



*Invested in America*

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*By electronic submission to [www.regulations.gov](http://www.regulations.gov)*

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street & Constitution Avenue, N.W.  
Washington, D.C. 20551

Re: Docket Number R-1397 and RIN AD 7100-58: Request for Public Comment on Proposed Rule to Implement the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity or Hedge Fund Activities

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (“SIFMA”)<sup>1</sup> appreciates the opportunity to provide the Board of Governors of the Federal Reserve System (the “**Board**”) with our comments on the Board’s proposed rules (the “**proposed rules**”) implementing the initial and extended conformance periods provided in new Section 13 of the Bank Holding Company Act (the “**Volcker Rule**”).

Under new Section 13(c)(1), the Volcker Rule is not effective until the earlier of 12 months after issuance of final rules implementing the Volcker Rule or two years after the date of enactment of the Volcker Rule. The Volcker Rule then grants banking entities an initial conformance period of two years following the effective date to bring their activities and investments in hedge funds and private equity funds (“**funds**”) into compliance with the Volcker Rule. The Board also has the discretionary authority to provide two types of additional extensions to the initial conformance period. First, the Board may grant up to three additional years for any non-conforming activities or investments in funds. Second, it may grant up to five additional years after this first set of extensions for investments in, or additional capital contributions to, certain illiquid funds, but only to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010. The Board also has authority to determine, based on all the facts and circumstances, that any fund is an “illiquid fund” and to provide temporary extended transition

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<sup>1</sup> SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit [www.sifma.org](http://www.sifma.org).

periods for illiquid investments in funds that do not fall within the definition of “illiquid fund,” in each case if certain standards are satisfied.

The purpose of Section 13(c) is to ensure that banking entities move steadily toward conforming their activities and investments in funds, while minimizing any disruption to the market, such as harm to the relevant banking entity, the funds it sponsors or invests in, the investors in such funds, the companies or other entities in which the funds are invested and the shareholders of the banking entity.<sup>2</sup> This purpose is apparent from the face and structure of the statute, and supported by statements by Senators Merkley and Hagan during the Senate’s consideration of the Volcker Rule.<sup>3</sup> The reason for providing the longest transition period for investments in illiquid funds is that they are the most difficult assets to divest without significant harm to the banking entity and those other stakeholders.

Although the Board’s proposed transition rules are generally consistent with this purpose, certain aspects are not. In particular, certain key aspects of the proposed rules would effectively strip the Board of its discretion to grant the extended conformance period for investments in illiquid funds. The proposed definitions for the elements of the term “illiquid fund” are so narrow that almost no fund will qualify, including most genuinely illiquid funds. Unless corrected, these narrow definitions will have the effect of forcing banking entities to unwind most of their investments in illiquid funds at depressed or even fire sale prices. Such forced sales at depressed prices will damage the capital and earnings of the banking entities. They will also potentially harm investors who based their investment decisions on the assumption that the banking entities would continue alongside them as sponsors and investors for the life of the funds. In Section I of this letter, we propose amendments to these definitions to make them more consistent with the statutory purpose of Section 13(c).

We believe that eliminating the Board’s discretion to grant the special extended conformance period for illiquid funds in this manner would be inconsistent with the purpose of Section 13(c). The purpose of the Volcker Rule is to promote the safety and soundness of banking entities, not to weaken safety and soundness by causing unnecessary losses to banking entities. The Board should not paint itself into a corner without the ability to exercise discretion unless compelled to do so by the statute. Far from compelling such a result, the statute gives the Board ample discretion to define the elements of the term “illiquid fund” in ways that are consistent with its purpose. Broader definitions of those elements are consistent with the statutory purpose because they preserve the Board’s discretion: the Board can always deny an extension request if the facts and circumstances warrant denial.

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<sup>2</sup> 75 Fed. Reg. 72741, 72742, 72743 (Nov. 26, 2010).

<sup>3</sup> 156 CONG. REC. S5889, S5899 (daily ed. July 15, 2010).

Our comments are designed to restore the Board's statutorily mandated discretion to grant – or deny – the special extended conformance period for illiquid funds. To illustrate how the comments in our letter could be implemented, we have included suggested amendments to the proposed rules in Annex A.

Finally, we believe that the substantive regulations that are required to be issued within nine months of the release of the Financial Stability Oversight Council's study on implementing the Volcker Rule could affect the transition rules in unexpected ways. As a result, we respectfully request that the Board issue its transition rules on an interim basis to permit an additional notice and comment period following the issuance of the substantive regulations.

## **I. Illiquid Funds**

We believe that the statutory definition of the term “illiquid fund” is too narrow. Accordingly, we suggest in Section V of this letter that, where warranted, the Board should exercise its authority to determine, based on all the facts and circumstances, that any fund is an “illiquid fund.” We also believe that the proposed rules would further restrict the statutory definition in a manner that Congress did not require or intend. The problem arises out of how the proposed rules would define certain elements of the term that are not themselves defined in the statute, such as “illiquid assets,” “principally invested,” “invested,” “contractually committed,” “contractual obligations” and “necessary to fulfill a contractual obligation.” We believe that the proposed definitions of these elements are inconsistent with the purpose of Section 13(c) because they would result in the exclusion of many genuinely illiquid funds that were principally invested, or contractually committed to principally invest, in illiquid assets as of May 1, 2010.

The Board has ample discretion to define these elements in a manner that is consistent with the purpose of Section 13(c). Under *Chevron v. Natural Resources Defense Council*,<sup>4</sup> any reasonable definitions adopted by the Board will be entitled to deference by the courts, unless the definitions are inconsistent with the text or purpose of Section 13(c). We believe that the proposed definitions would be more consistent with the purpose of Section 13(c) if they preserved the Board's discretion to treat more, rather than fewer, funds as illiquid funds. As noted above, a broader definition will preserve the Board's option to grant an extension for a genuinely illiquid fund if the facts and circumstances justify it. The Board can always deny an extension if the facts and circumstances do not justify it, even if the fund otherwise comes within the definition of an illiquid fund.

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<sup>4</sup> 467 U.S. 837 (1984).

## **A. Definition of “illiquid assets”**

While examples of illiquid assets are given in Section 13(h)(7) of the statute, the term “illiquid assets” is not comprehensively defined. We believe the term should be defined in the rules to be sufficiently comprehensive to cover all assets that are genuinely illiquid, including any real property, security, obligation, or other illiquid asset held by a fund, such as an investment in a portfolio company, a venture capital investment or any equity, partnership or other ownership interest in another fund. To this end, we believe that the definition of “illiquid assets” should be amended as proposed in Annex A to reflect the considerations that follow.

### **1. Illiquidity caused by contractual restrictions on transfer**

Illiquid assets should include assets that are subject to contractual restrictions on transfer. As the proposed rules acknowledge, fund assets are often subject to statutory or regulatory restrictions on transfer that justify treating them as illiquid assets. Contractual restrictions, such as those in a fund’s organizational documents or other agreements relating to an investment (for example, an agreement among shareholders (including the fund) of a portfolio company or an underwriting agreement with the underwriters of a public offering) are very common and can impose the same sort of restrictions that can cause an asset to be illiquid as statutory or regulatory restrictions.

### **2. Illiquidity caused by adverse market conditions**

Illiquid assets should also include otherwise liquid assets that become illiquid during a market disruption or other unusual market conditions, such as those experienced during late 2008. Such assets should be considered illiquid if they cannot be sold to unaffiliated third parties during such periods, except at a material discount to what their fair value was or is expected to be under normal market conditions.

### **3. Illiquidity caused by large positions**

Illiquid assets should also include the portion of any assets held by a banking entity or fund to the extent such portion cannot be promptly sold to a third party other than at a price that is materially lower than the prevailing market price for a “normal quantity” of such assets in the relevant market (as described below). This situation can arise in a variety of circumstances. For example, when a private equity fund takes a portfolio company public, it is typical for the offering to relate to a small percentage of the company’s total stock, for example 10 – 15 percent. In such a case, most of the remaining percentage would be very difficult for the private equity fund to sell except in smaller quantities over time and should be considered illiquid.

We believe that the prevailing market price should be determined by reference to paragraphs (h)(2), (3) or (4) and that a fair, reasonable and useful definition of a normal quantity of assets is 25 percent of the average daily trading volume of such assets in the relevant market during the immediately preceding four calendar weeks.<sup>5</sup> That is the definition used by the Securities and Exchange Commission (the “SEC”) in Rule 10b-18 under the Securities Exchange Act of 1934 for one of the conditions of its safe harbor from liability for market manipulation for public companies that repurchase their own equity securities. We believe that this definition is an appropriate definition of a normal quantity because the SEC has determined that repurchases of such amounts are unlikely to have a material adverse effect on the prevailing market prices.

#### **4. Illiquidity caused by other facts and circumstances**

Finally, the term “illiquid assets” should include any other assets that the Board determines to be illiquid under all the facts and circumstances. As the Board recognized in its discussion of the term “liquid asset,” “there may be situations where other, non-enumerated assets may be liquid even though they are not included in the [proposed definition of liquid assets].”<sup>6</sup> By the same token, we believe that there will be situations where assets that are not enumerated in the proposed definition of “illiquid assets” will be genuinely illiquid.

#### **5. Assets in the form of investments in other funds, including investments by a fund of funds**

On its face, the proposed definition of “illiquid assets” treats the ownership interest held by any fund in another fund as an illiquid asset for purposes of determining whether the first fund is an illiquid fund based on the same rules that apply to other assets. We believe that such an approach is appropriate.

The release accompanying the proposed rules, however, indicates that such ownership interests should not be treated as illiquid assets unless they are themselves illiquid *and* the funds in which they represent ownership interests are also illiquid funds.<sup>7</sup> There is no basis in the statute for such a double illiquidity requirement. Moreover, such a requirement is impractical and will preclude almost all such ownership interests from being treated as illiquid assets for purposes of the illiquid fund test, even when such interests are themselves genuinely illiquid. A fund that invests in other funds, such as a fund of funds, or a banking entity that makes investments in third-party funds for its own account, typically does not have any contractual or

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<sup>5</sup> For assets such as bonds or loans for which “average daily trading volume” may not be a useful metric, we suggest that prevailing market price be calculated with reference to such similar measure of price to quantity as the Board determines is appropriate.

<sup>6</sup> *Id.*

<sup>7</sup> *See* 75 Fed. Reg. 72741, 72744 (Nov. 26, 2010).

other rights to obtain sufficient information about the assets of an underlying fund to assess whether the underlying fund itself is an illiquid fund.

We believe that the Board should clarify that ownership interests held by one fund in another fund will be classified as illiquid assets for purposes of the illiquid fund test based on the same standards that apply to other assets – without regard to whether the underlying fund is itself an illiquid fund. Because the text of the proposed rules does not itself contain such a double illiquidity requirement, neither should the release accompanying the final rules.

**B. “Principally invest” / “principally invested”**

The statutory definition of the term “illiquid fund” uses but does not define the terms “principally invest” or “principally invested.” We therefore believe that the Board has substantial discretion to define those terms, provided that it adopts definitions that are reasonable and consistent with the purpose of Section 13(c) and established precedent. Unfortunately, we do not believe that the proposal to define “principally invested” to mean at least 75 percent of a fund’s consolidated total assets satisfies those standards. We believe that it would be unreasonable and inconsistent with that purpose and precedent to interpret “principally invest” or “principally invested” to mean a minimum threshold that is higher than 50 percent of a fund’s assets.

The release accompanying the proposed rules justifies the proposed definition by stating that “Congress appears to have structured the extended transition period for those types of funds that are clearly focused on, and invest substantially all of their capital in, illiquid assets.”<sup>8</sup> But the release cites no authority for this statement, and we have been unable to find any basis for it in the language or legislative history of the statute. Indeed, both the text of the Volcker Rule and its legislative history appear to be silent on what was meant by “principally invested” in illiquid assets.

If Congress had intended to limit the extended transition period to funds that invest “substantially all of their capital” in illiquid assets, it could have used those words instead of the words “principally invested.” Instead, it chose to define an illiquid fund as any fund that was, as of May 1, 2010, “principally invested” in illiquid assets and subsequently follows an investment strategy to “principally invest” in illiquid assets. Alternatively, the statute defines illiquid funds as any fund that was, as of May 1, 2010, invested in and contractually committed to “principally invest” in illiquid assets and subsequently follows an investment strategy to “principally invest” in illiquid assets.

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<sup>8</sup> *Id.* at 72745.

We are unaware of any precedent in the Bank Holding Company Act for interpreting the word “principally” to mean at least 75 percent. There is, however, a well-known precedent for interpreting the word “principally” to mean a percentage between 25 percent and 50 percent. That precedent is the Board’s own interpretation of the term “principally” in Section 20 of the Glass-Steagall Act. From 1933 until its repeal by the Gramm-Leach-Bliley Act of 1999 (the “**GLB Act**”), Section 20 prohibited banks from having any affiliate that was “engaged principally” in underwriting or dealing in securities, other than U.S. government securities or other bank-eligible securities. In its first order construing the term “engaged principally,” the Board rejected the applicant’s argument that the term “engaged principally” should be construed to mean more than 50 percent of a securities affiliate’s business. Instead, it construed the term “principally” to mean something less than 50 percent of a securities affiliate’s business.<sup>9</sup> The Board initially determined that a securities affiliate that derived less than 5 percent of its revenues from bank-ineligible underwriting and dealing would not be deemed to be “engaged principally” in such underwriting and dealing.<sup>10</sup> Over time, the Board gradually increased that revenue limit until, on the eve of the Gramm-Leach-Bliley Act, it had determined that a securities affiliate could derive up to 25 percent of its revenues from bank-ineligible underwriting and dealing without being deemed to be engaged principally in underwriting and dealing.<sup>11</sup>

Congress was aware of this history when it chose the word “principally” to define the level of investment in illiquid assets that would cause a fund to be treated as an illiquid fund. Indeed, when Congress wanted to signify a supermajority of a firm’s business in the Dodd-Frank Act, it knew how to do so. Thus, it used the words “predominantly engaged” in Section 201 of the Dodd-Frank Act and defined them to mean at least 85 percent of the firm’s revenues. This is consistent with the use of those words in Section 4(n) of the Bank Holding Company Act, which also defined them to mean at least 85 percent of the firm’s revenues.<sup>12</sup>

We believe that the definition of the term “principally invested” would be more consistent with the ordinary meaning of those words, the purpose of Section 13(c) and Board precedent if it preserved the Board’s discretion to treat more, rather than fewer, funds as illiquid funds if justified by the facts and circumstances. As noted above, a definition that sweeps in more funds will preserve the Board’s option to grant an extended conformance period to genuinely illiquid funds that meet the snapshot test. We therefore recommend, as set forth in Annex A, that

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<sup>9</sup> *Bankers Trust New York Corporation*, 73 Federal Reserve Bulletin 138, 140-42 (1987) (“*Bankers Trust Order*”). See also *Citicorp., J.P. Morgan & Co., and Bankers Trust New York Corp.*, 73 Federal Reserve Bulletin 473, 477-78, 482-83 (1987).

<sup>10</sup> *Bankers Trust Order*, 73 Federal Reserve Bulletin at 146.

<sup>11</sup> *Revenue Limit on Bank-Ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities*, 61 Federal Register 68750 (Dec. 30, 1996).

<sup>12</sup> 12 U.S.C. § 1843(n)(2).

“principally invested” be defined to mean at least 50 percent of a fund’s consolidated total assets (as reflected on the fund’s most recent prior financial statements prepared in accordance with applicable accounting standards, or valuation report or other comparable statements or reports to investors).

**C. “Invested”**

Neither the statute nor the proposed rules defines the term “invested” when it is not qualified by the word “principally.” The term “invested” is used in the alternative definition that captures funds that were not principally invested in illiquid assets as of May 1, 2010, but were contractually committed to principally invest in illiquid assets as of that date. The Board indicated in its release accompanying the proposed rules that the alternative definition is intended to cover start-up funds that were in the early stages of their investment period and may have invested only a small portion of their committed capital in illiquid assets as of May 1, 2010. We believe that the alternative definition was also intended to apply to seasoned funds that may not have met the “principally invested” threshold as of May 1, 2010 as a result of formerly illiquid assets becoming liquid (for example, portfolio companies having gone public), but that were contractually committed to principally invest in illiquid assets as of that date.

We believe that it would be most consistent with the purpose of Section 13(c) to interpret “invested,” when not qualified by the word “principally,” to mean invested in *any* illiquid asset so long as there was a contractual commitment to principally invest in such assets as of May 1, 2010.

**D. “Contractually committed”**

The proposed rules also contain a definition of the phrase “contractually committed” that unduly limits the scope of funds that would be treated as illiquid funds for purposes of the transition rules. Specifically, “contractually committed” is defined to refer only to the fund’s “organizational documents, or other documents that constitute a contractual obligation of the fund.” To be consistent with the purpose of the transition rules, we believe that the phrase “contractually committed” should be defined to include all promises that a fund’s investors would reasonably consider to be contracts between the fund or its sponsor and the fund’s investors. That would include any commitments, representations or other undertakings made in the fund’s organizational documents or offering materials provided to investors before their investment in the fund. We therefore recommend that the definition of “contractually committed” be amended as set forth in Annex A.

**E. “Necessary to fulfill a contractual obligation”**

The proposed rules provide that the extended conformance period for illiquid funds is only available to the extent “necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.”<sup>13</sup> In this respect, it mirrors the statutory language of the Volcker Rule. We believe, however, that the definition of “contractual obligation” and the implementation of the “necessary” condition in the proposed rules are not consistent with the purpose of Section 13(c).

**1. “Contractual obligation”**

Under the proposed rules, a banking entity would be treated as having a contractual obligation to take or retain an ownership interest in a fund only if the banking entity were prohibited under the terms of its ownership interest or other contractual arrangements from redeeming all of its ownership interests or selling or otherwise transferring such ownership interests to a third party. In addition, a banking entity would be treated as having a contractual obligation to make additional capital commitments to a fund only if it were required under the terms of its ownership or other contractual arrangements to provide such additional capital to the fund, without taking into consideration any other factors.

To be more consistent with the purpose of Section 13(c), we believe the term “contractual obligation” should be defined to include all promises that a fund’s investors would reasonably consider to be contracts between the fund or its sponsor and the fund’s investors. That would include any commitments, representations or other undertakings made in the fund’s organizational documents or offering materials provided to investors before their investment in the fund.

**2. “Necessary” condition**

The proposed rules also contain a provision that would treat a banking entity as having a contractual obligation only if the banking entity does not have the unilateral right to terminate the obligation and has not been able to obtain any necessary consents after using its reasonable best efforts to obtain them. This provision appears to be intended to give effect to the “necessary” condition discussed above. We believe that the proposed rules are far more restrictive than required under any reasonable interpretation of the “necessary” condition and are therefore inconsistent with the purpose of Section 13(c).

With respect to investments in sponsored funds, the proposed rules would appear to condition the extended conformance period on the exercise of all regulatory outs or other

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<sup>13</sup> *Id.* at 72750.

excuse provisions even if the exercise of such provisions would be inconsistent with the written commitments, representations or other undertakings provided by the banking entity to investors before they made their investment in the funds. With respect to investments in third-party funds, the proposed rules would appear to condition the extended conformance period on exercising regulatory outs or the taking of reasonable best efforts to obtain all necessary third-party consents even if obtaining such consents would require the banking entities to incur significant losses or suffer other material adverse effects.<sup>14</sup>

Those standards, which are not required by the statute, would make the extended conformance period unavailable for almost all illiquid funds. In the case of sponsored funds, fund documents almost always contain regulatory outs or other excuse provisions or rights to consent to certain actions for the sponsor. For example, fund documents almost always provide that a limited partner may transfer its limited partner interest in the fund with the consent of the fund's general partner. Accordingly, in such a case where a banking entity is the general partner, the banking entity has the unilateral contractual power to consent to a transfer of an interest it holds as a limited partner, at least if any other constraints on such power are disregarded as the proposed rule would apparently do. With this in mind, no such sponsored fund would be able to meet the "necessary" condition in the proposed rules and would therefore never be entitled to the extended conformance period despite the fact that these funds may be genuinely illiquid funds. We do not believe that such a result is consistent with the purpose of Section 13(c). In the case of third-party funds, there is always a price at which consent can be obtained from the sponsor, other investors or other stakeholders. The question is how high a cost a banking entity must accept in order to satisfy the reasonable best efforts condition.

As the sponsor of a fund, a banking entity owes fiduciary and other duties to the fund and to the fund's investors. The exercise by a banking entity of its excuse provisions or its right to consent to a redemption or transfer of its own interest in a sponsored fund could harm the fund, and the fund's investors, in violation of the banking entity's duties. If, for example, a redemption would result in the banking entity being paid in cash, the fund would need to liquidate investments to generate the cash and the fund's more liquid investments would likely be liquidated first to fund the redemption. This could give rise to a conflict of interest, as the banking entity would be determining the value of its interest and the non-redeeming investors

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<sup>14</sup> We note that the definition of "necessary" under the proposed rules creates a circularity that prevents the Board from granting an extended conformance period with respect to any investment by a banking entity in a fund for which a regulatory out exists, as shown in the following example: (i) regulatory outs become exercisable because it has become or may become illegal for a banking entity to hold an interest in a fund; and (ii) holding the interest becomes illegal or may become illegal when an extension is not or may not be available; but (iii) the reason the extension is not or may not be available is because the regulatory out exists. We believe that this kind of circularity is not consistent with the purpose of Section 13(c).

would be left with a more illiquid (and potentially less desirable) pool of assets than before the redemption.

Conflicts could also arise by virtue of the fact that the banking entity redeemed its interest ahead of other investors, or a ‘race to the exit’ could be sparked by the banking entity’s announcement of its intent to redeem its interest. In many instances, particularly in the private equity context, redemption of the banking entity’s interest would be impossible because of the illiquidity of the fund’s assets, in which case the banking entity would presumably be forced to transfer its interest in the secondary market in order to comply with the proposed rules. Conflicts of interest could arise if the consent of the general partner alone was sufficient to effect such a transfer because the banking entity would effectively be approving its own transfer.

Forcing banking entities to exercise their excuse provisions or rights to transfer would also violate the reasonable expectations of investors who, at the time they made the decision to invest in the fund, relied on the commitments, representations or other similar undertakings made by the fund or the fund sponsor in the fund’s organizational documents or offering materials. It has been standard market practice, for example, for investors to require that sponsors invest in the funds they sponsor in order to align the incentives of the sponsor and other investors – often this sponsor commitment has been substantial. We believe that requiring a sponsor to redeem or transfer its interest in a fund midway through the life of the fund contravenes the expectations of investors and materially alters the basis on which investors made their investment decisions.<sup>15</sup>

We believe that the proposed rules would be more consistent with the purpose of Section 13(c) if they were amended so that contractual obligations would qualify as “necessary” as long as:

- In the case of funds that are not sponsored by the banking entity:
  1. the obligation may not be terminated in the banking entity’s sole discretion; and

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<sup>15</sup> A substantial investment on the part of the sponsor in its private equity fund has always been considered to be a critical factor in an investor’s evaluation of the fund. We note that the Institutional Limited Partners Association (“**ILPA**”) adopted the ILPA Private Equity Principles more than a year ago, before the Volcker Rule had even been proposed by the Obama Administration. These principles were intended to set out “best practices” for investors to be mindful of when investing in private equity funds. More than 140 respected institutional investors, including some of the largest public and private pension funds, endowments and foundations, endorsed the principles. Among the best practices recommended in the principles is that “[t]he general partner should have a substantial equity interest in the fund to maintain a strong alignment of interest with the limited partners . . .” See ILPA Private Equity Principles, at 3 (September 8, 2009).

2. the banking entity has tried in good faith to obtain any necessary consents and has not been able to obtain them or act upon them without making material concessions.
- In the case of sponsored funds, the termination of the contractual obligation would be inconsistent with any written commitment, representation or other undertaking provided to investors before they made their investment in the fund.

### **3. Expiration of contractual obligation**

Under the proposed rules, the extended conformance period would expire immediately upon the termination of a contractual obligation. Because a banking entity will not be able to predict with any certainty when a contractual obligation will formally terminate (for example, when the general partner of a third-party fund consents to the transfer of the banking entity's interest, or when a sufficient number of limited partners consents to the termination of the banking entity's obligation to a sponsored fund), the proposed rules would be impractical and cause a banking entity to be in violation of the Volcker Rule without notice. We note that where a banking entity has multiple contractual obligations to a fund, the termination of one contractual obligation should not affect the continuation of the others or the banking entity's need for an extended conformance period in order to honor those other obligations. We therefore recommend, as set forth in Annex A, that a banking entity have a six-month grace period following termination of all contractual obligations to bring its activities and investments in a fund to which it no longer has a contractual obligation into compliance with the Volcker Rule, subject to extension by the Board for an additional six months.

#### **F. Satisfying the snap shot test**

The definition of "illiquid fund" should contain a practical way for determining whether a fund was sufficiently invested in illiquid assets as of May 1, 2010 to qualify. The proposed rules indicate that these tests are to be based on a fund's consolidated assets as reflected in its financial statements prepared in accordance with applicable accounting standards. This raises a practical concern: given the cost and complexity of valuation, most funds prepare financial statements only on certain dates, usually annually on an audited basis and quarterly on an unaudited basis. It would be very costly to require them to prepare special financial statements as of May 1, 2010.

We believe the definition would be more consistent with the purpose of Section 13(c) if it allowed funds to satisfy the May 1, 2010 tests based on the most recently available financial statements, valuation report or other comparable statements or reports to investors prepared prior to May 1, 2010. If the Board believes that such statements or reports would not

provide an accurate picture under a particular set of facts and circumstances, it could require a fund to prepare financial statements, a valuation report or other comparable statements or reports as of May 1, 2010. We note that, with respect to most investments by banking entities in third-party funds, the banking entity will not necessarily be able to cause the fund to prepare financial statements outside the ordinary course of the fund's operations.

## **II. Procedures**

### **A. Extension requests**

The proposed rules contemplate that banking entities would submit a request for an extended conformance period at least 90 days before the expiration of the prior conformance period. As a practical matter, banking entities cannot wait until the last 90 days of a conformance period to learn whether or not they will be granted an extension, especially for investments in illiquid funds. It would also be difficult if not impossible for the sponsor of a fund to take advantage of an investment opportunity for the fund if it were uncertain that it would be able to fulfill its contractual obligations to the fund going forward. Banking entities will need substantially more lead time if they might be forced to divest their interests. Forcing banking entities to wait until the last 90 days to know whether an extension will be granted would be a recipe for fire sales.

Instead, we urge the Board to recognize a procedure that allows banking entities to present a conformance plan well in advance of any deadline, including during the pre-effective period. The plan would include a timeline for divestiture and conformance for each fund covered by the plan, including all appropriate extensions, which the Board could evaluate and approve in one consolidated act. Upon the appropriate evidentiary showing, such an approval could provide notice to a banking entity that it would have, for example, the entire eight-year extended conformance period in which to conform certain highly illiquid investments. So long as the banking entity continued to meet its approved milestones according to the plan, it and its funds (including the investors in the funds) would benefit from certainty regarding the duration of the transition period for each fund. Where the banking entity failed to meet its approved milestones, the Board could impose appropriate consequences, including early disposition of the banking entity's illiquid interests. We also believe that, given the number of funds sponsored by banking entities, as well as the number of third-party funds in which banking entities are invested, requiring banking entities to seek extensions with respect to all such funds on an annual basis would impose significant operational burdens on the banking entities as well as on the Board in having to review the applications.

To facilitate the approach we recommend, the proposed rules should include a provision that allows the Board to consolidate all three of the one-year conformance periods

into a single three-year conformance period if the facts and circumstances warrant it. Similarly, the proposed rules should allow the Board to consolidate the three one-year periods with the additional five-year period for illiquid funds.

We would also recommend including a provision that would require the Board to process any extension request within 90 days after submission of an informationally complete request. The Board has typically included such a provision in other prior approval procedures in its other regulations.

Not only would our proposed approach be more consistent with the purpose of Section 13(c), but it would also be more consistent with an efficient use of the Board's administrative resources.

#### **B. Factors governing the Board's decision to grant extensions**

The proposed rules contain a number of factors that the Board may consider in deciding whether to grant or deny an extension request. We believe it would be more consistent with the purposes of the Volcker Rule and Section 13(c) to include certain additional factors, including whether an extension or denial would promote safety and soundness, financial stability or the minimization of harm to the banking entity and other stakeholders. We also believe that the Board should consider the impact of any extension or denial on the banking entity's duties to the fund, the fund's investors and the banking entity's shareholders, whether the extension or denial would create or reduce any conflicts of interest and the good faith compliance efforts previously made by the banking entity.

#### **III. Newly Designated Similar Funds**

Although the proposed rules properly create adjusted conformance periods for companies that become "banking entities" after the Volcker Rule's enactment date (July 21, 2010), we believe that the final rules should also create adjusted conformance periods for newly designated "similar funds." Fundamental fairness requires such adjusted transition periods because it is virtually impossible for banking entities to predict in advance what sort of funds the regulatory agencies may designate as a similar fund.

#### **IV. Clarifications**

##### **A. The conformance period (including extensions) should apply to all activities**

We believe that the Board should clarify that the reference to "activities" in Section 13(c)(2) of the statutory text includes all non-conforming activities, including new covered transactions entered into with sponsored or advised funds. A banking entity would

therefore be permitted to continue to enter into new covered transactions with funds established before the effective date of the Volcker Rule for the duration of the applicable conformance period as determined by the Board.

The text of Section 13(c)(2) of the Volcker Rule does not limit the applicability of the transition period to any particular class of activities, stating only that “A banking entity . . . shall bring its *activities and investments* into compliance with the requirements of [the Volcker Rule] not later than 2 years after the [effective date].” (Emphasis added). Senators Merkley and Levin similarly made no distinction among types of activities in their colloquy discussing Section 13(c)(2), referring only to “activities” that must be brought “in conformity with the law” by the end of the transition period.<sup>16</sup> We therefore recommend that the Board clarify that it will interpret the general conformance period and potential extensions to apply to all of a banking entity’s activities, including new covered transactions entered into with preexisting funds.

## **B. Employee investments**

We believe that the Board should also clarify that commitments made by employees of a banking entity prior to the effective date of the Volcker Rule to provide capital to funds sponsored by the banking entity, and to retain interests in such funds, are not subject to the Volcker Rule, and therefore need not be divested or otherwise terminated. We are not aware of any intent on the part of Congress to harm employees of banking entities by forcing them to divest their interests in sponsored funds at potentially material discounts to fair value. Doing so would violate fundamental fairness, be unnecessarily punitive and inconsistent with congressional intent.

## **V. Expanded Transition Provisions**

As noted above, we believe that the statutory definition of “illiquid fund” is too narrow because it only applies to funds that were illiquid as of May 1, 2010. This means that, among other consequences, the extended conformance period will not apply to funds that become illiquid after that date. We also believe that the extended conformance period is too narrow because it only considers the illiquidity of a fund and ignores the illiquidity of an ownership interest in the fund. While the proposed rules permit a banking entity to treat illiquid investments held by one fund in another fund as illiquid assets of the first fund for purposes of deciding whether the first fund is an illiquid fund, they do not provide an extended conformance period for *illiquid* investments in *liquid* funds.

We believe that the Board has the authority under Section 13(d)(1)(J) to determine, based on all the facts and circumstances, that any fund is an “illiquid fund” and to provide temporary extended transition periods for illiquid investments in funds that do not

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<sup>16</sup> 156 CONG. REC. S5898 (daily ed. July 15, 2010).

fall within the definition of “illiquid fund,” in each case if certain standards are satisfied. What is more, we believe that the Board’s authority under this provision is exclusive to the extent it is being exercised to create a temporary exemption in the nature of a transition rule.

Section 13(d)(1)(J) authorizes the Board to issue a rule exempting banking entities from any of the prohibitions or restrictions of the Volcker Rule if such an exemption would “promote and protect the safety and soundness of the banking entity and the financial stability of the United States.” Although it was designed mainly for permanent exemptions, under the logical principle that the greater includes the lesser, it also includes the authority to grant temporary exemptions in the nature of a transition rule. In addition, although the Board would be required to coordinate with the other Federal banking agencies, the SEC and the Commodity Futures Trading Commission if it were creating a permanent exemption, we do not believe the Board is required to coordinate with these other agencies when it is exercising this power to create a temporary exemption in the nature of a transition rule. The Volcker Rule expressly grants the Board exclusive authority over all transition rules.

It is important to note that the Board’s use of the authority contained in Section 13(d)(1)(J) of the statute to determine, based on all the facts and circumstances, that any fund is an “illiquid fund” and to provide temporary extended transition periods for illiquid investments in funds that do not fall within the definition of “illiquid fund” does not mean that the Board would have to grant any extended transition period requested by a banking entity. The Board could always deny an extension request if the facts and circumstances warranted denial.

**A. Authority to determine that any fund is an “illiquid fund”**

It is impossible to anticipate all the circumstances under which a genuinely illiquid fund might not be covered by the general definition of “illiquid fund.” In at least one common circumstance, a fund that was not principally invested in illiquid assets as of May 1, 2010 could become principally invested in such assets thereafter. This could occur because the fund subsequently acquired more illiquid assets, disposed of some of its liquid assets, or otherwise became genuinely illiquid because of changing market conditions or other factors. In many cases, assets that were liquid as of May 1, 2010 may become illiquid after that date, with the effect of causing a once liquid fund to become an illiquid fund.

In the absence of Board discretionary authority to provide an extended conformance period for investments in such genuinely illiquid funds, banking entities might be required to divest their interests in such funds at prices significantly below fair value, which would have a negative impact on their earnings and capital. This result would be contrary to the purpose of the transition rules and, to the extent it applies system-wide, could hinder or threaten

the safety and soundness of certain banking entities and the stability of the U.S. financial system. We believe this is sufficient to satisfy the standard to issue a rule under Section 13(d)(1)(J).

We therefore urge the Board, where warranted, to exercise its authority under Section 13(d)(1)(J) to issue a rule under which the Board would have the authority to determine, based on all the facts and circumstances, that any fund not otherwise covered by the statutory definition is an “illiquid fund.” We believe such an exercise of authority would make the extended conformance period for illiquid funds more consistent with the purpose of Section 13(c).

## **B. Illiquid ownership interests**

The harm that banking entities and other stakeholders could face if banking entities are forced to liquidate their genuinely illiquid investments in liquid funds too quickly is similar to the harm that the extended conformance period for investments in illiquid funds is designed to avoid or mitigate. For example, a banking entity could hold an ownership interest in a hedge fund sponsored by a third-party manager, which ownership interest is illiquid pursuant to the terms of the fund, such as where the interest is subject to a “lock-up” for a certain period of time and cannot be redeemed by the banking entity or the third-party manager has imposed a “gate” limiting redemptions by investors.<sup>17</sup> Under these circumstances, even if the hedge fund were not an “illiquid fund,” the ownership interest that the banking entity held in the hedge fund would be illiquid. Yet the statute does not provide an extended conformance period for such illiquid investments. It only allows such investments to be treated as illiquid assets for purposes of determining whether a particular fund is an “illiquid fund.”

In the absence of Board discretionary authority to provide an extended conformance period for illiquid investments in liquid funds, banking entities might be required to divest such illiquid investments at prices significantly below fair value, which would have a similar negative impact on their earnings and capital as being forced to divest their interests in illiquid funds. This result would be contrary to the purpose of the transition rules and, to the extent it applies system-wide, could hinder or threaten the safety and soundness of certain banking entities and the stability of the U.S. financial system. We believe this is sufficient to satisfy the standard to issue a rule under Section 13(d)(1)(J).

We therefore urge the Board to exercise its authority under Section 13(d)(1)(J) to provide temporary extended transition periods for illiquid investments in funds that do not fall within the definition of “illiquid fund,” similar to the extended conformance period for investments in illiquid funds. We believe such an exercise of authority would make the extended conformance periods more consistent with the purpose of Section 13(c).

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<sup>17</sup> We note that many sponsors of hedge funds imposed “gates” during the fall of 2008.

Board of Governors of the Federal Reserve System  
December 27, 2010  
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We thank the Board for the opportunity to comment on the proposed rules. If you have any questions, please do not hesitate to call me at 212-313-1114, or our counsel, Randall D. Guynn, Davis Polk & Wardwell LLP, at 212-450-4239, or Yukako Kawata, Davis Polk & Wardwell LLP, at 212-450-4896.

Sincerely,

A handwritten signature in black ink, appearing to read "R. Snook", with a stylized flourish at the end.

Randolph C. Snook  
Executive Vice President  
Securities Industry and Financial Markets Association

**Subpart K—Proprietary Trading and Relationships with Hedge Funds and Private Equity Funds**

**§ 225.180 Definitions.**

For purposes of this subpart:

(a) *Banking entity* means—

- (1) Any insured depository institution;
- (2) Any company that controls an insured depository institution;
- (3) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and
- (4) Any affiliate or subsidiary of any of the foregoing entities.

(b) *Hedge fund* and *private equity fund* mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)), determine.

(c) *Insured depository institution* has the same meaning as ordered to that term in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), except that for purposes of this subpart the term shall not include an institution that functions solely in a trust or fiduciary capacity if—

- (1) All or substantially all of the deposits of such institution are in trust funds and are received in a bona fide fiduciary capacity;
- (2) No deposits of such institution which are insured by the Federal Deposit Insurance Corporation are offered or marketed by or through an affiliate of such institution;
- (3) Such institution does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others or make commercial loans; and
- (4) Such institution does not—
  - (i) Obtain payment or payment related services from any Federal Reserve bank, including any service referred to in section 11A of the Federal Reserve Act (12 U.S.C. 248a); or

(ii) Exercise discount or borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act (12 U.S.C. 416(b)(7)).

(d) *Nonbank financial company supervised by the Board* means a nonbank financial company supervised by the Board of Governors, as defined in section 102 of the Financial Stability Act of 2010 (12 U.S.C. 5311).

(e) *Board* means the Board of Governors of the Federal Reserve System.

(f) *Illiquid fund* means a hedge fund or private equity fund that ~~as of May 1, 2010:~~ —

(1) Both—

(i) As of May 1, 2010,

(A) ~~(+)~~ Was principally invested in illiquid assets; or

(B) ~~(+)~~ Was invested in any, 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; or

(2) Is otherwise determined by the Board, based on all the facts and circumstances, to be an illiquid fund.

(3) For purposes of paragraph (f)(1)(i), a fund will be deemed to have been invested or principally invested in illiquid assets as of May 1, 2010 if it was so invested as shown in its most recent prior financial statements prepared in accordance with applicable accounting standards, or valuation report or other comparable statements or reports to investors.

(g) *Illiquid assets* means:

(1) ~~any~~ Any real property, security, obligation, ~~or other asset~~ ownership interest or other asset, including an investment in a portfolio company, a venture capital investment or an equity, partnership or other ownership interest in a hedge fund or private equity fund, that—

(i) ~~(+)~~ Is not a liquid asset; or

(ii) ~~(+)~~ Because of contractual, statutory or regulatory restrictions applicable to ~~the hedge fund, private equity fund or such~~ asset, cannot be offered, sold, or otherwise transferred by the ~~hedge fund or private equity fund~~ holder of such asset to a person that is unaffiliated with ~~the relevant banking entity~~ such holder, provided that any asset may be considered an illiquid asset under this paragraph (g)(2) only for so long as any such contractual, statutory or regulatory restriction is applicable; or

(iii) Because of market conditions, can only be sold by the holder of such asset to a person that is unaffiliated with such holder at a price that is materially lower than the price that could be obtained from a sale at the fair value of such asset under normal market conditions; or

(2) The portion of any securities, ownership interests or other assets to the extent such portion cannot be promptly sold to a person that is unaffiliated with the holder of such assets other than at a price that is materially lower than the price or quotation referred to in paragraphs (h)(2), (3) or (4) for an amount of such assets not in excess of 25 percent of the average daily trading volume of such assets during the immediately preceding four calendar weeks, or such similar measure of price to quantity as the Board determines is appropriate for a particular asset class; or

(3) Any other asset that the Board determines, based on all the facts and circumstances, is an illiquid asset.

(h) *Liquid asset* means:

(1) Cash or cash equivalents;

(2) An asset that is traded on a recognized, established exchange, trading facility or other market on which there exist 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 a particular asset almost instantaneously;

(3) An 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;

(4) An 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;

(5) An 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 in paragraphs (h)(1), (2), (3), or (4) of this section; and

(6) Any other asset that the Board determines, based on all the facts and circumstances, is a liquid asset.

(i) *Principally invested* and related definitions.—A hedge fund or private equity fund—

(1) ~~Is~~*Was* *principally invested* in illiquid assets for purposes of paragraph (f)(1)(i)(A) if at least ~~75~~50 percent of the fund's consolidated total assets (as reflected on the fund's most recent prior financial statements prepared in accordance with applicable accounting standards) ~~are~~, or valuation report or other comparable statements or reports to investors) were—

- (i) Illiquid assets; or
  - (ii) Risk-mitigating hedges entered into in connection with and related to individual or aggregated positions in, or holdings of, illiquid assets;
- (2) ~~Is~~Was contractually committed to principally invest in illiquid assets ~~if for purposes of paragraph (f)(1)(i)(B) if in~~ the fund's organizational documents, ~~or other documents that constitute a contractual obligation of the fund, provide for the fund to be principally invested in assets~~ or offering materials provided to investors before their investment in the fund, the relevant banking entity or the fund made a written commitment, representation or other similar undertaking to such investors to invest at least 50 percent of the fund's aggregate committed capital in assets or hedges as described in paragraph (i)(1) of this section ~~during the period beginning on the date when capital contributions are first received for the purpose of making investments and ending on the fund's expected termination date; and;~~
- (3) ~~Has~~Makes all investments pursuant to, and consistent with, an investment strategy to principally invest in ~~illiquid~~ assets or hedges as described in paragraph (i)(1) of this section if the fund—
- (i) Markets or holds itself out to investors as intending to principally invest in assets or hedges as described in paragraph (i)(1) of this section; or
  - (ii) Has a documented investment policy or practice of principally investing in assets or hedges as described in paragraph (i)(1) of this section.

**§ 225.181 Conformance period for banking entities engaged in prohibited proprietary trading or private fund activities.**

(a) *Conformance period.*

(1) *In general.*—Except as provided in paragraph (b)(2) or (3), a banking entity shall bring its activities and investments into compliance with the requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart no later than 2 years after the earlier of:

- (i) July 21, 2012; or
  - (ii) 12 months after the date on which final rules adopted under section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)) are published in the **Federal Register**.
- (2) New banking entities and similar funds.—

(i) A company that was not a banking entity, or a subsidiary or affiliate of a banking entity, as of July 21, 2010, and becomes a banking entity, or a subsidiary or affiliate of a banking entity, after that date shall bring its activities and investments into compliance with the requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart ~~before~~as if the conformance period described in paragraph (a)(1) ended on the later of—

(A) ~~(i)~~The conformance date determined in accordance with paragraph (a)(1) of this section; or

(B) ~~(ii)~~2 years after the date on which the company becomes a banking entity or a subsidiary or affiliate of a banking entity.

(ii) With respect to any company that is designated as a similar fund after July 21, 2010, the conformance period described in paragraph (a)(1) shall be deemed to have ended on the later of—

(A) The conformance date determined in accordance with paragraph (a)(1) of this section; or

(B) 2 years after the date on which the company is designated as a similar fund.

(3) *Extended conformance period.* The Board may extend the two-year period under paragraph (a)(1) or (2) of this section by not more than three one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13(c) of the Bank Holding Company Act (12 U.S.C. 1851(c)) and this subpart and would not be detrimental to the public interest. The Board may also consolidate all three one-year extensions into a single extension of three years, subject to such conditions as the Board may impose.

(b) *Illiquid funds.*

(1) *Extended transition period.*—The Board may further extend the period provided by paragraph (a) of this section during which a banking entity may acquire or retain an equity, partnership, or other ownership interest in, or otherwise provide additional capital to, a private equity fund or hedge fund if—

(i) The fund is an illiquid fund; and

(ii) ~~The~~Except for a fund determined to be illiquid under section 225.180(f)(2), the acquisition or retention of such 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.

(2) *Duration limited.* The Board may grant a banking entity only one extension under paragraph (b)(1) of this section and such extension—

(i) May not exceed 5 years beyond any conformance period granted under paragraph (a)(3) of this section; ~~and~~

(ii) ~~Shall terminate automatically on~~Except with respect to a fund determined to be illiquid under section 225.180(f)(2), shall terminate with respect to any particular contractual obligation six months after the date during any such extension on which the banking entity is no longer under ~~a~~such contractual obligation described in paragraph (b)(1)(ii) of this section, unless the Board has further extended this period by an additional six months; and

(iii) Subject to such conditions as the Board may impose, may be consolidated with any extension under paragraph (a)(3) of this section into a single extension of up to eight years.

(3) *Contractual obligation.* For purposes of this paragraph (b), other than (b)(1)(ii)—

(i) A banking entity has a contractual obligation to take or retain an equity, partnership, or other ownership interest in an illiquid fund if ~~the banking entity is prohibited under the terms of its equity, partnership, or other ownership interest in the fund or other contractual arrangements with the fund from—~~in the fund's organizational documents or offering materials provided to investors before their investment in the fund, the banking entity or the fund made a written commitment, representation or other similar undertaking to such investors that the banking entity would take or retain such interest in the fund.

(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 banking entity;~~

(ii) A banking entity has a contractual obligation to provide additional capital to an illiquid fund if ~~the banking entity is required under the terms of its equity, partnership, or other ownership interest in the fund or other contractual arrangements with the fund to~~in the fund's organizational documents or offering materials provided to investors before their investment in the fund, the banking entity or the fund made a written commitment, representation or other similar undertaking to such investors that the banking entity would provide additional capital to ~~such fund; and~~the fund.

(iii) ~~A banking entity shall be considered to have~~The acquisition or retention of an ownership interest, or provision of additional capital, is necessary to fulfill a

contractual obligation for purposes of paragraph (b)(~~31~~)(i)-~~or (ii) of this section~~B) only if—

(A) With respect to any fund that is not sponsored or controlled by the banking entity—

(x) ~~The~~the obligation may not be terminated by the banking entity ~~or any of its subsidiaries or affiliates~~in its sole discretion under the terms of its agreement with the fund; and

(y) ~~In~~in the case of an obligation that may be terminated with the consent of other persons, the banking entity ~~and its subsidiaries and affiliates have used their reasonable best~~has used good faith efforts to obtain such consent and such consent has ~~been denied~~not been obtained or cannot be obtained or acted upon without concessions being made (economic or otherwise) by the banking entity that are, in the reasonable judgment of the banking entity, materially adverse to the interests of the banking entity; or

(B) With respect to any fund that is sponsored or controlled by the banking entity, the termination of the obligation by the banking entity would be inconsistent with any written commitment, representation or other similar undertaking made in the fund's organizational documents or offering materials provided to investors before their investment in the fund.

(c) *Illiquid Ownership Interests.*

(1) *Extended transition period.*—The Board may further extend the period provided by paragraph (a) of this section during which a banking entity may acquire or retain an equity, partnership, or other ownership interest in a private equity fund or hedge fund that is not an “illiquid fund” under section 225.180(f) if the Board determines that such ownership interest is illiquid.

(2) *Duration limited.* The Board may grant a banking entity only one extension under paragraph (c)(1) of this section and such extension—

(i) May not exceed 5 years beyond any conformance period granted under paragraph (a)(3) of this section; and

(ii) Subject to such conditions as the Board may impose, may be consolidated with any extension under paragraph (a)(3) of this section into a single extension of up to eight years.

(d) *Approval required to hold interests in excess of time limit.*

(1) The conformance period in paragraph (a) may be extended in accordance with paragraph (a)(3) or (b)(1) of this section only with the approval of the Board. A banking entity that seeks the Board's approval for an extension of the conformance period under paragraph (a)(3) or for an extended transition period under paragraph (b)(1) of this section must—

(i) ~~(1)~~ Submit a request in writing to the Board at any time at least 90 days prior to the expiration of the applicable time period;

(ii) ~~(2)~~ Provide the reasons why the banking entity believes the extension should be granted, including information that addresses the factors in paragraph (d)(1) of this section; and

(iii) ~~(3)~~ Provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment(s).

(2) The Board will act on the request within 90 calendar days after the date of submission to the Board of a request submitted in compliance with paragraph (c)(1).

(e) ~~(4)~~ *Factors governing Board determinations.*

(1) *Extension requests generally.*—In reviewing any application for an extension under paragraph (a)(3) or (b)(1) of this section, the Board may consider all the facts and circumstances related to the activity, investment, or fund, including, to the extent relevant—

(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;
- (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 disposing of the activity or investment within the applicable period;
- (xi) Whether the extension would
  - (A) Promote the safety and soundness of the banking entity or banking entities generally;
  - (B) Promote the financial stability of the United States; or
  - (C) Minimize any harm, whether economic or otherwise, to the banking entity, the fund, the investors in the fund, the companies or other entities in which the fund is invested or the shareholders of the banking entity;
- (xii) The duties of the banking entity to the fund, the investors in the fund or the shareholders of the banking entity;
- (xiii) Whether an extension would alleviate a conflict of interest that may arise between the banking entity and investors in the fund;
- (xiv) The good faith efforts previously taken by the banking entity to divest or conform its activities to section 13 of the Bank Holding Company Act (12 U.S.C. 1851);  
and
- (xv) ~~(xi)~~ Any other factor that the Board believes appropriate.

(2) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, the Board will consult with such agency prior to the approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

(f) ~~(e)~~ *Authority to impose restrictions on activities or investments during any extension period.*

(1) *In general.* The Board may impose such conditions on any extension approved under paragraph (a)(3) or (b)(1) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart.

(2) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, the Board will consult with such agency prior to imposing conditions on the approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

(g) *Authority to grant exemptions.* The Board may grant any banking entity an exemption from any of the terms of section 13(c) of the Bank Holding Company Act (12 U.S.C. 1851(c)) or this subpart if, in the judgment of the Board, such exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

**§ 225.182 Conformance period for nonbank financial companies supervised by the board engaged in proprietary trading or private fund activities.**

(a) *Divestiture requirement.* A nonbank financial company supervised by the Board shall come into compliance with all applicable requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart, including any capital requirements or quantitative limitations adopted thereunder and applicable to the company, not later than 2 years after the date the company becomes a nonbank financial company supervised by the Board.

(b) *Extensions.* The Board may, by rule or order, extend the two-year period under paragraph (a) of this section by not more than three one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13(c) of the Bank Holding Company Act (12 U.S.C. 1851(c)) and this subpart and would not be detrimental to the public interest.

(c) *Approval required to hold interests in excess of time limit.* A nonbank financial company supervised by the Board that seeks the Board's approval for an extension of the conformance period under paragraph (b) of this section must—

(1) Submit a request in writing to the Board at least 90 days prior to the expiration of the applicable time period;

(2) Provide the reasons why the nonbank financial company supervised by the Board believes the extension should be granted; and

(3) Provide a detailed explanation of the company's plan for conforming the activity or investment(s) to any applicable requirements established under section 13(a)(2) or (f)(4) of the Bank Holding Company Act (12 U.S.C. 1851(a)(2) and (f)(4)).

(d) *Factors governing Board determinations.* In reviewing any application for an extension under paragraph (b) of this section, the Board may consider all the facts and circumstances related to the nonbank financial company and the request including, to the extent determined relevant by the Board, the factors described in § 225.181(d)(1).

(e) *Authority to impose restrictions on activities or investments during any extension period.* The Board may impose conditions on any extension approved under paragraph (b) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the nonbank financial company or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart.