Statement of Policy Regarding Illiquid Fund Investments Under Section 13 of the Bank Holding Company Act

On February 8, 2011, the Board issued its final rule to implement the provisions of section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") granting banking entities supervised by the Board a period of time to conform their activities and investments to the prohibitions and restrictions imposed by that section on proprietary trading activities and on hedge fund and private equity funds activities.[1] Subsequently, the Board received a number of requests for clarification of the manner in which this conformance period would apply to legacy illiquid fund investments under section 619 of the Dodd-Frank Act. The Board is issuing this interpretation to address these questions.

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") added a new section 13 to the Bank Holding Company Act of 1956 ("BHC Act") (codified at 12 U.S.C. § 1851) that generally prohibits banking entities from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (together, a "covered fund").[2] These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions.

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[1] See Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (Feb. 14, 2011) ("Conformance Rule").

[2] See 12 U.S.C. § 1851. A banking entity is defined by statute as any insured depository institution, any company affiliated with an insured depository institution, or any foreign bank that has a branch or agency in the United States, with certain limited exceptions.

Using authority the statute granted exclusively to the Board,[3] the Board has permitted banking entities until July 21, 2017, to conform to the Volcker Rule investments made by these firms in covered funds prior to December 31, 2013.[4] Section 13 also permits the Board, upon the application of a banking entity, to provide an additional transition period of up to five years to conform investments in certain legacy "illiquid funds." A number of banking entities and others, including members of Congress, have requested that the Board provide this additional transition period.[5]

An illiquid fund is defined by the statute as a fund that is "principally invested" in illiquid assets and holds itself out as employing a strategy to invest principally in illiquid assets.[6] The statute provides the possibility of an additional conformance period only for interests in an illiquid fund, or provision of additional capital to the fund, if the banking entity had a contractual obligation to provide funds to the illiquid fund that was in effect on May 1, 2010.[7] In addition, the statute provides that a banking entity may not engage in a prohibited covered fund investment after the date on which the contractual obligation

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[3] 12 U.S.C. § 1851(c)(2).

[4] Order Approving Extension of Conformance Period (July 7, 2016), available at: http://www.federalreserve.gov/newsevents/press/bcreg/20160707a.htm.

[5] See, e.g., Letters to Hon. Janet Yellen from Senators Mike Crapo, Tom Carper, Dean Heller and Gary Peters (May 24, 2016); from Senators Mark Warner, Chris Coons, Jon Tester, and Debbie Stabenow (May 24, 2016); from Representatives Randy Neugebauer, John Carney, Ed Royce, Jim Himes, Andy Barr, Terri Sewell, French Hill, John Delaney, Randy Hultgren, Denny Heck, Blaine Luetkemeyer, and Bill Foster (May 13, 2016); Letter to Hon. Daniel K. Tarullo from Senators Jeffrey A. Merkley and Mark R. Warner (Oct. 29, 2014); and Letter to Scott G. Alvarez from Representatives Gary C. Peters, John C. Carney, and Denny Heck (August 7, 2014).

[6] See 12 U.S.C. § 1851(h)(7).

[7] See 12 U.S.C. § 1851(c)(3)(A).

to invest in the illiquid fund terminates.[8] The statute does not provide a standard for the Board to consider in granting this additional, extended transition period, but provides that the Board may grant an extension for each fund only once and for any period up to 5 years.[9]

The legislative history of section 13 indicates that Congress intended to permit an extended transition period for illiquid funds to minimize market disruptions.[10] Market participants have argued that legacy illiquid funds are especially difficult to conform to the statute and final rule for a variety of reasons. In particular, market participants argue that illiquid funds are largely private equity, real estate, and venture capital funds that support start-up companies and long-term real estate development, and require the commitment of funds for a specified and extended term, after which the fund is liquidated. The success and return on these types of funds is dependent on the ongoing commitment of financial support by the investors for the duration of the fund. Banking entities contend that the returns on these funds are often not clear until near the end of the term of the fund when businesses in which the fund has invested have had a reasonable time to develop.

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[8] See 12 U.S.C. § 1851(c)(4)(A).

[9] See 12 U.S.C. § 1851(c)(3)(B).

[10] See 156 Cong. Reg. S5898-99 (daily ed. July 15, 2010) (colloquy of Sen. Merkley and Sen. Levin) ("Special illiquid funds may, if necessary, receive one 5-year extension and may also continue to honor certain contractual commitments during the transition period. The purpose of this extended wind-down period is to minimize market disruption while still steadily moving firms away from the risks of the restricted activities.")

In addition, after the enactment of the Gramm-Leach-Bliley Act,[11] financial holding companies became sponsor/managers of these funds as well as investors in these funds.[12] Firms argue that it is especially difficult to find a replacement sponsor/manager as the fund reaches its maturation, and that other investors in the fund expect the sponsor/manager to remain invested in the fund through maturity so that the sponsor/manager remains incentivized to achieve the highest returns possible for the investors.

Moreover, banking entities argue that it is particularly difficult to exit sponsored funds because the other investors expect the banking entity to retain its investment alongside the fund's investors and early exit would lead to reputational harm to the banking entity. Banking entities have contended that the reductions that have taken place to date for banking entities with large co-investments in illiquid sponsored funds generally are the result of harvesting of underlying investments in older vintage sponsored illiquid funds. They also contend that the sponsored funds that remain hold the most illiquid assets (e.g., real estate and infrastructure) and have had the least amount of time to execute their multiyear harvesting plan.

Banking entities argue that it is difficult to sell or terminate contractual commitments to third-party illiquid funds for a variety of reasons, including that the terms on which a banking entity is able to terminate a contractual obligation and sell these interests are often commercially unreasonable. Banking entities have indicated that buyers often demand deep discounts ranging from 20 percent to 90 percent relative to

[11] See Pub. L. 106–102, §103, 113 Stat. 1338, 1342 (1999).

[12] See 12 U.S.C. § 1843(k)(4)(H).

current net asset value, and may have little interest in the purchase of the fund if they do not want additional exposure to the general partner of the fund or the remaining assets of the fund. In addition, in seeking approval to exit investments in third-party funds, banking entities have been asked by the managers of some of those funds to provide broad indemnifications for the benefit of the fund, the fund's control parties (such as the general partner), the investment advisers of the fund, and each of those entities' respective officers that would require the banking entity to cover liabilities, costs, losses, or expenses arising directly or indirectly in connection with the transfer of the fund interest.

Banking entities also argue that additional time is needed to conform investments made by employees in sponsored legacy illiquid funds. In addition to limiting investments in covered funds by banking entities, the statute prohibits employees from investing in covered funds sponsored by the banking entity, with some exceptions. In particular, employees who do not provide investment advisory or other services to the funds are not permitted to invest in the fund under the Volcker Rule.[13]

Conforming historical employee investments in illiquid funds involves many of the same issues as conforming the firm's investments described above. In addition, employees made these investments with the expectation that they would retain the investment for the life of the fund, and there is generally no practical ability to redeem these investments. Firms argue that it is unfair to force employees, who prior to the Volcker Rule were permitted to invest in illiquid funds, to take a loss on these investments by forcing a premature sale of the investment. Moreover, banking entities

[13] See 12 U.S.C. § 1851(d)(1)(G)(vii).

argue that the terms on which employees are able to terminate a contractual obligation to an illiquid fund and sell an investment are often commercially unreasonable and that buyers would demand deep discounts.

As noted above, the Dodd-Frank Act specifically authorizes the Board to provide an additional period for a banking entity to conform its relationship with a legacy illiquid fund that includes a contractual obligation as of May 1, 2010, to make investments in the fund. The Dodd-Frank Act provides that the Board may grant the extension by application from the banking entity. The Board's Conformance Rule sets forth provisions governing the submission and review of extension requests.[14]

In keeping with the Dodd-Frank Act, the Board will follow a simplified and streamlined process that would require a banking entity seeking an extension to provide information that would allow the Board to confirm that each fund is a qualifying legacy illiquid fund, that the firm is making progress to conform its covered fund investments in accordance with the Dodd-Frank Act, and that the fund will either expire or be sold within the requested extension period. In particular, a firm requesting an extension of the conformance period for an illiquid fund relationship should submit:

- A list or simple chart of illiquid funds for which an extension is sought.
- A short description of each fund, including the investment strategy and types of investments made by each fund, which entity within the firm holds the investment, the size of each fund, the total exposure of the banking entity to each fund, the date by which each remaining illiquid fund is expected to mature by its terms or be conformed to section 13, and the banking entity's relationship with the fund (e.g., general partner, sponsor, investment adviser, investor).
- A description of the banking entity's specific efforts to divest or conform its illiquid funds, including a description of the overall covered funds (both liquid and illiquid) that have been divested or conformed to date, the progress that has

[14] See 12 CFR 225.181 and 225.182.

been made towards divesting or conforming the investments for which an extension is being sought (e.g., the number of funds sold, the number of funds that continue to be held, and the amount of investments remaining in each fund and in aggregate).

- A certification by the General Counsel or Chief Compliance Officer of the entity that sponsors or invests in the illiquid funds that each fund meets the definition of illiquid funds in section 13 of the BHC Act and the Board's Conformance Rule, including that the extension is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.[15]

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

The banking entity should submit a request in writing to the appropriate Reserve Bank at least 180 days prior to the expiration of the general conformance period (i.e., at least 180 days prior to July 21, 2017) and may submit the request earlier. Consistent with the statute, the extension would be granted for the shortest of (i) five years from the date of the expiration of the general conformance period, (ii) the date by which each remaining fund is expected to mature by its terms or be conformed to section 13 of the BHC Act, or (iii) a shorter period determined by the Board. The Board or Reserve Bank expects to act on each request within 30 days from the date the complete request is received by the Federal Reserve. The Board expects that the illiquid funds of banking entities will generally qualify for extensions, though extensions may not be granted in certain cases—for example, where the banking entity has not demonstrated meaningful progress to conform or divest its illiquid funds, has a deficient compliance program under the Volcker Rule, or where the Board has concerns about evasion.

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[15] See 12 U.S.C. § 1851(c)(3)-(c)(4) & (h)(7); 12 CFR 225.180(f).

In all cases, the Federal Reserve would monitor for evasion and retain its ability to require termination of or impose conditions on any extension as the Board determines are necessary or appropriate to protect the safety and soundness of the 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 BHC Act.

The Board's Conformance Rule also requires the Board to consult with the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, or Commodity Futures Trading Commission in the case of a banking entity that is primarily supervised by another agency prior to approval of the request for an extension for illiquid funds.[16] To facilitate this consultation, a banking entity should provide a copy of its extension request to the primary federal regulator of the banking entity. The attached SR letter gives additional guidance on the application process.

The Board is also providing additional guidance related to so-called "regulatory-out" provisions and "third-party consent" provisions in illiquid fund documentation. This guidance clarifies that a banking entity would not be required to exercise a regulatory-out provision or otherwise seek consent from third parties (such as the general partner or other investors in the fund) to terminate an investment in an illiquid fund in order to qualify for the extended transition period.

The other agencies charged with enforcing the requirements of section 13 of the BHC Act and the final rule plan to administer their oversight of banking entities under

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[16] 12 CFR 225.181(d)(3).

their respective jurisdictions in accordance with the Board's Conformance Rule and this guidance. Nothing in this guidance restricts in any way the authority of any agency to use its supervisory or other authority to limit any activity or investment the agency determines to be unsafe or unsound or otherwise inconsistent with applicable law.