

July 24, 2017

Volcker Rule

Federal Reserve Releases Guidance Regarding Requests for Conformance Period Extensions for Seed Investments in Covered Funds and Authorizes Reserve Banks to Approve Extensions

SUMMARY

On Monday afternoon, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) issued a supervisory letter (the “Supervisory Letter”) setting forth guidelines relating to banking entities’ applications to obtain an extension of the permitted seeding period for investments in hedge funds or private equity funds (“covered funds”) under Section 13 of the Bank Holding Company Act of 1956, as amended (the “BHC Act”), commonly known as the “Volcker Rule,” and issued an order (the “Order”) delegating the authority to approve such applications to the Federal Reserve Banks. Today’s Supervisory Letter and Order create a streamlined process for banking entities to seek approval to hold seed investments in covered funds for up to three years, subject to the procedural guidelines set forth in the Supervisory Letter and the other requirements of the Supervisory Letter and Order.

BACKGROUND

The Volcker Rule, as implemented by the final regulations issued thereunder (the “Final Rule”), imposes broad prohibitions on, among other things, a banking entity’s acquisition or retention of an ownership interest in a covered fund.¹ Notwithstanding this general prohibition, a banking entity that organizes and offers a covered fund in accordance with the requirements of the Final Rule² is permitted to acquire and retain an ownership interest in the covered fund for the purpose of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors (referred to as “seeding” the fund).³

Absent an extension, the permitted seeding period for any organized and offered covered fund terminates one year after the date of establishment of the fund, after which the banking entity’s seed investment

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must be reduced to an amount that does not exceed three percent of the total outstanding ownership interests in the fund (the “per-fund limitation”).⁴ A banking entity may apply to the Federal Reserve for approval to retain a seed investment beyond the initial one-year seeding period, for up to two additional years.⁵

SUPERVISORY LETTER AND ORDER

The Supervisory Letter provides that an application to obtain a seeding period extension must include the following elements:⁶

- the banking entity’s reasons for filing the application, including information that addresses each of the relevant factors governing the Federal Reserve’s evaluation of such applications, as set forth in the Final Rule and reproduced in Appendix A hereto, Attachment A;⁷
- the banking entity’s plan for reducing the permitted investment in each covered fund through redemption, sale, dilution or other methods to the per-fund limitation by the end of the extended seeding period;⁸ and
- the banking entity’s representation of whether it meets all of the applicable requirements with respect to permitted organizing and offering of a covered fund, as set forth in the Final Rule.⁹

With respect to the filing procedures for such applications, the Supervisory Letter directs banking entities to submit requests in writing to the Applications Unit of the Federal Reserve Bank in the district where the top-tier banking entity is headquartered at least 90 days prior to the expiration of the applicable time period. Applications should include the name of the banking entity requesting the extension, cite the section of the rule under which the banking entity is seeking an extension and identify the primary Agency responsible for supervision of the banking entity.

In the case of a banking entity that is primarily supervised by an Agency other than the Federal Reserve, the banking entity should provide a copy of the extension request and all correspondence related to the request to the relevant Agency. The Supervisory Letter provides a list of contacts at each other Agency and mailing information for those contacts, which is reproduced in Appendix A hereto, Attachment B.

Together with the Supervisory Letter, the Federal Reserve issued the Order, which delegates to the Federal Reserve Banks, in consultation with staff of the Federal Reserve, the authority to approve (but not deny) an application by a banking entity for an extension of the permitted seeding period for a covered fund if the following criteria are met:

- no significant issues have been identified regarding the banking entity’s compliance program;
- the banking entity has represented that all of the requirements under the Volcker Rule and Final Rule have been met;
- the banking entity provides a plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods by the end of the extension period; and

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- the primary Agency responsible for enforcing compliance with the Volcker Rule by the banking entity that invests in or sponsors the covered fund (if it is an Agency other than the Federal Reserve) does not object to the extension.

The Supervisory Letter indicates that the responsible Federal Reserve Bank should “expect to act” on an extension request within 30 days of receiving all required information.

Copies of the Supervisory Letter and the Order are attached as Appendix A and Appendix B, respectively.

* * *

ENDNOTES

¹ The Federal Reserve’s regulations implementing the Volcker Rule are set forth in 12 C.F.R. § 248. Citations to the Final Rule throughout this Memorandum are to the implementing regulations issued by the Federal Reserve. Each of the other federal regulatory agencies responsible for implementing and enforcing the Volcker Rule—*i.e.*, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (together with the Federal Reserve, the “Agencies”)—have issued substantially equivalent implementing regulations under the Volcker Rule.

² BHC Act § 13(d)(1)(G); 12 C.F.R. § 248.11(a).

³ BHC Act § 13(d)(4)(A); 12 C.F.R. § 248.12(a)(1).

⁴ BHC Act § 13(d)(4)(B); 12 C.F.R. § 248.12(a)(2). For this purpose, the “date of establishment” of a covered fund means the date on which the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund. In the case of an issuing entity of asset-backed securities, the date of establishment is the date on which the assets are initially transferred into the issuing entity of the asset-backed securities. 12 C.F.R. § 248.12(a)(2)(iv). The Final Rule permits a banking entity to hold an ownership interest in a covered fund in excess of three percent if required in order to meet the risk retention requirements of section 15G of the Securities Exchange Act of 1934 and the implementing regulations thereunder. 12 C.F.R. § 248.12(a)(2)(ii)(B).

⁵ BHC Act § 13(d)(4)(C); 12 C.F.R. § 248.12(e).

⁶ The procedure set out in the Supervisory Letter and Order is similar to the Board’s previously announced procedures for submitting a request for an extended transition period for a covered fund that qualifies as an “illiquid fund.” See Federal Reserve, Statement of Policy Regarding Illiquid Fund Investments under Section 13 of the Bank Holding Company Act (Dec. 12, 2016) and our December 13, 2016 Memorandum to Clients titled “[Federal Reserve Issues Policy Statement Regarding Volcker Rule Conformance Period Extensions for ‘Illiquid Funds.’](#)”

⁷ 12 C.F.R. § 248.12(e)(2).

⁸ Under the Final Rule, the requirement to have a documented plan to actively seek unaffiliated investors to reduce the banking entity’s ownership interest in the covered fund applies throughout the entire seeding period, regardless of whether any extension beyond the initial one-year period is sought. 12 C.F.R. § 248.12(a)(2)(i)(A).

⁹ BHC Act § 13(d)(1)(G); 12 C.F.R. § 248.11(a).

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF SUPERVISION
AND REGULATION

SR 17-5

July 24, 2017

**TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE
BANK AND TO FINANCIAL INSTITUTIONS SUBJECT TO SECTION 13 OF THE
BANK HOLDING COMPANY ACT**

**SUBJECT: Procedures for a Banking Entity to Request an Extension of the One-Year
Seeding Period for a Covered Fund**

Applicability: This guidance applies to all banking entities, including those banking entities with \$10 billion or less in consolidated assets, that are subject to section 13 of the Bank Holding Company Act (also known as the Volcker Rule), regardless of the banking entities' primary financial regulatory agency.

The Federal Reserve is issuing this letter to provide banking entities¹ with information on the procedures for submitting an application for an extension of the one-year seeding period for a hedge fund or private equity fund (referred to as a "covered fund") pursuant to section 13 of the Bank Holding Company Act of 1956 (BHC Act) and the implementing rules issued by the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) (collectively, the "agencies").² Under the statute, a banking entity must apply to the Board for an extension of the one-year seeding period for a covered fund regardless of the banking entity's primary financial regulatory agency.

¹ The term "banking entity" is defined by statute to include, with limited exceptions: (i) any insured depository institution (IDI) (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)); (ii) any company that controls an IDI (including a bank holding company (BHC), savings and loan holding company (SLHC), and any other company that controls an insured depository institution but that is not a BHC or SLHC, such as the parent company of an industrial loan company); (iii) any company that is treated as a BHC for purposes of section 8(a) of the International Banking Act of 1978 (for example, any foreign bank operating a branch or agency in the United States); and (iv) any affiliate or subsidiary of any of the foregoing (for example, a broker-dealer subsidiary of a BHC). 12 U.S.C. 1851(h)(1).

² In addition to the Board's rule (12 CFR 248.12(e)), a banking entity may apply for an extension of time, as applicable, pursuant to the OCC's rule (12 CFR 44.12(e)); the FDIC's rule (12 CFR 351.12(e)); the SEC's rule (17 CFR 255.12(e)); or the CFTC's rule (17 CFR 75.12(e)).

Background

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new section 13 to the BHC Act, also known as the Volcker Rule, which generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a covered fund, subject to certain exemptions.³ The agencies issued rules implementing section 13 of the BHC Act on December 10, 2013, which became effective on April 1, 2014.⁴

Under section 13 and the implementing regulations, a banking entity is permitted to acquire and retain an ownership interest in a covered fund in connection with organizing and offering the covered fund as long as certain requirements are met.⁵ Section 13(d)(4)(A) of the BHC Act and the implementing regulations permit a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers for the purpose of: (i) establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a de minimis investment, subject to several limitations.⁶

The statute and final rule require a banking entity to actively seek unaffiliated investors to reduce its investment in the covered fund, no later than one year after the date of establishment of the fund,⁷ to an amount that is not more than three percent of the total outstanding ownership interests in the fund (referred to as the “per-fund limitation”).⁸ A banking entity may request the

³ See 12 U.S.C. 1851.

⁴ See “Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds,” 79 *Federal Register* 5536; 79 *Federal Register* 5808 (Jan. 31, 2014). The Board’s rule is set forth in 12 CFR Part 248 (Regulation VV). The Board also previously announced procedures for submitting a request for an extended transition period for a covered fund that qualifies as an illiquid fund pursuant to section 13 of the BHC Act. See Board of Governors of the Federal Reserve System, “Statement of Policy Regarding Illiquid Fund Investments under Section 13 of the Bank Holding Company Act,” December 12, 2016, available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20161212b1.pdf>; and SR 16-18, “Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds.”

⁵ See 12 U.S.C. 1851(d)(1)(G) & (d)(4); 12 CFR 248.11(a)-(b).

⁶ 12 U.S.C. 1851(d)(4)(A); 12 CFR 248.12(a)(1).

⁷ The final rule defines “date of establishment” of a covered fund to mean the date on which the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund. In the case of an issuing entity of asset-backed securities, the date of establishment is the date on which the assets are initially transferred into the issuing entity of the asset-backed securities. See 12 CFR 248.12(a)(2)(iv).

⁸ See 12 U.S.C. 1851(d)(4)(B); see 12 CFR 248.12(a)(2). The final rule permits a banking entity to hold a greater amount of a covered fund under the per-fund limitation if required in order to meet the risk retention requirements of section 15G of the Securities Exchange Act and implementing regulations. See 12 CFR 248.12(a)(2)(ii)(B). The statute and final rule also provide that a banking entity’s aggregate investments in all covered funds may not exceed three percent of the banking entity’s applicable tier 1 capital (referred to as the “aggregate funds limitation”). Additionally, and consistent with the statute, the final rule requires that a banking entity’s investment in a covered fund, including retained earnings, be deducted from tier 1 capital of the banking entity for purposes of determining compliance with applicable regulatory capital standards (referred to as the “capital deduction requirement”). 12

Board's approval for an extension of time beyond the one-year period, for up to two additional years, to conform an investment to the per-fund limitation (referred to as the "seeding period").⁹ Under the statute, the Board may grant an extension of the seeding period if the Board finds that the extension would be consistent with safety and soundness and in the public interest.¹⁰

Requirements for Submitting Requests

In filing a request for an extension of the seeding period, a banking entity must provide the reasons for filing the application, including information that addresses each of the relevant factors contained in 12 CFR 248.12(e).¹¹ The banking entity also must explain its plan for reducing the permitted investment in each covered fund through redemption, sale, dilution or other methods, to the per-fund limitation by the end of the extended seeding period. Additionally, a banking entity should represent whether or not it meets all of the applicable requirements of section 13(d)(1)(G) of the BHC Act and 12 CFR 248.11 with respect to permitted organizing and offering of a covered fund.¹²

Procedures for Filing an Extension Request

A banking entity should submit its request for an extension of the seeding period in writing to the Applications Unit of the Federal Reserve Bank in the district where the top-tier banking entity is headquartered.¹³ The request should be submitted at least 90 days prior to the expiration of the applicable time period.¹⁴ The request should include the name of the banking entity requesting the extension, cite the section of the rule under which it is seeking an extension, and identify its primary financial regulatory agency. In the case of a banking entity that is primarily supervised by another agency, the banking entity should provide a copy of the extension request and all related correspondence related to the request to the relevant agency.¹⁵

U.S.C. 1851(d)(4)(B); *see also* 12 CFR 248.12 and SR letter 15-13, "Supervisory Guidance on the Capital Treatment of Certain Investments in Covered Funds under the Regulatory Capital Rule and the Volcker Rule."

⁹ *See* 12 U.S.C. 1851(d)(4)(C); 12 CFR 248.12(e).

¹⁰ *See* 12 U.S.C. 1851(d)(4)(C). In the implementing rules, the agencies recognized the potential for evasion of the restrictions contained in section 13 of the BHC Act through misuse of requests for extensions of the seeding period for covered funds and stated that the Board and the other agencies would monitor requests for extensions of the seeding period for activity in covered funds that is inconsistent with the requirements of section 13 of the BHC Act. *See* 79 *Federal Register* at 5725 and 5736.

¹¹ *See* 12 CFR 248.12(e)(2). *See* Attachment A, List of Factors Addressed in a Bank's Request.

¹² 12 U.S.C. 1851(d)(1)(G); 12 CFR 248.11(a).

¹³ For banking entities not regulated by the Federal Reserve, the following link provides information on each of the 12 Reserve Banks, including their addresses: www.federalreserveeducation.org/about-the-fed/structure-and-functions/districts/. For Federal Reserve-regulated banking entities, notices may also be submitted electronically through the Federal Reserve System's Electronic Applications System, E-Apps.

¹⁴ *See* 12 CFR 248.12(e)(1)(i).

¹⁵ *See* Attachment B, List of Contacts at Other Agencies.

The Federal Reserve will consult with that agency before acting on an extension request as required under the implementing rules.¹⁶

In addition to the information required to be submitted pursuant to the implementing rules for seeding period extension requests, a banking entity should provide the name, phone number, and email address of the entity's point of contact to whom Board and Reserve Bank staff may submit all inquiries.

Authority to grant (but not to deny) requests has been delegated to the Federal Reserve Banks, in consultation with Board staff.¹⁷ Federal Reserve Banks may approve extension requests if all of the following criteria are met:

- No significant issues have been identified regarding the banking entity's compliance program required under section __.20 of the final rule designed to help ensure and monitor compliance with the prohibitions and restrictions of the Volcker Rule;
- The banking entity has represented that all of the requirements under the Volcker Rule for organizing and offering a covered fund have been met, including the aggregate funds limitation and the capital deduction requirement;¹⁸
- The banking entity provides a plan for reducing the permitted investment in a covered fund through redemption, sale, dilution, or other methods by the end of the extension period; and
- The primary federal agency responsible for enforcing compliance with the Volcker Rule by the banking entity that invests in or sponsors the covered fund (if other than the Federal Reserve) does not object to the extension.

Consistent with the statute, the extension would be granted for a period of up to two years. The responsible Federal Reserve Bank should expect to act on an extension request within 30 days of receiving all required information. If the request does not meet the requirements for delegated action, the Federal Reserve Bank will immediately refer the matter to the Board. The Board may then approve or deny the request based on the relevant facts. In reviewing an extension request, the Board may consider any of the factors in the implementing rules.¹⁹ Refer to Attachment C, Sample Acknowledgment Letter.

Federal Reserve Banks are asked to distribute this letter to their supervised financial institutions and to appropriate supervisory staff. The Federal Reserve has provided a copy of this letter to the other agencies to inform their supervised institutions of this guidance.

¹⁶ See 12 CFR 248.12(e)(4).

¹⁷ See Board Order at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170724a1.pdf>

¹⁸ See 12 U.S.C. 1851(d)(1)(G); 12 CFR 248.11(a)-(b).

¹⁹ See 12 CFR 248.12(e)(2).

Questions regarding this guidance may be directed to:

- Division of Supervision and Regulation: Anna Harrington, Senior Supervisory Financial Analyst, at (202) 452-6406; Sean Campbell, Associate Director, at (202) 452-3706; and Kevin Tran, Supervisory Financial Analyst, at (202) 452-2309.
- Legal Division: Flora Ahn, Senior Counsel, at (202) 452-2317, Greg Frischmann, Counsel, at (202) 452-2803, Brian Chernoff, Senior Attorney, at (202) 452-2952, and Kirin Walsh, Attorney, at (202) 452-3058.

In addition, questions may be sent via the Board's public website.²⁰

Michael S. Gibson
Director

Attachments:

- A. List of Factors Addressed in a Bank's Request
- B. List of Contacts at Other Agencies
- C. Sample Acknowledgment Letter

Cross References to:

- SR letter 16-18, "Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds."
- SR letter 15-13, "Supervisory Guidance on the Capital Treatment of Certain Investments in Covered Funds under the Regulatory Capital Rule and the Volcker Rule"

²⁰ See <http://www.federalreserve.gov/apps/contactus/feedback.aspx>.

Attachment A
List of Factors Addressed in a Bank's Request

The rule provides that the Board may extend the seeding period for up to two additional years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. In reviewing any application, the Board may consider all the facts and circumstances related to the permitted investment in a covered fund, including:

- (i) Whether the investment would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;
- (ii) The contractual terms governing the banking entity's interest in the covered fund;
- (iii) The date on which the covered fund is expected to have attracted sufficient investments from investors unaffiliated with the banking entity to enable the banking entity to comply with the limitations in section __.12(a)(2)(i) of the final rule;
- (iv) The total exposure of the covered banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity and the financial stability of the United States;
- (v) The cost to the banking entity of divesting or disposing of the investment within the applicable period;
- (vi) Whether the investment or the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated parties, including clients, customers or counterparties to which it owes a duty;
- (vii) The banking entity's prior efforts to reduce through redemption, sale, dilution, or other methods its ownership interests in the covered fund, including activities related to the marketing of interests in such covered fund;
- (viii) Market conditions; and
- (ix) Any other factor that the Board believes appropriate.

Attachment B
List of Contacts at Other Agencies

Office of the Comptroller of the Currency

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Federal Deposit Insurance Corporation

Peter Yen
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Commodity Futures Trading Commission

Erik Remmler
Deputy Director, Registration and Compliance
Division of Swap Dealer and Intermediary Oversight
(202) 418-7630
eremmler@cftc.gov

Securities and Exchange Commission

Aaron T. Gilbride
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(202) 551-6906
gilbridea@sec.gov

Attachment C
Sample Acknowledgment Letter

[DATE]

[NAME]

[TITLE]

[FIRM NAME]

[ADDRESS]

[CITY, STATE, ZIP CODE]

Dear [NAME]:

This is to acknowledge receipt by the Federal Reserve Bank of [DISTRICT] (“Reserve Bank”), as of [RECEIPT DATE], of the request dated [APPLICATION DATE], by [APPLICANT], [CITY], [STATE] (the “Applicant”), for an extension of the one-year seeding period for a hedge fund or private equity fund pursuant to section 13 of the Bank Holding Company Act, 12 U.S.C. § 1851.

Consistent with the statute, an extension may be granted for a period of up to two years. The Reserve Bank expects to act on an extension request within 30 days of receiving all required information. If the request does not meet the requirements for delegated action by the Reserve Bank, the Reserve Bank will refer the matter to the Board. The Board may then approve or deny the request based on the relevant facts.

Please contact [RESERVE BANK PRIMARY CONTACT] at [PHONE NUMBER] or [ALTERNATE RESERVE BANK CONTACT], if you have any questions regarding this letter.

Sincerely,

Name of Reserve Bank Official
Title

FEDERAL RESERVE SYSTEM**Order Delegating Authority to Approve Extensions of Time to Divest an Ownership Interest in Certain Covered Funds under the Bank Holding Company Act**

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new section 13 to the Bank Holding Company Act of 1956, which 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”).¹ These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions.

Under section 13, a banking entity may make and retain an investment in a covered fund that the entity organizes and offers (i) to establish the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors or (ii) to make a de minimis investment.² Section 13 provides that an investment by a banking entity in a covered fund shall be reduced to an amount that is not more than 3 percent of the total ownership interests of the fund not later than one year after the date of establishment of the fund.³ Upon an application by a banking entity, the Board may extend for two additional years the period of time during which a banking entity must reduce its ownership interest in a covered fund to no more than 3 percent, if the Board finds that an extension would be consistent with safety and soundness and in the public interest.⁴

¹ 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.

² 12 U.S.C. § 1851(d)(4)(A).

³ 12 U.S.C. § 1851(d)(4)(B)(ii)(I).

⁴ 12 U.S.C. § 1851(d)(4)(C).

Pursuant to section 11(k) of the Federal Reserve Act, the Board may delegate by published order or rule any of its functions, other than those relating to rulemaking or pertaining principally to monetary and credit policies, to Board members and employees, Reserve Banks, or administrative law judges.⁵

The Board hereby delegates to the Federal Reserve Banks, in consultation with Board staff, the authority to approve (but not deny) an application by a banking entity for an extension of the period of time during which it must reduce its ownership interest in a covered fund to no more than 3 percent, if the following criteria are met:

- No significant issues have been identified regarding the banking entity's compliance program;
- The banking entity has represented that all of the requirements under section 13 and its implementing regulations for organizing and offering a covered fund have been met;
- The banking entity provides a plan for reducing the permitted investment in a covered fund through redemption, sale, dilution, or other methods by the end of the extension period; and
- The primary federal agency responsible for enforcing compliance with section 13 by the banking entity that invests in or sponsors the covered fund (if other than the Federal Reserve) does not object to the extension.

By order of the Board of Governors,⁶ effective July 24, 2017.

Ann E. Misback (signed)

Ann E. Misback
Secretary of the Board

⁵ 12 U.S.C. § 248(k)

⁶ Voting for this action: Chair Yellen, Vice Chairman Fischer, and Governors Powell and Brainard.