

Treasury Asset Management and Insurance Report Makes Three Recommendations Tied to the Volcker Rule

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Buried in the latest Treasury Report, the third in a series, are important gems on the Volcker Rule and on the concept of controlling influence.^[1] Of the three interesting new recommendations, two are limited to the covered funds portion of the Volcker Rule and build upon the recommendations in the Banking Report. The third recommendation touches on the Federal Reserve's controlling influence test and should be of broader interest.

1. ***The agencies responsible for administering the Volcker Rule ("Volcker Agencies") should "continue to refrain from enforcing the Volcker Rule's proprietary trading restrictions against foreign private funds that are not covered funds under the rule until a permanent solution to the identified challenges is implemented."*** This recommendation is a clear follow-on from the recommendation in the Banking Report that foreign funds that are owned or controlled by a foreign affiliate of a U.S. bank or a foreign bank with U.S. operations should be exempt from the definition of banking entity under the Volcker Rule.
2. ***The Volcker Agencies should also forbear on enforcement of the name-sharing restriction on funds sharing names with related banking entities.*** This recommendation is also a clear follow-on from the Banking Report in which Treasury recommended that Congress should amend the name sharing prohibition in the statute so that it only applies to a covered fund sharing the names of a banking group's insured depository institutions and holding companies, allowing related covered funds to share names with other affiliates in the banking group, provided that the separate identity of the fund is clearly disclosed to investors.
3. ***Congress should revise the definition of banking entity to include "only insured depository institutions, their holding companies, foreign banking organizations, and affiliates and subsidiaries of such entities that are at least 25% owned or otherwise controlled by such entities, defined as those in which there is 25% or more voting equity or voting power on the investment committee."*** This recommendation is new and potentially important in a range of areas. We discuss its implications below.

The third recommendation suggests that the definition of control for purposes of determining whether a firm is an affiliate or subsidiary of a banking entity for Volcker Rule purposes should be based on more objective factors—in this case, on whether 25% or more of the firm's equity is owned by the banking entity or whether the banking entity has 25% or more of the voting power on the firm's investment committee.

In essence, Treasury is suggesting that, for Volcker Rule purposes, the definition of control should be construed to be more in line with the objective standards for control that existed in the Bank Holding Company Act before the 1970 amendments to that Act. Under the statutory definition of control since the 1970 amendments, a banking entity is deemed to have control over a firm if it owns or controls 25% or more of the firm's voting equity, controls the election of a majority of the firm's directors or other governing body or has a controlling influence over the management or policies of the firm. Over the years, the Federal Reserve staff has interpreted the highly subjective controlling influence test to be more like a significant influence test, rather than a genuinely controlling influence test, and has applied it based on all the facts and circumstances, including a series of control factors such as board representation, contractual consent rights, and the nature and extent of business relationships.

Whether the Federal Reserve staff's controlling influence policy statements and lore remain appropriate in a broad range of contexts in the digital age is an open question worth deeper exploration that is beyond the scope of this blog. It is

clear, however, that in the context of relationships with funds, the current Federal Reserve staff approach has made it almost impossible to determine in advance whether a fund would be under a sufficiently controlling influence of a banking entity to be deemed its affiliate or subsidiary for Volcker Rule purposes, without an extensive case-by-case discussion with all five Volcker Agencies, which has proven to be completely impractical.

The Treasury Department is wise to raise this issue in its report. We read the Treasury's recommendation as a laudable attempt to make the definition of control and controlling influence more determinate and predictable in the Volcker Rule context. There are details to be worked out given the significant variation in ownership and governance structures of investment funds and other similar entities, but, even with all of those variations, any recalibration away from an open ended facts-and-circumstances test towards a more objective standard would be an improvement.^[2] We are not convinced, as Treasury seems to be, that Congressional action is needed to address the treatment of non-covered funds as banking entities. We believe it would be within the power of the Volcker Agencies, and especially the Federal Reserve, to provide principles that limit the facts and circumstances approach in a way that favors a more objective standard.

We hope that the Volcker Agencies will take into account these recommendations as they continue to review the Volcker Rule implementing regulations.

[1] The Treasury's [report on asset management and insurance regulation](#) ("Asset Management/Insurance Report") is the third in its series of reports issued in response to [Executive Order 13772 on the Core Principles for Regulating the U.S. Financial System](#).

Treasury's [first report in the series, on banks and credit unions](#), ("Banking Report") includes a number of recommendations spanning the Volcker Rule's proprietary trading, covered funds and compliance provisions. The Treasury's [second report covers capital markets regulation and includes a robust discussion of equity market structure issues](#).

[2] For example, whether having 25% of the voting power on an investment committee, on its own or in combination with another criterion, would amount to actual control will depend on who has the remaining 75% and other factors. Either Congress or the regulators will want to take this into account in deciding whether and how to implement the Treasury's recommendation.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Kirill Lebedev

+1 212 450 3232

kirill.lebedev@davispolk.com

Margaret E. Tahyar

+1 212 450 4379

margaret.tahyar@davispolk.com

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