November 10, 2011

Designation of Systemically Important Nonbank Financial Institutions under the Dodd-Frank Act

The Financial Stability Oversight Council ("FSOC") has published a proposed rule and interpretive guidance (together, the "Rule") that detail the criteria and process the FSOC would use to designate nonbank financial companies as systemically important pursuant to the Dodd-Frank Act. Any financial company designated as systemically important by the FSOC would be subject to supervision by the Board of Governors of the Federal Reserve System. Nonbank financial companies would also be required, among other things, to create a "living will" resolution plan and to comply with other Dodd-Frank Act regulations.

The FSOC has invited public comments on the Rule's framework and process for designating a nonbank financial company as systemically important. Comments are due December 19, 2011.

Three-Stage Determination Process

The Rule lays out a three-stage process for determining whether nonbank financial companies pose a threat to the financial stability of the United States. The process incorporates both qualitative and quantitative analyses, but is ultimately subject to the discretion of the FSOC. A nonbank financial company must pass through all three stages of the analytical process before the FSOC will designate it a systemically important financial institution. The Rule's framework and determination process is outlined below.

Stage 1

In the first stage, a nonbank financial company would have to meet two threshold criteria in order to move on to the greater scrutiny of Stage 2. The first threshold criterion requires a U.S. nonbank financial company to hold $50 billion in total global consolidated assets or a non-U.S. nonbank financial company to hold $50 billion in total U.S. consolidated assets. If this $50 billion threshold is met, the company must also meet just *one* of the following additional threshold criteria to move on to Stage 2:

- $30 billion in gross notional credit default swaps outstanding for which the nonbank financial company is the *reference entity,* with gross notional value equal to the sum of the credit default contracts bought (or equivalently sold);
- $3.5 billion in derivative liabilities, with derivative liabilities being equal to the fair value of all derivatives contracts in a negative position after taking into account the effects of master netting agreements and cash collateral held with the same counterparty on a net basis, if elected;
- $20 billion of outstanding loans borrowed and bonds issued;

- a leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1 or more; or
- a ratio of debt with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of at least 10 percent.

The Stage 1 analysis is to be based upon publicly available information and information from various regulatory agencies. The FSOC reserves the right to evaluate nonbank financial companies in Stage 1 based on other company-specific factors and ultimately retains broad discretion to designate companies for further Stage 2 review. As a result, the FSOC may include a nonbank financial company in Stage 2 even if the company does not meet the Stage 1 criteria.

Stage 2

In the second stage, the FSOC would "conduct a robust analysis" of the potential threat that each of the nonbank financial companies identified in Stage 1 could pose to "U.S. financial stability." The Stage 2 analysis would be conducted using publicly available information and information derived from various regulatory agencies. The Rule instructs the FSOC to use the following qualitative and quantitative factors as a framework for its Stage 2 analysis:

- *Interconnectedness*. The FSOC would consider the following factors, among others, to assess a company's interconnectedness: counterparty exposure to the nonbank financial company, the number and size of counterparties, the total amount of the nonbank financial company's net derivative exposures, the amount of credit default swaps outstanding, the loans borrowed and any reinsurance obligations.
- *Substitutability*. The FSOC would examine whether a nonbank financial entity is the dominant provider of services in an essential U.S. market and the extent to which other firms could provide similar services if that entity were to withdraw from the market.
- *Size*. The FSOC would look to total consolidated assets or liabilities, off-balance sheet exposures, total loan originations, direct written premiums and the extent to which assets are managed rather than owned by the nonbank financial company.
- *Leverage*. The FSOC would examine the total assets and total debt measured relative to total equity, the gross notional exposure of derivatives and off-balance sheet obligations relative to total equity, changes in leverage ratios and the ratio of risk to statutory capital.
- *Liquidity risk and maturity mismatch*. The FSOC would measure liquid asset ratios, callable debt as a fraction of total debt, the fraction of assets that are classified as level 2 or level 3 for purposes of determining fair value under applicable accounting standards and short-term debt as a percentage of total debt.
- *Existing regulatory scrutiny*. Finally, the FSOC would consider the extent of regulatory supervision, whether the nonbank financial company is registered with the SEC or the Commodity Futures Trading Commission or a bank regulator or other regulator (in the case of investment funds), the number of primary financial regulatory agencies and lead state regulators with regulatory oversight over the company (in the case of insurance companies), the extent to which foreign nonbank companies are subject to prudential standards in their home country (in the case of foreign-based companies) and the

current regulatory bodies' ability to impose reporting obligations, liquidity and capital requirements, resolution or enforcement.

Additionally, the FSOC would investigate, using readily available data, whether the resolution of the nonbank financial company could pose a threat to U.S. financial stability. Based on the resolution investigation and its evaluation of the foregoing factors, the FSOC would contact any nonbank financial company that it believes merits further Stage 3 evaluation.

Stage 3

A nonbank financial company in Stage 3 evaluations would first receive a "Notice of Consideration" from the FSOC and a request that the company provide specific information to the FSOC relating to resolvability, opacity of operations, complexity and level of regulatory scrutiny. Requested information may include confidential business information such as internal assessments, strategies, and any anticipated changes to the nonbank company's financial structure. The FSOC would use the confidential information to assess all factors that may directly or indirectly pose a threat to U.S. financial stability. The Stage 3 review would include a detailed assessment of the nonbank financial company's resolvability, during which the FSOC would assess the complexity of legal, funding and operational structures and obstacles to rapid and orderly resolution, and legal entity and cross-border operations issues, such as ability to separate functions and spin off services or business lines, the likelihood of preserving franchise value in a recovery or resolution scenario, maintaining the continuity of critical services, the degree of intra-group reliance on liquidity and funding, payment operation and risk management requirements and the size and nature of intra-group transactions.

If the FSOC determines by a two-thirds vote that a nonbank financial company is systemically important to the U.S. financial system, it would issue a "Proposed Determination," after which the nonbank financial company would be entitled to a hearing with the FSOC. The FSOC would then make a final determination by a two-thirds vote as to whether the company should be regulated under the Dodd-Frank Act. After a final determination by the FSOC, the company could bring an action in federal court for an order requiring the determination to be rescinded.

Material Financial Distress

The FSOC may determine, outside of the framework outlined above, that any "material financial distress" at a nonbank financial company poses a threat to the financial stability of the United States. Such a company could then become subject to Dodd-Frank regulations and Federal Reserve oversight without going through the three-stage analysis. The FSOC has stated that "material financial distress" exists when a nonbank entity is in immediate danger of insolvency or default.

Confidentiality

The Rule indicates that the FSOC will maintain the confidentiality of any private company information used in the determination process "to the fullest extent of applicable law." However, the Freedom of Information Act explicitly would apply to all information that is collected during the three-stage determination process. Any information submitted during the process that does not fall under an exception to the Freedom of Information Act would therefore be subject to possible public disclosure.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to:

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