

Federal Reserve Issues Final Rule for Compliance with the Volcker Rule under Dodd-Frank

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The Federal Reserve Board (the “Board”) has adopted a final rule (the “Final Rule”) implementing the time frame for banking entities to come into compliance with the prohibitions and restrictions on proprietary trading and investment in private equity and hedge funds imposed by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).

Section 619 of the Dodd-Frank Act, commonly known as the “Volcker Rule,” added a new Section 13 to the Bank Holding Company Act of 1956 (the “BHC Act”) that prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with, private equity funds or hedge funds. Entities covered by the prohibition include insured depository institutions, any company that controls an insured depository institution, and affiliates and subsidiaries of such entities. The new Section 13 of the BHC Act also subjects nonbank financial companies supervised by the Board (“Supervised NBFCs”) that engage in such proprietary trading activity or hold fund interests to additional capital requirements, quantitative limits or other restrictions as may be established by the Federal banking agencies, the SEC and the CFTC (the “Agencies”). Certain “permitted activities” are excepted from the Volcker Rule prohibitions, including proprietary trading in connection with underwriting or market-making activities, hedging activities, trading in government securities, and sponsorship by a banking entity of private equity or hedge funds for sale to customers, provided that the banking entity retains a *de minimis* investment only in the fund. The Volcker Rule takes effect twelve months after issuance by the Agencies of final rules pursuant to Section 13(b) of the BHC Act, or July 21, 2012, whichever is the earlier (the “Effective Date”).

Intended to give markets and firms an opportunity to adjust to implementation of the Volcker Rule, the Final Rule establishes conformance periods as follows:

- Banking entities and Supervised NBFCs are entitled, without the need for any action on the part of the Board, to a two-year conformance period following the Effective Date to wind down, sell or otherwise conform their activities, investments and relationships to the requirements of the Volcker Rule.
- The Board may grant up to three *separate* one-year extensions to the conformance period.
- A banking entity may petition the Board for an additional extended transition period with respect to any “illiquid fund,” during which period the bank may take or retain an ownership interest in, or otherwise provide additional capital to, the fund, if the extension is necessary to allow the bank to fulfill a contractual obligation that was in effect on May 1, 2010. The extension may not exceed five years, and the extension period will automatically terminate on the date during any such extension on which the bank is no longer contractually obligated to invest in, or provide capital to, the illiquid fund.
 - An “illiquid fund” is a fund that (i) 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 (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets. The Final Rule generally defines an “illiquid asset” as any asset that is not a liquid asset. “Liquid assets” include cash and cash equivalents, assets that are actively or routinely traded on markets or trading facilities and assets for which bid, offer or price quotations are widely available.
 - “Principally invested” means at least 75 percent of a fund’s consolidated total assets are illiquid assets. The 75 percent test rejected the analogy from Glass-Steagall, where “engaged principally” was interpreted as a 5 percent-25 percent threshold.
 - A banking entity will be considered to have a “contractual obligation” to: (i) remain invested in a fund if the banking entity is prohibited by contract from both (a) redeeming all of its equity, partnership or other ownership interests in the fund, and (b) selling or otherwise transferring all such ownership interests to a person that is not an affiliate of the bank and; (ii) provide additional capital to an illiquid fund if the banking entity is required, under contract, to provide additional capital. A contractual obligation will not exist for such purposes where the banking entity has the right and ability to redeem or sell its investment, unless the bank and its subsidiaries and affiliates have used their reasonable best efforts to obtain any requisite consents and such consents have been denied.

- Extension requests under the Final Rule must be submitted in writing to the Board at least 180 days prior to the expiration of the applicable time period.

The Final Rule deals only with the Board's responsibility for overseeing the transition period under the Volcker Rule. The Final Rule does not address the general application of the Volcker Rule to banking entities that are insurance companies or foreign entities, or whether banking entities also should have an extended period of time to conform investments in funds that do not qualify for the statute's extended transition for illiquid funds.