BNA Securities Regulation & Law Report™

REGULATORY REFORM

FSOC Reproposes the Nonbank SIFI Designation Rule: A Revised Procedure, But No Greater Clarity Regarding Who Will Be Designated or When

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For the first time in U.S. history, certain financial institutions that are not affiliated with a depository institution will be supervised and regulated by a U.S. banking regulator. Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''*Dodd-Frank*'') authorizes the Financial Stability Oversight Council (the ''*FSOC*'') to designate a nonbank financial company as systemically important, or a ''*Nonbank SIFI*''. Nonbank SIFIs will be subject to prudential regulation and supervision by the Board of Governors of the Federal Reserve System (the ''*FRB*''). Required prudential standards will include: capital, leverage and liquidity standards; risk management requirements; concentration limits; resolution plans (so-called ''living wills'') and stress tests. Other prudential standards may include a contingent capital requirement, enhanced disclosure requirements and short-term debt limits. The FRB is expected to issue proposed rules on these standards pursuant to Section 165(d) of Dodd-Frank in the first quarter of 2012.

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Over the past year, the FSOC has sought to develop a clear and workable framework detailing how it will apply the criteria in Dodd-Frank for designating Nonbank SIFIs. Many industry participants, including the potential candidates for designation, have sought clarity regarding the substantive standards and procedures that the FSOC will apply to designating Nonbank SIFIs.

On October 11, 2011, the FSOC issued a second proposed rule (the ''*Second NPR*'') in response to industry comment on the FSOC's initial proposal released in January 2011 (the ''*First NPR*'').[1] Many commenters criticized the First NPR for lacking the detail and specificity needed to provide nonbank financial companies with guidance regarding the determination process. Other than an elaboration of certain procedural steps and a categorization of the Dodd-Frank criteria, the First NPR provided little insight into how the statutory requirements of Section 113 of Dodd-Frank would be applied.

The Second NPR is substantively similar to the First NPR, but it provides additional detail about the designation process, including the analytical framework the FSOC proposes for its review and a description of a three-stage determination process. It is unclear whether these clarifications in the Second NPR will materially change the transparency of the determination process because ultimately the FSOC retains the same degree of discretion over the designation of Nonbank SIFIs. However, the Second NPR contains a number of open issues that will need to be addressed as the rule is finalized. Comments on the Second NPR are due December 19, 2011.

Statutory Framework

To designate a Nonbank SIFI, the FSOC must determine that at least one of two determination standards is

[1] Prior to the First NPR, on October 1, 2010, the FSOC posed 15 questions regarding how it should apply the statutory criteria in an advance notice of proposed rulemaking.

satisfied. The first standard requires a determination that material financial distress at the nonbank financial company could pose a threat to U.S. financial stability. The second standard requires a determination that the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the nonbank financial company could pose a threat to U.S. financial stability.

Under Section 106 of Dodd-Frank, a nonbank financial company includes a U.S. or foreign company (other than a bank holding company, a foreign banking organization that is treated as a bank holding company in the U.S., and certain other types of entities) that is ''predominantly engaged in financial activities''. A company is ''predominantly engaged in financial activities'' if (1) 85% or more of the company's consolidated annual gross revenues derive from activities that are financial in nature (as defined by the Bank Holding Company Act); or (2) 85% or more of the company's consolidated assets relate to activities that are financial in nature.[2]

Section 113 of Dodd-Frank sets forth the 10 statutory considerations the FSOC must consider in its designation of a Nonbank SIFI: (1) the extent of the leverage of the company; (2) the extent and nature of the off-balance-sheet exposures of the company; (3) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (4) the importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system; (5) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (6) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse; (7) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (8) the degree to which the company is already regulated by one or more primary financial regulatory agencies; (9) the amount and nature of the financial assets of the company; and (10) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding. In addition, the statute grants the FSOC discretion to consider any other risk-related factor it deems appropriate.

The Three-Stage Determination Process

The Second NPR sets forth a three-stage process to determine which companies will be designated as Nonbank SIFIs and therefore subject to prudential standards and supervision by the FRB. While the practical significance of the new three-stage process remains unclear, the FSOC's description of the first two steps in particular raises a number of important issues and questions.

Stage One

Stage One of the FSOC's proposed analysis would operate as an initial screen based on low thresholds applied to quantitative measures of potential systemic significance. It establishes an asset test and a series of uniform quantitative thresholds that would be applied to a broad group of nonbank financial companies. A nonbank financial company with $50 billion in global assets (for U.S. firms) or $50 billion in U.S. assets (for foreign firms) would move to the second stage of the FSOC's consideration if it also meets any of the following quantitative thresholds: (i) $30 billion or more in gross notional credit default swaps; (ii) $3.5 billion in derivative exposures (after accounting for cash collateral and netting agreements); (iii) $20 billion of outstanding borrowings (including issued debt securities); (iv) a minimum 15:1 assets to equity leverage ratio; or (v) short-term debt equal to 10% of total consolidated assets. The FSOC indicated that it will rely solely on existing public and regulatory sources in this initial screening.

Although this stage of the designation process is primarily focused on size, a nonbank financial company that does not exceed the asset test or any of the quantitative thresholds would not be protected by a ''safe harbor.'' According to the Second NPR, the FSOC would retain broad discretion to subject any company to further review, regardless of whether it would pass the Stage One screening.

As proposed, Stage One would not involve an analysis of the operations or activities of a nonbank financial company, and its practical effect as an initial filter is likely to be limited. Of the many financial companies that could pass through the initial filter, presumably most of these would be excluded in later stages. As a result, this first stage would leave many nonbank financial companies, including financial guarantors, asset management companies and insurance companies, with a number of issues to consider and little insight on which companies will be designated as systemically important.

The Stage One screen appears to be designed to provide transparency and to achieve the FSOC's stated objective of reducing potential negative effects stemming from the determination process. However, the concept of an initial screen based on public and regulatory criteria, as well as the FSOC's proposed procedures for applying it, creates a number of issues.

For instance, it appears that a company will not be notified of whether it has advanced to a Stage Two review, presumably because the FSOC believes that companies will have sufficient information to self-identify. However, certain nonbank financial companies may not be able to self-identify using this test—at least not yet—because the Second NPR identifies three areas where thresholds are subject to modification. First, the FSOC may impose specific thresholds for hedge funds and private equity funds based on forthcoming disclosure requirements on Form PF that advisers to hedge funds and private equity funds and commodity trading advisors must file with the U.S. Securities and Exchange Commission (the ''*SEC*'') or U.S. Commodities Futures Trading Commission (the ''*CFTC*'').[3] Second, the FSOC

[2] Pursuant to Section 102(b) of Dodd-Frank, in February, the FRB published a proposed amendment to Regulation Y detailing the requirements for determining whether a company is predominantly engaged in financial activities. *See* Definitions of ''Predominantly Engaged in Financial Activities'' and ''Significant'' Nonbank Financial Company and Bank Holding Company, 76 *Fed. Reg.* 7731 (Feb. 11, 2011). This proposal has not yet been finalized.

[3] On October 31, 2011, the SEC and CFTC adopted a joint rule implementing certain Dodd-Frank provisions requiring SEC-registered investment advisers that advise one or more private funds with at least $150 million in private fund assets

indicated that it may issue additional guidance for public comment regarding metrics for asset managers. Third, the FSOC intends to establish a new threshold relating to a nonbank financial company's current and potential future exposure from derivative liabilities after the SEC and CFTC finalize rules defining the terms ''major swap participant'' and ''major security-based swap participant'' (the definitions of which hinge on this analysis), and adopt final reporting requirements relating to swaps and security-based swaps.

The proposal does not indicate what information sources will be used or what time periods will be applied to measure assets, derivative exposures, etc. against the thresholds. Nor does the proposal address how the FSOC will take into account potential fluctuations, market conditions, or unexpected changes that may temporarily distort the calculations.

The broad criteria for the Stage One review may generate concern for nonbank financial companies that meet certain criteria but are clearly not systemically significant, leading to strategic questions regarding how proactive they will need to be in addressing a potential determination with the FSOC.

Stage Two

In Stage Two, the FSOC proposes to use quantitative and qualitative information from existing public and regulatory sources to evaluate a nonbank financial company's risk profile by applying the Dodd-Frank statutory considerations, which have been condensed into a framework based on six broad categories. They are:

- size;
- lack of substitutes for the financial services and products the company provides;
- interconnectedness with other financial firms;
- leverage;
- liquidity risk and maturity mismatch; and
- existing regulatory scrutiny.

Each category maps to one or more of the statutory considerations. As a practical matter, given the breadth of the Stage One thresholds, the Stage Two analysis is likely to be the more meaningful initial screen. The proposed guidance includes suggested metrics that the FSOC proposes to apply in each of the six categories. The FSOC acknowledged that a uniform set of metrics could not be developed for all industries. This view was shared by industry commenters, who generally agreed that a one-size-fits-all approach cannot be applied to all nonbank financial sectors that will be included in the Stage One screening because each presents different risk profiles that must be considered.

The proposal raises many questions regarding which metrics the FSOC will actually apply to individual firms, and how these metrics will be applied. In addition, the Second NPR indicates that the list of metrics is neither final nor exhaustive. It is unclear whether the FSOC intends to issue any new or modified metrics in a subsequent rulemaking subject to public notice and comment, or adopt them informally as part of the FSOC's implementation of the Stage Two review process. If the latter, this raises the additional question of whether a company that enters Stage Two will be informed of the metrics that are being applied to it. Without knowing which metrics were applied in the FSOC's review, companies may not have a meaningful sense of the information they would need to proffer to effectively contest a proposed determination.

In addition to the Dodd-Frank statutory criteria, the FSOC introduces a ''resolvability'' factor in both Stages Two and Three, where the FSOC proposes to evaluate whether the resolution of a nonbank financial company would pose a threat to U.S. financial stability. Potential implications that could arise from assessing the resolvability of a company in the determination process are described below in the overview of Stage Three.

The proposal raises a number of considerations for foreign nonbank companies that may be designated as systemically important by the FSOC. Several commenters have urged the FSOC to consult with home country supervisors before imposing heightened standards under U.S. law on international institutions, but the extent to which the FSOC will consult with foreign regulatory authorities remains unclear. Under the proposal, the FSOC, acting through the Treasury Secretary, must consult with the appropriate foreign regulatory authorities, but only to the extent the FSOC deems appropriate.

Beyond information obtained from existing public and regulatory sources, the Second NPR indicates that it will consider in Stage Two information that a nonbank financial company voluntarily provides. There are a number of issues that may affect whether nonbank financial companies will submit information in this stage. First, there is uncertainty over when the FSOC will begin its assessment of nonbank financial companies. Under the current proposal, it appears that companies may not be notified when they have been advanced to Stage Two of the process. They therefore may not know when they should or could be providing information to the FSOC. As a result, many institutions who determine that they meet the criteria to pass from Stage One or Stage Two may choose proactively to provide information to the FSOC to make early arguments to avoid a Stage Three review. This will be even more likely if institutions perceive—as the Second NPR seems to suggest—that the analysis conducted in Stage Two will provide a foundation for the analysis in Stage Three. Indeed, if all the institutions in Stage Two were to take this proactive approach, the FSOC could be inundated with voluntary submissions.

At the same time, concerns over the sufficiency of the confidentiality protections in the proposal may discourage some institutions from making voluntary submissions. The Second NPR clarifies that nonbank financial companies may request confidential treatment of nonpublic information submitted in accordance with the Freedom of Information Act. It remains unclear whether these confidentiality provisions will provide adequate assurances to nonbank financial companies subject to the process. Companies that believe they are being considered for Stage Two review may be hesitant to voluntarily submit information that would be helpful

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under management to file periodic reports with the SEC on Form PF beginning in March 2013. These reports were designed to facilitate the FSOC's ability to assess the extent of systemic risk posed by the activities of private funds or their advisers.

to negate a systemically important designation out of concern that such information could become public.

Stage Three

In Stage Three, the FSOC would work with the Office of Financial Research (''*OFR*'') or appropriate regulatory agency to conduct a final assessment of whether the company should be deemed a Nonbank SIFI. A company subject to a Stage Three screening would be given advance notice of its potential designation as a Nonbank SIFI and would likely be required to provide additional information about its operations to the FSOC. Any nonbank financial company that enters Stage Three can be expected to initiate a dialogue with the FSOC to build a case for why it should not be designated.

The proposed guidance indicates that the FSOC will further consider a nonbank financial company's resolvability in Stage Three, assessing whether the company's failure would have a material adverse impact on U.S. financial stability. The FSOC's explicit focus on resolvability is a noteworthy development in the Second NPR. In some respects, the inclusion of a resolvability factor may be viewed as an elaboration of the first determination standard, which requires the FSOC to determine whether material financial distress at the nonbank financial company could pose a threat to U.S. financial stability. If a company can demonstrate that it is ''resolvable,'' then presumably it could also establish that it would not pose a threat to U.S. financial stability.

The FSOC's focus on resolvability may also reflect a concern about the potential intersection between the Dodd-Frank Nonbank SIFI designation regime and the Orderly Liquidation Authority (''*OLA*'') provisions of Title II of Dodd-Frank. Under Title II of Dodd-Frank, the FDIC can be appointed as receiver to resolve a financial company (including a Nonbank SIFI) if the Treasury Secretary makes the required systemic risk determination. Especially because the determination of eligibility for an OLA resolution is made at or near the point of failure, there is not a perfect overlap between the set of financial companies that are designated as Nonbank SIFIs and the set of companies that would be resolved under OLA if they were to fail.[4] Recognition of this disconnect and its implications may have prompted the FSOC to take more explicit account of resolvability in the Nonbank SIFI designation process.

The FSOC's focus on resolvability is also consistent with the more general focus in the United States and internationally on resolution planning. Indeed, if a financial company is designated as a Nonbank SIFI, one of the prudential standards that will apply to it is the requirement to prepare a credible resolution plan, or ''living will.'' On the other hand, to the extent that the Nonbank SIFI designation process effectively requires a financial company to prepare something like a living will to address its ''resolvability,'' this would appear to ''put the cart before the horse'' for an institution advocating against being designated.

The proposal does not indicate how long a Stage Three review can be expected to last. Based on the proposal, a nonbank financial company could be subject to an unlimited number of additional information requests before its evidentiary record would be deemed ''complete''. The Second NPR modifies the length of time that a company would have to respond to a request for additional information. In the First NPR, the FSOC proposed that companies would have 30 days to respond to a request. In the current proposal, the FSOC may determine the length of this time frame in its sole discretion.

While some companies may prefer a protracted Stage Three process over prompt designation as a Nonbank SIFI, the proposal leaves open the possibility for burdensome information requests from nonbank financial companies in this stage, for an indefinite period of time. The proposal authorizes the OFR to subject nonbank financial companies, including companies that are not under consideration for a proposed or final determination, to periodic and other reporting requirements. In addition, if the FSOC cannot determine whether a nonbank financial company in this stage should be designated as systemically important, under Section 112(d) of Dodd-Frank, the FSOC may direct the FRB to conduct an examination to facilitate the determination process. The preamble of the Second NPR indicates that the FSOC may consult with the nonbank financial company's primary financial regulatory agency or home country supervisor prior to making a final determination.

At the end of the Stage Three analysis, the FSOC would vote on whether a company should receive a proposed Nonbank SIFI determination. Like a final determination, a proposed determination by the FSOC would require the affirmative vote of at least two-thirds of the FSOC's voting members,[5] including the affirmative vote of the FSOC's Chairperson, the Treasury Secretary. Upon an affirmative vote of the FSOC, a written notice stating the basis for the proposed determination would be issued to the nonbank financial company. After receiving a proposed determination, a nonbank financial company could request a hearing to contest the proposed determination.

The Second NPR clarifies that the final determination would be made public. The Second NPR also provides that the FSOC will no less than annually reevaluate determinations and could rescind determinations if the FSOC determines, by a two-thirds vote, that a Nonbank SIFI is no longer systemically important. It is not clear how often the FSOC will reevaluate nonbank financial companies that were reviewed in the determination process and *not* designated as systemically important by the FSOC. It is equally uncertain how often the

[4] That is, a Nonbank SIFI would not necessarily be resolved under OLA, and a financial company would not need to have been designated as a Nonbank SIFI in order to be resolved under OLA.

[5] The FSOC is composed of 10 voting members: the Treasury Secretary as Chairperson, the Chairman of the FRB, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chairman of the SEC, the Chairperson of the Federal Deposit Insurance Corporation (the ''*FDIC*''), the Chairperson of the CFTC, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board and an independent member of insurance expertise appointed by the President and confirmed by the Senate for a six-year term. The FSOC also includes 5 nonvoting members who serve in an advisory capacity: the Director of the OFR, the Director of the Federal Insurance Office, a state insurance commissioner determined by the state insurance commissioners, a state banking supervisor determined by the state banking supervisors and a state securities commissioner determined by the state securities commissioners.

   ISSN 0037-0665

FSOC will restart the process to consider new companies that cross the initial Stage One thresholds.

Other Considerations

The FSOC has sought to maintain significant discretion at every stage of the determination process. In addition, in emergency situations, the FSOC may abandon all or any part of determination framework if the FSOC determines that it is ''necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the U.S.'' And the FSOC, on its own initiative or at the request of the FRB, may subject a company other than a nonbank financial company to prudential standards and supervision by the FRB if the FSOC determines that the company operates or is organized in a manner as to evade a Nonbank SIFI designation.

At the international level, the Financial Stability Board (''*FSB*'') is developing a package of policy measures designed to enhance the supervision of global SIFIs (''*G-SIFIs*''). These measures include the implementation of recovery and resolution regimes and data collection requirements for G-SIFIs, and increased capital requirements for global systemically important banks. The interplay between the FSB's designation of G-SIFIs and the FSOC's designation of Nonbank SIFIs in the United States will remain a key area to watch in the coming months.

Conclusion

The ultimate practical effect of the FSOC's proposed approach to designating Nonbank SIFIs—including its articulation of the substantive criteria and its staging of the review process—remains unclear. The eventual outcome of the FSOC process (which institutions are designated as Nonbank SIFIs and why) will be closely monitored by multiple industry and market participants. At this point, few observers would say that they have a better sense following the Second NPR than before it of which institutions are likely to be designated as systemically important.

Indeed, there is no clear sense yet whether the FSOC will eventually designate large numbers of Nonbank SIFIs and then scale the heightened prudential standards that apply to them according to some measure of perceived systemic risk (as appears to be the likely outcome for bank holding companies with $50 billion or more in assets) or instead designate fewer Nonbank SIFIs following stricter consideration of actual systemic risks. And the members of the FSOC could have differing views on that fundamental question, including the FRB, which will be the agency charged with ongoing supervision of Nonbank SIFIs, and the FDIC, which will be the agency that would be charged in the future with resolving a financial institution under the FDIC's new OLA authority if its failure would have serious adverse effects on U.S. financial stability.

For institutions facing potential designation as a Nonbank SIFI, there will be important considerations of strategy for approaching the newly defined three-stage approach to the FSOC's analysis. Whether and when to engage proactively with the FSOC and the agencies represented on the FSOC will likely depend on the individual circumstances of the institution. In the meantime, institutions should continue to consider the arguments they would make on the merits of the designation criteria in light of how they have been articulated in the Second NPR.