CONSIDERATIONS FOR A VOLCKER RULE "PRIVATE FUNDS" STRATEGY

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INTRODUCTION

In December 2013, the Federal Reserve Board ("FRB") and several other related financial industry regulators adopted final regulations implementing the Volcker Rule. U.S. banking organizations and foreign banks with a U.S. banking presence are now evaluating their options and developing plans for Volcker Rule compliance, including with respect to interests that they hold in privately-offered funds (such as private equity and hedge funds).

This article provides: (1) general background information and a detailed description of the process and legal requirements for extensions of the conformance period and for certain "illiquid" fund investments and (2) the key considerations relating to the sale process for private fund interests in the secondary market.[1]

[1] This article also references the FRB's conformance period rule as issued in February 2011. When the Volcker Rule rulewriting agencies proposed regulations to implement the Volcker Rule in October 2011, the FRB requested comment on revisions to the conformance rule, but it has not yet acted to revise the rule. The procedures and standards described in this article could change if the FRB ultimately revises the conformance rule.

As discussed below, banking entities are encouraged to begin this fact-intensive and inherently time consuming process of developing a Volcker Rule compliance strategy for their fund interests as soon as possible, as the first deadline for submission of conformance period extensions is quickly approaching.

BACKGROUND

The Volcker Rule imposes broad restrictions on proprietary trading and sponsoring and investing in certain privately offered funds ("covered funds") by FDIC-insured banks and their affiliates and foreign banks with a U.S. banking presence ("banking entities"). In December 2013, the FRB, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Securities and Exchange Commission and Commodity Futures Trading Commission adopted final regulations implementing the Volcker Rule.[2]

The Volcker Rule became effective on July 21, 2012 and provided a two-year period for banking entities to bring their activities into conformance, *i.e.* until July 21, 2014.

The Volcker Rule permits the FRB to extend the two-year conformance period by up to three additional one-year periods, for an aggregate conformance period of five years.

In February 2011, the FRB adopted regulations that set out the process and legal standards that apply to requests for extensions of the conformance period (the "Conformance Rule").[3] In addition to the three one-year periods, the Conformance Rule allows a banking entity to apply for an additional extension of up to five years for investments in certain illiquid funds, and thus it is conceivable that a banking entity could maintain an investment in an illiquid fund for up to 8 years until as late as July 21, 2022.

In connection with the final regulations implementing the Volcker Rule, the FRB exercised its statutory authority to extend the two-year conformance period by one year, to July 21, 2015 (the "Conformance Period"), and therefore, the FRB retains statutory authority to grant two additional one-year extensions.

It is important to note that in providing the one-year extension of the conformance period, the FRB used one of the three available one year conformance period extensions available to the FRB or banking entities described above. Thus, the only way a banking

[2] *See* 79 Fed. Reg. 5535 (Jan. 31, 2014).

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

entity can hold a fund interest (for which a contractual commitment was in place on May 1, 2010) not permitted by the Volcker Rule beyond July 21, 2017 is to obtain approval to hold the interest as an illiquid fund.

PROCEDURES AND LEGAL STANDARDS GOVERNING EXTENSION REQUESTS

To request a one-year extension of the Conformance Period or a five-year extension for illiquid funds, a banking entity must submit a separate written request to the FRB for each extension being requested.

Any request for an extension must be submitted to the FRB at least 180 days prior to the expiration of the Conformance Period or any applicable extension period.

Thus, banking entities seeking an initial one-year extension of the Conformance Period must submit a request no later than January 2015. Assuming a banking entity is granted two one-year extensions (which must be requested separately), a subsequent request for a five-year extension for illiquid funds would need to be submitted by January 2017. The FRB will "seek to act" on any request for an extension no later than 90 days after receipt of all necessary information relating to the request.[4]

Under the Conformance Rule, the FRB may grant one-year extensions of the Conformance Period if the FRB determines that the extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. The FRB may grant an extension (including an extended transition period for illiquid funds) based on the criteria described below.

INFORMATION REQUIRED FOR ANY EXTENSION REQUEST

Any request for an extension (*i.e.*, a general one-year extension or an extended transition period for illiquid funds) must provide (1) the reasons why the banking entity believes the extension should be granted and (2) a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment.

In addition, the request should address the factors discussed below, which the FRB may consider in determining whether to grant an extension:

- whether the activity or investment involves or results in material conflicts of interest, results in a material exposure by the banking entity to high-risk assets or trading

[4] *See* 76 Fed. Reg. 8273 (Feb. 14, 2011).

strategies, or poses a threat to the safety and soundness of the banking entity or to U.S. financial stability;

- market conditions;
- the nature of the activity or investment;
- the date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;
- the degree of control held by the banking entity over the fund's investment decisions;
- the types of assets held by the fund, including whether any assets that were illiquid when first acquired by the fund have become liquid assets;
- the date on which the fund is expected to dissolve and liquidate, or its investments may be redeemed or sold;
- the total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, it may pose to the banking entity or U.S. financial stability;
- the cost to the banking entity of divesting or disposing of the activity or investment within the applicable period;
- whether the divestiture or conformance of the activity or investment would involve or result in a material conflict of interest between the banking entity and third parties to which it owes a duty;
- the banking entity's prior efforts to divest or conform the activity or investment(s), 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, partnership, or other ownership interest in, or provide additional capital to, the illiquid fund; and
- any other factor that the FRB believes appropriate.

In addition to addressing the specific factors described above, banking entities may find creating cash flow projections for their fund portfolio a highly informative data point for discussions with the FRB. Such cash flow projections provide helpful insights into the magnitude and timing of future fund capital calls and distributions, as well as total exposure, all of which can be incorporated into discussions with the FRB.

Depending upon a banking entity's resources, this important analytical data may be generated internally or prepared by a secondary advisor with fund valuation and analytics expertise.

SPECIAL REQUIREMENTS FOR 5-YEAR ILLIQUID FUND EXTENDED TRANSITION PERIODS

A banking entity may apply for an additional extension of up to five years to meet contractual commitments in place as of May 1, 2010 to a covered fund that qualifies as an "illiquid fund."

To qualify for the five-year extended transition period, a banking entity's relationship with a covered fund must meet two tests, the first focused on the fund and the second focused on the terms of the banking entity's investment in the fund.

Fund test. In order to satisfy the first test, the fund must be an "illiquid fund," meaning that as of May 1, 2010, the fund:

- was "principally invested" in "illiquid assets," or was invested in and "contractually obligated" to invest principally in, illiquid assets; and
- makes all investments pursuant to and consistent with an investment strategy to invest principally in illiquid assets.

A fund is considered 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. "Illiquid assets" generally include investments in privately held portfolio companies, real estate (other than made through publicly traded real estate investment trusts) and venture capital investments.

In determining whether a fund is "contractually committed" to invest principally in illiquid assets, the FRB will look to organizational and other documents that constitute a contractual obligation of the fund as well as written representations contained in the fund's offering materials. A fund is "contractually committed" to invest principally in illiquid assets if the fund's documents require it 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.

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. 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.

In the FRB's view, the Volcker Rule permits an extended transition period for an illiquid fund only "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. Whether a banking entity has the right to withdraw its investments or terminate its obligations to an illiquid fund will depend on the specific terms of those obligations (*e.g.*, whether the relevant documents include a "regulatory out").

If a banking entity's ability to redeem or sell fund interests is conditioned on the consent of an unaffiliated party, the banking entity would need to use "reasonable best efforts" to obtain such consent. The FRB has indicated, however, that a banking entity meets this test only if its efforts are met with "unreasonable demands" by a fund, unaffiliated general partner or other investors.

CONSIDERATIONS FOR A SECONDARY SALE PROCESS

For many banking entities affected by the Volcker Rule, exploring possible exemptions and extension requests associated with their holding of private equity interests has been the first step in developing an overall compliance strategy. Depending upon the outcome of this review and analysis, a secondary sale may be the most appropriate course of action.

When exploring a secondary sale of private fund interests, banking entities should evaluate a number of factors, including: (1) the goals and objectives of the selling banking entity and (2) the specific characteristics of the private fund portfolio.

In addition to the primary goal of ensuring that all private fund interests are sold and full Volcker Rule compliance is achieved, banking entities are likely to have other objectives that should be factored into the overall secondary sale strategy, including:

- *Price maximization / minimizing loss recognition*. A competitive process targeted to the most aggressive buyers of the specific assets in the portfolio will ensure pricing

tension and maximize proceeds. Various transaction structures can also be used to mitigate any loss on a sale.

- *Preserving general partner ("GP") relationships*. Banking entity sellers may also be sensitive to maintaining GP relationships due to ongoing business activities including lending. Ensuring proper GP communication and an efficiently run process will preserve and may even enhance these GP relationships.
- *Managing internal resource requirements*. Secondary sale transactions can be time consuming and resource intensive. Many of the responsibilities associated with a secondary sale are borne by the banking entity's secondary advisor and the involvement of bank personnel can be focused around specific elements and milestones of the sale process.

Each banking entity fund portfolio is unique, with specific characteristics including: (1) portfolio composition, (2) potential restrictions imposed by GPs and (3) other fund specific considerations that need to be reflected in the transaction process. These characteristics, discussed below, should be considered in tandem with the goals and objectives described above.

- *Portfolio composition*. Portfolio composition including investment strategy (buyout, venture, hedge, fund-of-funds, etc.), geography, and GP concentration will have an impact on the appropriate transaction process and the potential buyers that should be approached. For example, a homogeneous portfolio comprised primarily of buyout fund managers will likely have a different marketing strategy than a diversified portfolio consisting of fund managers across multiple investment strategies.
- *GP restrictions*. Specific GP restrictions are also a consideration when marketing large portfolios consisting of numerous interests. Certain GPs may wish to exert some control over the process with regard to either information sharing and / or targeted buyers.
- *Fund specific issues*. Certain funds may be subject to certain legal considerations or structures that add complexity to the transaction process. Examples include compliance with publicly traded partnership safe harbors, rights of first refusal, or the use of alternative investment vehicles to minimize exposure to unrelated business taxable income.

The banking entity's objectives and portfolio characteristics are ultimately synthesized into a customized marketing strategy. Key elements of the marketing strategy will include:

- *Number of auction rounds*. Marketing processes can be structured as a single- or multiple-round auction. A second round is typically included to provide a select group of investors time to perform additional due diligence and refine their final bid.
- *Breadth of marketing*. Marketing processes can include a broad universe of buyers or be targeted to a smaller group of buyers with a relatively more well-known appetite that matches the complexion of the funds portfolio. The ultimate approach will be determined primarily by the scale and strategy diversity of the portfolio.
- *Bidding flexibility*. The marketing process may require that buyers submit a bid for the entire portfolio or allow bids on sub-portfolios or specific funds. The appropriate bidding requirement is dependent on the objectives of the seller and complexion of the fund portfolio.

In addition to the process considerations noted above, there are a number of early data gathering and organizational steps (including those noted below) that need to be taken as soon as possible after a banking entity has made the decision to pursue a secondary sale.

- *Assemble portfolio data*. Compile a comprehensive fund-by-fund list of capital account data including committed capital, net asset value and unfunded commitments. Fund documentation including the governing legal documents (limited partnership agreements, side letters, etc.) and most recent financial reporting should also be assembled.

- *Establishment of decision making protocols*. A streamlined decision making process is critical to a successful secondary transaction. As bids are received, banking entities need to be in a position to quickly react to pricing and any other important elements of bids including proposed structural features such a deferred payment structure, as applicable.

CONCLUSION

Knowledgeable counsel and an experienced secondary sale financial advisor can be valuable resources in assisting banking entities with their development of a Volcker Rule compliance strategy that integrates a full evaluation of exemptions and extension requests as well as secondary sale options.

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