March 1, 2016

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

Re: Volcker Rule Conformance Period for Legacy Illiquid Funds

Dear Board of Governors of the Federal Reserve System:

SIFMA[1] and the ABA[2] write to express their members' concern regarding how the Board of Governors of the Federal Reserve System, by rule and interpretation, has chosen to implement the extended conformance period for illiquid funds. We believe that the approach taken by the Board fails to implement congressional intent and reduces the safety and soundness of banking entities without furthering any policy goal of the Volcker Rule.[3]

Congress clearly authorized the Board to permit an extended conformance period for a specific category of funds—illiquid funds that were in existence on May 1, 2010—for five years beyond the otherwise applicable Volcker Rule conformance date.[4] Congress's purpose was simple and clear: to permit these long-term illiquid funds to naturally phase out, consistent with their investment life cycles and the expectations of their initial investors (including third-party investors).[5] The conformance rule adopted by

[1] The Securities Industry and Financial Markets Association ("**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.

[2] The American Bankers Association ("**ABA**") is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than two million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.

[3] Section 13 of the Bank Holding Company Act of 1956, 12 U.S.C. § 1851, and the final implementing regulations promulgated thereunder, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014) [hereinafter Final Implementing Regulations] (together, the "**Volcker Rule**").

[4] 12 U.S.C. § 1851(c)(3).

[5] *See* 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (colloquy of Sen. Merkley and Sen. Levin) ("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. The definition of 'illiquid funds' [in the Volcker Rule] . . . is meant to cover, in general, very illiquid private equity funds that have deployed capital (….continued)

the Board in 2011, however, includes an unnecessarily narrow and unworkable, definition of the types of funds that are eligible for, and the conditions that must be met to qualify for, the extended conformance period contemplated by Congress for illiquid funds.[6] The Board itself has recognized that, because of the mismatch between the time of the issuance of its conformance rule in February 2011 and the final substantive regulations in December 2013, the conformance rule would not address various aspects of the Volcker Rule and would thus need to be revisited after completion of the final substantive regulations to ensure alignment with those regulations.[7]

SIFMA and ABA members have made, and continue to make, extensive efforts to come into full compliance with all aspects of the Volcker Rule, including conforming or selling many of their illiquid funds positions in anticipation of the July 21, 2017 conformance date generally applicable to legacy covered funds.[8] However, a number of the remaining legacy fund positions held by banking entities are highly illiquid and thus extremely difficult to sell or otherwise bring into conformance by the applicable conformance deadline. As such, their members are concerned that, without further action by the Board or its staff to make the extended conformance period available for these illiquid funds, banking entities would need to undertake conformance measures that could cause harm to unaffiliated investors in the funds, disrupt the illiquid portfolio companies held by these illiquid funds, negatively impact secondary markets for fund interests and impose unnecessary costs on banking entities without furthering any policy goal of the Volcker Rule.

For these reasons, and as discussed in more detail in this letter, SIFMA, the ABA and their members urge the Board to act promptly to align the conformance rule more closely with the Volcker Rule statutory language and congressional intent. We believe this action is important and appropriate in light of the need to address the unworkable

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to illiquid assets such as portfolio companies and real estate with a projected investment holding period of several years."). *See also* Letter from Jeffrey A. Merkley, Senator, U.S. Senate, and Mark R. Warner, Senator, U.S. Senate, to Daniel K. Tarullo, Governor, Bd. of Governors of the Fed. Reserve Sys. (Oct. 29, 2014) (on file with author) (writing to Federal Reserve Governor Daniel Tarullo to ask for an "appropriate transition period" for banking entities to wind down illiquid funds and avoid market disruptions).

[6] *See* Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265, 8275–77 (Feb. 14, 2011) [hereinafter Final Conformance Rule].

[7] *See* Final Conformance Rule, 76 Fed. Reg. at 8266; Federal Reserve Board, Order Approving Extension of Conformance Period Under Section 13 of the Bank Holding Company Act 1, 5 (Dec. 18, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm [hereinafter Legacy Funds Conformance Order].

[8] The Board granted banking entities until July 21, 2016 to conform investments in and relationships with covered funds and foreign funds that were in place prior to December 31, 2013, and announced its intention to act in 2015 to grant banking entities until July 21, 2017 to conform investments in and relationships with such legacy covered funds. *See* Legacy Funds Conformance Order, *supra* note 7, at 5–6.

misalignment between the conformance rule and the Volcker Rule final substantive regulations.

Congress Authorized an Extended Conformance Period for Illiquid Funds

In recognition of the unique characteristics of illiquid funds, the statutory text of the Volcker Rule explicitly contemplates an extended conformance period for a banking entity's legacy investments in such funds, to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.[9] This statutory authority permits the Board to give banking entities an additional five-year period beyond the three additional one-year extended conformance periods that the Board has provided (or has stated its intent to provide) for other types of activities or investments (i.e., until July 21, 2022) during which to bring their long-term illiquid fund investments into full conformance. This provision reflects Congress's recognition that the existing market for illiquid funds demands additional time for an orderly disposal of illiquid interests while minimizing disruption to portfolio companies and to other investors in illiquid funds.[10] In addition, Congress explicitly recognized the importance of accommodating the traditional asset management activities of banking entities.[11]

The Conformance Rule Fails to Fully Implement Congressional Intent

On February 9, 2011 the Board adopted a conformance rule that imposed additional conditions not required by the Volcker Rule statute and substantially limited the types of long-term illiquid funds that are eligible for the additional five-year conformance extension.[12] This rule was finalized more than six months before the Board and the other Volcker Rule regulators proposed substantive Volcker Rule regulations in October 2011[13] and two and a half years before those implementing regulations were

[9] 12 U.S.C. § 1851(c)(3).

[10] *See* 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (colloquy of Sen. Merkley and Sen. Levin). Indeed, as recognized by existing banking regulation, these funds generally have an initial period of several years to make investments, then several more years to operate and eventually dispose of those investments. *See, e.g.*, 12 C.F.R. §§ 225.172–73 (stating that the maximum holding period for merchant banking investments in portfolio companies is 10 years in general and 15 years for investments in certain qualifying private equity funds).

[11] 12 U.S.C. § 1851(d)(1)(G); 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan) (supporting amendment to "permit a banking entity to engage in a certain level of traditional asset management business, including the ability to sponsor and offer hedge and private equity funds"); 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (noting that the Volcker Rule "permits firms to organize and offer hedge funds or private equity funds as an asset management service to clients" and "it is important to remember that nothing in section 619 otherwise prohibits a bank from serving as an investment adviser to an independent hedge fund or private equity fund").

[12] *See* Final Conformance Rule, 76 Fed. Reg. at 8265.

[13] The notice of proposed rulemaking for the Volcker Rule implementing regulations specifically requested comment on whether any portion of the conformance rule should be revised. Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and (….continued)

finalized in December 2013. As a result of this timing mismatch, the conformance rule did not benefit from the significant amounts of information about banking entities' illiquid funds activities submitted to the Volcker Rule regulators during the comment process for the substantive regulations, and was not fully aligned with the requirements of the final substantive regulations.

The Board's conformance rule, in effect, reads the congressional intent for an extended conformance period for illiquid funds out of the law.[14] The conformance rule does so by defining illiquid funds that are eligible for an extended conformance period extremely narrowly and requiring the satisfaction of unduly difficult conditions, thereby unnecessarily limiting the universe of qualifying illiquid fund investments and making the extended conformance period nearly impossible to access. For example, the conformance rule limits "illiquid funds" to only those funds that were "principally" invested in (or contractually committed to principally invest in) illiquid assets—meaning 75% or more of the fund's total consolidated assets were illiquid assets or risk-mitigating hedges on such assets—as of May 1, 2010. This threshold disregards changes in the composition of a fund's assets over time and common practices used by funds to exit investments, and is well above long-standing interpretations of "principally" in other contexts.[15] Additionally, the rule construes the statutory requirement for a banking entity to have a contractual obligation to take or retain an interest in a fund far more narrowly than required by the statutory text, for example by requiring a banking entity to seek general partner consent to sell its interests if the banking entity is otherwise contractually prohibited from doing so. By so narrowly drawing the conformance rule and finalizing the rule before knowing the scope and common characteristics of investments in illiquid funds, the Board has failed to implement congressional intent.

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Private Equity Funds, 76 Fed. Reg. 68,846, 68,923 (proposed Nov. 7, 2011) ("Question 347. Should any portion of the Board's Conformance Rule be revised in light of other elements of the current proposed rule? If so, why and how?").

[14] As we described in our October 9, 2014 letter and in conversations with Board staff, the approach adopted in the conformance rule has resulted in few, if any, illiquid fund investments qualifying for the extended conformance period under the conformance rule. Letter from Timothy W. Cameron, Managing Dir. and Head, Asset Mgmt. Grp., SIFMA, and Matthew J. Nevins, Managing Dir. and Assoc. Gen. Counsel, Asset Mgmt. Grp., SIFMA, to Scott Alvarez, Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys. (Oct. 9, 2014) (on file with author).

[15] As the Board noted in the preamble to the conformance rule, while commenters requested a lower threshold for determining whether a fund is "principally invested" in illiquid assets for purposes of the Volcker Rule, in the Board's view commenters did not provide specific examples of funds that would potentially satisfy the "principally invested" asset test if it was set at a lower threshold, such as 50%. Final Conformance Rule, 76 Fed. Reg. at 8270. SIFMA, the ABA and their members stand ready to provide the Board with such examples and explanations to aid its reconsideration of the conformance rule.

The Board Should Revisit the Conformance Rule

Our members continue to work diligently and in good faith to bring their legacy illiquid fund investments into full conformance with the Volcker Rule, but they face mounting obstacles in disposing of or otherwise bringing their remaining illiquid fund investments into conformance by the July 21, 2017 conformance deadline. As recognized by Congress, there are inherent difficulties associated with selling or otherwise disposing of an illiquid fund investment prior to the end of the fund's natural life cycle.[16] These difficulties are exacerbated by the fact that, at this point in the conformance period, banking entities' remaining illiquid fund positions are those that are the most illiquid and, as such, are the most difficult to sell or to otherwise bring into full conformance on an accelerated timeline. These illiquid fund positions include positions in sponsored funds for which the banking entity acts as general partner and investment adviser with duties and obligations to all investors, as well as positions in funds sponsored by third-party managers.

Many of the assets held by these illiquid funds continue to suffer the lingering effects of the 2008 financial crisis, and the available purchasers of interests in illiquid covered funds cannot include banking entities that are prohibited under the Volcker Rule from acquiring new positions in these types of funds, which limits the ability of banking entities to dispose of their positions and likely increases the cost of doing so. Accordingly, the banking entities that bore the risks and costs of investing in illiquid funds will likely face forced losses on sales of their interests in those funds while secondary market purchasers, who did not shoulder these risks and costs, reap the benefits. This result runs counter to congressional intent.

In light of the obstacles described above and the number and magnitude of genuinely illiquid fund positions that continue to be held by banking entities, our members fear that it may not be possible for banking entities to dispose of their investments in their remaining illiquid funds by July 21, 2017 without potential harm to other investors in the funds, unnecessary costs to banking entities and serious disruption to the operations of the funds and the overall market for fund interests. Furthermore, the combination of potential losses for other investors in the remaining illiquid funds resulting from forced sales of fund interests by banking entities and the financial losses, costs and risks to banking entities could cause serious harm to banking organizations' ability to maintain their traditional asset management businesses. In adopting the Volcker Rule, Congress explicitly recognized the importance of accommodating the traditional asset management activities of banking entities and provided that these activities should be preserved.[17] The Board should seek to ensure that this important

[16] *See* 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (colloquy of Sen. Merkley and Sen. Levin).

[17] *See* 12 U.S.C. § 1851(d)(1)(G); 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan); 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley). *See also* Final Implementing Regulations, 79 Fed. Reg. at 5714 ("Section 13(d)(1)(G) of the BHC Act permits a banking entity to make investments in and sponsor covered funds within certain limits in connection with (….continued)

mandate is fully implemented, including by providing sufficient conformance time for asset management activities involving illiquid funds.

The harmful and widespread consequences of an industry-wide forced sale of illiquid fund interests outweigh and directly undermine any safety and soundness benefits that could be achieved by requiring banking entities to sell all of their nonconforming illiquid fund positions by the July 21, 2017 deadline. In many cases, banking entities have no or minimal commitments remaining to provide new capital to their remaining illiquid funds, so the extended conformance period would not be used to increase investments in these illiquid funds but would instead be used for the funds to naturally wind down, as the Volcker Rule statutory text contemplates. As a result, holding the interests during the extended conformance period envisioned by the Volcker Rule would not result in material new exposures to covered funds.

For these reasons, we request that the Board promptly take action so that, as envisioned by Congress, banking entities may avail themselves of the extended five-year conformance period for their remaining positions in those illiquid funds that would otherwise not qualify for the conformance period under the current conformance rule. More specifically, we recommend that the Board amend the conformance rule to designate a category of "illiquid private equity funds." For this limited category of illiquid private equity funds, the Board should clarify the application of the conformance rule's eligibility criteria so that those funds that are in fact illiquid would be eligible for a conformance period extension. If a modification of the conformance rule is not feasible, the Board or its staff could issue interpretive guidance to make the extended conformance period available for illiquid fund investments or to otherwise address the inherent challenges that banking entities face in bringing their illiquid funds into conformance with the Volcker Rule by July 21, 2017. Such interpretive action would be consistent with the Volcker Rule's statutory language and congressional intent and would be appropriate in light of the need to promptly address the unworkable misalignment between the conformance rule and the Volcker Rule final substantive regulations.

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We appreciate your consideration of this letter and stand ready to provide any additional information or assistance that you might find useful. Should you have any questions, please do not hesitate to contact Carter McDowell at (202) 962-7327 or Timothy E. Keehan at (202) 663-5479.

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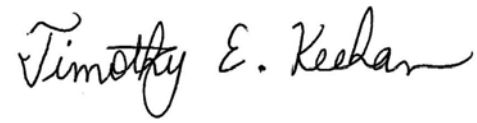
organizing and offering the covered fund.") (citing 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan)).

Sincerely,

Carter McDowell
Managing Director and Associate General Counsel
Securities Industry and Financial Markets Association



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cc: The Honorable Janet L. Yellen
Board of Governors of the Federal Reserve System

The Honorable Stanley Fischer
Board of Governors of the Federal Reserve System

The Honorable Daniel K. Tarullo
Board of Governors of the Federal Reserve System

The Honorable Jerome H. Powell
Board of Governors of the Federal Reserve System

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