

Working Summary of the Financial Stability Oversight Council's January 18, 2011 Proposed Rules on Designation of Systemically Important Nonbank Financial Companies

Summary as of January 19, 2011

Framing the Debate: Treasury Secretary Geithner Expresses Doubts About Objective Systemic Risk Criteria

The designation of systemically important nonbank financial companies has generated significant interest from multiple stakeholders about which companies the Financial Stability Oversight Council (“**FSOC**” or the “**Council**”) should designate, when such designation should happen and what criteria the FSOC should use, particularly in response to the FSOC’s October 6, 2010 Advance Notice of Proposed Rulemaking (the “**ANPR**”).¹ The main takeaway from the January 18, 2011 Notice of Proposed Rulemaking (the “**NPR**”) is that the key regulators, who recently lived through the financial crisis, are reluctant to adopt a formal rule that would limit their discretion to designate nonbank financial companies as systemically important. The actual text of the proposed rule, as opposed to the commentary in the proposal, is notable for the fact that it adds almost no new content to the broad statutory text in the Dodd-Frank Act. This result should not be a complete surprise given statements by Treasury Secretary Geithner in the January 13, 2011 report² by the Special Inspector General for the Troubled Asset Relief Program (“**SIGTARP**”) on the establishment of a systemic risk regime and the government’s role in responding to future financial crises:

- “[Secretary] Geithner told SIGTARP that he believed creating effective, purely objective criteria for evaluating systemic risk is not possible, saying ‘it depends too much on the state of the world at the time. You won’t be able to make a judgment about what’s systemic and what’s not until you know the nature of the shock’ the economy is undergoing. He also said that whatever objective criteria were developed in advance, markets and institutions would adjust and ‘migrate around them.’”
- “As Secretary Geithner told SIGTARP, while the Dodd-Frank Act gives the Government ‘better tools,’ and reduced the risk of failures, ‘[i]n the future we may have to do exceptional things again’ if the shock to the financial system is sufficiently large.”

The text of the proposed rule essentially reflects this reality by formalizing the wide discretion, contemplated by the Act, that the FSOC will have in designating nonbank financial companies. Both privately and at industry fora, key regulators have in the past months expressed the view that they have a

¹ The ANPR is available on the FSOC’s website at http://www.treasury.gov/initiatives/Documents/2010-25321_PI.pdf. Publicly submitted comments are available on the government’s online rulemaking portal, <http://www.regulations.gov> (search for file number FSOC-2010-0001).

² SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, EXTRAORDINARY FINANCIAL ASSISTANCE PROVIDED TO CITIGROUP, INC. (Jan. 13, 2011), <http://www.sig tarp.gov/reports/audit/2011/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf>.

good sense of who the top two or three first strike targets are in any particular sector but, after that, it becomes difficult. Without so stating directly, the commentary in the NPR reflects this view.

The FSOC has previously stated that it intends to finalize the designation rules by April 2011 and will then begin the process of examining which nonbank financial companies will be designated. It expects to continue to examine such designations on a regular basis. It is worth a reminder that the actual substance of systemic regulation, especially as applied outside of the banking sector, has not yet been the subject of post–Dodd-Frank public statements or pronouncements by the FSOC or other financial regulatory agencies except in the most general terms.

General Observations

- As expected, the commentary in the NPR does not indicate which firms or industries are being considered for designation or are likely to be designated.
 - The NPR discusses the need to adapt to the risks and business models in different industries and sectors, but does not state that any types of nonbank financial companies are *per se* systemically important or safe from designation.
- The NPR summarizes comments to the ANPR at a very general level and generally does not take a position with respect to the comments.
 - The NPR acknowledges broad consensus among commenters with respect to the following positions among others, but does not engage in detail:
 - Asset size should not be examined in isolation, and it does not fully reflect systemic risk.
 - The framework for designation must take into account differences in industries and sectors.
 - Companies already subject to prudential regulation are less likely to be systemically important.
 - Two exceptions to this trend:
 - The NPR states that receipt of previous federal assistance will not be a separate criterion, as “that assistance should be viewed in light of the facts and circumstances under which it was provided.”
 - The NPR acknowledges that commenters requested definitions of “material financial distress” and “financial stability,” but argues that a category-based framework, discussed below under “Designation Criteria and Categories,” removes the need for such definitions.
- The ANPR comments appear to have had little impact on the FSOC’s drafting of the proposed rule, which we believe was as much influenced by international discussions as by public commentary.
- **Comments must be submitted within 30 days of publication in the Federal Register.** The NPR has not yet been published in the Federal Register but such publication is expected shortly.
 - The short comment period and the lack of major impact of previous public comments raises a real question as to how much time and effort those nonbank financial companies who are concerned that they may be systemic, either now or in the future, should spend in trying to change the designation criteria.

Designation Criteria and Categories

- **Statutory Factors.** It bears repeating that the text of the proposed rule repeats the statutory factors, which we set forth in [Annex A](#), and ends with and “any other risk-related factor that the Council deems appropriate, either by regulation or on a case-by-case basis.” We are doubtful this will change substantially in the final rule.
- **Inclusion of subsidiaries.** The proposed rules amend references to “the company” to read “the company and its subsidiaries.” We believe this was implicit in the statutory text.
- **Six Categories of Criteria.** Citing a “theme” in comments received, the commentary in the NPR groups the statutory criteria for designating nonbank financial companies into six broad categories.³ **Although conceptually similar, the categories do not appear in this format in the text of the proposed rules.** The categories are:
 - Size;
 - Lack of substitutes for the financial services and products the company provides;
 - Interconnectedness with other financial firms;
 - Leverage;
 - Liquidity risk and maturity mismatch; and
 - Existing regulatory scrutiny.
- **Subgroups.** The discussion in the NPR further divides the six categories into two conceptual subgroups. The relationship between these groups resembles the two-part approach advocated in certain comment letters. None of this discussion appears in this format in the text of the proposed rule.
 - Size, lack of substitutes and interconnectedness “seek to assess the potential for spillovers from the firm’s distress to the broader financial system or real economy.”
 - Leverage, liquidity risk and maturity mismatch and existing regulatory scrutiny “seek to assess how vulnerable a company is to financial distress.”
- **Practical Application.** According to the commentary in the NPR, the FSOC “would evaluate nonbank financial companies in each of the six categories, **using quantitative metrics where possible.**” The NPR does not discuss potential quantitative metrics, and because neither the six categories nor any quantitative metrics appear in the actual text of the proposed rules, the contours of such an evaluation are unknown. Various academic and other sources have recently published quantitative metrics but none of these are adopted.
 - FSOC “expects to use its judgment, informed by data on the six categories,” to make designations, thus incorporating quantitative measures and qualitative judgment.
 - Qualitative judgment would include potential spillover effects from distress or failure of the company in both normal times and times of widespread financial stress.
 - **Industry- and sector-specific adaptation.** The commentary in the NPR contemplates using the same categories for all industries and sectors, but states that their application will be adapted to fit the risk and business models of specific industries and sectors. It adds that the

³ Annex A maps the statutory criteria to the six NPR categories of criteria.

metrics used likely will differ across industries and sectors and that the FSOC will review the metrics on a periodic basis and revise them as appropriate. None of these considerations appears in the text of the proposed rule.

Procedural Provisions

- **Additional Notice and Opportunity to Comment Prior to Designation.** The proposed rule implements the statutory provision requiring the FSOC to give companies advance notice of a proposed designation and the opportunity for a hearing. **In addition**, the proposed rule requires that the FSOC give written notice if it is **considering** a proposed determination, and allows the company to submit written materials to the FSOC explaining whether the company could pose a threat to US financial stability. This is the *Wells* notice-type procedure that some had mentioned during the comment process. Although it is not explicit in the NPR, we assume that the hearing is meant to be public and the *Wells* notice-type procedure is meant to be confidential.
- **Key questions:** How effective will these “pre-pre-designation” interactions be in deterring designations, or at least mitigating the severity of regulation once designated? Could this lead the designation process to effectively become more of a negotiation between FSOC and the company? Another key question is the extent to which these “pre-pre-designation” materials submitted to the FSOC would be treated as confidential or subject to disclosure under the Freedom of Information Act (“**FOIA**”). It is our view that most of the real negotiations will occur at this phase and that it will be a rare company that would seek a public hearing or judicial review.
- **Anti-Evasion, Emergency Exception, Rescission/Reevaluation and Judicial Review.** The proposed rules on anti-evasion powers (including the formation of intermediate holding companies), the emergency exception to notice-and-comment provisions, rescission and reevaluation of designations and judicial review generally track the statute.
 - The proposed rule clarifies that FSOC may not make a decision under the emergency exception until the time for requesting a hearing has elapsed or the company officially declines a hearing.
- **Back-Up Examination by the Federal Reserve.** The proposed rules implement the statutory provision allowing FSOC to request that the Board of Governors conduct a back-up examination if FSOC cannot determine whether a company poses a threat to US financial stability warranting designation.
- **Information Collection and Coordination.** The proposed rules implement FSOC’s statutory authority to receive and request reports and data from a variety of sources, and add state financial regulatory agencies to the list of eligible sources.

International Considerations

- **International Consistency.** The NPR states that the six categories of designation criteria are consistent with the approach currently being developed by the Basel Committee on Banking Supervision and the Financial Stability Board.
 - In the FSOC meeting, Michael S. Gibson, Associate Director of the Federal Reserve Board’s Division of Research and Statistics, added that US regulators will continue discussing how to measure systemic risk with their foreign counterparts through the Basel Committee, FSB and other fora, and plan to keep US and international frameworks as aligned as possible.

- **US Focus Maintained.** As in the statutory text, the criteria applicable to foreign nonbank financial companies are US-focused, e.g., the “amount and nature of the United States financial assets of the company and its subsidiaries.”
- **Consultation.** The NPR and proposed rules generally preserve the role of consultation with foreign regulatory authorities in the systemic risk regime including in designation and in exercise of the emergency exception to notice-and-comment provisions.
- **Regular Intervals and Yearly Redetermination.** The commentary to the NPR makes it clear that the FSOC expects to make regular determinations of systemic risk designations once the final rule is in place and, as contemplated by the statute, the proposed rule requires annual redeterminations.

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.

Randall D. Guynn	212 450 4239	randall.guynn@davispolk.com
Annette L. Nazareth	202 962 7075	annette.nazareth@davispolk.com
Margaret E. Tahyar	212 450 4379	margaret.tahyar@davispolk.com
Reena Agrawal Sahni	212 450 4801	reena.sahni@davispolk.com
Thomas J. Clarke	212 450 3011	thomas.clarke@davispolk.com

© 2011 Davis Polk & Wardwell LLP

Notice: This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have any questions about the matters covered in this publication, the names and office locations of all of our partners appear on our website, davispolk.com.

Mapping Statutory Systemic Risk Criteria to NPR Categories

The NPR contains a chart comparing the criteria enumerated in the statutory text of the Dodd-Frank Act to the six categories of criteria developed by the NPR as follows.

The proposed rules reiterate these statutory criteria but amend references to “the company” to read “the company and its subsidiaries.” Text specific to foreign nonbank financial companies is bracketed.

Dodd-Frank Act Section	Statutory Criterion	Corresponding NPR Categories
§ 113(a)(2)(A), (b)(2)(A)	“the extent of the leverage of the company”	Leverage
§ 113(a)(2)(B), (b)(2)(B)	“the extent and nature of the [United States related] off-balance-sheet exposures of the company”	Size Interconnectedness
§ 113(a)(2)(C), (b)(2)(C)	“the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies”	Interconnectedness
§ 113(a)(2)(D), (b)(2)(D)	“the importance of the company as a source of credit for [United States] households, businesses, and State and local governments and as a source of liquidity for the United States financial system”	Size Lack of substitutes
§ 113(a)(2)(E), (b)(2)(E)	“the importance of the company as a source of credit for low-income, minority, or underserved communities [in the United States], and the impact that the failure of such company would have on the availability of credit in such communities”	Lack of substitutes
§ 113(a)(2)(F), (b)(2)(F)	“the extent to which assets are managed rather than owed by the company, and the extent to which ownership of assets under management is diffuse”	Size Interconnectedness
§ 113(a)(2)(G), (b)(2)(G)	“the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company”	Size Lack of substitutes Interconnectedness
§ 113(a)(2)(H), (b)(2)(H)	“the degree to which the company is already regulated by 1 or more primary financial regulatory agencies”	Existing regulatory scrutiny
§ 113(a)(2)(I), (b)(2)(I)	“the amount and nature of the [United States] financial assets of the company”	Size Interconnectedness
§ 113(a)(2)(J), (b)(2)(J)	“the amount and types of the liabilities of the company [used to fund activities and operations in the United States], including the degree of reliance on short-term funding”	Liquidity risk and maturity mismatch Size Interconnectedness
§ 113(a)(2)(K), (b)(2)(K)	“any other risk-related factors that the Council deems appropriate”	“Appropriate category or categories based on the nature of the additional risk-related factor”