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ALERT MEMORANDUM

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Newly Released Interpretation of the Volcker Rule Clarifies that Foreign Banks Are Permitted to Invest in Third-Party Funds with U.S. Investors

On February 27, 2015, the regulatory agencies responsible for implementing the Volcker Rule released an FAQ regarding the interpretation of the Volcker Rule's exemption permitting foreign banking organizations to invest in and sponsor covered funds "solely outside of the United States" (the "SOTUS Exemption").[1] The FAQ confirms that the restriction in the SOTUS Exemption on offers and sales to residents of the United States (the "U.S. Marketing Restriction") applies only to marketing and sales activities undertaken by the foreign banking entity seeking to rely on the SOTUS Exemption, and not to third-party funds or fund sponsors.[2] As a result, the FAQ confirms that foreign banks should be able to rely on the SOTUS Exemption to invest in third-party funds without regard to whether those funds sell interests to U.S. investors, provided the other requirements of the SOTUS Exemption are met. The text of the FAQ and the SOTUS Exemption are attached below.

- As interpreted in the FAQ, the scope of the U.S. Marketing Restriction depends on whether the banking entity seeking to rely on the SOTUS Exemption sponsors or serves as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to the covered fund (a "Related Covered Fund") or does not sponsor or serve in any of those roles (a "Third-Party Covered Fund").
    - For Third-Party Covered Funds, the U.S. Marketing Restriction applies only to the marketing activities of the foreign banking organization seeking to rely on the SOTUS Exemption. Therefore, a foreign banking entity should be able to invest in a Third-Party Covered Fund that has been marketed to U.S. residents by the fund's sponsor, manager or distributor (or other parties) so long as the foreign banking entity and its affiliates do not participate in any offers or sales of covered fund interests to a resident of the United States.
    - For Related Covered Funds, the U.S. Marketing Restriction generally would prohibit any offering to U.S. investors, because the banking entity seeking to rely on the SOTUS Exemption would be deemed to have participated in any offering of the fund to U.S. residents. Secondary market sales of interests to U.S. residents should continue to be permissible, consistent with the discussion of such sales in the Final Rule's preamble.[3]
- As a result of the FAQ, foreign banking entities will be able to rely on the SOTUS Exemption to invest in covered funds in a number of scenarios where there was previously some uncertainty, including:
    - Preexisting and new Third-Party Covered Funds with U.S. investors;

  - Third-Party Covered Funds sponsored by U.S. asset managers where the manager has an ownership interest in the fund; and

  - Third-party securitization vehicles and structured products that are covered funds.

- The FAQ therefore has confirmed that Third-Party Covered Fund sponsors generally should not need to create parallel or feeder fund structures or alternative investment vehicles to segregate U.S. investors from foreign banking entities seeking to rely on the SOTUS Exemption. In addition, foreign banks that were considering restructuring preexisting investments in Third-Party Covered Funds that had been sold to U.S. investors should no longer need to pursue restructuring options with fund sponsors in order to permit reliance on the SOTUS Exemption.[4]

- It also appears that foreign banking entities should be able to rely on the SOTUS Exemption to invest in U.S.-domiciled Third Party Covered Funds with U.S. investors. Nothing in the statute or the Final Rule indicates that a fund must be domiciled outside of the United States in order to be eligible for the SOTUS Exemption, and this FAQ provides no indication that the Agencies hold a different view.

- The FAQ does not address the second major open interpretive question in the foreign fund context—the treatment of controlled foreign funds that are not "covered funds", such as foreign public funds, and whether they could be deemed banking entities subject to the Volcker Rule's restrictions on proprietary trading and covered fund investments. We understand that the Agencies are continuing to consider this issue, which, along with the interpretation of the U.S. Marketing Restriction addressed in this FAQ, have been the most significant open interpretive issues creating concerns among banks about the July 2015 compliance date. Many banks requested an extension of the Volcker Rule conformance period in relation to these issues in formal submissions to the Federal Reserve in January. Both issues were expected to be resolved by interpretation, and we are hopeful that the Agencies will release guidance on the banking entity issue in the near future as well.

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If you have any questions, please feel free to contact any of Derek Bush, Katherine Carroll, Hugh Conroy, Robert Cook, Patrick Fuller, Michael Mazzuchi, Robert Tortoriello, Alex Young-Anglim or any of your regular contacts at the firm. You may also contact any of our partners and counsel listed under "Banking and Financial Institutions" located in the "Practices" section of our website at http://www.clearygottlieb.com.

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1 See Volcker Rule Frequently Asked Questions (Feb. 17, 2015), available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#13.

The Volcker Rule was enacted as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and is codified as Section 13 of the Bank Holding Company Act of 1956, as amended. 12 U.S.C. § 1851. On December 10, 2013, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC"), the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and, together with the Federal Reserve, the FDIC, the OCC and the SEC, the "Agencies") approved substantively similar versions of final implementing regulations for the Volcker Rule (the "Final Rule"). See 12 C.F.R. pt. 44 (OCC); 12 C.F.R. pt. 248 (Federal Reserve); 12 C.F.R. pt. 351 (FDIC); 17 C.F.R. pt. 75 (CFTC); 17 C.F.R. pt. 255 (SEC); 79 Fed. Reg. 5536 (Jan. 31, 2014) (Federal Reserve, FDIC, OCC and SEC); 79 Fed. Reg. 5508 (Jan. 31, 2014) (CFTC).

The SOTUS Exemption is located at 12 U.S.C. § 1851(d)(1)(I) and Section __.13(b) of the Final Rule.

2 The U.S. Marketing Restriction provides that a foreign banking entity may rely on the SOTUS Exemption to sponsor or invest in a covered fund only if "[n]o ownership interest in the covered fund is offered for sale or sold to a resident of the United States". Final Rule § __.13(b)(1)(iii). Section __.13(b)(3) further provides that "[a]n ownership interest in a covered fund is not offered for sale or sold to a resident of the United States . . . only if it is sold or has been sold pursuant to an offering that does not target residents of the United States."

3 The preamble to the Final Rule indicates that a secondary market transfer of fund interests to a U.S. resident would not violate the U.S. Marketing Restriction so long as the fund "conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States." 79 Fed. Reg. at 5742.

4 A number of these preexisting investments may also have benefited from the Federal Reserve's extension of the Volcker Rule conformance period for legacy funds. See Order Approving Extension of Conformance Period Under Section 13 of the Bank Holding Company Act (Dec. 18, 2014), available at http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm.

Text of Volcker Rule Frequently Asked Question #13 Released by the Agencies

SOTUS Covered Fund Exemption: Marketing Restriction

13. Section 13(d)(1)(I) of the Bank Holding Company Act ("BHC Act") and section 248.13(b) of the final rule provide an exemption for certain covered fund activities conducted by foreign banking entities (the "SOTUS covered fund exemption") provided that, among other conditions, "no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States" (the "marketing restriction"). Does the marketing restriction apply only to the activities of a foreign banking entity that is seeking to rely on the SOTUS covered fund exemption or does it apply more generally to the activities of any person offering for sale or selling ownership interests in the covered fund? Sponsors of covered funds and foreign banking entities have asked how this condition would apply to a foreign banking entity that has made, or intends to make, an investment in a covered fund where the foreign banking entity (including its affiliates) does not sponsor, or serve, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to, the covered fund (a "third-party covered fund").

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The staffs of the Agencies believe that the marketing restriction applies to the activities of the foreign banking entity that is seeking to rely on the SOTUS covered fund exemption (including its affiliates). This is also reflected in the preamble discussion of the marketing restriction and the structure of the final rule as discussed below.

Consistent with Section 13(d)(1)(I) of the BHC Act, the marketing restriction in the final rule provides that "no ownership interest in the covered fund is offered for sale or sold to a resident of the United States." Section 248.13(b)(3) of the final rule provides that an ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of the marketing restriction if it is sold or has been sold pursuant to an offering that does not target residents of the United States. In describing the marketing restriction in the preamble, the Agencies stated that the marketing restriction serves to limit the SOTUS covered fund exemption so that it "does not advantage foreign banking entities relative to U.S. banking entities with respect to providing *their* covered fund services in the United States by prohibiting the offer or sale of ownership interests in *related* covered funds to residents of the United States."[17]

The marketing restriction, as implemented in the final rule, constrains the foreign banking entity in connection with its own activities with respect to covered funds rather than the activities of unaffiliated third parties, thereby ensuring that the foreign banking entity seeking to rely on the SOTUS covered fund exemption does not engage in an offering of ownership interests that targets residents of the United States.

This view is consistent with limiting the extraterritorial application of section 13 to foreign banking entities while seeking to ensure that the risks of covered fund investments by foreign

banking entities occur and remain solely outside of the United States.[18] If the marketing restriction were applied to the activities of third parties, such as the sponsor of a third-party covered fund (rather than the foreign banking entity investing in a third-party covered fund), the SOTUS covered fund exemption may not be available in certain circumstances where the risks and activities of a foreign banking entity with respect to its investment in the covered fund are solely outside the United States.[19]

A foreign banking entity (including its affiliates) that seeks to rely on the SOTUS covered fund exemption must comply with all of the conditions to that exemption, including the marketing restriction. A foreign banking entity that participates in an offer or sale of covered fund interests to a resident of the United States thus cannot rely on the SOTUS covered fund exemption with respect to that covered fund. Further, where a banking entity sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund, that banking entity will be viewed by the staffs as participating in any offer or sale by the covered fund of ownership interests in the covered fund, and therefore such foreign banking entity would not qualify for the SOTUS covered fund exemption for that covered fund if that covered fund offers or sells covered fund ownership interests to a resident of the United States.

17. See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 FR 5536 at 5742 (Jan. 31, 2014) (emphasis added).

18. See id. at 5740.

19. The staffs also note that foreign funds that sell securities to residents of the United States in an offering that targets residents of the United States will be covered funds under section 248.10(b)(i) of the final rule if such funds are unable to rely on an exclusion or exemption under the Investment Company Act other than section 3(c)(1) or 3(c)(7) of that Act. If the marketing restriction were to apply more generally to the activities of any person (including the covered fund itself), the applicability of the SOTUS covered fund exemption would be significantly limited because a third-party foreign fund's offering that targets residents of the United States would make the SOTUS covered fund exemption unavailable for all foreign banking entity investors in the fund. The Agencies' discussion of the SOTUS covered fund exemption in the preamble does not suggest that the Agencies understood the SOTUS covered fund exemption to have such a limited application.

The SOTUS Exemption: Section __.13(b) of the Final Rule

(b) *Certain permitted covered fund activities and investments outside of the United States*. (1) The prohibition contained in § 248.10(a) of this subpart does not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity only if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;

(ii) The activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act;

(iii) No ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and

(iv) The activity or investment occurs solely outside of the United States.

(2) An activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (b)(1)(ii) of this section only if:

(i) The activity or investment is conducted in accordance with the requirements of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of section 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of one or more States and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(1) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(2) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(3) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) An ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of paragraph (b)(1)(iii) of this section only if it is sold or has been sold pursuant to an offering that does not target residents of the United States.

(4) An activity or investment occurs solely outside of the United States for purposes of paragraph (b)(1)(iv) of this section only if:

(i) The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;

(iii) The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(iv) No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of this section, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank of which that branch, agency, or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.

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