

# Memorandum

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## Volcker Rule Update: Extension Granted for Legacy Funds

December 19, 2014

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On Thursday, the Federal Reserve Board made a much-welcomed announcement: the deadline for divesting or conforming investments and relationships with so-called “legacy covered funds” has been extended by one year to July 21, 2016. In addition, the Federal Reserve Board indicated that it intends to grant another one-year extension next year, which would bring the deadline for these funds to July 21, 2017, for a two-year additional extension.

### Background

The Volcker Rule is a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that generally prohibits a banking entity, when acting as principal, from sponsoring or investing in “covered funds” (which generally include funds that would be investment companies but for the exemptions provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940) or engaging in proprietary trading. The Volcker Rule became effective on July 21, 2012, but with a two-year conformance period ending July 21, 2014 for banking entities to divest or restructure their covered investments and relationships. On December 10, 2013, the Federal Reserve Board and several other federal banking and financial agencies issued final regulations implementing the substantive provisions of the Volcker Rule. Concurrent with the release of those regulations, the Federal Reserve Board issued a blanket, industry-wide one-year extension, which meant that banking entities had until July 21, 2015 to comply.

The Federal Reserve Board, which has sole authority to grant extensions, has now extended the compliance deadline another year to July 21, 2016. However, the extension is limited to investments and sponsorships in certain “legacy covered funds,” not to funds generally. Also, proprietary trading activities are not covered by this extension.

### Extension Applies to “Legacy Covered Funds” Only

The extension applies to “investments in and relationships with covered funds and foreign funds that may be subject to [the Volcker Rule] and that were in place prior to December 31, 2013.” Although the term “in place” is not defined in the extension order, it should be understood to mean that the relevant investment

and sponsoring-related activity must have been *made* or *in existence* prior to the cut-off date of December 31, 2013, as opposed to the fund merely being formed prior to such date. The Federal Reserve Board also noted that non-banking sponsors of covered funds in which foreign banks invest may use this time to restructure or conform these foreign bank investments.

The term “foreign fund” is not defined, and it is unclear whether it means both foreign covered funds and foreign *non-covered* funds. Foreign non-covered funds are funds that receive investments from foreign banking entities (and other non-U.S. investors) and avoid application of the Volcker Rule by not falling within the definition of “covered fund.” They have presented foreign banking entities and private fund sponsors with substantial restructuring challenges because of how the “banking entity” and “covered fund” definitions interact. In short, foreign non-covered funds may be swept up by the Volcker Rule, through the banking entity definition, if a foreign banking entity has a position of 25% or more of the fund’s total ownership interests or otherwise controls the fund through substantial governance rights. By contrast, a covered fund is excluded from the banking entity definition. Absent clarification to the contrary from the Federal Reserve Board, we believe it is reasonable to conclude that foreign non-covered funds that fall under the banking entity definition have the benefit of the extension if the control relationship (25% or greater ownership, etc.) was in place prior to December 31, 2013.

### **Prospects for a Final Extension to July 21, 2017**

The Federal Reserve Board has indicated that it “intends next year” to grant a final one-year extension “to permit banking entities until July 21, 2017, to conform ownership interests in and relationships with legacy covered funds.” The reason for this precatory language is that the Dodd-Frank Act authorizes the Federal Reserve Board only to grant general extensions to the conformance period “for not more than one year at a time.”

### **Illiquid Fund Extension Not Addressed**

The extension order does not address the five-year extension that may be granted, by application of a banking entity, with respect to certain illiquid funds, other than to say that the Federal Reserve Board will consider whether to take action regarding such funds at a later time.

### **“Good-Faith” Conformance Efforts**

In granting the latest one-year extension, the Federal Reserve Board has once again reminded banking entities that they are “expected” to take “good-faith efforts” to completely divest or conform their investments and activities by “no later than the end of the applicable conformance period.” For covered legacy funds addressed in the extension order, this deadline is July 21, 2016, and it is highly likely that the deadline will be eventually extended to July 21, 2017. Banking entities are expected to “make plans well in advance of the end of the extended conformance period” as to how they will divest or conform their legacy covered fund investments and activities to the Volcker Rule.

For further information about the recent extension order or the Volcker Rule generally, please contact any member of the Firm's Financial Institutions and Private Funds practices, including those listed below.

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