SIMPSON THACHER

MEMORANDUM

Federal Reserve Issues Proposed Transition Rules for "Volcker Rule" Compliance

November 19, 2010

Four months after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") on July 21, 2010,[1] the Board of Governors of the Federal Reserve System (the "Federal Reserve") has issued proposed transition rules for banking entities and certain other companies that will be subject to the Dodd-Frank Act's restrictions on proprietary trading and sponsoring or investing in hedge funds and private equity funds.[2] These restrictions (commonly referred to as the "Volcker Rule") do not become effective until the earlier of July 21, 2012 and one year after the issuance of final Volcker Rule implementing regulations (which will cover matters other than the transition process). Because the various regulatory agencies are not required to issue final implementing regulations until October 21, 2011, we expect that the effective date of the Volcker Rule will be July 21, 2012. In that case, banking entities will not have to achieve conformance with the Volcker Rule until July 21, 2014 (or later, depending on the availability of possible extensions). While banking entities are expected to use the 2012-2014 conformance period to wind down, divest or take other actions to conform their activities, investments and relationships to the requirements of the Volcker Rule, they are not prohibited from engaging in proprietary trading and private fund activities during that period.

Proposed rules relating to this conformance period, and possible extensions, were released by the Federal Reserve on November 17, 2010. The proposed rules are subject to a 45-day public comment period, which will commence once the proposal is published in the Federal Register. The proposed rules are intended to address only the transition process and do not address other substantive Volcker Rule questions (such as defining what is meant by "proprietary trading") that will be the subject of an interagency rulemaking process required to be completed by October 21, 2011. The Federal Reserve is required under the Volcker Rule to issue final rules regarding the transition process by January 21, 2011, which is the same deadline for the Financial Stability Oversight Council's much-awaited study and recommendations on the Volcker Rule's implementation.

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[1] For general background regarding the Dodd-Frank Act, please see our memorandum, titled "U.S. Congress Nears Completion of Landmark Financial Services Reform Legislation," dated July 6, 2010, *available at* http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=75&focusID=1013.

[2] 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 (i) engage in "proprietary trading" or (ii) "acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund." For background regarding the Volcker Rule, please see our memorandum, titled "The Volcker Rule Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act," dated July 14, 2010, *available at* http://www.simpsonthacher.com/siteContent.cfm?contentID=4&itemID=80&focusID=1014.

The proposed transition rules[3] provide a general two-year conformance period (expected to last until July 21, 2014) for banking entities engaged in prohibited proprietary trading or private fund activities. The rules provide a separate conformance period for nonbank financial companies supervised by the Federal Reserve—none of which have yet been designated—that will provide a two-year conformance period (with potential extensions) starting from the date of such designation. For banking entities, the proposed rules also implement a special extension period applicable to certain illiquid funds, as discussed below.

The proposed transition rules address only one aspect of the Volcker Rule—the timing issues related to compliance. The proposed rules were not intended to address other important aspects of the Volcker Rule that will be crucial to understanding the full implications of the Volcker Rule are not addressed. The proposed transition rules do not, for example, clarify the statutory definitions of certain terms, such as "hedge fund" and "private equity fund" (or "such similar funds" that may be subsumed by these terms), "banking entity" or "sponsor." Also, these proposed transition rules do not address the various additional capital requirements and other restrictions that may be applied under the Volcker Rule, including additional capital that may be required of banking entities that invest in or sponsor private funds during the conformance period. And they do not implement any of the affiliate transaction restrictions on relationships with private funds.

A. The General Conformance Period for Banking Entities: A Two-Year Minimum

As a way of allowing the markets and firms to adjust to the Volcker Rule, a general two-year conformance period is provided under the Dodd-Frank Act.[4] The two-year period commences upon the earlier of (i) two years from enactment (*i.e.*, July 21, 2012) or (ii) one year from the issuance of final implementing regulations. Assuming the period commences on the second anniversary of the Dodd-Frank Act, which we believe is the most likely outcome, then the two-year general conformance period will run until July 21, 2014. During this time, banking entities may continue to engage in proprietary trading or private fund activities, but will have to divest or conform such positions or activities by July 21, 2014, absent an extension.

The proposed transition rules (and the supplementary information accompanying the proposed rules) clarify how new banking entities should be treated under this timing. For a company that was not a banking entity (or a subsidiary or affiliate of a banking entity) at the time the Dodd-Frank Act was enacted but becomes a banking entity (or a subsidiary or affiliate of such banking entity) thereafter, then the conformance period would commence on the later of (i) the date on which the Volcker Rule's prohibitions would otherwise become effective to banking entities that were in existence at the time the Dodd-Frank Act was enacted or (ii) two years after the date on which such company first becomes a banking entity (or a subsidiary or affiliate of such banking entity).

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[3] The proposed transition rules will be made part of a new Subpart K of the Federal Reserve's Regulation Y (12 C.F.R. §§ 225.180 - 225.182).

[4] *See* Section 13(c)(2) of the BHC Act (as amended by Section 619 of the Dodd-Frank Act); 12 U.S.C. § 1851(c)(2).

B. Potential Extensions to the General Conformance Period

1. Potential One-Year Extensions to the Conformance Period: A Five-Year Maximum

Once the general conformance period has expired, the Federal Reserve may, upon a request by a banking entity, grant up to three additional one-year extension periods, if, in the Federal Reserve's judgment, each such one-year extension is consistent with the Volcker Rule and not detrimental to the public interest. The process for seeking a one-year extension and the factors relevant to a determination by the Federal Reserve are discussed in section 3 below.

2. Potential Five-Year Extension to the Conformance Period for "Illiquid Funds": The Five-Year "Add-On"

The Volcker Rule also provides for a single extension, which may be for as long as five years, with respect to an investment in an "illiquid fund" where the acquisition and retention of an interest in the fund, or the provision of additional capital to the fund, is "necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010." The proposed transition rules, if adopted, would define what constitutes an illiquid fund under the Volcker Rule. In also would clarify that the illiquid fund extension is in addition to, and not in lieu of, the three separate one-year extensions, something that is not entirely clear from the statutory language. Thus, a banking entity could have up to eight years after the expiration of the two-year general conformance period (*i.e.*, July 21, 2022) to make and retain qualifying illiquid fund investments.

It should be noted that the Volcker Rule prohibits both investments in and sponsorship of private funds. The Volcker Rule, by its terms, only provides the Federal Reserve with the authority to extend the period that a banking entity may make and retain an investment in an illiquid fund. Neither the Volcker Rule nor the Federal Reserve's proposed transition rules contemplate extensions of the conformance period for sponsorship of illiquid funds.

The process for seeking the five-year extension and the factors relevant to a determination by the Federal Reserve are discussed in section 3 below.

(i) The "Illiquid Fund" Definition

The five-year extension may only be requested with respect to investments in illiquid funds. The Volcker Rule defines an "illiquid fund" as a hedge fund or private equity 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 investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets. However, the proposed rules include a two-prong approach to defining an illiquid fund: the fund must invest in illiquid assets and the investment in the fund must itself be illiquid.

The proposed transition rules expand on certain key terms used in the statutory definition: "illiquid asset," "principally invested," "contractually committed to principally invest" and an "investment strategy to principally invest." These terms are critical to understanding the twin set of criteria that will need to be satisfied in order for a banking entity's investment in a hedge

fund or private equity fund to qualify for the illiquid fund extension. As described below, the first set of criteria relate to the fund itself, with the second set of criteria relating to the terms of banking entity's investment in the fund.

(ii) The Nature, Assets and Investment Strategy of the Fund

The first set of criteria focuses on the nature, assets and investment strategy of a hedge fund or private equity fund. For a fund to qualify as an illiquid fund it must, among other things, be invested in or be contractually committed to be principally invested in, and have an investment strategy centered on, "illiquid assets." The Federal Reserve's proposed transition rules define illiquid assets essentially by reference to what they are not. In so doing, the proposed transition rules contain a definition of "liquid assets," with a list that includes the following and expressly solicits comments as to whether additional or alternative metrics or screens should be considered:

- Cash and 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;
- Assets for which there are *bona fide*, competitive bid and offer quotations in recognized inter-dealer quotation systems or similar systems;
- Assets with prices that are quoted routinely in widely disseminated publications that are readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;
- Assets with initial terms of one year or less and that can be monetized or converted at maturity into liquid assets; and
- Other assets that the Federal Reserve may determine is a liquid asset.

The proposed rules provide some guidance on what is meant by these various categories of liquid assets. Most important, the Federal Reserve's discussion of the proposed rules makes it clear that the intent is to "include as illiquid assets investments in portfolio companies, investments in real estate (other than those made through publicly traded REITs), venture capital investments, and investments in other hedge funds or private equity funds that both are not publicly traded and invest in illiquid assets." The fact that some form of secondary trading exists with respect to such assets is insufficient, standing alone, for them to be treated as liquid assets. The proposed rules also clarify that an asset (such as restricted stock) is not liquid merely because it is part of a class that is liquid, if the particular asset held by the fund is illiquid because of legal restrictions on its sale.

The Volcker Rule also requires that the hedge fund or private equity fund either (i) have been "principally invested" in illiquid assets as of May 1, 2010, or (ii) have been invested to some degree in illiquid assets and "contractually committed to principally invest" in illiquid assets as of such date.

To be considered "principally invested" in illiquid assets, the proposed rules provide that at least 75% of the fund's consolidated total assets (as reflected on the fund's financial statements prepared in accordance with applicable accounting standards) must be either illiquid assets (*i.e.*,

not liquid assets) or risk-mitigating hedges entered into in connection with and related to individual or aggregated positions in illiquid assets. As examples, the Federal Reserve cites certain types of funds, such as real estate or start-up companies (*e.g.*, technology, life sciences, alternative energy or "clean tech") that focused "almost exclusively on one type of illiquid assets."

To be considered "contractually committed to principally invest" in illiquid assets as of May 1, 2010, a hedge fund's or private equity fund's organizational documents (limited partnership agreements, etc.) or other documents (side letter agreements, etc.) must obligate the fund to be principally invested in illiquid assets during the period beginning on the date when capital contributions are first received by the fund for the purpose of making investments and ending on the fund's expected termination date. The contractual commitment in question is not the investor's commitment to invest in the fund, but the fund's commitment to make investments principally in illiquid assets.

Finally, the proposed rules explain what is meant by a hedge fund or private equity fund having an "investment strategy to principally invest" in illiquid assets. Such a strategy is evidenced by either the fund (i) marketing or holding itself out to investors as "intending to principally invest" in illiquid assets, or (ii) having "a documented investment policy" of principally investing in illiquid assets. In its release, the Federal Reserve advises banking entities to consider whether a fund's organizational and contractual documents, marketing materials or investment policy provide for the fund to principally invest in illiquid assets by examining "whether the assets to be acquired by the fund (as specified in such materials) are of the type and nature that would be make the assets 'illiquid assets' or 'liquid assets' for purposes of the rule."

The language of the proposed rules make clear that, in order to qualify as an illiquid fund, the fund must both be contractually obligated to principally invest in illiquid assets, as evidenced by its organizational or other documents, and it must hold itself out to investors as intending to principally invest in such assets.

(iii) The Terms of the Banking Entity's Investment

The second set of criteria used in determining whether an illiquid fund extension period is available focuses on the terms of the banking entity's investment in a particular hedge fund or private equity fund. Specifically, the acquisition or retention of an interest in a fund, as well as the injection of additional capital into the fund, by a banking entity must be necessary to fulfill a "contractual obligation" that the banking entity had on May 1, 2010.

It is important to note that the authority to retain an investment in an illiquid fund automatically terminates on any date—which may occur in the middle of a five-year extension—on which the banking entity is no longer contractually obligated to retain the investment.

Under the proposed transition rules, a banking entity will be considered to have a contractual obligation to retain or make an equity, partnership or other ownership interest in an illiquid

fund if it would be prohibited under the terms of its equity, partnership or other ownership interest in the fund or under other contractual arrangements with the fund from (i) redeeming all of its interest in the fund or (ii) selling or otherwise transferring its ownership interests to an unaffiliated person. Furthermore, a banking entity will be considered to have a contractual obligation to make additional investments in an illiquid fund if it is required to do so under the terms of its equity, partnership or other ownership interest in the fund or under any other contractual arrangements it has with the fund.

An important qualification to a finding that a banking entity has a contractual obligation to make or retain an investment is that (i) the banking entity must not be able to effect a unilateral termination of the obligation pursuant to the terms of its agreement with the fund; and (ii) if it may terminate the obligation with the consent of another party or parties, the banking entity has used its reasonable best efforts to obtain such consent and such consent has been denied. With regard to (ii), we note that, under the terms of many illiquid fund documents, an investor does not have a right to redeem or transfer its interest without the general partner's consent, but the general partner of the fund will often accommodate such requests.

3. *The Extension Process and Factors Relevant to the Federal Reserve*

Whether seeking a one-year extension or a five-year illiquid fund extension, a banking entity must (i) submit a written request to the Federal Reserve for the extension at least 90 days prior to the expiration of the applicable time period; (ii) provide the reasons why it believes the extension should be granted; and (iii) offer a detailed explanation of its plan for divesting or conforming the activity or investment.

The factors to be addressed by a banking entity seeking an extension, and by the Federal Reserve in acting on such a request, include the following:

- 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;
- Nature of the activity or investment;
- Date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;
- Contractual terms governing the banking entity's interest in the fund;
- Degree of control held by the banking entity over investment decisions of the fund;
- Types of assets held by the fund;
- Expected date for the fund's winding up of its activities and liquidation, or when its investments may be redeemed or sold;
- 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 for the banking entity or for U.S. financial stability;

- Cost to the banking entity for disposing the activity or investment within the applicable period; and
- Other factors that the Federal Reserve believes to be appropriate.

If a banking entity is primarily supervised by another federal banking agency or by the SEC or CFTC, the Federal Reserve will consult with such agency prior to any approval of an extension request.

Under the proposed transition rules, the Federal Reserve will have the authority to impose conditions on any extension approval if such conditions are necessary or appropriate to (i) protect the safety and soundness of the banking entity or U.S. financial stability, (ii) respond to material conflicts of interest or other unsound banking practices or (iii) further the purposes of the Volcker Rule and related transition rules.

C. The Conformance Period for Nonbank Financial Companies Supervised by the Federal Reserve

Under the Dodd-Frank Act, the Federal Reserve is given supervisory authority over certain nonbank financial companies that are determined by the Financial Stability Oversight Council to be systemically important. Although such companies are not banking entities for purposes of the Volcker Rule, they will nevertheless be subject to quantitative limitations, capital charges or other restrictions in order to address risks that their proprietary trading activities or fund relationships pose. The proposed transition rules provide a two-year conformance period for such companies, with the two-year period commencing from the date on which a systemically important company becomes supervised by the Federal Reserve. These nonbank companies will also have an opportunity to apply for up to three one-year extensions.

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For more information about the Volcker Rule, the Federal Reserve's proposed transition rules or the process for submitting public comments, please contact a member of the Financial Institutions Group.

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