strategy. Wishing to comply with section 619 by applying the foreign funds exemption, CFBX decides to sponsor a Luxembourg-based fund that will be managed from offices in Europe and sold solely to non-US investors. Relationships with key potential investors in the Gulf and in Asia are held by placement agent employees in New York. However, because no "employee … physically located in the United States" can take part in offering the fund and because the Proposed Rules also broaden the definition of covered fund to include non-US funds (even those without US investors) that are equivalent to section 3(c)(1) or 3(c)(7) funds, CFBX cannot utilize its New York-based employees to contact non-US investors.

This is a strange result that is not required under section 619, and it is unclear why allowing US-based employees or affiliates of a Covered Foreign Bank to offer interests in a non-US fund to non-US investors could have any effect (adverse or otherwise) on systemic risk in the United States. Moreover, while DFA strives to prevent Covered Foreign Banks from undertaking activities in the US that US counterparts would not be able to perform,[6] the potential inability to access non-US investors that are clients of a Covered Foreign Bank's US affiliate could impede or even vitiate the ability of the Covered Foreign Bank to use the foreign funds exemption. Accordingly, the Agencies should implement an appropriate exemption in this regard.

The Proposed Rules do give helpful clarity in respect of US-based back office functions for Covered Foreign Banks that wish to sponsor funds under the foreign funds exemption. Sometimes when a foreign bank raises a fund outside of the US, the foreign bank may outsource investor verification, AML checks, recordkeeping and other administrative functions to affiliates or employees based in the US. The Proposed Rules provide that where a US affiliate or employee of a Covered Foreign Bank has no customer relationship and is involved "solely in providing administrative or so-called 'back office' functions to the fund" incidental to an offering that otherwise complies with the foreign funds exemption, then the employee or affiliate is not subject to the requirement that activities be conducted solely outside of the US.

Implementing the Ban on Selling Covered Funds to Residents of the US

Echoing section 619, the Proposed Rules require that "no ownership interest in such covered fund is offered for sale or sold to a resident of the United States."[7] As illustrated in the table above, "resident" breaks down into eight subsections.[8] One prominent issue is that many of the definitions could cover fund investors that are truly non-US but have *de minimis* contact with the US. For example, subsection (i) refers to any natural person resident in the US. This definition could pick up foreign investors who happen to be traveling in the US. Subsections (iv) and (vi) look at whether there are any trust or account beneficiaries that are US residents. This definition could pick up an entity where one of 100 named parties happens to be a US resident.

These definitions are clearly intended to be similar to those of SEC Regulation S, a kinship of definition that makes sense in the context of private funds. When US and non-US sponsors raise foreign funds, a common aspect of investor due diligence revolves around asking each

investor whether it is a US person and whether it satisfies key investor suitability thresholds. Likewise, investors into private equity and hedge funds are accustomed to rigorous KYC procedures that include determination of whether they are US persons for the purposes of US federal law. Because a Covered Foreign Bank that sponsors covered funds will already have in place the systems and practices to enable it to differentiate US residents from non-US residents (or it would need to establish such systems and practices independent of Volcker Rule requirements), the administrative cost imposed by the foreign funds exemption is likely to be marginal.

The greater costs in this instance stem from investment opportunities that Covered Foreign Banks will have to forgo or to which US investors will not have access. Covered Foreign Banks cannot invest in covered funds sponsored by US banking entities, even where the covered funds are raised in accordance with the Volcker Rule once it is effective, depriving those funds of a potentially critical source of foreign capital. When one of the partial aims of the Volcker Rule is to increase external capital into covered funds sponsored by US banks in accordance with the Rule (and to decrease US banks capital investment in covered funds), cutting off a group of potential investors seems counterintuitive (even if such a result is arguably required by a desire to maintain parity for US and non-US banking entities). Likewise, Covered Foreign Banks that sponsor investment funds will not offer their products to US investors, decreasing access for US institutional investors to opportunities in specific asset classes and global markets.

Conclusion

Although the Proposed Rules and the Preamble set some useful boundaries (explaining, for instance, that back-office functions can be handled in the US provided that the employees or entities involved have no client-facing role), they also push the application of section 619 beyond both its strict language and its intended use. The Agencies should amend the proposed rules to clarify that Covered Foreign Banks can liaise with non-US clients via US-based affiliates and employees. Likewise, the Agencies should consider whether depriving funds sponsored by US banking entities of capital from Covered Foreign Banks and narrowing foreign investment opportunities available to US investors (results of section 619 that are magnified in the Proposed Rules) serve the ideals that the Volcker Rule was enacted to promote.

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[1] 12 U.S.C. § 1851 (2011).
[2] Allen & Overy LLP, "Agencies release proposal to implement Volcker Rule and request comment," October 11, 2011, available here.
[3] Allen & Overy LLP, "The Volcker Rule and Foreign Banks: The Incredibly Shrinking Exemption for Trading Outside of the US," October 20, 2011, available here.
[4] Senate Report No. 111-176 (April 30, 2010).
[5] 12 C.F.R. § 211.20 *et seq.* (2011).
[6] Preamble, available here, p. 145.
[7] Proposed Rule § _.13(c)(3).
[8] Proposed Rule § _.2 (t).