FEDERAL RESERVE ISSUES FINAL REGULATION IMPLEMENTING THE VOLCKER RULE CONFORMANCE PERIOD

February 22, 2011

To Our Clients and Friends:

On February 14, 2011, the Federal Reserve Board (the "Board") published in the Federal Register a final regulation implementing the conformance period provisions of the Volcker Rule.[1] The Volcker Rule conformance period is the period during which banking entities must come into conformance with the Volcker Rule's restrictions on proprietary trading and on investing in or sponsoring private equity or hedge funds. The conformance period includes the two-year period following the effective date of the Volcker Rule, plus potential extensions of up to an additional eight years. The Board had asked for comment on a proposed rule to implement the conformance period in November 2010; in adopting the final rule, the Board—by its own admission—has made relatively modest changes to its original proposal.

Of paramount concern to many banking entities may be the difficulty in qualifying for the extended conformance period that the statute grants for investments in "illiquid funds." As in the Board's proposal, the final rule may make it exceedingly difficult for a banking entity to obtain this extended transition period, which may mean, among other things, that banking entity investors in private funds are forced to sell fund interests in the secondary market or to seek to withdraw or be excused from investments in private funds.

More helpfully, the Board clarified that the available conformance periods (inclusive of all applicable extensions) apply not only to banking entity investments but also to all activities and relationships that otherwise may be prohibited by the Volcker Rule. Thus, the extensions are available not only for investments in, but also for sponsorship of, private funds. In addition, proprietary trading activities qualify for the initial sets of extensions.

STATUTORY BACKGROUND

The Volcker Rule, which generally prohibits banking entities from engaging in proprietary trading or investing in and sponsoring private equity and hedge funds, becomes effective the earlier of (a) 12 months after the issuance of final implementing regulations by the Board and other agencies or (b) July 21, 2012 (the "Effective Date"). The Volcker Rule affords banking

[1] *See 76 Fed. Reg. 8265 (Feb. 14, 2011).*

entities time, after the Effective Date, to bring activities, investments and relationships into conformance with the rule's restrictions. Specifically, the statute provides a two-year generally applicable conformance period (*i.e.*, up to July 21, 2014). It also gives the Board authority to grant further extensions.

Under the Volcker Rule, the Board may extend the conformance period by granting three one-year extensions and, with respect to certain illiquid funds, by up to five years. The statute requires the Board to issue rules to implement these conformance period provisions.

GENERAL CONFORMANCE AND EXTENSIONS

The final rule follows the statutory construct and grants a general two-year conformance period after the Effective Date. The final rule also clarifies that a company that becomes newly subject to the Volcker Rule after the Effective Date because, for example, it acquires a bank or thrift, would have two years from the date on which it first becomes a banking entity to conform to the Volcker Rule's restrictions.

The Board's final rule also allows for three separate one-year extensions to the conformance period. In adopting the rule, the Board rejected requests that it consider granting all three extensions at one time under a single application. The Board interpreted its statutory authority more narrowly and stated that it could only grant three separate extensions, each requiring its own application from a banking entity.

The final rule provides that, in reviewing extension applications, the Board will consider the banking entity's "prior efforts to divest or conform the activity or investment, including, with respect to an illiquid fund, the extent to which the banking entity has made efforts to terminate or obtain a waiver of its contractual obligation to take or retain an equity … interest in, or provide additional capital to, the illiquid fund." The effect of this factor may be to require banking entities with investments in private funds to have undertaken efforts to divest such investments as a condition to obtaining the up-to-five-year extended transition period. It is unclear whether this factor also would be considered with respect to the three one-year extensions.

ILLIQUID FUNDS

The final rule allows a banking entity to apply for a single additional extension of up to five years to meet contractual commitments in place, as of May 1, 2010, to a private equity or hedge fund that qualifies as an "illiquid fund." The final rule provides that this extended transition period may be granted in addition to all other conformance periods, including the above-noted three one-year extensions. (Thus, it is conceivable that a banking entity could receive extensions to maintain an investment in an illiquid fund until as late as July 21, 2022.)

The final rule, like the Board's proposed rule, requires a banking entity's relationship with a private equity or hedge fund to meet two tests to qualify for the extended five-year transition period. The first test focuses on the fund; the second focuses on the terms of a banking entity's investment in the fund. The final rule makes clear that, even if both tests are met, an extension is not automatic; rather, the Board retains discretionary authority to grant, and to determine the length of, the extension.

Fund-Focused Test. The final rule's first test, as with the proposed rule, requires the fund to meet the definition of an "illiquid fund." Such a fund is one that, as of May 1, 2010, (a) was "principally invested" in "illiquid assets," or was invested in and "contractually obligated" to invest principally in, illiquid assets and (b) makes all investments pursuant to and consistent with an investment strategy to invest principally in illiquid assets. The final rule considers a fund to be "principally invested" in illiquid assets if at least 75 percent of the fund's assets are comprised of illiquid assets or related hedges. The Board rejected commenters' requests for a lower—50 percent—threshold.

The Board defined "illiquid assets" as instruments other than those with relatively short-term duration that are actively traded and, thus, can be converted into cash. Illiquid assets generally include investments in privately held portfolio companies, real estate (other than made through publicly traded REITs) and venture capital investments. The Board clarified that the term includes an asset that—because of contractual, statutory or regulatory restrictions applicable to the fund or asset—cannot be offered, sold or otherwise transferred to an unaffiliated person for three years or more.

The Board rejected comments that illiquid assets should include otherwise liquid instruments that, due to market conditions or other factors, are rendered illiquid. The Board read the Volcker Rule's reference to illiquid assets as encompassing only those assets that are illiquid "by their nature" rather than those that are illiquid due to market conditions or the size of a fund's holdings. Nevertheless, the Board said it would consider adverse market conditions in considering whether to grant otherwise qualified illiquid funds an up-to-five-year extended transition period.

The Board also expanded the types of documents that may be considered in determining whether a fund is "contractually committed" to invest principally in illiquid assets. The Board said it would look not only to organizational and other documents that constitute a contractual obligation of the fund, but also written representations contained in the fund's offering materials. The Board also determined that a fund would be viewed as "contractually committed" to invest principally in illiquid assets if such documents provided for the fund to be principally invested in illiquid assets at all times "other than during temporary periods," such as the period prior to receipt of capital contributions from investors or the period

during which a fund's investments are being liquidated and capital and profits are being returned to investors.

Banking Entity Investment Test. The second test focuses on the "contractual commitment" of a banking entity to retain an ownership interest or provide additional capital to a fund. As in the proposed rule, the final rule states that such a "contractual commitment" only exists if—and for so long as—agreements that were in place as of May 1, 2010 prohibit the banking entity from redeeming its ownership interests or selling or transferring such interests to a third party.

The Board declined to amend the definition to address concerns raised by "excuse" rights or other contractual provisions under which a fund investor may be able to terminate or limit its contractual obligations, including provisions requiring the consent of the general partner or other investors. In the Board's view, the Volcker Rule only permits an extended transition period for an illiquid fund "if and to the extent necessary" to fulfill the contractual obligation, which would not be the case if the banking entity could legally "withdraw" its investments or its commitments to the illiquid fund. The Board stated that a banking entity must exercise excuse or transfer rights "no later than the end of the Volcker Rule's general conformance period and any extensions thereof and should begin to plan for such actions."

The Board also noted that, if a banking entity's ability to redeem or sell its interests in a fund is conditioned on the consent of an unaffiliated party, the banking entity would need to use "reasonable best efforts" to obtain such consent. Despite requests from commenters, the Board declined to relax this standard. The Board did indicate, however, that a banking entity would meet the best-efforts test if its efforts were met with "unreasonable demands" by a fund general partner or other investors.

The final rule makes clear that any extended transition period terminates immediately and automatically if a banking entity is no longer contractually obligated to remain invested in or provide additional capital to an illiquid fund. In taking this approach, the Board rejected requests for a six-month transition period after the end of a contractual obligation.

PROCEDURES

The final rule requires all extension period applications to be submitted at least 180 days prior to the expiration of an applicable time period. The Board encourages firms to submit applications as early as possible and states that, if additional requests are contemplated as being necessary, they can be submitted after the first day of a newly extended period. The Board states that it will "seek to act" on an extension request no later than 90 days after receipt of a complete record.

Extension requests must be in writing and must provide the reasons why a banking entity believes an extension is warranted. The final rule includes a broad range of factors that an applicant must address and that the Board will consider in determining whether to grant an extension. That list has been expanded from the proposed rule to include whether a divestiture or conformance of an activity or investment would involve a material conflict of interest between the banking entity and the clients, customers or counterparties to which it owes a duty. The Board states that this factor will be relevant when the banking entity serves as a general partner or sponsor to a fund, but generally not when the banking entity is only a limited partner investor in a third-party fund.

Finally, the final rule makes clear that the Board retains the authority to impose conditions on any extension as the Board determines are necessary or appropriate to address conflicts of interest, safety and soundness, financial stability or other factors.

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