

Financial Stability Oversight Council Proposal Includes Few Clues About Who Will Be Designated as Systemically Significant

Nonbank financial companies (“nonbank companies”) looking for some hints regarding the likelihood that they could be designated as a systemically significant (“significant nonbank”) by the Financial Stability Oversight Council (“FSOC”) under Title I of the Dodd-Frank Act (“Act”) were disappointed on January 18, 2011, when FSOC issued its Notice of Proposed Rulemaking (“Proposal”). The FSOC provided only limited guidance as to how it intends to apply the criteria to various industries or whether any particular companies or industries are more or less likely to be targeted for designation. Further, the limited guidance offered is contained in the preamble of the Proposal rather than in the proposed rule itself, presumably in order to leave the FSOC with broad discretion in making these determinations. Comments on the Proposal will be due 30 days after its publication in the Federal Register.

Analysis of the Proposal

In the wake of the serious financial dislocations experienced over the last few years, Section 113 of the Act empowers the FSOC to designate a nonbank company for special supervision by the Board of Governors of the Federal Reserve System. Such a designation would occur if the FSOC determined that material financial distress at the company or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to the financial stability of the United States (*i.e.*, that the nonbank company is systemically significant). Special supervision would include enhanced prudential standards and the requirement for a living will. The Act lists 10 specific factors the FSOC must consider in determining whether a nonbank company is systemically significant, in addition to any other risk factors that the FSOC deems appropriate.

The Proposal follows the FSOC's October 6, 2010 issuance of an advanced notice of proposed rule

making (“ANPR”), which received significant public comment.¹ In the ANPR, the FSOC sought guidance with respect to each of the statutory factors and how they should be weighed through a series of specific questions. The specificity of those questions may have led some to expect that the FSOC would provide specific regulatory guidance regarding how the FSOC proposes to weigh and consider the statutory factors when contemplating or making a determination. However, as noted above, the preamble of the Proposal provides only limited guidance as to the FSOC's likely analytical approach. It essentially restates the statutory factors, apparently with the intent of leaving the FSOC with the broadest possible discretion to make whatever judgment it deems appropriate in any given case.

¹ See our October 2010 *DechertOnPoint*, “[Financial Stability Oversight Council Seeks Public Input on Designation of Significant Nonbanks and Volcker Rule.](#)”

In its preamble, the Proposal restates the specific questions that were raised for comment in the ANPR, and provides a short summary of the comments received in response to each question. However, the Proposal generally does not provide any indication of the FSOC's views with respect to those comments. The preamble to the Proposal merely sorts the statutory factors into six broad categories that the FSOC would consider when determining whether to designate a nonbank company as a significant nonbank and further organizes these categories into two groups. One group of factors—(i) a nonbank company's size, (ii) the lack of substitutes for the financial services and products the nonbank company provides, and (iii) interconnectedness with other financial firms—would assess the potential for contagion from a firm's distress to the broader financial system or the economy. The other group of factors—(i) leverage, (ii) liquidity risk and maturity mismatch, and (iii) existing regulatory scrutiny—would assess how vulnerable a nonbank company is to financial distress. The preamble also includes a chart that specifies under which of the six broad categories each individual statutory criterion would be considered.

The preamble also indicates that the FSOC would use the six categories when reviewing all industry sectors, although the FSOC would apply these categories differently to different industries as appropriate. The preamble does not provide any specific guidance as to how the FSOC would go about determining how to weigh the categories with respect to particular entities or industries. The preamble does clarify that the fact that a nonbank company has received federal assistance would not be considered as a separate criterion in the FSOC's proposed evaluation framework.

In addition, the FSOC indicates its intention to retain the right to consider any other risk-related factors it deems appropriate, either through regulation or on a case-by-case basis. While the preamble indicates that the FSOC would use "quantitative metrics" when possible in evaluating a nonbank company, the preamble specifically states that the FSOC would be free to use its informed judgment when making a determination.

In addition to the statutory factors discussed above, the proposed regulation would implement other provisions of Section 113 of the Act regarding (i) the anti-evasion authority of the FSOC, (ii) notice to and hearings for nonbank companies regarding their proposed systemically significant determinations and (iii) consultation, coordination and judicial review with respect to determinations.

One procedural note: the notice and hearing portions of the regulation include a provision that is not contained in the Act which would require the FSOC to provide a nonbank company with written notice that the FSOC is considering whether to determine that the nonbank company is systemically significant. Once this notice is issued, the nonbank company would have the opportunity to submit written materials setting forth its views. If the FSOC then determined that it intended to proceed, it would provide a subsequent written notice to the nonbank company, including an explanation of the basis for the proposed determination. At that time, the nonbank company would have an opportunity to request and receive an oral or written hearing before the FSOC to contest the proposed determination. Only after any hearing or opportunity for hearing would the FSOC make a final determination.² Allowing nonbank companies to provide relevant materials to the FSOC before it makes an initial determination may be intended to help the FSOC determine how to apply the six categories in a given case, without adopting a formal procedure to do so.



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² There are exceptions to this process under emergency circumstances.

Practice group contacts

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