

### **FSOC Proposes Rules for Board of Governors of the Federal Reserve's Supervision of Nonbank Financial Companies**

**October 20, 2011**

On October 11, the Financial Stability Oversight Council (the Council) released a second notice of proposed rulemaking and proposed interpretive guidance for determining whether a nonbank financial company would be subject to the Board of Governors of the Federal Reserve System's (the Board of Governors') enhanced supervision and regulation.<sup>1</sup> Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) defines a nonbank financial company (subject to certain exclusions) as a domestic or foreign company that is "predominantly engaged in financial activities." As a result, the FSOC may determine that certain broker-dealers, investment companies, asset managers, hedge funds, and other entities are subject to enhanced supervision and regulatory standards established by the Board of Governors.

The Council was established by Section 111 of the Dodd-Frank Act in order to, among other things, "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace." Section 113 of the Dodd-Frank Act authorizes the Council to determine that a nonbank financial company would be supervised by the Board of Governors and be subject to prudential standards in accordance with Title I of the Dodd-Frank Act if the nonbank financial company meets either of two standards.

Under the first standard, the Council may subject a nonbank financial company to enhanced supervision and regulation by the Board of Governors if the Council determines that "material financial distress" at the nonbank financial company could pose a threat to U.S. financial stability. Under the second standard, a nonbank financial company may be subject to supervision by the Board of Governors if the nature, scope, size, scale, concentration, interconnectedness, or mix of the nonbank financial company's activities could pose a threat to U.S. financial stability. In this second proposed rulemaking, the Council reveals a three-stage review process that it proposes to use to determine whether a company meets either of the two standards and therefore would be subject to enhanced supervision and regulation by the Board of Governors. The three-stage review process, however, would not be used in emergency situations that threaten U.S. financial stability.<sup>2</sup>

---

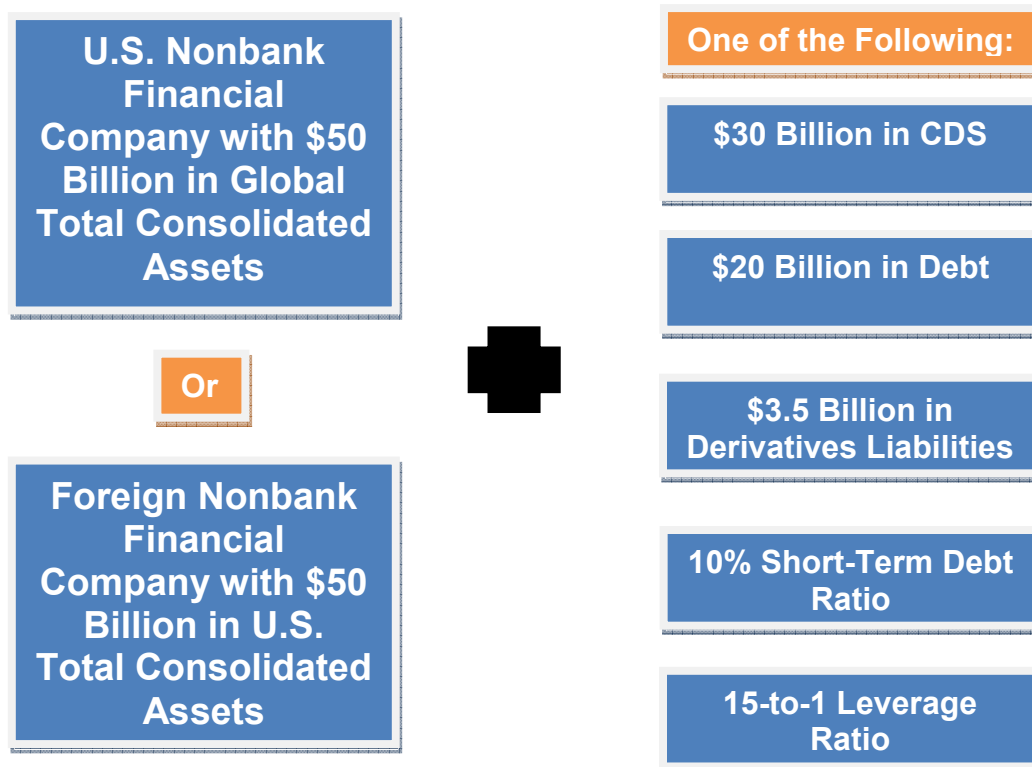
1. 12 C.F.R. § 1310 (2011) (available at <http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf>).

2. The Council reserves the right to waive or modify any of the notice or other procedural requirements of the Proposed Rule if the Council determines it is "necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States, pursuant to section 113(f) of the Dodd-Frank Act." 12 C.F.R. § 1310.22(a)(1) (2011).

## Stage 1

In Stage 1, the Council performs a quantitative analysis to identify nonbank financial companies that are subject to further evaluation. To meet the Council’s threshold, a U.S. nonbank financial company must have at least \$50 billion in global total consolidated assets and meet one of the specified additional quantitative thresholds. A foreign nonbank financial company must have at least \$50 billion in U.S. total consolidated assets and meet one of the additional quantitative thresholds. The additional quantitative thresholds are (1) \$30 billion in credit default swaps (CDSs) for which the firm is the reference entity, (2) \$20 billion in debt, (3) \$3.5 billion in derivatives liabilities, (4) a 10% short-term debt ratio, and (5) a 15-to-1 leverage ratio. During Stage 1, the Council will gather information regarding nonbank financial companies solely through existing public and regulatory sources.

While the Council will apply the Stage 1 thresholds to hedge funds and private equity firms and their advisers, the Council recognizes that there is less data publicly available for these types of entities. The Council anticipates that in 2012 advisers to hedge funds and private equity firms as well as commodity pool operators and commodity trading advisers will be required to file proposed Form PF with the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC).<sup>3</sup> Using data collected on proposed Form PF, as well as other data, the Council will consider whether it is necessary to establish additional thresholds in Stage 1 that would be tailored specifically to hedge funds and private equity firms and their advisers.



3. Form PF would require hedge fund advisers and other private fund advisers to report certain information on the private funds they advise to the SEC and/or the CFTC. See section II.C of "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisers on Form PF," Investment Advisers Act Release No. 3145 (Jan. 26, 2011), 76 Fed. Reg. 8068 (Feb. 11, 2011).

## Stage 2

Once a nonbank financial company has met the threshold requirements in Stage 1, the Council will conduct a more in-depth analysis of the company in Stage 2. In Stage 2, the Council will perform a qualitative analysis using industry-specific measures to determine whether a nonbank financial company's potential financial distress could pose a threat to U.S. financial stability. The Council will consider six factors when making this determination: (1) size, (2) substitutability, (3) interconnectedness, (4) leverage, (5) liquidity risk and maturity mismatch, and (6) existing regulatory scrutiny. These six factors are guided by 10 statutory considerations in sections 113(a)(2) and (b)(2) of the Dodd-Frank Act.<sup>4</sup>

The six factors can be divided into two categories. The first category, factors that seek to assess the potential impact of a nonbank financial company's financial distress on the broader economy, includes size, substitutability, and interconnectedness. Size refers to the amount of financial services or financial intermediation that a nonbank financial company provides. Substitutability refers to the extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity. Interconnectedness refers to the direct or indirect linkages between nonbank financial companies.

The second category, factors that seek to assess the vulnerability of a nonbank financial company to financial distress, includes leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. Leverage refers to a nonbank financial company's exposure or risk in relation to its equity capital. Liquidity risk is the risk that a nonbank financial company may not have sufficient funding to satisfy its short-term needs. Maturity mismatch is the difference between the maturities of a nonbank financial company's assets and that of its liabilities. Existing regulatory scrutiny is the extent to which a nonbank financial company is already subject to regulation.

---

4. Sections 113(a)(2) and (b)(2) of the Dodd-Frank Act provide the 10 statutory considerations: (1) The extent of the leverage of the company; (2) the extent and nature of the off-balance-sheet exposures of the company; (3) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (4) 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 United States financial system; (5) 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; (6) 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; (7) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (8) the degree to which the company is already regulated by one or more primary financial regulatory agencies; (9) the amount and nature of the financial assets of the company; and (10) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding. Additionally, the Council may consider any other risk-related factors that the Council deems appropriate.

**Factors that seek to assess the potential impact of a nonbank financial company's financial distress on the broader economy**

**Size**

**Substitutability**

**Interconnectedness**

**Factors that seek to assess the vulnerability of a nonbank financial company to financial distress**

**Leverage**

**Liquidity Risk and Maturity Mismatch**

**Existing Regulatory Scrutiny**

### **Stage 3**

If during its Stage 2 review the Council determines that a nonbank financial company requires additional review, the Council will perform a comprehensive review of the company in Stage 3 to determine whether the Council should make a Proposed Determination. A Proposed Determination is the Council's initial determination that a nonbank financial company will be subject to enhanced supervision and regulation by the Board of Governors.<sup>5</sup> Before a Proposed Determination is made, the Council will provide the nonbank financial company written notice that the Council is considering whether to make a Proposed Determination (a Notice of Consideration). The Notice of Consideration likely will include a request that the nonbank financial company submit to the Council additional information relevant to the review and will give the nonbank financial company the opportunity to contest the Proposed Determination. After the

---

<sup>5</sup> Enhanced supervision and regulatory standards are established by the Board of Governors under section 165 of the Dodd-Frank Act (12 U.S.C. § 5365).

nonbank financial company receives the Notice of Consideration, it will be subject to an in-depth evaluation, including (1) an evaluation of any information collected directly from the nonbank financial company, (2) an evaluation of the information considered in Stages 1 and 2, and (3) an evaluation of the nonbank financial company's resolvability.<sup>6</sup>

Next, the Council will consider whether to make a Proposed Determination. A Proposed Determination requires a vote of two-thirds of the Council's members, including an affirmative vote by the Council Chairperson. After the vote, the Council will issue a written notice, including an explanation of the basis of the Proposed Determination, to the nonbank financial company. If a Proposed Determination is made, the nonbank financial company may request a hearing to contest the Proposed Determination no later than 30 days after the receipt of the Proposed Determination.



After a hearing is conducted (if one has been requested), the Council will make a Final Determination by a two-thirds vote, including the affirmative vote of the Council Chairperson, regarding whether the nonbank financial company will be subject to enhanced supervision and regulation by the Board of Governors. A nonbank financial company that is subject to a Final Determination may bring an action to rescind the Final Determination in U.S. District Court.

If the Council makes a Final Determination that a nonbank financial company is subject to enhanced supervision and regulation by the Board of Governors, the Council must reevaluate that determination annually. If a nonbank financial company no longer meets the thresholds and standards detailed above, the Council will vote to rescind the determination. Two-thirds of the Council, including the Chairperson of the Council, must vote to rescind the determination.

The Council requests that comments on its Proposed Rule be submitted by December 19, 2011.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

#### **New York**

Jennifer L. Klass

212.223.7105

[jklass@morganlewis.com](mailto:jklass@morganlewis.com)

Andrew J. Donohue

212.223.6160

[adonohue@morganlewis.com](mailto:adonohue@morganlewis.com)

---

6. The evaluation of a nonbank financial company's resolvability is an "assessment of the complexity of the nonbank financial company's legal, funding, and operational structure." The evaluation also includes identifying "any obstacles to the rapid and orderly resolution of a nonbank financial company in a manner that would mitigate the risk that the nonbank financial company's failure would have a material adverse effect on financial stability." 12 C.F.R. § 1310 (*available at* <http://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designation%20NPR%20-%20Final%20with%20web%20disclaimer.pdf>).

**About Morgan, Lewis & Bockius LLP**

With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at [www.morganlewis.com](http://www.morganlewis.com).

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

**© 2011 Morgan, Lewis & Bockius LLP. All Rights Reserved.**

