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A SIFI in Three Easy Steps? FSOC Approves Final Rule for Nonbank SIFI Designations

HEATH P. TARBERT, SYLVIA A. MAYER, AND DERRICK D. CEPHAS

The authors examine the Final Rule issued by the Financial Stability Oversight Council implementing Section 113 of the Dodd-Frank Act – an important move toward enhanced regulation of systemically important financial institutions beyond large bank holding companies.

On April 3, 2012, the Financial Stability Oversight Council ("FSOC") voted to approve its long-awaited Final Rule implementing Section 113 of the Dodd-Frank Act, the controversial provision that directs the federal government to identify systemically important financial institutions ("SIFIs") outside the traditional banking sector that could pose a threat to the U.S. financial system.[1] Once designated by a two-thirds majority of the FSOC (including an affirmative vote of the treasury secretary), each "nonbank financial company," often referred to in short-hand as a "nonbank SIFI," would be placed under Federal Reserve Board ("Fed") supervision, as well as become subject to a host of enhanced prudential measures — including capital, liquidity, leverage, stress testing, resolution planning, and risk management requirements. The FSOC's recent approval of the Final Rule — as well as its accompanying interpretive Guidance[2] — is an important move toward the application of enhanced SIFI regulation beyond large bank

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holding companies with assets of $50 billion or greater.[3]

The FSOC issued its Final Rule following consideration of over 40 public comments to its Notice of Proposed Rulemaking (the "Proposed Rule"), released in October 2011.[4]

OVERVIEW

The Final Rule establishes a three-step process comprising three individual "stages" by which the FSOC will apply two "Determination Standards" (one based on actual or potential material financial distress and the other based on the nature, scope, size, scale, concentration, interconnectedness or mix of activities) to analyze whether a company may pose a threat to the financial stability of the U.S., along with a six-category analytic framework to determine whether a company should be deemed a nonbank SIFI. In an effort to increase the transparency of the process, the FSOC issued accompanying Guidance providing additional details and insights into the nonbank SIFI determination process.

NONBANK FINANCIAL COMPANIES

Only a "nonbank financial company" may be designated as systemically important by the FSOC under Section 113 of the Dodd-Frank Act and the Final Rule. It should be no surprise that the FSOC has interpreted "company" broadly to include any corporation, limited liability company, partnership, business trust, association, or similar organization.[5] That said, Congress specifically narrowed the class of potential nonbank SIFIs to companies that are not banks or bank holding companies that are nonetheless "predominantly engaged in financial activities" with certain exceptions — essentially meaning that 85 percent of a company's consolidated annual revenues or assets are derived from activities that are financial in nature. While the FSOC is charged with establishing criteria to distinguish between nonbank SIFIs and other nonbank financial companies, the Fed is charged with defining what constitutes a financial activity and it has issued a proposed rule under that authority, the comment period for which was recently extended until May 25, 2012.[6] The Fed is expected to issue a final interpretation before the end of the summer, allowing for

nonbank SIFI designations to commence in the late summer or early autumn.

DETERMINATION STANDARDS AND STATUTORY CONSIDERATIONS

Under the Final Rule, a particular nonbank financial company will be subject to Fed supervision and prudential standards if the FSOC determines: (i) material financial distress at the nonbank financial company could pose a threat to the financial stability of the U.S. (the “First Determination Standard”); or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the U.S. (the “Second Determination Standard”).

In deciding whether a particular nonbank financial company meets either of the Determination Standards, the FSOC must evaluate the ten statutory considerations required by Section 113, which the FSOC has consolidated into a six-category analytical framework: size, interconnectedness, lack of substitutes, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The FSOC has created a table (produced below) mapping the six categories to each of the ten statutorily mandated considerations.

Statutory considerations:	**Category or categories in which this consideration would be addresse**d:
(A) The extent of the leverage of the company	Leverage
(B) The extent and nature of the off-balance-sheet exposures of the company	Size; interconnectedness
(C) The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies	Interconnectedness
(D) The importance of the company 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	Size; substitutability

(E) The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities	Substitutability
(F) The extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse	Size; interconnectedness; substitutability
(G) The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company	Size; interconnectedness; substitutability
(H) The degree to which the company is already regulated by 1 or more primary financial regulatory agencies	Existing regulatory scrutiny
(I) The amount and nature of the financial assets of the company	Size; interconnectedness
(J) The amount and types of the liabilities of the company, including the degree of reliance on short-term funding	Liquidity risk and maturity mismatch; size; interconnect-edness
(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

During the comment period on the Proposed Rule, several commentators had questioned whether the six-category analytic framework would be effective if applied across or within industries. In response to such comments, the FSOC clarified in the Final Rule that evaluation of any nonbank financial company under the framework will be company-specific.

THE DETERMINATION PROCESS

The FSOC intends to follow a three-stage process involving an analysis based on an increasing amount of information to identify nonbank financial companies for determinations in non-emergency situations (the "Determination Process"). Determinations will be made based on company-specific evaluations and quantitative and qualitative information that the FSOC deems relevant to a particular company.

Stage 1: Initial Identification of Nonbank Financial Companies for Evaluation

In Stage 1 of the process, the FSOC will narrow the field of potential nonbank SIFIs by applying uniform quantitative thresholds, applicable across the financial sector. The quantitative thresholds employed at Stage 1 relate to the following more readily quantifiable analytical categories: size, interconnectedness, leverage, and liquidity risk and maturity mismatch. The objective of Stage 1 is merely to identify nonbank financial companies that should be subject to further evaluation in subsequent stages of review — Stage 1 is by no means a final determination of SIFI status. The FSOC believes that Stage 1 will be a useful tool that will allow nonbank financial companies and the public to assess whether a company will be subject to further evaluation.

A nonbank financial company will move to Stage 2 for further evaluation if it meets *both* the total consolidated assets threshold ($50 billion in global total consolidated assets for U.S. nonbank financial companies or $50 billion in U.S. total consolidated assets for foreign nonbank financial companies) and any one of the other thresholds listed below:

- *Credit Default Swaps Outstanding*: $30 billion in gross notional credit default swaps outstanding for which the nonbank financial company is the reference entity, where gross notional value equals the sum of credit default swap contracts bought (or equivalently sold).
- *Derivative Liabilities*: $3.5 billion of derivative liabilities, where derivative liabilities equals the fair value of any derivatives contracts in a negative position after taking into account the effects of master netting agree-

ments and cash collateral held with the same counterparty on a net basis.[7]

- *Total Debt Outstanding*: $20 billion of total debt outstanding. The definition of total debt outstanding will include (regardless of maturity) outstanding loans, bonds, repurchased agreements, commercial paper, securities lending arrangements, surplus notes (for insurance companies) and other indebtedness.
- *Leverage Ratio*: A minimum leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1. Separate accounts are excluded from the ratio calculation because such accounts are not available to satisfy claims of general creditors of the nonbank financial company.
- *Short-Term Debt Ratio*: Ratio of total debt outstanding (as defined above) with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent.

When applying the Stage 1 thresholds, the FSOC intends to use U.S. GAAP when available, and look to statutory accounting principles, international financial reporting standards, or other such data in the absence of GAAP-based financials.

As reporting requirements evolve, the FSOC may also review quantitative thresholds as appropriate. For example, it may consider credit exposure data proposed to be collected under Section 165(d) of the Dodd-Frank Act or swap information to be reported to swap data repositories under Section 728 of the statute.

Additionally, the FSOC stresses that because the uniform quantitative thresholds may not identify all of the means by which a nonbank financial company could pose a threat to financial stability of the U.S., it reserves the right to evaluate certain nonbank financial companies in this initial stage using other firm-specific qualitative or quantitative factors. Companies identified during Stage 1 will be subjected to the Stage 2 evaluation (the "Stage 2 Pool").

Stage 2: Review and Prioritization of Stage 2 Pool

At this stage of the process, the FSOC will conduct an in-depth analysis of each nonbank financial company to determine the potential threat that each could pose to U.S. financial stability. As in Stage 1, the FSOC will utilize publicly available information, including information possessed by the company's primary financial regulatory agency or home country supervisor. Based on this information, the FSOC will embark on a more focused evaluation of the "risk profile and characteristics of each individual nonbank financial company," using the six-category analytical framework discussed above. The FSOC will also evaluate the nonbank financial company using qualitative factors, such as whether the resolution of the specific nonbank financial company could pose a threat to U.S. financial stability, and the degree to which such nonbank financial company is already subject to regulatory scrutiny. As appropriate, in this stage the FSOC will begin consulting with the primary financial regulatory agency of each nonbank financial company and, to the extent it deems appropriate, the primary financial regulatory agency of each of its subsidiaries. After the completion of the Stage 2 analysis, the FSOC will notify the nonbank financial companies identified as requiring further review (the "Stage 3 Pool").

Stage 3: Review of Stage 3 Pool

At the final stage of review, the FSOC will use nonpublic information obtained directly from the nonbank financial company and likely consider qualitative factors such as a company's resolvability, the opacity of its operations, its complexity and the extent and nature of its regulatory scrutiny to analyze its potential to pose a threat to financial stability. The analysis will depend on the particular circumstance of each company under consideration. The FSOC will formally notify the nonbank financial company that it is under consideration for a Proposed Determination through a Notice of Consideration that will likely contain a request that the nonbank financial company provide certain additional financial information relevant to the FSOC's analysis. The FSOC will be seeking both qualitative and quantitative data, which may involve "confidential business information," including:

- internal assessments;

- internal risk management procedures;
- funding details;
- counterparty exposure or position data;
- strategic plans;
- resolvability;
- potential acquisitions or dispositions; and
- other anticipated changes to the nonbank financial company's business or structure that could affect the threat to U.S. financial stability posed by the nonbank financial company.

Whenever possible, however, the FSOC will rely on information available from the nonbank financial company's primary financial regulatory agency. As part of its submission to the FSOC, the nonbank financial company will be allowed to submit written materials contesting the FSOC's consideration of the nonbank financial company for a proposed determination.

With respect to its consideration of resolvability, the FSOC will assess the complexity of the nonbank financial company's legal, funding, and operational structure, as well as any impediments to its orderly and timely resolution. Additionally, the FSOC will focus on legal entity and cross-border operations issues in evaluating resolvability, including:

- the ability to separate functions and spin off services or business lines;
- the likelihood of preserving franchise value in a recovery or resolution scenario;
- the ability to maintain continuity of critical services within the existing or in a new legal entity or structure;
- the degree of the nonbank financial company's intra-group dependency for liquidity and funding;
- the need for payment operations and risk management; and
- the size and nature of the nonbank financial company's intra-group transactions.

NOTIFICATION AND PROCEDURAL RIGHTS

After completing the Determination Process, the FSOC will confer and vote on whether to make a Proposed Determination with respect to a certain nonbank financial company. If the FSOC decides to issue a Proposed Determination, then the FSOC will issue a written notice to the respective nonbank financial company, outlining the basis of the Proposed Determination. At this point, the nonbank financial company will be permitted to request an evidentiary hearing before the FSOC to contest the Proposed Determination. After such hearing, (if one is requested), the FSOC will determine by a vote of two-thirds of the voting members of the FSOC (including the affirmative vote of the treasury secretary) whether to subject a particular nonbank financial company to supervision by the Fed and to the enhanced prudential standards established under Section 165 of the Dodd-Frank Act and beyond (a "Final Determination"). Once again, the FSOC will provide the affected nonbank financial company with written notice of the FSOC's Final Determination, which will explain the rationale underlying the FSOC's decision. After the Final Determination is issued by the FSOC, the affected nonbank financial company may seek judicial review by bringing an action in federal district court seeking an order requiring the determination to be rescinded.

ANTI-EVASION PROVISION

The Final Rule includes an "escape valve" provision, which authorizes the FSOC to require that financial activities of a company that do not meet the statutory definition of a nonbank financial company be subject to Fed oversight and prudential standards, if the FSOC determines that (i) "material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of, the financial activities conducted directly or indirectly by a company … would pose a threat to the financial stability of the U.S., based on consideration" of the ten statutory considerations described above, and (ii) "[t]he company is organized or operates in such a manner as to evade the application of Title I of the Dodd-Frank Act" or the Final Rule. This provision, as its name suggests, aims to prevent attempts to evade regulation through creative structuring.

CONFIDENTIALITY

Addressing a concern raised by many commentators, the Final Rule requires that any "data, information, and reports," submitted in connection with the Determination Process, remain confidential. In addition, the submission of any non-publicly available data or information in connection with the Determination Process will not constitute a waiver of any privilege arising under federal or state law. However, the Final Rule goes on to provide that any information submitted remains subject to the provisions of the Freedom of Information Act ("FOIA"), including any exceptions thereunder. What is more, the FSOC released its FOIA Rule concurrent with the Final Rule to ensure data or information received pursuant to the nonbank SIFI process will benefit from such protections. Whether information will remain confidential, however, remains to be seen. The FSOC's determinations as to the application of FOIA in particular instances could be overturned by the federal courts, which retain the authority to construe the statute.

EMERGENCY EXCEPTION

Notwithstanding the procedural requirements outlined above, the FSOC may waive or modify any of the notice and procedural requirements with respect to a nonbank financial company if the FSOC determines that such waiver or modification is necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the U.S. The FSOC will provide written notice of the waiver or modification no later than 24 hours after the waiver or modification is granted. If a waiver or modification of the procedural requirements of the Final Rule is granted with respect to a nonbank financial company, such company will be afforded the right to an evidentiary hearing contesting the waiver or modification.

ANNUAL REEVALUATION AND RESCISSION OF DETERMINATIONS

"Not less frequently than annually," the FSOC is required under Section 113(d)(1) to reevaluate each currently effective determination and rescind

any such determination if the FSOC determines that the particular nonbank SIFI no longer meets the requirements outlined in the Final Rule. Prior to its annual reevaluation, the FSOC will notify each nonbank financial company that is subject to a currently effective determination and the company will have the opportunity to submit written materials contesting its determination. Reevaluations will focus on material changes to the nonbank financial company or the markets in which it operates since its previous review. Rescinding a determination requires an affirmative vote of two-thirds of the FSOC, including the treasury secretary. Upon rescission of a determination, the FSOC will notify the company and publicly announce the rescission.

IMPORTANT CHANGES

Although the Final Rule is substantially similar to the Proposed Rule, several differences, as well as responses to comments are worth highlighting:

- Within the six category framework, “outstanding loans borrowed and bonds issued” was changed to “total debt outstanding.” That threshold is defined broadly to include loans, bonds, repurchase agreements, commercial paper, securities lending arrangement, surplus notes, and other forms of indebtedness. The definition will also be used in calculating the short-term debt ratio threshold.
- The FSOC clarified that it intends to use U.S. GAAP when available, and look to statutory accounting principles, international financial reporting standards, or other such data in the absence of GAAP-based financials.
- Prior to conducting its reevaluation and rescission process, the FSOC will notify companies subject to currently effective determinations and allow them to contest the determinations in writing.
- The Final Rule clarified that there will be no broad, industry-wide “exemptions from potential determinations under Section 113 of the Dodd-Frank Act,” meaning that hedge funds, private equity firms, asset managers, and insurance companies could be designated.
- Furthermore, while hedge fund commentators had requested clarification as to whether separate funds would be considered separately for pur-

poses of total consolidated assets, the Final Rule remains unclear — the Guidance states that the FSOC "may consider the aggregate risks posed by separate funds that are managed by the same adviser, particularly if the funds' investments are identical or highly similar." Similarly, where asset managers asked for clarification as to how assets under management would be considered, the Final Rule merely states that the FSOC's "analysis will appropriately reflect the distinct nature of assets under management compared to the asset manager's own assets."

- The Final Rule noted that there is little data available for financial guarantors, asset management companies, private equity firms, and hedge funds. As a result, and in light of the new Form PF filing requiring financial disclosures, the FSOC will later "consider whether to establish an additional set of metrics or thresholds tailored to evaluate hedge funds and private equity firms and their advisers." Likewise, the FSOC "may develop additional guidance regarding possible metrics and thresholds relevant to determinations regarding asset managers[.]"
- For purposes of evaluating Stage 1 thresholds, the FSOC will consider global assets, liabilities, and operations for U.S. nonbank financial companies, but only U.S. assets, liabilities, and operations for foreign nonbank financial companies.
- The FSOC rejected the requests of several commentators to provide notice to a company if it progresses to Stage 2 or does not progress to Stage 3. Similarly, the FSOC rejected the suggestion that it explain the reasons why a company will be subjected to Stage 3 review.
- The FSOC will not publish or otherwise publicly identify those nonbank financial companies under evaluation.

CONCLUSION

The FSOC's recent issuance of the Final Rule interpreting Section 113 represents a critical milestone in the implementation of the Dodd-Frank Act. As some commentators have noted, the Final Rule's increased emphasis on risk-related metrics is an indicator that regulators understand the dangers of labeling some institutions as nonbank SIFIs while other companies with

similar risk profiles remain unregulated and unsupervised. Nevertheless, with the recent issuance of the Final Rule, regulators can now do something they never have had the luxury of doing: choosing which large financial institutions they will regulate and supervise.

NOTES

[1] Auth. to Require Supervision & Reg. of Certain Nonbank Fin. Companies, (Fin. Stability Oversight Council final Apr. 3, 2012) (to be codified at 12 C.F.R. pt. 1310) *available at* http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designations%20-%20Final%20Rule%20and%20Guidance.pdf.

[2] *Id*. at 76 (Appendix).

[3] *See* 12 U.S.C §§ 5365(a)(1), (b)(1), (c)(1), (d)(1), (e)(1), (f)(1).

[4] Auth. to Require Supervision & Reg. of Certain Nonbank Fin. Companies, 76 Fed. Reg. 64,264 (Fin. Stability Oversight Council proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310). The FSOC previously issued an advanced notice of proposed rulemaking, *see* 75 Fed. Reg. 61,653 (Oct. 6, 2010) and a notice of proposed rulemaking, *see* 76 Fed. Reg. 4,555 (Jan. 26, 2011).

[5] Unincorporated associations are not included within that definition.

[6] Definition of "Predominately Engaged in Fin. Activities" (Fed. Res. Bd. supplemental notice Apr. 2, 2012), http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120402a1.pdf*; see also*, Definitions of "Predominantly Engaged in Fin. Activities" and "Significant" Nonbank Financial Company and Bank Holding Company, 76 Fed. Reg. 29, 7,731 (proposed Feb. 11, 2011) (to be codified at 12 C.F.R. pt. 225).

[7] As final rules regarding reporting of data on swaps and security-based swaps come into effect, the FSOC may revisit the derivatives liability threshold to include a company's current and potential future exposures created by its outstanding derivatives.