

Client Alert

December 13, 2016

Federal Reserve Board Announces Procedures to Request an Extended Transition Period to Conform Illiquid Funds to the Volcker Rule

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On December 9, 2016, the Board of Governors of the Federal Reserve System (“Federal Reserve Board”) issued SR 16-18, “Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds” (“SR 16-18”).¹ A related policy statement was issued on December 12, 2016 (the “Policy Statement”).²

SR 16-18 and the Policy Statement provide guidance to banking entities³ on the procedures for requesting from the Federal Reserve Board an extension of the Volcker Rule’s⁴ conformance period for illiquid funds. An illiquid fund is a covered fund⁵ that (1) as of May 1, 2010, was principally invested in illiquid assets or was invested in, and contractually committed to principally invest in, illiquid assets; and (2) makes all investments pursuant to an investment strategy to principally invest in illiquid assets.⁶ Requests pursuant to SR 16-18 are required to be submitted no later than January 22, 2017.⁷

The Federal Reserve Board expects that illiquid funds will generally qualify for extensions of the conformance period, although extensions will not be granted in certain cases, including where: (1) a banking entity has not demonstrated progress toward meaningful compliance with the Volcker Rule; (2) a banking entity has a deficient Volcker Rule compliance program; or (3) the Federal Reserve Board has concerns about evasion.

SR 16-18 and the Policy Statement also provide that a banking entity seeking to qualify for an extension for an illiquid fund is not required to exercise a “regulatory out” provision or otherwise seek consent from third parties to terminate an investment.

¹ BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, SR 16-18, “Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds,” available at: <https://www.federalreserve.gov/bankinforeg/srletters/sr1618.htm>.

² BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, Statement of Policy Regarding Illiquid Fund Investments Under Section 13 of the Bank Holding Company Act, available at: <https://www.federalreserve.gov/newsevents/press/bcreg/20161212b.htm>.

³ Subject to certain exceptions, “banking entity” as defined in the Final Rule means: (i) any insured depository institution (“IDI”); (ii) any company that controls an IDI; (iii) any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and (iv) any affiliate or subsidiary of any entity described in (i) through (iii). See 12 C.F.R. § 248.2(c).

⁴ The “Volcker Rule” is contained in section 13 of the Bank Holding Company Act of 1956, as amended.

⁵ See 12 C.F.R. § 248.10(b) (defining the term “covered fund”).

⁶ See 12 C.F.R. § 225.180 (defining the term “illiquid fund”).

⁷ See 12 C.F.R. § 225.181. Please note that January 22, 2017 is a Sunday so all extension requests should be submitted by Friday January 20, 2017.

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BACKGROUND

The Volcker Rule generally prohibits a banking entity from engaging in proprietary trading or from sponsoring or investing in covered funds, subject to a number of exemptions.⁸ In December 2013, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (each an “Agency”) issued a final rule (the “Final Rule”) to implement the Volcker Rule.⁹

The Volcker Rule became effective on July 21, 2012, and by July 21, 2015, banking entities were required to conform to its requirements all of their investments in and relationships with covered funds made on or after December 31, 2013, and any proprietary trading activities. For covered funds that were in place prior to December 31, 2013 (“legacy covered funds”), however, the Federal Reserve Board extended the conformance deadline to July 21, 2017.¹⁰

In addition, the Federal Reserve Board is authorized, upon application by a banking entity, to grant an extension of the conformance period for up to five years for certain investments in certain illiquid funds.¹¹ The extension is only available with respect to illiquid funds where the acquisition or retention of an interest, or provision of additional capital, is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.¹²

Under this authority, the Federal Reserve Board may grant only one extension for up to five years.¹³ SR 16-18 and the Policy Statement state that the length of any extension granted for illiquid funds will be the shortest of: (1) five years from the date of the expiration of the general conformance period (i.e., until July 21, 2022); (2) the date that the illiquid fund is expected to mature by its terms or be conformed to the Volcker Rule; or (3) a shorter period as determined by the Federal Reserve Board.

REQUIREMENTS FOR SUBMITTING REQUESTS

SR 16-18 and the Policy Statement explain that the Federal Reserve Board will follow a simplified and streamlined process for handling extension requests for holding illiquid funds. In this connection, the Federal Reserve Board will require an extension request to contain the following information:¹⁴

- A list or chart of the illiquid funds that are the subject of the request;
- A short description of each illiquid fund;

⁸ See 12 U.S.C. § 1851(a)(1); see also 12 CFR §§ 248.3(a); 248.10(a).

⁹ See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014).

¹⁰ For a discussion of the 2016 extension of the conformance period to July 21, 2017, for legacy covered funds, see our client alert, available at: <https://media2.mofo.com/documents/160708volckerrule.pdf>; see also BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, Order Approving Extension of Conformance Period Under Section 13 of the Bank Holding Company Act (July 7, 2016), available at: <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160707a1.pdf>.

¹¹ See 12 U.S.C. § 1851(c)(3); 12 C.F.R. § 225.181.

¹² 12 U.S.C. § 1851(c)(3)(A); 12 C.F.R. § 225.181.

¹³ 12 U.S.C. § 1851(c)(3)(B); 12 C.F.R. § 225.181(b)(2).

¹⁴ Additional information on the requirements listed here is contained in SR 16-18.

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- A description of the banking entity's specific efforts to divest or conform its illiquid funds;
- A certification by the General Counsel or Chief Compliance Officer of the banking entity that (1) each fund meets the definition of an illiquid fund; and (2) an extension is necessary to fulfill a contractual obligation in effect on May 1, 2010;
- The length of the requested extension;
- A description of the banking entity's plan for divestment or conformance prior to the end of the extension period; and
- The name, phone number, and email address of the banking entity's point of contact to which the Federal Reserve Board and the Federal Reserve Bank staff may submit all inquiries.

After an extension is granted, the Federal Reserve Board could require a banking entity to provide a progress report on fund sales, maturities, or other conformance efforts at any time during the extended conformance period.

PROCEDURES FOR FILING AN EXTENSION REQUEST

SR 16-18 outlines the following procedures for filing extension requests:

- *How to File:* In writing.¹⁵
- *Where to File:* The Applications Unit of the appropriate Federal Reserve Bank in the district where the top-tier banking entity is headquartered.
- *Who to File:* The top-tier banking entity.
- *When to File:* At any time at least 180 days prior to the expiration of the general conformance period (i.e., on or before January 22, 2017).
- *Where to Send Copies:* If the banking entity that sponsors or invests in the illiquid fund is supervised by another Agency, the top-tier banking entity should provide a copy of the extension request to that Agency.¹⁶
- *Action by the Federal Reserve Banks:* The Federal Reserve Banks should act on an extension request within 30 days of receiving all information.¹⁷ If the request does not meet the requirements for delegated action, the Federal Reserve Bank will immediately refer the request to the Federal Reserve Board.

CRITERIA FOR APPROVAL

The Federal Reserve Banks have been delegated authority to grant (but not deny) requests in consultation with Federal Reserve Board staff. The Federal Reserve Bank may approve the request if the following criteria are met:

- The extension request only relates to illiquid funds;
- No significant issues have been identified with respect to the banking entity's Volcker Rule compliance program;

¹⁵ For banking entities regulated by the Federal Reserve Board, requests may be submitted electronically through the Federal Reserve System's Electronic Applications System, E-Apps.

¹⁶ Attachment One to SR 16-18 provides a list of contacts at other agencies to which copies of the extension request should be sent.

¹⁷ Attachment Two to SR 16-18 provides a sample acknowledgement letter to be sent to the banking entity by the Federal Reserve Bank after receiving an extension request.

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- The primary federal agency responsible for supervising the banking entity's compliance with the Volcker Rule does not object to the extension;
- The banking entity has made meaningful progress toward conforming its non-illiquid covered fund investments as of the date of the extension request; and
- The banking entity provides sufficient supporting information regarding its efforts to conform the illiquid funds.

CONCLUSION

The Federal Reserve Board generally expects to grant extensions to illiquid funds so long as the applicable criteria are met. SR 16-18 and the Policy Statement provide a streamlined application process for requesting an extension of the conformance period for illiquid funds. This provides some relief to impacted banking entities which previously may have had to file separate extension requests for each illiquid fund in which they held investments or sponsored. Nevertheless, SR 16-18 and the Policy Statement do not resolve the issue that the definition of an "illiquid fund" is exceedingly narrow and excludes many illiquid funds that Congress likely intended should have been able to take advantage of an extended conformance period.¹⁸

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¹⁸ See The Securities Industry and Financial Markets Association and the American Bankers Association, Letter to the Board of Governors of the Federal Reserve System, dated: March 1, 2016, available at: <http://www.sifma.org/issues/item.aspx?id=8589961730>.

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