



financial reform matters

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Fed Adopts Final Rule for Conformity with the Volcker Rule

On Wednesday, February 9, 2011, the Board of Governors of the Federal Reserve System (the “Board”) announced its adoption of a final rule concerning the period of time that banking entities and nonbank financial companies supervised by the Board have to comply with the new section 13 (the “Volcker Rule”) of the *Bank Holding Company Act of 1956* (the “BHC”), as added by Section 619 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the “Dodd-Frank Act”). As enacted on July 21, 2010, the Volcker Rule generally prohibits banking entities – broadly defined to include banks, parents of banks and subsidiaries and affiliates of either of them – from engaging in proprietary trading in securities, derivatives, or certain other financial instruments, and from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund. The Volcker Rule further permits the Board or other agencies to impose restrictions, such as capital charges or quantitative limits, on nonbank financial companies supervised by the Board.

The Volcker Rule will go into effect upon the earlier of (i) 12 months after the agencies issue final rules regarding section 13(b)(2) of the BHC Act and (ii) July 21, 2012. However, the Volcker Rule also provides institutions with time, after the Volcker Rule’s effective date, to conform their activities and investments to the law’s restrictions. Generally, each entity subject to the Volcker Rule is given two years to comply with it once it becomes effective, but the discussion of the availability of extensions is the most interesting aspect of the final rule. The Board’s final rule will be effective April 1, 2011. It is similar in most respects to the proposed rule issued for comment in November 2010.

Banking entities are already hard at work evaluating the impact of the Volcker Rule on their organizations. Hedge funds and private equity fund sponsors whose investors include affiliates of bank holding companies will need to understand the pressures that some of the investors are under as the Volcker Rule begins to take hold. In particular, such sponsors may need to assist their investors in evaluating whether the funds are considered “illiquid,” as described below.

The below is a summary of the final rule. The text of the final rule, and supplemental information regarding the final rule, is available at the Board’s website, [here](#).

Two-Year General Conformance Period and One-Year Extensions

Each banking entity will have two years from the effective date of the Volcker Rule, and each nonbanking financial company supervised by the Board will have two years from the date it becomes subject to the supervision of the Board, to bring their respective activities and investments into compliance with the Volcker Rule. Moreover, under the final rule, any company that acquires or otherwise first becomes affiliated with a banking entity after July 21, 2010, is not required to bring its activities and investments into conformance with the Volcker Rule until the later of (i) two years from the effective date of the Volcker Rule or (ii) two years from the date on which the company first became subject to the Volcker Rule. This two-year conformance period will continue to apply to new banking entities, even after the Volcker Rule and its implementing regulations become fully effective, to provide them with a comparable amount of time to comply with the Volcker Rule.

The final rule also implements the three one-year extensions to the conformance period permitted under the Volcker Rule. If the Board determines that an extension is consistent with the Volcker Rule's purposes and would not be detrimental to the public interest, a banking entity or nonbanking financial company supervised by the Board may receive up to three one-year extensions to bring its activities and investments into compliance with the Volcker Rule. While some commenters had urged the adoption of the leeway to obtain a three-year block extension, the final rule clarifies that each extension will be parceled out one year at a time.

Extended Five-Year Transition Period for Investments in Illiquid Funds

In recognition of the additional obstacles banking entities may face to conform their investments in illiquid funds, separate and apart from the garden variety extensions, the Volcker Rule provides that banking entities may seek the Board's approval for one extension of up to five years, in order to satisfy a contractual obligation, existing as of May 1, 2010, to an illiquid hedge fund or private equity fund. As implemented by the final rule, such an extension may only be granted once and, if warranted by the facts and circumstances, the Board may grant an extended transition period of less than five years. Under the Volcker Rule, when the banking entity is no longer subject to a contractual obligation to invest in or provide capital to an illiquid fund, the extended transition period automatically terminates. The final rule focuses on both how to define an illiquid fund and how to define such a contractual obligation.

A. Definition of Illiquid Fund

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 funds.

1. Definition of Illiquid Asset

An "illiquid asset" is defined (i) in the negative, as an asset that is not a liquid asset, (ii) as an asset that cannot be offered, sold or transferred to a person unaffiliated with the banking entity due to statutory or regulatory restrictions applicable to the fund or asset or (iii) as newly provided for in the final rule, as an asset that cannot be offered, sold or otherwise transferred for three years or more due to contractual restrictions applicable to the fund or asset. In turn, a "liquid asset" includes cash or cash equivalents, types of assets that may be sold in the short term at a price reasonably related to its fair market value or any other asset that the Board determines, based on all the facts and circumstances, to be a liquid asset. Despite the breadth of the catch-all provision that permits the Board to determine a liquid asset based on all of the facts and circumstances, the Board notes in the release accompanying final rule that the Volcker Rule provides that investments in portfolio companies, real estate and venture capital should typically be considered illiquid assets.

2. Definition of Principally Invest, Contractually Committed to Principally Invest or Has an Investment Strategy to Principally Invest

For a fund to be principally invested in illiquid assets, the final rule, like the proposed rule, imposes a bright-line 75 percent test, in which at least 75 percent of the fund's consolidated assets are either illiquid assets or risk-mitigating hedges entered into in connection with and related to individual or aggregated positions in, or holdings of, illiquid assets.

Likewise, a fund is contractually committed to principally invest in illiquid assets if the fund's organizational documents, other documents constituting a contractual obligation of the fund (including, for example, a side letter) or written representations in the fund's offering materials distributed to potential investors provide for the fund to be principally invested in illiquid assets at all times other than temporary periods. According to the express definition in the final rule, such temporary periods may include the period before the fund initially receives capital contributions or the period when the fund liquidates its investments and returns capital and the profits to its investors. The Board added that the written representations in the fund's offering materials may constitute a contractual commitment in recognition that funds generally are required by law to comply with such written representations.

A fund has an investment strategy to principally invest in illiquid assets if the fund markets or holds itself out as principally investing in illiquid assets or has a documented investment policy of principally investing in illiquid assets.

The Board noted, as an example, that the organizational documents offering materials or investment policy could state that the fund invests in "early-stage nonpublic companies," and suggested the documents need not detail that such securities cannot be traded on a recognized exchange, in order for such investments to be considered "illiquid assets." The Board encourages banking entities to therefore determine generally whether the assets described in the relevant documents are of the type and nature that constitute "liquid assets" or "illiquid assets" as defined in the final rule.

B. Definition of "Contractual Obligation"

The extended five-year transition period for investments in illiquid funds only applies if the banking entity must retain ownership in the fund, or provide additional capital to the fund, to fulfill a contractual obligation of the banking entity in effect on May 1, 2010. Such a contractual obligation to retain ownership in the fund exists if the banking entity is prohibited from redeeming all of its ownership interest in the fund and from selling or otherwise transferring all such ownership interest to a non-affiliate either under the terms of its ownership interest or other contractual arrangements. A contractual obligation to provide additional capital exists if, under the terms of its ownership interest or other contractual arrangements, the banking entity is required to provide additional capital to the fund. If the banking entity is the sponsor, a contractual obligation to retain ownership in the fund or provide additional capital to the fund also exists if it is required under the terms of the written representations made in the fund's offering materials distributed to potential investors.

The final rule, like the proposed rule, provides that no contractual obligation exists if the obligation may be terminated by the banking entity or any of its subsidiaries or affiliates or if the obligation may be terminated with others' consent unless the banking entity and its subsidiaries and affiliates have used reasonable best efforts to obtain such consent and such consent has been denied. The Board noted that the same provisions apply to a banking entity that negotiated the right under the fund documents to terminate its investment or commitments in the fund because such investment may violate applicable law or regulation (a "regulatory-out"). In effect, the Volcker Rule requires the banking entity to make use of such a regulatory-out upon the expiration of the conformance period or any applicable extension. If the termination right is subject to the consent of an unaffiliated third party, which the Board notes may include the general partner or other investors, the banking entity must then exercise its reasonable best efforts to obtain the unaffiliated third party's consent.

Applying for Requests for Extensions

The final rule requires that extension requests be submitted 180 days, not 90 days as initially proposed, prior to the expiration of its existing conformance period or extension. The earlier deadline provides the Board with more time to review the request and seek additional information and may provide the requesting entity with more notice of the Board's decision prior to the expiration of its existing conformance period or extension. The final rule added that the Board will seek to act upon the request no later than 90 days after receiving the applicant's complete record; however, failure to respond within the time period does not create an automatic approval of the extension.

The written request for an extension must set forth the reasons the Board should grant the request and the banking entity of nonbank financial company's plan to divest or conform its activity or investment. Although the final rule permits the Board to consider any facts or circumstances when considering an application, the final rule sets forth a non-exclusive list of thirteen factors the applicant must address, to the extent relevant.

Two of these enumerated factors were added in the final rule and one was modified from the proposed rule. First, the Board added whether complying with the Volcker Rule would involve or result in a material conflict of interest between the applicant and unaffiliated clients, customers or counterparties to which the applicant owes a duty. The Board added this factor, in particular, for those banking entities that serve as general partners or sponsor to a fund in which unaffiliated persons are investors. Second, the Board added the banking entity's prior efforts to comply with the Volcker Rule, including, with respect to an illiquid fund, reasonable best efforts to terminate or obtain a waiver of its contractual obligations. This factor comports with the final rule's requirement that the banking entity and its subsidiaries and affiliates have used their reasonable best efforts to obtain the necessary consents to terminate its contractual obligations. The Board also revised the factor that states it will consider the types of assets held by the fund, to further provide that it will consider whether any assets that were illiquid when acquired have since become liquid due to the expiration of statutory, regulatory or contractual restrictions on the offer, sale or transfer of the assets. In approving an extension request, the Board has the authority to impose conditions on the banking entity or nonbank financial company as it deems necessary or appropriate to further the purposes of the Volcker Rule. Because no general conditions are set forth, any conditions would be imposed on a case-by-case basis. If another federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission primarily supervises the applicant, the Board will consult with the appropriate agency during its review of the application and before imposing any conditions on the banking entity.

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If you have questions about the final rule or its impact on your business, please contact Ropes & Gray [Banking Practice](#) co-heads [Mark V. Nuccio](#) or [Alan Priest](#), or your usual contact at the firm.

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