

Memorandum

Investments by Foreign Banking Entities in Private Equity Funds

New Interpretation Says that the Marketing Restriction for SOTUS Funds Applies Only to Foreign Banking Entities, Not to Third Parties

March 2, 2015

On Friday, the Federal Reserve Board and other agencies with authority under the Volcker Rule issued guidance confirming that the marketing restriction under the so-called SOTUS (“solely outside of the United States”) exemption applies only to the activities of foreign banking entities, not to the activities of third parties generally. In short, this means that a foreign bank investing in a private equity fund pursuant to the SOTUS exemption may continue to rely on the exemption even if ownership interests in the fund are offered or sold to U.S. persons by an unaffiliated sponsor or another unaffiliated third party. This should generally allow foreign banks to invest directly in funds sponsored by private equity firms, without the need for separate offshore parallel funds. However, if a foreign bank participates in an offer or sale of fund interests to a U.S. person, it cannot rely on the SOTUS exemption.

The guidance, which was added to the agencies’ list of Frequently Asked Questions (“FAQs”), is appended to this memorandum.

The Volcker Rule is a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that generally prohibits a banking entity, when acting as principal, from sponsoring or investing in a “covered fund” (which generally is a fund that would be an investment company but for an exemption provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940) or engaging in proprietary trading. There are a number of important exemptions and exclusions. For foreign banks, the most important exemption is the SOTUS exemption, which applies to the acquisition or retention of an ownership interest in, or sponsorship of, a covered fund “solely outside of the United States.”

For the SOTUS exemption to apply, a number of conditions must be met, including the condition that “[n]o ownership interest in the covered fund is offered for sale or sold to a resident of the United States.” See 12 C.F.R. § 248.13(b)(1)(iii). Until Friday, it was not entirely clear how this marketing condition applied and

whether foreign banks could still rely on the SOTUS exemption if ownership interests in a covered fund were also marketed to U.S. persons by unaffiliated third parties (such as the fund's sponsor or another investor).

The new FAQ clarifies that the marketing restriction applies only to the activities of the foreign bank (including its affiliates) that seeks to rely on the SOTUS exemption; it does not encompass the activities of third parties that are unaffiliated with the foreign bank. As a result, if the sponsor or general partner of the covered fund or another limited partner offers or sells ownership interests to a U.S. person, a foreign bank's reliance on the SOTUS exemption would be unaffected.

Importantly, the new FAQ makes clear that the foreign bank may *not* rely on the SOTUS exemption if it "participates" in any offer or sale of covered fund interests to a U.S. person, which would presumably cover situations in which the foreign bank sells interests to U.S. persons either as principal or as a placement agent or distributor. According to the FAQ, participation encompasses a variety of roles by the foreign bank, such as if it acts as sponsor (*e.g.*, serving as the general partner; controlling the general partner or fund management; name sharing) or serves, directly or indirectly, as the investment manager, investment adviser, commodity pool operator or commodity trading advisor to the fund. However, participation would not include the role of a foreign bank as a limited partner.

The new FAQ is an important clarification and one that will have favorable implications for investments by foreign banks in covered funds. In many cases, it will obviate the need for sponsors to establish separate parallel covered funds for foreign bank investors.

For any questions about the Volcker Rule and the recent guidance, please contact any member of the Firm's Financial Institutions and Private Funds practices, including those listed below.

FINANCIAL INSTITUTIONS

Lee Meyerson

+1-212-455-3675

lmeyerson@stblaw.com

Mark Chorazak

+1-212-455-7613

mchorazak@stblaw.com

PRIVATE FUNDS

Thomas H. Bell

+1-212-455-2533

tbell@stblaw.com

Michael W. Wolitzer

+1-212-455-7440

mwolitzer@stblaw.com

Barrie B. Covit

+1-212-455-3141

bcovit@stblaw.com

Glenn R. Sarno

+1-212-455-2706

gsarno@stblaw.com

Jonathan A. Karen

+1-212-455-3274

jkaren@stblaw.com

Jason A. Herman

+1-212-455-3697

jherman@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

Appendix

SOTUS Covered Fund Exemption – Marketing Restriction

Question – 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”).

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 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.”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 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).

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.

As posted on the Federal Reserve Board's Website on February 27, 2015

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

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 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.



UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori
Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000