SULLIVAN & CROMWELL LLP

February 27, 2015

Volcker Rule

Agencies Release New Volcker Rule FAQ with Critical Guidance for Foreign Banking Entities and Fund Sponsors; Clarify That U.S. Marketing Restriction Under "SOTUS" Covered Fund Exemption Does Not Apply to Third Parties

Earlier today, the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the "Agencies") provided an important addition to their existing list of Frequently Asked Questions ("FAQs") addressing the implementation of section 13 of the Bank Holding Company Act of 1956, as amended (the "BHC Act"), commonly known as the "Volcker Rule."[1]

The Volcker Rule imposes broad prohibitions on proprietary trading and investing in and sponsoring private equity funds, hedge funds and certain other investment vehicles ("covered funds") by "banking entities" and their affiliates. The Volcker Rule, as implemented by the final rule issued by the Agencies (the "Final Rule"), provides an exemption from the covered fund prohibitions for foreign banking entities' acquisition or retention of an ownership interest in, or sponsorship of, a covered fund "solely outside of the United States" (the "SOTUS covered fund exemption").[2]

One of the conditions of the SOTUS covered fund exemption is that "[n]o ownership interest in the covered fund may be offered for sale or sold to a resident of the United States" (the "marketing restriction").[3] Following the issuance of the Final Rule, the marketing restriction became the subject of uncertainty and industry comment, as it was unclear whether foreign banking entities would be able to rely upon the SOTUS covered fund exemption with respect to investments in third party covered funds,

such as offshore feeder funds with U.S. tax-exempt investors or other covered funds, where the fund sponsor or investors other than the foreign banking entity had engaged in U.S. marketing activities.

The newly released FAQ clarifies that, in the context of a foreign banking entity's acquisition or retention of an ownership interest in a third party covered fund, the marketing restriction applies *only* to the activities of the foreign banking entity (including its affiliates) that is seeking to rely upon the SOTUS covered fund exemption and not to the activities of third parties, including the sponsor of the covered fund, other investors and the covered fund itself. Thus, a foreign banking entity's ability to rely on the exemption would not be lost as a result of third parties' marketing or selling activities to residents of the United States, provided that the foreign banking entity has not itself offered for sale or sold an ownership interest in the fund to a resident of the United States or participated in such an offer or sale. The FAQ notes that, where a banking entity sponsors[4] or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund, the banking entity will be viewed by the Agencies as participating in any offer or sale by the covered fund of ownership interests in the covered fund. Such a foreign banking entity would not qualify for the SOTUS covered fund exemption with respect to its investment in the covered fund if the covered fund offers or sells ownership interests to a resident of the United States.[5]

Prior to the release of the new FAQ, industry participants had expressed concerns that interpreting the marketing restriction to apply to third parties' activities would have significantly limited the practical use of the SOTUS covered fund exemption and entailed significant costs of compliance, as foreign banking entities would in many cases have been required to redeem, divest or restructure their investments in third party funds. As the Agencies acknowledged in the new FAQ, such a broad interpretation of the marketing restriction would have been inconsistent with the goal of "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." The new FAQ should provide welcome confirmation to both foreign banking entities and fund sponsors in this regard.

A copy of the new FAQ is attached as Appendix A.

* * *

ENDNOTES

[1] *See* Federal Reserve, Volcker Rule, Frequently Asked Questions (Feb. 27, 2015) *available at* http://federalreserve.gov/bankinforeg/volcker-rule/faq.htm#13.

[2] Final Rule § _.13(b). *See also* 12 U.S.C. § 1851(d)(1)(I).

[3] Final Rule § _.13(b)(1)(iii). For this purpose, "[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." Final Rule § _.13(b)(3). The other conditions of the SOTUS covered fund exemption are that: (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 State; (ii) the activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; and (iii) the activity or investment occurs solely outside of the United States, meaning that (A) 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; (B) 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; (C) 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 (D) 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. Final Rule § _.13(b).

[4] "Sponsor" means, with respect to a covered fund: (i) to serve as a general partner, managing member, or trustee of a covered fund, or to serve as a commodity pool operator with respect to a covered fund as defined in Final Rule Section _.10(b)(1)(ii); (ii) in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) to share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name. Final Rule § _.10(d)(9).

[5] In the supplementary information accompanying the Final Rule, the Agencies clarify that "[f]oreign banking entities should use precautions not to send offering materials into the United States or conduct discussions with persons located in the United States (other than to or with a person known to be a dealer or other professional fiduciary acting on behalf of a discretionary account or similar account for a person who is not a resident of the United States)." Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5742 (Jan. 31, 2014).

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Stefanie S. Trilling (+1-212-558-4752; trillings@sullcrom.com) in our New York office.

CONTACTS

New York

Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Elizabeth T. Davy	+1-212-558-7257	davye@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Michael T. Escue	+1-212-558-3721	escuem@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Andrew R. Gladin	+1-212-558-4080	gladina@sullcrom.com
Wendy M. Goldberg	+1-212-558-7915	goldbergw@sullcrom.com
David B. Harms	+1-212-558-3882	harmsd@sullcrom.com
Marion Leydier	+1-212-558-7925	leydierm@sullcrom.com
Erik D. Lindauer	+1-212-558-3548	lindauere@sullcrom.com
Jiang Liu	+1-212-558-3093	liujia@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Camille L. Orme	+1-212-558-3373	ormec@sullcrom.com
Richard A. Pollack	+1-212-558-3497	pollackr@sullcrom.com
Kenneth M. Raisler	+1-212-558-4675	raislerk@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com

Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com
Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com
Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com
Washington, D.C.		
Eric J. Kadel Jr.	+1-202-956-7640	kadelej@sullcrom.com
William F. Kroener III	+1-202-956-7095	kroenerw@sullcrom.com
J. Virgil Mattingly	+1-202-956-7028	mattinglyv@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com
Stephen H. Meyer	+1-202-956-7605	meyerst@sullcrom.com
Jennifer L. Sutton	+1-202-956-7060	suttonj@sullcrom.com
Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Los Angeles		
Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
London		
George H. White III	+44-20-7959-8570	whiteg@sullcrom.com
Tokyo		
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com

SOTUS Covered Fund Exemption: Marketing Restriction

Question: Section 13(d)(1)(I) of the Bank Holding Company Act ("BHC Act") and section 351.13(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").

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 351.13(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 <u>their</u> covered fund services in the United States by prohibiting the offer or sale of ownership interests in <u>related</u> 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 SOTUS covered fund exemption does not engage in an offering of ownership interests that targets residents of the United States.

[1] <u>See</u> 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).

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.

[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 351.10(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.