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The U.S. Volcker Rule And Its Restrictions On Fund Activities: A Primer For Non-U.S. Financial Institutions And The Fund Managers That Market To Them

By Keith Noreika and Carey S. Roberts, of Covington & Burling LLP.

As has been well publicized, the Volcker Rule is expected to have a significant impact on the global financial markets, changing the way that they operate in important ways, including how securities are underwritten, markets are made and financial institutions generate revenue. What has been less well publicized are the ways in which the Volcker Rule will affect the global asset management industry, particularly non-U.S. financial institutions, their affiliates and the fund managers with whom they invest.

Among its other provisions, the Volcker Rule restricts any "covered entity" from investing in or sponsoring certain types of investment funds. The surprise for many members of the asset management industry is the unprecedented extraterritorial reach of that restriction. "Covered entities" include not only U.S. banks but also non-U.S. banking institutions with a U.S. banking presence and their affiliates, wherever they are in the world, whether or not they engage in any banking-related or U.S.-facing activity. As a result, the Volcker Rule's restriction on fund investment and sponsorship is expected to lead to major changes in the way in which funds are structured, operate and raise capital globally.

Regulations implementing the Volcker Rule were proposed in late 2011 and early 2012. Regulators received over 16,000 letters commenting on the proposed regulations, many of which identified significant issues with the regulations. Although the final regulations are expected to differ from the proposed regulations in important ways, it's not yet clear how those changes will affect non-U.S. financial institutions.

This article discusses the contours of the Volcker Rule as reflected in the proposed implementing regulations, including the more controversial aspects of those regulations, with a particular emphasis on the ramifications for non-U.S. covered entities and the managers that market to them.

What Kind of Entities Are Subject to the Volcker Rule?

The "covered entities" that are subject to the Volcker Rule include U.S. insured depository institutions as well as non-U.S. banking institutions with a U.S. branch, agency or bank subsidiary and their global subsidiaries and affiliates. An entity is an "affiliate" of another entity if it controls, is controlled by or is under common control with the other entity. Under the U.S. Bank Holding Company Act, of which the Volcker Rule is a part, "control" can be found to exist based on an equity ownership interest of only 25 percent or, if a "controlling influence" is found to exist, with an even lower level of equity ownership interest. For instance, a 20 percent ownership stake with the right to appoint more than two members to an entity's board of directors would likely give rise to a finding that "control" exists for purposes of the Bank Holding Company Act.

As a result of this broad definition of control, a wide variety of non-U.S. entities with little or no connection with the U.S. banking industry may find themselves subject to the Volcker Rule's provisions, including its restrictions on investing in or sponsoring funds. For example, a Hong Kong captive investment fund that is 25 percent owned by a Swiss bank with a U.S. branch may be subject to the Volcker Rule even if the captive investment fund invests solely in Asia and has no contact with the United States. A start-up technology company in Japan may also find itself subject to the Volcker Rule if any of its significant equity investors include a banking entity with a U.S. banking presence. This would be the case even though the technology company has no banking-related operations and would affect the company's ability to invest in a venture capital or other investment fund.

What Kind of Fund Activities Are Restricted?

The Restriction

The Volcker Rule restricts covered entities from investing in or sponsoring "covered funds." "Sponsoring" a covered fund includes serving as the general partner or managing member of the fund, controlling a majority of the fund's directors or management, or sharing a name with the fund. The proposed regulations define "covered funds" by reference to the U.S. Investment Company Act of 1940 (the "'40 Act"), the general idea being to capture private investment funds that aren't registered or regulated in the United States but to exclude mutual funds and other U.S. registered investment companies.

The Definition of Covered Fund

Specifically, a "covered fund" is any entity that would be an investment company under the '40 Act but for the exemptions provided by Section 3(c)(1) and Section 3(c)(7) of that Act. Section 3(c)(1) is available to entities owned by 100 or fewer investors, while Section 3(c)(7) is available to entities owned solely by qualified purchasers. Significantly, the definition of "covered fund" also captures any non-U.S. entity that would need to rely on either of those exemptions if it were organized in the United States or offered to one or more U.S. residents. As a practical matter, Sections 3(c)(1) and 3(c)(7) are the exemptions most often relied upon by private equity funds, venture capital funds and hedge funds to avoid registration under the '40 Act. As a result, except in unusual circumstances, these types of entities would be "covered funds," whether they are located in the United States or elsewhere.

Issues Raised by the Definition of Covered Fund

One of the most significant issues raised by the Volcker Rule's restriction on covered fund activities is that many entities that are not traditional private equity funds, hedge funds or venture capital funds rely upon the Section 3(c)(1) and 3(c)(7) exemptions to avoid being classified as investment companies under the '40 Act. This category includes many non-U.S. funds that are subject to substantive regulation in their home jurisdictions but are not regulated in the United States, such as undertakings for collective investment in transferable securities (UCITS), UK listed investment trusts, German *Spezialfunds* and other European regulated funds. Despite in many ways being the functional equivalent of U.S. mutual funds, under the proposed implementing regulations, these non-U.S. funds would nonetheless be treated as "covered funds" and covered entities would be prohibited from sponsoring or investing in them. Given the size of the market for these funds and the extensive involvement of global banking institutions in that market, this is a significant issue and one that received significant attention during the comment letter process.

How Does the Exemption for Fund Activities that Occur Solely Outside the United States Work?

The Volcker Rule imposes a very broad prohibition on the fund activities described above, and then provides a series of narrowly tailored transaction-based exemptions to permit activities that are deemed legitimate. Among other things, the rule exempts funds organized in connection with a *bona fide* investment advisory business, fund investments that constitute risk-mitigating hedging activities, certain types of loan securitization vehicles, certain types of ordinary corporate structuring vehicles, and funds that invest in small businesses and certain other public policy initiatives. The most important exemption for non-U.S. financial institutions and their affiliates, as well as the fund managers that market to them, is the exemption for covered fund activities that occur "solely outside of the United States."

'Solely Outside of the United States' Exemption

In order to qualify for the "solely outside of the United States" exemption (which is also commonly referred to as the "SOTUS" exemption), the covered entity relying on the exemption may not be a U.S. entity and may not be controlled, directly or indirectly, by a U.S. entity. As a result, this exemption is available only to non-U.S. banking institutions and their non-U.S. subsidiaries and affiliates. The covered entity must also 1) meet the "Qualified Foreign Banking Organization" test under U.S. Regulation K (which generally requires that a majority of an organization's business be in banking and a majority of that banking business to be conducted outside the United States), or 2) if the entity is not itself licensed as a bank under non-U.S. law, meet a modified version of that test that essentially requires the majority of the entity's business to be located outside the United States.

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If a covered entity qualifies for the SOTUS exemption, the entity may invest in or sponsor a covered fund, provided that no ownership interest in the covered fund is offered or sold to a "resident of the United States." In addition, where a non-U.S. covered entity is relying on this exemption to sponsor a covered fund, no subsidiary, affiliate or employee of the covered entity involved in marketing the covered fund may be incorporated or physically located in the United States. Significantly, there is currently no restriction on the covered fund's ability to invest in the United States.

Issues Raised by the SOTUS Exemption

The SOTUS exemption for covered fund activities is not without its share of issues. In particular, the definition of "resident of the United States" in the proposed regulations is similar to, but broader than, the definition of "U.S. person" contained in Regulation S under the U.S. Securities Act of 1933. Many investment funds rely on Regulation S in order to market themselves to investors outside the United States. If the definition of "resident of the United States" used by the SOTUS exemption is not conformed to the Regulation S definition of "U.S. person," it will lead to strange results and complicate compliance. Covered funds relying on the SOTUS exemption will need to exclude investors that meet the Regulation S definition but not the SOTUS exemption, even though those excluded investors are, from a policy standpoint, not connected in any significant way with the United States. Existing funds that intend to rely on the SOTUS exemption for their activities may need to restructure themselves so that their investors meet the narrow definition of "resident of the United States" imposed by SOTUS, even if all of their existing investors currently meet the Regulation S standard.

The proposed implementing regulations do not indicate what covered entities will need to do in order to demonstrate that a particular covered fund meets the exemption's requirements. If, for example, a covered entity is relying on the exemption to sponsor its own fund, what will it need from prospective investors to ensure that those investors are not residents of the United States? Will a representation be sufficient or will additional diligence be required? If a covered entity is relying on the exemption to invest in an unaffiliated third-party fund, will the covered entity be able to rely on a representation from the fund manager that all other investors have represented that they are not residents of the United States? The proposed regulations don't provide answers to these very important questions.

The proposed implementing regulations also don't indicate whether parallel or master fund structures — *i.e.*, fund structures where non-U.S. resident investors either invest in a fund that makes parallel investments with a U.S.-investor fund or invest in a fund that feeds into a master fund that indirectly includes U.S. investors — are acceptable or will be deemed impermissible "workarounds." Nor is it clear whether covered funds relying on the exemption will need to restrict secondary transactions in fund interests so that they are not subsequently sold to residents of the United States.

Covered entities relying on the SOTUS exemption to sponsor a covered fund or to make a significant investment in a covered fund will also need to consider whether the fund is, as a result, an affiliate of the covered entity and so itself subject to the Volcker Rule's restrictions. If it is, the covered fund would need to find its own exemption to invest in other covered funds or to engage in proprietary trading, which is also restricted by the Volcker Rule.

Considerations for Investment Managers

Investment managers that market their funds to non-U.S. covered entities will need to make sure that those investments can continue. To the extent those covered entities are attempting to rely on the SOTUS exemption to make investments, fund managers will need to make sure that their funds are not marketed to any residents of the United States. This may require changes to traditional fund structures. For example, under current market practice, Regulation S non-U.S. persons and tax-exempt U.S. residents often invest through the same vehicle. If a fund manager wants to create a fund that is eligible for the SOTUS exemption, it will need to exclude tax-exempt U.S. residents and any other U.S. residents from the fund. As mentioned above, investment managers will also need to consider what kind of diligence is required to assure non-U.S. covered entities that no residents of the United States have invested, as well as whether secondary sales to residents of the United States must be prohibited and whether parallel and master fund structures are acceptable.

What's the Timing?

By statute, the Volcker Rule's restrictions become effective on July 21, 2012. The good news, however, is that the U.S. Federal Reserve Board recently effectively extended the effective date until July 21, 2014. This extension was provided in order to give regulators more time to finalize the implementing regulations and covered entities more time to then evaluate and comply with the requirements imposed by those regulations.

During this two-year conformance period, entities covered by the Volcker Rule are required to "engage in good-faith planning efforts" to permit them to conform their activities and investments to the requirements of the Volcker Rule by the end of that period. Among other things, these "good-faith planning efforts" require covered entities to develop and implement a conformance plan and, if required by the final implementing regulations, begin complying with recordkeeping and reporting requirements before July 21, 2014. As a supplement to the two-year conformance period, covered entities will be able to apply for up to three one-year general extensions and one five-year extension for certain illiquid investments.

Our Recommendations

Although the Volcker Rule is not yet effective and its implementing regulations are not yet final, there is little doubt that it will have significant consequences for the global asset management industry. Whatever form the final regulations take, substantial changes to fund structures are likely to be required so that non-U.S. financial institutions can continue to invest in and sponsor investment funds. Some covered entities may also find that they need to divest themselves of interests in certain investment funds, or in entire fund portfolios, leading to an increase in the market for secondary transactions and creating opportunities for other players. During the two-year conformance period, covered entities should review their global corporate structures in order to identify existing investments in and sponsorships of covered funds, and should then devise a strategy for addressing those activities.

We recommend that covered entities begin this exercise sooner rather than later, not only to meet the "good-faith planning efforts" requirement described above, but also so that required changes to their existing activities can be made in a way that minimizes disruption to their business and also takes advantage of any opportunities that arise as a result of the change in the regulatory landscape. Similarly, fund managers that market themselves to covered entities should review their existing relationships with covered entities, understand how the Volcker Rule's restrictions are likely to affect those relationships and consider how they can best position themselves to continue to access those investors.

Keith Noreika, a Partner in Covington & Burling LLP's Washington office, specializes in banking regulation and related litigation. He may be contacted at knoreika@cov.com. Carey Roberts, a Corporate Partner in the law firm's New York office, regularly advises investment funds and their managers on structuring, capital raising, and compliance matters, including issues related to the Volcker Rule. She may be contacted at croberts@cov.com.

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