Regulation of Systematically Important Financial Institutions

I. Analysis of Financial Stability Oversight Council Proposed Rule Regarding the Designation of Nonbank Financial Companies as Systemically Important

Overview of the Proposed Rule

On October 11, 2011, the Financial Stability Oversight Council (the Council) released its second notice of proposed rulemaking (the SIFI Notice) implementing its authority under Section 113 of the Dodd-Frank Act to designate certain nonbank financial companies for enhanced supervision and regulation by the Board of Governors of the Federal Reserve System.[1] Nonbank financial companies designated by the Council commonly are referred to as systemically important financial institutions, or SIFIs.[2] The proposed rule is accompanied by proposed interpretive guidance.

The proposed rule, together with the proposed guidance, moves towards providing some clarity on the designation process but preserves a significant amount of discretion for the Council. In particular, the proposed rule and guidance describe a three-stage process for winnowing the pool of prospective SIFIs:

In Stage 1, the Council will consider a series of specified quantitative metrics intended to eliminate from consideration many smaller, less interconnected firms.[3] By performing internal calculations using the published Stage 1 metrics, many firms will probably be able to anticipate whether they will advance in the consideration process to Stage 2.

Stage 2 will be a more substantive, firm-by-firm analysis that will examine both additional quantitative metrics and qualitative standards. The Council generally will rely on information available from existing public or regulatory sources to conduct Stage 2 review.[4] While the proposed rule and guidance describe the various metrics that the Council will consider in Stage 2, there appears to be little practical guidance that would assist any particular nonbank financial company in evaluating the likelihood that it would progress from Stage 2 to Stage 3 review.

Stage 3 is the final stage prior to Council designation and offers the first meaningful opportunity for a nonbank financial company to contest the Council's consideration. Stage 3 will involve a continuation of the qualitative and quantitative firm-by-firm assessment conducted under Stage 2, but the proposed rule and guidance suggest the Council will seek considerable additional information from the company in

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[1] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64264 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310) (the Proposed Rule), *available at* http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf.

[2] Under the Dodd-Frank Act, certain large, interconnected bank holding companies also will be SIFIs. In this article, however, we use the term "SIFIs" to refer only to nonbank SIFIs (except as otherwise indicated).

[3] *See* SIFI Notice at 62.

[4] *Id.*

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Stage 3. The culmination of Stage 3 will be the Council's vote as to whether or not to issue a notice of proposed determination of SIFI status.[5] As discussed below, the proposed rule will provide an opportunity to contest such a determination at the beginning of Stage 3.

Overall, the proposed rule and guidance may offer some further insight into how the Council views the concept of systemic risk. However, the standards and factors remain too general to serve as reliable tools for predicting whether a particular firm may be subject to designation. Accordingly, uncertainty regarding which firms may be brought within the heightened regulatory regime triggered by SIFI status is likely to linger for some time after the process of designation gets under way in 2012.

Standards and Factors for Designation

The proposed rule provides that a nonbank financial company may be designated as a SIFI if the Council determines that either of the following standards is met: first, material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States (the First Standard); or second, the nature, scope, size, scale, concentration, interconnectedness or mix of the nonbank financial company's activities could pose a threat to U.S. financial stability (the Second Standard).[6] The First and Second Standards are informed by the list of 10 statutory factors for consideration at Section 113(a)(2), as well as the "analytical framework" and qualitative and quantitative factors and metrics discussed in the proposed rule and guidance.

The Council did not define the terms "material financial distress" or "financial stability" in its January 26, 2011, notice of proposed rulemaking regarding the designation of nonbank financial companies. In response to a number of comments, however, the Council has included in the proposed guidance definitions of "material financial distress" and "threat to the financial stability of the United States," as well as further guidance on how it will assess the "nature, scope, size, scale, concentration, interconnectedness, or mix" of a nonbank financial company's activities.[7] The proposed guidance also offers additional details on how the Council will incorporate the list of 10 statutory factors for consideration into its evaluation of whether a nonbank financial company should be designated as a SIFI.[8]

Material Financial Distress

The First Standard concerns the impact on the U.S. financial system as the financial condition of a nonbank financial company deteriorates. Specifically, the First Standard questions whether "material financial distress" at a given nonbank financial company would pose a threat to U.S. financial stability. According to the proposed guidance, the Council believes that "material financial distress" will exist where a nonbank financial company "is in imminent danger of insolvency or defaulting on its financial obligations."[9] The proposed guidance does not define or otherwise expand on the concept of "imminent danger."

The Council will consider the threat posed by material financial distress at a given firm within the broader context of "a period of overall stress in the financial services industry and in a weak macroeconomic environment."[10] This context has the potential to increase the number of firms that will be designated by

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[5] SIFI Notice at 63.

[6] Proposed Rule § 1310.10(a). *See also* SIFI Notice at 52; Dodd-Frank Act § 113(a)(1), 12 U.S.C. § 5323(a)(1).

[7] SIFI Notice at 52-55.

[8] *See id.* at 55-62

[9] *Id.* at 54.

[10] *Id.*

examining the impact on a financial environment where even the failure of a relatively small, less interconnected financial firm could be significantly disruptive. Arguably, material financial distress at a firm that is truly "systemically important" would likely pose a threat to U.S. financial stability even in an otherwise robust macroeconomic environment.

Nature, Scope, Size, Scale, Concentration, Interconnectedness or Mix of Activities

The Second Standard concerns the impact on the U.S. financial system of the activities conducted by a given nonbank financial company without regard to the financial condition of the company. Under this standard, the Council will consider the nature of a nonbank financial company's business practices, conduct or operations in order to assess whether the company's activities could pose a threat to U.S. financial stability, whether or not the company is in a distressed condition.[11] The metrics described below in the discussion of the "Six-Category Framework" probably provide the best practical guidance currently available as to how the Council may evaluate the nature, scope, size, scale, concentration, interconnectedness or mix of a company's activities.

Threat to the Financial Stability of the United States

Both the First and the Second Standards require that the circumstances present a "threat to the financial stability of the United States."[12] The Council will consider a "threat to the financial stability of the United States" to exist if there would be an "impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."[13] Both the liquidity crisis and subsequent withdrawal of credit from the financial markets that occurred in the autumn of 2008 are likely to constitute the type of impairment about which the Council is concerned.

The proposed guidance notes that material financial distress and the riskiness of a firm's activities may be transmitted into the broader financial system through several channels, resulting in a threat to financial stability. The Council specifically identifies the following ways in which distress or risk may be spread: exposure to a troubled or risky firm, market disruption or losses caused by asset liquidation, and disruption caused by the loss of a critical function relied on by market participants.[14]

Exposure. The creditors, counterparties, investors or other market participants that have exposure to a distressed or risky firm represent a potential direct channel for contagion. Where parties have exposure to a nonbank financial company that is significant enough to materially impair those creditors, counterparties, investors or other market participants, these relationships may pose a threat to U.S. financial stability. The proposed guidance notes that, in its initial analysis of nonbank financial companies with respect to exposure, the Council expects to consider metrics including total consolidated assets, credit default swaps outstanding, derivative liabilities, loans and bonds outstanding, and leverage ratio.[15]

Asset Liquidation. The rapid liquidation of assets is another channel for the distress of a nonbank financial company to infect the broader market. A large-scale, rapid liquidation potentially could disrupt trading or funding in key markets. In addition, as prices are driven down by forced selling, the liquidation

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[11] *Id.* at 53.

[12] *Id.*

[13] *Id.*

[14] *See id.* at 53-54.

[15] *Id.* at 53.

could exacerbate losses at the firm attempting to sell those assets and likewise cause losses or funding problems for other firms with similar holdings.

The proposed guidance suggests that the Council views this channel as most relevant for a nonbank financial company with a funding and liquid asset profile that makes it likely that the company would be forced to liquidate assets quickly if it came under financial pressure. Accordingly, in evaluating this potential channel, the Council will focus on firms that rely more heavily on short-term funding and expects to consider metrics including total consolidated assets and short-term debt ratio.[16]

Critical Function or Service. The withdrawal of a critical function or service on which market participants rely could have a significant destabilizing effect on financial markets. As such, the Council sees a greater potential for threat where there would be no ready substitutes if a nonbank financial company were no longer able or willing to provide such a critical function or service.

The Council expects that its consideration of this channel will be largely firm-specific, rather than based upon a general metric. Because of this channel's focus on critical services, the Council's consideration will involve an assessment of the services a firm provides, its market share, and the ability of other firms to step in and replace those services if they were withdrawn.[17]

Analytical Framework for Statutory Considerations

The Dodd-Frank Act sets forth a list of 10 statutory considerations for the Council to consider when making a SIFI designation.[18] The proposed guidance attempts to provide additional detail by describing an "analytical framework" that the Council will use to evaluate these considerations. This proposed analytical framework divides the statutory considerations into two groups of three categories (the Six-Category Framework) and provides examples of the type of metrics the Council will consider under each of the six categories.[19] Nevertheless, the administrative step of grouping the 10 statutory factors into six new categories appears to be of little practical significance.

The Six-Category Framework is broken down as follows:

- categories designed to assess the potential impact of the nonbank financial company's financial distress on the broader economy:
  - size;
  - interconnectedness; and
  - substitutability; and
- categories designed to assess the vulnerability of a nonbank financial company to financial distress:
  - leverage;
  - liquidity risk and maturity mismatch; and
  - existing regulatory scrutiny.

[16] *Id.*

[17] *Id.* at 54.

[18] Dodd-Frank Act § 113(a)(2), 12 U.S.C. § 5323(a)(2).

[19] *See* SIFI Notice at 55-56. The Council's January 2011 notice of proposed rulemaking lacked any such examples.

The proposed guidance provides a chart that illustrates the relationship between the two groups, six categories, and 10 statutory factors applicable to U.S. nonbank financial companies. Certain statutory factors fall within multiple categories.[20]

Group	**Statutory factors** *Section 113(a)(2)*__	Category or categories in which this factor would be considered
Potential impact of the nonbank financial company's financial distress on the broader economy	(B) the extent and nature of the off-balance-sheet exposures of the company	Size; interconnectedness
	(C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies	Interconnectedness
	(E) 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	Substitutability
	(F) 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	Size; interconnectedness
	(G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company	Size; substitutability; interconnectedness
	(I) the amount and nature of the financial assets of the company	Size; interconnectedness
	(J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding	Size; interconnectedness
Vulnerability of a nonbank financial company to financial distress	(A) the extent of the leverage of the company	Leverage
	(H) the degree to which the company is already regulated by one or more primary financial regulatory agencies	Existing regulatory scrutiny
	(J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding	Liquidity risk and maturity mismatch
Other	(K) any other risk-related factors that the Council deems appropriate	Appropriate category or categories based on the nature of the additional risk-related factor

[20] *See id.* at 57.

The Six Categories

1. **Size.** The Council views the size of a nonbank financial company as a significant factor, although not the determining factor, in assessing whether the firm may pose a threat to U.S. financial stability. That is, holding other factors equal, a larger firm is likely to pose greater risk to U.S. financial stability than a smaller one. Accordingly, the Council expects to examine a number of metrics that relate to the size of a particular nonbank financial company. Consolidated assets and liabilities are likely to be the primary considerations in evaluating size. The proposed guidance also notes, however, that the Council will consider other indicators consistent with its notion of size, such as assets under management, off-balance sheet exposures (*e.g.*, lines of credit) and direct written premiums as reported by insurance companies.[21] These additional metrics appear intended to broaden the scope of the "size" evaluation but in some cases may be more indicative of market share or interconnectedness.

2. **Interconnectedness.** The Council views the interconnectedness of financial firms as a natural channel through which distress and risk may be transmitted into and through the financial system. In evaluating interconnectedness, the Council is expected to consider the number of counterparties a firm has, as well as the firm's importance to those counterparties and the extent to which those counterparties are, in turn, connected to other financial firms, the financial system and the broader economy.

   The Council will review the following metrics, among others, in evaluating a firm's interconnectedness:

   – counterparties' exposures to a nonbank financial company, including derivatives, reinsurance, loans, securities borrowing and lending, and lines of credit;

   – the number, size and financial strength of a nonbank financial company's counterparties, including the proportion of its counterparties' exposure to the nonbank financial company relative to the counterparties' capital;

   – aggregate amounts of a nonbank financial company's gross or net derivatives exposures and the number of its derivatives counterparties; and

   – the amount of gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity.[22]

3. **Substitutability.** The consideration of substitutability goes to the Council's concern that a threat to U.S. financial stability may be exacerbated by the sudden removal from the system of a function or service upon which other market participants rely. The Council expects to examine the extent to which other firms could provide similar services at a similar price and quantity if a nonbank financial company were to withdraw from a market. The primary metric for assessing substitutability will be the market share of a firm subject to evaluation and of competitors offering a substantially similar service.[23]

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[21] *Id.* at 59-60.
[22] *Id.* at 58.
[23] *Id.* at 58-60.

4. **Leverage.** The Council views leverage, which is a traditional source of supervisory concern, as a tool with the potential to amplify a company's risk of financial distress, both by raising "the likelihood that a company will suffer losses exceeding its capital" and by increasing a company's "dependence on its creditors' willingness and ability to fund its balance sheet."[24] The Council also believes that leverage has the potential to increase the risk a nonbank financial company poses to other firms and market participants.

   The proposed guidance discusses metrics, including the following, that the Council will use to evaluate a firm's leverage:

   - total assets and total debt measured relative to total equity, which is intended to measure financial leverage;
   - gross notional exposure of derivatives and off-balance sheet obligations relative to total equity or net assets under management, which is intended to show how much off-balance sheet leverage a nonbank financial company may have; and
   - the ratio of risk to statutory capital, which is relevant to certain insurance companies and is intended to show how much risk exposure a nonbank financial company has in relation to its ability to absorb loss.[25]

5. **Liquidity Risk and Maturity Mismatch.** Liquidity risk and maturity mismatch are related concerns that were highlighted during the recent financial crisis. Liquidity risk generally refers to the risk that a nonbank financial company will have insufficient cash or liquid assets on hand to cover its short-term funding needs. Liquidity risk can be heightened where formerly highly liquid assets (*e.g.*, auction rate securities) become illiquid due to market forces. Maturity mismatch refers to the similar concept that a firm may be funding long-term assets using short-term borrowing. In such cases, the firm is exposed to the risk that short-term funding tightens or dries up and the firm may suddenly face significantly increased funding costs, if funding is available at all. The proposed guidance notes that maturity mismatches may also exist where the duration of a nonbank's liabilities exceeds the duration of its assets. For example, an insurance company with liabilities of 30 years or more may have difficulty finding equivalently long-term assets.

   To assess liquidity risk and maturity mismatch, the Council proposes the following metrics:

   - fraction of assets that are classified as Level 2 and Level 3 under applicable accounting standards;
   - liquid asset ratios;
   - ratio of unencumbered and highly liquid assets to the net cash outflows that a nonbank financial company could encounter in a short-term stress scenario;
   - callable debt as a fraction of total debt;
   - asset-backed funding versus other funding;

[24] *Id.* at 60.

[25] *See id.*

– asset-liability duration and gap analysis; and

– short-term debt as a percentage of total debt and as a percentage of total assets.[26]

6. **Existing Regulatory Scrutiny.** Both as a statutory factor and as part of the Six-Category Framework, the Council will consider the current supervision of a particular nonbank financial company in determining whether it would be appropriate for the Council to designate the firm as a SIFI and subject it to heightened supervisory and prudential requirements.[27] This factor may be most useful to non-U.S. firms and U.S. insurance companies subject to significant supervision at the state level. Non-U.S. firms may be well positioned to demonstrate that home country supervision is sufficiently stringent to make SIFI status unnecessary in the United States. Likewise, insurance companies may be able to make a persuasive case that state regulation is more than adequate. It appears unlikely, however, that the Council would be dissuaded from designating as a SIFI a U.S. nonbank financial company based upon the firm being otherwise supervised by one of the Council's member agencies.

Procedure for SIFI Designation

The proposed guidance describes the three-stage process that the Council expects to follow in determining whether to designate a nonbank financial company as a SIFI. In Stage 1, a set of uniform quantitative thresholds will be applied to a broad group of nonbank financial companies in order to reduce the number of companies for additional review in Stage 2. Companies identified in Stage 1 will be further analyzed and prioritized in Stage 2, based upon a wider range of quantitative and qualitative information available to the Council. The information used in Stages 1 and 2 generally will be from public and regulatory sources. Companies selected for Stage 3 review will receive notice and be subject to an in-depth evaluation of information collected directly from the company as well as information collected during Stages 1 and 2. At the end of Stage 3, the Council will consider whether to make a proposed determination with respect to the nonbank financial company. The company may request a hearing if such a determination is made.

As the review process progresses through its successive stages, the potential demands upon the subject company to produce and report quantitative and qualitative information will increase, while the criteria for the determination will become more opaque.

Stage 1 Review

Overview. Stage 1 will identify a broad range of nonbank financial companies that the Council believes merit review. The Council plans to apply six uniform quantitative thresholds to this initial list of companies, using information that generally is available from existing public or regulatory resources. The evaluation will progress to Stage 2 if the company surpasses both the "total consolidated assets" threshold, plus one of the five other thresholds. In addition, in limited cases, the Council may subject certain companies during Stage 1 to review based on other company-specific factors, such as substitutability and existing regulatory scrutiny.[28] Thus, a company may still progress to Stage 2 of the review process even if it does not exceed any of the thresholds.

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[26] *Id.* at 60-61.

[27] *Id.* at 61-62.

[28] *See id.* at 63-66.

The Council believes the thresholds-based approach provides the maximum possible transparency, thereby reducing the likelihood that uncertainty about the determination process could negatively affect financial markets. Nonetheless, the Stage 1 review process will leave open a number of questions.

The proposed rule and guidance do not provide information on how the initial companies will be identified. It is possible that this list will include only those companies that exceed $50 billion in total consolidated assets, since the Council's thresholds-based test relies heavily on the assets threshold. The Council may include some companies below the $50 billion assets threshold, however, since the Council explicitly retains the authority to further evaluate or designate companies that do not exceed any of the thresholds.

Proposed Quantitative Thresholds. The Council's proposed thresholds-based test utilizes quantitative thresholds based on the following six metrics:

- total consolidated assets;
- credit default swaps outstanding;
- derivative liabilities;
- loans and bonds outstanding;
- leverage ratio; and
- short-term debt ratio.[29]

The Council selected the six quantitative thresholds because of their applicability to nonbank financial companies that operate in different types of financial markets and industries, the meaningful initial assessment that such thresholds provide regarding the potential for a nonbank financial company to pose a threat to financial stability in diverse markets and the current availability of data.[30] The six thresholds also relate to the four categories of the Six-Category Framework that the Council considered more readily quantifiable (*i.e.*, interconnectedness, size, leverage, and liquidity risk and maturity mismatch).

Even if a company does not surpass the total consolidated assets threshold plus one of the five other thresholds, the Council may further review the company to determine if it should be designated as a SIFI.[31] The proposed guidance explains that "because the uniform quantitative thresholds may not capture all of the potential ways in which a nonbank financial company could pose a threat to financial stability, the Council may, in limited cases, initially evaluate nonbank financial companies in Stage 1 based on other firm-specific qualitative or quantitative factors."[32] Thus, the thresholds do not form a safe harbor, and the Council leaves open the possibility that a company can be below all the thresholds but still become subject to further review in Stage 2 and a possible SIFI designation. This reduces the usefulness of a nonbank financial company being able to reproduce the Stage 1 calculations for itself. Furthermore, the Council provides little guidance regarding when such an occasion would occur, which reintroduces much of the uncertainty it sought to reduce by using a thresholds-based approach.

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[29] *Id.* at 64-65.

[30] *Id.* at 63.

[31] *See id.* at 65.

[32] *Id.*

Because the Council will rely in part on information available from regulatory sources to calculate a specific company's metrics, the Stage 1 process provides some clarity for nonbank financial companies regarding whether they will proceed to Stage 2. Although this information is available to the company, it may not be available to investors or the market. Therefore, some uncertainty will remain, which could negatively affect financial markets.

The Council increased uncertainty by stating that it would be adding an additional threshold relating to derivatives. In particular, once the SEC and the CFTC finalize certain rules, the Council intends to add a new threshold based on factors such as a nonbank financial company's current and potential future exposure from its outstanding derivatives. The Council intends to use such a threshold to assist in identifying major swap participants and major security-based swap participants that should be examined further in Stage 2.[33] Also, the Council states that it will consider evaluating certain companies using other yet-to-be established metrics or thresholds. These companies include hedge funds and private equity firms, including their advisers, as well as asset management companies and financial guarantors. The Council believes these companies may pose risks that are not well measured by the quantitative thresholds approach.[34]

The six quantitative thresholds also may change over time. The Council expects to review the thresholds as appropriate, *i.e.*, as reporting requirements evolve and new data about certain industries and companies become available.

A brief discussion of the six quantitative thresholds proposed by the Council appears below.

Assets — $50 Billion. The Council intends to establish a threshold of $50 billion in total consolidated assets. The metric will be based on global total consolidated assets for U.S. nonbank financial companies and U.S. total consolidated assets for foreign nonbank financial companies.[35] The total consolidated assets threshold is used as a basic measure of size. A nonbank financial company will be evaluated in Stage 2 if this threshold is satisfied along with one of the other five thresholds.[36]

Credit Default Swaps — $30 Billion. The Council intends to establish a threshold of $30 billion in gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity. Gross notional value equals the sum of credit default swaps contracts bought (or equivalently sold). This threshold is used to evaluate interconnectedness. [37]

Derivatives — $3.5 Billion. The Council intends to apply a threshold of $3.5 billion of derivative liabilities. The Accounting Standards Codification 815 will be used to calculate the derivative liabilities. The Council states that this threshold also is a proxy for interconnectedness.[38]

Loans and Bonds — $20 Billion. As another measure of interconnectedness, the Council intends to apply a threshold of $20 billion of outstanding loans borrowed and bonds issued. [39] The Council does not define "loans" or "bonds."

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[33] *Id.* at 21.

[34] *Id.* at 20.

[35] *Id.* at 64.

[36] *Id.*

[37] *Id.*

[38] *Id.* As discussed above, the Council intends, after the SEC and CFTC complete certain rulemaking, to create a new threshold based on current and potential future exposure from outstanding derivatives. It is not clear if the new threshold will modify or replace this threshold or instead result in two thresholds explicitly based on derivatives.

[39] *Id.*

Leverage — 15 to One. The Council intends to apply a minimum leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to one. The Council excludes separate accounts because they are not available to satisfy claims by general creditors.[40]

Short-Term Debt — 10 Percent. The Council intends to apply a threshold ratio of short-term debt to total consolidated assets (excluding separate accounts) of 10 percent. Short-term debt is debt with a maturity of less than 12 months. This threshold is a proxy for liquidity risk and maturity mismatch.[41]

Stage 2 Review

Individual Review Under Six-Category Framework. Once a nonbank financial company is identified in Stage 1, the Council will conduct a review of its risk profile and characteristics in Stage 2. Stage 2 will consist of a robust analysis of the potential threat the nonbank financial company could pose to the financial stability of the United States. This review generally will be based on information available to the Council from existing public or regulatory sources, such as reports filed with the primary financial regulatory agency or home country supervisor of the nonbank financial company. The review may include information provided voluntarily by the nonbank financial company.[42]

The Council's review in Stage 2 will be based on a range of quantitative and qualitative factors. Unlike Stage 1, this review is not limited to uniform quantitative metrics. The Stage 2 evaluation will use the Six-Category Framework described above and will include a review of qualitative factors, such as whether the resolution of the nonbank financial company could pose a threat to U.S. financial stability and the extent to which the nonbank financial company is already subject to regulation.[43]

Based on the Council's Stage 2 review, the Council will advance certain nonbank financial companies to Stage 3 for further evaluation.

Stage 3 Review

Notice of Consideration. Each nonbank financial company moved to the Stage 3 pool will receive a written notice that the nonbank financial company is under consideration for a proposed determination. The notice of consideration is likely to include a request that the nonbank financial company provide information that the Council deems relevant to its evaluation. Further, the nonbank financial company will have an opportunity to submit written materials to the Council to contest the Council's consideration of the nonbank financial company for a proposed determination. [44]

Continued Review Under the Six-Category Framework. The Council will conduct a detailed review of each nonbank financial company in the Stage 3 pool using the Six-Category Framework and the metrics described above.

Stage 3 review is expected to be a highly individualized review of the nonbank financial company's potential threat to U.S. financial stability, based both on the quantitative framework used in Stages 1

[40] *See id.* at 65.

[41] *Id.*

[42] *Id.* at 65-66.

[43] *Id.*

[44] *Id.* at 66.

and 2 as well as additional qualitative factors. This review will be based on information obtained from the nonbank financial company's primary regulator or the Office of Financial Research (the OFR). During this stage, the Council also has the ability to request information and reports from the nonbank financial company. These information requests are expected to involve both qualitative and quantitative data. The Council may request confidential business information, such as internal assessments and risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, potential acquisitions or dispositions, and any other anticipated changes to the nonbank financial company that could affect the nonbank financial company's impact on the financial stability of the United States.[45]

If the Council is unable to determine whether the activities of the nonbank financial company pose a threat to the financial stability of the United States, the Council may request that the Federal Reserve conduct an examination of the nonbank financial company and its subsidiaries for the sole purpose of determining whether the nonbank financial company should be supervised by the Federal Reserve. The Council will review the results of such examination in connection with any proposed or final determination.[46]

Qualitative Factors. In Stage 3, the Council expects to have access to a greater degree of qualitative information about an individual nonbank financial company than it will have had in the earlier stages of the review. This information may relate to factors that are not easily quantifiable. The Council acknowledges that certain of these factors may not directly cause a nonbank financial company to pose a threat to the financial stability of the United States, but these factors could mitigate or aggravate the potential of such a threat. These factors may include the nonbank financial company's resolvability, the opacity of its operations, its complexity and the extent to which it is subject to existing regulatory scrutiny and the nature of such scrutiny.[47]

The Stage 3 analysis will include an evaluation of the resolvability of the nonbank financial company and potential risks to financial stability in the event of the company's failure. This assessment will entail a review of the complexity of the nonbank financial company's legal, funding and operational structure, as well as any obstacles to the rapid and orderly resolution of the nonbank financial company. The evaluation also will consider legal entity and cross-border operations issues, including the ability to separate functions and spin off segments of the nonbank financial company, the likelihood of preserving franchise value in a recovery or resolution scenario, the need to maintain continuity of critical services, the degree of the nonbank financial company's intra-group dependency for liquidity and funding, payment operation and risk management needs, and the size and nature of the nonbank financial company's intragroup transactions.[48]

Confidentiality of Information. The Council intends to maintain the confidentiality of any data, information and reports submitted with respect to the designation process. Specifically, the proposed rule confirms that the submission of any nonpublicly available data or information shall not constitute a waiver of, or otherwise affect, any federal or state legal privilege to which the data or information is otherwise subject.[49] However, the Freedom of Information Act (FOIA) and the exceptions thereunder will apply to any data or information submitted in accordance with the designation process.[50]

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[45] *Id.*

[46] *See* Proposed Rule § 1310.10(c).

[47] *See* SIFI Notice at 66-67.

[48] *Id.*

[49] Proposed Rule § 1310.20(e)(2).

[50] Proposed Rule § 1310.20(e)(3).

Proposed Determination. The Council will notify the nonbank financial company once the Council has completed its data gathering and the evidentiary record is complete. At this point, the Council will review the relevant information regarding the nonbank financial company and consider the nonbank financial company for a proposed determination.[51]

The Council will be required to make a proposed determination within 180 days after the nonbank financial company receives the notice of completion. If the Council does not make a determination within this 180-day period, the Council may not make a determination without starting over from the beginning of Stage 3 with a subsequent Stage 3 notice of consideration.[52] The proposed rule does not limit the Council's ability to restart Stage 3 in the event this 180-day period expires without the issuance of a proposed determination.[53]

A proposed determination requires a two-thirds vote of the voting members of the Council then serving, including the affirmative vote of the Chairperson of the Council. The vote of the Council may not be delegated to any other party.[54]

Upon an affirmative vote by the Council, the Council will provide written notice of the proposed determination to the nonbank financial company, including an explanation of the basis of the proposed determination and the date by which the nonbank financial company may request an evidentiary hearing to contest the proposed determination.[55]

Opportunities to Contest Designation

The proposed rule includes several opportunities for a nonbank financial company to contest a designation by the Council, although such opportunities are limited to the latter stages of the Council's three-stage process and generally have short, or indeterminate, timeframes for the nonbank financial company to prepare its materials. As a result, companies that believe they meet the Stage 1 criteria described above should consider preparing relevant documentation well in advance of a formal request from the Council.

Notice of Consideration (1310.21(a))

After receiving a notice of consideration marking the beginning of Stage 3 review, a nonbank financial company will have the opportunity to submit written materials to the Council. This is the first opportunity a nonbank financial company will have to submit a formal counterargument to the Council. These materials may contest the Council's consideration of the nonbank financial company for a proposed determination, presenting the company's view that neither material financial distress at the nonbank financial company, nor the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the nonbank financial company, would be expected to pose a threat to the financial stability of the United States. There is no fixed time period for the nonbank financial company to prepare this information; the proposed rule gives the Council the authority to determine an appropriate timeframe.[56]

[51]Proposed Rule § 1310.21.

[52]Proposed Rule § 1310.21(f)(1).

[53]Proposed Rule § 1310.21(f)(2).

[54]Proposed Rule § 1310.10(b).

[55]Proposed Rule § 1310.21(b).

[56]Proposed Rule § 1310.21(a).

Notice of Proposed Determination (1310.21(c))

Upon receipt of a notice of proposed determination, the nonbank financial company will have the right to request an evidentiary hearing to contest the proposed determination. The nonbank financial company must request this hearing within 30 days after the receipt of the notice of proposed determination.[57]

If a nonbank financial company requests an evidentiary hearing, the Council will fix a time for the hearing not more than 30 days after receipt of the request. The hearing will consist of the submission of written materials (or, at the sole discretion of the Council, oral testimony and oral argument) to contest the proposed determination.[58]

Within 60 days after the hearing date, the Council must make a final determination with respect to the nonbank financial company's status. A final determination requires the same two-thirds vote of the voting members of the Council then serving, plus the affirmative vote of the Chairperson, that is required for a proposed determination. Upon a final determination, the Council will notify the nonbank financial company in writing of the final determination and include a statement of the basis for the Council's decision. The Council also will announce the decision publicly.[59]

If a nonbank financial company does not request an evidentiary hearing, the Council nevertheless will deliver a notice of final determination to the nonbank financial company and announce its decision publicly. Such final determination will be made within 10 days after the date by which the nonbank financial company could have requested an evidentiary hearing.[60]

Judicial Review

If the Council makes a final determination, the nonbank financial company may file for judicial review in U.S. district court. The nonbank financial company must commence such action within 30 days after receipt of the notice of final determination. The district court's review is limited to whether the final determination of the Council was arbitrary and capricious.[61]

Reevaluation and Rescission of Determinations

The Council will reevaluate each current determination not less frequently than annually and rescind any determination if the Council determines that the nonbank financial company no longer meets the standards for supervision by the Federal Reserve, taking into account the analytical framework described above. Rescinding a determination requires the same voting threshold as making a determination, *i.e.,* two-thirds of the voting members of the Council then serving, including the affirmative vote of the Chairperson of the Council.[62]

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[57] Proposed Rule § 1310.21(c)(2).

[58] Proposed Rule § 1310.21(c)(2).

[59] Proposed Rule § 1310.21(d).

[60] Proposed Rule § 1310.21(e).

[61] *See* Dodd-Frank Act § 113(h), 12 U.S.C. § 5323(h).

[62] Proposed Rule § 1310.23.

II. The Implications of Designation as a SIFI: New Rules Detail the 'Living Wills' Requirement for Bank and Nonbank SIFIs

On October 17, 2011, the Federal Reserve approved a final joint rule implementing the requirement of the Dodd-Frank Act that SIFIs periodically report "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure" to the Federal Reserve, the FDIC and the Council.[63] The final rule is identical to the proposed rule published by the FDIC on September 13 (which was the subject of a prior Skadden publication).[64] The final rule come into effect on November 30, 2011. Pursuant to the rule, designation of a financial institution as a SIFI has significant consequences with respect to a financial institution's planning and preparation for potential financial distress or insolvency. The institution will be required to prepare a so-called "living will," or contingency plan, for resolving its affairs under the U.S. Bankruptcy Code in the event that it experiences material financial distress.[65] If the institution is in danger of becoming insolvent, the FDIC may be appointed receiver pursuant to the Orderly Liquidation Authority contained in Article II of the Dodd-Frank Act.[66] In such case, the Secretary of the Treasury will use the institution's "living will" to determine whether resolution of the institution's affairs is best achieved under the Bankruptcy Code or the Orderly Liquidation Authority.

III. International Efforts to Identify and Designate Global SIFIs

On November 4, 2011, the G20 Finance Ministers and Central Bank Governors, through the Financial Stability Board (FSB), published the names of an initial group of 29 banks determined to be "global systemically important financial institutions" (G-SIFIs).[67] At the same time, the FSB released an "integrated set" of policy measures to address the risks to the global financial system from G-SIFIs.[68] Among these policy measures was a publication of the Basel Committee on Banking Supervision which established an assessment methodology featuring an "indicator-based measurement approach" for evaluating systemic risk that weights both categories and indicators of size, substitutability, interconnectedness, cross-jurisdictional activity, and complexity.[69] This framework is intended initially to be applied to global systemically important banks, however, it may be extended for use in the assessment of nonbank G-SIFIs and could be relevant to the Council's evaluation of nonbank SIFIs under the proposed rule.

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[63] Dodd-Frank Act § 165(d)(1), 12 U.S.C. § 5365(d)(1). The final rule is published as Regulation QQ for the Federal Reserve (12 C.F.R. Part 243) and Part 381 for the FDIC (12 C.F.R. Part 381), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111017a1.pdf. It applies to both interconnected large bank holding companies and nonbank institutions designated as SIFIs in the manner as described above.

[64] *See* Skadden, Arps, Slate, Meagher & Flom LLP, *Dodd-Frank, FDIC and FSA Rules Require Financial Companies to Develop Global Insolvency Contingency Plans* (Sept. 23, 2011), *available at* http://www.skadden.com/newsletters/Dodd-Frank_FDIC_and_FSA_Rules_Require_Financial_Companies_to_Develop_Global_Insolvency_Contingency_Plans.pdf. *See* also *Skadden Commentary on the Dodd-Frank Act, Orderly Liquidation Authority* (July 9, 2010), *available at* http://www.skadden.com/newsletters/FSR_Orderly_Liquidation_Authority.pdf.

[65] Dodd-Frank Act § 165(d)(4), 12 U.S.C. § 5365(d)(4).

[66] Dodd-Frank Act § 204(a), 12 U.S.C. § 5384(a).

[67] *See* Financial Stability Board, Policy Measures to Address Systemically Important Financial Institutions (November 4, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

[68] *Id.*

[69] *See* Basel Committee on Banking Supervision, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement* (November 2011), *available at* http://bis.org/publ/bcbs207.pdf