

Financial Stability Oversight Council Seeks Public Input on Designation of Significant Nonbanks and Volcker Rule

As one of its first official acts, the Financial Stability Oversight Council ("Council") has issued an advance notice of proposed rulemaking ("ANPR") inviting public comment on the criteria it should use in designating systemically important nonbank financial companies ("Significant Nonbanks"), which will be made subject to prudential regulation pursuant to Title I of the Dodd-Frank Act. The Council also has issued a request for information and public comment ("Volcker Request") regarding the study and recommendations ("Volcker Study") it is required to make in regard to Section 619 of the Act, the so-called "Volcker Rule." Comments on both the ANPR and the Request are due by November 5, 2010. For further analysis of these areas of the Act, see our [Analysis of Financial Regulatory Reform Legislation for American Bankers Association](#).

Significant Nonbank Designation ANPR

The Dodd-Frank Act sets forth a number of factors that the Council must consider in designating Significant Nonbanks, but the manner in which the Council interprets and applies these factors may determine whether particular nonbank financial companies are selected and, more generally, how broad an impact the Dodd-Frank Act may have on the U.S. financial services industry. If a nonbank financial company is determined to be systemically significant, it will be regulated to various degrees, including as to its capital requirements and ultimate resolution, by the Federal Reserve Board and, in certain respects, by other agencies, including the FDIC. So, the stakes of the rulemaking are significant.

The ANPR presents an important opportunity for nonbanking financial services organizations to participate by presenting 15 topics for comment, consisting of the following:

- **Metrics** – How should the Council measure the factors it is required to consider under the Dodd-Frank Act?

- The Council may be considering developing a matrix of supporting and mitigating systemically significant factors similar to the Civil Money Penalty Matrix used by the Federal bank regulatory agencies. Thus, the relative weight of factors relied upon by the Council should be carefully considered by commenters.

- **Eligibility** – What types of nonbank financial companies should the FSOC evaluate? Should the evaluation standards vary across industries?
- **Foreign Nonbank Companies** – Are there unique international considerations when designating foreign nonbank financial companies?
- **Exclusions** – Are there simple standards that can be used to exclude certain nonbank financial companies from consideration for possible designation?

- This topic may be of particular interest as a way to mitigate the uncertainty created by the Dodd-Frank Act for nonbank financial companies and their shareholders, creditors and counterparties when such companies are “on the bubble” for selection. For example, should nonbank financial companies be subject to a minimum \$50 billion asset size, as is the case with bank holding companies (“BHCs”), in order to be eligible to be designated as a Significant Nonbank?
- Size, Scope and Scale – How should a nonbank financial company be measured? Should measurements be risk-weighted, off-balance-sheet exposures be considered and the amount and concentration of assets under management be factors? If so, how should side arrangements and implicit obligations to provide financial support to sponsored or managed funds be evaluated?
 - For example, do off-balance-sheet exposures or assets under management, which are not considered when determining whether a BHC is subject to enhanced supervision, present a different risk profile than on-balance-sheet assets and liabilities?
- Significance as a Funding Source – How should the Council measure a nonbank financial company’s role as a source of credit for households, businesses, and governments and as a source of liquidity, including its role as a source of credit for low-income, minority and underserved communities?
- Interconnectedness – What types of exposure to other companies should be considered, and how should such exposure be measured?
 - The economic crisis of 2008 put a spotlight on the risks posed by a company whose failure could have a broad or cascading impact across other large firms or industries. As a result, the empirical approach used by the Council to qualitatively measure and evaluate such relationships is likely to be of particular significance in designating Significant Nonbanks.
- Leverage – Should this evaluation standard vary across industries? Should leverage standards that apply to banking organizations, such as Basel III recommendations, be considered?
- Liabilities – How should funding concentrations and excessive reliance on a particular type of funding be measured? Are there relevant mitigating factors?
 - A liquidity crisis can have a highly destabilizing impact even if a company has satisfactory asset quality. Here again, the methods used to evaluate the pros and cons of various funding strategies are likely to be of particular significance in the Significant Nonbank designation process.
- Existing Regulation – Is coverage by existing financial regulation a relevant consideration? Are certain areas of regulation particularly significant?
 - Existing financial regulation would appear to be highly relevant, particularly to the extent that turf wars among the regulators represented on the Council become a factor in Council actions.
- Public Disclosure – How important is enhanced transparency to a nonbank financial company and its risk management practices?
- Bailouts – Is a nonbank financial company’s participation in government programs to restore the functioning of the U.S. financial system a relevant consideration?
- Best Practices – Are there methods to evaluate interconnectedness and risk concentrations used by certain companies or industries that could be more broadly applied?
- Definitions – Should the Council define “material financial distress” or “financial stability?”
- Additional Factors – Are there other relevant risk-related factors to be considered when designating Significant Nonbanks?

Volcker Rule Study

The Volcker Rule prohibits “banking entities” from engaging in proprietary trading and from investing in, sponsoring or maintaining certain additional relationships with hedge funds and private equity funds. The Volcker Rule will have a far reaching impact on the financial services industry. See [Dodd-Frank’s Limitations on Risk Taking: An Analysis of the Volcker Rule’s Restrictions on Proprietary Trading and Investments In and Sponsorship of Hedge Funds and Private Equity Funds](#). The Volcker Study will give the Council an opportunity to address some of the contradictory features of the Volcker Rule or suggest important clarifications.

The Dodd-Frank Act calls for the Volcker Study to be completed no later than six months after its enactment.

The release of the Volcker Study will, in turn, trigger a nine month period for the regulatory agencies to issue final rules implementing the Volcker Rule. As a result, the Volcker Request offers industry participants an important first bite at the apple in helping shape the rules that will govern the actual application of the Volcker Rule.

The Volcker Request seeks public comment on the 12 questions summarized below. While some of these questions are very specific, others are open-ended, providing industry participants an opportunity to comment not just on the details but also on the broader framework of the Volcker Rule. As the precise concerns underlying the Volcker Rule are not clearly spelled out in the Rule or limited legislative history, and in many respects the actual prohibitions of the Volcker Rule do not appear to be well-aligned with the apparent concerns, commenters would be well-advised to address both types of questions. By doing so, industry participants may be able to help the Council and the financial regulatory agencies construct a rational set of carefully tailored rules that achieve an agreed upon set of narrow objectives without needlessly interfering with the ability of banking entities to engage in legitimate, valued business activities.

- Volcker Study General Goals – The first question asks for comment on the seven goals for the Volcker Study as set forth in Section 619(b) of the Dodd-Frank Act. Briefly, these goals are to (i) enhance safety and soundness of banking entities, (ii) minimize risk that a banking entity will engage in unsafe and unsound activities, (iii) limit inappropriate transfers of federal subsidies to unregulated entities, (iv) reduce conflicts of interest with customers, (v) limit activities that have caused undue risk or loss or might reasonably be expected to create undue risk or loss, (vi) accommodate insurance companies subject to state insurance regulation, and (vii) appropriately time the divestiture of illiquid assets.
- Key Factors and Considerations – The Volcker Request seeks comment on the key factors and considerations that should be taken into account in making recommendations on the proprietary trading portions of the Volcker Rule and, separately, on the private equity and hedge fund portions of the Volcker Rule.
- Definitions of Key Terms – This question identifies fifteen terms and phrases used in the Volcker Rule and requests input on the factors and considerations that should inform decisions on the definitions of those terms.
- General Limitations on Permitted Activities – This question asks what factors and considerations should be taken into account when making determinations as to whether transactions or activities would involve a material conflict of interest, a material exposure to high-risk assets or high-risk trading strategies, or a threat to safety and soundness.
- Additional Capital and Quantitative Limitations – What are the relevant factors and considerations relating to the possible imposition of additional capital or quantitative limitations on those proprietary trading or hedge and private equity fund activities that are permitted under the Volcker Rule?
- Identifying and Limiting Risk – The Volcker Request seeks input from industry participants on (i) the types of practices, transactions, and structures that have historically been or may in the future be associated with increased risks, (ii) those practices, policies and procedures that historically have exacerbated or mitigated risks or losses, and (iii) those practices, policies, and procedures that might be useful in the future to limit undue risk or losses.
- Anti-Evasion Factors and Considerations – What should be taken into account in developing safeguards against evasion of the Volcker Rule?
- International Implications – This request focuses generally on the international implications of applying the Volcker Rule to banking entities that operate outside the United States.
 - Interestingly, three specific situations are mentioned: a domestic banking entity with access to foreign exchanges; a foreign affiliate of a domestic banking entity; and a foreign nonbank financial company, but no reference is made to foreign banking entities.
- Timing of Divestitures of Illiquid Assets – What timing issues are raised in connection with the divestiture of illiquid assets?
- Other Qualitative or Quantitative Factors – The Volcker Request concludes with an open-ended invitation for commenters to submit their views with respect to any qualitative or quantitative factors that should be considered.

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This update was authored by Thomas P. Vartanian (+1 202 261 3439; thomas.vartanian@dechert.com), Robert H. Ledig (+1 202 261 3454, robert.ledig@dechert.com), David J. Harris (+1 202 261 3385, david.harris@dechert.com) and Gordon L. Miller (+1 202 261 3467, gordon.miller@dechert.com).

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit our [Financial Institutions page](#).

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David L. Ansell

Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

David J. Harris

Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert H. Ledig

Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

Thomas P. Vartanian

Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com



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