Summary of the Federal Reserve's Final Regulations on the Conformance Period for the Volcker Rule

The Federal Reserve issued final regulations implementing the conformance period during which banking entities must bring their activities, investments and relationships into compliance with the prohibitions and restrictions in the Volcker Rule.[1] The final regulations apply to both proprietary trading and hedge fund or private equity fund activities, but most of the provisions relate to hedge funds and private equity funds, and especially to illiquid funds. They become effective on April 1, 2011.

The two most important takeaways from the final regulations are the following:

- **Conformance period applies to all activities, investments and relationships**. In response to several comments asking for clarification that the conformance period applies to both investments and activities otherwise prohibited or restricted by the Volcker Rule, including new covered transactions entered into with funds that were established before the effective date,[2] the Federal Reserve made the following clarifying statement in its release accompanying the final regulations:
  - "The general conformance period (including any extension thereof) is available for both banking entities and nonbank financial companies supervised by the Board for ***activities*** commenced prior to the Volcker Rule's effective date and applies to any ***activities, investments and relationships*** that may be prohibited or restricted by the Volcker Rule."[3] (Emphasis added.)
- **Very hard to qualify for extended transition period for illiquid funds**. Although the Federal Reserve relaxed several of the proposed eligibility conditions for the extended transition period for illiquid funds, the overall impact of the remaining conditions is still very restrictive. As a result, many banking entities may be forced to unwind their investments in funds principally invested in illiquid assets, as well as their illiquid investments in funds not principally invested in illiquid assets, at depressed or even fire sale prices. Such forced sales at depressed prices could be very disruptive to the U.S. economy, damage the capital and earnings of the U.S. banking industry, and potentially harm investors who based their investment decisions on the assumption that the banking entities would continue alongside them as sponsors and investors for the life of the funds.

General Conformance Period and Extensions

- **2-year general conformance period**. The final rules provide that, subject to potential extensions, banking entities in existence as of July 21, 2010 will have 2 years after the effective date of the Volcker Rule (the earlier of July 21, 2012 and 12 months after the issuance of final rules by the relevant agencies) in which to bring their activities and investments into compliance with the prohibitions and restrictions of the Volcker Rule.

---

[1] Federal Reserve Board, Final Rule, Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, Docket No. R-1397 (February 9, 2011) ("**Final Rule**").

[2] *See* Comment Letter on Proposed Transition Rules from the Securities Industry and Financial Markets Association, at 14-15 (Dec. 27, 2010), avail. at www.sifma.org/issues/item.aspx?id=22813.

[3] Release Accompanying Final Rule, at 6. We do not believe that the Federal Reserve's description of its exclusive authority to issue transition rules, see *id*. at 2-3, was intended to qualify or otherwise limit this general clarifying statement.

- **Up to 3 separate one-year extensions**. A banking entity would be permitted to apply for, and the Federal Reserve would have the discretion to grant, up to 3 separate extensions of the general conformance period, one year at a time.
  - **No consolidation of multiple extensions in a single three-year extension**. The Federal Reserve rejected a suggestion in the comment letters that it permit all 3 one-year extensions to be consolidated into a single 3-year extension.
- **A single extension of up to 5 additional years for illiquid funds**. A banking entity would also be permitted to apply for, and the Federal Reserve would have the discretion to grant, a single extension of up to 5 additional years to retain or make additional investments in illiquid funds, if certain conditions are satisfied.
  - **No consolidation of the extended transition period for illiquid funds with any of the other extensions**. The Federal Reserve rejected a suggestion in the comment letters that it permit the 5-year extended transition period and all 3 of the one-year extensions to be consolidated into a single 8-year extension.
- **Extensions run consecutively rather than concurrently**. Extensions run consecutively rather than concurrently, *i.e.*, a banking entity would have up to 5 years after the effective date of the Volcker Rule to conform any investment or activity, and up to 10 years to conform any investment or obligation to invest in an illiquid fund, if the conditions for particular extensions are satisfied.
- **Special conformance period**
  - **New banking entities**. Companies that become banking entities after July 21, 2010 will be entitled to a conformance period equal to the longer of the 2-year general conformance period discussed above and 2 years after the date on which they became a banking entities. They will also be eligible for both the 3 one-year extensions and the up-to-five year extension for investments in illiquid funds.

Conditions for extended transition period for illiquid funds

- **Basic eligibility conditions**. In order for a banking entity to be eligible for an extended transition period to retain or make additional investments in an illiquid fund, the following conditions must be satisfied:
  - The fund must be an illiquid fund; and
  - The investment, or provision of additional capital, must be “necessary” to fulfill a “contractual obligation” of the banking entity to retain or make additional investments that was in effect on May 1, 2010.
- **Federal Reserve discretion**. Even if a banking entity satisfies both of these conditions, the Federal Reserve has the discretion to deny the extension or limit it to less than five years. The Federal Reserve may not, however, grant more than one extension to the banking entity for illiquid funds or for more than five years.

Definition of illiquid fund

- **Very narrow definition.** The final regulations define “illiquid fund” so narrowly that there is a substantial risk that very few genuinely illiquid funds will qualify as illiquid funds, as defined by the final regulations.
  - **May be inconsistent with purpose of the extended conformance period**. The definition may be so restrictive as to be inconsistent with the purpose of the extended transition period, which is “to minimize disruption of existing investments in illiquid funds and permit banking entities to fulfill

existing obligations to illiquid funds while still steadily moving banking entities toward conformance with the prohibitions and restrictions of the Volcker Rule."[4]

- **Definition of illiquid fund**
  - **Definition**. To be an "illiquid fund," a hedge fund or private equity fund must satisfy both a snapshot and a continuous condition test.
    - **Snapshot test**. As of May 1, 2010, the fund must have been either:
      - "principally invested" in "illiquid assets"; or
      - invested to some degree[5] and "contractually committed" to principally invest in "illiquid assets".
    - **Continuous condition test**. In addition, all investments must be made pursuant to and consistent with an investment strategy to principally invest in illiquid assets.
  - **Subsequent liquidity a negative factor**. If a fund satisfied the snapshot test, but the fund's assets subsequently became more liquid, the Federal Reserve will consider that as a negative factor in exercising its discretion whether to grant or deny an extension request. One example would be previously illiquid investments in portfolio companies that become liquid assets (as defined by the final regulations) as a result of initial public offerings.
- **Definition of principally invested.** The final regulations defined "principally invested" in illiquid assets as having invested at least 75% of a fund's consolidated assets in illiquid assets or risk-mitigating hedges related to such illiquid assets.
  - **Lower threshold rejected**. The Federal Reserve rejected a suggestion in the comment letters that "principally invested" be defined at a 50% level.
  - **Most recent interim financial statements**. Although not reflected in the text of the final regulations, the Federal Reserve stated in its release accompanying the final regulations that a banking entity would be permitted to use a fund's most recent financial statements prepared in accordance with GAAP or other appropriate accounting standards as of any date between February 28, 2010 and May 1, 2010 (*e.g.*, March 31, 2010) to determine whether the fund was "principally invested in illiquid assets" as of May 1, 2010.
    - **Year-end financial statements**. The Federal Reserve did not indicate whether it would permit a banking entity to rely on a fund's financial statements as of December 31, 2009, if the fund did not prepare quarterly or other interim financial statements between year-end 2009 and May 1, 2010.
- **Definition of illiquid assets**
  - **Definition**. The final regulations defined "illiquid assets" as any real property, security, obligation, or other asset that:
    - **Not a liquid asset**. Is **<u>not</u>** a "liquid asset";
    - **Statutory or regulatory restrictions on transfer**. Cannot be offered, sold or otherwise transferred to a third party because of statutory or regulatory restrictions on transfer; or

---

[4] Release Accompanying Final Rule, at 7, citing 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[5] Release Accompanying Final Rule, at 11.

        - **Contractual restrictions on transfer**. Cannot be offered, sold or otherwise transferred for a period of 3 years or more to a third party because of contractual restrictions on transfer.
    - **Expanded definition rejected**. The Federal Reserve rejected suggestions in the comment letters that the definition of illiquid assets be expanded to include:
        - **Price-moving quantities**. Liquid assets that are held in such large quantities that they cannot be sold all at once without substantially moving market prices downward.
            - **Inconsistency**. The rejection of this proposed definition seems inconsistent with the Federal Reserve's statement in its release accompanying the final rules that certain of its alternative definitions of liquid assets "are designed to identify securities that are liquid and may be sold promptly at a price that is reasonably related to its fair value."
        - **Adverse market conditions**. Liquid assets during extreme market conditions such as those that exist during a financial panic, when otherwise liquid assets become illiquid.
            - **Inconsistency**. The rejection of this proposed definition seems inconsistent with the Federal Reserve's statement in its release accompanying the final rules that certain of its alternative definitions of liquid assets "are designed to identify securities that are liquid and may be sold promptly at a price that is reasonably related to its fair value."
            - **Discretionary factor**. Although the Federal Reserve rejected adverse market conditions as a way to define illiquid assets, it said it would consider adverse market conditions and a banking entity's previous efforts to conform its hedge fund and private equity fund activities in deciding whether or not to grant an extended conformance period for otherwise eligible illiquid funds.
        - **Discretionary authority.** Any other asset that the Federal Reserve determines, based on all the facts and circumstances, to be an illiquid asset.
    - **Examples of illiquid assets.** The Federal Reserve identified the following assets as examples of illiquid assets:
        - investments in portfolio companies;
        - investments in real estate (except through publicly traded REITs);
        - "venture capital opportunities"; and
        - investments in other hedge funds and private equity funds where "such investments do not qualify as liquid assets."
- **Definition of liquid assets**. The final regulations defined "liquid assets" as:
    - **Cash**. Cash or cash equivalents;
    - **Regulated exchange**. Any asset 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;
    - **Inter-dealer quotation system**. Any asset 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;

  - **Widely disseminated publication**. Any asset the price of which is 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;
  - **Short-term debt obligations**. Any asset 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
  - **Discretionary authority**. Any other asset that the Federal Reserve determines, based on all the facts and circumstances, to be a liquid asset.
- **Contractually committed**. A fund will be deemed to have been contractually committed to principally invest in illiquid assets as of May 1, 2010 if its organizational documents, other documents that constitute a contractual obligation of the fund, or written representations contained in the fund's offering materials distributed to potential investors provided 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.
- **Investment strategy**. A fund will be deemed to have made all of its investments pursuant to an investment strategy to principally invest in illiquid assets if it:
  - Markets or holds itself out to investors as intending to principally invest in illiquid assets; or
  - Has a documented policy of principally investing in illiquid assets.

Necessary to fulfill a contractual obligation as of May 1, 2010

- **Very restrictive condition.** As noted above, the first condition for a banking entity to be eligible for an extended conformance period to retain or make additional investments in a fund is that the fund fall within the very narrow definition of an "illiquid fund" in the final regulations. The second condition is that the retention or making of the investment be "necessary" to fulfill a "contractual obligation" that was in effect on May 1, 2010. This second condition is defined so restrictively in the final regulations that there is a substantial risk that few investments in the already restricted number of illiquid funds that will fall within the regulatory definition of that term may qualify for an extended transition period.
  - **May be inconsistent with purpose of the extended conformance period**. This condition, as defined in the final regulations, may be so difficult to satisfy as to be inconsistent with the purpose of the extended transition period, which is "to minimize disruption of existing investments in illiquid funds and permit banking entities to fulfill existing obligations to illiquid funds while still steadily moving banking entities toward conformance with the prohibitions and restrictions of the Volcker Rule."[6]
- **Contractual obligations**
  - **To retain an investment**. Subject to the "necessary" conditions below, a banking entity will be deemed to have a contractual obligation to take or retain an ownership interest in a fund if the banking entity is ***prohibited*** from redeeming all of its ownership interests in the fund and from selling or otherwise transferring all such ownership interests to a third party:

[6] Release Accompanying Final Rule, at 7, citing 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Merkley).

- under the terms of its ownership interest or other contractual arrangements with the fund or unaffiliated investors in the fund; or
- 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.

- **To provide additional capital**. Subject to the "necessary" conditions below, a banking entity will be deemed to have a contractual obligation to provide additional capital to an illiquid fund if the banking entity is ***required*** to provide additional capital to the fund:
  - under the terms of its ownership interest or other contractual arrangements with the fund or unaffiliated investors in the fund; or
  - 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.

- **Necessary conditions**
  - **Standard**. A banking entity will be deemed to have a contractual obligation to retain an investment in or provide additional capital to an illiquid fund, ***only if***:
    - **No unilateral termination power**. The obligation may not be terminated by the banking entity under the terms of its agreement with the fund; and
    - **Consent denied after reasonable best efforts to obtain it**. In the case of an obligation that may be terminated with the consent of other persons, *e.g.*, the fund's general partner or other investors, the banking entity has used its reasonable best efforts to obtain such consent and such consent has been denied.
  - **Depends on the terms of the contractual obligations.** The Federal Reserve observed that whether a banking entity has the unilateral right to terminate its contractual obligations and withdraw its investments or refuse to make additional capital contributions depends on the specific terms of its contractual obligations with the relevant illiquid fund.
    - **Excuse provisions or regulatory outs**. Thus, if the enactment of the Volcker Rule, the issuance of the final regulations or some other event would be a regulatory or other excuse event giving a banking entity the unilateral right to terminate its contractual obligation to retain an investment in or provide additional capital to an illiquid fund, the banking entity would be required to exercise that right and the necessary conditions would not be satisfied.
    - **Unreasonable demands in return for consent.** In its release accompanying the final regulations, the Federal Reserve said that in determining whether a banking entity used its reasonable best efforts to obtain any necessary consents, it would take into consideration whether "an unaffiliated general partner or other investors denied the request due to the failure of the banking entity to agree to unreasonable demands by the general partner or investors."

Automatic termination of extended transition period

- **Automatic termination.** If after the Federal Reserve grants an extended transition period, the acquisition or retention of an ownership interest or the provision of additional capital is no longer necessary to fulfill a contractual obligation that was in effect as of May 1, 2011, the extended transition period terminates automatically and immediately.
  - **No grace period**. The Federal Reserve rejected a suggestion in the comment letters that the final rule provide a 6-month "grace period" to divest or conform any nonconforming investments in illiquid funds if the fulfillment of a contractual obligation is no longer necessary. It may not be

possible to anticipate this event or to divest any related investment instantly, upon the automatic termination of the extended transition period.

Process and Factors for Granting of Extensions

- **Process for applying for an extension** (either a one-year general extension or an extended transition period for illiquid funds).
  - **Separate applications**. The banking entity must apply separately for each extension.
  - **Timing for submission**. Applications must be submitted at least **180** days prior to the expiration of the 2-year general transition period or any subsequent extension period.
    - The Federal Reserve also encouraged firms to submit their extension requests as early as possible. If additional requests are contemplated as being necessary after a permissible extension has been granted, a banking entity or nonbank financial company supervised by the Board may submit an additional request after the first day of the newly-extended period, and the Federal Reserve would consider each request submitted in accordance with the procedures contained in the final rule."
  - **Content**. Applications must be in writing and provide the reasons why the banking entity believes the extension should be granted, including information addressing the factors discussed below and providing a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment for which the extension is sought.
  - **Processing time.** The final regulations provide 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 with respect to such request."
    - **Estimated time to prepare an extension request**. In its Paperwork Reduction Act analysis, the Federal Reserve estimated that it will only take 3 hours for a banking entity to prepare an extension request with a complete record.
  - **Factors**. The Federal Reserve will consider applications for extensions in light of "all the facts and circumstances related to the activity, investment, or fund, including, to the extent relevant":

    (i) whether the activity or investment involves or results in material conflict of interest / material exposure to high-risk assets or trading strategies / poses a threat to safety and soundness or U.S financial stability

    (ii) market conditions

    (iii) nature of activity or investment

    (iv) date contractual obligation to invest in a fund was incurred / expires

    (v) contractual terms governing the banking entity's investment in fund

    (vi) degree of control held by the banking entity over investment decisions of the fund

    (vii) types of assets held by a 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) expected wind-up / liquidation date of fund

    (ix) total exposure of the banking entity to activity or investment and the risks that disposing of or maintaining it may pose to the banking entity or financial stability

(x) cost to banking entity of divesting or disposing of the activity or investment within the applicable period

(xi) whether 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 the Board believes appropriate.

- **Consultation with other agencies for certain banking entities.** Where a banking entity is primarily supervised by another agency, the Board will consult with the other agency before approving an extension.
- **Conditions on extensions.** The Federal Reserve may impose any conditions on an extension that it determines to be necessary or appropriate to protect the safety and soundness of the banking entity or U.S. financial stability, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of the Volcker Rule. The Federal Reserve will consult with other agencies prior to imposing such conditions with respect to a banking entity primarily supervised by such other agency.

Systemically Important Nonbank Financial Companies

- **Transition period for systemically important nonbank financial companies**. Systemically important nonbank financial companies designated as such after the Volcker Rule's effective date will have a 2-year transition period plus eligibility for 3 one-year extensions.
    - The same application deadline, application requirements, timing of the Board's grant of a request following application, and possibility of conditions on investments or activities during any extensions granted apply to systemically important nonbank financial companies as apply to banking entities.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Robert L.D. Colby	202 962 7121	robert.colby@davispolk.com
Luigi L. De Ghenghi	212 450 4296	luigi.deghenghi@davispolk.com
John L. Douglas	212 450 4145	john.douglas@davispolk.com
Yukako Kawata	212 450 4896	yukako.kawata@davispolk.com
Arthur S. Long	212 450 4742	arthur.long@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Margaret E. Tahyar	212 450 4379	margaret.tahyar@davispolk.com
Thomas J. Clarke	212 450 3011	thomas.clarke@davispolk.com
Alexander Young-Anglim	212 450 4809	alexander.young-anglim@davispolk.com