

The Volcker Rule: troublesome implications for non-US banks

BY FREDERICK J. KNECHT, KEITH A. NOREIKA AND CAREY S. ROBERTS

The Volcker Rule, enacted by the US government as a part of the Dodd-Frank Act, is increasingly recognised by non-US financial institutions as posing potentially far-reaching implications for their operations. It presents unprecedented issues for foreign banks because of its extraterritorial reach: it applies to any banking institution, wherever situated, that has a US branch, agency or bank subsidiary, as well as to the institution's other subsidiaries and affiliates around the globe. Whether an entity is a 'subsidiary' or 'affiliate' of another entity for purposes of the Volcker Rule depends on whether it controls or is under common control with the other entity, but, significantly, control can be found to exist based on an equity ownership interest of only 25 percent or more. As an example, a Singapore company that is not itself a bank, but is 35 percent owned by a Swiss financial institution that has a US bank branch, would likely be subject to the Volcker Rule restrictions in respect of its activities, wherever conducted. This represents a marked departure from the usual approach taken by the United States with respect to regulation of foreign banks and will require foreign banks, and their subsidiaries and affiliates, to structure their global activities carefully.

Volcker Rule generally. In its main elements, the Volcker Rule restricts banking institutions and, as discussed above, their subsidiaries and affiliates from engaging in: (i) proprietary trading (which, very generally, means trading in securities or certain other financial instruments as principal); and (ii) investing in or sponsoring private investment funds, such as hedge funds and private equity funds. In October 2011, proposed rules implementing the Volcker Rule were issued that shed further light on the likely scope of these restrictions.

'Proprietary trading' is primarily intended to capture short-term trading but, under the proposed rules, would also capture the acquisition of financial positions that are either subject to market risk capital rules or, if the covered entity is a dealer in securities, swaps or certain other types of financial instruments, related to the entity's dealing activities, whether or not those positions are acquired for the short-term. The restrictions on investing in or sponsoring private investment funds also apply broadly, and could capture wholly-owned investment subsidiaries of banking institutions.

Foreign bank transactional exemptions. The Volcker Rule provides a number of narrowly-tailored transaction-based (not entity-based) exemptions to its proprietary trading and private investment fund restrictions, including for certain underwriting, market-making and hedging transactions, as well as investment fund activities related to a bona

fide asset management business. Most importantly for foreign banks, though, the Volcker Rule also exempts transactions conducted 'solely outside of the United States'. In order to qualify for this exemption, the entity engaged in the activity may not be a US entity and may not be controlled, directly or indirectly, by a US entity (under the liberal definition of 'control' noted above). As a result, only foreign banking institutions and certain of their subsidiaries and affiliates will be able to take advantage of the 'solely outside of the United States' exemption. The entity engaged in the activity must also either be a qualified foreign banking organisation under US Regulation K or meet a modified version of that test if the covered entity itself is not a bank. Then, the proprietary trading or private investment fund activity must conform with specific transactional requirements, as outlined below.

Proprietary trading solely outside of the United States. In the case of proprietary trading by foreign covered entities, under the proposed rules, a transaction is deemed to have occurred 'solely outside of the United States' only if: (i) no party to the transaction is a resident of the United States; (ii) no personnel of the foreign covered banking entity who are 'directly involved' in the transaction (which generally excludes personnel performing administrative, clerical or ministerial functions) are physically located in the United States; and (iii) the transaction is executed wholly outside of the United States.

Foreign banks will have to grapple with several issues under these rules. First, the proposed definition of a 'resident of the United States' is broad and would restrict foreign banks from trading with US entities and individuals, non-US brokers acting for US residents and, in many cases, US brokers acting for non-US residents. Second, foreign banks with trading personnel in the United States will likely need to relocate or reorganise those operations. Finally, the rules do not indicate what it means for a transaction to be 'executed' wholly outside of the United States, and it appears this could prohibit trading over US stock and other exchanges.

Private investment fund activities solely outside of the United States. Under the proposed rules, a qualifying foreign covered banking entity may invest in, or sponsor, a private investment fund 'solely outside of the United States' only if: (i) no other subsidiary, affiliate or employee of the foreign covered banking entity that is involved in the offer and sale of an ownership interest in the covered fund is incorporated or physically located in the United States; and (ii) no ownership interest in the covered fund is offered or sold to a resident of the United States (broadly defined, as described above).



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Private investment funds that want to attract investments from foreign banking entities and their subsidiaries and affiliates will need to ensure that the funds are structured so as not to be marketed to any US resident. Many such funds are currently structured so that non-US persons and US tax-exempt organisations invest together, through the same vehicle. Also, although the proposed rules are not clear on this point, funds may need to prohibit secondary sales to US residents, as well.

Compliance program requirements. In addition to the restrictions described above, the proposed regulations would impose potentially significant compliance and reporting requirements on covered entities, including foreign banks and their non-US subsidiaries and affiliates. The extent of these requirements will depend in large part on the size of the entity and the magnitude of its activities. For the largest, most active entities, they would require detailed written compliance policies and procedures, internal controls, a management framework, record-keeping, internal training and independent testing, as well as detailed reporting of certain quantitative measurements related to the covered entity's trading activities.

Conclusion. The newly proposed rules under the Volcker Rule are subject to comment until 13 January 2012. Comments from financial

institutions and industry groups are anticipated to be extensive, and the final rules may differ from those proposed. However, it seems clear that the extraterritorial reach of the Volcker Rule to the offshore activities of non-US banks is likely to be substantial and, in many respects, surprising. The Volcker Rule will become effective on 21 July 2012. Covered entities will have until July 2014 (and potentially through extension periods beyond that) in order to bring their activities into compliance, although, as currently proposed, the required compliance and reporting programs must be in place by 21 July 2012. Non-US financial institutions and their subsidiaries and affiliates, wherever located, should begin now to determine the degree to which their activities may be affected, and what changes may be need to be contemplated for their businesses, personnel and internal compliance and control functions. ■

Frederick J. Knecht, Keith A. Noreika and Carey S. Roberts are partners at Covington & Burling LLP.

Mr Knecht can be contacted on +1 (212) 841 1193 or by email: fknecht@cov.com.

Mr Noreika can be contacted on +1 (202) 662 5497 or by email: knoreika@cov.com.

Ms Roberts can be contacted on +1 (212) 841 1034 or be email: croberts@cov.com.

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