C A D W A L A D E R

Cadwalader, Wickersham & Taft LLP
New York London Charlotte Washington Beijing

One World Financial Center, New York, NY 10281
Tel 212 504 6000 Fax 212 504 6666
www.cadwalader.com

Clients&FriendsMemo

Fed Issues Final Regulations on the Volcker Rule's Extension Periods

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On February 9, 2011, the Board of Governors of the Federal Reserve System (the "**Federal Reserve Board**") issued final regulations implementing the various conformance and extension periods under the Dodd-Frank Act's "Volcker Rule."[1] These new regulations will be codified as new Subpart K of the Federal Reserve Board's Regulation Y.[2]

Background

The Volcker Rule prohibits *banking entities* – generally, FDIC-insured depository institutions, their holding companies, and U.S. branches of foreign banks, and any of their respective affiliates – from (a) engaging in proprietary trading, (b) investing in or sponsoring a hedge fund or private equity fund, or (c) entering into certain transactions with a hedge fund or private equity fund advised, managed, or sponsored by the banking entity or its affiliate, subject to certain exceptions. The Volcker Rule does not impose such bars on nonbank financial companies deemed systemically significant and subject to Federal Reserve Board supervision, but does require the agencies to impose capital charges and quantitative limits on the proprietary trading and fund investing activities of such entities.

The Volcker Rule becomes effective on July 21, 2012 or one year after final implementing regulations are issued by the banking and securities agencies, whichever occurs first. These extension period regulations are not the final implementing regulations that trigger the effective date of the Volcker Rule; the agencies are expected to begin the rulemaking process on the implementing regulations later this year.[3] Rather, the recently issued regulations establish the period in which banking entities will be required to come into conformance once the Volcker Rule itself becomes effective.

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1 The Volcker Rule was enacted as Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203, 124 Stat. 1376 (2010) (H.R. 4173).

2 12 CFR Part 225, Subpart K.

3 For additional information concerning the Volcker Rule, please refer to Cadwalader's Clients & Friends Memo, *An Analysis of the Dodd-Frank Act's Volcker Rule* (October 15, 2010), http://www.cadwalader.com/assets/client_friend/101510VolckerRuleAnalysis.pdf.

General Conformance Period

As set forth in the Volcker Rule itself, the regulations state that a banking entity must come into compliance with the Volcker Rule within two years after the Volcker Rule becomes effective. If an entity first becomes a banking entity *after* the effective date of the Volcker Rule – for example, if a foreign bank were to establish a U.S. branch and thereby become a *banking entity* – the regulations state that the banking entity must come into compliance within two years of the date it first became a banking entity – *i.e.*, the date it establishes a U.S. branch.[4]

The final regulations confirm that a similar two-year conformance period applies with respect to nonbank entities that are deemed systemically significant and therefore subjected to Federal Reserve Board supervision. These entities will have two years, beginning on the date they are deemed systemically significant, to come into compliance with the capital requirements and quantitative limits of the Volcker Rule with respect to any ongoing proprietary trading or fund investing activities within the scope of the Volcker Rule.[5]

Discretionary Conformance Period Extensions

Although banking entities (and systemically significant nonbank entities) have two years to come into compliance with the Volcker Rule, the Volcker Rule allows the Federal Reserve Board to grant up to three one-year extensions on an individual entity basis. These one-year conformance period extensions commence at the end of the normal two-year conformance period. Thus, under the Volcker Rule, a banking entity may request that it be allowed to retain proprietary trading activities or fund investments after the end of the two-year conformance period. The final regulations reflect this discretionary authority, and stipulate that each extension period must be requested individually – a banking entity may not request all three extensions simultaneously – and the extension periods must run consecutively.[6]

The Supplementary Information accompanying the final regulations makes it clear that the extension periods are applicable to any activity that is restricted or prohibited by the Volcker Rule. Thus, extensions may be granted with respect to banking entities that advise, manage, or sponsor private equity funds or hedge funds and thus become subject to the transactional restriction, and also may be granted to nonbank entities that are deemed systemically significant and thus become subject to

4 *See* 12 CFR § 225.181(a)(2).

5 12 CFR § 225.182(a).

6 12 CFR § 225.181(c). In many respects, the three one-year conformance periods are substantially similar to the conformance period extensions allowed under the Bank Holding Company Act for new bank holding companies with any ongoing impermissible activities. *See*, *e.g.*, 12 USC § 1843(a); 12 CFR § 225.138.

the Volcker Rule's capital charges and quantitative restrictions on proprietary trading and fund investing activities.[7]

Special Extension for Investments in Illiquid Funds

The Volcker Rule confers on the Federal Reserve Board the authority to grant a discretionary one-time five-year extension to a banking entity that is contractually obligated to maintain an investment in an *illiquid fund*. Much of the final rulemaking and its Supplementary Information is devoted to this aspect of the Volcker Rule.

Under the Volcker Rule, an *illiquid fund* is defined as a fund that, on May 1, 2010, was principally invested in illiquid assets, or was invested in, and contractually committed to principally invest in, illiquid assets. The Rule left undefined such critical terms as *illiquid assets, principally invested, and contractually committed*. The final regulations define these terms:

Illiquid Assets

In the final regulations, an *illiquid asset* is defined as any asset that is (i) not a *liquid asset*; (ii) an asset that cannot be sold by the fund to a person unaffiliated with the banking entity due to statutory or regulatory restrictions applicable to the fund; or (iii) an asset that cannot be sold by the fund for a period of three or more years to a person unaffiliated with the banking entity due to contractual restrictions.[8]

A *liquid asset* is in turn defined as:

- Cash or cash equivalents;
- Any asset that is traded on a recognized, established exchange, trading facility or other market on which there exists independent, bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for the asset almost instantaneously;
- Any asset for which there are bona fide, competitive bid and offer quotations in a recognized inter-dealer quotation system or similar system or for which multiple dealers furnish bona fide, competitive bid and offer quotations to other brokers and dealers on request;

[7] *See* 12 CFR § 225.182(b).

[8] 12 CFR § 225.180(g).

- Any asset the price of which is quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;
- Any asset with an initial term of one year or less and the payments on which at maturity may be settled, closed-out, or paid in cash or one or more other liquid assets described above; and
- Any other asset that the Federal Reserve Board determines, based on all the facts and circumstances, is a liquid asset.[9]

The final regulations and accompanying Supplementary Information indicate that whether an asset is illiquid is generally determined as of May 1, 2010. Thus, a fund that was principally invested in assets that were considered illiquid assets on May 1, 2010, but which assets have become liquid, will still be considered an illiquid fund for purposes of the Volcker Rule. However, the Federal Reserve Board will take into account the extent to which illiquid assets have become liquid assets when deciding whether to grant a five-year extension. Thus, an illiquid fund that now holds predominantly liquid assets may be less likely to obtain the special five-year extension. On the other hand, a fund that was *not* principally invested in illiquid assets (or was not contractually committed to invest in illiquid assets) on May 1, 2010 will not be entitled to the five-year extension at all, even if its assets have since become illiquid.

Principally Invested

The final regulations adopt the 75% standard of *principally invested* as announced in the proposed rulemaking. Thus, a fund is considered *principally invested* in illiquid assets if at least 75% of its assets are comprised of illiquid assets. The final regulations require that the determination be made based on the fund's most recent financial statements (prepared under U.S. GAAP) in the 90 days preceding May 1, 2010. The final regulations also allow a fund to include in its 75% calculation and treat as illiquid assets any assets, even if liquid, to the extent they are held by the fund as risk-mitigating hedges for its illiquid assets.[10]

Contractually Committed

The final regulations state that whether a fund is *contractually committed* to invest in illiquid assets may be determined based on either the fund's organizational documents or offering materials. Similarly, the regulations state that a fund is treated as if it has such a contractual commitment (and

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9 12 CFR § 225.180(h). The Supplementary Information accompanying the final regulations notes that the components of the definition of *liquid assets* was derived from other existing federal banking securities laws.

10 12 CFR § 225.180(i).

therefore is deemed principally invested in illiquid assets) if the fund markets or holds itself out to investors as intending to principally invest in illiquid assets, or has a documented investment policy of principally investing in such assets.[11] Once again, the relevant date for such a determination is as of May 1, 2010. Whether such offering materials, marketing materials, or investment policy in fact reflect investments in illiquid assets will be determined by the nature of the assets, and the materials do not need to specify that the assets are in fact illiquid. Thus, a written policy to invest in equity securities issued by early-stage nonpublic companies will be considered to be an investment policy to invest in illiquid assets, regardless whether those equity shares later become registered and therefore liquid.

Duration of the Special Five-Year Extension

The final regulations allow the special five-year extension to run consecutively after the end of the one-year conformance period extensions (if any) granted by the Federal Reserve Board.[12] Thus, in theory the banking entity may seek three consecutive one-year conformance period extensions after the end of the initial two-year statutory conformance period, and then may seek a special extension, of up to five years, for any investment in an illiquid fund.

The Federal Reserve Board is not required to grant a five-year extension; it may grant a shorter extension, but in no case may it grant a longer extension. Regardless, the extension expires under the terms in the Federal Reserve's grant, or when the banking entity ceases to have a contractual obligation to invest in the illiquid fund, whichever occurs first.

Contractual Obligations

As mentioned above, the Volcker Rule states that the special five-year extension terminates on the earlier of five years after it is granted or once the banking entity ceases to have a *contractual obligation* to invest in the illiquid fund. The Rule also requires that, to be eligible for the extension in the first instance, such a contractual obligation must have been in existence on May 1, 2010.

The final regulations require that any such *contractual obligation* be reflected in the written terms of the banking entity's contractual arrangements with the fund or with the nonaffiliated investors in the fund. If the banking entity is also the fund sponsor, the contractual obligation may be reflected in written representations made to nonaffiliated investors in the fund.[13]

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[11] *Id.*

[12] 12 CFR § 225.181(b)(2)(i).

[13] 12 CFR § 225.181(b)(3)(i).

The regulations also state that a contractual obligation will not be considered to exist if the banking entity has the ability to avoid or terminate the obligation, or if termination of the obligation requires third-party consent but the banking entity has not used its “reasonable best efforts” to obtain such consent.[14] Thus, if a banking entity has the legal right to redeem or sell its investment, the banking entity must do so before the end of the initial two-year conformance period and any one-year conformance periods granted by the Federal Reserve Board, regardless of economic consequence, and will not be entitled to the five-year extension period. Similarly, if a banking entity is able to terminate its investment with third-party consent but has not exercised its reasonable best efforts to obtain such third-party consent, the banking entity will not be eligible for any special five year extension.

The final regulations and Supplementary Information reiterate that the five-year extension period terminates *immediately* upon the elimination of any contractual commitment, and no grace period will be afforded. Thus, if a banking entity is granted a five-year special extension and, during the course of that extension the banking entity’s contractual obligation to maintain the investment is terminated, the banking entity must, under the terms of the final regulations, immediately dispose of its interest in the fund *on that date*.[15]

Extension Procedures

The final regulations describe the procedures for requesting, and the criteria to be considered by the Federal Reserve Board in connection with, a request for either a one-year extension to the conformance period or the special five-year extension with respect to illiquid fund investments. The final rules require that any such request be filed at least 180 days in advance, and the Federal Reserve Board must act on the request within 90 days – thus giving the applicant at least 90 days to come into compliance if the request is denied.[16] However, in the Supplementary Information, the Federal Reserve Board noted that the 180-day requirement was merely the latest possible date that a request may be filed, and encouraged entities subject to the Volcker Rule to submit extension requests earlier if possible.

The factors to be considered by the Federal Reserve Board in determining whether to grant an extension include:

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[14] 12 CFR § 225.181(b)(3)(iii).

[15] 12 CFR § 225.181(b)(2).

[16] 12 CFR §§ 225.181(c), (d)(2), 225.182(c).

(i) 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;

(ii) Market conditions;

(iii) The nature of the activity or investment;

(iv) The date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;

(v) The contractual terms governing the banking entity's interest in the fund;

(vi) The degree of control held by the banking entity over investment decisions of the fund;

(vii) The types of assets held by the fund, including whether any assets that were illiquid when first acquired by the fund have become liquid assets, such as, for example, because any statutory, regulatory, or contractual restrictions on the offer, sale, or transfer of such assets have expired;

(viii) The date on which the fund is expected to wind up its activities and liquidate, or its investments may be redeemed or sold;

(ix) The 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 to the banking entity or the financial stability of the United States;

(x) The cost to the banking entity of divesting or disposing of the activity or investment within the applicable period;

(xi) Whether the divestiture or conformance of the activity or investment would involve or result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty;

(xii) The banking entity's prior efforts to divest or conform the activity or investment(s), including, with respect to an illiquid fund, the extent to which the banking entity has made efforts to terminate or obtain a waiver of its contractual obligation to take or retain an equity, partnership, or other ownership interest in, or provide additional capital to, the illiquid fund; and

(xiii) Any other factor that the Federal Reserve Board believes appropriate.[17]

Effective Date

The final regulations become effective on April 1, 2011. Thus, banking entities in theory could begin seeking extensions on that date. Given the ambiguities throughout the Volcker Rule, clients should, unless special circumstances indicate otherwise, postpone any filing of an extension request until the agencies issue final implementing regulations. However, clients should now be assessing the likelihood of obtaining extensions for their existing Volcker Rule activities and investments.

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We hope you find this helpful. Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

Scott Cammarn	+1 704 348 5363	scott.cammarn@cwt.com
Steven Lofchie	+1 212 504 6700	steven.lofchie@cwt.com
Bryan Shipp	+1 212 504 5615	bryan.shipp@cwt.com

[17] 12 CFR §§ 225.181(d), 225.182(d).