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Leveraged Finance Group Client Alert:
Do You Have "Good Faith"? What Banking Entities Must do During the Volcker Rule Conformance Period

On April 19, 2012, the Board of Governors of the Federal Reserve System ("**Board**") issued a statement of policy (the "**Conformance Statement**") clarifying that a banking entity covered by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the so-called "**Volcker Rule**") has until July 21, 2014 (unless extended by the Board) to fully conform its activities and investments to the requirements of that section (the "**Conformance Period**"). [1]

The Volcker Rule presents the potential for drastic change to covered banking entities through largely banning their participation in proprietary trading or hedge fund and private equity investments.[2] The Volcker Rule itself became effective on July 21, 2012, notwithstanding the lack of a final rule adoption from the five federal agencies charged with its implementation. [3]

In the Conformance Statement, the Board clarified for covered banking entities that they would have a two-year period—until July 21, 2014—in which to "conform all of their activities and investments." However, the Conformance Statement also places conformance obligations on covered banking entities *during* the Conformance Period. Below, we review what covered banking entities must do during this period

[1] "Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities," *77 Fed. Reg. 33,949* (June 8, 2012).
[2] 12 U.S.C. § 1851.
[3] The Board, the Federal Deposit Insurance Corporation ("**FDIC**"), the Office of the Comptroller of the Currency ("**OCC**"), and the Securities and Exchange Commission ("**SEC**") published a proposed rule on November 7, 2011. 76 Fed. Reg. 68,846 (Nov. 7, 2011). The Commodity Futures Trading Commission ("**CFTC**") issued a proposed rule that is substantively the same on February 14, 2012. 77 Fed. Reg. 8332 (Feb. 14, 2012). These agencies ("**Agencies**") have not yet issued a final rule.

in order to conform their activities to the requirements of the Volcker Rule during the Conformance Period.

DISCUSSION

The only direct guidance provided by the Board on activities during the Volcker Rule Conformance Period comes from the Conformance Statement, which it released in response to requests for clarification of the manner in which the Conformance Period "would apply to various activities and investments covered by" the Volcker Rule. [4] The Board stated that "[d]uring the conformance period, every banking entity that engages in an activity or holds an investment covered by [the Volcker Rule] is expected to engage in good-faith efforts, appropriate for its activities and investments," to enable it to conform its activities and investments to the requirements of the Volcker Rule "by no later than the end of the conformance period."[5] The Board also pointed to the almost identical language of an issuing release for a regulation that governs Conformance Period activity under the Volcker Rule ("**Conformance Rule**"). [6] In this release, the Board provided that during the Conformance Period, companies must engage in "good faith efforts" that will result in conformance by no later than the end of the Conformance Period. [7]

The meaning of "good faith efforts" during the Conformance Period is critical to many banking entities that must now wind down proprietary trading departments and divest positions in hedge funds and private equity funds. Unfortunately, the vagueness of this "good faith" mandate and the lack of direct contextual guidance have led to a large divergence of opinions on what must be done. Some banking entities have already begun divesting proprietary trading activities and liquidating funds holdings, while other banking entities have continued to enter into such trades and maintain funds positions and plan to continue to do so right up until the conformance deadline. Still other banking entities have focused on maintaining the same level of covered activities while not materially increasing their risk profile.

There is no definition of “good faith efforts” to be found in any of the text of the Volcker Rule, the draft agency promulgation, or the Conformance Rule or Conformance Statement. Therefore, banking entities must look to analogous provisions in banking and commercial laws or regulations that offer guidance on the meaning placed on "good faith efforts" by courts, legislatures, and federal banking

[4] *77 Fed. Reg. at 33,949.*
[5] *Id. at 33,950.* The Board also provided that covered banking entities should develop a “conformance plan.” Id.
[6] 76 Fed. Reg. 8,265 (Feb. 14, 2011). This is codified at 12 C.F.R. §§ 225.180-182.
[7] *Id. at 8,274.*

regulators. The below analysis of these sources offers banking entities a more complete picture on how relevant authorities will interpret "good faith efforts" during the Conformance Period.

DIVESTITURE PERIODS UNDER THE BHC ACT

Divestiture requirements under the BHC Act can arise in number of ways: the Board may order divestiture in connection with an acquisition that violates the law; [8] the divestiture may be required because of a statutory requirement resulting from an amendment or addition to the BHC Act; [9]or perhaps most commonly, divestiture requirements could arise from debt previously contracted ("**DPC**")—as a result of foreclosing upon collateral held by the bank in satisfaction of DPC. [10] Companies that find themselves in one of these situations will be given a period of time in which to remove the impermissible assets. This divestiture period varies in time depending on the situation; for DPC the period is typically five years. [11] Often divestiture is not a simple process, and depending on the market for the asset in question, may require considerable time and resources. For companies unable to divest assets by the end of the divestiture period, a request for extension of the period must be made with the Board. 12 C.F.R. § 265.7(a)(2) directs the Board to make its decision to deny or grant these extension requests based on, among several factors, the party's "good faith efforts" to comply with the original divestiture period. [12]

Interpretive letters issued by the Board in response to requests to extend divestiture periods under the BHC Act provide valuable insight into the Board's view on what constitutes "good faith efforts" to comply. The Board gave guidance on the meaning of "good faith" efforts in a statement of policy concerning divestitures by bank holding companies.[13] In this policy statement, the Board encouraged companies to try to "complete the divestiture as early as possible during the specific period." Second, the Board urged the creation and submission of a divestiture plan that specifies the manner in which the divestiture will be accomplished and set out a "time table for taking such steps."[14] Note the similarities of the policy statement standard with the "good faith planning efforts" requirements of the Conformance Period. Finally, the Board addressed the issue of extension of deadlines. The Board stated that unfavorable market conditions or possibility of loss will not by

[8] 12 C.F.R § 225.138.
[9] *Id.*
[10] *Id.*
[11] 12 C.F.R. § 225.22(d)(1).
[12] *Id.*at § 265.7(a)(2).
[13] *Id*. at § 225.138.
[14] *Id.*

themselves be reason enough for granting extension, especially "if the company has failed to take earlier steps" when conditions were more favorable.[15] Significantly, the Board also noted that "normally, a request for an extension will not be considered unless the company has established that it has made *substantial and continued* good faith efforts to accomplish the divestiture within the prescribed period." [16]

Individual rulings on requests for divestiture period extensions provide additional insight into what the Board finds to be "good faith efforts." Generally speaking, it appears that "good faith efforts" means making "substantial progress" towards conformity.[17] The Board appears to have allowed an extension for most companies that were able to divest a majority of the impermissible assets during the initial divestiture period.[18] The fact patterns from the successful requests were similar in that each company had sold the majority of its impermissible positions and had made consistent efforts to sell the entirety of the positions but was prevented because of insufficient demand or other external factors. Additionally, some letters cited as evidence of good faith efforts the fact that the requesting companies did not acquire any additional non-conforming assets during the divestiture period.[19]

OTHER TITLE 12 REGULATORY PROVISIONS

Title 12 of the Code of Federal Regulations contains a number of other provisions that provide guidance on how the Board will determine whether a banking entity is acting in “good faith” during the Conformance Period.

Under Federal Reserve Regulation R, the concept of "good faith" plays an important role in determining whether a bank can remain exempt from the definition of a "broker" under the securities laws despite making certain compliance mistakes. [20] The provision allows banks that act in "good faith" and that have "reasonable policies and procedures in place to comply with the requirements" to avoid being designated as a "broker" simply because the bank failed to comply with "respect to a particular customer." An analogy can be drawn from this context to that of banks attempting to comply with the Volcker Rule. The "reasonable policies" for compliance language in Regulation R is similar to the "good faith planning efforts" to comply language that applies during the Conformance Period. Regulation R goes on to offer more guidance on what "good faith compliance" means, stating that in

[15] *Id.* at (a)(4).
[16] *Id.* (emphasis added).
[17] *1996 Fed. Res. Interp. Ltr. LEXIS 278.*
[18] *1999 Fed. Res. Interp. Ltr. LEXIS 65; 1998 Fed. Res. Interp. Ltr. LEXIS 111.*
[19] *1996 Fed. Res. Interp. Ltr. LEXIS 278.*
[20] 12 C.F.R. § 218.701.

addition to having reasonable policies in place the bank needs to also take "reasonable and prompt steps to remedy the error" when it is discovered.[21]

"GOOD FAITH" IN NEW YORK COMMERCIAL LAW

The activities of covered banking entities are subject to several provisions of the Uniform Commercial Code. Under the New York Uniform Commercial Code ("**NY UCC**"), the term "good faith" is used in the context of secured transactions ("**Article 9**") and transactions in commercial paper ("**Article 3**"). Case law interpreting the NY UCC provides examples of when certain entities are considered to be acting in "good faith". Although these statutory and case law standards are used in differing contexts, these sources of authority may nonetheless offer persuasive influence to the Board as it interprets the good faith efforts requirement of the Conformance Period.

Article 9 § 102 of the NY UCC defines the term "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[22] Article 3 § 103 of the NY UCC defines "good faith" identically in provisions governing negotiable instruments, such as commercial paper and other notes. [23]

Several cases interpreting the NY UCC adopt a flexible interpretation of the meaning of the term "good faith" by considering the facts and circumstances of the transaction at issue, as well as what is considered reasonable for a particular industry. For example, in industries with inherently speculative or subjective valuation factors, changes in market conditions that negatively affect valuation estimates do not constitute bad faith actions on behalf of the parties.[24] Courts have been willing to read "good faith" broadly when applying it to differing circumstances, and the Board should likewise take into account specific practices of the financial services industry when interpreting what is required by banking entities during the Conformance Period. Because banks are subject to Article 3 of the NY UCC when acting as holders in due course,[25] the New York commercial law usage of good faith may influence how the Board determines whether a banking entity is acting in "good

[21] *Id.* § 218.701(a)(1)(iv).
[22] N.Y. U.C.C. art. 9 § 102(a)(43) (McKinney 2001).
[23] N.Y. U.C.C. art 3 § 103(a)(4).
[24] *Christie's Inc. v. Davis*, 247 F. Supp. 2d 414, 421 (S.D.N.Y. 2002) (concluding that when debtors defaulted on notes secured by pieces of fine art and furniture as collateral, creditors did establish superior right of possession of collateral, were not required to assign value to each item, and did not act in bad faith by offering reduced valuations due to changed market conditions and other economic and aesthetic factors).
[25] N.Y. U.C.C. art 3 § 302(1) (McKinney 2001) (stating that a party is a holder in due course when: (1) it was in possession of the notes in question; (2) it acquired the notes for value; (3) in good faith; and (4) without notice of fraud or any adverse claims to the notes).

faith" during the Conformance Period. Relevant case law indicates that "good faith," as used in the context of determining whether a party is a noteholder in due course, does not require the exercise of due care but rather depends on the actual knowledge of the parties based on their specific circumstances and industries. [26]

The Board should adopt the flexibility shown by the courts in applying the NY UCC and take into account particular financial services industry practices in determining whether a banking entity is engaging in "good faith efforts" to bring its activities and investments into conformance during the Conformance Period by looking at, for example, standard market practices for winding down complex trading operations or the long-term nature of private equity fund and hedge fund investments.

CONCLUSION

The Conformance Statement clearly shows that the Board expects banking entities to make some effort at conforming their activities and investments during the Conformance Period. The question is how much effort must a banking entity give to be seen as making a "good faith effort"? Given the lack of clarity on the meaning of the term "good faith efforts" in the Conformance Statement, it would not be surprising if the Board looked for guidance in analogous provisions in commercial law and in its own regulations. In the event that the Board looks to these sources, it would likely require a banking entity to engage in ongoing efforts to conform its activities as early as possible during the Conformance Period in accordance with a time table established in the banking entity's conformance plan. These efforts should be in proportion to the size and complexity of the banking entity's activities, and should include reasonable steps to promptly end or conform any covered activities by the end of the Conformance Period. The Board would also be more likely to favorably consider a banking entity's request for an extension of the Conformance Period beyond July 21, 2014 if such entity is able to show that it has made serious efforts at conformity by the time it makes the request.

Finally, we hope that the Board will adopt a flexible approach to conformance that recognizes market realities and financial services industry practices.

*Gabrielle Paolini, Law Clerk, contributed to this article.

[26] *In re AppOnline.com, Inc.,* 321 B.R. 614, 624 (Bankr. E.D.N.Y. 2003) (holding that under New York law, any lack of due diligence by warehouse lenders that purchased mortgage notes did not affect their "good faith" and did not prevent them from qualifying as holders in due course).

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