Client Update

Volcker Rule FAQ Expands Ability of Non-U.S. Banks to Invest in Private Funds

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On Friday afternoon, the Federal Reserve and other implementing agencies issued an important new interpretation of the Volcker Rule and the final Volcker Rule regulations.[1] The new interpretation, styled as a response to a Frequently Asked Question, makes it substantially easier for a non-U.S. banking entity[2] to invest directly in private equity funds, hedge funds and other private funds organized and sponsored by fund sponsors that are not affiliated with the non-U.S. banking entity, even if those funds are offered to U.S. investors by the unaffiliated fund sponsors.[3]

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[1] 79 Fed. Reg. 5536 (Jan. 31, 2014)(the "Final Rules").

[2] A "non-U.S. banking entity" is any banking entity that is not, and is not controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any U.S. state. *See* Final Rules § _.10(b)(1)(iii).

[3] Volcker Rule FAQs are available on the agencies' websites, including the Federal Reserve Board website at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm. The new FAQ is Question 13 and was posted on February 27, 2015. Also on Friday, the SEC released a speech by Commissioner Kara Stein. The Volcker Rule: Observations on Systemic Resiliency, Competition, and Implementation (Feb. 9, 2015), available at http://www.sec.gov/news/speech/volcker-rule-observations-on-systemic-resiliency-competition.html. In the speech, Commissioner Stein made several suggestions for the ongoing functioning of the interagency interpretive process. In particular, Commissioner Stein suggested that the interagency Volcker Rule Working Group consider "establishing a deadline, such as 60 days, for indicating whether a question regarding the Volcker Rule will be answered or not, and then have a deadline for answering it." She also suggested that the agencies provide additional clarity and transparency around the types of questions that are being presented to the working group. Whether Commissioner Stein's suggestions will be implemented remains unclear at this stage.

NEW FAQ CLARIFIES THAT THE SOTUS FUND MARKETING RESTRICTION DOES NOT APPLY TO THIRD-PARTY FUND SPONSORS

The Volcker Rule, among other things, prohibits a "banking entity" from sponsoring, acquiring or retaining an ownership interest in a "covered fund," which includes most private funds. However, the final Volcker Rule regulations permit non-U.S. banking entities to make investments in covered funds "solely outside of the United States," subject to a number of conditions (the "SOTUS fund exemption"). Among those conditions, the SOTUS fund exemption includes a restriction on offerings that target U.S. residents.

The new FAQ addresses the scope of the U.S. offering restriction of the SOTUS fund exemption in the following key ways:

- The FAQ states that the U.S. offering restriction only applies to the sponsoring or investing non-U.S. banking entity and its affiliates that seek to rely on the SOTUS fund exemption.[4] In addition, the U.S. offering restriction would apply where the banking entity sponsors or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to the covered fund.
- The FAQ clarifies that the U.S. offering restriction does not apply to a covered fund sponsored by a third party unaffiliated with the non-U.S. banking entity making the investment if the non-U.S. banking entity (and its affiliates) does not participate in the offering of the interests of the covered fund to U.S. residents.

The new FAQ notes that applying the U.S. offering restriction exclusively to a non-U.S. banking entity that is sponsoring or investing in the covered fund is consistent with the purposes of the SOTUS fund exemption to (i) limit the extraterritorial application of the Volcker Rule, (ii) limit risks to the U.S. financial system and (iii) provide for competitive equality between U.S. and foreign banking organizations with respect to the offering of covered fund services in the United States.[5]

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[4] This interpretation had been suggested by multiple commenters prior to the adoption of the Final Rules. *See* 79 Fed. Reg. at 5741, n. 2431-37 (citing, among others, comment letters from the Institute of International Bankers, the Private Equity Growth Capital Council and the Securities Industry and Financial Markets Association).

[5] This view is consistent with the consensus interpretation letter of Debevoise & Plimpton LLP and 14 other leading law firms regarding foreign bank investments in parallel fund structures under the Volcker Rule. *See* Client Update, Foreign Bank Investments in Parallel Fund Structures under the Volcker Rule (May 1, 2014), http://www.debevoise.com/insights/publications/2014/05/foreign-bank-investments-in-parallel-fund-struct__.

Implications for Third-Party Sponsors

The new FAQ substantially addresses many of the Volcker Rule issues faced by third-party fund sponsors.

- *Simplified Fund Structures*. A fund sponsor not affiliated with the investing bank may offer covered fund interests simultaneously to U.S. investors and non-U.S. banking entities without forming parallel funds or using other complicated structures.
- *No Transfer Restrictions*. There is no requirement that the sponsor prohibit transfers from non-U.S. investors to U.S. investors.
- *Choice of U.S. or Non-U.S. Jurisdiction*. As a general matter, the private fund could be organized in the United States or outside of the United States and still could qualify as a SOTUS fund, so long as the fund relies on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "ICA") or is otherwise included in the definition of "covered fund."
- *Available for Bank and Non-Bank Sponsors*. The new FAQ does not appear to make a distinction between non-banking entity fund sponsors and banking entity fund sponsors. Therefore, a banking entity may be able to sponsor a covered fund under the final Volcker regulations' "asset management exemption," and another unaffiliated non-U.S. banking entity would appear to be able to invest in such fund in reliance on the SOTUS fund exemption.

The new FAQ does not address a separate interpretive question under the Volcker Rule regarding the application of the definition of "banking entity" to certain fund structures. Thus, two effective restrictions on private funds remain:

- *Wholly-Owned Subsidiary Restriction*. A SOTUS fund may not be a "wholly-owned subsidiary" of a banking entity (*e.g.*, a single-investor fund where the investor owns 100%).
- *Restriction on Control of Non-Covered Fund*. A non-U.S. banking entity may not "control" a fund organized outside of the United States that is offered only to non-U.S. investors and does not rely on Sections 3(c)(1) or 3(c)(7) of the ICA (*i.e.*, a "foreign excluded fund" or "foreign non-covered fund") by, for example, holding 25% or more of the fund's voting securities.

Under each of these circumstances, the fund itself may be considered a banking entity (and therefore itself subject to the Volcker Rule restrictions).

Implications for Non-U.S. Banking Entity Investors

The new FAQ considerably eases the burden on investing by non-U.S. banking entities in private funds.

- *No Representations on U.S. Offering Necessary*. Non-U.S. banking entities should no longer need representations or other assurances that a third-party fund sponsor will not make an offering that targets U.S. residents.
- *Representations on Covered Fund Status and Wholly-Owned Subsidiary*. In fact, the only Volcker Rule-related assurances that a non-U.S. banking entity may need when investing in a SOTUS fund would be representations or covenants to ensure that a fund maintains its covered fund status (so it can qualify for the SOTUS exemption) and that the SOTUS fund does not become a wholly-owned subsidiary of the non-U.S. banking entity (for the reasons discussed above).
- *Other SOTUS Fund Restrictions Remain*. A non-U.S. banking entity must also still comply with the remaining restrictions under the SOTUS fund exception, including, among other things, (i) the decision making (and the relevant personnel) of the non-U.S. banking entity must be located outside of the United States, (ii) the investment by the non-U.S. banking entity must not be accounted for by a branch or an affiliate in the United States, and (iii) the financing of the investment must not come from a U.S. branch or affiliate of the non-U.S. banking entity.

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Please contact us with any questions you may have.