THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 27 No. 5 May 2011

THE VOLCKER RULE AND THE FUTURE OF PRIVATE EQUITY

The Volcker Rule, among other things, restricts any "banking entity" and its parents, affiliates and subsidiaries, from acquiring or retaining ownership interests, or otherwise sponsoring, any "private equity fund." There are exceptions and carve-outs for organizing and offering private equity funds under certain conditions. The FSOC has issued guidance on the Rule and the Federal Reserve has set conformance periods for compliance. The authors provide a summary of the Rule's intended effects on private equity activities, review these materials, and note key provisions that still require clarification by regulators.

By Heath Tarbert and Alex Radetsky *

The Dodd-Frank Act is the most sweeping financial reform legislation since the Great Depression.[1] It addresses a wide range of subjects – including systemic risk, bank safety and soundness, swaps and derivatives, investment management, and corporate governance.[2] While many of Dodd-Frank's provisions will significantly impact the financial sector over the next decade, one section in particular carries the potential to alter dramatically the longstanding relationship between financial institutions and private equity funds: section 619, commonly known as the "Volcker Rule."[3] The Rule and its namesake, former Federal Reserve Chairman Paul Volcker,[4] aim to curb exotic activities and excessive risk-taking by banks and other financial institutions.[5] Because private equity investments are

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

[2] *Id.* § 1(b).

[3] *Id.* § 619.

[4] Remarks by the President on Financial Reform (Jan 21, 2010) *available at* http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform.

[5] FINANCIAL STABILITY OVERSIGHT COUNCIL, U.S. DEPT. OF TREASURY, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 52-55 (2011) [hereinafter FSOC Study].

∗ HEATH TARBERT is senior counsel at Weil, Gotshal & Manges LLP in Washington, D.C. and New York. Until March 2010, he served as special counsel to the U.S. Senate Banking Committee, where the Volcker Rule was introduced. ALEX RADETSKY is an associate in the Financial Institutions Regulatory Group in the New York office of Weil, Gotshal & Manges. The authors are very grateful to Todd Hinson for his research assistance. Mr. Tarbert and Mr. Radetsky can be reached at heath.tarbert@weil.com and alex.radetsky@weil.com, respectively.

IN THIS ISSUE

RSCR Publications LLC Published 12 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $650 per year in U.S., Canada, and Mexico; $695 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call (866) 425-1171 or visit our Web site at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@hotmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail shimmelfarb@comcast.net. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 1051-1741.

among those activities targeted by the Volcker Rule, many have begun pondering the future of private equity as it relates to financial institutions.

The Volcker Rule contains two basic restrictions: (1) a prohibition on proprietary trading, and (2) a ban on certain hedge fund and private equity activities.[6] The proprietary trading component prohibits any "banking entity" from buying and selling any security, derivative, or other financial instrument for its own "trading account," as opposed to purchases and sales for the benefit of customer accounts.[7] This article focuses on the second component of the Volcker Rule, which – subject to certain exceptions – restricts banking entities from acquiring or retaining any equity, partnership, or other ownership interest in, or otherwise sponsoring, any hedge fund or private equity fund.[8] That is to say, the Rule operates to separate private equity sponsorship and investment activities from the traditional business of banking. For the past decade, however, the banking sector and the private equity industry have become closely intertwined; some of the largest and most active private equity funds are sponsored by financial institutions. Furthermore, independently sponsored private equity funds often have multiple banks participating as limited partners or co-investors.

Dramatic changes will not necessarily occur overnight. Before the banking sector and the private equity community can fully understand and prepare for the Volcker Rule's impact, the Federal Reserve and other regulators must clarify the mechanics of the Rule's implementation through successive waves of regulations, orders, and conformance period extensions. On January 18, 2011, the Financial Stability Oversight Council (FSOC) – a new body that includes the heads of all federal financial regulators – published initial guidance on the Rule in the FSOC Study.[9] With the publication of the FSOC Study, the Volcker Rule's implementation period formally began. As discussed further below, however, the final implementing regulations have not yet been promulgated.[10] Although at this juncture the Volcker Rule arguably raises more questions than it answers, this article outlines the basics of the Rule as it will likely apply to private equity activities. In doing so, the article discusses recent developments – including the FSOC Study and the Federal Reserve's specific rulemaking on conformance period parameters. Despite the Volcker Rule's inherent ambiguity in the absence of final implementing regulations, there is little question that its long-term impact on the banking sector's involvement in private equity will be far from superficial.

BANKING ENTITIES

The Volcker Rule does not affect all private equity funds, but only those having certain relationships with a "banking entity," as the term is defined by Dodd-Frank.[11] The statutory definition of "banking entity" includes any depository institution insured by the FDIC, along with any of the institution's parents, affiliates, or subsidiaries.[12] Certain foreign banks supervised by the Federal Reserve are also covered.[13] Aside from a small carve-out for an institution acting solely in a trust or fiduciary capacity, the Volcker Rule's prohibitions capture all of the following:

- FDIC-insured national or state banks;
- FDIC-insured savings associations, industrial loan companies, credit card banks, edge or agreement corporations, or other entities;
- bank holding companies (BHCs);
- savings and loan holding companies (SLHCs);
- foreign banking institutions regulated as BHCs; and

[6] Dodd-Frank Act § 619(a)(1)(A)-(B).

[7] *Id.* §§ 619(a)(1)(A), 619(h)(4), 619(h)(6).

[8] *Id.* §§ 619(a)(1)(B), 619(d).

[9] The study regarding the implementation of the Volcker Rule was published within six months after the enactment of the Dodd-Frank Act, pursuant to section 619(b)(1).

[10] Dodd-Frank Act § 619(b)(2)(A).

[11] *Id.* § 619(f).

[12] *Id.* § 619(h)(1).

[13] *Id.* § 619(f)(2).

- parents, subsidiaries, or affiliates of any of the above.[14]

The expansiveness of the foregoing list is striking. For example, there are approximately 7650 FDIC-insured depository institutions operating in the United States.[15] Because the definition extends also to parents and affiliates of any banking entity, thousands of additional companies will inevitably be subject to the Volcker Rule.[16] What is more, because the definition of a "banking entity" goes far beyond institutions traditionally considered "banks" in common parlance, some non-bank companies with substantial private equity activities and investments may consider divesting their depository-institution subsidiaries in order to avoid the Volcker Rule altogether.[17]

PRIVATE EQUITY FUNDS

As noted above, the Volcker Rule restricts both proprietary trading and certain activities related to private equity and hedge funds. The Obama Administration and Congress feared that banking entities could utilize private fund investments as a way to conduct proprietary trading and thereby effectively create a loophole in the Volcker Rule's ban on proprietary trading.[18] Consequently, the Volcker Rule forbids a banking entity from acquiring or retaining "any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or a private equity fund."[19] "Ownership," as the term is used in the Volcker Rule, is far-reaching and appears to have been interpreted broadly by regulators to include any carried interest, as well as initial capital investments.[20] The term "sponsorship" is similarly broad, and includes a banking entity acting as the fund's general partner or managing member, as well its having the authority to elect or control (or its employees, officers, directors, or agents constituting) a majority of a fund's directors, trustees, or management.[21] Sponsorship also may be imputed if the banking entity shares a similar name with the fund.[22] Definitions for these statutory terms remain forthcoming in the rulemaking process, as the Federal Reserve and other regulators work to promulgate final regulations.

Among the most important statutory terms is "private equity fund." Under Dodd-Frank, the term includes any entity that would be classified as an investment company under the Investment Company Act of 1940, but for the specific exceptions found in sections 3(c)(1) and 3(c)(7) of that statute.[23] Both of these provisions are familiar to private equity professionals. Section 3(c)(1) is an exception for funds with 100 or fewer beneficial owners, and section 3(c)(7) is an exception for funds in which all securities are issued only to qualified purchasers. In most cases, private equity funds are established in a manner that relies on one or both of these provisions to avoid registration with the SEC under the Investment Company Act. Under the Volcker Rule, therefore, private equity funds are identified largely by reference to what they are not. Nevertheless, Dodd-Frank also permits regulators to identify and develop criteria for classifying any "similar funds" (apart from 3(c)(1) and

---

[14] *Id.* § 619(h)(1).

[15] Standard Report #3, Predefined Standard Reports, Statistics on Depository Institutions, Federal Deposit Insurance Corporation (March 25, 2011) *available at* http://www2.fdic.gov/SDI/main.asp.

[16] Indeed, as some have pointed out, the definition of "banking entity" when read literally goes on ad infinitum. Because even permissible private equity funds under the *de minimis* exception, discussed in the text accompanying notes 29-50 *infra*, are affiliates of a banking entity, these funds would themselves be banking entities and therefore technically prohibited – a result that of course makes no sense. The FSOC has acknowledged the circuitousness of the definition and has instructed regulators to clarify it. FSOC Study, at 68-69.

[17] For institutions potentially subject to Dodd-Frank's systemic risk regime, however, this debanking strategy may not effectively alleviate the Volcker Rule's burdens. Although the Volcker Rule's prohibitions technically apply only to banking entities and not to designated "non-bank financial companies" under the new systemic risk regime, Dodd-Frank directs the Federal Reserve or another appropriate agency to impose additional capital charges, quantitative limits, or other restrictions on non-bank financial companies. *See generally* Dodd-Frank Act §§ 161-176. This does not explicitly prohibit non-bank financial companies from having investments in, or relationships with, hedge funds or private equity funds, but the aforementioned systemic risk measures may effectively limit the ability of a designated non-bank financial company to divest its depository-institution subsidiaries and continue to engage in private fund activities. FSOC Study at 6.

[18] Dodd-Frank Act § 619(a)(1)(B).

[19] *Id.* § 619(a)(1)(B).

[20] *Id.* § 619(f); *see also* FSOC Study, at 66 (discussing carried interest and the treatment of invested and committed capital).

[21] Dodd-Frank Act § 619(h)(5)(A)-(B).

[22] *Id.* § 619(h)(5)(C).

[23] *Id.* § 619(h)(2).

3(c)(7) funds) as "private equity funds" in subsequent rulemakings.[24]

As a result, the definition of private equity fund is simultaneously under- and over-inclusive. The "similar funds" language targets the former drawback, but the statutory text provides little solace for the latter problem. Within a typical large financial institution, many subsidiaries or affiliates having nothing to do with private equity activities may avail themselves of sections 3(c)(1) and 3(c)(7) to obviate the need for SEC registration.[25] Consequently, some non-private equity fund entities may arguably fall within the Volcker Rule's restrictions. The plain statutory text notwithstanding, Barney Frank, former Chairman of the House Financial Services Committee, has claimed that Congress never intended the Volcker Rule to cover entities such as operating subsidiaries or joint ventures that may happen to rely on sections 3(c)(1) or 3(c)(7).[26] It remains to be seen how the Federal Reserve and other regulators will respond to this definitional challenge.

Relatedly, the FSOC Study addresses the aforementioned fear that banking entities might restructure their private fund activities as an end-run around the Volcker Rule. As mentioned above, the central purpose of the private funds prohibition was to ensure that banks do not use such vehicles to conduct proprietary trading. One goal of the FSOC Study was to develop guidelines to assist the Federal Reserve and other regulators in defining the scope of what constitutes a prohibited private fund. The FSOC Study recommends classification of private funds by factors such as investment activities and other characteristics apart from their legal status under the Investment Company Act – particularly when construing the term "similar funds" as discussed above.[27] Such factors include the fund's compensation structure, the type of trading and investment strategy the fund employs, the fund's use of leverage, as well as the breadth and independence of the fund's investor base.[28]

DE MINIMIS EXCEPTION

Despite the Volcker Rule's blanket prohibition on private fund ownership and sponsorship, Congress included an important exception specifically geared toward private equity activities.[29] Section 619(d) explicitly allows for a banking entity to organize and to offer a private equity fund – provided certain requirements are satisfied.[30] In order to avail itself of this provision, the banking entity must provide bona fide trust, fiduciary, or investment advisory services to the fund.[31] Second, the banking entity must organize and offer the fund only to its customers who use such services.[32] Third, the banking entity must comply with applicable limitations on state-regulated insurance companies, as relevant.[33] Fourth, the banking entity must not assume, insure, or guarantee the fund's performance or obligations.[34] Fifth, the banking entity must disclose to investors that they will solely bear any

[24] Dodd-Frank Act §§ 619(h)(2), 619(b)(2).

[25] Common examples include real estate investment trusts (commonly called REITs), acquisition vehicles, venture capital funds, joint ventures investing in an operating company or non-investment securities, vehicles designed to hold loans or other debt instruments, unregistered life insurance company separate accounts, closely held family investment pools, structures created for cash management and cash investment, and structures created for the purchase of offshore unregistered Regulation S securities. *See* Letter from Richard M. Whiting, Exec. Dir. and Gen Counsel, Financial Services Roundtable, to Financial Stability Oversight Council, U.S. Dept. of Treasury (Nov. 5. 2010), *available at* http://www.fsround.org/fsr/policy_issues/regulatory/pdfs/pdfs10/FSOCLetter-VolckerStudyNovember52010.pdf.

[26] During the floor debate on the Volcker Rule in the House of Representatives, Representative Himes asked Chairman Frank for the following clarification: "I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings." Chairman Frank responded: "The point the gentleman makes is absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do." 156 CONG. REC. H5226 (daily ed. Jun. 30, 2010).

[27] FSOC Study at 62.

[28] *Id.* at 62-63.

[29] The Dodd-Frank Act also includes a handful of other exceptions, most of which address the proprietary trading component of the Volcker Rule. *See* Dodd-Frank Act § 619(a)-(e).

[30] The *de minimis* exception also covers the organization and offering of hedge funds. *Id.* § 619(d)(1)(G).

[31] *Id.* § 619(d)(1)(G)(i).

[32] *Id.* § 619(d)(1)(G)(ii).

[33] *Id.* § 619(d)(1)(G)(iv).

[34] *Id.* § 619(d)(1)(G)(v).

losses from the fund.[35] Sixth, the banking entity must neither have the same name as, or a similar name to, the fund.[36] Seventh, the banking entity must not permit any of its directors or employees who are not directly engaged in providing services to the fund to invest or otherwise hold any ownership interest in the fund.[37] Eighth, the banking entity may not enter into certain types of specified transactions with the fund or engage in other transactions violative of the restrictions on transactions with affiliates set forth in sections 23A and 23B of the Federal Reserve Act.[38] Finally, the banking entity must not acquire or retain any equity interest in the fund, except for one or more *de minimis* investments that conform to the following requirements:

- within one year of the fund's establishment (with a possible two-year extension) the banking entity must reduce its investment to 3% or less of the total ownership of the fund; and

- the banking entity must limit investments in all such funds to 3% or less of its Tier 1 capital.

No doubt many banking entities will consider organizing, offering, and sponsoring new funds pursuant to what has become known as the "*de minimis* exception." But the private fund activities of some U.S. financial institutions may already exceed both 3% thresholds. Moreover, the *de minimis* exception is ambiguous as to whether these limitations apply to existing funds or only to those future funds established specifically in reliance on the exception. Many believe the better reading of the statute is that the banking entities may use the exception for new funds even as pre-Volcker Rule investments are wound down, but ultimately the Federal Reserve and other regulators must clarify this point in future rulemakings.

The FSOC Study includes some relevant recommendations regarding the *de minimis* exception. In particular, it suggests that because Dodd-Frank does not define "customers," regulators should consider analogous provisions in other banking and securities laws.[39] The study also recommends that regulators should take into account in each circumstance whether there is a continuing customer relationship or simply sporadic contact based solely on discrete needs, whether there is a direct relationship with the customer or an indirect relationship with an agent or advisor of the customer, and whether it was the customer or the banking entity that initiated the relationship.[40] Presumably, a continuing and direct customer relationship where the service was initiated at the customer's request would constitute sufficient evidence of a bona fide customer relationship for purposes of the Volcker Rule.

In addition, the FSOC Study emphasizes the importance of ensuring that the *de minimis* exception does not in any way impose undue risks on banking entities.[41] One particularly important concern is ensuring that banking entities do not understate relevant risks. Final implementing rules may therefore include some metric to measure commitments to invest capital in addition to any actual cash investments made.[42] Such rules are also likely to address the treatment of carried interest and, specifically, whether it is considered to remain in the fund for purposes of the *de minimis* calculation.[43] Further rulemaking developments are expected to address the treatment of synthetic ownership interests as well as the extent to which employee investments in a given fund are counted toward either or both of the 3% limits.[44]

On the surface the *de minimis* exception seems quite puzzling. First, the exception applies by its terms only to those banking entities that "organize and offer" a fund.[45] This is significantly narrower than the Volcker Rule's general prohibition that unambiguously extends to "any ownership interest."[46] On its face, therefore, the Volcker Rule would prohibit even a negligible passive interest in a private equity fund while simultaneously allowing a banking entity to go to much greater lengths in organizing and offering its own fund. Indeed, this aspect of the *de minimis* exception is counterintuitive,

[35] *Id.* § 619(d)(1)(G)(viii).

[36] *Id.* § 619(d)(1)(G)(vi).

[37] *Id.* § 619(d)(1)(G)(vii).

[38] *Id.* § 619(d)(1)(G)(iii).

[39] FSOC Study at 7, 63.

[40] *Id.* at 63-64.

[41] *Id.* at 66.

[42] *Id.*

[43] The FSOC Study states that banking regulators "should consider the proper treatment of carried interest for purposes of the *de minimis* calculation, including whether carried interest that remains in the fund, at the election of the party to whom it is allocated, should be treated the same or differently than carried interest that is removed from the fund when contractually allocated or earned." FSOC Study at 66.

[44] *Id.*

[45] Dodd-Frank Act § 619(d)(4)(A).

[46] *Id.* § 619(a)(1)(B).

since a banking entity arguably exposes itself to far greater economic and reputational risks when sponsoring funds as opposed to investing in them on a strictly passive basis. Nevertheless, the FSOC Study largely confirms this plain reading of the statutory text. The distinction the FSOC draws is that the *de minimis* exception is meant to "be connected to customer-related activities."[47] Presumably, passive interests held for the banking entity's own account would not advance the needs or convenience of customers.

A second puzzling aspect of the de minimis exception – and the Volcker Rule on the whole – is its seeming incongruence with the merchant banking activities permissible for certain banking entities under section 4(k)(4)(H) of the Bank Holding Company Act of 1956 (BHC Act).[48] Prior to Dodd-Frank, most private equity activities were conducted pursuant to that statutory grant of authority and the Federal Reserve's regulations implementing it. Those regulations established one scheme for direct investments in commercial portfolio companies and another for interests in private equity funds invested in such companies.[49] While the Volcker Rule clearly addresses investments in private equity funds, it says nothing of merchant banking activities through direct holdings, and section 4(k)(4)(H) remains entirely intact despite Dodd-Frank's revision or elimination of other provisions in the BHC Act.

Finally, there is the question of market viability – *i.e.*, whether banking-entity-sponsored funds will be able to compete successfully with independent private equity funds. One point of concern is the 3% limit on seed equity after the initial one-year period. Limited partners and other investors in private equity funds favor so-called "skin-in-the-game" – a parallel economic interest of the sponsor or general partner that achieves a proper alignment of incentives. An equity interest of only 3% may fail to satisfy market expectations. Indeed, the most current set of principles endorsed by the Institutional Limited Partners Association call for a fund's sponsor or general partner to retain a "substantial equity interest."[50]

[47] FSOC Study at 66.

[48] Bank Holding Company Act of 1956 § 4(k)(4)(H) (2009).

[49] *See* 12 C.F.R. § 225.170 *et seq.*

[50] *Private Equity Principles: Version 2.0*, Institutional Limited Partners Association (Jan. 2011) (recommending that the sponsor or general partner "have a substantial equity interest in the fund, and it should be contributed in cash as opposed to being contributed through the waiver of management fees"), *available at* http://ilpa.org/wp-content/uploads/2011/01/ILPA-Private-Equity-Principles-2.0.pdf.

FOREIGN FUND EXCEPTION

Apart from the *de minimis* exception, the Volcker Rule permits banking entities to sponsor or invest in a private equity fund outside the United States, so long as "no ownership interest in such … fund is offered for sale or sold to a resident of the United States" and "the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States."[51] The Volcker Rule thus permits private equity activities outside the United States, but only if a foreign entity – one which is essentially not headquartered in the United States – ultimately controls the fund.

Even regulators must concede this exception puts U.S.-based financial institutions on an unequal footing with their foreign counterparts. Foreign-based banking entities may avoid the Volcker Rule by moving their private equity activities overseas. However, U.S.-based institutions may not avail themselves of this option and therefore must conform both domestic and overseas private equity activities to the Volcker Rule's strictures. In creating the foreign fund exception, Congress's foremost aim was to protect FDIC-insured deposits from becoming a source of direct or indirect funding for private fund activities by U.S. banking entities – regardless of whether those activities were conducted within the United States or abroad. At the same time, the exception implicitly recognizes that regulators in Europe, Asia, and elsewhere may decide not to adopt prohibitions akin to those of the Volcker Rule for financial institutions organized and operating in their jurisdictions. Notwithstanding, Congress may have unwittingly damaged the ability of U.S. financial institutions to compete successfully with their foreign counterparts both domestically and overseas.

CONFORMANCE PERIOD RULES

Although much of the Volcker Rule remains subject to further delineation by regulators, the Federal Reserve recently promulgated a final rule relating to the Volcker Rule's conformance period (Final Rule).[52] By mid-October 2011, the Federal Reserve and other regulators

[51] Dodd-Frank Act § 619(d)(1)(I).

[52] Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8266 (Feb. 14, 2011) (to be codified at 12 C.F.R. 225.200 pt. L), *available at* http://www.federalregister.gov/articles/2011/02/14/2011-3199/conformance-period-for-entities-engaged-in-prohibited-proprietary-trading-or-private-equity-fund-or#p-3.

must issue final implementing regulations on all aspects of the Volcker Rule, including on many of the definitions discussed above.[53] Yet the Volcker Rule only becomes "effective" 12 months after the final regulations are issued, or on July 21, 2012, whichever date comes first.[54] Moreover, Congress has provided banking entities with an initial two-year divestment period from the effective date to comply with the Volcker Rule.[55] The divestment period itself may be even longer for certain private equity funds due to the availability of extensions. Indeed, Congress has provided for up to three one-year extensions as well as a single five-year extension for illiquid funds.

One-Year Extensions

The Federal Reserve, by rule or by order, generally may extend the two-year conformance period by up to three additional one-year periods – for a potential aggregate conformance period of five years.[56] For each one-year extension, a banking entity must submit a written request to the Federal Reserve:

- at least 180 days prior to the expiration of the applicable time period;
- citing the reasons why the extension should be granted; and
- providing a detailed explanation of the banking entity's plan for divesting or conforming the investment(s).

Once a request is submitted, the Federal Reserve must determine that an extension would be consistent with congressional aims and not otherwise detrimental to the public interest, the safety and soundness of the banking entity, or the overall financial stability of the United States.[57] The Federal Reserve will take action no later than 90 days after receipt of all necessary information relating to the extension request. If an extension is granted, then the Federal Reserve may impose any additional conditions it believes are appropriate.[58]

---

[53] Dodd-Frank Act § 619(b).

[54] *Id.* § 619(c).

[55] *Id.* § 619(c)(1).

[56] *Id.* § 619(c)(2).

[57] The Final Rule lays out a set of factors that the Federal Reserve will use in considering each request:

(i) Whether the activity or investment

(A) involves or results in material conflicts of interest between the banking entity (or non-bank financial company supervised by the Board) and its clients, customers or counterparties;

footnote continued from previous column…

(B) would result, directly or indirectly, in a material exposure by the banking entity (or company) to high-risk assets or high-risk trading strategies;

(C) would pose a threat to the safety and soundness of the banking entity (orcompany); or

(D) would pose a threat to the financial stability of the UnitedStates;

(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;

(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 (or company) to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity (or company);

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

(xi) any other factor that the Federal Reserve believes appropriate.

Supra note 52, 76 Fed Reg. at 8273.

[58] In cases where the banking entity is primarily supervised by another Federal banking agency, the SEC, or the Commodity Futures Trading Commission, the Federal Reserve will consult

Although the Federal Reserve may grant up to three separate one-year extensions, it may not grant all three at once. A banking entity must apply each year for an additional extension.

Illiquid Funds Extension

Banking entities that experience difficulty in conforming their investments in illiquid funds during the initial five-year extended conformance period (2012-2017) may request that the Federal Reserve extend the conformance period by up to an additional five years in order to permit the banking entity to meet certain contractual commitments in an "illiquid fund."[59] The Volcker Rule authorizes the Federal Reserve to extend the period during which a banking entity may take or retain an ownership interest in – or otherwise provide additional capital to – an illiquid fund, but only "to the extent necessary [for the banking entity] to fulfill a contractual obligation that was in effect on May 1, 2010."[60] The banking entity must apply for this additional five-year extension in the same manner as a one-year extension request.[61] The Federal Reserve may grant only one extended transition period with respect to each illiquid fund.[62] Although the legislative history is silent, this additional extension was likely intended for private equity funds given the nature and timing of their typical investment strategies. As a result of a combination of all available extensions, it may be possible for a banking entity to qualify for a conformance period of up to 10 years from the Volcker Rule's effective date.

In order for a banking entity to qualify for an illiquid fund extension, it must satisfy two sets of criteria. The first set focuses on the nature, assets, and overall investment strategy of the private equity fund itself. The second set focuses on the particulars of the banking entity's investment in the fund.

footnote continued from previous page…

with the primary supervisor prior to approving any extension request by the banking entity, as well as before imposing conditions in connection with the approval of the request. *Id.* at 8274.

[59] *Id.* at 8267.

[60] Dodd-Frank Act § 619(c)(3)(A).

[61] *Supra* note 52, 76 Fed. Reg. at 8267.

[62] *Id.*

Fund-focused Criteria

The Final Rule defines an "illiquid fund" to mean any private equity fund that:

- as of May 1, 2010, was principally invested in illiquid assets, *or* was invested in and contractually obligated to principally invest in illiquid assets; *and*
- makes all investments pursuant to and consistent with an investment strategy to principally invest in illiquid assets.[63]

The Final Rule does not define "illiquid asset" directly, but rather focuses on what constitutes a "liquid asset."[64] For Volcker Rule purposes, then, any asset that is not clearly a liquid asset is by default an illiquid asset. The definition of liquid asset is designed to capture the wide range of instruments and assets that a typical private fund would actively or routinely trade on markets or trading facilities – including equity and debt securities, derivatives, commodity futures, and instruments with a short-term duration that can be monetized or converted at maturity into a liquid asset.[65] Furthermore, the Final Rule explicitly treats as illiquid assets investments made by funds in "privately held portfolio companies, real estate (other than those made through publicly traded REITs), and venture capital opportunities, as well as investments in other hedge funds or private equity funds where such investments do not qualify as liquid assets."[66] The Final Rule also provides that an asset – including a liquid security – may be considered an illiquid asset if – because of statutory, regulatory, or contractual restrictions – the asset is precluded from being traded for at least a three-year period.[67] Because the typical private equity fund invests over long periods in portfolio companies and assets for which no public markets often exist, private equity activities will no doubt benefit from the availability of this additional five-year extension.

The Final Rule provides that a fund will be considered "principally invested" in illiquid assets if at least 75% of the fund's consolidated assets are – or are

[63] *Id.* at 8267-8268.

[64] *Id.* at 8268.

[65] The Federal Reserve has also reserved the authority to determine that any other particular asset constitutes a liquid asset, based on all the facts and circumstances. *Id.*

[66] *Id.* at 8268-8269.

[67] *Id.*

expected to be – illiquid assets or certain risk-mitigating hedges.[68] Furthermore, a fund will be "contractually committed to principally invest" in illiquid assets as of May 1, 2010, if the fund's organizational documents (*e.g.*, limited partnership agreement), or other contractual documents (*e.g.*, binding side letter) in effect as of May 1, 2010, provide for the fund to be principally invested in illiquid assets during the period – beginning on the date when capital contributions are first received by the fund for the purpose of making investments and ending on the fund's expected termination date.[69] Finally, a fund will be deemed to have an "investment strategy to principally invest" in illiquid assets if the fund: (i) markets or holds itself out to investors as having that strategy; (ii) has a documented investment policy reflecting such a strategy; *or* (iii) has written representations in the fund's offering materials and organizational documents regarding its investment obligations and strategy.[70]

Banking-Entity-focused Criteria

As noted above, a banking entity's interest in a private equity fund qualifies for the extended transition period only for the fulfillment of a contractual obligation that was in effect on May 1, 2010.[71] A banking entity will be considered to have a "contractual obligation" if it is prohibited from redeeming, selling, or transferring all of its ownership interests in the fund.[72] Furthermore, a banking entity will be considered to have a "contractual obligation" [73] only if the obligation cannot be terminated, and the banking entity made reasonable but unsuccessful efforts to obtain termination consents from third parties.[74]

MONITORING COMPLIANCE

The FSOC Study addresses the important issue of ensuring that every banking entity maintain a Volcker Rule compliance regime. According to the study, an effective compliance regime should include investment and risk oversight, engagement by the board of directors, certification of compliance by the CEO, and an overall degree of transparency.[75] The banking entity should develop – and its board of directors should approve – "objectives, strategies, and policies governing permissible investments in … private equity funds."[76] The policies must be well-documented and clearly communicated within the organization, and the banking entity should actively monitor its risk profile and the performance of its investments. These policies should identify the aggregate exposure to private equity investments – both funded and committed – that the banking entity is willing to accept. Banking entities also should establish systems to prevent impermissible investments or transactions – supplemented by internal controls, checks and balances, and audit trials to ensure their proper functioning. According to the FSOC Study, the banking entity's CEO should "be required to attest publicly to the ongoing effectiveness of the internal compliance regime."[77] Additionally, the FSOC has directed regulators to consider whether to require banking entities to disclose publicly certain information about private equity investments. Moreover, the FSOC Study highlights the importance of potential disclosures relating to the types and amounts of individual investments, returns, portfolio concentrations, and the contributions of those investments to the banking entity's reported earnings and capital.[78]

CONCLUSION

Many members of Congress and officials within the Obama Administration greeted the passage of Dodd-Frank with considerable fanfare, believing the package of reforms would deliver quick and beneficial changes to the U.S. financial system. But Dodd-Frank's impact has

---

[68] *Id.* at 8276.

[69] *Id.* at 8269-8272.

[70] *Id*. at 8269-8271. Requirement (iii) applies even if such investments may later be convertible into publicly traded securities (such as, for example, in connection with an initial public offering).

[71] *Id.* at 8271-8272.

[72] *Id.*

[73] *Id.*

[74] Although, as explained in note 16 *supra*, "non-bank financial companies" subject to Dodd-Frank's systemic risk regime (that are otherwise not "banking entities") are not explicitly subject to the Volcker Rule's main prohibitions, they must nonetheless comply with any capital and related restrictions imposed by the FSOC and Federal Reserve. Similar to banking entities, non-bank financial companies will have a two-year conformance

footnote continued from previous column…

period, which the Federal Reserve may extend with up to three additional one-year periods. Dodd-Frank Act §§ 113-115.

[75] FSOC Study at 69-70.

[76] *Id.* at 69.

[77] *Id.* at 70.

[78] *Id.*

been far from immediate and its ultimate effects are difficult to predict. In particular, the Volcker Rule's conformance period may stretch for up to a decade as regulators develop final rules and grant extensions in carrying out Congress's mandate. The content of the final regulations will largely determine the future of the longstanding nexus between financial institutions and private equity funds. Without a doubt, banking entities will be constrained in their ability to participate as limited partners and to sponsor their own funds on a substantial scale. Yet the Volcker Rule is equally likely to encourage new structures that permit financial institutions and their customers to benefit from certain private equity activities while concurrently protecting FDIC-insured deposits and improving the overall safety and soundness of the U.S. banking system. ■

The Review of Banking & Financial Services