

Alert

Volcker Rule Update: New Guidance on Extensions for Illiquid Fund Investments

December 14, 2016

On Dec. 12, 2016, the Federal Reserve Board (“Board”) issued a policy statement clarifying how it will consider requests for extensions made by banking entities seeking up to an additional five years beyond July 21, 2017 to conform legacy “illiquid fund” investments with Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which is commonly referred to as the “Volcker Rule.”¹ The Board instituted a streamlined submission process requiring banking entities to provide information that would allow the Board to confirm that: (1) the fund in question qualifies, (2) the banking entity is making progress to conform the fund investment to the Volcker Rule requirements, and (3) that either the fund will expire or the investment will be divested by the end of the requested extension period. The Board also indicated that the illiquid fund investments will “generally qualify for extensions” unless the information described above raises concerns. Requests for extensions of the conformance period must be submitted to the appropriate Federal Reserve Bank by Jan. 21, 2017.

The Board also clarified that a banking entity would not be required to attempt to exercise a so-called “regulatory out” provision or otherwise seek third-party consent to terminate an investment in an illiquid fund in order to qualify for the additional extension period.

Background

The Volcker Rule generally prohibits banking entities from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a “covered fund,” which is generally defined as any issuer that would be an investment company under the Investment Company Act of 1940 but for the exemptions contained in Sections 3(c)(1) and 3(c)(7).²

The Dodd-Frank Act provided banking entities with a two-year conformance period, until July 21, 2014, to align their activities and investments to the requirements of the Volcker Rule. The statute further gave the Board the discretion to grant up to three one-year extensions of the conformance period (potentially extending the conformance period until as late as July 21, 2017).³

¹ See [Statement of Policy Regarding Illiquid Fund Investments Under Section 13 of the Bank Holding Company Act](#) (Dec. 12, 2016) (the “Policy Statement”).

² 15 U.S.C. 80a-3(c)(1) or (7); 12 C.F.R. § 248.10(b)(1)(i). A separate [SRZ Memorandum](#), published on Dec. 23, 2013, summarizes the Volcker Rule’s effect on fund activities.

³ 12 U.S.C. § 1851(c)(2).

On Dec. 10, 2013, the Board extended the conformance period for one additional year, until July 21, 2015.⁴ One year later, on Dec. 18, 2014, the Board again granted a one-year extension, until July 21, 2016, and further announced its intention to grant an additional one-year extension of the conformance period until July 21, 2017, which it formalized on July 7, 2016.⁵ These last two one-year extensions were applicable only with respect to those investments in and relationships with covered funds that were in place prior to Dec. 31, 2013 (each referred to as a “legacy” situation).⁶

In addition to the three one-year extensions, the statute also permitted the Board to provide banking entities with one additional extension of up to five years to conform certain legacy “illiquid funds.”⁷ An “illiquid fund” is a fund that is: (1) principally invested in illiquid assets,⁸ and (2) whose principal strategy is to invest in such illiquid assets.⁹ The Board may only grant such an extension once, and the extension may only be granted where the banking entity had a contractual obligation to provide funds to the illiquid fund that was operational as of May 1, 2010.¹⁰

Filing Requirements

In the Policy Statement, the Board instituted a simplified and streamlined process for granting extensions of the holding period for illiquid funds. Banking entities seeking an extension must submit the following information in writing at any point between now and Jan. 21, 2017:

- A list or simple chart of illiquid funds for which an extension is sought;
- A short description of each fund, including the investment strategy and types of investments made by each fund, which banking 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 overall covered funds (both liquid and illiquid) that have been divested or conformed to date, the progress that has been made towards divesting or conforming the investments for which an extension is being 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 constitutes an “illiquid fund” under the

⁴ See [Order Approving Extension of Conformance Period](#) (Dec. 10, 2013).

⁵ See [Order Approving Extension of Conformance Period](#) (Dec. 18, 2014). See also [Order Approving Extension of Conformance Period](#).

⁶ *Id.*

⁷ 12 U.S.C. § 1851(h)(7).

⁸ 12 U.S.C. § 1851(h)(7)(A)(i) (“... illiquid assets, such as portfolio companies, real estate investments, and venture capital investments”).

⁹ 12 U.S.C. § 1851(h)(7)(A)(i) (“makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets. In issuing rules regarding this subparagraph, the Board shall take into consideration the terms of investment for the hedge fund or private equity fund, including contractual obligations, the ability of the fund to divest of assets held by the fund, and any other factors that the Board determines are appropriate.”).

¹⁰ 12 U.S.C. § 1851(c)(3)(A).

Volcker Rule, including that the extension is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010; and

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

The Board indicated that it expects illiquid funds will “generally qualify for extensions,” but notes that requests may be denied where a banking entity has not “demonstrated meaningful progress” to conform or divest its illiquid assets, has a “deficient” Volcker Rule compliance program, or where the Board has concerns about “evasion.”

Filing Procedures

In the Policy Statement, the Board announced that it is delegating authority to the Federal Reserve Banks to grant (but not deny) extension requests if all of the following criteria are met:

- The request relates only to illiquid funds;
- No significant issues have been identified regarding the banking entity's compliance program designed to help ensure and monitor compliance with the prohibitions and restrictions of the Volcker Rule;
- The primary federal agency responsible for the banking entity's compliance with the Volcker Rule (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 in non-illiquid funds) as of the date of the 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).

Extensions would be granted 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) a shorter period determined by the Board. The Board anticipates that complete extension requests will be acted on within 30 days of receipt.

“Regulatory Out” and Third-party Consent Provisions

The Policy Statement also clarified that a banking entity would not be required to exercise a so-called “regulatory out” provision or otherwise seek consent from third parties (e.g., the fund's general partner or other investors) to terminate an investment in an illiquid fund in order to qualify for the extended transition period. “Regulatory out” provisions are contractual terms whereby a banking entity's obligation to remain invested in a fund (or to make a capital contribution) may be excused or otherwise terminated if the banking entity's compliance with the obligation would cause, or would be reasonably likely to cause, the banking entity or the fund to be in violation of applicable laws and regulations.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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