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A legal update from Dechert's Financial Institutions Group

FSOC Issues New Proposed SIFI Designation Rule

The Financial Stability Oversight Council ("FSOC") on October 11 issued a second notice of proposed rulemaking ("Second Notice") regarding its process for designating a nonbank financial company as a systemically important financial institution ("SIFI"). The Second Notice provides new quantitative information to companies regarding their status as potential candidates for designation at the initial stage of review, but the FSOC would retain substantial discretion at subsequent stages. There will be a 60-day comment period following publication of the Second Notice in the Federal Register.

Background

Section 113 of the Dodd-Frank Act ("Act") authorizes the FSOC to designate U.S. and foreign nonbank financial companies as SIFIs, which would then be subject to heightened prudential standards and to supervision and enforcement action by the Federal Reserve Board ("FRB"). The FSOC issued an advance notice of proposed rulemaking in October 2010 in which it sought public comments on how the statutory standards for SIFI designation should be applied. Commenters provided extensive and detailed analysis and recommendations as to how particular standards should be applied and particular financial industry sectors should be addressed. In January 2011, the FSOC issued a notice of proposed rulemaking ("First Notice") that was criticized by commenters and members of Congress for not providing any indication of the FSOC's reaction to the public comments and providing little indication of how the FSOC would apply the statutory standards.[1] Members of the FSOC acknowledged to Congress that they needed to reconsider their approach to SIFI designation.[2]

Second Notice

The text of the proposed rule set forth in the Second Notice does not differ in any significant aspect from the text of the first proposed rule. The FSOC has responded to the criticism of the First Notice by attaching an appendix to the proposed rule ("Appendix") which provides guidance in the form of (i) an analytical framework for the statutory standards and (ii) a three-stage process for initially identifying eligible companies and ultimately determining whether to issue a notice of proposed determination of SIFI status to particular nonbank financial companies.

Analytical Framework

The Act requires the FSOC to designate nonbank financial companies as SIFIs if it determines that their material financial distress or their nature, scope, size, scale, concentration, interconnectedness or mix of activities could pose a threat to U.S.

[1] See *DechertOnPoint* Financial Stability Oversight Council Proposal Includes Few Clues About Who Will Be Designated as Significant and *DechertOnPoint* Dechert Issues Comment Letter Regarding Financial Stability Oversight Council's Proposed Rule Regarding the Designation of Systemically Important Financial Companies.

[2] See *DechertOnPoint* Designation of Systemically Important Financial Institutions, Living Wills and Enhanced Prudential Regulation One Year Later: A Question of Balance.

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financial stability. The Act also sets forth ten factors that the FSOC must consider when making this determination and authorizes the FSOC to consider any other risk-related factors that it may deem appropriate.

In the preamble of the First Notice, the FSOC organized the ten statutory factors into six categories. Three categories—leverage, liquidity risk and existing regulatory scrutiny—were intended to evaluate a company's susceptibility to financial distress. The other three categories—interconnectedness, sustainability and size—were intended to evaluate the impact that a company's material financial distress could have on the financial services industry and the broader economy. In the Second Notice, the FSOC has placed this matrix in the Appendix, together with a discussion of each category and of metrics that may indicate the presence of related risks.

Three-Stage Process

The Appendix details a three-stage process for making a preliminary determination whether to designate a nonbank financial company as a SIFI.

Stage 1

In Stage 1, the FSOC would use a set of quantitative tests, based on widely available data that would apply to companies in all sectors of the financial services industry, in order to identify companies requiring further scrutiny. Stage 1 would not provide a "safe harbor" since the FSOC would retain the statutory authority to prevent evasion and to consider other factors that it deems appropriate.

The Stage 1 screening is based on six factors. One factor—size—is paramount. A nonbank financial company must have $50 billion or more of total consolidated assets (or, in the case of a non-U.S. company, $50 billion or more of total U.S. consolidated assets) before the other factors are considered. A company must also satisfy at least one of the other five factors to be selected for further analysis:

- $30 billion notional amount of credit default swaps ("CDS") outstanding for which the company is the reference entity;
- $3.5 billion of exposure on all derivatives contracts after all netting agreements and cash collateral are taken into account;
- $20 billion of outstanding borrowings, including bonds issued;
- Maximum leverage ratio of 15:1; or
- Short-term debt equal to 10% of total consolidated assets.

The quantitative tests raise several issues:

Why $50 billion?

In the Appendix, the FSOC has stated that this test is consistent with the Act, which in Section 165 uses the same amount to identify large bank holding companies subject to enhanced prudential standards. However, this explanation is curious given that in Section 113 Congress chose ***not*** to set any dollar threshold for SIFIs and listed size as only one of several factors without giving it any particular prominence. The FSOC has not articulated why $50 billion of either global or U.S. total consolidated assets is otherwise an appropriate measure.

Investment Funds

The Second Notice presumably refers to balance sheet assets with respect to the $50 billion asset threshold. Thus, assets under management generally would not be included. Notably, the Appendix states that the FSOC may apply the quantitative tests to investment funds managed by a nonbank financial company as if the funds were a single entity if their investments are identical or highly similar. This statement does not expressly address whether this consideration would have the effect of adding non-balance-sheet assets to the balance sheets of an asset manager for the purpose of calculating whether a company meets the asset threshold.

Alternative Tests and Alternative Supervision

The FSOC has acknowledged in the preamble of the Second Notice that the quantitative tests may not fully serve to identify companies in all sectors of the financial services industry for further review. For example, the FSOC has stated that less data is available for hedge funds and private equity funds than for certain other types of nonbank financial companies, and that it will look at data to be provided by investment advisers on the hedge funds and private equity funds they advise on new Form PF and other data to help it decide whether to

establish additional quantitative tests tailored to hedge funds, private equity funds and their advisers. With regard to asset managers generally, the FSOC also has stated the following:

> In addition, the [FSOC], its member agencies and the [Office of Financial Research in the Department of the Treasury] will analyze the extent to which there are potential threats to U.S. financial stability arising from asset management companies. This analysis will consider what threats exist, if any, and whether such threats can be mitigated by subjecting such companies to [FRB] supervision and prudential standards, or whether they are better addressed through other regulatory measures. The [FSOC] may issue additional guidance for public comment regarding potential additional metrics and thresholds relevant to asset manager determinations.

The FSOC's comments regarding possible alternative means to assess whether asset managers pose a possible threat to U.S. financial stability suggests the possible use of Section 120 of the Act. That section grants the FSOC the authority to make recommendations to financial regulatory agencies to apply new or heightened standards or safeguards for a financial activity or practice conducted by companies under their respective jurisdictions. Any recommendation must take into account its cost to long-term economic growth, and a financial regulatory agency may elect not to follow the FSOC's recommendations by filing a written explanation with the FSOC.

Why CDS?

The fact that a company is the reference entity for a large volume of CDS may indicate that it has issued a large amount of indebtedness and that its creditors are concerned regarding its performance. It may also indicate a large amount of speculation by third parties regarding a company's prospects. The Appendix states that this test is intended to measure a company's interconnectedness, but there may be other ways to measure this that are not subject to the "noise" of third-party activity and to rapid fluctuations in the level of activity.

Stages 2 and 3

Following Stage 1, a company that has been preliminarily identified or otherwise flagged would be subject in Stage 2 to more comprehensive and company-specific analysis, addressing qualitative as well as quantitative factors. If the FSOC believed that further review were necessary, in Stage 3 it would review data requested directly from the company. If the FSOC were to decide to consider making a preliminary determination, it would notify the company and give it an opportunity to submit written materials within a time period determined by the FSOC.

"Resolvability"

The Appendix states that a Stage 3 analysis would include an evaluation of a nonbank financial company's "resolvability." This would entail an assessment of several factors, including the complexity of a company's legal, funding and operational structure; obstacles to its rapid and orderly resolution while mitigating risks to financial stability; operational issues that must be resolved in order to divest business lines; and preparations to avoid disruptions of critical services. These and the other resolvability factors described in the Appendix are the same factors set forth in the FDIC's and FRB's final rule under Section 165(d) of the Act for evaluating a large bank holding company's or SIFI's living will. This may have the effect of expanding resolution planning far beyond the designated companies subject to Section 165(d), possibly at significant expense to the companies involved.

Preliminary Determination and Subsequent Proceedings

Based on the results of all three stages of review, and applying those results to the statutory standards, the FSOC would make a preliminary determination whether a company should be designated a SIFI. The FSOC would notify a company if a preliminary determination to designate it has been made, including the reasons for the decision. The company would have the opportunity to submit documents in response to the proposed determination and to request a hearing before the FSOC to contest its designation. If the FSOC were to make a final determination in favor of designation, the company could challenge the decision in a specified federal district court.

Confidentiality

The proposed rule states that the FSOC shall maintain the confidentiality of any data, information and reports submitted under the proposed rule. The proposed rule also states that the Freedom of Information Act ("FOIA") shall apply to any data or information submitted. The proposed rule does not indicate which FOIA exemptions the FSOC would consider applying to materials related to the designation process. In particular, it does not address whether the FSOC would consider the data, information and reports submitted as confidential supervisory information under Exemption 8 of FOIA.[3]

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This update was authored by Thomas P. Vartanian (+1 202 261 3439; thomas.vartanian@dechert.com), Robert H. Ledig (+1 202 261 3454, robert.ledig@dechert.com) and Gordon L. Miller (+1 202 261 3467; gordon.miller@dechert.com).

3 In the preamble to the final rule for resolution plans, the FDIC and the FRB have indicated that "large portions" of the materials submitted are expected to be eligible to be withheld from the public under Exemptions 4 and 8 of FOIA. See *DechertOnPoint* Living Will Requirements Come into Focus.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at http://www.dechert.com/financial_institutions.

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David L. Ansell
Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

Robert H. Ledig
Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Gordon L. Miller
Washington, D.C.
+1 202 261 3467
gordon.miller@dechert.com

Dechert LLP

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