

Memorandum

Volcker Rule Update: Extensions for Illiquid Funds

December 13, 2016

On December 12, the Federal Reserve clarified how it will consider requests by banking entities for a special extension under the Volcker Rule for “illiquid funds.” Banking entities seeking extensions will be required to submit streamlined information regarding the funds for which an extension is requested, a description of specific efforts made to divest or conform funds, and plans for divesting or conforming each illiquid fund within the requested extension period. Also, in a departure from previous statements, the Federal Reserve will *not* require banking entities to exercise a “regulatory-out” provision or otherwise seek general partner consent to terminate an investment in order to qualify for an extension.

The Federal Reserve expects that illiquid funds “will generally qualify for extensions” (except in certain cases) and that complete requests will be acted on within 30 days of receipt. Absent an extension, banking entities are required to divest or conform their investments in covered private equity funds and hedge funds by July 21, 2017. Because an illiquid fund extension is for up to five years and in addition to other extensions, a full five-year extension (when taken together with the three separate one-year extensions the Federal Reserve has already granted) means that a banking entity would have until July 21, 2022 to divest or conform an illiquid fund. The Volcker Rule does not authorize the Federal Reserve to grant any additional extensions beyond this date.

Extension requests must be submitted to the appropriate Federal Reserve Bank by January 21, 2017.

Background

The Volcker Rule is a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) that generally prohibits a banking entity, when acting as principal, from sponsoring or investing in a “covered fund” (which generally is a fund that would be an investment company but for an exemption provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940) or engaging in proprietary trading.

The Dodd-Frank Act included a special, one-time extension for “illiquid funds.” This extension was in addition to other available extensions and was for a maximum of five years. An illiquid fund is a fund that is “principally invested” in illiquid assets (*e.g.*, real estate, infrastructure) and holds itself out as employing a strategy to invest principally in illiquid assets. In order for a banking entity to obtain this extension, it must have had a contractual obligation in effect on May 1, 2010 to take or retain an interest in, or otherwise provide capital to, the illiquid fund.

Prior to the Federal Reserve’s announcement, it was unclear whether the process to obtain an illiquid funds extension would be difficult and whether such extensions would be freely given. The Federal Reserve’s statement yesterday allays those concerns, giving significant weight to arguments by market participants that a number of unique circumstances had complicated divesting or conforming illiquid funds. For example, the Federal Reserve recognized arguments relating to: the difficulty of financial holding companies that had sponsored funds to find replacement sponsors, the “deep discounts” (ranging from 20% to 90% of current net asset value) that secondary buyers had demanded, the “broad indemnifications” that third-party fund managers had requested from banking entity investors as a condition to approving exit/transfer requests, and the unfairness of forcing certain employees of a banking entity to divest fund holdings at a loss.

Illiquid Fund Extension Requirements

The Federal Reserve has said it will follow a “simplified and streamlined”—and fairly expedited—process for dealing with illiquid fund extension requests. In particular, the following items must be provided by a banking entity requesting an extension for an illiquid fund investment or relationship:

- A list or simple chart of each illiquid fund for which an extension is sought;
- A brief description of each fund, including the investment strategy and types of investments made by each fund, which entity within the firm holds the investment, the size of each fund, the total exposure of the banking entity to each fund, the date by which each remaining illiquid fund is expected to mature by its terms or be conformed to the Volcker Rule, and the banking entity’s relationship with the fund (*e.g.*, general partner, sponsor, investment adviser, investor);
- A description of the banking entity’s “specific efforts” to divest or conform its illiquid funds, including a description of the covered funds (both liquid and illiquid) that have been divested or conformed to date, the progress that has been made with respect to investments for which an extension is sought (*e.g.*, the number of funds sold, the number of funds that continue to be held, and the amount of investments remaining in each fund and in aggregate);
- A certification by the General Counsel or Chief Compliance Officer of the banking entity that sponsors or invests in the illiquid funds that each fund meets the “illiquid fund” definition, including that the extension is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010; and

- Information on the length of the requested extension and a description of the banking entity's plan for divesting or conforming each illiquid fund prior to the end of the requested extension period.

In a related supervisory letter (SR Letter No. 16-18), the Federal Reserve indicated that the authority to grant (but not to deny) requests has been delegated to the Federal Reserve Banks. Federal Reserve Banks may approve extension requests if all of the following criteria are met:

- The extension request relates only to illiquid funds;
- No significant issues have been identified on the firm's Volcker Rule compliance program;
- The primary federal agency responsible for compliance with the Volcker Rule by the banking entity that invests in or sponsors the illiquid fund (if other than the Federal Reserve) does not object to the extension;
- The banking entity has made meaningful progress toward conforming the majority of its covered fund investments (including funds other than illiquid funds) as of the date of the extension request; and
- The banking entity provides supporting information regarding its efforts to conform the illiquid funds for which an extension is being sought. Such supporting information could include, but would not be limited to, information regarding specific bids that have been sought and other specific actions taken to conform the funds for which an extension is being sought.

Banking entities may submit extension requests anytime between now and January 21, 2017 to their appropriate Federal Reserve Bank, with a copy also provided to the primary federal regulator of the particular banking entity (such as the OCC if the entity making the request is a national bank). The Federal Reserve anticipates that a complete extension request will be acted on within 30 days of receipt. Although the Federal Reserve has said that it expects illiquid funds will "generally qualify for extensions," requests may be denied if the banking entity has not demonstrated "meaningful progress" to divest or conform its illiquid funds, if it has a deficient compliance program under the Volcker Rule, or where the Federal Reserve has concerns about evasion.

If granted, an extension would be for the *shortest of*: (i) five years from the date of the expiration of the general conformance period (*i.e.*, July 21, 2022), (ii) the date by which each remaining fund is expected to mature by its terms or be conformed to the Volcker Rule, or (iii) any shorter period determined by the Federal Reserve.

No Need to Exercise "Regulatory-Out" Provisions or Obtain Third-Party Consents

The Federal Reserve has provided guidance on so-called "regulatory-out" and third-party consent provisions in illiquid fund documentation. Such provisions generally enable a limited partner to withdraw from a fund if its continued holding would cause such investor (or the fund) to be in violation of applicable laws or

regulations. However, the terms of a regulatory-out provision may allow the investor to redeem or sell its investment only with the approval of the general partner, or only if the general partner concurs that retention of the investor's ownership interest would result in a violation of law.

Significantly, the Federal Reserve has clarified that a banking entity will not be required to attempt to exercise a regulatory-out provision or otherwise seek consent from third parties to terminate an investment in an illiquid fund as a condition to qualifying for the extended transition period.¹

For questions regarding the Volcker Rule and the extension for illiquid funds, please contact any member of the Firm's Financial Institutions Group.

Lee A. Meyerson

+1-212-455-3675

lmeyerson@stblaw.com

Keith A. Noreika

+1-202-636-5864

keith.noreika@stblaw.com

Mark Chorazak

+1-212-455-7613

mchorazak@stblaw.com

Spencer A. Sloan

+1-212-455-7821

spencer.sloan@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

¹ Under the Federal Reserve's conformance rule from 2011, the Federal Reserve had indicated that if a banking entity's contractual obligations to an illiquid fund "provide the banking entity the right and ability to redeem or sell its investment if the banking entity determines that continued ownership of the investment would violate the Volcker Rule, the banking entity must exercise that right no later than the end of the Volcker Rule's general conformance period and any extensions thereof." In addition, where such right "under a regulatory-out provision . . . may be dependent on the consent of an unaffiliated party . . . , the banking entity and its affiliates must use their reasonable best efforts to obtain such consent." See 76 Fed. Reg. 8265, 8272 (Feb. 14, 2011).

Simpson
Thacher
Worldwide



UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000