Volcker Rule Conformance Periods

Federal Reserve Adopts Final Rule Implementing Volcker Rule
Conformance Periods

SUMMARY
On February 9, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) adopted a final rule (the “Final Conformance Rule”) implementing the conformance periods during which banking entities and nonbank financial companies supervised by the Federal Reserve must bring their activities and investments into compliance with the so-called “Volcker Rule” (the “Volcker Rule”) provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The Final Conformance Rule includes some significant changes in response to public comments but was in most respects adopted as proposed. As a result, among other things, the availability of the special extension period for illiquid funds is likely to remain quite limited. In the Final Conformance Rule, the Federal Reserve:

- Expanded the definition of “illiquid asset” to include assets that are subject to a contractual restriction on sale or redemption for a period of three years or more;
- Added that a hedge fund or private equity fund may be “contractually committed” to principally invest in illiquid assets or be “contractually obligated” to invest or remain invested in the fund based on written representations in offering materials;
- Extended the deadline for a request for an extension of a conformance period from 90 days to 180 days before the end of the relevant conformance period and clarified that the Federal Reserve expects to act on an extension request within 90 days after receipt of a complete record;
- Removed a qualification that assets that are illiquid because of a restriction on transfer will become liquid if the restriction expires and otherwise confirmed that the “principally invested in illiquid assets” test is a one-time test, but added that the Federal Reserve will consider the extent to which illiquid assets have become liquid when acting on extension requests;
- Allowed funds to use financial statements prepared under U.S. Generally Accepted Accounting Principles or other applicable accounting standards as of any date between February 28, 2010 and May 1, 2010 instead of specially prepared May 1 financial statements to determine if they are “principally invested” in illiquid assets;
Added factors that the Federal Reserve will consider when acting on extension requests, including whether divestiture or conformance would result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty; and

Clarified that the Federal Reserve will consider unreasonable demands by an unaffiliated sponsor or investor in determining whether a banking entity has used “reasonable best efforts” to obtain consent to withdraw from an illiquid fund.

According to the Federal Reserve, the Final Conformance Rule does not address definitional or other aspects of the Volcker Rule that will be addressed in the interagency rulemaking process implementing the substantive provisions of the Volcker Rule. For example, key terms in the Volcker Rule, such as the definitions of “banking entity”, “hedge fund” and “private equity fund”, were included without modification from the statutory text. The Federal Reserve expects to review the Final Conformance Rule after completion of the interagency rulemaking process to determine whether modifications are necessary.

The adoption of the Final Conformance Rule substantially as proposed reflects a narrow view by the Federal Reserve of the availability of extension periods. It remains to be seen, however, whether the Federal Reserve will take a restrictive approach in ruling on individual extension applications. That said, rulemaking on extension periods does not necessarily presage a restrictive view of the substantive provisions of the Volcker Rule.

BACKGROUND

Subject to certain important exemptions, the Volcker Rule, which is contained in a new Section 13 of the Bank Holding Company Act of 1956, prohibits a subject “banking entity” from engaging in “proprietary trading”; acquiring or retaining any equity, partnership or other ownership interest in or sponsoring a “hedge fund or a private equity fund”; and entering into “covered transactions” (as defined in Section 23A of the Federal Reserve Act) with a hedge fund or private equity fund sponsored or advised by the banking entity. Although the Volcker Rule does not prohibit nonbank financial companies that may become subject to supervision by the Federal Reserve from engaging in similar activities, the Federal Reserve or other appropriate agencies may impose additional capital charges, quantitative limits, or other restrictions on these companies that engage in such activities, make such investments or maintain such relationships. The prohibitions called for by the Volcker Rule become effective on the earlier of 12 months after adoption of the required final agency rules and two years after enactment of Dodd-Frank.

Dodd-Frank grants banking entities and nonbank financial companies supervised by the Federal Reserve two years after the effective date of the Volcker Rule, which will be no later than July 21, 2012, to bring their activities and investments into compliance with the requirements of the Rule (or two years after a nonbank financial company is designated for Federal Reserve supervision by the Financial Stability Oversight Council, if later). The Volcker Rule authorizes the Federal Reserve, by rule or order, to extend this two-year period for not more than one year at a time for up to a total extension of three years if, in the judgment of the Federal Reserve, such an extension is consistent with the purposes of the Volcker Rule.
and would not be detrimental to the public interest. Further, the Federal Reserve is authorized to grant one additional extension of up to five years for a banking entity to take or retain an interest in, or provide additional capital to, an illiquid fund to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.

The Federal Reserve released a proposed rule on November 17, 2010 (the “Proposed Conformance Rule”), and public comments were due by January 10, 2011. The Final Conformance Rule was adopted on February 9, 2011.

DISCUSSION

General Conformance Period. In the Final Conformance Rule, as in the Proposed Conformance Rule, the Federal Reserve has clarified that, if a company becomes a banking entity, or a subsidiary or an affiliate of a banking entity, after July 21, 2010, compliance with the Volcker Rule must occur before the later of (i) the date the Volcker Rule would otherwise become effective and (ii) two years after the date the entity first becomes a banking entity, or a subsidiary or an affiliate of a banking entity.

The Federal Reserve further clarified in the commentary in the Final Conformance Rule release (the “Commentary”) that the general conformance period (including any one-year extensions thereof) is available to both banking entities and nonbank financial companies supervised by the Federal Reserve for activities commenced after the enactment of Dodd-Frank but before the Volcker Rule’s effective date and applies to any activities, investments and relationships that may be prohibited or restricted by the Volcker Rule. This implies that nonconforming activities or investments cannot be initiated after the effective date of the Volcker Rule.

The Final Conformance Rule still does not directly address whether the prohibition in Section 13(f) of the Volcker Rule on covered transactions by a banking entity with a hedge or private equity fund that is managed, advised or sponsored by the banking entity is applicable during the two-year conformance period or any extension of that period. However, the reference in the Commentary to prohibited relationships and not just to prohibited activities and investments suggests that the better reading is that the conformance periods do extend the time for a banking entity to comply with the covered transaction prohibition.

Extension of General Conformance Period. The Federal Reserve may extend the statutorily prescribed two-year conformance period by up to three periods of one year each, so that the maximum general conformance period for any subject entity cannot exceed five years. In the Commentary, the Federal Reserve noted that the statute “provides a general conformance period of up to 5 years for any asset, which should assist banking entities in transitioning large positions or assets to the requirements of the Volcker Rule.” The Federal Reserve clarified in the Final Conformance Rule that the extensions must be granted one year at a time, and therefore each extension request must be separate. However, the
Federal Reserve noted in the Commentary that a banking entity can submit an additional extension request as early as the first day of the newly extended period. Such extensions must be requested in writing at least 180 days (instead of the 90 days in the Proposed Conformance Rule) before the applicable conformance period expiration date, include specified information and describe the subject entity’s plan to conform or divest prohibited activities or investments. The Final Conformance Rule also adds that the Federal Reserve will seek to act on any request for an extension no later than 90 days after the receipt of a complete record. The Federal Reserve will consider extension requests “in light of all relevant facts and circumstances” and will act in consultation with a banking entity’s primary regulator, if applicable. The Proposed Conformance Rule had a broad but nonexclusive list of factors that the Federal Reserve may consider, including:

- whether the activity or investment (A) involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties; (B) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (C) would pose a threat to the safety and soundness of the banking entity; or (D) would pose a threat to the financial stability of the United States;
- 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 contractual terms governing the banking entity’s interest in the fund (if applicable);
- the degree of control held by the banking entity over investment decisions of the fund (if applicable);
- the types of assets held by the fund (if applicable);
- the date on which the fund is expected to wind up its activities and liquidate or its investments may be redeemed or sold (if applicable);
- the total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity or the financial stability of the United States; and
- the cost to the banking entity of disposing of the activity or investment within the applicable period.

The Final Conformance Rule retains the list from the Proposed Conformance Rule and adds the following factors:

- with respect to the type of assets held by the fund, whether any assets that were illiquid when first acquired by the fund have become liquid assets, such as, for example, because any statutory, regulatory or contractual restrictions on the offer, sale or transfer of such assets have expired;
- 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 unaffiliated clients, customers or counterparties to which it owes a duty; and
- 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
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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.

The Federal Reserve may consider the same factors when determining whether to grant extension requests by nonbank financial companies supervised by the Federal Reserve.

According to the Commentary, the second new factor may be relevant when the banking entity serves as general partner or sponsor to a fund in which unaffiliated persons are investors, but generally would not be relevant when the banking entity (in addition to having an investment) serves only as investment advisor to the fund, because serving as an investment advisor is generally permissible even if the banking entity divests its ownership interest.

The third new factor makes it explicit that the Federal Reserve will consider what efforts a banking entity has made to conform or divest impermissible activities or investments. As explained in the Commentary: “The [Federal Reserve] expects all banking entities and nonbank financial companies supervised by the [Federal Reserve] to make reasonable and good-faith efforts to divest or otherwise confirm their prohibited activities and investments within the prescribed time periods.”

The Final Conformance Rule grants the Federal Reserve wide latitude to impose conditions on any extension granted if, in the Federal Reserve’s judgment, such conditions are necessary or appropriate to protect “the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of Section 13 of the BHC Act and the proposed rules.” If the banking entity is primarily supervised by another regulator, the Federal Reserve will consult with that regulator before imposing any conditions on its approval.

**Special Extended Period for Illiquid Funds.** In addition to the two-year general conformance period and any one or more one-year extensions that have been granted, a separate extension with respect to illiquid funds is available. The Federal Reserve, upon application from a banking entity using the same procedures as those for obtaining a one-year extension of the general conformance period, may grant a one-time extension for up to five years during which the banking entity may take or retain its equity, partnership or other interest in, or otherwise provide additional capital to, such a fund to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010. The maximum possible period for conforming investments in illiquid funds is therefore ten years. Under the Final Conformance Rule, as under the Proposed Conformance Rule, any extension period granted in respect of illiquid funds automatically terminates on the date “during any such extension” on which the banking entity is no longer contractually obligated to acquire or retain its interest in, or provide capital to, the illiquid fund. In response to public comments, including a request that the Final Conformance Rule allow a limited “grace period” after the termination of the contractual obligation, the Federal Reserve noted that the statutory text of the Volcker Rule specifically provides that a five-year extension will terminate by operation of law on the date when the contractual obligation terminates. This limitation could significantly reduce the value of
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the five-year exemption. If a contractual obligation terminates during the extension period, the Volcker Rule applies immediately, and immediate divestiture of an illiquid fund investment would be required, unless the investment could be held under one of the Volcker Rule’s general exemptions.

The criteria that the Federal Reserve must use when evaluating an application for extension of a conformance period for an illiquid fund can be broadly divided between “fund-based” and “investment-based”.

**Fund-based criteria.** In conformity with Dodd-Frank’s statutory language, an “illiquid fund” is defined as a hedge fund or private equity fund that (i) as of May 1, 2010, was “principally invested” in “illiquid assets”, or was invested in, and “contractually committed” to principally invest in, illiquid assets; and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

**“Illiquid Assets”.** “Illiquid assets” are assets that are not “liquid assets”. “Liquid assets” are defined as:

- cash or cash equivalents;
- assets that are traded on a recognized, established exchange, trading facility or other market on which there exist independent, bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for the asset almost instantaneously;
- assets for which there are bona fide, competitive bid and offer quotations in a recognized inter-dealer quotation system or similar system or for which multiple dealers furnish bona fide, competitive bid and offer quotations to other brokers and dealers on request;
- assets the price of which are quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;
- assets with an initial term of one year or less and the payments on which at maturity may be settled, closed-out, or paid in cash or one or more other liquid assets described above; and
- any other asset that the Federal Reserve determines, based on all the facts and circumstances, is a liquid asset.

These definitions have not changed from the Proposed Conformance Rule and are based on standards and regulations of the Federal Reserve and SEC that are designed to identify securities that are liquid and may be sold promptly at a price that is reasonably related to their fair value. As a result, illiquid assets should include, if they are not publicly traded, investments in portfolio companies, real estate investments (except those made through publicly traded REITs), venture capital investments, and investments in other hedge funds or private equity funds. The Commentary makes it clear that an investment in another hedge fund or private equity fund should generally be an illiquid asset as long as the investment itself does not qualify as a liquid asset.
Under the Proposed Conformance Rule, liquid assets would have been considered illiquid if, but only for so long as, a statutory or regulatory restriction applicable to a hedge fund, private equity fund or asset prohibits transfer to an entity that is unaffiliated with the relevant banking entity, or if another statutory or regulatory restriction applies such as those under the Federal securities laws (e.g., Rule 144A restrictions). Under the Final Conformance Rule, an illiquid asset will not become a liquid asset if the statutory or regulatory restriction lapses. However, the impact of this change may be limited because, when evaluating extension requests, the Final Conformance Rule states that the Federal Reserve will consider whether any assets that were illiquid when first acquired by the fund have become liquid assets because any statutory, regulatory or contractual restrictions on the transfer of such assets have expired.

Under the Final Conformance Rule, an asset will also be considered illiquid if a contractual restriction prohibits transfer to an unaffiliated person for a period of more than three years. The Final Conformance Rule did not include any additional circumstances under which an otherwise liquid asset would be considered illiquid, such as market conditions that could have a material effect on the price of an asset when sold.

"Principally Invested". Under the Final Conformance Rule, a hedge fund or private equity fund is considered to be "principally invested" in illiquid assets if at least 75% of the fund’s consolidated total assets are illiquid assets or related risk-mitigating hedging positions. Although many commenters requested a lower threshold, the Federal Reserve adopted the 75% threshold as proposed. In a change from the Proposed Conformance Rule, the Commentary says that the Final Conformance Rule will allow the "principally invested" determination to be made based on a fund’s most recent financial statements as of any date between February 28, 2010 and May 1, 2010, rather than only as of May 1, 2010. The Federal Reserve made this change in response to several comments that funds often prepare their financial statements at the end of each calendar quarter and may not have financial statements dated as of May 1, 2010. The Commentary provides that financial statements must be based on U.S. Generally Accepted Accounting Principles or on other applicable accounting standards.

Under the Proposed Conformance Rule, a fund would have been considered to be "contractually committed to principally invest" in illiquid assets as of May 1, 2010 if the fund’s contractual obligations or organizational documents in effect as of that date provide for the fund to be principally invested in illiquid assets between the initial receipt of capital contributions and the fund’s expected termination. Under the Final Conformance Rule, a fund is considered to be "contractually committed to principally invest" in illiquid assets as of May 1, 2010 if the fund’s contractual obligations or organizational documents or written representations in the fund’s offering documents distributed to potential investors in effect as of that date provide for the fund to be principally invested in illiquid assets at all times other than during temporary periods, such as the period prior to the initial receipt of capital contributions from investors or the period during which the fund’s investments are being liquidated and capital and profits are being returned to investors. A fund is considered to have an "investment strategy to principally invest" in illiquid
assets if the fund either “markets or holds itself out to investors as intending to principally invest in illiquid assets” or “has a documented investment policy of principally investing in illiquid assets”.

**Investment-based criteria.** Under the Proposed Conformance Rule, a banking entity would have had a “contractual obligation” to invest or remain invested in a fund or to provide additional capital to a fund only if the banking entity is prohibited by the terms of its interest in the fund or other contractual arrangements with the fund from both (i) redeeming all its ownership interests in the fund and (ii) selling or otherwise transferring all such ownership interests to a person that is not an affiliate of the banking entity. Commenters noted that this definition could be too narrow, as funds typically are bound to comply with any written representations contained in their offering documents and could be subject to liability under the Federal securities laws if they fail to do so. Further, a banking entity could have a contractual obligation to another investor but not to the fund itself. In response to these comments, the Federal Reserve expanded the definition in the Final Conformance Rule so that a “contractual obligation” can arise from the terms of the banking entity’s interest in the fund or other contractual arrangements with the fund as well as from other contractual arrangements with unaffiliated investors in the fund and, similar to the change to the definition of “contractually committed to principally invest”, if the banking entity is the sponsor of the fund, under the terms of a written representation made by the banking entity in the fund’s offering materials distributed to potential investors.

Under both the Proposed Conformance Rule and the Final Conformance Rule, no “contractual obligation” will be deemed to exist if the obligation may be terminated by the banking entity or with the consent of other persons, unless the banking entity has used its reasonable best efforts to obtain such consent and such consent has been denied. The Federal Reserve did not modify the reasonable best efforts standard, as some commenters requested. According to the Commentary, when determining whether to grant an extension, however, the Federal Reserve will consider whether the banking entity has used reasonable best efforts to obtain consent but an unaffiliated general partner or other investors denied the request because the banking entity failed to agree to unreasonable demands.

The Federal Reserve affirmed its view in the Final Conformance Rule that if a banking entity or any of its subsidiaries or affiliates has the contractual right to terminate the banking entity’s commitments to invest or remain invested in a fund or to provide additional capital to an illiquid fund, then the banking entity is not “contractually obligated”. Such rights could include the right to terminate an investment to avoid violations of law (a “regulatory out”), regardless of the intent behind the right.

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2 The Federal Reserve has adopted the “receipt of a complete record” standard in other application processing rules. Because the Federal Reserve has discretion to determine when the record is complete, this standard can often result in extensions of the deadline.

3 According to the Commentary (but not the text of the Final Conformance Rule itself), a fund will also be considered to be principally invested in illiquid assets if at least 75 percent of assets are “expected to be” composed of illiquid assets.

4 Despite the discussion in the Commentary, all references to financial statements in the actual text of the Final Rule have been deleted.
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