Client Alert

March 2, 2015

Agencies Issue Guidance for Foreign Banking Entities on the Application of the Marketing Restriction for the Volcker Rule's SOTUS Covered Fund Exemption

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On Friday, February 27, 2015, the Volcker Inter-Agency Group[1] posted a new frequently asked question (FAQ 13), clarifying the scope of the so-called "marketing restriction" under the SOTUS covered fund exemption. The SOTUS covered fund exemption is available to foreign banking entities, including foreign banking organizations (FBOs) and their non-US affiliates, that invest in certain private funds "solely outside the United States," subject to certain conditions. To qualify for the SOTUS covered fund exemption, the marketing restriction requires that ownership interests in a SOTUS fund must be sold (or must have been sold) pursuant to an offering that does not target residents of the United States. FAQ 13 explains that the marketing restriction applies only to the activities of a foreign banking entity (including its affiliates) and does not apply where the foreign banking entity seeks to invest in a covered fund that is sponsored and marketed by a third party. The complete text of FAQ 13 and a link to the Federal Reserve Board's webpage is attached to this client alert.

Section 13 of the Bank Holding Company Act of 1956 (also called the Volcker Rule)[2] imposes broad prohibitions and restrictions on proprietary trading and investing in and sponsoring private equity funds and hedge funds (covered funds) for "banking entities" and their affiliates. The Volcker Rule, as implemented by the final rule published by the Agencies in December 2013 (the Final Rule), provides for various exemptions from these prohibitions and restrictions. One exemption permits foreign banking entities to invest in and sponsor covered funds to the extent that these activities are conducted solely outside the United States (the so-called SOTUS covered fund exemption).[3] Among other requirements, the SOTUS covered fund exemption requires that ownership interests in the covered fund in which the foreign banking entity invests are (or have been) sold only in an offering that does not target residents of the United States (the marketing restriction).

Under the marketing restriction, it has been clear that a foreign banking entity cannot rely on the SOTUS covered fund exemption for a foreign private fund that the foreign banking entity sponsors, and as to which the foreign banking entity offers ownership interests to U.S. residents. However, before the issuance of FAQ 13, it was unclear whether a foreign banking entity could invest under the SOTUS covered fund exemption in a foreign private fund organized and offered by a third party (a third-party fund) where the third party (and not the foreign banking entity) offered ownership interests to U.S. residents.

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[1] The Volcker Inter-Agency Group consists of representatives from the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC, and, collectively, the Agencies).

[2] 12 U.S.C. § 1851 *et seq*.

[3] For the Federal Reserve Board, *see* 12 C.F.R. § 248.13(b).

FAQ 13 now clarifies that the marketing restriction applies only where the foreign banking entity (as opposed to a third party) offers ownership interests in a covered fund to U.S. residents. A foreign banking entity that sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator, or commodity trading advisor to a covered fund will be viewed under FAQ 13 as "participating in any offer or sale by the covered fund of ownership interests in the covered fund." Thus, a foreign banking entity cannot rely on the SOTUS covered fund exemption for a covered fund in which it serves in any of the foregoing capacities.

The Agencies observed that their view is "consistent with limiting the extraterritorial application of [the Volcker Rule] 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."

However, FAQ 13 provides that the marketing restriction does not apply to the sponsorship and offering of a covered fund by an unaffiliated third party. Therefore, a foreign banking entity may invest in a covered fund pursuant to the SOTUS covered fund exemption that is sponsored by a third party and offered by that third party to residents of the United States, provided that the foreign banking entity complies with all other conditions of the SOTUS covered fund exemption. These conditions include the following:

- The foreign banking entity may not be directly or indirectly controlled by a U.S. banking entity;
- The foreign banking entity must be a qualifying foreign banking organization, or "QFBO" (or QFBO-like) — in other words, a majority of its business and banking activities must be outside the United States, or if not a foreign banking organization, a majority of its business must be outside the United States;
- Investment/sponsorship decisions must be made outside of the United States;
- The fund investment, including any related hedging transactions, must be booked outside of the United States in an entity that is not organized under the laws of the United States; and
- No financing of any fund investment may be provided by a U.S. affiliate of the FBO.

FAQ 13 provides long-awaited and sought-for relief to foreign banking entities. Without this critical guidance, foreign banking entities had been concerned that the practical use of the SOTUS covered fund exemption would be severely limited. Many foreign banking entities are reported to have widely invested in third-party funds that would meet the SOTUS covered fund exemption but for the uncertainty surrounding the marketing restriction. In addition, foreign banking entities were concerned, among other things, that it would have been impractical, if not impossible, to ensure that no unaffiliated third party to a covered fund in which a foreign banking entity had a passive investment was offering ownership interests to U.S. residents.

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APPENDIX

SOTUS Covered Fund Exemption: Marketing Restriction

http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm

Question 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").

Posted: 2/27/2015

Answer: 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."[1]

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

[1] *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).

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.[2] 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.[3]

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.

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[2] *See* id. at 5740.

[3] 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.