March 30, 2011

Greetings! We're from the Fed and We're Here to Supervise You

While banks and bank holding companies are extensively supervised in virtually all of their operations, important financial institutions can escape that regime by not controlling a bank with U.S. banking operations. New rules described here will provide for the identification of systemically important nonbank financial institutions and for determination of whether they should be subject to the Federal Reserve's supervisory system. Proposed regulations would require companies to develop information concerning their operations that would be used to make this determination, based on existing standards that are virtually unknown to nonbank companies. Those that are considered to be financial institutions and to be systemically important will become subject to significant constraints on their operations, with additional complications possible as non-U.S supervisors debate analogous requirements for globally significant financial institutions.

Nonbank companies should remain alert for the factors that will be used to determine whether they come within this magic circle, the requirements that will apply to them if they do, and the possibility to fight such a determination.

I. Background

2010: Identifying systemically important nonbank financial companies

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") establishes a system to designate nonbank financial companies to be subject to prudential supervision by the Board of Governors of the Federal Reserve System (the "Fed").[1] Many leading financial institutions avoided Fed supervision by not owning a U.S. bank, which many observers credit with a major role in causing the financial crisis. In order to close this regulatory gap, the Dodd-Frank Act authorizes a new committee, the Financial Stability Oversight Council ("FSOC"), to designate such certain large, interconnected financial firms for prudential supervision by the Fed upon a finding by the FSOC that the firm is (a) a "nonbank financial company" that is (b) "systemically important."[2] Under the Act, in order for a nonbank company to be considered financial—and consequently potentially subject to consolidated supervision by the Fed—it must be "predominantly engaged in financial activities."

2011: FSOC and the Fed propose rules to start the process

In January and February 2011, the FSOC and the Fed released proposed rules relating to the designation of certain nonbank financial companies as systemically important. The Fed's proposed rule would establish a test for determining whether a company is "predominantly engaged in financial activities."[3] The FSOC's proposed rule would set out the criteria, processes and procedures for designation of nonbank financial companies within the definition issued by the Fed as systemically important.[4]

When will FSOC determinations be made?

The FSOC has indicated that it will begin assessing the systemic importance of nonbank financial companies shortly after the adoption of a final rule, for which the FSOC has set a non-statutory provisional deadline of April 2011. At this time, it is unclear on what basis the FSOC would select companies to screen.

[1] Dodd-Frank Act (Dodd-Frank Wall Street Reform and Consumer Protection Act), Public Law No. 111-203, 124 Stat. 1376 (2010), at § 113.

[2] The FSOC is composed of the heads of the various financial regulators and is chaired by the Secretary of the Treasury. Dodd-Frank Act § 111.

[3] 76 Fed.Reg. 7731 (Feb. 11, 2011).

[4] 76 Fed.Reg. 4555 (Jan. 26, 2011).

II. The First Test: Are You a "Financial Company"?

A. The test set out by the Fed determines if a company is a "financial company"

A nonbank company would only come within the ambit of the FSOC's designation authority if it is "financial," which under the Act means that the company must be "predominantly engaged in financial activities." The task of defining this term is given to the Fed.[5] Thus, the FSOC may determine that a particular nonbank company should be supervised under Dodd-Frank only after it determines that the company qualifies under this test.

The Fed's proposed rule sets out a quantitative test based on gross revenues and consolidated assets to determine whether a nonbank company is "predominantly engaged in financial activities."

B. "Predominantly Engaged in Financial Activities"

1. "Financial activities" are defined with respect to existing Fed rules

Under the proposed rule, gross financial revenues and total financial assets would be those revenues derived from, or those assets related to, activities that are "financial in nature" or the ownership, control or activities of an insured depository institution.

The list of activities deemed "financial in nature" is extensive and has been developed by the Fed over many years through statute and rulemaking.[6] Activities that are financial in nature include:

- all forms of lending;
- all securities underwriting, market-making and brokerage;
- financial advice;
- private equity investing;
- sponsoring, organizing and managing mutual and private funds; and
- insurance agency and underwriting activities.

The proposed rule also expressly recognizes that additional activities may be determined to be "financial in nature" by the Fed.[7]

5 Dodd-Frank Act § 102(a)(6), (b).

6 Section 225.86 of Regulation Y, 12 C.F.R. § 225.86 (2010).

7 A company may request a determination from the Fed as to whether a particular activity is "financial in nature" for the purposes of systemic designation.

2. "Predominantly engaged" is determined in accordance with "the 85% test," or on a case-by-case basis at the determination of the Fed

The Fed's proposed rule establishes a test (the "85% Test") for determining whether a company is "predominantly engaged in financial activities." The proposed rule provides that a company is "predominantly engaged in financial activities" if:

- the consolidated annual gross financial revenues of the company in either of its two most recently completed fiscal years represent 85% or more of its consolidated annual gross revenues (as determined in accordance with applicable accounting standards) in that fiscal year; or
- the consolidated total financial assets of the company as of the end of either of its two most recently completed fiscal years represent 85% or more of the company's consolidated total assets (as determined in accordance with applicable accounting standards) as of the end of that fiscal year.[8]

The Fed has also reserved the right to designate a company as "predominantly engaged in financial activities" even if it does not meet the 85% Test. The Fed may do so on a case-by-case basis based on "the full range of information that may be available concerning the company's activities and assets...."[9]

The 85% Test appears to be based on an analogous statutory test adopted in 1999 to determine whether a company that would become subject to the BHC Act (and take advantage of liberalized activity restrictions) could continue to engage in activities impermissible under the BHC Act.[10] The Fed adapted the statutory test by regulation to allow bank holding companies to acquire companies engaged in impermissible activities so long as at least 85% of the target's assets and revenues during the previous two years were derived from permissible activities.[11] In its implementation, this test has posed significant problems, especially in bank holding company acquisitions, often because nonbank companies have not determined what proportion of their assets and revenues are derived from permissible and impermissible activities – because they had no reason to design their systems to capture this information. The current methods of determining percentages of permissible business in the transaction setting are not likely going to be satisfactory to the Fed or to the company for Dodd-Frank Act purposes. However, in many cases institutions are so heavily engaged in financial activities that precise calibrations will likely not be necessary.

8 The test provided above will cover a company's consolidated subsidiaries. The proposed rule offers two complex rules of construction to aid companies in the application of the 85% Test, which apply to minority, noncontrolling equity investments in unconsolidated entities.

9 76 Fed. Reg. at 7735.

10 Section 4(n)(1) and (2) of the BHC Act, 12 U.S.C. § 1843(n)(1) and (2), enacted pursuant to the Gramm-Leach-Bliley Act of 1999 for those bank holding companies that qualify as "financial holding companies" and thereby become eligible to engage in virtually all financial activities. The Gramm-Leach-Bliley standard applied only to revenues, not to assets. Compare the recently proposed standard by the Federal Deposit Insurance Corporation under Title II of the Dodd-Frank Act for the application of orderly liquidation authority of nonbank financial companies, which also refers only to revenues and not assets to determine that a company is financial for purposes of its special liquidation authority. See 76 Fed. Reg. 16324 (March 23, 2011).

11 Section 225.85(a)(3) of Regulation Y, 12 C.F.R. § 225.85(a)(3) (2010).

III. The Second Test: FSOC Designation

A. The FSOC test

There are two aspects to this part of the test. The FSOC has to determine as a substantive matter that a particular company is significant. The FSOC is also required to comply with procedural requirements in making this determination.

B. FSOC procedural requirements

The Act mandates that:

- Any designation be made pursuant to a vote of two-thirds of the FSOC's voting members (including the affirmative vote of its chairperson, the Secretary of the Treasury);
- Any company subject to a proposed determination be given notice and an opportunity for a hearing before a final determination is made; and
- Before making any final determination, the FSOC would be required to consult with the primary financial regulatory agency, if any, of a nonbank financial company and any subsidiary thereof being considered for Fed supervision.[12]

It appears that any preliminary determination by the FSOC would be announced publicly. Any company subject to such a preliminary designation might choose not to challenge the determination due to the attendant publicity and possible market repercussions. Also, a company can challenge a final determination by bringing an action in federal district court. The court may rescind the final determination of systemic importance only if it finds that the determination was arbitrary and capricious, traditionally a very high burden.

The proposed rule would require the FSOC to review at least annually each currently effective determination and rescind, upon a two-thirds vote including an affirmative vote by the chairperson, any determination if the FSOC finds that the company is no longer systemically important.[13]

[12] The company would also be provided an opportunity to submit written materials to the FSOC concerning its view of whether it is systemically important. If the FSOC proceeds with a determination that the financial institution is systemically significant, then it would be required to provide the company with written notice of the proposed determination, which would include an explanation of the basis of the proposed determination. At this juncture, the company would be able to request a written or oral hearing before the FSOC to contest the proposed determination. Within 60 days of any hearing, the FSOC would be required to make a final determination whether the company is systemically important and would be subject to prudential supervision by the Fed. If no hearing is requested, the FSOC must make its determination within 10 days of the hearing request period. Dodd-Frank Act § 113(a)(1), (e) and 76 Fed. Reg. at 4565-67.

[13] 76 Fed.Reg. at 4561, 4566. It is unclear whether the possibility of being found to have ceased being systemically significant is a realistic one.

C. The FSOC substantive criteria

The Act also sets out the criteria that are to be considered by the FSOC in making a determination that a nonbank financial company is systemically important. These criteria are:

- the extent of the company's leverage;
- the extent and nature of the company's off-balance sheet exposures;
- the extent and nature of the company's interconnectedness with other significant nonbank financial companies and significant bank holding companies;
- the importance of the company as source of credit for households, businesses and State and local governments and as a source of liquidity for the US financial system;
- the importance of the company as a source of credit for low-income, minority or underserved communities, and the impact that the failure of the company would have on the availability of credit in those communities;
- 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;
- the nature, scope, size, scale, concentration, interconnectedness and mix of the company's activities;
- the degree to which the company is already regulated by one or more primary financial regulatory agencies;
- the amount and nature of the company's financial assets;
- the amount and types of the company's liabilities, including the degree of its reliance on short-term funding; and
- any other risk-related factors the FSOC deems appropriate.[14]

The FSOC's proposed rules incorporate each of the statutory factors, and, more importantly, provide some guidance on how to apply these factors. The FSOC has proposed a framework organized around six categories, each incorporating one or more of the statutory factors:

- size;
- lack of substitutes for the company's financial services and products;
- interconnectedness with other financial firms;
- leverage;

[14] Dodd-Frank Act § 113(a)(2). There is no statutory minimum on, for example, the amount of assets that would be necessary in order to be found to be systemically important. All bank holding companies are deemed to be systemically important if they have assets of at least $50 billion. Dodd-Frank Act § 165(a)(1).

- liquidity risk and maturity mismatches; and
- existing regulatory scrutiny.[15]

In addition, the FSOC could consider any other risk-related factors it deems appropriate.[16]

The FSOC notes that it believes that its proposed framework is consistent with the international approach to identifying systemically important firms by the Basel Committee on Banking Supervision and the Financial Stability Board, and that this should reduce concerns about globally active financial institutions being subject to different regimes.[17]

D. FSOC review of non-U.S. companies

A substantially similar set of criteria and framework would be applied in the consideration of a non-U.S. nonbank financial company for designation for supervision by the Fed. In its determination whether to designate a non-U.S. nonbank financial company for prudential supervision by the Fed, the FSOC would focus on the U.S. assets and operations of the non-U.S. company and would also consider the extent to which the company is subject to consolidated prudential supervision in its home country and whether such supervision is administered by an authority comparable to the Fed.

IV. Opportunities and Challenges for Nonbank Companies

Fed supervision would entail costly requirements, including:

- capital requirements;
- leverage constraints;
- credit exposure reporting;
- concentration limits on aggregate exposure to any one counterparty;
- examinations;
- reporting requirements; and
- perhaps the adoption of a resolution plan or "living will" that would provide for the orderly unwinding of the company should it become insolvent.

15 76 Fed. Reg. at 4560-61.

16 For a compliant about the open-endedness of the FSOC standards, see the comment letter to the FSOC from the Investment Company Institute (Feb. 25, 2011).

17 76 Fed. Reg. at 4561.

All of this awaits future rulemaking to be done by January 2012. Oddly, the FSOC has not yet proposed regulations providing detail on the nature of these requirements; rather, it has proposed to adopt regulations first on how significant financial companies would be selected and adopt others later to determine what requirements to impose on them. Whatever the details, it seems clear that they would require the implementation of a major compliance and internal oversight regime by the nonbank financial company.

The proposed rules create certain challenges and leave unresolved certain issues for nonbank companies that will hopefully be clarified with the issuance of final rules. The analysis required to determine whether a company is "predominantly engaged in financial activities" requires an internal review of a company's activities and assets that has historically only been required of banking entities subject to the BHC Act. Under the proposed rule, certain nonbank companies may be required to (or may find it prudent to) monitor their activities and investments as if they were subject to the BHC Act. To be sure, there would be costs incident to this enhanced monitoring.

Compounding the problem is that determining whether a particular activity is financial in nature under the BHC Act is not always obvious or intuitive. In many cases, there are several technical requirements that must be met in order to make the determination. These requirements may not neatly fit in the context of an entity which is not subject to BHCA rules. Sources of possible confusion may include whether derivatives activities as well as investments by a company (e.g., certain investments in funds) will be deemed to be "financial" assets under the Fed's rule.

Finally, despite the FSOC's belief that its proposal is consistent with analogous rules being considered on a global scale, the extent to which the U.S. rules conform to international ones bears close watching. The constraints of the language of Dodd-Frank, the U.S. financial regulators' ingrained approaches to supervision, and the U.S. political process make some suspicion about consistency of the final product appropriate.

V. Conclusion

The FSOC's authority under the Dodd-Frank Act to designate certain nonbank financial companies as systemically important and subject to prudential supervision by the Fed is of vital importance to a host of companies, such as funds and commercial companies with financial arms. The FSOC's and the Fed's proposed rules, while creating certain ambiguities, provide guidance on how the designation process is likely to work and on what basis a nonbank company would be deemed "financial."

The costs of such a designation would be great to a company deemed systemically important, and while the proposed rules provide certain avenues to avoid or contest a systemic designation, it will be of utmost importance to monitor the development of the proposed rules into final rules so that nonbank companies can properly assess the risks and parameters of the FSOC's designation authority.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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:

Barnabas W.B. Reynolds
London
+44 20 7655 5528
barney.reynolds@shearman.com

Bradley K. Sabel
New York
+1 212 848 8410
bsabel@shearman.com

Russell D. Sacks
New York
+1 212 848 7585
rsacks@shearman.com

Azam H. Aziz
New York
+1 212 848 8154
aaziz@shearman.com

Laura S. Friedrich
New York
+1 212 848 7411
laura.friedrich@shearman.com

Geoffrey B. Goldman
New York
+1 212 848 4867
geoffrey.goldman@shearman.com

Nathan J. Greene
New York
+1 212 848 4668
ngreene@shearman.com

Donna M. Parisi
New York
+1 212 848 7367
dparisi@shearman.com

Paul S. Schreiber
New York
+1 212 848 8920
pschreiber@shearman.com

Donald N. Lamson
Washington, D.C.
+1 202 508 8130
donald.lamson@shearman.com

Gregg Rozansky
New York
+1 212 848 4055
gregg.rozansky@shearman.com

Azad Ali
London
+44 20 7655 5659
azad.ali@shearman.com

Aatif Ahmad
London
+44 20 7655 5120
aatif.ahmad@shearman.com

Shriram Bhashyam
New York
+1 212 848 7110
shriram.bhashyam@shearman.com