The Volcker Rule Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act

July 14, 2010

On June 30, 2010, the U.S. House of Representatives passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which is widely expected to be passed by the U.S. Senate and signed into law by President Obama. Among the most consequential features of the Dodd-Frank Act is the so-called "Volcker Rule". Named after Paul Volcker, the former chairman of the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the current head of the President's Economic Recovery Advisory Board, the Volcker Rule will, subject to limited exceptions, ban banking organizations from engaging in proprietary trading and sponsoring or investing in hedge funds and private equity funds. Our July 6, 2010 memorandum, "U.S. Congress Nears Completion of Landmark Financial Services Reform Legislation", provided an overview of the Dodd-Frank Act. This memorandum provides additional detail on the Volcker Rule.

A. THE BASIC PROHIBITION

Under the Dodd-Frank Act, a new Section 13 is added to the Bank Holding Company Act (the "BHC Act") to provide that "a banking entity shall not (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."

1. Key Terms Contained in the Prohibition

(i) "Banking Entity"

A "banking entity" is defined to include (i) an insured depository institution (*i.e.*, banks, thrifts, credit card banks, industrial banks, but excluding limited purpose trust companies that satisfy certain requirements), (ii) any company that controls an insured depository institution (*i.e.*, bank holding companies, savings and loan holding companies, and any company that directly or indirectly controls a nonbank bank, such as an industrial loan company or a credit card bank, including any private equity and industrial firms, such as BMW and General Electric, that control industrial loan companies or federal savings banks); (iii) any company that is treated as a bank holding company under the International Banking Act (*i.e.*, a foreign bank that has a U.S. branch, agency or commercial lending subsidiary, and any company that directly or indirectly controls such a bank); and (iv) any "affiliate" or subsidiary"[1] of any of these entities.

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1 For purposes of the BHC Act, a "subsidiary" is any company that is controlled by another company, and "control" conclusively exists when 25% or more of the voting shares of a company are held by another company (although control can also be found at lower ownership levels).

As discussed below, a nonbank financial company that becomes subject to the supervision of the Federal Reserve by virtue of a determination by the Financial Stability Oversight Council that such company is systemically important is not a "banking entity" under the Volcker Rule.

(ii) "Hedge Fund or Private Equity Fund"

The term "hedge fund or private equity fund" is defined in Section 13 to mean an issuer that would be an investment company but for the exemptions contained in Section 3(c)(1) (funds with 100 or fewer beneficial owners) or Section 3(c)(7) (funds all the holders of which are "qualified purchasers") of the Investment Company Act of 1940 (the "ICA") "or such similar funds as the appropriate Federal banking agencies, the [SEC] and the [CFTC] may determine" in the implementation of the Volcker Rule regulations that such regulators are required to issue pursuant to Section 13(b)(2) (referred to in this memorandum as the "Section 13(b)(2) Regulations").

(A) "Similar Funds"

As a general matter, private funds that are exempt from the ICA based on exemptions other than those provided by Sections 3(c)(1) and 3(c)(7) of the ICA are not subject to the restrictions of Section 13 of the BHC Act. For example, funds exempt under ICA Rule 3a-1 (issuers that primarily own stock of their subsidiaries), Section 6(b) of the ICA (employees' securities companies) and Section 3(c)(5)(C) of the ICA (funds that hold mortgages) are not covered. However, in their Section 13(b)(2) Regulations, the regulators have the authority to extend the restrictions of Section 13 to relationships of banking entities with "similar funds." The regulators are required to coordinate with each other and seek consistency in their Section 13(b)(2) Regulations. However, the key role in defining what constitutes a "similar fund" is likely to be played by the Federal Reserve because funds that will become subject to the restrictions of Section 13 will typically be directly or indirectly controlled by a bank holding company and the SEC would likely not have jurisdiction over such funds under Section 13 because its responsibility under that section for investment companies is limited to those that are required to be registered under the ICA.

As discussed below, in adopting their Section 13(b)(2) Regulations, the regulators are to be guided by a study to be conducted by the Financial Stability Oversight Council, which is in turn to be guided by criteria specified in the Dodd-Frank Act that may be summarized as follows: safety and soundness of banks; fair competition between those affiliated with banks and those not; and reduction of conflicts of interests between banking entities and their customers. These criteria ultimately should guide what other funds are treated as "similar funds."

Note that, if more than 25% of the voting shares of a company are held by a banking entity as a merchant banking investment, then the portfolio company is itself a "banking entity" for purposes of this section. An "affiliate" is any company that controls, is controlled by, or is under common control with, another company.

A managed account for a banking entity that invests in lock step with a fund that is a "hedge fund or private equity fund" might be found to be a similar fund or might be proscribed by the regulators under their separate authority (discussed below) to prevent evasions of Section 13.

(B) Private Funds that are Bank Holding Companies

There are a number of private equity funds that are engaged in the business of acquiring controlling interests in banking entities. Typically, the fund is controlled by an entity, which is the general partner or managing member of the fund, and the fund acquires controlling interests in banks, thrifts and their holding companies. The fund relies on Section 3(c)(1) or 3(c)(7) of the ICA. The controlling entity in the structure is a "banking entity" because it is a bank holding company and under Section 13 that controlling entity will be permitted to sponsor the fund, including by acting as its general partner, only if it satisfies the terms of the exemption for private funds sponsored by banking entities (discussed below). That exemption has a number of limitations, including a requirement that the controlling banking entity not own more than 3% of the fund and that its aggregate investments in such funds not exceed 3% of its capital.

(iii) "Sponsor"

To "sponsor" is defined for purposes of Section 13 to mean: (i) "to serve as a general partner, managing member, or trustee of a fund," (ii) "in any manner to select or to control . . . a majority of the directors, trustees, or management of a fund," or (iii) "to share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name."

(iv) "Proprietary Trading"

The term "proprietary trading" is defined for purposes of Section 13 to mean "engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell . . . any security, any derivative, any contract of sale of a commodity for future delivery, . . . or any other security or financial instrument" that the regulators may, under their Section 13(b)(2) Regulations, determine.

The term "trading account" is defined to mean "any account used for acquiring or taking positions in [such] securities and instruments . . . principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) and any other accounts" that the regulators may, under their Section 13(b)(2) Regulations, determine. Although Section 13 does not include definitions of "near term" or "short-term", it seems clear that proprietary trading should not include merchant banking investments by banking entities where the intention is to hold the investment for a year or more.

A number of bank holding companies have obtained authority to trade commodities and commodity derivatives. The definition of "proprietary trading" covers certain commodity derivatives, but it is much less restrictive than the definition of that term in the bill that passed the Senate in May, which included all "commodities".

2. Rule of Construction for Sale or Securitization of Loans

The Dodd-Frank Act explicitly provides that the restrictions in Section 13 are not to be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Federal Reserve to sell or securitize loans. The Section 13(b)(2) Regulations will presumably exempt vehicles established for that purpose.

B. EXCLUSIONS FROM THE PROHIBITION

1. Regulatory Discretion to Permit Otherwise Prohibited Activities

The language of Section 13(a)(1), which contains the basic prohibition, leaves out the language in the bill that passed the Senate in May, which made the prohibition "subject to the recommendations and modifications" of the Financial Stability Oversight Council. However, the federal banking agencies, the SEC and the CFTC, are required to consider the Financial Stability Oversight Council's recommendations in writing their Section 13(b)(2) Regulations and the regulators are expressly authorized to permit "activities" (which presumably would include both proprietary trading and private fund activities) that they determine by rule "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."

2. Expressly Permissible Types of Proprietary Trading

The following activities are exempt from the Volcker Rule's basic prohibition on proprietary trading by banking entities:

- Purchases and sales of securities issued by the U.S. government and certain government-sponsored enterprises.

- Purchases and sales of securities in connection with underwriting and market-making activities to the extent such activities "are designed not to exceed the reasonably expected near term demands of clients, customers or counterparties."

- "Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity that are designed to reduce the specific risks to a banking entity in connection with and related to such positions, contracts, or other holdings."

- Purchases and sales on behalf of customers.

- Investments by insurance companies that are banking entities for the general account of the insurance company (discussed further below).

- Proprietary trading by foreign banking organizations in reliance on Section 4(c)(9) or Section 4(c)(13) of the BHC Act (discussed further below).

Insurance company investments are subject to the Section 13 prohibition in the first instance only if the insurance company is a "banking entity" because it controls or is under common control with either an insured depository institution or a foreign bank that is treated as a bank holding company.

A number of insurance companies own limited purpose trust companies. As long as such trust companies fit within the limited purpose trust company exemption from the definition of "banking entity" in the Volcker Rule, then ownership of such trust companies will not cause the insurance company or its affiliates to be subject to the Volcker Rule. Also, a number of insurance companies acquired thrift institutions prior to 1999 and, prior to the Dodd-Frank Act, were permitted to own such thrift institutions without the insurance company or its affiliates (other than the thrift) being subject to activity restrictions or capital requirements. Under the Dodd-Frank Act, such insurance companies will be subject to capital requirements and, under some circumstances, to activity restrictions, including the application of Section 13. We expect that some insurance companies may evaluate whether divestiture of the thrift institution is preferable to compliance with the new restrictions.

The Section 13 prohibition does not extend to investments by an insurance company for its general account in accordance with state insurance laws unless the Federal banking regulators jointly determine that such laws are insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States. This limitation on the application of the Volcker Rule to insurance companies, however, does not serve to expand otherwise applicable limitations on the activities of insurance companies that are subject to the BHC Act. In particular, this exemption from the prohibition of the Volcker Rule does not appear to affect the Federal Reserve's interpretation of the insurance company merchant banking provisions in the BHC Act. To date, the Federal Reserve has interpreted the ability of insurance companies that are financial holding companies to make merchant banking investments in real estate in the same restrictive manner in which the Federal Reserve has interpreted the provision for other financial holding companies.

The Volcker Rule also permits proprietary trading conducted pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act by certain foreign banking organizations. This exemption will be available for proprietary trading activities of qualifying foreign banking organizations so long as they do not engage in such activities in the United States. Section 4(c)(9) and Section 4(c)(13) are implemented by the Federal Reserve under Regulation K. Regulation K defines the term to "engage in an activity in the United States" to mean that the activity may not be conducted through an office (other than a representative office) or subsidiary that is located in the United States. However, in the interest of competitive equality with U.S. banking organizations, Regulation K has sometimes been interpreted by Federal Reserve staff to include transactions with U.S. persons that are not conducted through an office or subsidiary in the United States.

3. <u>Expressly Permitted Sponsorships of and Investments in Private Funds</u>

The prohibition against a banking entity sponsoring or investing in private funds does not apply in the following circumstances:

- *Small business investment company investments.*

- *Sponsorship of and investments in hedge and private equity funds pursuant to Section 4(c)(9) or 4(c)(13) of the BHC Act by a banking entity that is not directly or indirectly controlled by a banking entity that is organized under U.S. law solely outside of the U.S. and provided that no ownership interest in such fund is offered or sold to a resident of the United States.*

- *Private equity and hedge funds that are sponsored by the banking entity itself, subject to the following conditions:*

    - "[T]he fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity."

      The inability of a banking entity to offer interests in such a fund to persons that are not already trust, fiduciary or investment advisory clients of the banking entity, if interpreted narrowly, will significantly limit the value of this exemption.

    - The banking entity's investment in the fund is for the purpose of making a *de minimis* investment or providing seed money and

        - Not later than 1 year after establishment of the fund (which the Federal Reserve may extend for an additional 2 years if consistent with safety and soundness and in the public interest) the investment is reduced to 3% or less of the fund's total ownership interests;

        - The investment is not material to the banking entity (as defined by the regulators in their Section 13(b)(2) Regulations) and in aggregate all such investments do not exceed 3% of the tier 1 capital of the banking entity; and

        - The aggregate amount of such investments is deducted from both the assets and the tangible equity of the banking entity "and the amount of the deduction shall increase commensurate with the leverage of the hedge fund or the private equity fund."[2]

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[2] It is unclear what is meant by "commensurate" in the quoted language. A requirement that all leverage of such a fund be deducted from the capital of the investing banking entity would effectively prohibit banking entities from investing in significantly leveraged funds.

It is important to observe that this authority of a banking entity to make *de minimis* investments in private equity and hedge funds is limited to funds that are sponsored by the banking entity and that meet all of the requirements for such sponsored funds. This provision does not authorize *de minimis* investments in third party funds.

- No director or employee of the banking entity—other than those that are "directly engaged in providing investment advisory or other services" to the fund—takes or retains an ownership interest in the fund.

  This provision may be extended by the regulators to restrict employee investment vehicles for employees of a banking entity (such as employees' securities companies under Section 6(b) of the ICA) from investing side-by-side with a fund sponsored by the same banking entity.

- The banking entity does not directly or indirectly guarantee the obligations or performance of the fund or share its name or a variation of its name with the fund, and informs investors that any fund losses will be borne by investors.

- The banking entity complies with the affiliate transaction restrictions discussed below under "Restrictions on Transactions with Private Funds".

- *The regulators may also exempt from the Volcker Rule "[s]uch other "activity" as the appropriate Federal banking agencies, the [SEC] and the [CFTC] determine, by rule . . . would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."*

  In addition to those expressly permitted activities, the regulators are given the discretion to exempt from the ban on proprietary trading and on investing or sponsoring private funds activities specifically determined to promote and protect both the safety and soundness of the institution engaging in it and U.S. financial stability. However, it is unlikely that the regulators will use that authority aggressively, at least initially. Also, as discussed below, the regulators are not allowed to deem an activity permissible if it would have certain adverse effects, such as creating a material conflict of interest, so it is possible that rather than use this discretion to expand the list of permissible activities, the regulators may impose additional restrictions on activities that the statute expressly permits.

- *There is no express exemption for investments in private funds by insurance companies.*

  Insurance companies that are banking entities are generally subject to Section 13. There is an exemption, discussed above, for investments by such insurance companies for their general account in securities and other instruments that are described in the definition of "proprietary trading". There is no similar exemption for insurance company investments in hedge funds and private equity funds. (In contrast, there are separate exemptions under Section Sections 4(c)(9) and 4(c)(13) of the BHC Act for qualifying foreign banking organizations with respect to their proprietary trading and their investments in hedge funds and private equity funds). On the face of the statute, insurance companies that are banking entities are subject to the same restrictions on investing in and sponsoring private funds as are bank holding companies. It is possible that the Financial Stability Oversight Council, which in the study it is to conduct (discussed below) that is to inform the Section 13(b)(2) Regulations is required to "appropriately accommodate the business of insurance within an insurance company," will conclude that the absence of an exemption for insurance company investments in funds was an oversight and will recommend that such an exemption be provided.

4. Limitations on Exclusions and Anti-Evasion

Notwithstanding the statute's designation of an activity as generally permissible, an activity will not be permitted if it would involve a material conflict of interest (to be defined by the regulators in their Section 13(b)(2) Regulations) between the banking entity and its clients, customers or counterparties; result in a material exposure of the banking entity to high-risk assets or trading strategies (as defined by the regulators in their Section 13(b)(2) Regulations); pose a threat to the safety and soundness of the banking entity; or pose a threat to the financial stability of the United States. The regulators in their Section 13(b)(2) Regulations may also impose additional capital requirements and quantitative limitations (including diversification requirements) regarding permitted activities if appropriate to protect the safety and soundness of the banking entities engaged in them.

Whenever a regulatory agency has reasonable cause to believe that a banking entity or a nonbank financial company that is supervised by the Federal Reserve has made an investment or engaged in an activity "in a manner that functions as an evasion" of Section 13, the regulatory agency may order the banking entity or company to terminate the activity and, if applicable, divest the investment.

5. Restrictions on Transactions with Private Funds

(i) Prohibition on "Covered Transactions"

(A) Section 23A of the Federal Reserve Act

Section 23A is intended to protect an insured depository institution (and, indirectly, the Deposit Insurance Fund) from transactions with its parent and cross-stream affiliates that are disadvantageous to the insured depository institution. Section 23A applies to specified "covered transactions," including loans, extensions of credit, purchases of assets and affiliate securities, and issuance of guarantees by the insured depository institution. These transactions are subject to quantitative restrictions (in aggregate, such transactions with all affiliates may not exceed 20% of the capital of the depository institution) and, in the case of loans and other extensions of credit, must be fully collateralized with U.S. government securities or, if other collateral is used, must be collateralized up to 140% of the amount of the loan.

(B) The Volcker Rule Prohibition on Covered Transactions

Section 13 prohibits a banking entity, and any affiliate of the banking entity, from entering into any covered transaction with a hedge fund or a private equity fund for which the banking entity serves as investment advisor or that it sponsors pursuant to the exemption discussed above. This is a prohibition on entering into "covered transactions," which is much more restrictive than subjecting such transactions to the quantitative and other restrictions of Section 23A. (The prohibition presumably will not be read to prohibit otherwise permitted investments in up to 3% of a sponsored fund, which, as an investment in a security issued by an affiliate, comes within the definition of "covered transaction.")

In contrast to the language of the "Levin Amendment," the proposal offered by Senators Carl Levin and Jeff Merkley during the Senate's initial consideration of the Volcker Rule in May and which arguably applied only to the parent bank holding company and the affiliate that served as investment adviser, the Section 13 prohibition on covered transactions applies to the banking entity and all of its "affiliates."

Section 13 does not clearly prohibit transactions between the banking entity and portfolio companies controlled by the private fund. The prohibition by its terms applies to transactions by a banking entity with "the fund, or with any other hedge fund or private equity fund that is controlled by such fund." If the intent were to cover portfolio companies, the language could have been written to say "the fund, or with any company that is controlled by such fund." Also, the prohibition on covered transactions specifically mentions affiliates of the banking entity in several places but not affiliates of the private funds, which suggests that it was not intended to cover transactions between a banking entity, on the one hand, and portfolio companies of private funds that are advised or sponsored by the banking entity, on the other. While it could be argued that such transactions give rise to the same conflicts of interest that the Volcker Rule was intended to address, it is not clear that such conflicts are as pronounced where the banking entity has no or a nominal investment in the fund.

There is an exception from the prohibition on covered transactions for "any prime brokerage transaction" with a hedge fund or private equity fund advised or sponsored by a banking entity if the Federal Reserve determines that the transaction is consistent with the safe and sound operation of the banking entity or a nonbank financial company that is supervised by the Federal Reserve. Such transactions are not subject to the covered transaction ban, but the regulators have the authority to impose restrictions on them, as discussed below. Exemption of prime brokerage transactions from the covered transactions ban does not exempt them from the requirement that they satisfy Section 23B (discussed below).

(ii) Imposition of Section 23B Restrictions

Section 23B of the Federal Reserve Act imposes a qualitative restriction on transactions between an insured depository institution and its affiliates, generally requiring that such transactions be on arm's length or better terms from the perspective of the insured depository institution. Section 23B applies not only to "covered transactions," but also to any transaction in which an affiliate is receiving a fee for providing services; a transaction involving the payment of money or the furnishing of services to an affiliate; a transaction involving the sale of assets or securities to an affiliate; and any transaction with a third party in which an affiliate has a financial interest.

Section 13 provides that any transaction between a banking entity and a hedge fund or a private equity fund for which the banking entity serves as investment advisor or that it sponsors pursuant to the exemption discussed above shall be subject to Section 23B as if the banking entity were an insured depository institution and "such hedge fund or private equity fund were an affiliate thereof."

Unlike the prohibition on "covered transactions", which applies to transactions between a banking entity and all of its affiliates on the one hand and a private fund that is sponsored or advised by the banking entity, the Section 23B restriction, by its terms, applies only to transactions between the private fund and the banking entity that is actually serving as investment advisor or sponsor.

6. Treatment of Nonbank Financial Companies Supervised by the Federal Reserve

A nonbank financial company that the Financial Stability Oversight Council has determined is systemically important enough to require supervision by the Federal Reserve System is not a "banking entity" for purposes of the prohibition. However, Section 13(a)(2) provides that, under the regulations adopted by the Federal Reserve to implement this section, such companies "shall be subject . . . to additional capital requirements for and additional quantitative limits" with regard to their proprietary trading and private fund activities (other than those that are permitted for banking entities).

While nonbank financial companies that are supervised by the Federal Reserve are not subject to the ban on covered transactions with private funds that they advise or in which they invest or to Section 23B with respect to those transactions, the Section 13(b)(2) Regulations are required to include "additional capital requirements or other restrictions" on such companies to address "the risks to and conflicts of interest" that the ban on covered transactions is intended to address in the case of banking entities.

C. IMPLEMENTATION OF THE VOLCKER RULE

1. Study by the Financial Stability Oversight Council

The Financial Stability Oversight Council is required to study and issue recommendations regarding Section 13 within 6 months of enactment. The Dodd-Frank Act incorporates a variety of matters that the Financial Stability Oversight Council is to consider (including conflicts of interest, financial stability, and the cost and availability of financial services) in issuing such recommendations. However, the listed considerations are probably less significant than the fact that, in contrast to the bill that passed the Senate last May, the Financial Stability Oversight Council is not given explicit authority to modify the prohibitions.

2. Section 13(b)(2) Regulations

Within 9 months of completion of the Financial Stability Oversight Council's study, the federal banking, securities and commodities regulators are to issue regulations implementing the Section 13 provisions, and such regulations are to become effective not later than 2 years from the date of enactment of the Dodd-Frank Act. As noted previously, although a number of regulators will be issuing such rules, it appears that the Federal Reserve will have the lead role because most banking organizations engage in sponsorship of and investment in private funds and investing (as opposed to trading) in non-government securities through bank holding company entities that are not insured depository institutions.

3. Transition Rules

(i) The Effective Date

The Volcker Rule becomes effective the earlier of (i) 12 months after the Section 13(b)(2) Regulations are issued or (ii) 2 years from enactment. Because it seems very unlikely that such regulations will be issued three months prior to the date when they are required to be issued (15 months after enactment), in all likelihood the Volcker Rule will become effective two years after enactment. This section of the memorandum assumes that the legislation will be enacted in 2010 and that the Volcker Rule will become effective two years from enactment.

(ii) The Conformance Period

(A) The General Rule: 4 Years (2014)

The general rule is that Section 13 takes effect (*i.e.*, a subject entity needs to conform by no longer sponsoring or making or retaining investments in private funds or engaging in proprietary trading) within (presumably the later of) 2 years from the effective date of the rules (*i.e.*, not more than 4 years from enactment) and the date on which the entity or company became a bank holding company or nonbank financial company supervised by the Federal Reserve. This conformance period may be extended under certain circumstances, as described below.

Notwithstanding this conformance period, on the date on which the "Commission"[3] issues rules implementing Section 13 (which will be not later than 15 months after enactment), the Federal banking agencies, the SEC and the CFTC shall issue rules "to impose additional capital requirements, and any other restrictions, as appropriate, on any equity partnership, or

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[3] The "Commission" is defined in the statute to refer to the SEC or the CFTC, depending on the context. It may be that this provision should have referred to the Federal Reserve rather than the "Commission," but, if so, this appears to be a harmless error.

ownership interest in or sponsorship of a hedge fund or private equity fund by a banking entity", which restrictions will apply during the conformance period.

(B) Federal Reserve Extensions: Up to 7 Years (2017)

The Board, by rule or order, may extend the conformance period, one year at a time, for up to 3 additional years (*i.e.*, 7 years from enactment) if it determines such extensions to be "consistent with the purposes of this section and not detrimental to the public interest.

(C) Federal Reserve Extensions for Illiquid Funds: Up to 12 Years (2022)

(1) Definition of "Illiquid Fund"

Section 13 defines an "illiquid fund" to be a hedge fund or private equity fund that as of May 1, 2010, was principally invested in or was invested in and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments. In issuing regulations to implement this provision, the Federal Reserve is to consider the fund's contractual obligations and the ability of the fund to divest assets, and any other factors the Federal Reserve determines are appropriate.

For purposes of this provision, "hedge fund" includes any fund that comes within the general definition of "hedge fund and private equity fund," while "private equity fund" excludes "private equity funds" as that term is used in Section 203(m) of the Investment Advisers Act. The cited section, which was added by the Dodd-Frank Act and exempts from registration investment advisers with less than $150 million in assets under management, does not, in fact, use the term "private equity fund". This drafting glitch does not appear to have any practical implications.

(2) The "Illiquid Fund" Extension

The Federal Reserve is authorized to grant additional extensions upon the application of a banking entity to take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010." Such extensions permit additional investments, not just retention of an interest, to fulfill a contractual obligation.

Instead of multiple one-year extensions, this provision contemplates a single five-year extension. There seems to be no reason that this extension could not be added on to the 3 one-year extensions, but it is subject to the limitation that the extension is required to satisfy a contractual obligation in effect on May 1, 2010.

The illiquid fund provisions state that divestiture is required on the earlier of the date that "the contractual obligation to invest" in the illiquid fund terminates and the date on which any illiquid fund extension granted by the Federal Reserve expires. This language seems to be inconsistent with the remainder of the conformance provisions, under which any extension beyond the initial two-year conformance period (*i.e.*, 4 years from enactment) are within the Federal Reserve's discretion.

(D) Federal Reserve Regulations Regarding the Conformance Period

Although the Section 13(b)(2) Regulations are not required to be issued until 15 months after enactment of the Dodd-Frank Act, the Federal Reserve is required to issue rules regarding the conformance period within 6 months of enactment. The issuance of the conformance regulations relatively early in the transition period should help banking entities plan for the transition by providing some guidance on the question whether they are likely to qualify for extensions from the Federal Reserve to bring their activities into conformance.

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For more information about the recent legislation and its potential implications, please contact a member of our Private Funds or Financial Institutions groups.

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