News Bulletin

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Extraterritoriality: The Volcker Rule

As the U.S. bank regulatory agencies continue their efforts to implement the Volcker Rule under increasing political pressure to stiffen the Rule's requirements, it is worth revisiting how the Rule, in its current proposed form, might affect non-U.S. banks and their activities even outside the United States. The full impact of the Volcker Rule on non-U.S. trading and fund businesses is only now coming into focus, as the U.S. bank regulators expect banking firms, including non-U.S. firms, to begin to develop compliance programs. This bulletin summarizes in a single place the ways in which the Volcker Rule may reach outside the U.S. borders and attempt to restrict the trading and investment fund-related activities of foreign banking firms.

In a nutshell, a non-U.S. firm with a subsidiary bank organized under U.S. law or with a branch or agency office in the United States may engage in trading or fund-related activity outside the United States only if (i) the activity has no U.S. contacts (including staff, facilities for the activity, and clients or counterparties) and (ii) the firm abides by several continuing requirements.[1]

The Volcker Rule broadly forbids "proprietary trading" and "investing in or sponsoring" a hedge fund or a private equity fund, two prohibitions that apply to both U.S. and non-U.S. banking firms and to activities both inside and outside the United States.[2] For non-U.S. firms with a presence in the United States, the Rule does permit certain trading and fund-related activity outside the United States—but this permission is not a wholesale exemption. In order to conduct otherwise forbidden trading or fund activity outside the United States, a non-U.S. firm must satisfy several conditions, and it must adhere to several continuing requirements. 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 could become an issue when a non-U.S. banking firm is seeking U.S. regulatory approval to expand its U.S. banking operations.

A non-U.S. banking firm with a U.S. presence that plans to continue its trading and fund-related businesses outside the United States should consider four questions:

(i) whether its non-U.S. subsidiaries are "banking entities" that are covered by the Volcker Rule;

(ii) whether its activities are subject to the Rule;

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

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

(iv) 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. Non-U.S. Firms Covered by the Rule

The Rule applies to any "banking entity." The term includes all non-U.S. banks that either maintain a branch or agency office in the United States or control a "commercial lending company," as well as any affiliate or subsidiary of a non-U.S. bank. These banks or companies are referred to in the United States as "foreign banking organizations," or "FBOs," and we will use this term throughout this paper. The only way for an FBO to avoid Volcker fully is to limit its U.S. presence to a representative office, which may not engage in banking activities but only in liaison, research, and other non-substantive representative activities on behalf of the FBO.

2. Activities Subject to the Rule

The 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. *Trading*

The ban on proprietary trading prohibits, with some exceptions, taking a position in a security in any of three circumstances:[3]

- 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. This treatment would extend to trading assets held on the books of a U.S. branch or agency office of a foreign banking organization. Under the language of the Rule and its preamble, it seems unlikely that this provision would reach any trading assets or liabilities held outside the United States.

- 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. Many of the same instruments can be held for investment as well as

[3] Of particular interest to non-U.S. banks may be the Volcker provision that permits entities to trade 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.

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 the Rule.

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 issues securities) 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 Volcker 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).[4] There are eleven other exceptions from the definition of investment company in the ICA; none of these triggers the Volcker Rule.

For FBOs, the Rule states that the ban reaches funds organized or offered outside the United States but that would be encompassed 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 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 Volcker 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. Additionally, funds of funds organized and offered in the United States are exempt from Volcker, while identical funds organized and offered outside the United States are covered. Further, many of these 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 Volcker Rule, but, in order to be offered and sold in the U.S., would have to rely on an ICA exemption.

Securitization transactions are something of a special case under Volcker, although the Rule does not distinguish between activity in the United States and that 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.

[4] 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.

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 Volcker 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.

3. Conditions for Trading or Investing Outside the United States

An entity of an FBO that either trades on a proprietary basis or invests in or sponsors funds outside the United States is not, on that basis alone, wholly free from the Volcker prohibitions.[5] The exemptions for non-U.S. activities require such an entity to meet four conditions:

Entity. The entity must have been organized outside the United States. The entity will be an FBO, or it will not.

- If it is an FBO, then two requirements apply:
    - The entity must be a "qualifying" FBO, 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, two out of three).
    - The entity must conduct its trading or fund-related activity in compliance with certain rules of the Federal Reserve Board (the "Board") in Regulation K. These rules cover a range of matters, including obtaining appropriate regulatory approvals or filing appropriate notices, cooperating with Federal Reserve examinations of branch and agency offices, and adhering to limits on loans to one borrower.
- If it not an FBO, then it must meet any two of three tests:
    - The entity's assets outside the United States exceed its assets inside the United States.
    - 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.
    - 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.
- Note that all of these tests are at the entity level.

[5] The 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.

Holding company. Any affiliate or subsidiary of the FBO that controls the entity must be organized outside the United States.

Counterparty. No counterparty to the trade or investor in the fund may be a “resident of the United States.” The Rule defines this term 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. The activity must occur solely outside the United States:

- As to trading, this requirement entails
  - No use of execution facilities.
  - No personnel directly engaged in the trading may be physically located in the United States. A trading decision could not be made in the United States and executed abroad.
- As to fund-related activity:
  - No interest in the fund may be offered or sold to a United States resident.[6]
  - The fund must have been organized outside the United States.

An FBO that satisfies these conditions and can rely on one of the outside-the-United States 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.

4. 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 allowance for trading or fund-related work outside the United States, 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 occurs outside the United States, 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. The entity must provide information and other materials

[6] 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.

  - 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.

B. *Additional Restrictions on Fund-Related Activity*

An additional set of restrictions applies when the work of an FBO or one of its subsidiaries 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.)

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 "outside-the-U.S." status 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;
- 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.

5. Implementation and Enforcement

The efforts of U.S. regulators to apply the Volcker Rule, particularly the prudential backstops, to trading and fund-related activities of non-U.S. banks outside of the United States face 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.

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 the Volcker Rule. 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 Rule policies. The Act does not purport to exempt the Volcker Rule from the matters that should be handled on a cooperative international basis.[7]

Overall, the requirements of the proposed Volcker Rule 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.

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

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