

**FEDERAL RESERVE BOARD PROPOSES RULE ON KEY DEFINITIONS COVERING
REGULATION OF NONBANK FINANCIAL COMPANIES**

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) was enacted. Section 113 of the comprehensive legislation granted the newly created Financial Stability Oversight Council (“FSOC”) the authority to designate certain U.S. and foreign nonbank financial companies to be regulated and supervised by the Board of Governors of the Federal Reserve System (the “Federal Reserve”).¹ On February 8, 2011, as required by the Dodd-Frank Act, the Federal Reserve issued a notice of proposed rulemaking (the “Release”) to establish a test to determine if nonbank companies are “predominantly engaged in financial activities,” and to define “significant nonbank financial companies” and “significant bank holding companies.” The following is a brief overview of the proposed regulation.

Under Section 113 of the Dodd-Frank Act, FSOC must first assess whether a nonbank company is “predominantly engaged in financial activities” when determining whether that nonbank company should be subject to Federal Reserve supervision. If the nonbank company is deemed to be “predominantly engaged in financial activities,” FSOC must then apply a number of statutory factors to determine whether the company could pose a threat to the financial stability of the United States, including the company’s size and leverage and the extent and nature of the company’s transactions and relationships with other “significant nonbank financial companies” and “significant bank holding companies.” The number of companies meeting the criteria proposed by the definitions in the Release is likely to be greater than under the Dodd-Frank Act’s statutory requirements, potentially increasing the number of nonbank transactions and business relationships subject to FSOC’s scrutiny.

The Federal Reserve proposed that a company is “predominantly engaged in financial activities” if (1) the consolidated annual gross financial revenues of the company in either of its two most recently completed fiscal years represent 85 percent or more of the company’s consolidated annual gross revenues in that fiscal year or (2) the consolidated total financial assets of the company as of the end of either of its two most recently completed fiscal years represent 85 percent or more of the company’s consolidated total assets as of the end of that fiscal year.² The key distinction between the Federal Reserve’s proposed definition and the Dodd-Frank Act’s statutory language is that the Federal Reserve’s definition, if adopted, would specify that a

¹ Section 113 of the Dodd-Frank Act.

² For both tests, companies must determine whether the 85 percent threshold is met based on applicable accounting standards. This includes U.S. generally accepted accounting principles (GAAP), international financial reporting standards (IFRS), or such other standards that the Federal Reserve deems appropriate, so long as the company uses the same accounting standards in the ordinary course of business preparing its consolidated financial statements.

company could meet the 85 percent gross financial revenues or financial assets thresholds can be met in either of its two most recent fiscal years. The Dodd-Frank Act's definition of the term does not specify the time period over which gross revenues or assets should be considered. Under the Federal Reserve's proposed definition, a company that experiences a short-term decline in financial revenues or assets, so that it meets the 85 percent revenues or assets threshold at any one fiscal year-end over the past two fiscal years, may be deemed to be a nonbank financial company. As a result, the two-year test likely subjects a greater number of nonbank companies to the potential of Federal Reserve supervision.

To determine which assets and revenues count toward the 85 percent tests, nonbank companies must look to 12 C.F.R. § 225.86 of the Federal Reserve's Regulation Y for a list of all of the activities which the Federal Reserve has determined to be financial in nature under section 4(k) of the Bank Holding Company Act of 1956 ("BHCA"), as amended by the Gramm-Leach-Bliley Act of 1999.³ If the nonbank company engages in any of the activities included in 12 C.F.R. § 225.86, the company must include all assets or revenues attributable to that activity as financial revenues and assets for purposes of the 85 percent tests. This standard is broadly defined to include any activity that the Federal Reserve has determined to be "financial in nature" under section 4(k) of the BHCA, even if a bank holding company or foreign banking organization could conduct the activity under a legal authority other than section 4(k) of the BHCA. Section 113(c) of the Dodd-Frank Act includes an anti-evasion provision which gives FSOC the authority to subject any nonbank company to Federal Reserve regulation if that company is found to engage in activities that are financial in nature but conducts those activities in a manner to avoid crossing the 85 percent thresholds.

The Release also includes proposed definitions for "significant nonbank financial company" and "significant bank holding company," which are terms to be used by FSOC when evaluating the extent and nature of a nonbank financial company's transactions and relationships. The Dodd-Frank Act did not provide a definition for "significant nonbank financial company" or "significant bank holding company," but instead directed the Federal Reserve to define the terms. "Significant nonbank financial company" is proposed to be defined as (1) any nonbank financial company supervised by the Federal Reserve and (2) any other nonbank financial company that had \$50 billion or more in total consolidated assets as of the end of its most recently completed fiscal year. "Significant bank holding company" is proposed to be defined as any bank holding company or foreign banking organization that had \$50 billion or more in total consolidated assets as of the end of the most recently completed calendar year. Companies that meet the criteria for these definitions are not necessarily subjected to additional supervision and regulation. However, there are practical implications for such companies, because these definitions are one of the key factors considered by FSOC in its designation of nonbank financial companies for Federal Reserve regulation, and companies that meet the definitions' criteria may be required to provide additional information to FSOC and other federal agencies.

³ Specifically, 12 C.F.R. §§ 225.28(b) and 225.86(a), (b) and (c) include the activities that are "financial in nature" under the proposed rule. The Federal Reserve specifically notes that the activities it has deemed to be "incidental" to financial activities or "complementary" to financial activities are not considered financial activities for purposes of the proposed 85 percent tests.

The Release includes a number of specific questions for which the Federal Reserve requests comment. All comments on the proposed rule are due by March 30, 2011.

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