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Dodd-Frank: FSOC Deals the Remaining Cards, But Still Does Not Reveal its Hand

On April 3, 2012 the Financial Stability Oversight Council issued its final rule and interpretive guidance governing its process for designating a nonbank financial company as a systemically important financial institution under the Dodd-Frank Act. The adoption of the Final Rule marks the completion of the highly anticipated standards for designating SIFIs, a process that first began in October 2010. While there have been changes made to the process, much remains to be understood how the FSOC will use its authority to determine whether a nonbank financial company should be supervised and subject to prudential standards. It is widely anticipated that designations of some SIFIs will be made before year-end, making us wonder whether the designation process has been underway without final rules being in place.

The Statute

Section 113 of the Dodd-Frank Act[1] authorizes the Financial Stability Oversight Council ("FSOC") to designate a nonbank financial company to be supervised by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and be subject to prudential standards[2]. The FSOC will make a designation after determining that material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to the financial stability of the United States.

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). In this note we refer to a nonbank financial company that is subject to such a determination as a "SIFI" or a "company." We also refer to the process by which a company is designated as a SIFI either as a "determination" or a "designation." All section references in this note are to the Dodd-Frank Act.

[2] Section 115 subjects SIFIs to enhanced supervision and prudential standards. Section 165(b) mandates the Federal Reserve to establish prudential standards for companies that have been designated as possibly posing a threat to US financial stability to include concentration limits and requirements relating to risk-based capital, leverage, risk management, resolution plans, and credit exposure reporting. The Federal Reserve also may adopt standards relating to contingent capital, enhanced public disclosures, and short-term debt limits.

A SIFI is defined as a domestic or foreign company that is "predominantly engaged in financial activities," other than bank holding companies and certain other types of firms.[3] A company is "predominantly engaged" in financial activities if either (i) the annual gross revenues derived by the company and its subsidiaries from financial activities, and from the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and its subsidiaries related to financial activities, and related to the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated assets of the company.

Federal Reserve Implementing Rule

The Federal Reserve proposed a rule a year ago establishing the criteria for determining whether a company is predominantly engaged in financial activities for purposes of Title I, and thus potentially a nonbank financial company. Commenters suggested that a company engaging in an activity that does not comply with conditions applicable to a bank holding company engaging in the same activity is not engaging in a financial activity for purposes of Title I and thus should not be designated as a SIFI. For example, a firm that organizes, sponsors, and manages an open-end investment company could avoid being engaged in a financial activity if it owns a percentage of the fund that exceeds the level permitted to a financial holding company. In reaction, the Federal Reserve recently amended the proposal to clarify that any activity referenced in section 4(k) of the Bank Holding Company Act of 1956 ("BHCA") will be considered to be a financial activity without regard to conditions imposed on bank holding companies that do not define the activity itself.[4]

FSOC Implementing Rules

The road to adopt implementing regulations has been deliberate. The FSOC issued an advance notice of proposed rulemaking on October 6, 2010, seeking comment on the factors that the Dodd-Frank Act requires to be considered in designating a company as a SIFI. On January 26, 2011, the FSOC issued a notice of proposed rulemaking ("Proposal") seeking comment regarding the specific criteria and analytic framework that it should apply in making designations. The FSOC on October 11, 2011 issued a re-proposal, including interpretive guidance ("Guidance") regarding the designation framework. On April 3, 2012, the FSOC issued a final rule ("Final Rule") and Guidance describing the manner in which it will apply the statutory standards and considerations, and the processes that it will follow in making determinations.[5]

[3] Section 115 also subjects bank holding companies of more than $50 billion in assets to enhanced supervision and prudential standards.

[4] "Definitions of 'Predominantly Engaged in Financial Activities' and 'Significant Nonbank Financialk Company and Bank Holding Company,'" 76 FR 7731 (Feb. 11, 2011), "Definition of Predominantly Engaged in Financial Activities," 77 FR 21494 (Apr. 10, 2012), and 77 FR 22,686 (Apr. 17, 2012) (technical correction).

[5] "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," 75 FR 61,653 (Oct. 6, 2010), 76 FR 4,555 (Jan. 26, 2011), 76 FR 64,264 (Oct. 18, 2011), and 77 FR 21,637 (Apr. 11, 2012). If you would like to read about the rulemaking, you may wish to see our client memoranda, "Greetings! We're from the Fed and We're Here to Supervise You," (March 30, 2011) http://www.shearman.com/files/Publication/90aae1b4- 4e2c-4cf7-b430-3f7112b244a6/Presentation/PublicationAttachment/6fec6c18-be2d-4451-9972-01f357922c6a/FIA-03302011- Nonbank_Financial_Companies_March_2011.pdf, and "The FSOC Re-Proposal of Rules for Designating SIFIs: Something Old and Something New," http://www.shearman.com/files/Publication/e6a5c8c6-19a5-4fc4-94d4-2c645429d944/Presentation/PublicationAttachment/35957b3e-995a-4de0-9fff-42f7b13b323f/FIA-102511-The-FSOC-Re-Proposal-of-Rules-for-Designating-SIFIs-Something-Old-and-Somet.pdf.

Framework for Making Determinations

The Dodd-Frank Act specifies 11 factors that the FSOC must consider when evaluating whether to make a determination in non-emergency situations. The FSOC translated the statutory considerations into six categories: (i) size, (ii) interconnectedness, (iii) substitutability, (iv) leverage, (v) liquidity risk and maturity mismatch, and (vi) existing regulatory scrutiny. The first three categories relate to the potential impact of a company's financial distress on the broader economy. The other three relate to the vulnerability of a company to financial distress.

Stage 1

The first stage ("Stage 1") of the process narrows the universe of financial companies by applying thresholds related to size, interconnectedness, leverage, and liquidity risk and maturity mismatch. A company will be subject to additional review if it meets both the size threshold and any one of the other thresholds. A company thus may predict whether it will be subject to additional review by the FSOC under Stage 1.

The Thresholds are—

- $50 billion in total consolidated assets;
- $30 billion in gross notional credit default swaps outstanding for which a company is the reference entity;
- $3.5 billion of derivative liabilities;
- $20 billion in total debt outstanding;
- 15 to 1 leverage ratio of total consolidated assets (excluding separate accounts) to total equity; and
- 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months to total consolidated assets (excluding separate accounts).

The FSOC selected the thresholds based on their applicability to a diverse set of companies and because the data underlying these thresholds are generally available. The FSOC sought to ensure that the thresholds would have captured companies that encountered material financial distress during the financial crisis of 2007–2008. The FSOC recognized that it may lack relevant data to assess all relevant companies using the thresholds and that the approach is imperfect in that the thresholds may not adequately measure risks posed by particular companies.

The FSOC declined to apply different thresholds depending on the industry in which the company operates because many companies engage in financial activities across multiple segments of the financial markets. The FSOC will apply the thresholds based on the global assets, liabilities, and operations of the company and its subsidiaries. However, for non-US companies, the FSOC will calculate the thresholds based solely on the US assets, liabilities and operations of the company and its subsidiaries.

FSOC acknowledged that financial guarantors, asset management companies, private equity firms, and hedge funds may pose risks that are not well-measured by the thresholds approach, but nonetheless elected to evaluate these entities under the Guidance. The FSOC may consider the aggregate risks posed by separate funds that are managed by the same adviser, particularly if the funds' investments are highly similar. The FSOC will consider the distinct nature of assets under management compared to the asset manager's own assets.

Stage 2

In the second stage ("Stage 2"), the FSOC will analyze the threat that each identified company could pose to US financial stability based on information available through existing public and regulatory sources, including information possessed by the company's primary financial regulatory agency or home country supervisor, and any information voluntarily submitted by the company. The evaluation will be based on industry- and company-specific factors, using the six-category framework.[6]

Stage 3

The FSOC next would identify the companies that merit further review in the third stage ("Stage 3"). Companies will receive notice that they are being considered for a proposed determination and an opportunity to submit materials within 30 days. The analysis will use information collected directly from the company, generally by the Office of Financial Research (the "OFR"), in addition to the information considered during Stages 1 and 2. The FSOC will rely on information available from the OFR or any member agency or primary financial regulatory agency that regulates a company before requiring the submission of reports from a company.[7]

The FSOC will consider qualitative factors that relate to the potential of the company to pose a threat to US financial stability, such as resolvability, opacity of operations, complexity, and the extent and nature of existing regulatory scrutiny. The FSOC may consult with the company's primary financial regulatory agency or home country supervisor for its views.

Post-Determination Hearing

The FSOC will provide the company a written explanation of the basis of any proposed determination that it makes regarding the company after the Stage 3 review. The company may request a hearing to contest the decision but there is no right to an oral hearing. Hearings on determinations will be nonpublic. A hearing may be before the FSOC or its representatives. The FSOC will reconsider its designations annually. In the event the FSOC determines to rescind a designation, it will notify the company and make a public announcement.

Observations

The Final Rule and Guidance prompt us to re-plow some of the same ground we covered at earlier stages of the rulemaking process. There have been few structural changes to the rule. While there are some changes, they are minor and reveal

[6] The Guidance describes three channels through which the negative effects of a company's material financial distress or activities may flow and thereby pose a threat to US financial stability: (i) exposure of creditors, counterparties, investors, or other market participants to a company; (ii) disruptions caused by the liquidation of a company; and (iii) the inability or unwillingness of a company to provide a critical function or service relied upon by market participants and for which there are no ready substitutes.

[7] The FSOC intends to maintain the confidentiality of information it receives during the determination process. The Freedom of Information Act ("FOIA") and the FSOC's FOIA rule will apply to data and information received by the FSOC. Companies' submissions will likely contain or consist of "trade secrets and commercial or financial information obtained from a person and privileged or confidential" and information that is "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions," that may be exempt from disclosure under exemptions 4 and 8 of the FOIA.

simple refinements. One can anticipate a reaction that the Final Rule and Guidance do not provide a sufficient degree of certainty and transparency and they may draw a judicial challenge.

Opposing Ideas

In answer to the question, "Is my company likely to be designated a SIFI and what can I do to prevent that from happening," as before, one can make only a rough prediction. Two opposing ideas continue to collide. On the one hand, it is difficult to devise metrics to serve as a proxy for excluding companies from designation in every instance. The FSOC reasonably wants to preserve its discretion to designate an "outlier" that poses risk to the system but that would not be captured by the six factors. On the other hand, companies seek certainty as to their potential status as SIFIs. Because these positions essentially are irreconcilable, observers are bound to react that the Final Rule still is too vague.

The FSOC used the final rule to maximize its flexibility in making determinations and refused to reduce its determination decision to a formula. It stressed that the evaluation of any company under the framework will be company-specific. The FSOC may subject any company to further review when warranted, irrespective of whether the company meets the thresholds, for any reason, including a lack of available data. Due to the diverse types of companies to be evaluated and the unique threats that these companies may pose to US financial stability, the analysis and timing of review will depend on the particular circumstances of each company under consideration and the nature of the threat it may pose to US financial stability. The FSOC has discretion as to the format of any hearing.

The thinking that there are "channels" through which a company most likely will transmit its financial distress to other firms and markets still is intriguing, but questions as to the effect of the channels on the determination process remain unanswered. Does the FSOC believe other channels could stoke contagion, but to a lesser extent? What are the attributes of the three identified channels and how do they relate to the determination process?

Need for Refinement

The process can be further refined. The Guidance largely repeats the original proposal's framework for incorporating the statutory considerations and is hardly probing. There are examples of metrics for evaluating a nonbank financial company, but because the list is not exclusive, applying the metrics to a particular company could lead to diverging conclusions whether a company warrants designation as a SIFI. Stage 1 presents a clear logic, but demonstrates weaknesses. The metrics are not new, and some, like size, are intuitive. What makes these metrics appropriate, to the exclusion of others? Identifying a safe harbor with greater precision might represent a loss of some discretion for the FSOC, but it would help deflect potential challenges that the proposal is too vague.

Stage 2 – A Mystery

The description of Stage 2 provides even less insight into the FSOC's thinking than the discussion of Stage 1. The scope and depth of Stage 2 analysis remain essentially a mystery. The relative absence of detail, when contrasted with the greater detail provided concerning Stages 1 and 3, is bound to lead to further criticism.

On the Bubble in Stage 3

In Stage 3, for a company "on the bubble," it will be necessary to consider how to respond to the FSOC's request for information. We continue to consider the analogy of a company receiving an invitation to submit a "Wells submission" when the SEC staff is considering an enforcement action. In both situations one would ask, "How cooperative should a company be in providing materials?"

Is Resistance Futile?

Another question is whether and under what circumstances a company should resist a designation? The FSOC made resistance very difficult. There is no requirement of notice to companies before the Stage 2 evaluation begins, or opportunity for companies to submit information at that stage. There is no indication that FSOC will provide an explanation of the basis for its evaluation of any company that is reviewed in Stage 2 but does not exceed the Stage 1 thresholds. FSOC will not explain the basis for any decision to proceed to stage 3, even though that would permit the company to present pertinent information in response. The FSOC will notify a company that has been evaluated in Stage 3 if the company, either before or after a proposed determination, ceases to be considered for determination. The FSOC may adjust its process for providing notifications to companies as it gains experience with the determination process.

The designation process cannot occur overnight. It is widely anticipated that there will be at least some determinations made before year-end, leading us to ask whether the process already is underway and, if so, is it performed in accordance with rules that only recently have become final? These questions may prompt a SIFI that is unhappy with its designation to consider making such a challenge.

Ongoing Process Issues

Commenters requested either that the Guidance be incorporated into the rule text, or that the FSOC commit to providing the public with notice and an opportunity to comment on any proposed changes to the Guidance, to ensure that the FSOC's actions would be made consistently and fairly and that the public would have notice of any changes to the Guidance. The FSOC responded, cryptically, by stating that in the future it may provide the public with notice and an opportunity to comment on those changes, as it determines appropriate.

Judicial Challenge?

At a more basic level, one wonders whether the Final Rule and Guidance may attract a judicial challenge. The FSOC refused to acknowledge that cost-benefit analysis would be required in making determinations. One commenter argued that Title I violates the US Constitution based on the limited judicial review of FSOC determinations and the scope of the delegation of Congressional authority for the regulation of companies under Title I. The FSOC simply disagreed and refused to address these issues in the Final Rule.

Federal Reserve Amendment

Finally, the Federal Reserve's amendment of the "predominantly engaged" proposal provides little more than comic relief. The original proposal would have used, in a fairly straightforward manner, the so-called "laundry list" of permissible BHCA financial activities that may be engaged in by financial holding companies ("FHCs"). However, some commenters noted that the list included restrictions on the conduct of several of the activities that must be complied with by FHCs, such as having no officer interlocks with companies in which they have made merchant banking investments, and that failing to comply with those limits would mean that assets and revenues associated with the activity would not be "financial." The object of categorizing activities as non-financial is that a company might avoid being predominantly engaged in financial activities and therefore not eligible to be designated a SIFI by the FSOC.

The Federal Reserve apparently considered this such a calamitous consequence that it issued the amendment to its original proposal to remove several conditions. The justification, or fig leaf depending on your point of view, is that many conditions were imposed for safety and soundness reasons and were not inherent in the nature of the activity itself. As a result, the revised proposal would sweep in a wider range of activity within the "financial" category. Effectively the Federal Reserve wants to avoid being hoisted on its own petard. How many companies would avoid being "predominantly engaged" under the original proposal is very difficult to tell, but it seems unlikely that the amendment plugs a significant loophole.

Conclusion

The FSOC deserves praise for revealing in greater detail the process it will follow in making designations, but the process still is indefinite and largely opaque. Nonbank companies engaged in financial activities still will have significant questions as to whether they may be subject to designation. Only as the process of making determinations proceeds will we gain a greater appreciation of the mechanics.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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