

## FSOC Releases Proposed Rules on Designation of Systemically Important Nonbank Financial Companies

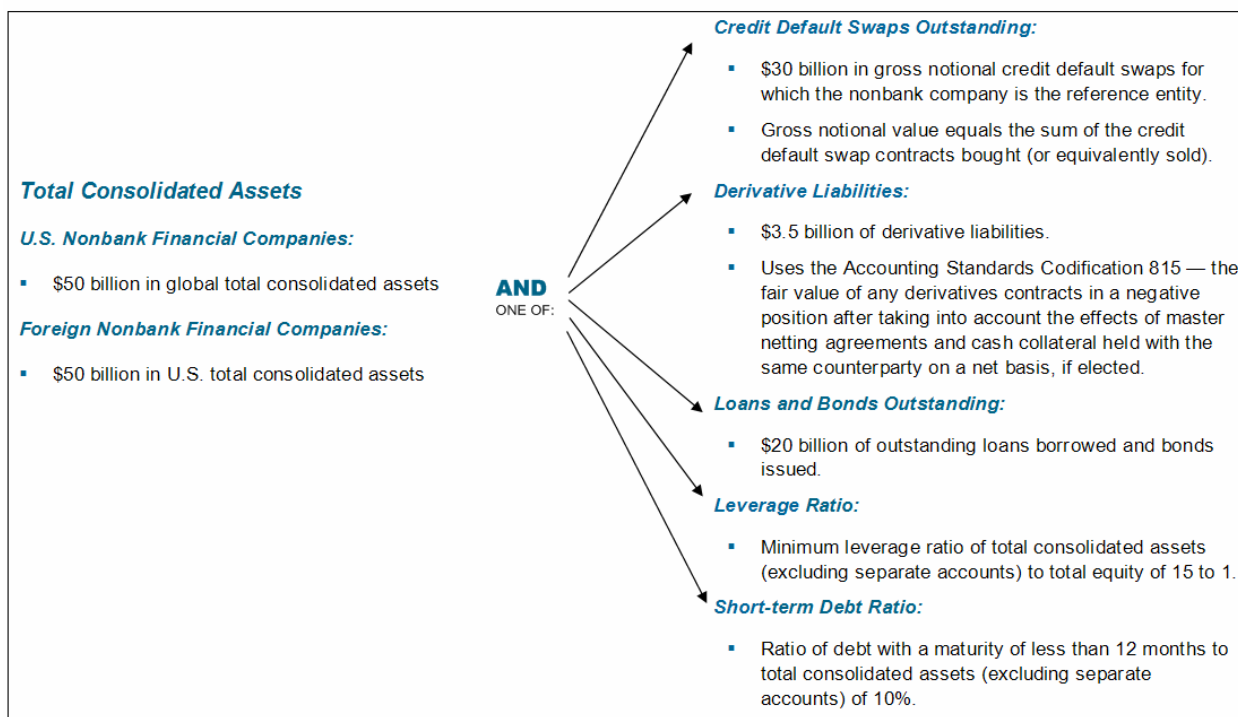
**Overview.** The Financial Stability Oversight Council recently approved a proposed rule and guidance setting out the metrics and process it would use to designate a nonbank financial company as systemically important under the Dodd-Frank Act. Despite the addition of metrics, and a description of the three-stage designation process, the proposed rule is substantially similar to the much-criticized proposed rule issued in January 2011.

### Three-Stage Designation Process

**Stage 1.** In Stage 1, the Council would apply a set of *uniform quantitative metrics* to a broad group of financial companies in order to identify companies to be subject to *further evaluation*.

- The quantitative metrics thresholds to be applied at this stage are set out in the Stage 1 Chart (below).
- The anticipated information sources at this stage are set out in the chart on page 4 of this memorandum.

#### STAGE 1: UNIFORM QUANTITATIVE METRICS THRESHOLDS



#### Key Points to Note:

- **Other Metrics.** In certain limited cases, the Council could evaluate nonbank financial companies based on other company-specific qualitative or quantitative data, but no further information about these cases is provided in the proposed guidance.
- **Discretion.** The Council may include a nonbank financial company in its “Stage 2 Pool” *even if the company does not meet the threshold criteria in Stage 1*. Thus, the Council retains significant discretion regarding whom it will subject to further review.
- **Investment Funds.** For the purposes of applying the quantitative metrics thresholds to investment funds managed by a nonbank financial company, the Council may consider the funds as a *single entity* if their investments are identical or highly similar.

**Questions and Concerns About the Metrics.** The Council has stated its intention to review and revise the Stage 1 metrics on an on-going basis as reporting requirements evolve. Some specific areas of future focus include:

- **Derivatives.** The Stage 1 threshold for derivatives liabilities captures only the *current* exposure of a nonbank financial company. The Council intends to establish a *new* Stage 1 threshold based on potential future exposure from such nonbank financial company’s outstanding derivatives after the final SEC and CFTC rules for the “major swap participant” and “major security-based swap participant” definitions and the rules relating to reporting of data on swaps and security-based swaps come into effect.
- **Hedge Funds and Private Equity Firms.** The Council intends to apply Stage 1 thresholds to these entities, but acknowledges that the quantitative measures may not be appropriate for hedge funds and private equity firms. The release points out that 2012 marks the year that advisers to hedge funds and private equity firms, as well as commodity pool operators and commodity trading advisors, will begin submitting Form PF to the SEC. The Council intends to rely on the information and data disclosed to the SEC on the new Form PF to determine whether to establish additional Stage 1 quantitative metrics applicable to hedge funds, PE firms and their advisors.
- **Asset Managers.** Based on comments in the proposed rule release, it is not yet clear how the proposed guidance will be applicable to asset managers. The release states that the Council may issue additional guidance for comment on asset managers and the threats they pose, if any, to U.S. financial stability, and whether such threats can be mitigated by subjecting such entities to Federal Reserve supervision or whether they are better addressed through other measures and/or supervisory bodies.
- **Credit-Default Swaps.** The proposed threshold applies to *all* gross notional credit default swaps for which a nonbank financial company is the *reference entity*. This means that if third parties choose to write credit default swaps on the credit of a nonbank financial company, such company will have no control over whether it meets this threshold.

**Stage 2.** In Stage 2, the Council would analyze the potential threat posed by a nonbank financial company if such company exceeds the threshold test laid out in Stage 1 or if the Council otherwise determines that a company warrants further review.

**STAGE 2: MEASURING IMPACT AND VULNERABILITY USING A SIX-CATEGORY FRAMEWORK**

<p><b>1. Interconnectedness.</b> Direct or indirect linkages between financial companies that may be conduits for transmission of material distress. Metrics include:</p> <ul style="list-style-type: none"> <li>▪ Counterparties’ exposure to the nonbank financial company (including derivatives, reinsurance, loans, securities, lines of credit facilitating settlement and clearing activities) and number, size and financial strength of such counterparties (including identification of principal contractual counterparties);</li> <li>▪ Aggregate amounts of gross or net derivatives exposure and number of derivatives counterparties;</li> <li>▪ Gross notional credit default swaps outstanding for which the nonbank financial company is the reference entity;</li> <li>▪ Outstanding loans borrowed and bonds issued;</li> <li>▪ Reinsurance obligations.</li> </ul> <p><b>2. Substitutability.</b> Extent to which the nonbank financial company is the primary or dominant provider of services and extent to which other firms could provide similar services at a similar price/quantity in a timely manner:</p> <ul style="list-style-type: none"> <li>▪ Requires an evaluation of the costs involved to market participants to switch providers, the timeframe and the extent to which competitors of the nonbank financial company are likely to experience stress at the same time;</li> <li>▪ Metrics include: market share, stability of market share across time and market share of the nonbank financial company and its competitors for related products or services.</li> </ul> <p><b>3. Size.</b> Conventionally measured by assets, liabilities and capital of the firm. Council intends to take into account off-balance sheet assets and liabilities and assets under management. Metrics include:</p> <ul style="list-style-type: none"> <li>▪ Total consolidated assets and liabilities; total risk-weighted assets, off-balance sheet exposures;</li> <li>▪ Assets under management (<i>funds</i>);</li> <li>▪ <i>Insurance companies:</i> direct written premiums (aggregate under all lines of business) and risk in force (aggregate risk exposure);</li> <li>▪ Total loan originations.</li> </ul>	<p><b>4. Leverage.</b> Typically measures ratio of debt to capital, but measures proposed by the Council take into account economic risk. Metrics used to assess leverage include:</p> <ul style="list-style-type: none"> <li>▪ Total assets and total debt measured relative to total equity;</li> <li>▪ Gross notional exposure of derivatives and off-balance sheet obligations relative to total equity or net assets under management;</li> <li>▪ <i>Insurance companies:</i> ratio of risk to statutory capital;</li> <li>▪ Changes in leverage ratios.</li> </ul> <p><b>5. Liquidity Risk and Maturity Mismatch.</b> Risk that a company may have insufficient funds to satisfy short-term needs and differences between maturities of a company’s assets and liabilities. Metrics include:</p> <ul style="list-style-type: none"> <li>▪ Fraction of assets that are classified as level 2 or 3 under applicable accounting standards;</li> <li>▪ Liquid asset ratios, intended to repay short-term debt;</li> <li>▪ Ratio of unencumbered and highly liquid assets to net cash outflows;</li> <li>▪ Callable debt as a fraction of total debt;</li> <li>▪ Asset-backed funding versus other funding;</li> <li>▪ Asset-liability duration and gap analysis;</li> <li>▪ Short-term debt as a percentage of total debt and a percentage of total assets.</li> </ul> <p><b>6. Existing Regulatory Scrutiny.</b> Extent to which the applicable company is already subject to regulation and the consistency of such regulation across sectors. Metrics include:</p> <ul style="list-style-type: none"> <li>▪ Existence of consolidated supervision (extent to which non-regulated entities are supervised on a group-wide basis);</li> <li>▪ <i>Investment funds:</i> is the fund or manager registered with the SEC, the CFTC or a bank or other regulator?</li> <li>▪ <i>Insurance companies:</i> number of primary financial regulatory agencies and the number of “lead state” regulators;</li> <li>▪ <i>Foreign-based entities:</i> extent to which a nonbank financial company is subject to prudential standards in its home country;</li> <li>▪ Current regulatory bodies’ ability to impose detailed and timely regulatory reporting obligations, capital or liquidity requirements, enforcement actions and resolutions.</li> </ul>
<p><b>Additional Stage 2 Factor:</b> Whether the <i>resolution</i> of a nonbank financial company could pose a threat to U.S. stability.</p>	

- The Stage 2 Chart above outlines the six-category analytic framework to be applied in Stage 2.
- The anticipated information sources at this stage are set out in the chart on page 4 of this memorandum.

**Stage 3.** The key test for Stage 3 is whether the company’s *material financial distress* would pose a threat to U.S. financial stability. The focus in this stage is on the transmission channels through which the company’s distress would affect the broader economy. The Council has included a new determination criterion – the nonbank financial company’s *resolvability* – as a consideration during this stage of the process.

- The Stage 3 Chart below sets out the factors to be considered and the subsequent designation procedures to be applied in Stage 3.
- The anticipated information sources at this stage are set out in the chart on page 4 of this memorandum.

**STAGE 3: ASSESSMENT OF IMPACT OF MATERIAL FINANCIAL DISTRESS ON U.S. FINANCIAL STABILITY**

<p><b>Notice of Consideration:</b></p> <ul style="list-style-type: none"> <li>▪ A nonbank company in Stage 3 will receive a “<b>Notice of Consideration</b>” that it is under consideration for a Proposed Determination.</li> </ul> <p><b>Factors:</b> Council expects to access information relating to factors that are not easily quantifiable or may not directly pose a threat to financial stability, but could mitigate or aggravate such potential. Factors include:</p> <ul style="list-style-type: none"> <li>▪ <b>Resolvability;</b></li> <li>▪ Opacity of operations;</li> <li>▪ Complexity; and</li> <li>▪ Regulatory scrutiny.</li> </ul> <p><b>Resolvability:</b></p> <ul style="list-style-type: none"> <li>▪ Assessment of a company’s complexity of legal, funding and operational structures and obstacles to a rapid and orderly resolution.</li> <li>▪ Legal entity and cross-border operations issues:             <ul style="list-style-type: none"> <li>▪ Ability to separate functions and spin-off services including critical services within the existing or new legal entity or structure;</li> <li>▪ Degree of intra-group dependency for liquidity and funding;</li> <li>▪ Payment operation and risk management needs; and</li> <li>▪ The size and nature of the intra-group transactions.</li> </ul> </li> </ul>		<p><b>Subsequent Procedures:</b></p> <ul style="list-style-type: none"> <li>▪ Council intends to notify any nonbank financial company which receives a <b>Notice of Consideration</b> when it determines the evidentiary record is complete.</li> <li>▪ Will issue a written <b>Notice of Proposed Determination</b> to the nonbank financial company, which will set out an explanation of the basis for the determination.</li> <li>▪ The nonbank financial company can request a hearing within 30 days.</li> <li>▪ The hearing must be scheduled by the Council within 30 days of receiving the request.</li> <li>▪ Council needs to approve a Proposed Determination by a 2/3 majority vote.</li> <li>▪ The Council will make <b>public</b> its final determination.</li> </ul>
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Under the proposed rule, a nonbank financial company that reaches Stage 3 will receive a “Notice of Consideration” from the Council, which may include a request for information, but not necessarily. This may be the point at which the most negotiation and bilateral dialogue between the Council and the nonbank financial company will take place. It is also worth noting that the Council will consider information voluntarily provided by the nonbank financial company in Stage 2 and this may also be a point where a nonbank financial company concerned about a potential designation may be able to educate the Council about its business model, its business plans and any changes that could be made to avoid designation. If the Council determines that a designation should occur, it will issue a Notice of Designation, which will trigger the right to an evidentiary hearing and judicial review.

The Council reserves significant flexibility to treat different types of firms, and even individual firms within those types, differently as it deems appropriate. Where the current framework may indeed be inappropriate, the Council signals the potential for future industry-specific rulemaking, but offers few details of what such rulemaking would entail. In addition, the Council retains flexibility throughout the designation process to bring firms into consideration which may not otherwise meet the stated criteria or for which the stated criteria are inapplicable. As for the criteria themselves, the six-category analytic framework contained in Stage 2 is taken from the original January 2011 proposed rule, though the Council has given a little more explanation on how it selected the six categories and potential qualitative and quantitative data it may consider within each category. The Council’s overall approach to the proposed rule and guidance is not surprising, given that the statutory criteria for systemic importance are open-ended and thus the Council is unlikely to issue regulations or guidance that would tie its hands.

**Timing.** The release is a re-proposal of the Council's January 2011 proposed rule and not a notice of final rulemaking. There is a 60-day comment period that commences upon publication of the proposed rule in the Federal Register. Thus comments likely will be due in the second half of December. We predict that a final rule will not be in place until the second quarter of 2012. The timeframe for implementing the three-stage process is not clear and, indeed, the Council need not wait for a final rule to begin working through the stages. One conclusion to draw from the Council's consistent references to "Stage 2 Pools" and "Stage 3 Pools" is that they are expecting to conduct the designation process in waves. If so, this would allow the Council to begin with a group of high-priority targets determined on the basis of size, visibility or function and assess other nonbank financial companies later. We would not be surprised if companies were not contacted until well into 2012. That said, an emergency situation or a worsening of the economic situation could result in faster designations.

**Information Collection and Confidentiality.** The Council has now stated that it will make *public* any determination of systemic importance, which is a change from the initial proposed rule. The Council has attempted to improve the confidentiality provisions included in the proposed rule, in particular noting that the Council will maintain the confidentiality of non-public information and retain privilege for information provided during the process. However, the Freedom of Information Act explicitly applies to all information collected in the designation process and it is unknown in practice how the Council would apply the exceptions to maintain the confidentiality of the non-public information it collects.

**INFORMATION SOURCES AT EACH STAGE**

	Stage 1	Stage 2	Stage 3
<b>Information Sources</b>	Public and regulatory sources	<p>Information available through existing sources, including:</p> <ul style="list-style-type: none"> <li>Information possessed by the company's primary financial regulatory agency;</li> <li>The home country supervisor; or</li> <li>Information provided on a <b>voluntary basis</b> by the company.</li> </ul>	<p><b>Notice of Consideration</b> will likely include a request for information:</p> <ul style="list-style-type: none"> <li>Limited to materials in writing;</li> <li>May include requests for confidential business information such as internal assessments, internal risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, potential acquisitions or dispositions, anticipated changes to the company's business or structure;</li> <li>Council will consult with the primary financial regulatory authority or appropriate foreign regulatory authority during the information-collection process and before making a final determination, if appropriate.</li> </ul>

**Revised Procedural Provisions in the Revised Proposed Rule.** The requirement that the Council provide the nonbank financial company with a notice when it deems its evidentiary record to be complete is now incorporated into the proposed rule (as well as the interpretive guidance). The Council now has 180 days following the provision of the notice that the evidentiary process is complete to make a proposed determination. If it fails to do so, it is required to provide an additional notice to the nonbank financial company under consideration for designation.

The rules dealing with *judicial review* and relating to the *establishment of intermediate holding companies*, which were included in the initial proposed rule, are not in the revised proposed rule.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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