

US Regulators Make Sense of Volcker Rule's "SOTUS" Covered Fund Exemption, Explain That US Marketing Restriction Does Not Apply to Third-Party Covered Funds

The Board of Governors of the Federal Reserve System (the Fed) and the other US Federal financial regulators (collectively, the Agencies)¹ recently published an addition to their list of Frequently Asked Questions about Section 13 of the Bank Holding Company Act of 1956, as amended (otherwise known as the Volcker Rule), and the final regulations adopted by the Agencies in December 2013 to implement the Volcker Rule (the Implementing Regulations).² The Implementing Regulations include an exemption from the Volcker Rule's "covered funds" prohibition that permits non-US banking entities to sponsor or acquire ownership interests in covered funds "solely outside of the United States" (the SOTUS Covered Fund Exemption). The SOTUS Covered Fund Exemption requires, among other things, that "[n]o ownership interest in the covered fund is offered for sale or sold to a resident of the United States" (the US Marketing Restriction).³ The new Frequently Asked Question – the thirteenth to be published, according to the Fed's numbering scheme (FAQ 13) – clarifies the intent of the US Marketing Restriction and decisively limits its extraterritorial impact on the global banking and alternative investment management sectors.⁴

¹ In addition to the Fed, the Agencies are the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

² Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014) (adopted Dec. 10, 2013).

³ 12 C.F.R. § 248.13(b)(1)(iii).

⁴ See Volcker Rule, Frequently Asked Questions, SOTUS Covered Fund Exemption: Marketing Restriction (Feb. 27, 2015) (available at <http://federalreserve.gov/bankinfo/volcker-rule/faq.htm>).

The Volcker Rule exemption for covered funds activities and investments outside the United States originally proposed by the Agencies in October 2011,⁵ like the Implementing Regulations, would have required that “[n]o ownership interest in the covered fund is offered for sale or sold to a resident of the United States” – using the passive voice to phrase the restriction, without specifying whose conduct it would restrict. Commenters on the proposal noted the resulting ambiguity, and in the preamble to the Implementing Regulations the Agencies acknowledged the commenters’ concerns:

Certain commenters argued that because of the way the restriction in the statute and proposed rule was written, it was unclear whether the restriction on offering for sale to a resident of the United States applied to the foreign banking entity or to any third party that establishes a fund. Commenters argued the prohibition against offers or sales of ownership interests to residents of the United States should apply only to offers and sales of covered funds organized and offered by the foreign banking entity but not to covered funds established by unaffiliated third parties. These commenters reasoned that *a foreign banking entity should be permitted to make a passive investment in a covered fund sponsored and controlled by an unaffiliated third party that has U.S. investors as long as the foreign banking entity does not itself offer or sell ownership interest[s] in the covered fund to residents of the United States.*⁶

Nevertheless, following a lengthy recapitulation of various commenters’ arguments, the Agencies concluded rather unhelpfully that “[a]fter considering comments received on the proposal, the final rule retains the statutory requirement that no ownership interest in the covered fund be offered for sale to a resident of the United States.”⁷

As a result, from the adoption of the Implementing Regulations until the publication of FAQ 13 well over a year later, the US Marketing Restriction meant that a non-US banking entity could, in reliance on the SOTUS Covered Fund Exemption, acquire ownership interests in a covered fund that was not sponsored, advised or managed by the non-US banking entity (a Third-Party Covered Fund), *but only* if no ownership interests in the Third-Party Covered Fund were offered or sold to US residents.⁸ At least this was generally understood to be the Agencies’ position. For example, a “consensus interpretation” issued by 15 US-based law firms following the adoption of the Implementing Regulations suggested that a non-US banking entity could acquire ownership interests in either a Third-Party Covered Fund offered and sold exclusively to non-US investors or a Foreign Non-Covered Fund (each, a Parallel Foreign Fund), where the Parallel Foreign Fund invests alongside a Third- Party Covered Fund offered and sold to US residents, without falling foul of the Volcker Rule or the Implementing Regulations.⁹ If the prevailing view of the US Marketing Restriction was that a non-US banking entity could acquire ownership interests in a Third-Party Covered Fund offered and sold to US residents, then building a consensus around the Parallel Foreign Fund structure would have been pointless.

FAQ 13 reverses the commonly held understanding of the US Marketing Restriction. From now on, under the Volcker Rule and the Implementing Regulations:

A non-US banking entity may, in reliance on the SOTUS Covered Fund Exemption, acquire ownership interests in a Third- Party Covered Fund, *even if* ownership interests in the Third-Party Covered Fund are offered or sold to US residents.

The sponsor of a Third-Party Covered Fund may allow non-US banking entities to invest *even if* ownership interests in the Third-Party Covered Fund are offered and sold to US residents, and *without* structuring a Parallel Foreign Fund exclusively for non-US banking entities and other non-US investors.

⁵ Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 68,846 (Nov. 7, 2011) (notice of proposed rulemaking, Oct.11, 2011).

⁶ Implementing Regulations, at 5741 (emphasis added).

⁷ *Id.* at 5742.

⁸ A non-US banking entity may also, without relying on the SOTUS Covered Fund Exemption, acquire ownership interests in a non-US fund whose ownership interests *and* other outstanding securities are owned exclusively by non-US persons, because such a fund (a Foreign Non-Covered Fund) is not a “covered fund” under the Volcker Rule and the Implementing Regulations.

⁹ See Consensus Interpretation of the Implementation of Parallel Fund Structures under the Volcker Rule (May 1, 2014).

In short, where a non-US banking entity invests in a Third-Party Covered Fund, the Agencies now explicitly recognize that the policies underlying the Volcker Rule and the SOTUS Covered Fund Exemption do *not* prohibit ownership interests in the Third-Party Covered Fund from being offered or sold to US residents by the fund’s non-bank sponsor, by the fund’s other investors, or by the fund itself. The US Marketing Restriction only applies to the non-US banking entity’s *own* activities in connection with the Third-Party Covered Fund.

By clarifying the intent of the US Marketing Restriction, the Agencies have taken a positive and vital step toward limiting the overall extraterritorial impact of the Volcker Rule’s covered funds prohibition. It must be said, however, that FAQ 13 would have been even more helpful if it had been published a year or so earlier or, better still, made part of the Implementing Regulations adopted in December 2013.¹⁰ Since that time, the global banking and alternative investment management sectors have made extraordinary efforts to conform covered funds activities and investments outside the United States to the requirements of the SOTUS Covered Fund Exemption in general and the US Marketing Restriction in particular. These compliance efforts have entailed significant financial and strategic costs. Under time pressure, and in some cases under less-than-optimal terms, many non-US banking entities have already sold all or substantial parts of the Third-Party Covered Fund portfolios that they believed the US Marketing Restriction would require them to divest before the end of the Volcker Rule conformance period.¹¹ Threatened with losing an important part of their investor base, many non-bank sponsors of Third-Party Covered Funds have devoted a great deal of time and expense to structure Parallel Foreign Funds that could accommodate non-US banking entity investors in both new and existing fund vehicles.

FAQ 13 provides welcome relief from one of the more inexplicable consequences of the Volcker Rule. But it turns out that the costs of compliance with the SOTUS Covered Fund Exemption in respect of Third-Party Covered Funds prior to the publication of FAQ 13 were entirely unnecessary – and entirely avoidable. In our view, the lesson to be drawn from this experience is that the Volcker Rule and other complex structural reforms require a more forthright engagement with commenters during the consultative phase of any rulemaking and more definitive guidance in response to questions of scope and interpretation raised in comments on proposed rules.

¹⁰ For their part, the Agencies disagree that the preamble to the Implementing Regulations dictated the conclusion that a non-US banking entity relying on the SOTUS Covered Fund Exemption could acquire ownership interests in a Third-Party Covered Fund only if no ownership interests in the Third-Party Covered Fund were offered or sold to US residents. In FAQ 13, the Agencies assert that “[the] discussion of the SOTUS covered fund exemption in the preamble [to the Implementing Regulations] does not suggest that the Agencies understood the SOTUS covered fund exemption to have such a limited application.” See FAQ 13 at footnote 19.

¹¹ The Volcker Rule conformance period, which the Fed extended to July 21, 2015 in connection with the adoption of the Implementing Regulations, was recently further extended to July 21, 2017 in respect of covered funds in place prior to December 31, 2013. See Order Approving Extension of Conformance Period Under Section 13 of the Bank Holding Company Act (Dec. 18, 2014).

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