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Alert

Volcker Rule Update: Agencies Clarify Ability of Non-U.S. Banks to Invest in Third-Party Funds

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On Feb. 27, 2015, the Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Securities and Exchange Commission (collectively, the "Agencies") published a new FAQ on the Agencies' rule promulgated under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is commonly referred to as the "Volcker Rule."[1] The new FAQ now makes clear that the Volcker Rule does not necessarily prohibit non-U.S. banking entities from investing in third-party managed hedge funds and private equity funds, even where the ownership interests of such funds are marketed and sold to U.S. investors.[2]

The Volcker Rule contains an exemption that permits eligible non-U.S. banking entities[3] to hold ownership interests in "covered funds," so long as such activity occurs "solely outside the United States." This exemption, commonly known as the "SOTUS exemption" requires, among other conditions, that "no ownership interest in the covered fund is offered for sale or sold to a resident of the United States."[4] However, the FAQ makes clear that this requirement does not prevent a third-party manager from offering or selling the fund's interests to U.S. investors, so long as *the banking entity* is not involved in such marketing or sales activity. In other words, eligible non-U.S. banking entities will still be able to

[1] A separate SRZ *Memorandum*, published on Dec. 23, 2013, summarizes the Volcker Rule's effect on fund activities.

[2] The new FAQ (#13) is available on the Federal Reserve's website.

[3] In order for a banking entity to use this exemption, the following criteria must be satisfied:

(i) The banking entity must not be organized, or directly or indirectly controlled by a banking entity organized, in a U.S. jurisdiction (including any U.S. territory or commonwealth);

(ii) If the entity is a "foreign banking organization" under 12 C.F.R. Part 211 ("Regulation K"), it must qualify for the exemption thereunder;

(iii) If the entity is not a "foreign banking organization" under Regulation K, it must satisfy at least two of the following:

a. Its total assets held outside the United States exceed those held in the United States;

b. Its total revenues from its non-U.S. business exceed those from its U.S. business;

c. Its total net income from its non-U.S. business exceed that from its U.S. business.

[4] *E.g.*, 12 C.F.R. § 248.13(b)(iii).

invest in third-party funds regardless of whether those funds also have U.S. investors, so long as they do not participate in marketing the fund.[5]

To avail themselves of the SOTUS exemption, eligible non-U.S. banking entities will still have to ensure that:

- The banking entity (or office thereof) holding the investment, as principal, (and the banking entity (or office thereof) that has decision-making authority over the investment, if different) is not organized or located in the United States;
- No relevant personnel of the banking entity with decision-making authority over the investment are located in the United States (excluding "back office" personnel);
- The investment is not accounted for as principal, directly or indirectly, on a consolidated basis by a branch or affiliate organized or located in the United States; and
- No financing for the investment is provided, directly or indirectly, by a branch or affiliate organized or located in the United States.

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[5] Furthermore, if the banking entity (or an affiliate) acts as sponsor 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 automatically will be deemed to be participating in the marketing of the fund's ownership interests.