SIMPSON THACHER

MEMORANDUM

FSOC Releases Proposed Rules and Guidance on Designation of Systemically Important Nonbank Financial Companies

October 24, 2011

On October 11, 2011, the Financial Stability Oversight Council (the "FSOC") issued a second notice of proposed rulemaking and interpretive guidance (the "NPR") regarding the standards and process that it will use to determine whether a nonbank financial company[1] should be treated as "systemically important" and, therefore, subject to supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and prudential standards in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The FSOC issued a notice of proposed rulemaking earlier this year on this topic, which was criticized as being too vague. Although the body of the regulation included in the NPR remains somewhat skeletal, primarily repeating the statutory language, the FSOC added an appendix that provides significant additional guidance on how it will make such determinations. In particular, the NPR outlines a three-stage process that the FSOC intends to follow in non-emergency situations and provides a detailed description of the analysis the FSOC intends to conduct during each stage of its review. Comments on the FSOC's proposal are due by December 19, 2011.

THREE-STAGE DETERMINATION PROCESS

The NPR proposes a three-stage process by which the FSOC will determine whether to designate a nonbank financial company for supervision by the Federal Reserve and prudential standards. In Stage 1, the FSOC will seek to identify nonbank financial companies that merit individual review by applying six uniform quantitative thresholds (discussed below), using publicly available and regulatory data. If the FSOC determines that a company meets the requirements of Stage 1, it will proceed to Stage 2 of its review, conducting an individual review based on a broad range of qualitative and quantitative, company- and industry-specific information, available primarily through public and regulatory sources. A nonbank financial company that meets the requirements of Stage 2 will proceed to Stage 3, a comprehensive review that incorporates information collected directly from the company on a confidential basis. At the conclusion of a review that reaches Stage 3, the FSOC will determine whether or

[1] Title I of Dodd-Frank defines a "nonbank financial company" as a domestic or foreign company that is "predominantly engaged in financial activities" in the United States, other than bank holding companies and certain other types of firms. In general, "predominantly engaged" means 85% of consolidated annual gross revenues or total assets are from financial activities. The FSOC intends to interpret the term "company" broadly, to include any corporation, limited liability company, partnership, business trust, association (incorporated or unincorporated), or similar organization.

not to designate the nonbank financial company and thereby subject it to Federal Reserve supervision and prudential standards. Designated companies will have rights of appeal.

STANDARD UNDER DODD-FRANK AND THE FSOC'S PROPOSED SIX-FACTOR ANALYSIS

Dodd-Frank authorizes the FSOC to subject a nonbank financial company to supervision by the Federal Reserve and prudential standards if the FSOC determines that either: (i) "material financial distress" at the nonbank financial company or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of the nonbank financial company's activities could pose a threat to the financial stability of the United States.

Section 113 of Dodd-Frank lists ten considerations that the FSOC must take into account in making such determination,[2] which the FSOC has condensed into a six-category analytical framework: (i) interconnectedness, (ii) substitutability[3], (iii) size, (iv) leverage, (v) liquidity risk and maturity mismatch, and (vi) existing regulatory scrutiny.

QUANTITATIVE STANDARDS FOR STAGE 1

The first stage in the FSOC's determination process involves a review of certain quantitative information relating to a particular nonbank financial company. Because the FSOC is relying on quantitative thresholds using publicly available data in the first stage, nonbank financial companies should be able to assess whether they are likely to be subject to further evaluation by the FSOC, though, as noted below, the FSOC also has authority to consider information that is not captured by these quantitative thresholds.

The FSOC has identified six quantitative thresholds, deriving from four of its analytical factors (size, interconnectedness, leverage, and liquidity risk and maturity mismatch). The FSOC will

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2 The statutory factors are: (i) the extent of the leverage of the company; (ii) the extent and nature of the off-balance sheet exposures of the company; (iii) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (iv) 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; (v) 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; (vi) 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; (vii) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (viii) the degree to which the company is already regulated by one or more primary financial regulatory agencies; (ix) the amount and nature of the financial assets of the company; (x) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (xi) any other risk-related factors that the FSOC deems appropriate.

3 The NPR describes "substitutability" as the extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity if the nonbank financial company withdraws from a particular market.

progress to Stage 2 of its review if the company meets *both* the "total consolidated assets" threshold *and* any one of the five other quantitative thresholds, as set forth below:

- *Total Consolidated Assets*. $50 billion in global total consolidated assets for U.S. nonbank financial companies or $50 billion in U.S. total consolidated assets for foreign nonbank financial companies. This threshold is consistent with the Dodd-Frank threshold of $50 billion in assets for subjecting bank holding companies to enhanced prudential standards.

- *Credit Default Swaps Outstanding*. $30 billion in gross notional credit default swaps ("CDS") outstanding for which the nonbank financial company is the reference entity. Gross notional value equals the sum of CDS contracts bought (or equivalently sold).

- *Derivative Liabilities*. $3.5 billion of derivative liabilities. In accordance with Accounting Standards Codification 815, derivative liabilities equals the fair value of any derivatives contracts in a negative position after taking into account the effects of master netting agreements and cash collateral held with the same counterparty on a net basis, if elected.

- *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. The FSOC intends to exclude separate accounts from this calculation because separate accounts are not available to claims by general creditors of a nonbank financial company.

- *Short-Term Debt Ratio*. Finally, the FSOC intends to apply a threshold ratio of debt with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent.

The NPR does not clearly specify whether the FSOC will look only to balance sheet assets for purposes of the test of $50 billion in total consolidated assets. The plain meaning of the phrase suggests the FSOC intends to use total consolidated assets as determined using applicable financial reporting standards. In its discussion of the size criterion within its overall analytical framework, however, the FSOC stated:

> Size is conventionally measured by the assets, liabilities and capital of the firm. However, such measures of size may not provide complete or accurate assessments of the scale of a nonbank financial company's risk potential. Thus, the [FSOC] also intends to take into account off-balance sheet assets and liabilities and assets under management in a manner that recognizes the unique and distinct nature of these classes. Other measures of size, such as numbers of customers and counterparties, may also be relevant.[4]

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[4] 76 Fed. Reg. 64264, 64280 (Oct. 18, 2011).

In responses to the NPR, industry participants are likely to seek clarification as to whether the FSOC plans to use only balance sheet assets or include assets under management for purposes of Stage 1.

In addition to the quantitative thresholds noted above, the FSOC may, in limited cases, initially evaluate nonbank financial companies in Stage 1 based on other firm-specific qualitative or quantitative factors, such as substitutability and existing regulatory scrutiny.

The quantitative measures described in the NPR are subject to change, as more information becomes available to the FSOC. The NPR acknowledges, for example, that while the FSOC will apply the Stage 1 thresholds to all types of nonbank financial companies, including financial guarantors, asset management companies, private equity firms, and hedge funds, these companies may pose risks that are not well measured by the quantitative thresholds approach. In the case of private equity and hedge funds, the FSOC intends to consider whether to establish an additional set of metrics or thresholds tailored to better evaluate these companies, once they begin reporting to the FSOC in 2012 using the new Form PF. In the case of derivatives exposures of nonbanking financial companies, new derivatives regulations are being developed by the Securities and Exchange Commission and Commodity Futures Exchange Commission, and the FSOC may establish new Stage 1 thresholds based on factors that better capture current and potential future exposures from outstanding derivatives once those regulations are complete.

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