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Parallel Fund Structures Under the Volcker Rule

Skadden was one of 15 law firms that participated in the development of a recently released consensus interpretation letter regarding the ability of non-U.S. banking entities to invest in certain parallel funds organized by non-bank sponsors. The parallel fund structure addressed in the letter includes (i) one or more "covered funds"[1] offered to U.S. investors and (ii) one or more "foreign non-covered funds" or "SOTUS Funds"[2] that invest together in underlying portfolio companies or other assets. The consensus view is that these parallel fund investments are permissible as long as (i) the parallel funds are separate legal entities and have separate investors and (ii) the offering documents include disclosure that the parallel foreign fund is only being offered to non-U.S. persons. The interpretations set forth in the letter are based on the final implementing rules under the Volcker Rule and the preamble thereto and are subject to revision based on subsequent rulemaking, written interpretations or guidance.

The letter begins on the following page.

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1 With respect to investments by non-U.S. banking entities, a "covered fund" means (i) an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or (ii) a commodity pool (as defined under the Commodity Exchange Act) for which either (i) the commodity pool operator has claimed an exemption under 17 CFR §4.7 or (ii) the commodity pool operator is registered, substantially all the participant units are owned by qualified eligible persons, and there has been no public offering to persons other than qualified eligible persons. Final Rules § _.10(b)(1).

2 A SOTUS fund is a covered fund that, among other things, has not sold any ownership interests pursuant to an offering that targets U.S. persons and, thus, is offered "solely outside the United States." Final Rules §_.13(b)

Consensus Interpretation of the Implementation of Parallel Fund Structures under the Volcker Rule

This memorandum sets forth the consensus interpretation of the undersigned law firms with respect to the ability of non-U.S. banking entities[1] to invest in certain parallel funds organized by private fund sponsors that are not "banking entities" ("non-bank sponsors") under the final regulations (the "Final Rules")[2] implementing Section 13 of the Bank Holding Company Act of 1956, as amended (the "Volcker Rule").[3] For purposes of this memorandum, a parallel fund structure includes (i) one or more "covered funds"[4] that is offered to, among other persons, U.S. investors in reliance on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "parallel covered fund") and (ii) one or more "foreign non-covered funds" or "SOTUS funds" (each as defined herein) (the "parallel foreign fund"; together with the parallel covered fund, the "parallel funds") that invest together and in parallel in underlying portfolio companies or other assets.

I. Executive Summary

We believe that the Final Rules permit non-U.S. banking entities to invest in parallel foreign funds in a parallel fund structure organized by a non-bank sponsor that satisfies the following conditions: (i) the parallel funds are organized as separate legal entities and have separate sets of investors, and (ii) the offering documents or other similar materials provided to investors in the parallel foreign fund include a disclosure that the parallel foreign fund is being offered exclusively to non-U.S. persons. This view applies to both a parallel fund structure that has been organized for new investments and a parallel fund structure that has been formed pursuant to a restructuring of an existing covered fund.

In our view, subject to appropriate disclosure, the parallel funds may include features that are common in traditional parallel fund structures and, therefore, the parallel funds may, among other things, (i) be managed by the same sponsor; (ii) offer interests with the same or substantially the same economic terms and voting rights (including cross-voting on collective governance issues); (iii) invest in the same portfolio investments, on a *pro rata* basis; (iv) share the same investment process and governance structures (including the sharing of an investor

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1 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).

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).

3 12 U.S.C. § 1851.

4 With respect to investments by non-U.S. banking entities, a "covered fund" means (i) an issuer that relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 or (ii) a commodity pool (as defined under the Commodity Exchange Act) for which either (A) the commodity pool operator has claimed an exemption under 17 CFR §4.7 or (B) the commodity pool operator is registered, substantially all the participant units are owned by qualified eligible persons, and there has been no public offering to persons other than qualified eligible persons. Final Rules § _.10(b)(1). As discussed *infra* note 5, there are certain additional funds that would be covered funds with respect to investments by U.S. banking entities.

representative body); and (v) share liabilities, including contribution for investor defaults, indemnification, fund expenses, credit facilities and carried interest.

II. Legal Analysis

Under Section _.10(a) of the Final Rules, a non-U.S. banking entity is prohibited from, directly or indirectly, as principal, acquiring or retaining any ownership interest in or sponsoring a "covered fund," unless an exclusion or exemption is available. Pursuant to Section _.10(b)(1)(iii), a non-U.S. banking entity is permitted to acquire and retain ownership interests in certain foreign funds that are not included in the definition of "covered fund" with respect to non-U.S. banking entities but that are included in the definition of "covered fund" with respect to U.S. banking entities ("foreign non-covered funds").[5] Section _.13(b) also permits certain non-U.S. banking entities to acquire or retain an ownership interest in certain covered funds that, among other things, have not sold any ownership interests pursuant to an offering that targets U.S. persons and, thus, are offered "solely outside the United States" ("SOTUS funds").[6] Neither Section _.10(b)(1)(iii) nor Section _.13(b) includes any prohibition on the ability of foreign non-covered funds or SOTUS funds to invest in parallel with a covered fund.

In the preamble to the Final Rules (the "Preamble"), the federal banking agencies, the Securities and Exchange Commission and the Commodity Futures Trading Commission (the "Agencies") acknowledged that commenters on the Agencies' proposed regulations under the Volcker Rule had argued that parallel fund structures and multi-tier structures should not be precluded under the Volcker Rule. In response, the Agencies stated that certain multi-tier fund structures may be required to be "integrated" for purposes of determining compliance with the Final Rules.[7] In particular, the Agencies suggested that integration *may* be required for a SOTUS fund (i) that is organized or operated for the purpose of investing in another covered fund that is sold pursuant to an offering that targets U.S. investors *and* (ii) that is organized and offered (or advised) by the non-U.S. banking entity seeking to sponsor or invest in the SOTUS fund.[8] A plain reading of the

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5 A fund would be a "covered fund" with respect to the acquisition or retention of an ownership interest by a U.S. banking entity (but not a non-U.S. banking entity) if (i) the fund is organized or established outside the United States, (ii) the ownership interests of the fund are offered and sold solely outside the United States, (iii) the fund is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, (iv) if the fund was subject to U.S. securities laws, the fund could not rely on an exclusion or exemption from the definition of "investment company" under the Investment Company Act of 1940 other than the exemptions contained in Sections 3(c)(1) and 3(c)(7) of that Act and (v) is not otherwise a "covered fund," as defined *supra* note 4.

6 In this memorandum, a SOTUS fund is referred to as a parallel foreign fund, but a SOTUS fund may be organized in a U.S. jurisdiction.

7 79 Fed. Reg. 5536 at 5742 - 5743 ("With respect to the treatment of multi-tiered fund structures under the foreign fund exemption, the Agencies expect that activities related to certain complex fund structures should be integrated in order to determine whether an ownership interest in a covered fund is offered for sale to a resident of the United States.").

8 *Id.* at 5743 ("For example, a banking entity may not be able to rely on the foreign fund exemption to sponsor or invest in an initial covered fund (that is offered for sale only overseas and not to residents of the

Agencies' discussion is that parallel funds organized, offered and advised by a sponsor other than the investing banking entity are not required to be integrated. Indeed, the Agencies do not raise any concerns about such structures in the Final Rules or the Preamble.

Section _.21(a) prohibits any banking entity from acting "in a manner that functions as an evasion of the requirements of [the Volcker Rule or the Final Rules], including through an abuse of any activity or investment permitted under [the Final Rules]." An investment in a parallel foreign fund by a non-U.S. banking entity should not be an evasion of the Final Rules, as it would not be inconsistent with any of the purposes for not including foreign non-covered funds as covered funds or the exemption for SOTUS funds. As set forth in the Preamble, the purposes of the exclusion of foreign non-covered funds and the exemption for SOTUS funds were to (i) limit the extraterritorial application of the Volcker Rule,[9] (ii) limit the risks to U.S. banking entities and the U.S. financial system[10] 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.[11]

None of these purposes are evaded or violated by an investment by a non-U.S. banking entity in a parallel foreign fund. To the contrary, prohibiting investments by non-U.S. banking entities in parallel foreign funds would expand the extraterritorial application of the Volcker Rule and negatively impact non-bank sponsors but would not reduce the risk to the U.S. financial system or bring further alignment of the competitive equality with respect to offering covered fund

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United States) that is itself organized or operated for the purpose of investing in another covered fund (that is sold pursuant to an offering that targets U.S. residents) and that is either organized and offered or is advised by that banking entity.").

9 *Id.* at 5672 (discussing excluding foreign non-covered funds and noting that "section 13 includes other provisions that explicitly limit its extra-territorial application to the activities of foreign banks outside the United States."); *id.* at 5738 ("As described in the proposal, the purpose of this statutory exemption appears to be to limit the extraterritorial application of the statutory restrictions on covered fund activities and investments….").

10 *Id.* at 5672 ("[S]ection 13 of the BHC Act applies to the global operations of U.S. banking entities, and one of the purposes of section 13 is to reduce the risk to the U.S. financial system of activities with and investments in covered funds."); *id.* ("In particular, the Agencies were concerned that a definition of covered fund that did not include foreign funds would allow U.S. banking entities to be exposed to risks and engage in covered fund activities outside the United States that are specifically prohibited in the United States. This result would undermine section 13 and pose risks to U.S. banking entities and the stability of the U.S. financial system that section 13 was designed to prevent."); *id.* ("This approach is designed to include within the definition of covered fund only foreign entities that would pose risks to U.S. banking entities of the type section 13 was designed to address."); *id.* at 5742 ("[O]ne of the purposes of section 13 is to limit the risk to banking entities and the financial system of the United States.").

11 *Id.* at 5672 – 5673 ("Thus, the rule is designed to provide parity -- and no competitive advantages or disadvantages -- between U.S. and non-U.S. funds sold within the United States."); *id.* at 5742 ("Another purpose of the statute appears to be to permit foreign banking entities to engage in foreign activities without being subject to the restrictions of section 13 while also ensuring that these foreign entities do not receive a competitive advantage over U.S. banking entities with respect to offering and selling *their covered fund services in the United States.*")(emphasis added).

services by U.S. and non-U.S. banking entities.[12] Similarly, including additional restrictions on the parallel fund structure (such as requiring separate governance, separate investment processes or different investor economics that are not typical in a traditional parallel fund structure) would not further any of the purposes of the Volcker Rule and could negatively impact non-bank investors, including through increased expenses as well as further complexity. Notably, such additional restrictions are not mentioned anywhere in the Final Rules or the Preamble.

III. Conclusion

For all of the reasons given above, we believe that a non-U.S. banking entity may invest in a parallel foreign fund organized by a non-bank sponsor that contemporaneously offers a parallel covered fund to, among other persons, U.S. investors. This structure does not violate any of the provisions of the Final Rules and does not seek to evade the Volcker Rule or the Final Rules or abuse any of the activities or investments permitted thereunder. Our interpretation is based on the recently adopted Final Rules and the Preamble and is subject to revision based on subsequent rulemaking, written interpretations or guidance.

Nothing in this memorandum should be interpreted to mean that a fund structure that does not satisfy the conditions discussed herein would be prohibited under the Final Rules. We believe that there are other fund structures in which non-U.S. banking entities may invest under the Final Rules, and these structures should not be viewed as an evasion of the Volcker Rule or the Final Rules.

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The interpretations set forth in this memorandum do not constitute legal advice on any particular set of facts. The views expressed in this memorandum are the views of the undersigned law firms and not the clients that they represent from time to time and are not intended to address any specific matter on which any of the firms may be advising or in which any of the firms may be appearing on behalf of their clients. No person should act or rely on any interpretation contained in this memorandum without first seeking the advice of legal counsel.

[12] We note that investments by non-U.S. banking entities in parallel foreign funds will remain subject to regulation under the applicable laws, and supervision by the applicable regulatory agencies, of the home jurisdictions of the non-U.S. banking entities.