

**FINANCIAL STABILITY OVERSIGHT COUNCIL RELEASES PROPOSED RULE
REGARDING DESIGNATION OF NONBANK FINANCIAL COMPANIES**

On October 11, 2011, the Financial Stability Oversight Council (“FSOC”) released a second notice of proposed rulemaking (the “October NPR”) to develop regulations implementing Section 113 of the Dodd-Frank Act.¹ Section 113 grants FSOC the authority to subject certain United States and foreign nonbank financial companies² to supervision by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) and prudential standards. The October NPR modifies and enhances its previous proposal and guidance by (1) proposing a three-stage evaluation process to identify with increasing scrutiny the companies which pose the greatest threat to U.S. financial stability, culminating in FSOC’s designation of those companies, (2) certain uniform quantitative metrics to be used in the three-stage process, and (3) significant explanatory guidance included as an Appendix (the “Appendix”).

Each nonbank financial company designated by FSOC will be subject to a recently approved joint final rule (the “Final Rule”) adopted by the Federal Reserve and the Federal Deposit Insurance Corporation (the “FDIC” and together with the Federal Reserve, the “Agencies”) that implements the Dodd-Frank Act’s resolution plan provisions by requiring FSOC-designated nonbank financial companies to submit “living wills” to the Agencies annually. As a result, FSOC designation immediately imposes significant regulatory and compliance burdens on nonbank financial companies as they adjust to operating under Federal Reserve supervision and regulation. The Final Rule includes many substantive and procedural details regarding living wills, including initial and annual submission deadlines, minimum informational content, applicable insolvency regimes, corporate governance, confidentiality concerns and other procedural requirements. This memorandum briefly summarizes some of the critical modifications made by FSOC in the October NPR and highlights some of the resolution plans’ key details contained in the Final Rule.

I. Nonbank Financial Company Designations under the October NPR

The October NPR is FSOC’s latest in a series of releases addressing the implementation of Section 113 of the Dodd-Frank Act.³ In the January NPR, FSOC proposed a six-category

¹ 76 FR 64264.

² The definitions for “foreign nonbank financial companies” and “U.S. nonbank financial companies” in the October NPR are in part contingent on the defined term “predominantly engaged in financial activities,” which is defined in Section 102(a)(6) of the Dodd-Frank Act and subject to implementing regulations promulgated by the Federal Reserve. On February 11, 2011, the Federal Reserve published a notice of proposed rulemaking proposing requirements for determining if a company is predominantly engaged in financial activities. 76 FR 7731.

³ On October 6, 2010, FSOC issued an advance notice of proposed rulemaking seeking public input regarding the appropriate criteria and analytical framework FSOC should employ to make nonbank financial company designations. On January 26, 2011, FSOC issued its first notice of proposed rulemaking (the “January NPR”), initially developing a six-category analytical framework to apply the ten considerations required by Section 113(a)(2) of the Dodd-Frank Act in order to make final designations.

framework to evaluate each nonbank financial company for potential designation based strictly on qualitative analysis of the six categories and declined to include any quantitative metrics. Many commenters to the January NPR expressed concern that the proposed framework's near-exclusive reliance on qualitative factors and analysis lacked the detail and quantifiable metrics necessary for implementing an effective framework. In response to those comments, FSOC proposes a three-stage evaluation process in which each nonbank financial company will be subjected to progressively more detailed and in-depth evaluations, applying certain quantitative metrics that are intended to give market participants more certainty regarding where companies stand.

Stage 1—Quantitative Threshold Test

In Stage 1, FSOC introduces a two-part test utilizing six quantitative criteria to identify the subset of nonbank financial companies that may satisfy one of the two FSOC determination standards⁴ and thus require further evaluation in subsequent stages of the process. The six criteria are similar to the January NPR's framework in establishing quantitative thresholds for size, interconnectedness, leverage, and liquidity risk and maturity mismatch. The data used by FSOC to conduct each company's Stage 1 test will be derived solely from publicly available information and regulatory sources.

The first part of the test looks at a company's total consolidated asset size against established thresholds: (i) for U.S. nonbank financial companies, the threshold is \$50 billion in global total consolidated assets and (ii) for foreign nonbank financial companies, the threshold is \$50 billion in U.S. total consolidated assets. If the company exceeds the size threshold in part one, then the second part applies, in which the company must exceed one of the following five thresholds—

- **Credit Default Swaps Outstanding:** \$30 billion in gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity.
- **Derivative Liabilities:** \$3.5 billion of derivative liabilities determined in accordance with Accounting Standards Codification 815.
- **Loans and Bonds Outstanding:** \$20 billion of outstanding loans borrowed and bonds issued.
- **Leverage Ratio:** a minimum leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1.
- **Short-Term Debt Ratio:** a ratio of debt with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent.

⁴ 12 CFR § 1310.10(a) in the October NPR. The "First Determination Standard" applies if FSOC determines that "material financial distress" at the nonbank financial company could pose a threat to U.S. financial stability. The "Second Determination Standard" applies if FSOC determines that the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities could pose a threat to U.S. financial stability. In the Appendix, FSOC states that it expects significant overlap between the two standards.

The quantitative metrics included in Stage 1 are intended to apply to all industries in which nonbank financial companies operate, but FSOC identifies specific industries for which the proposed metrics may not adequately identify the appropriate companies for continued review.⁵ Beginning in 2012, hedge funds, private equity funds and others will be required to file Form PF with the Securities and Exchange Commission (“SEC”) or the Commodity Futures Trading Commission (“CFTC”), as applicable. Using financial disclosures required in these filings and other sources, FSOC will consider developing an additional set of metrics or thresholds to evaluate those types of companies in Stage 1. For asset management companies, FSOC and its various member agencies will analyze the potential risks those companies pose to the U.S. financial system, and consider mitigating those risks through FSOC designation, promulgating additional regulations, or developing additional quantitative metrics relevant to asset managers.

FSOC will periodically review and assess the quantitative thresholds as new data becomes available over time, and may adjust thresholds.⁶ Critically, if FSOC determines that the quantitative thresholds in the first stage inadequately assess the ways in which a particular company might pose a threat to U.S. financial stability, FSOC may evaluate other company-specific qualitative or quantitative factors.

Stage 2—Application of Six-Category Framework

The second stage of the October NPR’s three-stage process focuses on the potential threat each individual nonbank financial company could pose to U.S. financial stability. FSOC will apply a broader version of the January NPR framework to evaluate each company’s risk profile and characteristics in light of the framework’s six categories. The Appendix includes comprehensive detail, discussion and guidance on the six-category framework’s function so each of the six categories can be used to either qualitatively evaluate a company using both industry-specific and company-specific factors, or assess sample representative quantitative metrics. FSOC also proposes to add at least two additional qualitative factors, such as the impact of the company’s resolution on the broader economy and the extent to which the company is already subject to existing regulation. The Stage 2 analysis will be based solely on information available to FSOC from public or regulatory sources, including information obtained from the company’s primary financial regulatory agency or home country supervisor and information provided voluntarily by the company.

Stage 3—In-Depth Analysis and FSOC Determination

In the final stage of the three-stage evaluation process, FSOC will conduct a detailed, in-depth review of each company, focusing on whether that company could pose a threat to U.S. financial stability due to its material financial distress or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities. FSOC has developed several additional analyses to assess the potential threat a company could pose to U.S. financial stability:

⁵ These industries include financial guarantors, asset management companies, private equity firms, and hedge funds.

⁶ For example, as more data becomes available in connection with additional regulations promulgated by the SEC and CFTC regarding swap transactions, FSOC will promulgate new quantitative metrics to more appropriately measure each company’s derivative liabilities.

- **Transmission Channels:** focuses on the transmission channels that FSOC has identified as most likely to transmit the negative effects of a company's material financial distress to the broader markets: exposure, asset liquidation, and critical functions or services.⁷ FSOC will review how each of those transmission channels relates to the company's mix of business and activities.
- **Six-Category Framework:** applies Stage 2's six-category framework and qualitative and quantitative metrics to assess the likely extent of transmission of the company's material financial distress to the broader economy.
- **Qualitative Factors:** aggregates several qualitative factors assessing a company's potential to pose a threat to U.S. financial stability, including the company's resolvability, the opacity or complexity of its operations, and the extent of its existing regulatory scrutiny and the nature of such scrutiny.

In Stage 3, FSOC will have access to all information compiled about each company during the first two stages, as well as information requested directly from the company through FSOC's information requests. At the conclusion of Stage 2, each company marked for evaluation in Stage 3 will receive notice that it is under consideration for a proposed determination. In that notice, FSOC will likely include a request to the company to provide certain quantitative and qualitative information that FSOC deems relevant to its evaluation.

FSOC's information request may vary significantly based on each nonbank financial company's business and activities and the information already available to FSOC through other sources, but it will likely include requests for confidential business information such as internal assessments and procedures, strategic plans, funding details, and potential acquisitions and dispositions, as well as other anticipated changes to the company's business. Although FSOC may request confidential and other business information directly from the company under its broad authority, it must work with the Office of Financial Regulation and other primary financial regulatory agencies to use information already available through publicly available or regulatory sources. FSOC and its member agencies are required to maintain the confidentiality of such information to the fullest extent of applicable law.

II. Agencies Adopt Final Rule for Resolution Plans

Section 165(d) of the Dodd-Frank Act requires certain covered companies to submit "living wills." Living wills are designed to give the Agencies a detailed plan, or "blueprint," for the rapid and orderly resolution of the company under the Bankruptcy Code (or other applicable resolution regime) if it experiences material financial distress. Living wills may also reduce the likelihood that the FDIC will use its orderly liquidation authority under Title II of the Dodd-

⁷ In the Appendix, FSOC defines the term "threat to the financial stability of the United States" as an "impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." In addition, FSOC identifies the primary channels, or methods of transmission, that may lead to impairment of financial intermediation and financial market functioning.

Frank Act, an option of last resort that is significantly more drastic and potentially economically destabilizing.

Designation by FSOC subjects a nonbank financial company to significant burdens of additional supervision and prudential regulation by the Federal Reserve. For companies previously subject to little or no regulation, the new regulatory environment may be particularly challenging due to the significant changes needed to comply and remain in compliance with regulations. FSOC designation will require nonbank financial companies to devote significant resources to preparing their initial living will, with ongoing obligations to monitor and update the living will's informational content, strategic analysis, corporate governance, regulatory reporting and compliance, among others, resulting in a material financial and managerial cost to the company.

The Final Rule culminates the living will rulemaking process that began with the enactment of the Dodd-Frank Act and included a notice of proposed rulemaking released by the Agencies on April 22, 2011. The Final Rule provides important details regarding many procedural and substantive requirements of living wills, of which some are highlighted below:⁸

- **Effective date of Final Rule:** November 30, 2011
- **Applicable insolvency regime:** a covered company must provide strategic analysis of how the company would be resolved under Title 11 of the U.S. Code (the “Bankruptcy Code”), but there are exceptions—
 - FDIC-insured institutions apply Federal Deposit Insurance Act
 - Broker-dealers apply Securities Investor Protection Act
 - Insurance companies apply applicable state insurance insolvency laws
- **Covered company:** any bank holding company with more than \$50 billion in total consolidated assets; any foreign bank or holding company with more than \$50 billion in total consolidated assets; any nonbank financial company designated by FSOC for supervision by the Federal Reserve.
- **Timing of initial submissions:**
 - Covered companies over \$250 billion in nonbank assets: July 1, 2012
 - Covered companies with \$100-250 billion in nonbank assets: July 1, 2013
 - Covered companies with less than \$100 billion in nonbank assets: December 31, 2013

⁸ On September 13, 2011, using its authority under the Federal Deposit Insurance Act, the FDIC released an interim final rule (the “FDIC IFR”) requiring all U.S. insured depository institutions with \$50 billion of more in total assets to submit a living will.

- **Timing of annual submissions:** each covered company must submit an updated living will on or before the one year anniversary of the date of submission of its initial living will.
- **Material updates:** covered companies must submit notice within 45 days of any event, occurrence, change of conditions or circumstances or other change that could have a material effect on the company's living will.
- **Content of initial submissions:** focus on critical and core operations, strategic analysis, identifying interconnections and interdependencies among material entities.
- **Board approval:** the board of directors of the covered company must approve the initial living will and annual living wills; the board of directors of foreign-based covered companies may appoint a delegee to approve the initial living will and annual living wills.
- **Confidentiality:** living wills must be submitted in two parts: a public and a confidential file, in which standard Freedom of Information Act regime will apply.
- **Tailored resolution plans:** applies only to covered companies with less than \$100 billion in total nonbank assets and if that covered company's depository institution subsidiaries comprise at least 85% of the covered company's total consolidated assets.

Until its publication in the Federal Register, the Final Rule is available on the FDIC's and the Federal Reserve's websites.

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If you have any questions regarding this memorandum, please contact David S. Katz (202-303-1149, dkatz@willkie.com), Scott R. Tkacz (202-303-1145, stkacz@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099 and has an office located at 1875 K Street, NW, Washington, DC 20006-1238. Our New York telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our Washington, D.C. telephone number is (202) 303-1000 and our facsimile number is (202) 303-2000. Our website is located at www.willkie.com.

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