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Systemically Important Nonbank Financial Institutions: FSOC Approves Final Rule

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On April 11, 2012, the Financial Stability Oversight Council (the "Council") gave more shape to the framework of systemic risk regulation by publishing a final rule (the "Rule") that sets forth the process for the designation of nonbank financial institutions as systemically important.[1] Once designated, these systemically important financial institutions ("SIFIs") will be supervised by the Federal Reserve Board (the "Board") in much the same way that it supervises bank holding companies with $50 billion or more in consolidated assets. This supervision will involve the use of more rigorous "enhanced prudential standards" than apply to bank holding companies below the $50 billion floor. The Board proposed such standards earlier this year. Large nonbank financial companies should review the Rule with care, given the onerous consequences of designation and the intricacies of the designation process.

The designation of nonbank financial firms as SIFIs is one tool, but perhaps not the most efficient tool, for addressing systemic risk in the financial services industry. The Dodd-Frank Act Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act") provides two other tools: the identification and regulation of systemically risky activities across all financial institutions and authority to resolve distressed SIFIs in an organized manner outside the bankruptcy and bank receivership processes.

Because many firms are likely to engage in any given line of business that presents a high level of risk, the identification and regulation of these activities across the financial services industry is the most effective way to address systemic risk. The regulators will be able to collect information on how several firms operate the business and manage the attendant risks, which will enable the regulators to establish a sophisticated industry-wide approach. By contrast, the designation of particular firms will focus on idiosyncrasies and unique risks to financial stability that can only be handled on an institution-specific basis. This approach will create at best a materially smaller body of knowledge that can be applied to the regulation of other large firms. Nevertheless, the Council has chosen to concentrate on the designation of nonbank financial firms as presenting threats to U.S. financial stability. The review of activities that may lead to systemic risk seems to be a lower priority.

Important consequences will flow from designation as a SIFI. Designation would adversely affect the ability of these institutions to compete with their undesignated competitors due to increased costs and supervisory impact on their decision making process. Under the Rule, a significant number of large financial firms could be pulled into the Council's designation process. The Rule establishes quantitative thresholds to identify firms subject to the process, which appear to be at least in part "reverse engineered" based on experiences from the financial crisis. However, the metrics would also sweep up firms that would pose widely divergent levels and types of risk to financial stability, including many firms that do not warrant designation. Moreover, the Council has made clear that the universe of covered firms may go beyond those firms that meet the quantitative thresholds.

The Council has declined to provide any kind of exemption or safe harbor for sectors of the financial services industry that would seem to present no real threat to financial stability, either because regulation of particular activities would more effectively and more equitably address any risks posed, or because the bank holding company model would not effectively address any risks posed.

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[1] Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies 77 Fed. Reg. 21637 (Apr. 11, 2012).

The uncertainties in the process and the consequences strongly suggest that firms that would exceed any of the specified metrics, as well as other financial firms that could be viewed as presenting risks to financial stability, develop a strategy to take the initiative in addressing the Council's likely concerns based on the information in the Rule, and as discussed more fully below.

This paper explains the basis for and the elements of such a strategy. Attached are two annexes, one a detailed analysis of the Rule and the other a description of a related rulemaking by the Board on the definition of "predominantly engaged in financial activities."[2]

Overview of the Rule

The Rule contemplates that the Board supervise those financial firms that may disrupt the U.S. financial system as a result of either their threatened failure or the nature and scope of their activities. The Council sees primarily three types of threats that could create such disruption: (i) exposures of third parties to the firm such that an adverse event at the firm could "materially impair" those third parties; (ii) reliance on short-term funding or other actions that would require the firm, if troubled, to liquidate its assets quickly in a volume and at prices that would disrupt trading or funding across the markets; and (iii) the disappearance of or diminution in critical financial functions that other market participants could not replace when the firm withdraws from the market.

The process that the Council will use to designate the nonbank financial firms that could pose one or more of these threats involves the identification of a potentially large group of institutions—that part of the process known as Stage 1—followed by a winnowing-out process—referred to as Stages 2 and 3.

The universe of firms that will be subject to the Council's designation process includes—but is not limited to—firms with more than $50 billion in total worldwide consolidated assets that cross at least one of the five quantitative thresholds in the table below.

Gross notional credit default swaps outstanding for which the firm is the reference entity	$30 billion
Derivative liabilities	$3.5 billion
Total debt outstanding	$20 billion
Leverage ratio—total consolidated assets to total equity	15:1
Short-term debt ratio—total debt outstanding with a maturity of less than 12 months to total consolidated assets	10 percent

These thresholds appear to be designed to identify firms with more than $50 billion in consolidated worldwide assets with a higher risk of failure or, to a lesser extent, a higher risk to counterparties if they should fail.

[2] The Council may designate as systemically important only those firms "predominantly engaged in financial activities." The Board is responsible for defining "predominantly" and determining the precise meaning of "financial activities" and is now developing a rule. A final rule on this issue is, in our view, a pre-condition to any final designation by the Council, and we discuss it further below.

Nonbank financial firms that do not meet either the $50 billion threshold or any of the other thresholds are not necessarily home free. The Council has reserved its authority to place other nonbank financial firms in Stage 2 and has said that the fact that a nonbank financial firm does not meet the thresholds does not mean that it will not be designated as systemically important. In the supplementary information to the Rule, the Council observes that it may wish to assess the systemic risks associated with certain firms that do not currently disclose information that is sufficient to take the necessary measurements.

The thresholds do not necessarily reflect real risks to financial stability. For example, as to risks, an institution with $50 billion in total worldwide assets and only $20 billion in debt outstanding could have a tier 1 leverage ratio of 60 percent and conservative investments as assets. Further, the holders of the debt could be so many and so diverse that the remote possibility of failure of the firm would pose virtually no risk of domino failures of financial firms that could threaten paralysis of the financial system. Although such a firm should be eliminated from the designation process fairly readily, other firms that may be viewed as presenting higher levels of risk will want to be in a position to address the potential designation process.

Moreover, the thresholds already are in a state of flux. In the supplementary information to the Rule, the Council said that it anticipated revising the threshold for derivative liabilities once the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") have finalized the definitions of "major swap participant" and "major security-based swap participant" to address potential future exposures. Since then, the two agencies have released a joint final rule on these definitions.[3] An element of the definitions is whether the participants hold "substantial positions" in different kinds of swaps. Whether these position thresholds will constitute another quantitative threshold for Stage 1 remains to be seen. The Council also expects to rely on the new Forms PF that hedge funds and private equity funds will be required to file with the SEC. For asset management firms, the Council is still considering whether these firms in general could pose a threat to financial stability and, if so, what the appropriate metrics would be. Firms will want to consider how the resolution of these issues will affect their relationships to the stated thresholds.

A firm that meets the stated thresholds in Stage 1 automatically enters Stage 2. The Council may place other firms in Stage 2 as well. The nature of Stage 2 would suggest that the Council will or should notify a firm at least informally that it has entered Stage 2, but the Rule offers no assurance that it will do so. In this stage, the Council will begin to undertake a company-specific review of the risks posed by the firm. The Council will apply six categories of factors: interconnectedness, substitutability, size, leverage, liquidity and maturity mismatch, and existing regulatory scrutiny. Each factor has several qualitative and quantitative elements. As we discuss further below, firms should keep in mind the relationship between these six factors and the threats of credit risk to counterparties, disruption of markets due to liquidation of assets and loss of critical functions.

Among these factors, interconnectedness clearly relates to counterparty credit risk while substitutability appears to relate to loss of critical functions. Size relates to interconnectedness as well as potential for market disruption. Size also affects loss of critical functions although perhaps less directly. Leverage, liquidity, maturity mismatch and existing regulatory scrutiny relate to the likelihood of a problem at a firm more than to the consequences of the problem.

[3] As of the date of this paper, the final rule had not been officially published. It may be accessed at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041812b.pdf.

The distinction between likelihood and effect is important. Likelihood of a problem is an issue that may be common to markets or business line,s and logically should be dealt with through more general regulatory and supervisory regimes. If these issues are addressed appropriately under existing regulatory and supervisory regimes or Section 120, the need to designate individual institutions on the basis of such factors should be greatly reduced.

The Stage 2 and Stage 3 reviews are a continuum but differ in the sources of the information that the Council considers. In Stage 2, the Council will rely on public information and material available from the firm's regulators that has been analyzed by the Treasury Department's Office of Financial Research ("OFR"). If the Council believes that this information is insufficient to make a determination of a firm's possible threat to financial stability, it will move the firm to Stage 3, where it will request, through OFR, and take into account, information from the firm.

A firm's participation in Stage 2 is not entirely clear. In the supplementary information to the Rule, the Council describes Stage 3 as the time for a firm's active participation in the designation process. Yet the Rule provides that the Council may review material provided by a firm in Stage 2.[4]

The Council may choose not to place a large nonbank firm into Stage 3, evidently satisfied on the basis of public and supervisory information that the firm does not present systemic risk. Nevertheless, the Council regards a decision not to move a firm into Stage 3 as "preliminary" and does not plan initially to notify firms that they have not been moved to Stage 3. Such firms will be left in limbo, apparently in perpetuity.

Stage 3 is the formal part of the process and includes specific deadlines. Once the Council decides that it needs information from a firm directly, it will issue a Notice of Consideration, which will include a request for information. The request may be wide ranging, and the Council has not indicated what a request is likely to cover. Once the Council believes it has a full record on which to make a designation, it will issue a Notice of Proposed Determination. Upon receipt of this notice, a firm will have 30 days in which to request a hearing. The Council will then set a time for a hearing within 30 days of the firm's request, and this date will serve as a deadline for the submission of relevant information. If the firm does not request a hearing, the Council will render a decision within 40 days of the firm's receipt of the Notice of Proposed Determination—meaning that the firm will have substantially less time to prepare and submit information if it does not request a hearing. If the Council determines that it will designate a firm as systemically important, it will give the firm one day's advance notice before releasing a final determination so that the firm can prepare appropriate disclosures, releases, or other communications. The firm has a right to judicial review, whether or not it has requested a hearing and one has taken place.

Public statements by Treasury Department officials indicate that the Council is likely to designate its first SIFIs before the end of 2012. In order to do so, given the time periods in Stage 3, the Council will need to issue Notices of Consideration early in the summer.

The Rule describes Stages 2 and 3 as seriatim events, but the Council's evaluation of a particular firm could result in a slightly different process. For example, the Council may decide at the outset that its decision will be governed by information held by the firm and issue a Notice of Consideration at an earlier point than with respect to other firms. Alternatively, the Council could decide, solely on the basis of Stage 2 information, that it intends to designate a firm as

[4] *See* 12 C.F.R. § 1310.20(b)(4). However, as noted above, not all firms may be aware that they are in Stage 2.

systemically important and that an information request is unnecessary. In this event, the Council could issue a Notice of Proposed Determination without a prior Notice of Consideration.

The only public disclosure that the Council will make is the publication of the final designation.

The "Predominantly Engaged" Rulemaking

Implementation of the Rule is linked to a separate and ongoing rulemaking by the Board on the meaning of "predominantly engaged." Section 113 limits the designation process to "nonbank financial companies," a term that, under section 102(a)(4), includes only those companies that are "predominantly engaged in financial activities." The Board is charged with implementing this term through rulemaking. Section 102(a)(6) requires that the Board's regulation include two tests—that a firm is predominantly engaged when 85% of its assets or revenues are derived from activities permitted to financial holding companies.

Currently pending is a proposed rule from the Board that remains open for comment.[5] Annex 2 describes the rulemaking in detail. In light of the complexity both of accounting rules and of the structure of many large nonbank firms, firms with material non-financial business should carefully review how the proposed rule attributes assets and revenues to financial and non-financial operations. This mapping process may require significant time and resources, particularly for firms that are not required to use U.S. generally accepted accounting principles.

Finalization of a rule interpreting "predominantly engaged" is not, in the Council's view, essential to the designation process.[6] The Council apparently will begin its process before the Board has issued its final rule. This procedure may not matter for firms that are clearly predominantly engaged but firms near to the line could be put to substantial expense addressing a potential designation for no reason. Moreover, as we explain in Annex 2, we believe that the Council does not, as a matter of law, have the authority to designate a nonbank firm as systemically important without the Board's final rule that describes which firms may be subject to the designation process. Notwithstanding this principle, it is likely that the Council has already begun to review certain nonbank financial firms for designation.

Preparation

Every nonbank financial firm with consolidated assets of more than $50 billion or that does not meet that threshold but that either meets one of the other thresholds or that has reason to believe that the Council could designate it on a qualitative basis, should develop a strategy for addressing the designation process. Three considerations drive the need for a strategy.

First, the Council has not limited itself to those firms that exceed the quantitative thresholds. Firms that approach or exceed the thresholds are, of course, at the greatest risk of designation and have an attendant greater need for a strategy to address designation. The Council has identified private equity funds, and hedge funds as firms that may be subject to designation, even if they do not meet any of the quantitative thresholds. A firm that provides a specialized

[5] 77 Fed. Reg. 21494 (Apr. 10, 2012). This notice is a supplement to an earlier proposal that remains pending, 76 Fed. Reg. 7731 (Feb. 11, 2011). The two releases should be read together.

[6] Finalization of the proposed rule and completion of other rulemakings "are not essential to the Council's consideration of whether a nonbank financial company could pose a threat to U.S. financial stability, and the Council has the statutory authority to proceed with determinations under section 113 of the Dodd-Frank Act prior to the adoption of such rules." 77 Fed. Reg. 21637, 21639 (Apr. 11, 2012).

but critical product or that dominates a particular product or service market where there are relatively high barriers to entry may be subject to the process as well.

Second, once a large firm meets one of the thresholds, the process may begin to gain momentum towards a designation of systemic importance. Entry into Stage 2 is automatic, and the Council appears loathe to remove a firm from consideration solely on the basis of the Stage 2 review. Further, the amount and quality of the regulatory information on different types of financial firms may vary, reinforcing the Council's inclination to undertake Stage 3 reviews. Nevertheless, it is not clear that a concentrated effort to educate the Council's staff on why a firm should not be designated would receive appropriate attention.

Third, designation, or even the perception that designation is likely, may have a material effect on a nonbank financial firm's earnings and operations. Section 113 requires that the Board subject these firms to "enhanced prudential standards" that are the same as or substantially similar to the new and more stringent standards that the Board will apply to bank holding companies with total consolidated assets of more than $50 billion. The Board recently proposed such standards, and they have been strongly opposed by banking institutions that are potentially subject to them.[7] Among other things, the standards could require designated nonbank financial firms to comply with bank holding company regulatory capital requirements, to operate with higher levels of capital and to maintain higher levels of liquidity. Although a nonbank financial firm should have the ability to establish an intermediate holding company that would be subject to the proposed requirements instead, the requirements for such a company are unclear. If the capital standards in the proposed rule apply to the entire firm, the impact of these requirements should not be underestimated. Firms also would be subject to greater oversight and additional limits if their capital were to dip below certain levels or other weaknesses became apparent.

Accordingly, any firm that may be swept into Stage 2 should begin to analyze how it may be reviewed by the Council and what material would be pertinent to that review. The Guidance indicates that the Council will evaluate a firm from the perspective of whether distress at a nonbank financial firm might cause others to become distressed and whether distress at these other companies might cause distress at still other otherwise healthy nonbank financial firms. The central question then is whether either development could contribute to a credit exposure crisis, a liquidity crisis, or the loss of critical products or services that are not readily available. We discuss approaches to these factors below, as well as ways to analyze how those factors might contribute to any of the three crises that the Council has identified. The specific components of each of the factors are described in Annex 1.[8]

Anticipating how the Council actually will analyze each nonbank financial firm is complex because of the web of factors and potential sources of disruption, as well as the lack of

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[7] 77 Fed. Reg. 594 (Jan. 5, 2012).

[8] While section 113 and the interpretive guidance (in its description of the Second Determination) raise the possibility that a firm will be designated solely on the basis of its complexity, apparently in the absence of financial distress, the substance of the interpretive guidance deals with scenarios of distress. Given the discussion in the guidance, we would hope that the Council would understand that complexity in the absence of distress is not a meaningful indicator of systemic importance and will not devote inordinate attention to the issue. A firm's activities alone could be problematic only if the firm is so large that a business decision that will not materially affect its financial position could have a ripple effect on smaller counterparties. A healthy firm also might decide to terminate a line of business that would affect smaller participants. In either case, the harm necessarily would be limited to smaller counterparties, and the ripple effect would not be systemically important.

precedents. At the same time, these uncertainties suggest that there may be room to educate the Council on why designation of particular firms is inappropriate, including why other approaches to any risks that the firm may present would be more effective. Indeed, a firm may wish to consider proposing other prudential standards.

Three general points are worth keeping in mind as a firm approaches the analysis of systemic risk. First, while each of these factors should be analyzed with care, communications with the Council should address a broader theme. The designation process ultimately is intended to protect against a future financial crisis. A firm therefore should explain how it fared during the crisis and how it was able to avoid material financial distress. Certain financial firms, among them mutual funds and other asset managers and life insurance companies, have long histories of financial stability in volatile markets, and should make that point to the Council.

Second, some of the Council's concerns have been addressed in the enhanced prudential standards that the Board recently proposed. Since the purpose of the enhanced prudential standards is to reduce systemic risk, a firm that meets these standards should not pose risk with respect to the factor that such standards address. For example, a firm that would comply with the counterparty credit risk exposure limits in the proposed standards should present little or no risk that distress at the firm would create systemically important exposures for those counterparties. Additionally, while the proposed standards call for institution-specific liquidity requirements (rather than stating quantitative standards across the board), a firm that would meet the liquidity requirements that currently are part of Basel III should not present material risk of a liquidity event that would force asset sales that would disrupt the market.[9]

Third, a nonbank financial firm that has been designated as systemically important must prepare and submit two related plans: a capital plan (or recovery plan) to the Board and a plan for its orderly liquidation in the event of failure to the Board and the Federal Deposit Insurance Corporation. A firm should consider whether it could develop plans of this nature before a designation in order to demonstrate the ease of a recapitalization and an orderly liquidation and the corresponding absence of systemic risk.

Material financial distress

The designation of a nonbank financial firm as systemically important is a complex process. The Council must make two determinations: whether material financial distress, or a combination of factors at the firm, could pose a threat to the financial stability of the United States. Such a threat likely would come through one (or more) of three channels, which are evaluated on the basis of six categories of factors.

The Council will measure the potential effects of financial distress primarily by three factors—size, interconnectedness, and substitutability. In addition to undertaking the appropriate measurements of these factors, we suggest that a firm discuss the precondition to the Council's material financial distress—the likelihood that distress would occur.

Size. The possibility that material financial distress would disrupt the financial markets will be measured initially by size. Total consolidated assets do not necessarily correlate with any of the

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[9] Basel III includes two liquidity requirements, a liquidity coverage ratio that addresses liquidity over the next 30 days and a net stable funding ratio that measures liquidity over the coming twelve months. See Basel Comm. On Bkg. Supervision, Basel III: International framework for liquidity risk measurement, standards and monitoring (Dec. 2010), accessible at http://www.bis.org/publ/bcbs188.pdf. The Basel Committee, however, is still reviewing both ratios.

threats of disruptive credit risk to counterparties, disruption of markets due to liquidation of assets or loss of critical functions. A firm should explain the elements and diversity of its balance sheet, the distinct risks to counterparties, potential effects of the liquidation of assets, and the availability of substitutes for the services that the firm provides. The firm's balance sheet relative to that of its competitors and counterparties should be described as well.

Interconnectedness. The analysis of size should overlap with that of interconnectedness, that is, significant concentrated liabilities are most likely to present concerns about interconnectedness. A firm should be prepared to identify the third parties that have substantial exposure to it. A rule of thumb should be that a firm presents possible systemic exposure risk to a third party where that party's exposure to the firm exceeds 25 percent of that party's capital.[10] This standard is the converse of the rule in section 165(e) and the Board's enhanced prudential standards that a nonbank financial firm's exposure to another party should not exceed 25% of the firm's total capital. Exposures below that level should present limited systemic concerns.

Substitutability. This factor presents interesting issues because it should be the principal if not the sole determinant of the "crucial products and services" decision that the Council must make.[11] Regarding experience, in the history of bank regulation, substitutability is an antitrust concept that the federal banking agencies have applied in the competition analyses that are a necessary part of the review of merger and acquisition applications. Specifically, substitutability is considered where a market must be defined in order to calculate market share. This analysis does not create a solid precedent for a systemic risk assessment, because the possibility of reduced competition is different from a potential risk to financial stability. Moreover, the banking agencies' analysis of substitutability has been somewhat crude—the markets that have been defined using substitutability have been those for deposits and commercial loans. The products and services offered by large financial institutions are more complex and determining substitutes may be a difficult process.

As a result, a firm should be prepared to educate the Council about substitutability and the importance of distinguishing substitutability as a systemic issue for its more traditional place in competition assessments. In particular, a firm should explain how nominally different products serve similar economic functions and are ready substitutes for one another in the credit and capital markets, as well as how any barriers to entry into the market can be overcome.

Vulnerability to financial distress

Vulnerability to financial distress is a function of three factors, which are somewhat more limited in scope than those that relate to material financial distress: leverage, liquidity risk and maturity mismatch, and the degree of regulatory scrutiny. In addressing the quantitative elements of these factors, a firm should demonstrate how its measurements compare to industry standards and those of its peers to the extent such information is available. In addition, this area in particular should be influenced by how a firm's business model faired in past financial crises.

Leverage. The potential risks inherent in leverage is that lower levels of equity may hasten undercapitalization in a time of stress and generally will make it more difficult for a nonbank

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[10] For firms with $500 billion or more in worldwide consolidated assets, the rule of thumb should be 10 percent of capital for exposures to any other firms with $500 billion or more in worldwide consolidated assets.

[11] The services most likely to present substitutability concerns are those where there is a high concentration—exchanges and clearinghouses. Title VIII of the Act addresses the potential systemic risk of the providers of these services—"financial market utilities"—and the Council already has addressed the potential systemic risk of these services in a final rule. 76 Fed. Reg. 44763 (July 27, 2011).

financial firm to find necessary financing when financial markets are disrupted. However, leverage involves more than just levels of equity. Short-term liabilities are more likely to trigger assets sales that will, in turn, put pressure on capital than will longer term liabilities. The character of the holders of the liabilities and their potential for flight will also be important. Holders of insurance policies may be much less susceptible to panics that create liquidity pressures than risk-averse holders of unsecured demand obligations. Since different forms of debt and the cost of funds will have different effects on counterparties and future access to liquidity, communications with the Council should analyze a firm's debt structure. A firm should also, of course, explain how it plans to obtain liquidity when under stress and, if applicable, how it has done so in the past. Generally, access to liquidity through assets sales is probably the least favorable approach under the Council's analysis.

Arguably, a protected anchorage, if not a complete safe harbor exists: a ratio of total liabilities to total equity of 15:1. (The bank capital rules present the leverage ratio in converse form, here 6.67 percent.) This ratio is a ceiling imposed by section 165(j) of the Act and the Board's proposed enhanced prudential standards on those nonbank financial firms and bank holding companies with assets greater than $50 billion that present a "grave threat" to U.S. financial stability.

Liquidity risk and maturity mismatch. Liquidity risk for the Council's purpose is the degree to which a nonbank financial firm relies on short-term funding and the firm's ability to find replacement funding. The issue is whether the firm maintains a sufficient amount of readily liquid assets to cover any liabilities over 30-day and one-year time horizons. As noted above, liquidity risk is closely related to, if not a component of leverage. Any submission should identify with precision the nature of any reliance on short-term funding—i.e., which business lines do and do not rely on short-term funding—the diversity of its funding sources and the response of the firm if its different lines are affected by the loss in such funding.

Maturity mismatch relates to the differences in the maturities of a nonbank financial firm's assets and of its liabilities. A firm should be prepared not only to identify the different maturities but also to show any links between particular assets and particular liabilities, which would show the real impact of maturity mismatches. In this regard, the liquidity of assets and the volatility of the markets for these assets will be important components in analyzing their maturity. In addition, interest rate risk is a function partly of maturity mismatches and should be part of the firm's analysis.

Regulatory oversight. Much of the information on the quality of regulatory oversight should already be available to the Council through its member agencies. For example, the insurance regulators' representative can speak to state insurance regulation. The Board has significant relationships with foreign regulators, a number of whom regulate nonbank financial companies as well as banking institutions. The Board already has determined that several foreign regulators provide comprehensive consolidated supervision in the banking sector, and these determinations may inform the Council's analysis. Nevertheless, communication, and more significantly, understanding between and among regulators is notoriously incomplete. In any case, the Council is unlikely to have a full understanding of the specific experience of a firm with its regulators, and a firm should be prepared to provide that information.

Annex 1 – The Final Rule

Statutory Requirements

Section 113 of Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or the "Act")[1] authorizes the Financial Stability Oversight Council (the "Council") to determine that a nonbank financial institution be supervised by the Board and be subject to enhanced prudential standards if the Council determines that either (i) material financial distress at the company, or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities, "could pose a threat to the financial stability of the United States." Such a determination requires a two-thirds vote by the voting members of the Council. The provision identifies ten factors for the Council to consider when reviewing a U.S. nonbank financial company:

i. The extent of the leverage of the company;

ii. The extent and nature of its off-balance-sheet exposures;

iii. The extent and nature of its transactions and relationships with other significant nonbank financial companies and significant bank holding companies;

iv. The company's importance 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;

v. The company's importance as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of the company would have on the availability of credit in such communities;

vi. The extent to which assets are managed rather than owned, and the extent to which the ownership of such assets is diffuse;

vii. The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

viii. The degree to which the company is already regulated by 1 or more primary financial regulatory agencies;

ix. The amount and nature of the company's financial assets; and

x. The amount and types of the company's liabilities, including the degree to which it relies on short-term funding.

The factors are nearly the same for foreign nonbank financial firms. The one difference is that the eighth factor is replaced by consideration of the nature of the home-country supervision of a firm. The Council is required, as part of the determination process, to consult with the firm's primary financial regulator and any foreign regulatory authorities as appropriate.

[1] Pub. L. No. 111-203, § 113, 124 Stat. 1376, 1398 (July 21, 2010) (codified at 12 U.S.C. § 5323).

Section 113 also outlines the procedures for the Council to follow in making a determination. The Council must provide a company with advance notice that the Council plans to designate the firm as systemically important. The firm may request a hearing within 30 days. If it does so, the Council must schedule a hearing within 30 days, and the firm may submit additional information within those 30 days. The Council must render a final determination within 60 days after hearing. If the firm does not request a hearing, the Council must notify the firm of its final determination within 40 days of the firm's receipt of the advance notice.[2] The Council may waive any of the procedural requirements if necessary or appropriate to prevent or mitigate threats to financial stability. The Council must review the determination of each nonbanking firm annually.

Judicial review of a final determination is available, whether or not a hearing has been held. A firm has 30 days in which to file suit in U.S. District Court for either the district in which the firm's headquarters are located or the District of Columbia. The court's standard of review is whether the Council's determination was "arbitrary and capricious."

The Rule

The Rule is the result of a lengthy process. In October 2010, the Council published an advance notice of proposed rulemaking that posed several questions about the nature of systemic importance.[3] In January 2011, the Council proposed a set of criteria that reflected the section 113 factors without significant further detail.[4] Following comments that complained about the lack of guidance in the January proposal, the Council released a second proposal in October 2011, with a formal rule and interpretive guidance.[5] The Rule adopts substantially all of the second proposal. The formal regulation itself is procedural in nature. The substantive discussion of the Council's analysis of systemic importance lies in the interpretive guidance, with some gloss provided in the Council's explanation of the Rule in the supplementary information.

Analytic Framework

The designation of a nonbank financial firm as systemically important is a complex process. The Council must make two determinations, whether material financial distress (the "First Determination Standard") or a combination of factors at the firm (the "Second Determination Standard") could pose a threat to the financial stability of the United States. Such a threat likely would come through one (or more) of three channels, which are evaluated on the basis of six categories of factors.

Determination Standards

The ultimate decision of a threat to financial stability will be based on either or both of two different standards, depending on which set of facts exists. The Council recognizes that in many cases both determinations will be justified.

[2] Presumably a firm can submit additional information without requesting a hearing. If it does so, however, it would have substantially less than 40 days in which to do so. The firm will have a total of 60 days, however, if it requests a hearing.
[3] 75 Fed. Reg. 61653 (Oct. 18, 2010).
[4] 76 Fed. Reg. 4555) (Jan. 26, 2011).
[5] 76 Fed. Reg. 64264 (Oct. 18, 2011).

- "Material distress," which the Council refers to as the "First Determination Standard," exists when a firm is in "imminent danger of insolvency or defaulting on its obligations." The Council explains that it will assess material distress in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment.

- The combination of factors—the nature, scope, size, scale, concentration, interconnectedness, or mix of activities—constitutes the "Second Determination Standard." This determination does not include an assessment of a nonbank financial firm's distress and appears to rest solely on the current characteristics of the firm.

Both standards require a finding that a nonbank financial firm presents threat to financial stability. The Council explains that a threat exists "if there would be an impairment of financial intermediation or of financial market functions that would be sufficiently severe to inflict significant damage on the broader economy."

Channels of Threats to Financial Stability

In the interpretive guidance, the Council identifies three channels that would facilitate transmission of the negative effects of a firm's material distress or characteristics to other firms and markets. These channels are not the only mechanisms for systemic risk to arise. It may be fair to assume, however, that many systemic risk designations will be based on findings that one or more of the channels is the source of the transmission of risk. In analyzing each of the channels, the Council will apply different factors, including combinations of six sets of factors, which we explain in greater detail below. With respect to the three channels, they are as follows:

- Exposures by the firm's creditors, counterparties, investors or other market participants that would materially impair those participants. The Council's analysis of this channel likely would be based on five sets of factors: total consolidated assets, credit default swaps outstanding, derivative liabilities, total debt outstanding, and leverage ratio.

- Assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings. This channel would come into play when a firm relies heavily on short-term funding. The sets of factors relevant to this analysis are total consolidated assets and the short-term debt ratio.

- Critical functions or services on which market participants rely and for which there are no ready substitutes. In large part, this analysis is a review of the competitiveness of the markets in which a firm participates and the services it provides. These services include those identified in section 113: the provision of (i) liquidity to the U.S. financial system, (ii) credit to low-income, minority, or underserved communities, or (iii) credit to households, businesses and state and local governments. The focal points of the review are the firm's market share of particular services and the ability of other firms to replace those services. The analysis of this channel does not appear to involve any of quantitative factors applied in the other two channels.

The Council advises that in all cases it will examine a firm's complexity and opaqueness, as well as whether resolution of the firm in bankruptcy would disrupt key markets or have a material adverse impact on other financial firms or markets.

Factors

In order to evaluate whether a nonbank financial firm presents consequences that could flow through any of the three channels and thus support a systemic designation under either of the two determination standards, the Council will apply six categories of factors. These factors are a re-formulation of the ten factors enumerated in section 113 and the formal regulation. Taken together, the factors largely follow those approved by the G-20 for the designation of globally systemically important banks, although the Rule's criteria have a U.S., rather than global, focus.

- *Interconnectedness*. This factor relates to the number and quality of a firm's relationships with counterparties and those counterparties' other relationships. The Council's assessment of this factor may involve several measurements:

  - Counterparties' exposures to a nonbank financial firm, including derivatives, reinsurance, loans, securities borrowing and lending, and lines of credit that facilitate settlement and clearing activities.

  - Number, size, and financial strength of a nonbank financial firm's counterparties, including the proportion of its counterparties' exposure to the nonbank financial company relative to the counterparties' capital.

  - Identity of a nonbank financial company's principal contractual counterparties, which reflects the concentration of the nonbank financial firm's assets financed by particular firms and the importance of the nonbank financial firm's counterparties to the market.

  - Aggregate amounts of a nonbank financial firm's gross or net derivatives exposures and the number of its derivatives counterparties.

  - The amount of gross notional credit default swaps outstanding for which a nonbank financial firm or its parent is the reference entity.

  - Total debt outstanding, which captures a nonbank financial firm's sources of funding.

- *Substitutability*. This factor resembles the competitive analysis that commonly occurs in connection with merger or acquisition applications. The systemic risk concern is that other firms may not be able to provide the products and services of a distressed or complex firm readily and at a comparable price if that firm withdraws from the market, particularly if the company is the dominant provider. The Council may use several metrics, as follows:

  - Market shares of the company and its competitors in particular markets.

  - The stability of market share across firms in the market over time.

  - Market shares for products and services that provide a substantially similar economic function as the primary market under consideration.

- *Size.* The size factors are intended to capture the amount of financial services or financial intermediation that a nonbank financial firm provides. Size may also signal the extent to which distress at a firm may transmit risk to other firms and markets. Size metrics include:
  - Total consolidated assets or liabilities
  - Total risk-weighted assets
  - Off-balance sheet exposures where the company has a risk of loss, such as lines of credit.
  - Assets under management and the extent to which ownership is diffuse.
  - For insurance companies, direct written premiums.
  - Risk in force—the aggregate risk exposure from risk underwritten in insurance related to certain financial risks, such as mortgage insurance.
  - Total loan originations, by loan type, in number and dollar amount.
- *Leverage.* This set of factors covers exposure or risk in relation to equity capital and is one indication of the risk of financial distress to a firm. According to the Council, greater leverage raises the likelihood that the firm may suffer losses exceeding its capital and makes the firm more dependent on creditors' willingness and ability to fund the balance sheet. Greater leverage also will increase the exposure of other financial institutions to the firm and increase the size of possible asset liquidations.
  - Total assets and total debt measured relative to total equity
  - Gross notional exposure of derivatives and off-balance sheet obligations relative to total equity or to net assets under management
  - Ratio of risk to statutory capital
  - Changes in leverage ratios
- *Liquidity and maturity mismatch.* As described in the interpretive guidance, liquidity refers to the risk that a company may not have sufficient funding to satisfy its short-term needs, either through its cash flows, maturing assets, or assets saleable at prices equivalent to book value, or through its ability to access funding markets. The specific concern is whether a firm holds assets that will have a liquid market in times of distress; such assets generally are cash instruments or Treasury securities. Maturity mismatch refers to the difference between the maturities of a firm's assets and liabilities. Mismatches, particularly where a firm must fund long-term assets with short-term liabilities, affect a firm's ability to survive a period of stress that may limit access to funding and to withstand shocks in the yield curve. The relevant metrics include:

- 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

- Asset-liability duration and gap analysis

- Short-term debt as a percentage of total debt and as a percentage of total assets.

- *Existing regulatory scrutiny.* The Council will look to the consistency of regulation across nonbank financial firms within a sector, across different sectors, and providing similar services, and the statutory authority of the regulators.

  - The extent of state or federal regulatory scrutiny, including processes or systems for peer review; inter-regulatory coordination and cooperation; and whether existing regulators have the ability to impose detailed and timely reporting obligations, capital and liquidity requirements, and enforcement actions, and to resolve the company.

  - The existence and effectiveness of consolidated supervision, and a determination of whether and how non-regulated entities and groups within a nonbank financial company are supervised on a group-wide basis.

  - For entities based outside the United States, the extent to which a nonbank financial company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority.

Three-Stage Determination Process

The Rule sets forth a three-stage process for determining which nonbank financial companies will be supervised by the Board or will be exempt from such supervision. The difference between the stages does not appear to reflect different standards of review but rather the level of confidence that the Council has in the information available for each firm. Each stage is based on different data points.

Stage 1

This stage identifies nonbank financial companies for further review based primarily on six quantitative thresholds.[6] The necessary threshold is size: the Council will review only those

[6] In applying these thresholds, the Council may—and, in all likelihood, will—aggregate legally separate funds that are managed by the same adviser, particularly if the funds' investments are identical or highly similar. The application of

companies with total consolidated assets of $50 billion or more. Size will be measured on the most recently available data on a quarterly basis. A nonbank financial firm over the $50 billion mark then will be measured against five additional thresholds, and if it passes any one of them, it will move on to Stage 2. The five thresholds are as follows:

- Gross notional credit default swaps outstanding for which the company is the reference entity: $30 billion. The Council will calculate this threshold using data available from the Trade Information Warehouse although it may later use data from other sources.

- Derivative liabilities: $3.5 billion. Derivative liabilities consist of the fair value of derivative contracts in a negative position. In making the calculation, the Council will take account of netting arrangements and cash collateral with the same counterparty. This calculation will include derivatives embedded in insurance products and accounted for separately under generally accepted accounting principles, even though statutory accounting principles that apply to insurance companies do not provide for separate accounting. The risks associated with embedded derivatives will be part of the Council's review in Stages 2 and 3.

- Total debt outstanding: $20 billion. Total debt is defined broadly to include secured and unsecured loans, bonds, repurchase agreements, commercial paper, securities lending arrangements, surplus notes (for insurance companies), and other forms of indebtedness.

- Leverage ratio—total consolidated assets to total equity: 15:1. Assets in separate accounts will not be included in this calculation.

- Short-term debt ratio—total debt outstanding with a maturity of less than 12 months to total consolidated assets: 10%.

The Council will calculate these measurements using global assets, liabilities, and operations of a U.S. nonbank financial company. For foreign companies, the Council will consider only U.S. assets, liabilities, and operations. GAAP will govern the application of the thresholds, unless statutory or insurance accounting principles apply.

These thresholds are not conclusive. The fact that a large nonbank financial firm does not trigger any of the thresholds is no guarantee that the firm will not be reviewed for potential systemic risk. The Council reserves the right to place such firms into Stage 2 if "further analysis … is warranted." The Council explains that the State 1 thresholds "do not reflect a determination … that nonbank financial companies that do not meet the thresholds will not be designated" as systemically important. Rather, the thresholds "are designed to identify nonbank financial companies for further evaluation based on the statutory standards and considerations."

More specifically, the Council contemplates revising one threshold and adding two more. The threshold to be revised is that for derivative liabilities. In its present form, the metric captures only current exposures. Recently finalized definitions of "major swap participant" and "major securities-based swap participant" by the Commodity Futures Trading Commission ("CFTC")

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the thresholds will, however, "appropriately reflect" the distinction between assets under management and an asset manager's own assets. The Council notes that data reported on Form PF will be useful in this review.

and the Securities and Exchange Commission ("SEC") include a methodology for measuring the potential future exposure created by an entity's outstanding derivatives, with respect to certain institutions.[7] The rule then sets forth its own quantitative standards of swap and security-based swap positions that would cause the holder to be deemed "major." The Council has indicated that this methodology could lead to refinements in the derivative liabilities threshold; whether the Council will adopt the same thresholds as the CFTC and SEC remains to be seen.

As to one of the new thresholds, the Council in the supplementary information singles out financial guarantors, asset management companies, private equity firms, and hedge funds as the types of firms that "may pose risks that are not well-measured by the quantitative thresholds approach." With respect specifically to hedge funds and private equity funds, "less data are generally available about these companies" than about others. The Council observes that the Forms PF that these funds will be required to file beginning in June 2012 may provide useful data and that it may then establish additional thresholds for these firms. Any such development is several months away at the earliest.

The other new threshold would apply to asset management companies. The Council observes in the supplementary information that it is still analyzing the extent to which asset management companies could present potential threats to U.S. financial stability and, if so, whether such threats are better addressed through enhanced prudential standards and Board supervision or through other means. As it addresses these questions, the Council may develop additional Stage 1 thresholds. However, until any additions to the Stage 1 metrics are made, nonfinancial firms that do not publicly report information that the Council can apply against the thresholds may be faced with a Stage 2 evaluation.

Stage 2

This stage involves a "robust" analysis of the potential threat that a nonbank financial firm may pose to U.S. financial stability, either as a result of material distress or because of the nature of the firm and its operations. The analysis largely employs the six categories of factors described above. The Stage 2 analysis

> will be based on information already available to the Council through existing public and regulatory sources, including information possessed by the company's primary financial regulatory agency or home country supervisor, as appropriate, and information voluntarily submitted by the company.

Another source of information will be the Office of Financial Research ("OFR"). An ongoing duty of the OFR is to coordinate with the member agencies of the Council and any other primary financial regulatory agencies to collect and analyze data from those agencies about particular institutions. Stage 2 also will involve two qualitative assessments that may not be covered fully

[7] As of the date of this paper, the final rule had not been published officially. It may be accessed at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister041812b.pdf. The agencies' definitions of "substantial financial position" are complex and beyond the scope of this paper, but the general rule is that an institution's position in a given category of swaps is significant if either its daily average aggregate uncollateralized exposure is $1 billion or more or if the sum of its daily average aggregate uncollateralized outward exposure plus its daily average aggregate potential outward exposure is $2 billion or more. For rate swaps, the thresholds are $3 billion and $6 billion, respectively. The definitions are to be codified at 12 C.F.R. § 1.3(jjj) (CFTC) and 12 C.F.R. § 240.3a67-3 (SEC).

by the six categories of factors: the extent to which a nonbank financial firm is regulated and whether the resolution of the firm could pose a threat to financial stability.

The resolvability issue is whether the firm's entry into bankruptcy or an analogous insolvency proceeding will mitigate or aggravate a company's potential threat to financial stability. This evaluation will entail an assessment of the company's structure and any obstacles to its "rapid and orderly resolution." Factors that the Council will consider include the ability to separate functions and spin off services or business lines; the likelihood of preserving franchise value in a recovery or resolution scenario and of maintaining continuity of critical services within the existing or a new legal entity or structure; the company's intra-group dependency for liquidity and funding, payment operation, and risk management needs; and the size and nature of intra-group transactions. This evaluation requires much (but not all) of the quantitative and qualitative information that a nonbank financial firm must provide in a resolution plan—after it has been deemed systemically important. The evaluation also will include much of the same analysis as the review of a resolution plan by the Board and the Federal Deposit Insurance Corporation. How the Council will deal with the possible circularity of its review remains to be seen.

The extent to which a firm may voluntarily submit information to the Council or otherwise participate in Stage 2 is unclear. In the supplementary information to the Rule, the Council appears to reject suggestions that a firm be notified of Stage 2 or that it be permitted to participate in this stage: "the Council believes that Stage 3 provides a sufficient opportunity for nonbank financial companies to participate in the Determination Process." Nevertheless, the interpretive guidance makes a fleeting reference to this possibility.

The Rule does not state a precise standard that the Council will apply in moving a firm from Stage 2 into Stage 3. It is evident, however, the Council will base its decision on the adequacy of information from sources other than the firm. That is, when the Council decides that it needs additional information from a firm itself, it will have moved the firm into Stage 3. We are not certain that the Council will deem any firms not systemically important solely on the basis of Stage 2 information. The Council states that it will not provide any firm a notice that it will not move into Stage 3 because of "the preliminary nature" of the Stage 2 evaluation, although the Council may provide such notification as it gains experience in the Determination Process. Moreover, although the Council does not address the issue, the regulatory and other information available for a nonbank financial institution is substantially less than the examination and other reports available for bank holding companies, and in many circumstances is unlikely to be deemed sufficient.

The examination process may provide additional information before the Council moves a firm from Stage 2 to the Stage 3 process for collecting information directly from the firm. If the Council cannot, on the basis of information available publicly and from other regulatory sources, decide whether a nonbank financial firm is systemically important, the Council may ask the Board to examine the firm. The purpose of such an examination is limited to whether the firm should be designated as systemically important. Given the extensive time often involved in even a relatively focused examination of a large and complex banking organization, the time required for this type of examination may discourage or even preclude the Council from suggesting it.

Stage 3

This stage includes both the gathering of information on a firm to create the largest record possible for the firm and the final determination of a firm's threat, if any, to financial stability. The underlying analysis and the application of the six sets of factors necessary to make this determination is essentially the same as in Stage 2, and the Council repeatedly refers to the analysis in Stages 2 and 3 as a single analysis.

Stage 3 will involve up to three notices. Stage 3 commences with the delivery to a nonbank financial firm of a "Notice of Consideration" from the Council. The notice will include a request for information that the Council deems relevant and accordingly is likely to be wide-ranging. The request may involve both quantitative and qualitative information. The supplementary information in the Rule indicates that the request will include internal assessments, internal risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, and potential acquisitions or dispositions. The Council explains that in reviewing this information, it may pay greater attention to issues of opacity and complexity than it had in Stage 2. Assessments of resolvability and of the nature of the current regulatory oversight of a firm will also be part of Stage 3.

Formal Determination

Once the Council believes it has all of the information necessary to make a determination, it will so notify the firm involved through a Notice of Proposed Determination. The NPD commences the formal determination process; the process set forth in the Rule adheres to the statutory requirements described above. A firm will have 30 days in which to request a hearing. If it does so, the Council must set a date within the next 30 days for the hearing; during these roughly 30 days; the firm may collect information to present at the hearing or, presumably, beforehand. After the hearing, the Council will have 60 days in which to make a final determination. If the firm does not request a hearing, then the Council must make a decision within 40 days of the firm's receipt of the Proposed Determination. Thus a firm that does not request a hearing but that wishes to provide additional information will, in all probability, have significantly fewer than 30 days in which to provide any additional information. Judicial review is available under the terms of the Act.

Public statements from Treasury Department officials suggest that the Council may issue its first designations before the end of 2012. Given the several time periods in Stage 3, the Council would have to begin to issue Notices of Consideration by early summer in order to meet a year-end deadline.

Public Information

Throughout the designation process, the only information that the Council will release to the public will be the final determination of systemic importance. The Council will alert a firm, one business day in advance of making the designation public, so that the firm can prepare appropriate responses and disclosure materials. Of course, counterparties, investors, and other market participants will be able to determine whether a nonbank financial firm will enter Stage 1. All firms that cross one of the Stage 1 thresholds will be subject to considerable public attention. Whether a firm is required by the securities laws to make public disclosures about the designation process before the Council publishes the final determination is a matter for firms to discuss with securities counsel.

Any information submitted to the Council by a nonbank financial firm will be protected under the Freedom of Information Act in the same way that data submitted to another federal financial regulatory agency is handled.

Annex 2 -- "Predominantly Engaged in Financial Activities"

The authority of the Financial Stability Oversight Council (the "Council") to designate a firm as systemically important is limited to those firms that meet the definition of "nonbank financial company" under section 102(a)(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[13] The term is limited to any firm "predominantly engaged in financial activities." Section 102(b) charges the Federal Reserve Board (the "Board") with defining that term through rulemaking. Section 102(a)(6) requires that the Board's rule contain two tests, one relating to 85 percent of assets and the other 85 percent of revenues. In our view, as discussed further below, the Council cannot begin to implement its rule until the Board has completed the regulation that will define the universe of nonbank financial firms potentially subject to the Council's designation process. The Council, however, disagrees.

"Nonbank financial company" is a term that includes only those companies "predominantly engaged in financial activities." The Board is required to implement this standard through regulation, but it is constrained by specific statutory requirements. Under section 102(a)(6), financial activities are those that are financial in nature under section 4(k) of the Bank Holding Company Act.[14] Under the same provision, a company is "predominantly" engaged in financial activities if one of two conditions exists: either (i) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of an insured depository institution, represent 85 percent or more of the consolidated assets of the company.

The Board has been considering certain refinements to the statutory definitions. In February 2011, the Board proposed regulations that would apply both of the 85 percent tests to each of the past two calendar years. An institution that met either test in either of the two years would be regarded as being "predominantly" engaged in financial activities. This proposal provided no further explanation of "financial activity." The Board received several comments the applicability of the restrictions on the conduct of certain financial activities, particularly investment activities, by bank holding companies.

In response, the Board last week revised the February 2011 proposal to address "financial activities" in greater detail.[15] The guiding principle is that "any activity referenced in section 4(k) will be considered to be a financial activity without regard to conditions that were imposed on bank holding companies that do not define the activity itself."[16] Conditions not applicable to the definition of "predominantly engaged" include those "that were imposed to ensure that the activity is conducted in a safe and sound manner, to prevent a financial holding company from controlling a commercial firm, or to comply with another provision of law."[17]

Merchant banking may be the best single example of the Board's approach to "predominantly engaged." Two conditions that bank holding companies must observe—a requirement that shares be held for a reasonable period of time to enable sale or disposition on a reasonable

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[13] Pub. L. No. 111-203, 124 Stat.1376 (July 21, 2010), codified at 12 U.S.C. § 5301 et seq.
[14] 12 U.S.C. § 1843(k). An activity may be regarded as financial either by statute, regulation, or administrative order.
[15] 77 Fed. Reg. 21494 (Apr. 10, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-04-10/pdf/2012-8515.pdf.
[16] *Id.* at 21495.
[17] *Id.* at 21495 n. 9.

basis consistent with the firm's underwriting, merchant, or investment banking activities, and the prohibition on routine management of a portfolio company other than for purposes of recognizing a reasonable return—are essential elements of merchant banking and apply when considering whether a nonbank financial firm is engaged in this activity. Other restrictions, by contrast, do not apply, including a requirement that a firm engaged in underwriting or merchant or investment banking have a securities or insurance company affiliate and restrictions on the nature of shares, assets or ownership interests.

Nonbank firms should bear in mind that bank holding company-related restrictions will not come into play when evaluating those firms' financial activities. A firm that provides an agency transactional service, such as providing securities brokerage services, acting as a riskless principal, providing private placement services, and acting as a futures commission merchant, is engaged in a financial activity. Bank holding company restrictions, such as prohibitions on underwriting and dealing associated with brokerage services and on purchasing or repurchasing securities for the company's own account in connection with private placement services, and rules on exchange trading and guarantees of certain liabilities with respect to futures commission merchant activities, do not apply. Derivative transactions also constitute a financial activity regardless of whether the derivative contract is bank-eligible or not and whether physical settlement is provided for. Organizing, sponsoring, and managing a mutual fund is a financial activity even if the firm also exercise managerial control over companies in which the fund invests or holds more than 25% of the equity of the fund, two characteristics prohibited for bank holding companies.

A critical legal issue for the Council is whether it may begin the designation process for nonbank financial firms before the Board has completed the rulemaking that defines this term. Neither the Council's nor the Board's rulemaking addresses the issue. We do not believe that the Council may do so. Section 102(b) is explicit that the Board "shall establish, by regulation, the requirements for determining if a company is predominantly engaged in financial activities, as defined in subsection (a)(6)." Thus, a determination of the level of a company's engagement in financial activities cannot be made until the Board has issued regulations. The legislative history on the definition of "predominantly engaged" supports this result:

> [Section 102] requires the Board … to establish by rulemaking the criteria for determining whether a company is substantially engaged in financial activities to qualify as a nonbank financial company…. [T]his provision is intended to provide certainty by mandating the establishment of the criteria through the public notice and comment process required for rulemaking.[18]

The Council's process for designating nonbank financial firms accordingly can be understood only in relation to the Board's rulemaking on the meaning of "predominantly engaged in financial activities." Indeed, as a matter of law, that rulemaking must be completed before the Council can make a final designation of a nonbank firm as systemically important.

[18] S. Rep. No. 111-176 (Apr. 30, 2010).

Systemically Important Nonbank Financial Institutions: FSOC Approves Final Rule

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