

THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy



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Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, D.C. 20551

**Re: Conformance Period for Entities Engaged in Prohibited Proprietary Trading
or Private Equity Fund or Hedge Fund Activities**

File Number: FR Doc. 2010-29277

Ladies and Gentlemen:

The Financial Services Roundtable (the "Roundtable") appreciates the opportunity to provide the Board of Governors of the Federal Reserve System (the "Board") with its comments on a proposed rule (the "Proposed Rule") to implement the conformance period for entities engaged in prohibited proprietary trading or private equity fund or hedge fund activities under section 619 (the "Volcker Rule") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), as set forth in the Board's Notice of Proposed Rulemaking published in the Federal Register on November 26, 2010 (the "Conformance Period Comment Request"¹).

The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for \$74.6 trillion in managed assets, \$1.1 trillion in revenue, and 2.4 million jobs.

In this letter, the Roundtable will focus its comments on funds that are closed-end pooled investment vehicles, most frequently organized as limited partnerships, that pursue a variety of investment strategies such as buyout, real estate, mezzanine debt, distressed and infrastructure investing ("private equity funds"), as well as hedge funds that invest in illiquid assets, and hence are illiquid ("illiquid hedge funds"). The

¹ 75 Fed. Reg. 72741 (November 26, 2010).

Roundtable will offer general comments on the proposed rule and specific comments on two items: (i) the determination of which illiquid funds are eligible for the extended transition period (including the definition of “contractual obligation” and “illiquid fund”) and (ii) the process by which these extensions will be granted. Overall, our comments reflect the belief that the Board should adjust the Proposed Rule to give itself the full range of discretion needed to allow covered funds to run their full course and promote the safety and soundness of covered banking entities, as intended by Congress.

I. Background and General Recommendations

A. Banking Entity as Fund Investor: Fund Interests are Not Redeemable and Are Subject to Restrictions on Transfer; The Market for Sales of Limited Partner Interests in Private Equity Funds is Small and Illiquid

At the outset, the Roundtable notes the particularly illiquid characteristics of private equity funds as an asset class. First, managers or controlling entities (frequently referred to as “general partners”) and sponsors of private equity funds do not permit the investors in the funds (frequently referred to as “limited partners”) to redeem their interests in private equity funds.

Second, the general partners and sponsors of private equity funds generally could not permit their limited partners to redeem their interests in the funds even if they wished to permit redemption, because (i) the investments held by private equity funds typically are unregistered securities, often of operating businesses, which cannot be easily disposed of to raise cash to redeem investors and (ii) most private equity funds do not, and are not permitted to, borrow to redeem investors or for any other purpose.

Third, transfers of interests in private equity funds are subject to legal and contractual limitations on resale. The interest of a limited partner in a private equity fund may only be transferred by that limited partner in a private placement transaction, because interests in private equity funds typically are not registered under the Securities Act of 1933. Furthermore, for a variety of other legal, business and tax reasons, the partnership agreements and other governing documents of private equity funds further restrict transfers, including by requiring that transfers of interests in a fund may only be made with the written consent of the general partner of the fund, which the general partner may or may not grant.

Fourth, there are a limited number of investors in private equity funds, and an even smaller universe of investors that are interested in acquiring interests of private equity funds in private secondary sales. Investors in private equity funds consist primarily of institutional and very high net worth individual investors seeking higher returns and able to take on the risk associated with acquiring, for a minimum investment often of at least \$5 million per fund, illiquid interests in funds that (i) are in turn invested in highly illiquid assets, (ii) are difficult to value and (iii) only provide limited

information about the funds and its holdings to persons not currently invested in the fund in question.

For all these reasons, and as further discussed below, banking entities that are limited partners in private equity funds and seek to dispose of their interests in those funds will require time, and incur legal and other expenses, to dispose of those interests, and even then may find buyers willing to purchase those interests only at a substantial discount from their value.

B. Banking Entity as Fund Sponsor: Early Dissolution of Private Equity Funds are Harmful to Fund Sponsors and Investors

Because the assets held by private equity funds are highly illiquid, a premature dissolution of a fund and accompanying disposition of those assets (or distribution of those assets in-kind to the fund's investors) results in economic losses that are harmful to the fund sponsor and the investors in the fund. See discussion at Section II.A.2.(a) and (b) below.

C. Banking Entity as Fund Sponsor: Sales of General Partner Interests in Private Equity Funds Are Complex and Rare

The interest of a general partner of a private equity fund is even less liquid than the interest of a limited partner and typically is not transferable without the consent of the limited partners. Or, if such interest is transferable, the transfer could result in a termination of the management company's investment advisory agreement with the fund, or the suspension of the fund's investment period, or give the limited partners the right to remove the general partner or dissolve the fund. There is no market for the sale of controlling interests in private equity funds, although such businesses could in theory be sold (and from time to time have been sold) with the consent of the fund's limited partners to a third party wishing to take control of the fund, such as another private equity firm or the investment professionals employed by the fund manager, just as any other investment management business could be sold, with all the attendant complexity, cost and risks. (See discussion at Section II.A.2.(c) below.)

Accordingly, dispositions of a private equity fund business are rare, and when they do occur they are effected by way of complex, highly negotiated transactions typically requiring consent of the fund investors.

D. The Volcker Rule Represents a Fundamental Change in the Types of Investments that Banks Have Been Permitted to Make for Many Years

As the legislative history makes clear, the implementation of the Volcker Rule is designed to proceed over a period of years "[to] give markets and firms an opportunity to

adjust”² to the Volcker Rule. This is a recognition not only of the fact that implementation of the Volcker Rule would likely have a significant effect both on banking entities and the markets themselves (including for the reasons outlined in Section I.A., B. and C. above), but also of the fact that the Volcker Rule represents a fundamental change in the regulatory regime established by the Gramm-Leach-Bliley Act, which among other things expressly authorized financial holding companies to sponsor and invest in private equity funds under the expanded financial activity powers provided by the Gramm-Leach-Bliley Act. In addition, both prior to and subsequent to the enactment of the Gramm-Leach-Bliley Act, bank holding companies have regularly made passive limited partnership investments in private funds and hedge funds under the general authority provided by section 4(c)(6) of the Bank Holding Company Act of 1956.³

E. General Recommendations

The Roundtable is concerned that the Proposed Rule, as currently drafted, may not give banking entities all the time that they need to unwind or dispose of their long-permissible sponsorships of and investments in private equity funds. If conformance period extensions are not freely granted, the Roundtable is concerned that, in view of the nature of the markets described in Sections I.A, B. and C. above and as further discussed below, banking entities will be forced to dispose of a large portion of their private equity fund holdings at a substantial discount. The adverse effect of such fire sales on the safety and soundness of banking entities is contrary to the basic purpose of subsections (c)(2) and (c)(3) of the Volcker Rule and contrary to the public interest. A simultaneous forced divestiture of general partner and/or limited partner interests in private equity funds would create significant market disruptions that the Roundtable believes would adversely affect the banking entities that sponsor and invest in private equity funds, as well as other investors in the private fund markets, and the markets themselves.

Accordingly, the Roundtable believes that the Proposed Rule should contain a presumption that the conformance period extensions contemplated by the Volcker Rule will be granted for any private equity fund that meets the definition of an illiquid fund. Furthermore, the Roundtable believes that the Board should retain as much discretion as possible under the rule that eventually is adopted to act where the safety and soundness of a banking entity is threatened. For example, in addition to the specific changes that we propose in this letter below, we recommend that the Board consider issuing the rule as an interim final rule to allow for greater observation of its impact. We also believe that the rule should provide the Board with the flexibility to react to unexpected events or effects in the future, for example, by providing for an adjustment to the application procedure to reduce the administrative burden on the Board, or to provide extensions of general

² 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley).

³ 12 U.S.C. § 1843(c)(6).

applicability to banking entities rather than on a case-by-case basis. Furthermore, we believe that the Board should not be hesitant to utilize its exemptive authority under subsection (d)(1)(J) of the Volcker Rule to address situations which may not fall within the other provisions of the rule with respect to extensions, but could have detrimental effects on the safety and soundness of the banking entity and the financial stability of the United States. We believe that the Board's flexible use of this exemptive authority is inherent in Congress's intended implementation of the Volcker Rule.

Considerations of *fairness* dictate that banking entities be allowed to hold these investments (investments that were fully permissible at the times made) for the maximum possible period consistent with the original rules applicable to the investments and the investment strategies underlying the investments. Considerations of *safety and soundness* dictate that banking entities not be forced to divest these investments at a loss or at a discount to what they would otherwise realize in a standard investment and disposition strategy for the asset. Considerations of *market stability* dictate that the implementation of the Volcker Rule not force fire sales of fund interests by the banking sector as a whole, which would result in an additional correlation risk for (i) the banking entities themselves, (ii) other fund investors, such as public and private pension funds and university endowments, and (iii) the private fund markets. These considerations should inform each judgment made with respect to the implementation of the conformance period provisions of the Volcker Rule.

II. Illiquid Funds

Subsection (c)(3)(A) of the Volcker Rule sets forth two requirements for granting an extended transition period: (i) the investment must be in an "illiquid fund" and (ii) the extension is available only to the extent "necessary to fulfill a contractual obligation that was in effect on May 1, 2010."

The statutory purpose for this additional conformance period extension was to allow banking entities to hold their investments in illiquid funds for the terms of those funds. The intent of the provision was to cover funds that had "deployed capital to illiquid assets such as portfolio companies and real estate with a projected investment holding period of several years."⁴

We believe that an overly restrictive interpretation of the statutory language would produce exactly the types of consequences that the provision was intended to avoid. We first discuss the consequences of an overly restrictive interpretation of the requirements of subsection (c)(3)(A) before reviewing and commenting on the specific definitions proposed by the Board.

⁴ 156 Cong. Rec. at S5899 (daily ed. July 15, 2010) (statement of Sen. Merkley).

A. General Principles and Consequences

The consequences for banking entities of an overly restrictive implementation of the Volcker Rule's conformance period provisions are outlined below in two contexts: (i) where the banking entity is an investor in a third-party private equity fund and (ii) where the banking entity is the sponsor of the private equity fund.

1. *Banking Entity as Investor*

Forcing a banking entity to divest its interest in a third-party private equity fund prior to the end of the natural life of the fund⁵ most likely would require the banking entity to sell the interest at a substantial discount, because the secondary market for such interests is so thin and illiquid. The degree of interest of secondary market participants and the prices payable for interests in private equity funds vary dramatically, depending on the type of private equity fund in question (buyout, venture capital, real estate, etc.), the stage of the fund's life (*e.g.*, the percentage of the fund's capital commitments invested; the percentage of the fund's investments that have been disposed of), the perceived quality of the fund's sponsor, the perceived quality of the fund's portfolio and general economic conditions. Whatever the facts, the secondary market for fund interests has the following core characteristics: (i) significant discounts to the value of the underlying assets, (ii) significant price volatility and dispersion and (iii) a limited number of traditional participants.

Studies have shown that, even under ordinary market conditions, secondary interests in private equity funds sell at significant discounts to their net asset value ("NAV"). For example, the average high bid for limited partner interests in private equity buyout funds has ranged from 42% to 86% of NAV in the last two years.⁶ The average high bid for other types of private equity funds (including natural resource, real estate and distressed funds, and funds of funds) has ranged from 63% to 75% of NAV in the last two years.⁷

The discount on the secondary market would be driven even higher if a large category of illiquid fund investors (*i.e.*, all banking entities) were required to divest at the same time (*e.g.*, July 21 of any year beginning in 2014), creating a correlated risk that would not exist without the forced divestiture. The recent financial crisis offers evidence

⁵ The typical private equity fund has a term of 10 years, subject to extension for two or three one-year periods if additional time is needed to dispose of the fund's investments. Funds of funds and infrastructure funds may have longer terms of 15 years or more.

⁶ See, *e.g.*, Chris Bonfield & Andy Nick, Cogent Partners, *Secondary Pricing Trends & Analysis* 1,4 (July 2010)

⁷ *Id.* at 3.

as to how such correlated sales would affect prices. During 2008, for example, market conditions combined with a high number of fund limited partners seeking to sell fund interests resulted in fund interests being priced at about 40% of NAV. In addition to general economic factors, the analysis of secondary market movements point to the relative size of supply and demand as being a key determinant of the discounts on secondary markets.⁸ U.S. banking institutions account for between 9% and 12% of the total capital invested in private equity funds (a total value of around \$100 billion).⁹ An increase in the supply of secondary market interests of this size would have a dramatic effect on prices in the secondary market.

Exacerbating this effect on price is the fact that secondary market activity for private equity fund interests historically has been very low. Furthermore, the secondary market for venture capital funds in the past year has all but dried up. Venture capital funds now account for about 2% of secondary sales, while historically accounting for between 25% to 33% of sales.¹⁰ Similarly, the secondary market for interests in real estate funds is extremely thin, due to significant structural issues relating to the fact that only two or three active buyers exist of a size sufficient to bid for interests in real estate funds. A variety of other factors have contributed to the thinness of the secondary markets, including the limited universe of eligible sophisticated investors and limitations on certain primary market investors participating in the secondary market. For example, pension plans may be limited by ERISA regulations from increasing their interests in a fund past a certain point, and therefore a pension plan may be unable to purchase additional secondary interests in that fund.

Finally, a simultaneous fire sale of fund interests would force banking entities to book losses, with adverse effects on the safety and soundness of the banking system precisely at a time when the banking system will be required to be building capital under the Dodd-Frank Act requirements and Basel III. Although it is difficult to predict how high the discount of secondary interests might reach as a result of fire sales of fund interests, the secondary market has reached discounts in some cases of upwards of 50% during periods of financial stress. Furthermore, a fire sale would allow other buyers in the secondary market to gain a windfall from the transactions at the cost of the banking system. We do not believe that Congress intended to transfer the economic value arising from discounted fire sales from the banking system to other secondary market investors.

⁸ Id. at 4.

⁹ Press Release, Preqin, Effects of Obama's Proposal on Alternatives Industry Significant (Jan. 22, 2010); *Implications of the Volcker Rule for Financial Stability: Hearing before the S. Committee on Banking, Housing and Urban Affairs*, 156th Cong. 13 (2010) (statement of Hal S. Scott, Nomura Professor of International Financial Systems, Harvard Law School).

¹⁰ Bonfield & Nick, *supra* note 8 at 3.

2. *Banking Entity as Sponsor*

If a banking entity were the sponsor (*e.g.*, general partner and/or manager) of a private equity fund, unless all necessary conformance period extensions are granted, under the Proposed Rule the banking entity sponsor would be required to (i) cause the fund to dispose of its illiquid assets (*i.e.*, investments) and dissolve the fund, (ii) cause the fund to distribute its illiquid assets in-kind to the investors in the fund and dissolve the fund, (iii) attempt to transfer the sponsorship of the fund to a third-party, or (iv) attempt to transfer a portion of its ownership interest to a third party so that its remaining ownership interest conformed to the 3% *de minimis* exemption in the Volcker Rule.

(a) Sale of Fund Assets Followed by Dissolution

The illiquid assets in an illiquid fund would be sold at a discount for the same economic reasons that the illiquid interests in funds would be sold at a discount (*i.e.*, difficulty of valuation and absence of liquidity/buyers in the market). Where the sponsored fund is a fund-of-funds, the risks would be the same. Forcing fund sponsors to find buyers for each of their portfolio investments before those investments are mature will result in low valuations and, in addition to resulting in suboptimal pricing for the banking entity and its investors, each portfolio company and its existing investors would be harmed by the low prevailing market prices.

Under these circumstances, the economic effects of these fire sales would again be detrimental to the safety and soundness of the banking entity, as well as to other investors in the fund, who would receive a distribution in liquidation of less than the fair value of the fund's assets.

Since the banking entity as sponsor owes a fiduciary duty to the fund, such a fire sale of assets could be viewed as a breach of fiduciary duty absent contractual provisions limiting the duty. Under many circumstances, fund organizational documents allow for the dissolution of the fund or replacement of the general partner where regulatory or legal changes make the fund's continued operations impracticable. However, the banking entity will still have a fiduciary duty during the dissolution to get the best execution for the sales of the illiquid assets. If an overly restrictive approach to granting extensions of the conformance period is adopted, the banking entity would face pressure to divest the illiquid assets of the fund sooner than would otherwise be optimal, while its fiduciary duty might well require it to pursue a longer divestment period in order to maximize returns to other investors. It is not sound as a policy matter or a legal matter to put banking entities in a situation where, as fund managers, they are effectively forced to place their own interests above the interests of investors. Indeed, the Volcker's Rule's objective of risk minimization, the interests of investors, and the interests of banking

entities themselves all converge in the fiduciary context, and hence the convergence of these interests favors the maximum possible conformance period for funds.¹¹

(b) Distribution-In-Kind of Assets and Dissolution

In an attempt to avoid a fire sale of illiquid assets, a private equity fund sponsor could theoretically distribute the fund's assets in-kind to the fund investors. However, under these circumstances, the assets would be passed to investors unlikely to have the capacity or expertise to adequately manage those assets and, in the case of funds of funds, could result in the distribution of illiquid funds to banking entities ineligible to hold them. Thus, the investors in the fund would either be required to engage money managers to manage those illiquid securities, or to sell those securities at a discount (for the reasons described in the preceding section), in each case most likely ultimately realizing even less than would be the case if the fund were to sell the securities in a block, since ownership would now be widely dispersed (for example, a control premium that might have been payable to the fund as seller of a controlling or large block of share of a portfolio company would not be payable to a limited partner now holding a fraction of the fund's interest in the company).

In addition, a distribution in-kind is likely to require the consent of lenders to or other shareholders of many, and perhaps all, of the underlying portfolio companies. If granted, the underlying portfolio company would then be in a situation where its illiquid securities -- instead of being held by a single large, sophisticated shareholder in the business of investing in businesses (the fund), appointing directors to the company's board and often providing managerial assistance and support -- is replaced with multiple shareholders (the general partner and the former limited partners of the fund, which can number in the dozens, or hundreds) who are not in the business of managing illiquid securities. The portfolio companies would lose access to the financial and operating expertise that private equity firms make available to their portfolio companies. Other shareholders besides the fund, including perhaps portfolio company management and employees, would find themselves sharing ownership of a privately held company with a very different and much larger group of shareholders. The additional cost burden of soliciting consent from multiple shareholders would likely be significant. For some portfolio companies, such a dissolution might require the company to become subject to public reporting requirements, introducing an even larger cost and regulatory burden.

¹¹ It is important to note that Senator Merkley explicitly stated that the Volcker Rule "permits firms to organize and offer hedge funds and private equity funds as an asset management service to clients." 156 Cong. Rec. S5897 (daily ed. July 15, 2010). Senator Brown also indicated that his amendments to the Volcker Rule were intended to protect the ability of banking entities to engage in the asset management business. 156 Cong. Rec. S6242 (daily ed. July 26, 2010). Both of these statements indicate Congressional recognition of the importance of banking entities' fiduciary duties to investors.

Again, for policy and legal reasons, we do not believe that it is appropriate to take such a restrictive approach to granting extensions to the conformance period that a sponsoring banking entity is in a position where it is forced to consider in-kind distributions, to the detriment of the limited partners of the fund and the fund's portfolio companies, in connection with a forced dissolution of its sponsored fund.

(c) Transfer through Replacement of General Partner

Fund organizational documents typically do not permit the replacement of a private equity fund's general partner or manager except with the consent of the fund's limited partners – and there is no obligation on the part of limited partners to grant such consent. Replacing the general partner comes with a number of associated complexities, including (i) the challenge of finding a replacement general partner with similar skills and a similar investment philosophy, (ii) the economic issues associated with the introduction of a new general partner, which could result in limited partners in the fund paying additional fees or the banking entity retaining liability, and (iii) the lost economic value to the banking entity sponsor arising from the fact that the fund's "upside" often occurs in the later years of the fund's life. In the "harvest" period of a successful fund, the banking entity would forfeit its right to significant compensation (the "carried interest") that was made possible by excellent investments made during the early years of the fund's life. We believe that the Board should recognize the potentially significant costs to the banking entity sponsor (not to mention the limited partners) that would result from a premature disposition by a banking entity sponsor of its ownership interest in a private equity fund.

(d) Transfer of Portion of Ownership Interest

A banking entity could also attempt to transfer a portion of its ownership interest in a private equity fund so that its remaining ownership interest conformed to the 3% *de minimis* exemption applicable under subsections (d)(1)(G) and (d)(4)(B) of the Volcker Rule. However, such an attempt would give rise to the same difficulties associated with transfers of fund interests mentioned above, including (i) the difficulty and complexity associated with the process of transferring the fund interest, (ii) the difficulties associated with securing an eligible buyer, (iii) the harm inflicted on other investors in the fund, and (iv) the harm that the banking entity itself would incur because of the illiquidity of the secondary interest. In sum, an attempt by a fund to transfer a portion of an ownership interest offers little benefit to the banking entity, and if anything, would subject the banking entity to the same harmful effects that the Proposed Rule will likely cause if implemented.

B. Definition of "Contractual Obligation"

We request that the Board use the ordinary and natural meaning of "contractual obligation" to mean a commitment to invest made in a pre-existing contract (such as a

subscription agreement with respect to a private equity fund), because the statute was intended to permit all banks with pre-existing contractual arrangements with illiquid funds to have the opportunity to secure the benefits of the five year conformance period extension if needed. We urge the Board not to add the additional requirement that the pre-existing contract also prohibit the banking entity from selling its interest or unwinding the relationship. We believe that the reason for the requirement that a contractual obligation must have existed before May 2010 was to restrict eligibility for the time extension, so that banking entities which invested in funds with knowledge of the pendency of the Volcker Rule would not be eligible for an extension. That is why the statutory provision does not have the additional requirement that the pre-existing contract must include a provision that *prohibits* sales or redemptions. The statutory provision is about timing, not the nature of the contract or the potential for early exit.¹² Alternatively, if the current definition is maintained, we ask the Board to provide greater clarity as to several of the underlying elements of the definition, including a less restrictive interpretation of the term “prohibited.”

1. *The Definition is Unduly Restrictive*

We believe that the proposed definition of “contractual obligation” in section 225.181(b)(3) of the Proposed Rule is unduly restrictive and could result in virtually all illiquid funds being ineligible to apply for the extension period. The standard contractual provisions of illiquid funds would likely not satisfy the proposed definition of “contractual obligation” if that term is defined to include an obligation to remain invested, not just to honor capital commitments. The organizational documents that are typical for a private fund allow for the fund’s dissolution due to changes in law or regulations that prohibit the fund’s effective operation. Standard industry fund organizational documents also allow an investor to transfer its interest with the approval of the general partner.¹³ Because of these standard provisions, the proposed definition

¹² A contractual prohibition on transfer would itself make the interest illiquid regardless of the nature of the underlying interests. Given the focus on the nature of the illiquid funds, this cannot have been the intent of the use of the term “contractual obligation.”

¹³ A banking entity investor could, depending on the precise language of the provision in a particular fund organizational document, also qualify to be excused from funding its share of a future investment by a private equity fund. Private equity fund “excuse” provisions are drafted with the intent of providing limited partners with one-off excuses from funding specific investments in which it might, for example, be illegal (for example under state or non-U.S. law) or contrary to their investment policy for them to participate. However, these provisions generally were not drafted for the purpose of permitting a generalized excuse from all future investments by a fund, and they typically do not excuse a limited partner from paying its full share of fund expenses, including management fees. For this and other reasons, we believe that it is unlikely that a banking entity would be eligible to invoke an excuse right for all subsequent investments made by the fund, and that in any event it would be imprudent and inappropriate for a limited partner to be required to seek to exercise such rights.

could result in virtually no private fund qualifying for the illiquid fund definition, which cannot have been the intent of the statute.

(a) Statutory Purpose

There is no support in the legislative history for this restrictive definition of “contractual obligation.”¹⁴ Congress was aware that the illiquidity of fund assets, as well as existing market practices, dictated that investors and sponsors generally would remain invested for the life of the fund. It is virtually inconceivable that Congress intended the term “contractual obligation” to eliminate potentially all illiquid funds from being eligible from applying for an extension. Uncertainty as to which contractual commitments will satisfy the definition of “contractual obligation” is contrary to Congress’s desire to create “certainty in the market with respect to divestiture.”¹⁵

(b) Ordinary Meaning

The Proposed Rule provides that a contractual obligation only exists if the obligation may not be terminated by the banking entity. Contract law does not interpret a contractual obligation as existing only if there is no right to termination.¹⁶ Rather, a “contractual obligation” exists as long as a party to the contract has a legal duty to take a specific course of action to complete performance.¹⁷ Thus, contrary to the provisions in subsection 225.181(b)(3), the ordinary understanding of “contractual obligation” exists even if a party to the contract may terminate it.

2. *Clarifications Necessary*

The Board should provide greater clarity as to what a banking entity will be required to do in order for a “contractual obligation” to be recognized. The proposed rule states that a contractual obligation only exists if (i) the banking entity cannot unilaterally act to terminate the obligation (*e.g.*, the ability to unilaterally sell or transfer an interest) or (ii) the banking entity has used its reasonable best efforts to obtain consent to terminate such an obligation.

¹⁴ Senator Merkley described the provision as allowing banking entities to “continue to honor certain contractual commitments.” 156 Cong. Rec. at S5899. This indicates that the definition was intended to refer to making contemplated capital contributions, not remaining invested in the fund.

¹⁵ *Id.* at S5899.

¹⁶ See Joseph M. Perillo & Helen H. Bender, *Corbin on Contracts: Formation of Contracts* § 6.1 (Rev. ed. 1995). For example, the concept of “mutuality of obligation” was the traditional means by which a contract was formed. This concept, however, did not require that contract was not capable of being terminated within the terms of the contract.

¹⁷ *Id.*

We believe that the concept of a “prohibition” on redemption, sale or transfer should be clarified. The traditional definition of “prohibition”, for example, makes little sense in the context of most private equity funds, which normally permit a redemption only with the consent of the general partner. In effect, this consent requirement stands as a practical prohibition on redemption.

We believe that greater clarity must be provided as to what constitutes a “requirement” to provide additional capital. The organizational documents of many funds which would likely be subject to early divestiture contain language which (i) permits a limited partner in the fund to refuse to honor future capital call obligations because of adverse changes in law, or (ii) allows partners in the fund to opt-in to particular investments on a case-by-case basis (a “pledge” fund). In both cases, however, the limited partners are required to continue to pay management fees to the fund’s general partner based on the initial contractual obligation to invest capital. We do not believe that requiring that the contractual obligation not be terminable without regard to the financial penalty associated with such termination is consistent with the intent behind the illiquid fund extension.

We believe that there is also considerable uncertainty as to when a banking entity will be viewed as having the ability to terminate (either unilaterally or with consent). For example, it is unclear under the language of the Proposed Rule whether a banking entity would be deemed to have the ability to terminate the contract if, under the terms of the contract, there would be a substantial cost or penalty for termination.

Along similar lines, it is unclear what “reasonable best efforts” requires of a banking entity. As noted above, the standard contractual provision requires that a fund investor seek the consent of the general partner prior to transferring (or redeeming) its interest. Any such effort would involve transaction costs; however it is unclear what level of transaction costs would take a transaction beyond “reasonable best efforts.” To provide greater clarity, we believe that the test of “commercially reasonable efforts” should be substituted for the “reasonable best efforts” test. A banking entity should be deemed to have satisfied the “commercially reasonable efforts” test if it has investigated a potential sale, but has determined that price of the sale (including transaction costs or any other cost imposed by the persons whose consent would be required (*e.g.*, the general partner)) does not reflect a fund’s NAV.

C. Definition of “Liquid” and “Illiquid” Assets

The Roundtable requests that the Board alter the proposed definitions of “liquid asset” and “illiquid asset” to (i) fully reflect the existing definitions of illiquid assets in the Dodd-Frank Act, (ii) include alternative reasons for illiquidity other than marketability, such as when the asset has been pledged as security, (iii) focus on the volume of the asset’s trading in a particular market, (iv) include consideration of whether the asset could be sold at a price reasonably equivalent to its fundamental value, and (v)

change the unit of measurement of illiquidity from the individual asset to the entire holding.

1. *Assets that are Illiquid by Statute*

As a matter of clear statutory intent, the Roundtable asks the Board to recognize Congressional intent with respect to the liquidity of certain asset classes. Subsection (h)(7)(A)(i) includes “portfolio companies, real estate investments, and venture capital investments” to be illiquid assets. Because sub-section (h)(7)(A)(i) provides no qualifiers or restrictions on the definitions of “portfolio company,” “real estate investment,” or “venture capital investment,” these investments should be deemed illiquid per the terms of the statute, even if they might otherwise satisfy the Board’s proposed definitions of “liquid” assets. By carving out such investments from possible classification as “liquid,” the Board will be giving full credit to explicit Congressional intent as to the liquidity of these asset types.

2. *Other Bases for Illiquidity*

It is important to note that the proposed definitions for liquid and illiquid assets give little or no recognition to situations where the asset or interest in question serves to hedge another position or is encumbered by security interests or other existing claims. In order to recognize the importance of such arrangements to the asset liquidity analysis, the Roundtable proposes that relevant language in the proposed sub-section 225.180(g)(2) of the Proposed Rule be altered to read “Because of **statutory legal, regulatory or contractual** restrictions....”.

3. *Volume Measurements*

The proposed definitions would, as written, leave open the possibility that a small number of trades would be reported as “indicative” of liquidity, and then repeated through various financial networks or electronic price aggregators. Of course, such a propagation of price information would overstate the actual size, viability and liquidity of the market. Indeed, prices quoted in such publications (whether print or electronic) may reflect unique buyer or seller characteristics, and may not be available in additional volume or to other market participants. In addition, there is also a risk that the reported prices will reflect price models, as opposed to actual competitive bid and offer quotations that would be available in a recognized exchange or inter-dealer quotation system.

An asset should not be deemed a “liquid asset” merely because entities that transact in that asset report prices for the asset. Because asset sales occur for a variety of reasons (including the need of market participants to conduct asset fire sales), market prices for assets, especially those assets not widely traded, may not reflect an asset’s fair value. Rather than focus solely on the presence of price quotations by market

participants, the rule should also focus on the volume or magnitude of trading in a particular market as a percentage of the assets outstanding.

4. *Connection of Price to Liquidity*

Perhaps most importantly, the Roundtable asks the Board to formulate changes to the Proposed Rule recognizing that an asset is illiquid if a banking entity is unable to sell the asset at its fair value during the period over which the asset's liquidity is being measured.

Other regulatory bodies have recognized the important relationship between price and fair value for purposes of the liquidity analysis. For example, (i) the Department of the Treasury defines a "liquid asset" to be "cash or other property readily convertible into cash with little or no loss of value,"¹⁸ and (ii) the Basel Committee on Banking Supervision recognizes that "assets are considered to be high quality liquid assets if they can be easily and immediately converted into cash at little or no loss of value."¹⁹ While the time frame over which liquidity is measured is different, we believe that the fundamental concept is the same for a longer time frame.

5. *Illiquidity of the Entire Holding*

Finally, the Roundtable wishes to point out that the Board's proposed definitions of liquid assets focus on the liquidity of the *individual* interests in an asset, rather than looking to whether (and at what price) the fund will be able to sell its entire ownership interest in the illiquid asset at the time divestiture is required. For example, if a fund held 95% of a thinly (but publicly) traded company, a single security would be considered liquid, but the entire 95% interest would not, because the block discount resulting from a simultaneous sale of the 95% interest would render the fund interest functionally illiquid.

D. Definition of "Principally Invested"

The Roundtable believes that the 75% threshold in proposed subsection 225.180(i)(1)'s definition of "principally invested" in illiquid assets is unnecessarily restrictive. In this context, "principally" should be given its ordinary meaning, and interpreted to mean more than 50%. The Board states that it is interpreting "principally" to mean that a fund invest "substantially all of their capital in, illiquid assets;"²⁰ however, "principally" is not synonymous with "predominant," "substantially all," or "almost all."

¹⁸ 31 CFR § 29.502.

¹⁹ Bank for International Settlements, Basel Committee on Banking Supervision, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* 5 (December 2010).

²⁰ 75 Fed. Reg. at 72745.

Rather, the plain meaning of “principally” is most similar to “most importantly.”²¹ Indeed, when a fund is invested in two types of assets (liquid and illiquid), we believe that the most reasonable test for which of the two types is most important should be which category has a larger value (*i.e.*, which assets make up more than 50% of the total value of the assets). It would be an inappropriate, and indeed an incongruous result, if a fund held 30% of its value in liquid assets and 70% in illiquid assets and the liquid assets were judged to be the “principal” investment of the fund. We also note that from a practical perspective, the marketability of interests in a fund that has substantial investments in illiquid assets (even if less than 50%) will be significantly limited. The Board has previously acknowledged that “principally” means “primary,” “substantial,” “leading,” “important,” or “outstanding,” rather than “predominant” or “almost all.”²² Because the Board used a 75-25% split when interpreting the term “principally” in the Glass-Steagall Act context to permit a so-called “Section 20” subsidiary to engage in no more than 25% of otherwise impermissible Glass-Steagall activities, the Board’s own precedent calls for “principally” to be interpreted to mean significantly less than 75%. Thus, interpreting “principally” to mean more than 50% is consistent both with the actual reality of fund investment choices and the Board’s previous guidance on the issue.

The Roundtable also urges the Board to look to relevant guidance from the Securities and Exchange Commission. Looking to SEC guidance is warranted, given that an illiquid fund is primarily defined based on its exclusion from the definition of “investment company” under the Investment Company Act and the fact that Congress specifically suggested that the Board consult the SEC when formulating its own interpretations.²³ The SEC has taken the general position that “principally” is satisfied at

²¹ Webster’s Third New International Dictionary definition of “principal”: “most important, consequential, or influential.” Cambridge Dictionary of American English, Second Edition definition of “principal”: “first in order of importance.” The American Heritage College Dictionary definition of “principal”: “first, highest, or foremost in rank, importance, or degree.”

²² See Bankers Trust New York Corporation, 73 Federal Reserve Bulletin 140-142 (1987) (interpreting Section 20 of the Glass-Steagall Act).

²³ 156 Cong. Rec. at S5899 (“The Board, in consultation with the SEC, should therefore adopt rules to define the contours of an illiquid fund as appropriate to capture the intent of the provision.”).

more than 50%.²⁴ Further, the SEC has interpreted “substantially all” to mean a much higher standard (at least greater than 90 to 95%).²⁵

E. Definition of “Contractually Committed”

The Roundtable requests that the Board use the ordinary business meaning of “contractually committed” to mean a commitment made in a pre-existing contract, and to choose a meaning that does not impose additional time restraints inconsistent with the statute.

The requirement that the contractual commitment to invest principally in illiquid assets must be for the entire life of the fund from “the date when capital contributions are first received for the purpose of making investments” goes beyond the requirements of the statute. The purpose of this statutory provision is to ensure that as of May 1, 2010, the fund was contractually committed to principally invest in illiquid assets. The plain language of the statute supports this reading. For those funds that were not principally invested in illiquid assets on May 1, 2010, the statute requires that (i) the fund had invested in illiquid assets and (ii) contractually committed to principally invest in illiquid assets. The Proposed Rule’s requirement that the fund must be principally invested in illiquid assets for the entire period following the initial drawdown for investments is inconsistent with the statutory language. The statute does not require that illiquid assets as of May 1, 2010 represent the principal portion of the fund’s assets.

If Congress had intended to require that the fund be principally invested in illiquid assets as soon as it began making drawdowns on capital commitments for investments, then it would not have included the requirement that the fund was already invested in illiquid assets.

Most importantly, we believe that the Proposed Rule’s requirement that this commitment must reside in the fund’s organizational documents is overly restrictive. Many organizational documents are drafted to provide broad powers to the fund while the

²⁴ See, e.g., *In re Paribas Corp.*, SEC Release No. IC6589 (June 23, 1971) (Order) and SEC Release No. 6549 (May 21, 1971)(Application); *Federated Capital Mgmt. Assoc.*, SEC No-Action Letter (Aug. 1, 1975). See also Rule 11a-1-1(T)(b) (deeming an issuer “to meet the requirements of Section 11(a)(1)(G)(i) of the Act if during its preceding fiscal year more than 50 percent of its gross revenues was derived from one or more of the sources specified in that section.”)

²⁵ See *Exemption for Certain Investment Advisers Operating Through the Internet*, SEC Release No. IA-2028 (April 12, 2002) (“We define the term “substantially all” in the proposed rule to mean that at least 90 percent of the investment adviser’s clients obtain advice exclusively through the interactive website.”); *Technical Revisions to the Rules and Forms Regulating Money Market Funds*, SEC Release Nos. 33-7479; IC-22921 (Dec. 2, 1997) (“...some money market funds may now invest more than five percent but less than substantially all of their assets in shares of another money market fund.”)

practical restrictions on a fund's investment strategies or other activities are instead found in the fund's offering memorandum or other disclosure documents. Investors routinely rely on the representations and restrictions in a fund's offering memorandum, even if the restrictions in the offering memorandum are not duplicated in the organizational documents. Investors are further justified in their reliance on offering materials because of the anti-fraud provisions of Rule 10b-5 under the Securities Exchange Act of 1934, which are designed to prevent material misstatements or omissions. An existing illiquid fund should not be disadvantaged in the application of the Proposed Rule because the substance of its pre-existing investment strategy and restrictions are not found in the fund's organizational documents. Therefore, an affirmative statement in a fund's disclosure documentation that the fund's investment strategy is to principally invest in illiquid assets should be sufficient to meet the "contractually committed" test. The definition should be revised to refer to:

"the fund's organizational documents, or other documents such as its offering memorandum that create the contractual obligation of the fund, its general partner or investment adviser . . .".

F. Sponsorship and Third-Party Fund Interests

As currently written, the Proposed Rule presents significant concerns with respect to funds sponsored by banking entities. Although section 225.181(b) of the Proposed Rule permits the Board to extend the transition period for an illiquid fund if the banking entity acquires or retains an ownership interest in the fund, it is unclear from the language of the Proposed Rule whether this extension relates to a sponsorship relationship as well as the "ownership interest." Nothing in the Proposed Rule expressly indicates that the Board intends it to apply to extensions which permit banking entities not only to realize the benefits of their investments during the conformance period contemplated in the Volcker Rule, but also to carry out their obligations as sponsors of funds, obligations also contemplated by the Volcker Rule. We request that the Proposed Rule be clarified to confirm that a sponsorship relationship is also covered by the extension under section 225.181(b).

The Proposed Rule as currently written also presents significant concerns for banking entity interests in third-party funds that are illiquid. Of primary concern is the fact that the Proposed Rule does not address the key differences between a situation where a banking entity invests in a third-party fund and a situation where a banking entity sponsors a fund or a fund of funds. For example, when a banking entity is an investor in a third-party fund, the ability of the banking entity to unwind its investment is only indirectly related to the liquidity of the assets that the fund actually invests in. In fact, the banking entity might not be able to unwind its interest, in that the third party fund could lawfully prevent the banking entity from transferring or selling the fund interest. Even in cases of funds invested in highly *liquid* assets, if the interests are not redeemable and the secondary market is illiquid, then the prospects of a market disruption due to forced

divestiture are quite high. Although these circumstances may be uncommon, the Roundtable believes that the Board's final rule should provide guidance on how banking entities should dispose of illiquid interests.

III. Application Process

The Roundtable requests that the Board provide greater clarity as to the processes underlying both (i) initial extensions of the conformance period and (ii) the application for the further extension period for illiquid funds.

A. Extension of Conformance Period

Subsection (c)(2) of the Volcker Rule provides that the Board may "by rule or order" extend the initial conformance period for not more than one year at a time for up to three years in the aggregate. Section 225.181(c) of the Proposed Rule proposes to implement the provisions of the Volcker Rule by requiring an individual application or application by each banking entity for each activity or investment. The prospect of applications being required for each investment by each banking entity subject to the Volcker Rule suggests an enormous and unwarranted burden on the Board and its staff as well as on the many banking entities subject to the Volcker Rule. We ask the Board to consider the use of a general rule or order as the general mechanism for the extension, with individual applications only being required for special circumstances that do not fall within the tenure of the general rule or order. The Board could also streamline the approval process, by making the results of the approval process for a particular illiquid fund available to all other banking entities with investments in the fund.

We urge the Board to issue any such extension of the conformance period as soon as reasonably practicable. The greater certainty any banking entity has, the greater its ability to maximize the value at which it divests its assets, and, therefore, the less disruptive to the safety and soundness of the banking entity.

We suggest that one method by which this guidance could be given within the statutory authority would be to approve long-term divestiture plans by banking entities prior to the conformance period, where any extension to the conformance period is conditioned on the banking entities' fidelity to that plan at the end of each year.

B. Extension Period for Illiquid Funds

The Board also has the authority to extend the conformance period once (for up to five years) upon the application of a banking entity with respect to its illiquid funds. We believe that the Proposed Rule and the release do not provide sufficient certainty to banking entities for long-term planning required to bring their investments in compliance with the Volcker Rule.

1. *Timing*

The rule only specifies the deadline prior to which the banking entity must submit its application (90 days) and does not provide guidance as to how soon a banking entity may apply and how soon thereafter the Board expects to grant or deny the extension. The Board should clarify that an application is permitted as soon as the rule is finalized, and should also clarify that a banking entity may apply for and be approved for the five year extension at the same time it applies for the initial extensions. Such clarification will provide needed certainty for banking entities.

2. *Divestiture Period if Application Denied*

The Proposed Rule fails to specify a reasonable divestiture period in the event that an application is denied. Due to the generally illiquid nature of funds in secondary markets, even for funds that may not be technically “illiquid” under the rule, immediate divestiture often will not be feasible. The Board should provide a reasonable timeframe and process for dealing with these situations.

3. *Automatic Termination*

Given that the illiquid fund extension was intended to reduce risk in the banking system, we do not believe that an automatic termination provision is necessary or appropriate. Because many illiquid funds will have run off within the extended transition period, we believe that the only appropriate termination to the extension is a situation where the investment is fully realized or transferred. The potential for abrupt terminations will cause significant uncertainty, and depending on the final definition of “contractual obligation,” will perhaps make compliance impossible. For instance, in a case where fund documents were amended at a future point to permit redemption, an automatic termination might leave the banking entity without sufficient time to exercise the redemption right. The banking entity might also not be able to properly evaluate whether exercising the redemption right was in its best interest. In such situations, the banking entity would not be in compliance during the intervening time period. Because the extended transition period was intended to allow sufficient time for banking entities to wind down investment portfolios not in compliance with the Volcker Rule, we believe that the automatic termination provision should be deleted.

4. *Applications*

Although lacking clarity, the Proposed Rule appears to suggest very detailed, formal applications by each banking entity with respect to each of its illiquid funds, followed by an individualized determination by the Board. The Board should provide for a more streamlined process specifying simpler categories of required information, rather than requiring a detailed analysis of each and every fund investment. For example, the application process might provide for a certification by the banking entity of the status of

a fund as an “illiquid fund” with an automatic grant of the five-year extension. This certification could be made subject to audit, but would ease the administrative burden on the Board of needing to review every application while providing a streamlined process and certainty to the banking entities and the financial markets.

We estimate that hundreds of funds could be considered eligible for classification as an “illiquid fund.” We believe that individualized applications and individualized consideration of each of those applications would create an unnecessarily lengthy and burdensome process.

To provide greater clarity and relieve administrative burden, the Roundtable requests that the Board consider creating safe harbors for certain types of funds, *e.g.*, the Board could provide for relatively automatic extensions for funds principally invested in certain asset classes (such as real estate), and clarify and explain how such a process would function.

5. *Additional Restrictions*

We believe that the Board should provide greater clarity as to what, if any, types of additional restrictions it may apply to illiquid fund investments as part of the extension process. Any such additional restrictions could have significant effects on the statutory purpose of providing an orderly wind-down period and thus should be considered carefully and explored in the comment process.

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The Financial Services Roundtable thanks the FSOC for the opportunity to comment on the Proposed Rule. If you have any questions, please do not hesitate to call Peter Freeman or me at 202-289-4322.

Sincerely,



Richard M. Whiting
Executive Director and General Counsel
Financial Services Roundtable