FEDERAL RESERVE ISSUES PROPOSED RULE ADDRESSING THE VOLCKER RULE'S CONFORMANCE PERIOD

November 30, 2010

To Our Clients and Friends:

On November 26, the Federal Reserve Board (the "FRB") published a proposed rule in the *Federal Register* that would implement the provisions of the Volcker Rule that were designed to give banking entities time to conform their activities and investments to the Rule's restrictions. *See* 75 Fed. Reg. 72,741 (Nov. 26, 2010). The proposed rule is open for public comment until January 10, 2011. In general, there are few surprises in the FRB's proposed rule, although, as discussed below, some banks and industry groups have expressed concern about – and likely will be commenting on – how the FRB would implement the special, extended conformance period for certain illiquid funds.

The proposed rule is, of course, relevant to banking entities, in that it attempts to clarify the time frames within which financial institutions with insured depository institution affiliates may retain their investments in private equity and hedge funds and engage in proprietary trading activities. The proposed rule also may be relevant to others that may be indirectly affected by the proposal. For example, the proposal should be of interest to secondary buyers of fund interests and to private fund sponsors wishing to understand the time frames within which banking entity investors (LPs) may seek to sell their fund interests in the secondary market or, possibly, seek to redeem, be excused from or withdraw from their investments in (or obligations to contribute additional capital to) private funds in which banking entity LPs have invested.

Background. Regulations implementing the Volcker Rule are required to be in place by October 21, 2011, and the Volcker Rule becomes effective 12 months after such rules are final or on July 21, 2012, whichever is earlier (the "effective date"). The Volcker Rule then gives banking entities two years from the effective date (*i.e.*, until no later than July 21, 2014) to bring activities and investments into conformance (the "conformance period").

The Volcker Rule also permits extensions to this conformance period at the discretion of the FRB. The FRB, by rule or order, may grant up to three 1-year conformance period extensions (*i.e.*, at the latest, the conformance period could be extended to July 21, 2017). Additionally, on application of a banking entity, the FRB has discretion to grant up to a 5-year extension (*i.e.*, conceivably as late as July 21, 2022) with respect to a banking entity's investment in certain illiquid funds "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010."

Although other aspects of the Volcker Rule are to be implemented through an interagency rulemaking process, the FRB alone is required to issue regulations regarding the Volcker Rule's conformance periods. The FRB's proposed rule is designed to fulfill this statutory mandate.

Proposal. The FRB's proposed rule, as expected, addresses exclusively the conformance period; it does not attempt to resolve any other issues under the Volcker Rule. Thus, for example, the proposed rule does not seek to clarify terms like "private equity fund" and does not address whether additional capital or other restrictions will be applied to the private equity and hedge fund investments of banking entities during the conformance period or otherwise. This approach was not unexpected; in meetings, the FRB staff indicated a desire not to usurp the broader interagency rulemaking that will take place in 2011.

The FRB's proposed rule addresses a number of specific matters with respect to the conformance period:

Requesting Conformance Period Extensions. The proposed rule would allow any banking entity to request up to three successive 1-year extensions to the standard 2-year conformance period. Extensions may be sought in writing at least 90 days prior to the expiration of the applicable period; must provide reasons why an extension should be granted and must provide a detailed explanation of the banking entity's plan for divesting or conforming an activity or investment. Any such extension would apply to a banking entity's sponsorship of private equity and hedge funds in addition to a banking entity's investment in private equity and hedge funds.

It appears from the proposed rule that extension requests will need to be fairly detailed. It is not clear what efforts, if any, banking entities will need to take prior to the end of a conformance period to convince the FRB that an extension should be granted. Also, the FRB retains the authority under the proposed rule to impose restrictions and conditions on any extensions that it grants.

Extended Conformance Period for Illiquid Funds. The proposed rule also would allow banking entities to seek an extension of the conformance period of up to 5 years with respect to its investments in certain "illiquid funds." The proposed rule indicates that such an illiquid fund extension period would be added to any standard conformance extensions. Thus, under the FRB's proposal, the Volcker Rule would not apply to a banking entity's investment in a particular illiquid fund until as late as July 21, 2022, if the three 1-year standard extensions were granted to such banking entity and the full 5-year extension was granted with respect to such illiquid fund. Again, it is not clear what efforts, if any, banking entities will need to take prior to the end of the (previously extended) conformance period to convince the FRB that the additional (up to) 5-year extension should be granted.

The extended conformance period for illiquid funds appears to be available only with respect to a banking entity's investments in private equity and hedge funds, but not to a banking entity's sponsorship of private equity and hedge funds.

Qualifying for the Extended Conformance Period. The proposed rule notes that, to qualify for the extended illiquid funds transition period, two tests need to be met – one at the level of the fund's portfolio investments and the second at the level of the banking entity's commitment to/investment in the fund. The second is more controversial.

The first test is fund focused, and it requires a fund to satisfy the definition of an "illiquid fund." The proposed rule would define an illiquid fund to include private equity funds that, as of May 1, 2010, (a) were principally (at least 75%) invested in illiquid assets, or were invested in, and contractually obligated to invest principally in, illiquid assets; and (b) make all of their investments pursuant to and consistent with an investment strategy to invest principally in illiquid assets. Illiquid assets are instruments other than those with relatively short-term durations that can be converted into cash. Illiquid assets include investments in real estate (other than those made through publicly traded REITs), venture capital and buyout investments, and investment in other funds that are not publicly traded and that invest in illiquid assets.

As to the second test, the banking entity's retention of fund interests or provision of additional capital to a fund must be necessary to fulfill a "contractual obligation" in effect on May 1, 2010. A contractual obligation exists if (and for as long as), pursuant to agreements in place on May 1, 2010, the banking entity is prohibited from (a) redeeming its ownership stake in the fund and (b) selling or transferring its ownership interests to a third party (which, for most private funds, requires the consent of the general partner or equivalent entity in a non-partnership fund structure). Under the proposed rule, however, a necessary contractual obligation would not exist if (i) the banking entity were able to terminate its obligation or (ii) the obligation could be terminated with the consent of the fund's general partner or others, unless the banking entity has used reasonable best efforts to seek such consent and such consent has been denied.

This second test has generated concern on the part of many industry participants and trade associations. If this aspect of the proposed rule were adopted without change, it could force banking entities to attempt to withdraw or transfer their interests, even if this would have a negative economic impact on the banking entities. There also is concern about what would constitute sufficient "reasonable best efforts" on the part of a banking entity to seek a consent to terminate a contractual obligation.

The FRB has welcomed comment on all aspects of the proposed rule. Specifically, the FRB has asked whether the definition of "contractual obligation" is appropriate and whether other

definitions could better achieve the Volcker Rule's objectives. We expect many in the industry may seek to address this point in meetings with and comments to the FRB.

Please feel free to contact us with any questions.

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