Client Update
Federal Reserve Issues Guidance on Extended Transition Period for Illiquid Funds

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Yesterday, on December 12, 2016, the Federal Reserve Board (the "FRB") issued much-anticipated guidance on how banking entities may seek an extended transition period for "illiquid funds" under the Volcker Rule. Debevoise has long advocated for the FRB to address illiquid funds issues through guidance, and we believe the FRB's guidance is a positive step that will allow industry participants to move towards Volcker Rule compliance in an orderly manner.

The extended transition period allows banking entities to hold certain legacy illiquid fund interests for up to an additional five years, beyond the current July 21, 2017 conformance date. Below, we provide background and key points and then an overview of the guidance.

BACKGROUND

Under the Volcker Rule, banking entities generally are prohibited from acquiring or retaining ownership interests in, sponsoring or having certain relationships with covered funds. The restrictions and prohibitions of the Volcker Rule became effective on July 21, 2012, with banking entities having until July 21, 2014 to achieve conformance. Through three separate one-year extensions, the FRB extended the conformance period for investments in, and relationships with, so-called "legacy" covered funds until July 21, 2017 (legacy covered funds are those funds with respect to which a banking entity invested or had a relationship as of December 31, 2013).

The Volcker Rule also permits the FRB to grant an additional, extended transition period of up to five years (i.e., until July 21, 2022) for certain "illiquid funds" to the extent necessary for a banking entity to fulfill a "contractual obligation" that was in effect on May 1, 2010. The newly issued guidance, in the form of a Policy Statement and Supervision and Regulation Letter (SR 16-18), sets forth the procedures for banking entities wishing to file an application for an extended transition period and provides insight into how the FRB intends to review those requests.[1]

KEY POINTS

Key points regarding the guidance are as follows.

- Banking entities are not required to exercise a regulatory-out provision or seek consent from third parties (i.e., a general partner or other investors) to terminate an investment in an illiquid fund in order to qualify for the extended transition period. (This was a key point of concern for banking entities.)
- The FRB requests information to show a banking entity has made "meaningful progress toward confirming the majority of" its covered fund investments and asks for supporting information to demonstrate this type of action (such as information on bids that have been sought).
- The guidance appears to indicate that the FRB will grant extended transition periods to provide additional time "to conform investments made by employees in sponsored legacy illiquid funds."
- The General Counsel or Chief Compliance Officer of the entity that sponsors or invests in the illiquid funds is required to provide a certification that each fund meets the definition of "illiquid fund" under both the Volcker Rule's statutory provisions and the FRB's rule implementing the statutory conformance provisions (the "Conformance Rule").
- The FRB delegated authority to approve (but not deny) applications to the Reserve Banks and said that illiquid funds "will generally qualify" for extensions, although applications may be referred to the FRB.
- The Reserve Banks are expected to act on requests within 30 days from when the request is complete.
- The FRB may require a banking entity to provide a progress report on fund sales, maturities or other conformance efforts during the period the banking entity holds illiquid fund interests in reliance on an extension.

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[1] FRB, Statement of Policy Regarding Illiquid Fund Investments Under Section 13 of the Bank Holding Company Act (Dec. 12, 2016), *available* at https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20161212b1.pdf; SR 16-18, Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds (Dec. 12, 2016), *available at* https://www.federalreserve.gov/bankinforeg/srletters/sr1618.pdf.

OVERVIEW OF GUIDANCE

The FRB indicated that it anticipates that the illiquid fund interests will generally qualify for extended transition periods, unless a banking entity has not demonstrated meaningful progress towards conforming its illiquid fund interests, the banking entity has a deficient Volcker Rule compliance program more generally or the FRB has evasion concerns.

The guidance also sets forth the process by which banking entities can seek an extended conformance period. A request for an extended transition period must be submitted to the Applications Unit of the appropriate Federal Reserve Bank at least 180 days prior to the expiration of the general conformance period (i.e., January 20, 2017). The responsible Reserve Bank is expected to act on the banking entity's request within 30 days of receiving "all required information," a phrase that suggests that the 30-day clock will not start to run until the Reserve Bank (and FRB staff) are satisfied that a filing is complete.

Banking entities also are expected to provide the following information in connection with their request:

- a list of the illiquid funds for which an extension is being sought;
- a short description of each illiquid fund, its investment strategy and types of investments made by each fund, which entity within the firm holds the investment, the size of each fund, the total exposure of the banking entity to each fund, the date by which the illiquid fund investment is expected to mature or be conformed with the Volcker Rule, and the banking entity's relationship with the fund (e.g., general partner, sponsor, investment adviser, investor);
- a description of the banking entity's specific efforts to divest or conform its investments in illiquid funds, including a description of the overall covered funds (both liquid and illiquid) that have been divested or conformed to date, the progress that has been made towards divesting or conforming the investments for which an extension is being sought (e.g., the number of funds sold, the number of funds that continue to be held, and the amount of investments remaining in each fund and in the aggregate);
- a certification by the General Counsel or Chief Compliance Officer of the banking entity that each fund subject to the request meets the definition of "illiquid funds" set forth in the Volcker Rule and the FRB's Conformance Rule; and

- the length of the requested extended transition period and a description of the banking entity's plan for divesting or conforming each illiquid fund prior to the end of such transition period.

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Please do not hesitate to contact us with any questions.