

## E-ALERT | Financial Institutions

January 20, 2011

### FINANCIAL STABILITY OVERSIGHT COUNCIL RELEASES NOTICE OF PROPOSED RULEMAKING ON AUTHORITY TO DESIGNATE NONBANK FINANCIAL COMPANIES FOR FEDERAL RESERVE PRUDENTIAL SUPERVISION

On January 18, 2011, the Financial Stability Oversight Council (FSOC) released a notice of proposed rulemaking (“NPR”) implementing the Council’s authority, pursuant to section 113 of Dodd-Frank,<sup>1</sup> to designate nonbank financial companies for enhanced prudential supervision by the Federal Reserve – that is, for new systemic risk regulation by the Federal Reserve.

The FSOC’s NPR follows closely the statutory provisions in Dodd-Frank regarding the FSOC’s designation authority. At the end of the day, the NPR sheds remarkably little new light on what nonbank financial companies are likely to be designated for enhanced prudential regulation by the Federal Reserve.

The following outline summarizes the key provisions of the NPR.

#### COMPANIES SUBJECT TO FSOC DESIGNATION

- The FSOC may designate any “U.S. nonbank financial company” or “foreign nonbank financial company” for enhanced prudential supervision by the Federal Reserve if the Council determines that material financial distress at the company, or the company’s nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to U.S. financial stability.
  - A “U.S. nonbank financial company” is any company (other than a bank holding company and certain other financial institutions enumerated in the NPR) that is (1) incorporated or organized under the laws of the United States or any state and (2) “predominantly engaged in financial activities”<sup>2</sup> as defined by Federal Reserve regulation.
  - A “foreign nonbank financial company” is any company (other than a company that is, or is treated in the United States as, a bank holding company) that is (1) incorporated or organized in a country other than the United States and (2) predominantly engaged in financial activities as defined by Federal Reserve regulation, including through a branch in the United States.
  - The NPR does not address the safe harbor provision in section 170 of Dodd-Frank, in which the Federal Reserve is required to promulgate regulations setting forth the criteria for exempting certain types or classes of U.S. nonbank financial companies and foreign nonbank

---

<sup>1</sup> For additional information on section 113 of Dodd-Frank, please refer to our previous client alert, [Systemic Risk Regulation and Orderly Liquidation of Systemically Important Firms](#) (July 21, 2010).

<sup>2</sup> Dodd-Frank requires the Federal Reserve to promulgate separate regulations for determining whether a company is “predominantly engaged in financial activities.” The Federal Reserve has not yet released proposed or final regulations regarding this definition.

financial companies from FSOC designation. (Those safe harbor regulations are not required to be promulgated by the Federal Reserve until 18 months after enactment of Dodd-Frank.)

- **Anti-Evasion Provision.** The FSOC may require that the financial activities of a company be subject to prudential standards by the Federal Reserve if the FSOC determines that (1) material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of, the financial activities could pose a threat to U.S. financial stability and (2) the company is organized or operates in such a manner as to evade FSOC designation. A company subject to such a determination may establish, or may be required by the Federal Reserve to establish, an intermediate holding company, consistent with Federal Reserve regulations, orders, and guidance, to conduct the financial activities subject to Federal Reserve prudential supervision. Such an intermediate holding company will be treated as a nonbank financial company subject to enhanced prudential supervision by the Federal Reserve.

## CONSIDERATIONS FOR DESIGNATION

- In designating a company for enhanced prudential supervision, the FSOC must consider (1) the leverage of the company;<sup>3</sup> (2) the off-balance sheet exposures of the company; (3) the company's transactions and relationships 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 U.S. 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 the 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; (10) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (11) any other risk-related factors that the FSOC deems appropriate, either by regulation or on a case-by-case basis.
- The preamble to the NPR suggests that the FSOC will organize its evaluation of a nonbank financial company into six categories: (1) size, (2) lack of substitutes for the financial services and products provided by the company, (3) interconnectedness with other financial firms, (4) leverage, (5) liquidity risk and maturity mismatch, and (6) existing regulatory scrutiny. The first three categories are intended to assess the potential for a company's financial distress to "spillover" to the broader financial system or economy, and the last three categories are intended to assess how vulnerable a company is to financial distress.

## DESIGNATION PROCESS

- **Data Collection.** The NPR includes authority for the FSOC to collect data and information regarding any nonbank financial company either from the company itself, or from any federal or state financial regulatory agency, in order to assess whether a nonbank financial company poses a threat to U.S. financial stability.
- **Initial Notice.** After identifying a nonbank financial company for possible designation, the FSOC will provide the company with a written notice that the FSOC is considering whether to make a "proposed determination" that the company be subject to enhanced prudential supervision by the Federal Reserve. The company will have an opportunity to submit written materials in response.

---

<sup>3</sup> All references in this section to "company" include the company's subsidiaries.

- **Notice of Proposed Determination.** If the FSOC decides to approve (by two-thirds vote of the voting members of the FSOC, including the Chairperson of the FSOC) a “proposed determination” that a nonbank financial company be subject to enhanced prudential supervision by the Federal Reserve, the FSOC will send to the company a written notice of the proposed determination including an explanation of the basis for designating the company.
- **Hearings.** A company may, within 30 days of receipt of the proposed determination notice, request in writing an opportunity for a written or oral hearing before the FSOC to contest the proposed determination. The FSOC is required to hold a hearing in response to a timely request from the company.
- **Notice of Final Determination.** If a company requests a hearing, within 60 days of the hearing the FSOC must make a final determination (by two-thirds vote of the voting members of the FSOC, including the Chairperson of the FSOC) regarding whether the company should be subject to enhanced prudential supervision by the Federal Reserve. If there is no hearing, the FSOC must make a final determination within 10 days after the date by which the company could have requested a hearing.
- **Judicial Review.** If the FSOC makes a final determination subjecting a nonbank financial company to enhanced prudential supervision by the Federal Reserve, the company may, within 30 days after receipt of the final determination, bring an action in the U.S. district court for the district in which the company’s home office is located or in the U.S. District Court for the District of Columbia, for an order requiring that the final determination be rescinded. The court’s review of the final determination is limited to whether the FSOC’s final determination was arbitrary and capricious.
- **Emergency Exception.** The NPR includes an emergency exception that allows the FSOC to modify or to waive entirely the designation procedures if necessary or appropriate to prevent or mitigate threats posed by a nonbank financial company to U.S. financial stability.
- **Periodic Reevaluation of Designations.** The FSOC is required to reevaluate, at least annually, each of its final designations and rescind any designations that no longer meet the governing standards.

---

If you have any questions concerning the FSOC’s NPR, please contact any of the following members of our financial institutions practice group:

<b>Stuart Stock</b>	202.662.5384	<a href="mailto:sstock@cov.com">sstock@cov.com</a>
<b>John Dugan</b>	202.662.5051	<a href="mailto:jdugan@cov.com">jdugan@cov.com</a>
<b>Keith Noreika</b>	202.662.5497	<a href="mailto:knoreika@cov.com">knoreika@cov.com</a>
<b>Michael Nonaka</b>	202.662.5727	<a href="mailto:mnonaka@cov.com">mnonaka@cov.com</a>

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to [unsubscribe@cov.com](mailto:unsubscribe@cov.com) if you do not wish to receive future emails or electronic alerts.

© 2011 Covington & Burling LLP, 1201 Pennsylvania Avenue, NW, Washington, DC 20004-2401. All rights reserved.