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Financial Institutions Regulatory Alert

Federal Regulatory Agencies Issue New Guidance on the "SOTUS Exemption" to the Volcker Rule

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On February 27, 2015, the Federal Reserve Board and the other federal regulatory agencies responsible for implementing and enforcing the Volcker Rule issued new guidance relating to the so-called "SOTUS Exemption" to the Volcker Rule. The guidance was made public as part of the FRB's (and the other agencies') Frequently Asked Questions (FAQs). It provides non-U.S. banking entities and their affiliates which seek to invest in covered funds that are sponsored by unaffiliated entities (third party covered funds) in reliance on the SOTUS Exemption with significant new flexibility with respect to such investments.

SOTUS requires that ownership interests in a covered fund that relies on the SOTUS Exemption not be offered and sold in an offering that targets U.S. residents (the "marketing restriction"). Prior to February 27, 2015, it was believed that the marketing restriction applied to all offers and sales of ownership interests in a covered fund that relied on the SOTUS Exemption. The FRB and the other agencies clarified this issue on such date by enunciating the position that the marketing restriction applied only to non-U.S. banking entities (and their affiliates) that made investments in or sponsored covered funds in reliance on the SOTUS Exemption and not to others who might sponsor covered funds or invest therein without reliance on the SOTUS Exemption. The practical import of this newly articulated position is that non-U.S. banking entities can now invest in covered funds that have U.S. investors in reliance on the SOTUS Exemption so long as non-U.S. banking entities themselves do not engage in U.S. marketing activities. This new guidance appears likely to obviate the need to establish separate parallel funds (which are not offered or sold in an offering that targets U.S. residents) to accommodate non-U.S. banking entity investors which rely on the SOTUS Exemption. In that case, non-U.S. banking entity investors could be admitted to an existing fund vehicle even if that fund vehicle has U.S. investors or was offered to U.S. residents so long as the non-U.S. banking entity investors satisfy all of the requirements of SOTUS, including the marketing restriction.

As noted above, a non-U.S. banking entity that seeks to invest in (or sponsor) a covered fund in reliance on the SOTUS Exemption will still be required to satisfy all of the requirements of the SOTUS Exemption, including the marketing restriction. The SOTUS Exemption requirements are as follows:

- the non-U.S. banking entity may not be organized by, 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;
- the activity or investment by the non-U.S. banking entity must be made pursuant to Sections 4(c)(9) or 4(c)(13) of the Bank Holding Company Act;
- no ownership interest in the covered fund may be offered for sale or sold by the non-U.S. banking entity to a resident of the United States; and
- the activity or investment by the non-U.S. banking entity must occur solely outside the United States.

In sum, a non-U.S. banking entity that invests in a covered fund in reliance on the SOTUS Exemption can do so in compliance with the SOTUS Exemption (even if ownership interests in such covered fund were offered and sold to U.S. residents by the sponsor and/or other investors in such covered fund) so long as such non-U.S. banking entity:

- does not sponsor and does not serve directly or indirectly as the investment manager, investment advisor, commodity pool operator or commodity trading advisor to such covered fund; and
- satisfies all of the requirements of the SOTUS Exemption, including the marketing restriction, which would prohibit the non-U.S. banking entity from participating in any marketing efforts that target U.S. residents.

The FAQ noted, in addition, that any non-U.S. banking entity that serves as a sponsor or investment manager, investment advisor, commodity pool operator and/or commodity trading advisor of a covered fund that targets U.S. residents will be deemed to have itself "participated" in the offer and sale of ownership interests in the covered fund to U.S. residents in contravention of the marketing restrictions under the SOTUS Exemption.

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

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Please contact Derrick D. Cephas 212 310 8797 with any questions relating to the foregoing.

If you have questions concerning the contents of this issue, or would like more information about Weil's Financial Institutions Regulatory practice group, please speak to your regular contact at Weil, or to:

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Exhibit A

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.

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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.

View the new FAQ on the Federal Reserve Board's website:

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