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Federal Reserve Board Extends the Volcker Rule Conformance Period for Legacy Funds

By Julian Hammar

On December 18, 2014, the Board of Governors of the Federal Reserve System (“Board”) issued an order extending for an additional year – i.e., until **July 21, 2016** – the Volcker Rule conformance period for banking entities to conform their investment in and relationships with covered funds and with foreign funds that may be subject to the Volcker Rule, and that were in place prior to December 31, 2013 (“legacy funds”). The order also announces the Board’s intention to grant the final one-year extension of the conformance period pursuant to its authority until **July 21, 2017**.¹ The order is available [here](#). No extension was granted for the conformance period for proprietary trading, which still will expire on **July 21, 2015**.

RATIONALE

Public commenters had requested an extended period of time to allow banking entities to conform to the Volcker Rule or divest covered fund investments. Conformance with the Volcker Rule will require, among other things, banking entities to discontinue certain prohibited relationships with covered funds and obtain appropriate consents from and make disclosures to investors in such funds. In the Board’s view, the extensions allow for the divestiture of fund investments in an orderly manner consistent with protecting the safety and soundness of banking entities, reduce potential disruptive effects that significant divestitures of covered funds could have on markets, allow banking entities additional time to conform their relationships with covered funds, and are consistent with the legislative history of Section 619 of the Dodd-Frank Act.

Although not discussed in the order, it is hoped that during the extensions of the conformance period, the regulatory agencies will address certain interpretive issues under the Volcker Rule that have made it difficult for banking entities to make definitive choices regarding compliance and/or divestiture.

The timing of the order also reflects the pendency of the January 21, 2015 deadline for individual extension requests (six months before the previous July 21, 2015 conformance deadline), many of which will no longer be needed by reason of this omnibus extension.

CONSISTENCY WITH CLO ANNOUNCEMENT

The extensions are consistent with the Board’s previous announcement in April 2014 regarding collateralized loan obligations (“CLOs”).² With respect to CLOs, the Board had previously indicated that it intended to grant two one-year

¹ Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) only authorizes the Board to grant extensions 1 year at a time, necessitating a two-step process.

² See Statement Regarding the Treatment of Collateralized Loan Obligations Under Section 13 of the Bank Holding Company Act (April 7, 2014), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140407a1.pdf>.

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extensions (expiring on July 21, 2017) for banking entities with investments in CLOs that were in place prior to December 31, 2013, to conform their activities to those permitted under the Volcker Rule.

KEY ASPECTS OF THE ORDER

Here are key aspects of the Board's order:

- **No Extension for Proprietary Trading:** The order does not extend the conformance period for proprietary trading activities. Banking entities must conform to the Volcker regulations regarding proprietary trading by **July 21, 2015**, unless they obtain a specific extension upon request. Specific extension requests are required to be made no later than **January 21, 2015**.
- **Legacy Funds Only:** As noted above, the order extends the conformance period only for sponsorship of, investments in, or relationships with legacy funds.
- **No Extension for Post-December 31, 2013 Activity:** The order does not extend the conformance period for sponsorship, new relationships or investments by banking entities (including foreign funds that are banking entities) in covered funds after December 31, 2013 (although if the relationship or investment was committed before 2014 and funded or carried out thereafter it likely would be permitted to be made or retained during the extended conformance period). Accordingly, all such post-December 31, 2013 covered fund or foreign fund activity, investments, or relationships (unless committed prior to 2014) must be in conformance with the Volcker Rule by **July 21, 2015**, unless specific extensions are granted on request. Specific extension requests are required to be made no later than **January 21, 2015**.
- **Per-Fund and Aggregate Investment Limits:** Banking entities should have until the end of the extended conformance period to conform their permissible investments in covered funds to the applicable per-fund and aggregate investment limits.
- **Super 23A and 23B:** The extension provides banking entities additional time to undo or conform their pre-2014 relationships with covered funds that are prohibited by the Volcker Rule. However, such relationships that were initiated after December 31, 2013 would need to be undone or conformed by July 21, 2015, unless permitted by a specific extension upon request.
- **Branding:** Legacy funds relying on the asset management exemption may continue to use names associated with the sponsoring banking entities through the extended conformance period.
- **Employee Investments in Sponsored Funds:** Legacy funds relying on the asset management exemption would be permitted additional time to redeem or otherwise restructure pre-2014 investments (or pre-2014 commitments to invest) in legacy funds by employees, officers or directors that are not permitted by the Volcker Rule.

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- **Illiquid Funds:** The Board will consider whether to take action regarding certain illiquid funds.³ The Board may grant a banking entity an extension for up to five years to the extent necessary for the banking entity to fulfill a contractual obligation in effect on May 1, 2010 to take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund. The order does not address any additional transition period for such funds. However, while the Board is considering the issue, legacy illiquid fund investments and relationships should be able to rely upon the newly extended conformance period for legacy funds.
- **Good Faith Efforts:** The Board emphasized that banking entities must act in good faith to conform all of their activities and investments to the requirements of the Volcker Rule by no later than the expiration of the applicable conformance period. In this regard, the Board's June 2012 Statement of Policy on Volcker Rule Conformance activities remains fully in effect.⁴ The Board further states that it expects banking entities to plan "well in advance" of the end of the extended conformance period regarding how they will conform or divest legacy funds in an orderly and safe and sound manner.
- **Other Agencies:** The order states that the other agencies responsible for enforcing the Volcker Rule will apply the final regulations in accordance with the Board's order.

OTHER CONSIDERATIONS

- **Foreign Non-Covered Funds.** Foreign banking organization ("FBO") trade organizations and others have requested regulatory agencies to reconsider the characterization of foreign non-covered funds as "banking entities" under the Volcker Rule. The agencies have this request under consideration. Characterization as a "banking entity" subjects foreign non-covered funds to the Volcker Rule prohibitions on investment in covered funds and proprietary trading. In contrast, foreign exempt funds (in other words, "SOTUS" funds) are considered covered funds and thus not characterized as "banking entities." The extension should permit such pre-2014 foreign non-covered funds additional time to resolve their pre-2014 investments (including investments pursuant to pre-2014 capital commitments) in covered funds, while affording time for the regulatory agencies to address the characterization and treatment of foreign private and public non-covered funds.
- **SOTUS Fund Offering Restriction:** FBOs have sought guidance as to whether they may invest in funds that have been offered to U.S. residents by sponsors other than themselves. In other words, they have sought an interpretation that would construe the "offering restriction" for a SOTUS fund to be limited to the FBO or FBO affiliate sponsoring the fund. Such an interpretation would permit an FBO to invest in a SOTUS fund offered by another sponsor to U.S. persons. The extension should generally permit FBOs to retain pre-2014 investments (including investments pursuant to pre-2014 capital commitments) in covered funds through the end of the extended conformance period, including pre-2014 investments in funds that have been offered to U.S. residents by another sponsor but in all other respects qualify as a "SOTUS" fund.

³ An illiquid fund is defined by the Board as a hedge fund or private equity fund that as of May 1, 2010 was principally invested in illiquid assets or was invested in, and contractually committed to principally invested in, illiquid assets and makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets. Illiquid assets are defined to mean any asset that is not a liquid asset, or is subject to certain regulatory or contractual restrictions that prevent a fund from offering, selling or otherwise transferring the asset. Liquid assets include cash or cash equivalents, exchange-traded assets, certain inter-dealer traded assets, assets the price of which is quoted routinely in a widely disseminated publication, and certain assets with a term of less than one year. See 12 C.F.R. 225.180.

⁴ See Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 77 Fed. Reg. 33949 (June 8, 2012).

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- **Secondary Trading:** Industry groups have expressed concern that secondary fund trading has been and will continue to be inhibited owing to uncertainties regarding the characterization of funds as covered or non-covered, including the difficulty of determining precisely which Investment Company Act exemption might apply to each such fund. The extension granted by the order will not apply to post-2013 trades. Accordingly, banking entities engaged in such secondary trading will likely need to request specific extensions of the conformance period applicable to their situations.

The conformance period extension provides banking entities with much needed breathing room with respect to conforming their covered fund investments and relationships. However, there remain many unanswered questions about the Volcker Rule's application to foreign funds and covered funds, which, it is hoped, will be addressed by the regulators during the conformance period.

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