Davis Polk

Volcker Rule Materials
Proprietary Trading

November 26, 2010

Proposed Conformance Rules

temporary industry-wide waiver or guidance, to allow use of the data correction factor for room air conditioners. This relief would be automatically superseded by the effective date of the new DOE test procedure.

AHAM looks forward to meeting with DOE at the earliest opportunity to discuss this important matter.

[FR Doc. 2010–29773 Filed 11–24–10; 8:45 am]

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FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R–1397]

RIN AD 7100–58

Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities

AGENCY: Board of Governors of the Federal Reserve System ("Board").

ACTION: Proposed rule; request for public comment.

SUMMARY: The Board is requesting comment on a proposed rule that would implement the conformance period during which banking entities and nonbank financial companies supervised by the Board must bring their activities and investments into compliance with the prohibitions and restrictions on proprietary trading and relationships with hedge funds and private equity funds imposed by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Section 619 is commonly referred to as the "Volcker Rule."

DATES: *Comments:* Comments should be received on or before January 10, 2011.

ADDRESSES: You may submit comments, identified by Docket No. R–1397 and RIN No. AD 7100–58, by any of the following methods:

- *Agency Web Site: http://www.federalreserve.gov.* Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.
- *E-mail: regs.comments@federalreserve.gov.* Include Docket Number R–1397 and RIN AD 7100–58 in the subject line of the message.
- *Fax:* (202) 452–3819 or (202) 452–3102.
- *Mail:* Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm* as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper form in Room MP–500 of the Board's Martin Building (20th and C Streets, NW) between 9 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Brian P. Knestout, Senior Attorney, (202) 452–2249, Jeremy R. Newell, Senior Attorney, (202) 452–3239, Christopher M. Paridon, Senior Attorney, (202) 452–3274, or Kieran J. Fallon, Associate General Counsel, (202) 452–5270, Legal Division; David K. Lynch, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. Users of Telecommunication Device for Deaf (TDD) only, call (202) 263–4869.

SUPPLEMENTARY INFORMATION:

I. Background

The Dodd-Frank Act was enacted on July 21, 2010.[1] Section 619 of the Dodd-Frank Act adds a new section 13 to the Bank Holding Company Act of 1956 ("BHC Act") (to be codified at 12 U.S.C. 1851) that generally prohibits banking entities [2] from engaging in proprietary trading or from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund.[3] The new section 13 of the BHC Act also provides for nonbank financial companies supervised by the Board that engage in such activities or have such investments to be subject to additional capital requirements, quantitative limits, or other restrictions.[4] These prohibitions and other provisions of section 619 are commonly known, and referred to herein, as the "Volcker Rule."

Specifically, the Volcker Rule prohibits banking entities from engaging in proprietary trading (as defined by the Volcker Rule) or from acquiring or retaining any ownership interest in, or sponsoring, a hedge fund or private equity fund.[5] The Volcker Rule, however, also expressly provides certain exceptions from these prohibitions, including, among others, exceptions that allow a banking entity, subject to certain terms, conditions, and restrictions, to: (i) Trade in obligations of the United States or any agency thereof, obligations issued by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*), and obligations of any State or of any political subdivision thereof; [6] (ii) purchase and sell securities and other instruments in connection with underwriting or market-making related activities, to the extent that any such activities are designed not to exceed the reasonable near term demands of clients, customers, or counterparties; [7] (iii) engage in risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings; [8] and (iv) purchase, sell, acquire, or dispose of securities and other instruments on behalf of customers.[9] Additionally, the Volcker Rule permits the appropriate agency or agencies, by rule, to grant other exceptions from the prohibitions on proprietary trading and investing in, or

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111–203, 124 Stat. 1376 (2010).

[2] The term "banking entity" is defined in section 13(h)(1) of the BHC Act, as amended by section 619 of the Dodd-Frank Act. *See* 12 U.S.C. 1851(h)(1). The term means any insured depository institution (other than certain limited purpose trust institutions), any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106), and any affiliate or subsidiary of any of the foregoing.

[3] The Volcker Rule defines the terms "hedge fund" and "private equity fund" as an issuer that would be an investment company, as defined under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of that Act, or any such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") may, by rule, determine should be treated as a hedge fund or private equity fund. *See* 12 U.S.C. 1851(h)(2).

[4] *See* 12 U.S.C. 1851(a)(2) and (f)(4). A "nonbank financial company supervised by the Board" is a nonbank financial company or other company that has been designated by the Financial Stability Oversight Council ("FSOC") under section 113 of the Dodd-Frank Act as requiring supervision and regulation by the Board on a consolidated basis because of the danger such company may pose to the financial stability of the United States.

[5] 12 U.S.C. 1851(a)(1)(A) and (B).

[6] *Id.* at § 1851(d)(1)(A).

[7] *Id.* at § 1851(d)(1)(B).

[8] *Id.* at § 1851(d)(1)(C).

[9] *Id.* at § 1851(d)(1)(D).

sponsoring, a hedge fund or private equity fund if the agency(ies) determine that the exception would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.[10] However, no transaction, class of transactions, or activity may be permitted if the relevant agency(ies) determine that the transaction, class of transactions, or activity would: (i) Result in a material conflict of interest; (ii) result in a material exposure of the banking entity to high-risk assets or high-risk trading strategies; (iii) pose a threat to the safety and soundness of the banking entity; or (iv) pose a threat to the financial stability of the United States.[11]

The Volcker Rule separately prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, and any affiliate of the banking entity, from entering into any transaction with the fund, or any other hedge fund or private equity fund controlled by such fund, that would be a "covered transaction" as defined in section 23A of the Federal Reserve Act,[12] as if such banking entity or affiliate were a member bank and the hedge fund or private equity fund were an affiliate thereof.[13] There are, however, certain exceptions to this prohibition.[14]

The Volcker Rule does not prohibit nonbank financial companies supervised by the Board from engaging in proprietary trading, or from having the types of investments in or relationships with hedge funds or private equity funds that banking entities are prohibited or restricted from having under the Volcker Rule. However, the Volcker Rule provides for the Board or other appropriate agency to impose additional capital charges, quantitative limits, or other restrictions on nonbank financial companies supervised by the Board or their subsidiaries that are engaged in such activities or maintain such relationships.[15]

The Board and several other agencies have responsibilities with respect to the Volcker Rule. The FSOC is required to conduct a study and make recommendations by January 21, 2011, on the implementation of the Volcker Rule.[16] As a general matter, authority for developing and adopting regulations to implement the prohibitions and restrictions of the Volcker Rule is divided between the Board, the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the CFTC and the SEC in the manner provided in section 13(b)(2) of the BHC Act.[17] The Board and these other agencies are directed to adopt implementing rules not later than 9 months after the FSOC completes its study.[18] The restrictions and prohibitions of the Volcker Rule become effective 12 months after issuance of final rules by the agencies, or July 21, 2012, whichever is earlier.

The Board, however, is solely charged with adopting rules to implement the provisions of the Volcker Rule that provide a banking entity or a nonbank financial company supervised by the Board a period of time *after* the effective date of the Volcker Rule to bring the activities, investments, and relationships of the banking entity or company commenced, acquired, or entered into before the Volcker Rule's effective date into compliance with the Volcker Rule and the agencies' implementing regulations.[19] This period is intended to give markets and firms an opportunity to adjust to the Volcker Rule.[20] The Dodd-Frank Act requires that the Board issue rules to implement this conformance period no later than January 21, 2011.

II. Overview of Proposed Rule

In accordance with the mandate of the Dodd-Frank Act, the Board is requesting comment on a proposed rule that would implement the conformance period provisions of the Volcker Rule. The proposed rule does *not* address other aspects of the Volcker Rule which, as noted above, are subject to separate rulemaking requirements under section 13(b)(2) of the BHC Act.[21] Because the proposed rule is not intended to address the definitional and other issues that are appropriately the subject of that coordinated, interagency rulemaking process, the proposed rule incorporates without modification the definitions of "banking entity," "hedge fund," and "private equity fund" contained in the Dodd-Frank Act.[22] In addition, the Board has structured the proposed rule to address only those matters that are essential to implementation of the conformance period provisions of the Volcker Rule.

In developing this proposal, the Board considered, among other factors, the language and legislative history of the Dodd-Frank Act and the Volcker Rule, and the Board's experience in supervising and regulating banking entities' trading activities and investments in, or relationships with, hedge funds and private equity funds. The Board also consulted with the Department of the Treasury, the OCC, the FDIC, the SEC, and the CFTC. The Board invites public comment on all aspects of its proposal implementing the conformance period.

A. General Conformance Period

As noted above, the prohibitions and restrictions of the Volcker Rule do not take effect until the earlier of July 21, 2012, or 12 months after the issuance of final regulations by the rulewriting agencies under section 13(b)(2) of the BHC Act. However, in order to allow the markets and firms to adjust to these prohibitions and restrictions, the Volcker Rule also, by its terms and without any action by the Board, provides banking entities and nonbank financial companies supervised by the Board an additional conformance period during which the entity or company can wind down, sell, or otherwise conform its activities, investments, and relationships to the requirements of the Volcker Rule. Under the statute, this conformance period generally extends through the date that is 2 years after the date on which the prohibitions become effective or, in the case of a nonbank financial company supervised by the Board, 2 years after the company is designated by the FSOC for supervision by the Board, if that period is later.

Section 225.181(a) of the proposed rule implements these provisions. In addition, section 225.181(a)(2) of the proposed rule clarifies how the conformance period applies to a company that first becomes a banking entity after July 21, 2010 (the date of enactment of the Dodd-Frank Act), because, for example, the company acquires or becomes affiliated with an insured depository institution for the first time. In these circumstances, the restrictions and prohibitions of the Volcker Rule would first become effective with respect to the company only at the time it became a banking entity. Accordingly, the proposed rule

[10] *Id.* at § 1851(d)(1)(J).

[11] *See id.* at § 1851(d)(2).

[12] *See* 12 U.S.C. 371c.

[13] 12 U.S.C. 1851(f)(1).

[14] *See id.* at § 1851(f)(3).

[15] *See id.* at § 1851(a)(2), (d)(4).

[16] *See id.* § 1851(b)(1). The FSOC recently requested public comment on a number of issues to assist the FSOC in conducting its study. *See* 75 FR 61,758 (Oct. 6, 2010).

[17] *See* 12 U.S.C. 1851(b)(2). The Secretary of the Treasury, as Chairperson of the FSOC, is responsible for coordinating the agencies' rulemakings under the Volcker Rule. *See id.* at § 1851(b)(2)(B)(ii).

[18] *See id.* at § 1851(b)(2)(A).

[19] *See id.* at § 1851(c)(6).

[20] *See* 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (Statement of Senator Merkley).

[21] *See id.* at § 1851(b)(2).

[22] Proposed Rule 225.180(a)–(c).

provides that such a company generally must bring its activities, investments, and relationships into compliance with the requirements of the Volcker Rule before the later of: (i) The date the Volcker Rule's prohibitions would otherwise become effective with respect to the company under section 225.181(a)(1) of the Proposed Rule; or (ii) 2 years after the date on which the company first becomes a banking entity. Thus, for example, a company that first becomes a banking entity on January 1, 2015, would have until January 1, 2017, to bring its activities and investments into conformance with the requirements of section 13 of the BHC Act and its implementing regulations. This proposal provides comparable treatment to "new" banking entities and nonbank financial companies supervised by the Board, and is consistent with the manner in which newly established bank holding companies are treated for purposes of the nonbanking restrictions under section 4 of the BHC Act.[23]

B. Extension of Conformance Period

The Volcker Rule permits the Board, by rule or by order, to extend the generally available two-year conformance period by up to three additional one-year periods, for an aggregate conformance period of 5 years.[24] Section 225.181(a)(3) of the proposed rule implements this authority. In order to grant any extension, the Board must determine that the extension is consistent with the purposes of the Volcker Rule and would not be detrimental to the public interest. The proposed rule requires that any banking entity that seeks a one-year extension of the conformance period under this authority submit a request to the Board. Any such request for an extension must: (1) Be submitted in writing to the Board at least 90 days prior to the expiration of the applicable time period; (2) provide the reasons why the banking entity believes the extension should be granted; and (3) provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment(s).

In addition, the proposed rule provides that any extension request by a banking entity must address each of the following matters (to the extent they are relevant): (i) Whether the activity or investment (A) involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties; (B) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (C) would pose a threat to the safety and soundness of the banking entity; or (D) would pose a threat to the financial stability of the United States; (ii) market conditions; (iii) the nature of the activity or investment; (iv) the date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires; (v) the contractual terms governing the banking entity's interest in the fund (if applicable); (vi) the degree of control held by the banking entity over investment decisions of the fund (if applicable); (vii) the types of assets held by the fund (if applicable); (viii) the date on which the fund is expected to wind up its activities and liquidate or its investments may be redeemed or sold (if applicable); (ix) the total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity or the financial stability of the United States; (x) the cost to the banking entity of disposing of the activity or investment within the applicable period; and (xi) any other factor that the Board believes appropriate. Under the proposal, the Board would consider requests for an extension in light of all relevant facts and circumstances, including the factors described above. These factors are not exclusive, and under the proposal, the Board retains the ability to consider other factors or considerations that it deems appropriate. The Board specifically requests comment on whether these factors are appropriate, certain factors should be removed, or any additional factors should be included.

The proposed rule would allow the Board to impose conditions on any extension granted under the proposed rule if the Board determines such conditions are necessary or appropriate to protect the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the BHC Act and the proposed rules.[25] In cases where the banking entity is primarily supervised by another Federal banking agency, the SEC, or the CFTC, the Board would consult with such agency both in connection with its review of the application and, if applicable, prior to imposing conditions in connection with the approval of any request by the banking entity for an extension of the conformance period under the proposed rule.

C. Extended Transition Period for Illiquid Funds

Section 619 of the Dodd-Frank Act includes a special provision to address the difficulty banking entities may experience in conforming investments in illiquid funds. This provision expressly permits a banking entity to request the Board's approval for an additional extension of up to 5 years in order to permit the banking entity to meet contractual commitments in place as of May 21, 2010, to a hedge fund or private equity fund that qualifies as an "illiquid fund." Specifically, the statute provides that the Board may extend the period during which a banking entity may take or retain an ownership interest in, or otherwise provide additional capital to, an illiquid fund, but only if the extension is necessary to allow the banking entity to fulfill a contractual obligation that was in effect on May 1, 2010.[26] Any extended transition period with respect to an illiquid fund may not exceed 5 years and may be in addition to the conformance period available under other provisions of the Volcker Rule.[27] However, any extended transition period granted with respect to an illiquid fund, by statute, automatically terminates on the date during any such extension on which the banking entity is no longer under a contractual obligation to invest in, or provide capital to, the illiquid fund. The purpose of this extended transition or "wind-down" period for investments in an illiquid fund is to minimize disruption of existing investments in illiquid funds and permit banking entities to fulfill existing obligations to illiquid funds while still steadily moving banking entities toward conformance with the prohibitions and restrictions of the Volcker Rule.[28]

Section 225.181(b) of the proposed rule implements the statute's extended transition period for illiquid funds. As a general matter, to qualify for the statute's extended transition period a banking entity's investment in, or relationship with, a hedge fund or private equity fund must meet two sets of criteria. The first set of criteria

[23] *See* 12 U.S.C. 1843(a)(2).

[24] 12 U.S.C. 1851(c)(2).

[25] Nothing in the Volcker Rule or the proposed rule limits or otherwise affects the authority that the Board, the other Federal banking agencies, the SEC, or the CFTC may have under other provisions of law. In the case of the Board, these authorities include, but are not limited to, section 8 of the Federal Deposit Insurance Act and section 8 of the BHC Act. *See* 12 U.S.C. 1818, 1847.

[26] *Id.* at § 1851(c)(3)(A).

[27] *Id.* at § 1851(c)(3)(B).

[28] *See* 156 Cong. Rec. S5899 (daily ed. July 15, 2010) (statement of Sen. Merkley).

focuses on the nature, assets and investment strategy of the hedge fund or private equity fund itself. The second set of criteria focuses on the terms of the banking entity's investment in the hedge fund or private equity fund.

1. Fund-Focused Criteria

As noted above, the extended transition period under section 13(c)(3) of the BHC Act is available only with respect to investments made in an "illiquid fund," and then only with respect to investments in or commitments to these funds made as of May 1, 2010. In accordance with the text of the Volcker Rule, the proposed rule defines an "illiquid fund" to mean a hedge fund or private equity fund that: (i) As of May 1, 2010, was principally invested in illiquid assets, *or* was invested in, and contractually committed to principally invest in, illiquid assets; and (ii) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.[29] In determining how to implement the definition of an illiquid fund, the Board considered, among other things, the terms of the statute, as well as information (including confidential supervisory information) concerning the terms of investments in hedge funds or private equity funds, the characteristics of liquid and illiquid assets, and the ability of a fund to divest assets held by the fund.

The proposed rule defines several terms that are integral to the statute's definition of an illiquid fund, including the terms or phrases "illiquid asset," "principally invested" in illiquid assets, "contractually committed to principally invest" in illiquid assets, and "investment strategy to principally invest" in illiquid assets.

a. "*Illiquid Asset.*"

The proposed rule generally defines an "illiquid asset" as any asset that is not a liquid asset. In turn, "liquid assets" are defined to include:

- Cash or cash equivalents;
- An asset that is traded on a recognized, established exchange, trading facility or other market on which there exist independent, bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for the asset almost instantaneously;
- An asset for which there are bona fide, competitive bid and offer quotations in a recognized inter-dealer quotation system or similar system or for which multiple dealers furnish bona fide, competitive bid and offer quotations to other brokers and dealers on request;
- An asset the price of which is quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;
- An asset with an initial term of one year or less and the payments on which at maturity may be settled, closed-out, or paid in cash or one or more other liquid assets described above; and
- Any other asset that the Board determines, based on all the facts and circumstances, is a liquid asset.[30]

The standards contained in the second, third, and fourth standards above are based on existing standards in the Federal banking and securities laws that are designed to identify securities that are liquid and may be sold promptly at a price that is reasonably related to its fair value. Specifically, the second standard above is based in part on the SEC's definition of securities for which a "ready market" exists for purposes of the net capital rules applicable to broker-dealers under the Securities Exchange Act of 1934 ("Exchange Act").[31] Similarly, the third standard above is based, in part, on the actions regularly taken by a "qualified OTC market maker" as defined in the SEC's Rule 3b–8, with respect to securities under the Exchange Act.[32] The fourth standard above is based, in part, on the criteria used to identify whether a security or other asset is a "marketable security" or a "liquid asset" for purposes of the Board's Regulation W governing transactions between member banks and their affiliates.[33] In each instance, the proposal represents a modification of the standards to reflect the broader range of financial instruments (including derivatives) or other assets that may be held by a hedge fund or private equity fund and that should be considered "liquid" if traded or quoted in the manner described. The Board has proposed using these standards (which are generally understood within the banking and financial services industries) to help promote ready and measurable compliance with the requirements of the Volcker Rule. These standards are designed to capture the wide range of instruments and assets (or their equivalents) that one actively or routinely trades on markets or trading facilities, as for which bid, offer or price quotations are widely available, and that, therefore, should be considered as liquid assets for purposes of the Volcker Rule's provision regarding illiquid funds. For example, these standards would treat as a liquid asset: (i) Equity and debt securities, derivatives, and commodity futures traded on a registered securities exchange, board of trade, alternative trading system, electronic trading platform or similar market that provides independent, bona fide offers to buy and sell; (ii) assets traded on an electronic inter-dealer quotation system, such as OTC Bulletin Board or the system maintained by PINK OTC Markets, Inc., as well as over-the-counter derivatives, debt securities (such as corporate bonds), and syndicated commercial loans for which active inter-dealer markets exist; and (iii) financial instruments for which indicative price data is supplied by an electronic service, such as Markit Group Limited.

The fifth standard is designed to capture instruments with a relatively short-term duration and that can be monetized or converted at maturity into a liquid asset. The Board recognizes that there may be situations where other, non-enumerated assets may be liquid even though they are not included in the standards contained in sections 225.181(h)(1)—(5) of the proposed rule. In order to address these situations, the Board has expressly retained the ability to determine that any other asset is a liquid asset, based on all the facts and circumstances.

On the other hand, consistent with the purpose of the Volcker Rule, this proposed approach to defining illiquid assets should include as illiquid assets investments in portfolio companies, investments in real estate (other than those made through publicly traded REITs), venture capital investments, and investments in other hedge funds or private equity funds that both are not publicly traded *and* invest in illiquid assets. The proposed rule also provides that an asset—including a liquid asset such as a security—may be considered an "illiquid asset" if, because of statutory or regulatory restrictions applicable to the hedge fund, private equity fund or asset, the asset cannot be offered, sold, or otherwise transferred by the hedge fund or private equity fund to a person that is unaffiliated with the banking entity. This approach recognizes situations where, for example, a security held by a fund is subject to one or more statutory or regulatory restrictions under the Federal securities laws (such as under Rule 144A of the Securities Act of 1933

[29] Proposed Rule 225.180(e).

[30] Proposed Rule 225.180(h).

[31] *See* 15 CFR 240.15c3–1(c)(11)(i).

[32] *See* 15 CFR 240.3b–8(a).

[33] *See* 12 CFR 223.42(e) and (f)(5).

regarding private resales of securities to institutions) that temporarily prohibit the transferability or resale of the security.[34] However, the proposed rule expressly provides that an asset may be considered an illiquid asset under this provision only for so long as and to the extent that the relevant statutory or regulatory restriction is effective.[35] Once the relevant statutory or regulatory restriction is no longer applicable to the asset, hedge fund, or private equity fund, the asset would cease to be treated as an illiquid asset and would be a "liquid asset" if it met any of the standards contained in sections 225.181(g)(1)–(6) of the proposed rule.

The Board is interested in receiving comments on the appropriateness of the definitions and standards mentioned above, as well as whether there are particular types of assets that should be defined, by rule, as liquid or illiquid. If so, what types of assets would these be?

b. "*Principally invested.*"

The statute's fund-related criteria also require that the hedge fund or private equity fund either (1) have been principally invested in illiquid assets as of May 1, 2010, or (2) have been invested to some degree in illiquid assets and contractually committed to principally invest in illiquid assets as of such date. In addition, in either case, the fund must make all of its investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

Many types of hedge funds and private equity funds have investment strategies that focus almost exclusively on one type of illiquid assets, such as real estate or start-up companies (including new or emerging companies in the technology, life sciences, alternative energy, or "clean tech" areas).[36] These types of hedge funds and private equity funds typically request capital contributions from their investors only when particular investment opportunities have been identified and hold only a small portion of their assets in cash or other liquid assets (other than during brief periods pending the investment of capital or the distribution of proceeds from the sale of an investment). By limiting the availability of the extended transition period to hedge funds or private equity funds that "principally invest" in and have an investment strategy to principally invest in illiquid assets, such as real estate, nonpublic portfolio companies, and venture capital opportunities, Congress appears to have structured the extended transition period for those types of funds that are clearly focused on, and invest substantially all of their capital in, illiquid assets.

Accordingly, the proposed rule provides that a hedge fund or private equity fund will be considered to be "principally invested" in illiquid assets only if at least 75 percent of the fund's consolidated total assets are, or are expected to be, comprised of illiquid assets or risk-mitigating hedges entered into in connection with, and related to, individual or aggregated positions in, or holdings of, illiquid assets.[37] The proposal would allow a fund to count risk-mitigating hedging positions that are related to the fund's holdings of illiquid assets towards the 75 percent asset test because such positions are, by definition, associated with the fund's illiquid holdings. In addition, this approach is consistent with safe and sound risk-management practices and other provisions of the Volcker Rule.[38]

The proposed rule also provides that a fund will be considered "contractually committed to principally invest" in illiquid assets as of May 1, 2010, if the fund's organizational documents (such as the limited partnership agreement in the case of a fund organized in this manner), or other documents that constitute a contractual obligation of the fund (such as a binding side letter agreement entered into with investors) that was in effect as of May 1, 2010, provide for the fund to be principally invested in illiquid assets during the period beginning on the date when capital contributions are first received by the fund for the purpose of making investments and ending on the fund's expected termination date.[39] This definition is intended to recognize that an illiquid fund may have more than 25 percent of its assets in liquid assets (such as cash or money market instruments) during its initial pre-investment organizational period, while the fund seeks to meet its investment objective of investing principally in illiquid assets.

Additionally, the proposed rule provides that a fund would be considered to have an "investment strategy to principally invest" in illiquid assets if the fund either: (i) Markets or holds itself out to investors as intending to principally invest in illiquid assets; or (ii) has a documented investment policy of principally investing in illiquid assets.[40] In considering whether a hedge fund or private equity fund's organizational documents, marketing materials, or investment policy provide for the fund to principally invest in illiquid assets, banking entities should consider whether the assets to be acquired by the fund (as specified in such materials) are of the type and nature that would make the assets "illiquid assets" or "liquid assets" for purposes of the rule. For example, under the proposal, if a fund's investment strategy provides for the fund to primarily invest in publicly traded stocks or OTC derivatives that are regularly bought and sold in the inter-dealer market, the fund would not be considered to have an investment strategy to principally invest in illiquid assets. This would be the case even if the fund's investment strategy did not indicate that the assets acquired by the fund must be traded on a recognized exchange, trading facility, or market of the type described in section 225.180(h)(2) or quoted on inter-dealer systems of the type described in section 225.180(h)(3). Likewise, under the proposal, a fund generally would be considered to be contractually committed to invest in illiquid assets if the fund's organizational documents provide for the fund to invest in the equity of early-stage nonpublic companies, even if the fund's documents do not specify that the equity of such companies must not be traded or quoted in the manner described in section 225.180(h)(2)–(4).

The Board is interested in receiving comments on the appropriateness of these criteria and on whether there are other indicia of being "contractually committed to principally invest," or having an "investment strategy to principally invest," in illiquid assets that would better achieve the Volcker Rule's objectives.

2. Criteria Focused on the Banking Entity's Investment

Besides meeting the criteria described above, a banking entity's interest in a hedge fund or private equity fund qualifies for the extended transition period in section 13(c)(3) of the BHC Act only if the banking entity's retention of that ownership interest in the fund, or provision of additional capital to the fund, is necessary to fulfill a contractual

[34] *See* 15 CFR 230.144a.

[35] Proposed Rule 225.180(g)(2).

[36] Accordingly, institutional investors, such as pension plans and endowments, that seek exposure to different types of assets typically invest in a range of different types of hedge funds or private equity funds to obtain diversification across asset classes.

[37] Proposed Rule 225.180(i).

[38] *See* 12 U.S.C. 1851(d)(1)(C). The Board expects to interpret the language concerning risk-mitigating hedges consistent with the manner in which such language is implemented through the rulemaking process conducted under section 13(b)(2) of the BHC Act.

[39] Proposed Rule 225.180(i)(2).

[40] Proposed Rule 225.180(i)(3).

obligation of the banking entity that was in effect on May 1, 2010.[41] This statutory restriction complements and reinforces the fund-related criteria discussed above because a fund that is principally invested in *liquid* assets is unlikely to require its investors to commit to remaining invested in the fund for, or provide additional capital over, an extended period of time.

The proposed rule provides that a banking entity will be considered to have a "contractual obligation" to remain invested in a fund only if the banking entity, under the contractual terms of its equity, partnership, or other ownership interest in the fund or other contractual arrangements with the fund that were in effect as of May 1, 2010, is prohibited from both: (i) Redeeming all of its equity, partnership, or other ownership interests in the fund; and (ii) selling or otherwise transferring all such ownership interests to a person that is not an affiliate of the banking entity.[42] Similarly, the proposed rule specifies that a banking entity has a contractual obligation to provide additional capital to an illiquid fund only if the banking entity is required, under the contractual terms of its equity, partnership, or other ownership interest in the fund or other contractual arrangements with the fund that were in effect as of May 1, 2010, to provide additional capital to the fund.

In the Board's experience, to the extent that contractual obligations described above exist between a banking entity and a hedge fund or private equity fund, such obligations often may be waived with the consent of the general partner and/or the other investors in the fund. To address these situations, the proposed rule provides that either of the contractual obligations described above will not be considered to be in effect with respect to a banking entity if: (i) The obligation may be terminated by the banking entity or any of its subsidiaries or affiliates; or (ii) the obligation may be terminated with the consent of other persons *unless* the banking entity and its subsidiaries and affiliates have used their reasonable best efforts to obtain such consent and such consent has been denied.[43] These provisions are intended to ensure that the banking entity's obligation to remain invested in, or provide additional capital to, a fund cannot be terminated by the banking entity itself or through its reasonable best efforts.

The Board invites comments on the appropriateness of the criteria contained in the definition. For example, are there other ways to define a "contractual obligation" that would better achieve the objectives of the Volcker Rule's conformance period?

3. Application for Extended Transition Period

Under section 619 of the Dodd-Frank Act, a banking entity may take advantage of the extended transition period with respect to an investment in a qualifying illiquid fund only with the approval of the Board. Section 225.181(b) of the proposed rule implements this requirement. A banking entity that seeks an extended transition period with respect to an illiquid fund must submit a request to the Board in accordance with the requirements of section 225.181(c). Any request must address the factors specified in section 225.181(d) of the proposed rule, as described in Part II above. The Board expects to carefully review requests for an extended transition period to ensure that the banking entity's interest in the fund and the fund's assets and investment strategy satisfy the requirements contained in the rule in order to be eligible for an extended transition period. As noted above, in cases where the banking entity is primarily supervised by another Federal banking agency, the SEC, or the CFTC, the Board would consult with such agency both in connection with its review of the application and, if applicable, prior to imposing conditions in connection with the approval of any request by the banking entity seeking an extended transition period with respect to an illiquid fund under the proposed rule.

As provided in the Volcker Rule, the Board may grant a banking entity only one extended transition period with respect to any illiquid fund, which may not exceed 5 years.[44] The Volcker Rule expressly states that any extended transition period will automatically terminate (unless it already expired by its terms) on the date on which the contractual obligation to invest in, or provide additional capital to, the illiquid fund terminates.[45] Section 225.181(b)(2)(ii) implements this termination requirement.

4. Exception for Private Equity Funds as Defined Under the Investment Advisors Act of 1940

Section 13(h)(7)(B) of the BHC Act provides that, for purposes of the definition of an "illiquid fund," the term "hedge fund" shall not include a "private equity fund," as such term is used in section 203(m) of the Investment Advisors Act of 1940 (15 U.S.C. 80b–3(m))."[46] However, section 203(m) of the Investment Advisors Act, as added by section 408 of the Dodd-Frank Act, does not contain a definition of, nor does it use the term, "private equity fund." Moreover, Congress' intent in adopting this exclusion is unclear. For example, a fund that invests primarily in nonpublic portfolio companies, which are commonly referred to in the investment community as "private equity funds," appears to be the type of fund that the Volcker Rule intended to potentially qualify as an "illiquid fund." As noted earlier, the Volcker Rule specifically includes investments in "portfolio companies" as an example of an "illiquid asset," one of the key terms used to define an "illiquid fund."

In any event, the Board does not believe that it is necessary to resolve the ambiguity surrounding this provision because the exclusion would not have any effect on the ability of a fund to qualify as an illiquid fund. This is because the Volcker Rule defines a "hedge fund" and a "private equity fund" synonymously.[47] Thus, any illiquid fund that would have been excluded from the definition of "hedge fund" because it met the missing definition of a "private equity fund" in the Investment Advisors Act could still qualify for the extended conformance period afforded to illiquid funds as a "private equity fund" under the Volcker Rule itself.

D. Nonbank Financial Companies Supervised by the Board

As noted above, the Volcker Rule does not prohibit nonbank financial companies supervised by the Board from engaging in proprietary trading, or from having the types of investments in or relationships with hedge funds or private equity funds that banking entities are prohibited or restricted from having under the Volcker Rule. However, the Volcker Rule provides that the Board or other appropriate agency impose additional capital charges, quantitative limits, or other restrictions on nonbank financial companies supervised by the Board or their

[41] 12 U.S.C. 1851(c)(3)(A).

[42] Proposed Rule 225.181(b)(3)(i).

[43] Proposed Rule 225.181(b)(3)(iii)(A) and (B).

[44] The statute provides that a banking entity may apply for a single extension with respect to an illiquid fund, and that such extension may not exceed 5 years. In light of the statutory language, the Board retains the right to grant an extended transition period of less than 5 years if, based on all the facts and circumstances, it determines such extension is appropriate.

[45] *Id.* at § 1851(c)(4).

[46] *See* 12 U.S.C. 1851(h)(7)(B).

[47] 12 U.S.C. 1851(h)(2).

subsidiaries that are engaged in such activities or maintain such relationships.[48] Like banking entities, the Volcker Rule provides a nonbank financial company supervised by the Board two years after the date the company becomes a nonbank financial company supervised by the Board to conform its activities to any applicable requirements of the Volcker Rule, including any capital requirements or quantitative limitations adopted thereunder and applicable to the company. The Volcker Rule also provides the Board the ability to extend this two-year conformance period by up to three additional one-year periods.[49] Section 225.182 of the proposed rule implements the conformance period for nonbank financial companies supervised by the Board. A nonbank financial company supervised by the Board seeking an extension must submit a request to the Board under the same time frame as required of banking entities.

III. Request for Comments

The Board invites comments on all aspects of the proposed rule. Comments are specifically requested on the following matters:

1. Are the definitions contained in the proposed rule appropriate? Would other definitions be more consistent with the language or purposes of the Volcker Rule?

2. Is the proposed requirement that at least 75 percent of a fund's assets be "illiquid assets" or related hedges appropriate in order for a fund to meet the definition of "principally invested"? Would an alternative number, metric, or other indicia be more consistent with the purposes of the Volcker Rule?

3. Are the enumerated criteria for determining what qualifies as a "liquid asset" appropriate? If not, what additional or alternative metrics or screens should the Board consider?

4. Are there particular types of assets that should be defined, by rule, as illiquid? If so, what types of assets would these be? Would the assets generally be considered illiquid assets under the terms of the proposed rule?

5. What will the potential impact of the proposed rule be on affected entities?

6. Are there any additional factors that the Board should consider in reviewing a request for an extension of the conformance period? Are there additional factors that the Board should consider in reviewing a request for an extension with respect to an illiquid fund?

7. Are there specific additional conditions or limitations that the Board should, by rule, impose in connection with granting an extension of the conformance period? If so, what conditions or limitations would be appropriate? Alternatively, should the Board and the other Federal agencies responsible for implementing the Volcker Rule consider what conditions or limitations might be appropriate to apply to prohibited activities that are conducted during the conformance period (including any extension thereof) on a tailored or case-by-case basis?

8. Are there other matters that the Board should address as part of the conformance period rulemaking required by section 13(c)(6) of the BHC Act?

IV. Administrative Law Matters

A. Paperwork Reduction Act Analysis

In accordance with the Paperwork Reduction Act of 1995 ("PRA"),[50] the Board reviewed the proposed rule under the authority delegated to the Board by Office of Management and Budget ("OMB"). The Board may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid OMB control number.

Sections 225.181(c) and 225.182(c) of the proposed rule contain collections of information that are subject to the PRA. The OMB control number for these information collections will be assigned. These collections of information would only be required for banking entities and nonbank financial companies supervised by the Board that voluntarily decide to seek an extension of time to conform their activities to the Volcker Rule or divest their interest in an illiquid hedge fund or private equity fund. As discussed in the Supplementary Information, the Dodd-Frank Act generally requires banking entities and nonbank financial holding companies supervised by the Board to conform their activities and investments to the restrictions in the Volcker Rule within 2 years of the effective date of the Volcker Rule's restrictions. The proposed rule implements this conformance period and, as permitted by the Dodd-Frank Act, permits a banking entity or nonbank financial company supervised by the Board to request an extension of time to conform its activities to the Volcker Rule. Section 225.181(c) would require an application for an extension by a banking entity to be (1) submitted in writing to the Board at least 90 days prior to the expiration of the applicable time period, (2) provide the reasons why the banking entity believes the extension should be granted, and (3) provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment(s). Section 225.182(c) would require an application for an extension by a nonbank financial holding company to be (1) submitted in writing to the Board at least 90 days prior to the expiration of the applicable time period, (2) provide the reasons why the nonbank financial holding company believes the extension should be granted, and (3) provide a detailed explanation of the company's plan for coming into compliance with the requirements of the Volcker Rule. A banking entity or nonbank financial company supervised by the Board may request confidential treatment of information submitted as part of an extension request in accordance with the Freedom of Information Act.

The estimated burden per request is 1 hour. It is estimated that there were approximately 7,200 banking entities as of December 31, 2009. Of that number, the Board estimates that approximately 720 banking entities would request an extension of the conformance period under the proposed rule. Therefore, the total amount of annual burden is estimated to be 720 hours. The number of nonbank financial companies supervised by the Board will be determined by the FSOC in accordance with the procedures established under the Dodd-Frank Act. Accordingly, the Board is unable at this time to estimate the number of nonbank financial companies supervised by the Board that might request an extension of the Volcker Rule conformance period under the proposed rule.

Comments are invited on:

(a) Whether the information collection is necessary for the proper performance of the agency functions; including whether the information has practical utility;

(b) The accuracy of the estimate of the burden of the information collection, including the cost of compliance;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected; and

(d) Ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology.

[48] *See* 12 U.S.C. 1851(a)(2), (d)(4).

[49] 12 U.S.C. 1851(c)(2).

[50] 44 U.S.C. 3506; 5 CFR 1320, Appendix A.1.

B. Initial Regulatory Flexibility Act Analysis

In accordance with Section 3(a) of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.,* ("RFA"), the Board is publishing an initial regulatory flexibility analysis of the proposed rule. The RFA requires an agency either to provide an initial regulatory flexibility analysis with a proposed rule for which a general notice of proposed rulemaking is required or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. Based on this analysis and for the reasons stated below, the Board believes that this proposed rule would not have a significant economic impact on a substantial number of small entities. Nevertheless, the Board is publishing an initial regulatory flexibility analysis and requesting public comment in the following areas. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

The Volcker Rule, adopted as a new section 13 of the BHC Act, applies to all banking entities and nonbank financial companies supervised by the Board, regardless of size. The Board is proposing to amend Regulation Y to implement the provisions of the Dodd-Frank Act that allow a banking entity—including a small banking entity—or a nonbank financial company supervised by the Board to obtain, with the Board's approval, an extended period of time to conform its activities and investments to the requirements of the Volcker Rule. Under the proposed rule, a banking entity of any size may request up to three one-year extensions of the general two-year conformance period provided under section 13 of the BHC Act, as well as one extension of up to five years to divest certain ownership interests in a hedge fund or private equity fund that qualifies as an "illiquid fund" under the statute and proposed rule. The SUPPLEMENTARY INFORMATION provides additional information regarding the reasons for, and the objective and legal basis of, the proposed rule.

Under regulations issued by the Small Business Administration ("SBA"), a bank or other depository institution is considered "small" if it has $175 million or less in assets.[51] As of December 31, 2009, there were approximately 2450 small bank holding companies, 293 small savings association, 132 small national banks, 73 small State member banks, 665 small State nonmember banks, and 21 small foreign banking organizations that are subject to section 8 of the International Banking Act of 1978. As of that date, there were no nonbank financial companies supervised by the Board. The Volcker Rule would affect only those entities that engage in activities or that hold investments prohibited or restricted under the terms of the Volcker Rule. As explained above, the Board estimates that of the total number of banking entities that would be affected by the Volcker Rule, approximately 10 percent would likely file an extension request under the proposed rule. Based on its supervisory experience, the Board believes that small banking entities are less likely to be engaged in the types of activities or hold investments prohibited under the Volcker Rule, and as such estimates that only 5 percent of small banking entities likely would file an extension request under the proposal. The Board specifically seeks comment on whether this estimate is appropriate. The Board notes that the impact of the proposal on entities choosing to take advantage of the proposal's extended conformance period provided under the proposed rule would be positive and not adverse. This is because the proposed rule would allow affected entities to seek and obtain an extended period of time to conform their activities, investments, or relationships to the requirements of the Volcker Rule. The Board also has taken several steps to reduce the potential burden of the proposed rule on all banking entities, including small banking entities. For example, the proposed rule establishes a straightforward process for banking entities, including small banking entities, to request an extension of the conformance period or an extended transition period with respect to an investment in an illiquid fund, and permits such requests to be submitted in letter form. The proposed rule also uses standards drawn from existing federal banking and securities regulations to help define the types of funds that may qualify as an "illiquid fund" under the statute and the proposed rule, which should assist small banking entities in determining whether their investments qualify for the extended transition period available for investments in illiquid funds.

As discussed in the SUPPLEMENTARY INFORMATION, the Dodd-Frank Act requires that the Board adopt rules implementing the Volcker Rule's conformance period by January 21, 2011. The Board does not believe that the proposed rule duplicates, overlaps, or conflicts with any other Federal rules. The Board requests comment on whether there are additional steps that the Board could take to reduce the potential burden on small banking entities consistent with the terms and purpose of section 13 of the BHC Act. The Board will carefully review any comments received on these issues during the public comment period.

[51] 13 CFR 121.201.

Solicitation of Comments on Use of Plain Language

Section 722 of the GLBA required the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Board invites comment on how to make the interim final rule easier to understand. For example, the Board requests comment on such questions as:

- Have we organized the material to suit your needs? If not, how could the rule be more clearly stated?
- Are the requirements in the rule clearly stated? If not, how could the rule be more clearly stated?
- Do the regulations contain technical language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes would make the regulation easier to understand?
- Would more, but shorter, sections be better? If so, which sections should be changed?
- What else could we do to make the regulation easier to understand?

List of Subjects in 12 CFR Part 225

Administrative practice and procedure, Banks, banking, Holding companies, Reporting and recordkeeping requirements, Securities.

Authority and Issuance

For the reasons stated in the preamble, the Board proposes to amend Regulation Y, 12 CFR part 225, as set forth below:

Proposed Rules

The Board proposes to adopt rules under part 225 of Title 12, Chapter II of the Code of Federal Regulations, as follows:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 is revised to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1851, 1972(1), 3106, 3108, 3310, 3331–3351, 3907, and 3909; 15 U.S.C. 6801 and 6805.

Subpart L—Conditions to Orders

2. Add a new subpart L heading as set forth above, and designate § 225.200 under subpart L.

3. Add Subpart K to part 225 to read as follows:

Subpart K—Proprietary Trading and Relationships with Hedge Funds and Private Equity Funds

Subpart K—Proprietary Trading and Relationships with Hedge Funds and Private Equity Funds

§ 225.180 Definitions.

For purposes of this subpart:

(a) *Banking entity* means—

(1) Any insured depository institution;

(2) Any company that controls an insured depository institution;

(3) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978; and

(4) Any affiliate or subsidiary of any of the foregoing entities.

(b) *Hedge fund* and *private equity fund* mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)), determine.

(c) *Insured depository institution* has the same meaning as ordered to that term in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813), except that for purposes of this subpart the term shall not include an institution that functions solely in a trust or fiduciary capacity if—

(1) All or substantially all of the deposits of such institution are in trust funds and are received in a bona fide fiduciary capacity;

(2) No deposits of such institution which are insured by the Federal Deposit Insurance Corporation are offered or marketed by or through an affiliate of such institution;

(3) Such institution does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others or make commercial loans; and

(4) Such institution does not—

(i) Obtain payment or payment related services from any Federal Reserve bank, including any service referred to in section 11A of the Federal Reserve Act (12 U.S.C. 248a); or

(ii) Exercise discount or borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act (12 U.S.C. 416(b)(7)).

(d) *Nonbank financial company supervised by the Board* means a nonbank financial company supervised by the Board of Governors, as defined in section 102 of the Financial Stability Act of 2010 (12 U.S.C. 5311).

(e) *Board* means the Board of Governors of the Federal Reserve System.

(f) *Illiquid fund* means a hedge fund or private equity fund that as of May 1, 2010:

(1) Was principally invested in illiquid assets; or

(2) Was invested in, and contractually committed to principally invest in, illiquid assets; and

(3) Makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

(g) *Illiquid assets* means any real property, security, obligation, or other asset that—

(1) Is not a liquid asset; or

(2) Because of statutory or regulatory restrictions applicable to the hedge fund, private equity fund or asset, cannot be offered, sold, or otherwise transferred by the hedge fund or private equity fund to a person that is unaffiliated with the relevant banking entity, *provided that* any asset may be considered an illiquid asset under this paragraph (g)(2) only for so long as such statutory or regulatory restriction is applicable.

(h) *Liquid asset* means:

(1) Cash or cash equivalents;

(2) An asset that is traded on a recognized, established exchange, trading facility or other market on which there exist independent, bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular asset almost instantaneously;

(3) An asset for which there are bona fide, competitive bid and offer quotations in a recognized inter-dealer quotation system or similar system or for which multiple dealers furnish bona fide, competitive bid and offer quotations to other brokers and dealers on request;

(4) An asset the price of which is quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;

(5) An asset with an initial term of one year or less and the payments on which at maturity may be settled, closed-out, or paid in cash or one or more other liquid assets described in paragraphs (h)(1), (2), (3), or (4) of this section; and

(6) Any other asset that the Board determines, based on all the facts and circumstances, is a liquid asset.

(i) *Principally invested* and related definitions.—A hedge fund or private equity fund—

(1) Is *principally invested* in illiquid assets if at least 75 percent of the fund's consolidated total assets (as reflected on the fund's financial statements prepared in accordance with applicable accounting standards) are—

(i) Illiquid assets; or

(ii) Risk-mitigating hedges entered into in connection with and related to individual or aggregated positions in, or holdings of, illiquid assets;

(2) Is *contractually committed to principally invest* in illiquid assets if the fund's organizational documents, or other documents that constitute a contractual obligation of the fund, provide for the fund to be principally invested in assets described in paragraph (i)(1) of this section during the period beginning on the date when capital contributions are first received for the purpose of making investments and ending on the fund's expected termination date; and

(3) Has an *investment strategy to principally invest* in illiquid assets if the fund—

(i) Markets or holds itself out to investors as intending to principally invest in assets described in paragraph (i)(1) of this section; or

(ii) Has a documented investment policy of principally investing in assets described in paragraph (i)(1) of this section.

§ 225.181 Conformance period for banking entities engaged in prohibited proprietary trading or private fund activities.

(a) *Conformance period.* (1) *In general.*—Except as provided in paragraph (b)(2) or (3), a banking entity shall bring its activities and investments into compliance with the requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart no later than 2 years after the earlier of:

(i) July 21, 2012; or

(ii) 12 months after the date on which final rules adopted under section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)) are published in the **Federal Register**.

(2) *New banking entities.*—A company that was not a banking entity, or a subsidiary or affiliate of a banking entity, as of July 21, 2010, and becomes a banking entity, or a subsidiary or affiliate of a banking entity, after that date shall bring its activities and investments into compliance with the requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart before the later of—

(i) The conformance date determined in accordance with paragraph (a)(1) of this section; or

(ii) 2 years after the date on which the company becomes a banking entity or a subsidiary or affiliate of a banking entity.

(3) *Extended conformance period.* The Board may extend the two-year period under paragraph (a)(1) or (2) of this section by not more than three one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart and would not be detrimental to the public interest.

(b) *Illiquid funds.* (1) *Extended transition period.*—The Board may further extend the period provided by paragraph (a) of this section during which a banking entity may acquire or retain an equity, partnership, or other ownership interest in, or otherwise provide additional capital to, a private equity fund or hedge fund if—

(i) The fund is an illiquid fund; and

(ii) The acquisition or retention of such interest, or provision of additional capital, is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.

(2) *Duration limited.* The Board may grant a banking entity only one extension under paragraph (b)(1) of this section and such extension—

(i) May not exceed 5 years beyond any conformance period granted under paragraph (a)(3) of this section; and

(ii) Shall terminate automatically on the date during any such extension on which the banking entity is no longer under a contractual obligation described in paragraph (b)(1)(ii) of this section.

(3) *Contractual obligation.* For purposes of this paragraph (b)—

(i) A banking entity has a contractual obligation to take or retain an equity, partnership, or other ownership interest in an illiquid fund if the banking entity is prohibited under the terms of its equity, partnership, or other ownership interest in the fund or other contractual arrangements with the fund from—

(A) Redeeming all of its equity, partnership, or other ownership interests in the fund; and

(B) Selling or otherwise transferring all such ownership interests to a person that is not an affiliate of the banking entity;

(ii) A banking entity has a contractual obligation to provide additional capital to an illiquid fund if the banking entity is required under the terms of its equity, partnership, or other ownership interest in the fund or other contractual arrangements with the fund to provide additional capital to such fund; and

(iii) A banking entity shall be considered to have a contractual obligation for purposes of paragraph (b)(3)(i) or (ii) of this section only if—

(A) The obligation may not be terminated by the banking entity or any of its subsidiaries or affiliates under the terms of its agreement with the fund; and

(B) In the case of an obligation that may be terminated with the consent of other persons, the banking entity and its subsidiaries and affiliates have used their reasonable best efforts to obtain such consent and such consent has been denied.

(c) *Approval required to hold interests in excess of time limit.* The conformance period in paragraph (a) may be extended in accordance with paragraph (a)(3) or (b)(1) of this section only with the approval of the Board. A banking entity that seeks the Board's approval for an extension of the conformance period under paragraph (a)(3) or for an extended transition period under paragraph (b)(1) of this section must—

(1) Submit a request in writing to the Board at least 90 days prior to the expiration of the applicable time period;

(2) Provide the reasons why the banking entity believes the extension should be granted, including information that addresses the factors in paragraph (d)(1) of this section; and

(3) Provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment(s).

(d) *Factors governing Board determinations.*

(1) *Extension requests generally.*—In reviewing any application for an extension under paragraph (a)(3) or (b)(1) of this section, the Board may consider all the facts and circumstances related to the activity, investment, or fund, including, to the extent relevant—

(i) Whether the activity or investment—

(A) Involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties;

(B) Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;

(C) Would pose a threat to the safety and soundness of the banking entity; or

(D) Would pose a threat to the financial stability of the United States;

(ii) Market conditions;

(iii) The nature of the activity or investment;

(iv) The date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;

(v) The contractual terms governing the banking entity's interest in the fund;

(vi) The degree of control held by the banking entity over investment decisions of the fund;

(vii) The types of assets held by the fund;

(viii) The date on which the fund is expected to wind up its activities and liquidate, or its investments may be redeemed or sold;

(ix) The total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity or the financial stability of the United States;

(x) The cost to the banking entity of disposing of the activity or investment within the applicable period; and

(xi) Any other factor that the Board believes appropriate.

(2) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, the Board will consult with such agency prior to the approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

(e) *Authority to impose restrictions on activities or investments during any extension period.*

(1) *In general.* The Board may impose such conditions on any extension approved under paragraph (a)(3) or (b)(1) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of 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 Bank Holding Company Act (12 U.S.C. 1851) and this subpart.

(2) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, the Board will consult with such agency prior to imposing conditions on the approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

§ 225.182 Conformance period for nonbank financial companies supervised by the board engaged in proprietary trading or private fund activities.

(a) *Divestiture requirement.* A nonbank financial company supervised by the Board shall come into compliance with all applicable requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart, including any capital requirements or quantitative limitations adopted thereunder and applicable to the company, not later than 2 years after the date the company becomes a nonbank financial company supervised by the Board.

(b) *Extensions.* The Board may, by rule or order, extend the two-year period under paragraph (a) of this section by not more than three one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart and would not be detrimental to the public interest.

(c) *Approval required to hold interests in excess of time limit.* A nonbank financial company supervised by the Board that seeks the Board's approval for an extension of the conformance period under paragraph (b) of this section must—

(1) Submit a request in writing to the Board at least 90 days prior to the expiration of the applicable time period;

(2) Provide the reasons why the nonbank financial company supervised by the Board believes the extension should be granted; and

(3) Provide a detailed explanation of the company's plan for conforming the activity or investment(s) to any applicable requirements established under section 13(a)(2) or (f)(4) of the Bank Holding Company Act (12 U.S.C. 1851(a)(2) and (f)(4)).

(d) *Factors governing Board determinations.* In reviewing any application for an extension under paragraph (b) of this section, the Board may consider all the facts and circumstances related to the nonbank financial company and the request including, to the extent determined relevant by the Board, the factors described in § 225.181(d)(1).

(e) *Authority to impose restrictions on activities or investments during any extension period.* The Board may impose conditions on any extension approved under paragraph (b) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the nonbank financial company or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart.

By order of the Board of Governors of the Federal Reserve System, November 16, 2010.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 2010–29277 Filed 11–24–10; 8:45 am]

BILLING CODE 6210–01–P

FEDERAL HOUSING FINANCE AGENCY

12 CFR Part 1278

RIN 2590–AA37

Voluntary Mergers of Federal Home Loan Banks

AGENCY: Federal Housing Finance Agency.

ACTION: Notice of proposed rulemaking; request for comment.

SUMMARY: Section 1209 of the Housing and Economic Recovery Act of 2008 (HERA) amended section 26 of the Federal Home Loan Bank Act (Bank Act) to permit any Federal Home Loan Bank (Bank) to merge with another Bank with the approval of its board of directors, its members, and the Director of the Federal Housing Finance Agency (FHFA). This proposed rule would establish the conditions and procedures for the consideration and approval of voluntary Bank mergers.

DATES: Written comments must be received on or before January 25, 2011.

ADDRESSES: You may submit your comments, identified by regulatory information number (RIN) 2590–AA37, by any of the following methods:

- *E-mail:* Comments to Alfred M. Pollard, General Counsel may be sent by e-mail to *RegComments@fhfa.gov.* Please include "RIN 2590–AA37" in the subject line of the message.
- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments. If you submit your comment to the *Federal eRulemaking Portal,* please also send it by e-mail to FHFA at *RegComments@fhfa.gov* to ensure timely receipt by FHFA. Please include "RIN 2590–AA37" in the subject line of the message.
- *U.S. Mail, United Parcel Service, Federal Express, or Other Mail Service:* The mailing address for comments is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590–AA37, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552.
- *Hand Delivered/Courier:* The hand delivery address is: Alfred M. Pollard, General Counsel, Attention: Comments/RIN 2590–AA37, Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The package should be logged at the Guard Desk, First Floor, on business days between 9 a.m. and 5 p.m.

FOR FURTHER INFORMATION CONTACT: John P. Foley, Senior Financial Analyst, Policy and Program Development, *john.foley@fhfa.gov,* (202) 408–2828 (this is not a toll-free number), Federal Housing Finance Agency, 1625 Eye Street, NW., Washington, DC 20006; Eric M. Raudenbush, Assistant General Counsel, *eric.raudenbush@fhfa.gov,* (202) 414–6421 (this is not a toll-free number); Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. The telephone number for the Telecommunications Device for the Hearing Impaired is (800) 877–8339.

SUPPLEMENTARY INFORMATION:

I. Comments

FHFA invites comments on all aspects of the proposed rule and will take all comments into consideration before issuing the final rule. Copies of all comments will be posted without change, including any personal information you provide, such as your name and address, on the FHFA Internet Web site at *http://www.fhfa.gov.* In addition, copies of all comments received will be available for examination by the public on business days between the hours of 10 a.m. and 3 p.m. at the Federal Housing Finance Agency, Fourth Floor, 1700 G Street, NW., Washington, DC 20552. To make an appointment to inspect comments, please call the Office of General Counsel at (202) 414–6924.

II. Background

A. The Federal Home Loan Bank System

The twelve regional Banks are instrumentalities of the United States