First take
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Ten key points from the Fed's Volcker Rule covered funds extension

Last week, the Federal Reserve extended the Volcker Rule's conformance period for "legacy covered funds" until July 21, 2016, and indicated it would likely extend the period further to July 21, 2017. The extension to 2016 is the second of three possible one-year extensions the Federal Reserve may issue under the Dodd-Frank Act (regulators provided an initial one-year extension when the Volcker Rule was finalized in December 2013[1]).

"Legacy covered funds" are defined as covered funds (or foreign funds) in place by December 31, 2013 that are subject to the Volcker Rule. Any investment in or relationship with a covered (or foreign) fund made after December 31, 2013 is not included in the recent extension and must still conform with all Volcker Rule provisions by July 21, 2015 (absent further extensions).

The extension eases the time pressure to divest many covered fund investments (along with easing the resulting downward price pressure by third party buyers). Banks restructuring employee investments and other legal structures included in the Volcker Rule's broad definition of "covered fund" also benefit from additional time to obtain required regulatory and contractual approvals, and to implement controls to ensure ongoing compliance.

1. **Extension requests are still likely necessary by January 22, 2015:** Most banks will still need to file an extension request with the Federal Reserve due to the continued lack of regulatory guidance regarding certain covered funds and due to individual operational concerns in monitoring and controlling covered fund activity. Foreign banks are most impacted by this lack of guidance (discussed below), but most banks face compliance challenges stemming from secondary securitization interest trading and Super 23A (also discussed below). While the elimination of the need for extension requests for legacy covered funds is welcome, work will still be needed to file particular extension requests prior to the January 22, 2015 deadline.
2. **The extension does not provide long hoped-for interpretive guidance relieving certain foreign funds from proprietary trading restrictions:** Despite the extension, certain foreign funds (e.g., UCITS) are still classified under the Volcker Rule's drafting as "banking entities," thus subjecting them to the Volcker Rule's proprietary trading restrictions. Under the US Bank Holding Company Act, when a bank has at least 25% control of the board of directors of an affiliate, that affiliate is also deemed a banking entity. Because the Volcker Rule applies proprietary trading restrictions to all banking entities, any foreign fund with a bank-controlled board (which is required in many non-US jurisdictions by law or market convention) is brought under the proprietary trading restriction. The extension provides temporary relief

[1] See PwC's *Regulatory Brief, Volcker Shrugged* (December 2013).

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from this outcome, but only for foreign funds formed by December 31, 2013. If US regulators do not act by July 21, 2015, many foreign funds formed since the beginning of this year will find themselves in double jeopardy – i.e., caught by Volcker's proprietary trading restrictions, in addition to its covered fund provisions.

3. **Investments by foreign banks in non-US third party funds also remain in limbo:** The Volcker Rule allows foreign banks to invest in foreign third party funds (i.e., private funds not offered to US investors) as long as the fund is not marketed to US investors. However, Volcker drafting ambiguity about which entity's marketing efforts (i.e., the foreign bank's or the third party fund's) trigger covered fund status under the Volcker Rule has caused uncertainty at foreign banks regarding what third party fund investment activities are allowed and what conformance efforts are required (these funds have not benefitted thus far from the "solely outside the US" exception). While many third party funds do not actively market to US residents, conducting diligence to confirm that fact is often difficult due to the unwillingness of third party funds to provide detailed investor information (and due to broad offering language in non-US funds that does not completely preclude the possibility of US investors). Similar to the banking entity issue, the current extension applies only to foreign investments in third party funds made by December 31, 2013.

4. **Secondary market trading in covered funds is not addressed:** No relief was provided for secondary trading of covered fund ownership interests (e.g., securitizations and CLOs) under the Volcker Rule's market making exemption. Securitizations received exclusions from the definition of a covered fund, but only if they held a narrow category of assets and did not include the possibility of a transfer of management rights to certain debt holders. This stringent combination of requirements has resulted in a number of securitizations qualifying as covered funds. Although third party vendors are working towards a technological solution for classifying these securitizations as covered funds and ownership interests, banks with large securitization trading books must continue to evaluate those positions to address the operational challenge of tracking their value to be sure they fall below the Tier 1 capital limit (discussed below). Substantial work remains to implement data feeds and reporting systems to allow real-time inclusion of secondary trading interests to be incorporated into the limit.

5. **Tier 1 capital test receives reprieve:** Banks no longer face an adverse impact in 2015 to their Tier 1 capital limit as a result of legacy covered funds. This limit, under the Volcker Rule, requires banks to keep the value of their permissible covered fund investments below three percent of their Tier 1 capital (measured using the historical cost basis of fund investments) and requires that the higher of historical cost basis or market value of each covered fund investment be deducted from Tier 1 capital before applying the limit. Covered funds with a large variance between historical cost basis and market value will therefore experience a disproportionate impact on the outcome of their Tier 1 capital tests. Because legacy covered funds will not be included in the Tier 1 capital calculation until likely 2017 (or perhaps beyond for illiquid funds, discussed below), banks will generally have more capital available to absorb covered fund interests acquired under the market making exemption.

6. **Super 23A solutions still required:** The extension is unclear regarding what Super 23A relief is granted for legacy covered funds for transactions beginning in 2014. While the industry interprets what "relationships" (as referred to in the extension) with legacy covered funds are permitted as of January 1, 2014, there remains a need for Super 23A controls for new funds formed after that date. It is unlikely that banks will run dual Super 23A compliance programs (i.e., one for legacy covered funds that may permit additional transactions and one for funds formed since January 2014 with more restrictions) due to operational challenges and the invitation for confusion and error, with side-by-side programs targeting similar products. Banks cannot ignore Super 23A for another two and half years, even for legacy covered funds, and will likely need to include all covered funds in new Super 23A monitoring and compliance controls.

7. **Compliance program will likely need to include many legacy covered funds as early as 2015:** The extension does not apply to the development of a bank-wide supervisory structure and Volcker compliance program. All investments and relationships related to investments in covered funds made by banks since January 1, 2014 will still be subject to Volcker Rule compliance requirements as of July 21, 2015. Compliance program testing and sub-certifications will also still be required for the initial CEO attestation due by March 31, 2016. The need for operational clarity will likely mean that many legacy covered funds will be included in the compliance framework from day one.

8. **Good-faith efforts expected:** The extension makes it clear that banks should continue moving forward with conformance plans for legacy covered funds and must do so "well in advance of the end of the extended conformance period." In our view, banks should seek to demonstrate to regulators that they are using the extension productively and not kicking the conformance can down the calendar. We believe that particularly time-consuming administrative activities should be continued at the current pace, including updating offering memoranda disclosures, changing names for funds that continue to be marketed, and restructuring investment vehicles.

9. **Volcker Rule oversight and examinations will continue:** Regulators aside from the Federal Reserve will consider the extension when administering Volcker Rule oversight, but as noted above, there are a number of conformance activities that are not impacted by this extension. Furthermore, the interim Volcker Rule compliance expectations released by the OCC in June 2014 are largely still applicable despite the extension.

10. **Even a two year extension does not solve the problem of all current illiquid investments:** Legacy covered fund ownership interests terminating after 2017 that do not meet the illiquid fund extension criteria still pose significant challenges for longer term compliance with the Volcker Rule. Although the extension order suggests an additional five year extension will be granted (as provided for in Dodd-Frank) for investment commitments made by banks (prior to May 2010) to illiquid private equity-style funds, investments made in liquid hedge funds (prior to May 2010) that have since become illiquid (due to the creation of side pockets or other illiquid holding vehicles) do not fit the statutory definition for "illiquid fund" and are not eligible for the additional five year extension. These formerly liquid funds must conform with the Volcker Rule within the next two and a half years, and therefore face challenges due to (a) the inability to sell such positions because of their low or nominal market value, (b) a prohibition on third party sales due to contractual terms, or (c) continued price pressure resulting from regulatory timing requirements.

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