SULLIVAN & CROMWELL LLP

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Volcker Rule

Agencies Release Guidance on Applicability of Volcker Rule "Super 23A" Provisions During Conformance Period; Clarify Application to Pre-Existing Covered Transactions

On November 20, 2015, staffs of the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the "Agencies") provided an important addition to their existing list of Frequently Asked Questions ("FAQs") addressing the implementation of section 13 of the Bank Holding Company Act of 1956, as amended, commonly known as the "Volcker Rule."[1]

The Volcker Rule, as implemented by the final rule issued by the Agencies (the "Final Rule"), imposes broad prohibitions on proprietary trading and investing in and engaging in certain relationships with private equity funds, hedge funds and certain other investment vehicles ("covered funds") by "banking entities" and their affiliates. The so-called "Super 23A" provisions of the Volcker Rule prohibit any banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor or sponsor[2] to a covered fund, or that organizes and offers a covered fund or continues to hold an ownership interest in an issuing entity of asset-backed securities that is a covered fund pursuant to the organizing and offering exemption, and any affiliate of such a banking entity, from entering into a covered transaction, as defined under Section 23A of the Federal Reserve Act, with the fund or with any other covered fund that is controlled by such fund.[3]

Banking entities generally were required to bring their activities and investments into conformance with the Volcker Rule by July 21, 2015 (other than in the case of certain legacy funds, as discussed below).[4]

The FAQ clarifies the applicability of Super 23A to covered transactions that were initially entered into or subsequently amended during the Volcker Rule conformance period.

The FAQ states that, as a general matter (i.e., other than with respect to legacy funds as discussed below), on or after July 21, 2015, a banking entity may not enter into a new covered transaction with a covered fund that is subject to Super 23A. However, an adjustment to a material term of an existing extension of credit—for example, an increase in the amount of, extension of the maturity of, or adjustment to the interest rate term of the extension of credit—would itself be viewed by staffs of the Agencies as entering into a new covered transaction and would be restricted by Super 23A if such adjustment were made on or after July 21, 2015.[5]

By implication, covered transactions that were entered into prior to July 21, 2015 would not be restricted by Super 23A and would not require conformance by the end of the conformance period, so long as they are not amended after July 21, 2015 in a manner that adjusts any material term. Banking entities would need to evaluate changes not expressly addressed by the FAQ to determine whether they result in modification of a material term.[6]

The FAQ also notes that a banking entity should evaluate whether an existing covered transaction guarantees, assumes or otherwise insures the obligations or performance of the covered fund (or of any covered fund in which such covered fund invests), which is not permitted under the conditions of the organizing and offering exemption.[7] Therefore, consideration needs to be given as to whether an existing covered transaction with an organized and offered covered fund may be prohibited if the covered transaction constitutes a guarantee, even if the covered transaction was entered into prior to July 21, 2015 and has not been materially modified after that date.

Finally, the FAQ reiterates that legacy investments in and relationships with a covered fund—that is, investments made and relationships entered into by a banking entity prior to December 31, 2013—should conform to Super 23A "by the end of the applicable conformance period," which is currently July 21, 2016 and is expected to be further extended to July 21, 2017.[8] The FAQ's reference to conformance "by the end of the applicable conformance period" appears to make clear that new covered transactions with legacy covered funds (including material amendments to existing covered transactions) may be entered into during the conformance period, so long as they are brought into conformance by the end of that period and the banking entity engages in good-faith efforts to achieve that outcome.

A copy of the new FAQ is attached to this Memorandum as Appendix A.

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ENDNOTES

1 *See* Federal Reserve, Volcker Rule, Frequently Asked Questions (Nov. 20, 2015), *available at* http://federalreserve.gov/bankinforeg/volcker-rule/faq.htm#20. Staffs of the Agencies concurrently issued another addition to their existing list of FAQs regarding residual market-making positions, which is not addressed in this Memorandum. *See* Federal Reserve, Volcker Rule, Frequently Asked Questions (Nov. 20, 2015), *available at* http://federalreserve.gov/bankinforeg/volcker-rule/faq.htm#19.

2 "Sponsor" means, with respect to a covered fund: (i) to serve as a general partner, managing member or trustee of a covered fund, or to serve as a commodity pool operator with respect to a covered fund as defined in Final Rule §_.10(b)(1)(ii); (ii) in any manner to select or to control (or to have employees, officers, directors or agents who constitute) a majority of the directors, trustees or management of a covered fund; or (iii) to share with a covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name. Final Rule § _.10(d)(9).

3 Final Rule § _.14(a); *see also* 12 U.S.C. § 371c(b)(7) (defining "covered transaction").

4 Federal Reserve, Board Order Approving Extension of Conformance Period (Dec. 10. 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

5 The FAQ notes that the treatment of these adjustments as "entering into" new covered transactions for Super 23A purposes is based on the definition of "extension of credit" under the Federal Reserve's Regulation W, which implements Section 23A of the Federal Reserve Act. Regulation W defines an "extension of credit" to an affiliate—which is a type of covered transaction as defined under Section 23A of the Federal Reserve Act—to mean the making or renewal of a loan, the granting of a line of credit or the extending of credit in any manner whatsoever, including on an intraday basis, to an affiliate. Any increase in the amount of, extension of the maturity of, or adjustment to the interest rate term or other material term of, an extension of credit to an affiliate is considered to be an extension of credit under Regulation W. 12 C.F.R. § 223.3(o)(5).

6 Banking entities should be able to take into account existing rules and guidance applicable to "extensions of credit" under Regulation W where relevant in making any such determinations. 12 C.F.R. Part 223; *see also* Federal Reserve, Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76,560 (Dec. 12, 2002).

7 Final Rule § _.11(a)(5).

8 *See* Federal Reserve, Board Order Approving Extension of Conformance Period under Section 13 of the Bank Holding Company Act (Dec. 18, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm.

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Applicability of the Restrictions in Section 13(f) of the BHC Act

Question: When does a banking entity become subject to the restrictions of section 13(f) and section 248.14 of the final rule with respect to a covered transaction with a covered fund? What about existing covered transactions?

Answer: Section 13(f) of the BHC Act provides that no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund ("covered fund"), or that organizes and offers a covered fund pursuant to section 13(d)(1)(G), and no affiliate of such entity, may enter into a transaction with the fund, or with any other covered fund that is controlled by such fund, that would be a covered transaction as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c) ("covered transaction"), as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereof.[1] Section 248.14 of the final rule implements this statutory restriction.[2]

The statute gave banking entities a conformance period until July 21, 2014 to comply with the requirements of the Volcker Rule, and the Board extended this period by one year at the time of issuance of the final rule until July 21, 2015.[3] As a general matter, on or after July 21, 2015, a banking entity may not enter into a covered transaction with a covered fund where the banking entity serves as investment manager, investment adviser, or sponsor to the covered fund or relies on the exemption in section 13(d)(1)(G). Staffs of the agencies believe that this restriction would apply to any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate[4] or other material term of, an existing extension of credit.[5] In addition, with respect to any existing covered transaction, a banking entity should evaluate whether the transaction guarantees, assumes or otherwise insures the obligations or performance

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[1] *See* 12 U.S.C. 1851(f).

[2] *See* 12 CFR 248.14(a).

[3] *See* 12 U.S.C. 1851(c)(2); *see also* Board Order Approving Extension of Conformance Period (Dec. 10. 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.

[4] A floating-rate loan does not become a new covered transaction whenever the interest rate changes as a result of an increase or decrease in the index rate. If the banking entity and the borrower, however, amend the loan agreement to change the interest rate term, for example, from "LIBOR plus 100 basis points" to "LIBOR plus 150 basis points," or from reference to the LIBOR index to the banking entity's prime rate, the parties have engaged in a new covered transaction. *See, e.g.*, Transactions Between Member Banks and Their Affiliates, 67 FR 76,560, 76,570 n.67.

[5] This is based on the definition of "extension of credit" under the Board's Regulation W promulgated under the Federal Reserve Act. *See, e.g.*, 12 CFR 223.3(o)(5).

of the covered fund (or of any covered fund in which such covered fund invests) as prohibited by section 248.11(a)(5) of the final rule.[6]

The conformance period for legacy investments in and relationships with a covered fund (i.e., investments made and relationships entered into by a banking entity prior to December 31, 2013) currently ends on July 21, 2016.[7] Staffs of the Agencies would expect a banking entity to engage in good-faith efforts during the conformance period to ensure that its investments in and relationships with legacy covered funds conform to section 248.14 of the final rule by the end of the applicable conformance period.[8]

[6] A banking entity must be in conformance with the requirements of the final rule, including as applicable the requirements of section 13(d)(1)(G), with respect to non-legacy covered funds (i.e., a covered fund which a banking entity sponsored or invested in after December 31, 2013) following July 21, 2015.

[7] The Board granted banking entities until July 21, 2016, to conform investments in and relationships with covered funds that were in place prior to December 31, 2013, and announced its intention to act next year to grant banking entities until July 21, 2017, to conform investments in and relationships with legacy covered funds. *See* Board Order Approving Extension of Conformance Period under Section 13 of the Bank Holding Company Act (December 18, 2014) (hereinafter "Board's Conformance Period Order"), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm.

[8] *See* Board's Conformance Period Order.