



Federal Reserve Publishes Final Rule Regarding the Conformance Period for the “Volcker Rule”

On February 9, 2011, the Board of Governors of the Federal Reserve System (“Federal Reserve”) published a final rule (“Final Rule”) implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) that give banking entities a defined period of time to conform their proprietary trading and hedge fund and private equity fund (“Covered Private Fund”) activities to the so-called Volcker Rule.¹ The Final Rule gives such entities a conformance period of two years, with the possibility of three one-year extensions, and an additional period of up to five years for investments in illiquid funds. In addition, the Final Rule provides further clarity regarding illiquid funds, the Volcker Rule’s effect on nonbank financial institutions subject to Federal Reserve supervision, and the procedures governing extension requests. In a number of respects, the Final Rule was modified from the Federal Reserve’s proposed rule,² the differences from which we have highlighted below. The Final Rule will become effective on April 1, 2011.

Background: The Volcker Rule

Section 619 of the Dodd-Frank Act adds a new section 13 to the Bank Holding Company Act of 1956 (“BHC Act”) (to be codified at 12 U.S.C. 1851)—the so-called Volcker Rule, named after Paul Volcker, the former Chairman of the Federal Reserve who was the principal advocate of this measure. In general, the Volcker Rule prohibits banking entities from engaging in proprietary trading in securities, derivatives, or certain other financial instruments, and from investing in, sponsoring, or having certain relationships with a Covered Private Fund. New section 13 of the BHC Act provides banking entities two years to bring their activities and investments into compliance with the Volcker Rule, and allows the Federal Reserve to extend this conformance period under certain conditions.

The Volcker Rule will not take effect until the earlier of July 21, 2012, or 12 months after the issuance of the final regulations implementing the prohibitions and restrictions of the Volcker Rule. In January, as required by new section 13(b)(1) of the BHC Act, the Financial Stability Oversight Council (“FSOC”) issued its study, which provides recommendations to the various federal agencies responsible for implementing the Volcker Rule.³ (NOTE: Our analysis of the FSOC study and recommendations is available [here](#).) By statute, the responsible agencies must jointly develop and adopt implementing regulations within nine months of the completion of the study, or no later than October 2011. The Federal Reserve alone, however, has the authority to adopt rules in connection with the conformance period, as described below. In adopting the Final Rule, the Federal Reserve was

¹ 76 Fed. Reg. 8265 (February 14, 2011).

² 75 Fed. Reg. 72741 (November 26, 2010).

³ The FSOC “Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Fund & Private Equity Funds” is available at www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20Org.pdf.

careful to note that the Final Rule does not address any of the definitional or substantive aspects of the Volcker Rule.

General Conformance Period

Under the Volcker Rule, banking entities are provided with a two-year conformance period after the Volcker Rule takes effect (which is the earlier of July 21, 2012 or 12 months after the issuance of final regulations by the responsible agencies) during which they can wind down, sell, or otherwise conform their activities, investments, and relationships to the requirements of the Volcker Rule. The Final Rule implements this two-year period and clarifies that a company becoming a banking entity after the enactment of the Dodd-Frank Act (July 21, 2010) would be provided with the same two-year conformance period, starting from the day such company becomes a banking entity.

The Federal Reserve, by rule or by order, may extend the two-year conformance period by up to three additional one-year periods if the Federal Reserve determines that an extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. The Final Rule clarifies that the Federal Reserve may only grant three separate one-year extensions and may not grant all three one-year extensions at one time.

Extended Transition Period for Illiquid Funds

Section 13(c)(3) of the BHC Act provides banking entities with the ability to apply for an extension of the conformance period of up to five years in order to meet any contractual obligations in place as of May 1, 2010, to a Covered Private Fund that qualifies as an “illiquid fund.” The Final Rule clarifies that an extended transition period for illiquid funds would be in addition to the general conformance period. Therefore, conceivably, banking entities may be able to retain certain investments in or fulfill commitments to an illiquid fund made as of May 1, 2010, up to ten years after the Volcker Rule takes effect. However, by statute any extended transition period granted with respect to an illiquid fund automatically terminates when the banking entity is no longer contractually obligated to invest in, or provide capital to, the illiquid fund. In the discussion of the Final Rule, the Federal Reserve clarifies that if a banking entity has the contractual right to terminate its investments or commitments to an illiquid fund because such investments or commitments would be prohibited by the Volcker Rule (*e.g.*, a “regulatory-out” provision) after the expiration of the general conformance period and any extension thereof, then an extended transition period would not be granted, because the banking entity could legally withdraw from its investments or commitments without violating its contractual obligations.

The Final Rule broadens the definition of “illiquid fund” from the proposed rule,⁴ such that it now covers a Covered Private Fund that as of May 1, 2010, (i) was principally invested in illiquid assets or was invested in, and contractually committed to principally invest in, illiquid assets, and (ii) makes all its investment pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets. In addition, the Final Rule defines the terms “illiquid assets,” “principally invested” in illiquid assets, “contractually committed to principally invest” in illiquid assets,⁵ and “investment strategy to principally invest” in illiquid assets. “Illiquid assets” would generally be defined as assets that do not fit within the existing standards for “liquid assets” under the federal banking and securities laws, in particular the Securities and Exchange Commission’s broker-dealer net capital rules and its Rule 3b-8 under the Securities Exchange Act of 1934 and the Federal Reserve’s Regulation W governing bank transactions with affiliates (*i.e.*, assets that may be promptly bought and sold at a price reasonably related to their fair value, and instruments with a relatively short (one year or less) duration period and that can be monetized or converted at maturity into a liquid asset). A Covered Private Fund is “principally invested” in illiquid assets under the Final Rule, if: (i) at least 75 percent of the fund’s consolidated total assets are comprised

⁴ The proposed rule did not include in the definition of illiquid funds situations where an asset is subject to a contractual restriction on sale or redemption for a period of three (3) years or more.

⁵ The Final Rule also broadens the types of documents that may be considered in determining whether a Covered Private Fund is “contractually committed to principally invest” in illiquid assets or whether a banking entity that has sponsored a Covered Private Fund is contractually committed to invest in or remain invested in the fund.

of illiquid assets or risk-mitigating hedges related thereto; (ii) the fund is contractually committed to principally invest in illiquid assets; and (iii) the fund has an investment strategy to principally invest in illiquid assets.

Application for Extension

A banking entity seeking an extension of the conformance period or applying for an extended transition period for illiquid funds must (i) submit a request to the Federal Reserve in writing at least 180 days prior to the expiration of the applicable time period,⁶ (ii) provide reasons why the banking entity believes the extension should be granted, and (iii) provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment. Under the Final Rule the Federal Reserve may consider all facts and circumstances related to the activity, investment, or fund when reviewing an application for extension, to the extent relevant, including the following:

- i) 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 (the "prudential backstop" requirements of the Volcker Rule);
- ii) Market conditions;
- iii) The nature of the activity or investment;
- iv) The date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;
- v) The contractual terms governing the banking entity's interest in the fund;
- vi) The degree of control held by the banking entity over investment decisions of the fund;
- vii) 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, such as, for example, because any statutory, regulatory, or contractual restrictions on the offer, sale, or transfer of such assets have expired;
- viii) The date on which the fund is expected to wind up its activities and liquidate or its investments may be redeemed or sold;
- ix) 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;
- x) The cost to the banking entity of disposing of the activity or investment within the applicable period;
- xi) 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;
- xii) 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
- xiii) Any other factor that the Federal Reserve believes appropriate.

⁶ The Final Rule extends from 90 to 180 days the number of days in advance a request for an extension of the conformance period by a specific company must be filed with the Board.

The Federal Reserve will seek to act on any request for an extension of the conformance period or an extended transition period for illiquid funds no later than 90 days after the receipt of a complete record of the request.⁷ In addition, the Federal Reserve may impose such conditions on any extension as it deems necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of section 13 of the BHC Act and the Final Rule.

Nonbank Financial Companies Supervised by the Federal Reserve

Under the Volcker Rule, nonbank financial companies supervised by the Federal Reserve do not face the same prohibitions or restrictions from engaging in proprietary trading, or from having the types of investments in or relationships with Covered Private Funds maintained by banking entities. However, the Volcker Rule provides that the Federal Reserve or other appropriate agencies impose additional capital requirements, quantitative limits, or other restrictions on nonbank financial companies supervised by the Federal Reserve in connection with such activities or investments. The Final Rule implements the statutory provisions and applies the Volcker Rule transition and conformance periods to nonbank financial companies supervised by the Federal Reserve. The same two-year conformance period (generally measured from the date the FSOC designates a nonbank financial company for supervision by the Federal Reserve), available extensions, and associated procedures governing extension requests discussed above will apply to nonbank financial companies supervised by the Federal Reserve.

NOTE: The entire Final Rule and the related press release from the Federal Reserve can be found at:

Rule: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20110209a1.pdf>

Press Release: <http://www.federalreserve.gov/newsevents/press/bcreg/20110209a.htm>

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

⁷ The Final Rule explicitly provides, where the proposed rule did not, that the Board expects to act on extension requests within 90 days from receipt of a complete record.