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Dodd-Frank

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The Dawning of **Systemic Regulation**

Dodd-Frank monitors the economy from an overall point of view.

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THE DODD-FRANK Wall Street Reform and Consumer Financial Protection Act (Dodd-Frank)[1] has created, for the first time in U.S. financial services regulation, a constellation of federal regulators that will attempt to monitor the economy from an overall systemic point of view. The task is not turning out to be as easy as it seemed.

The Financial Stability Oversight Council (Council) has been criticized by commenters and a wide array of others, including senators, congressmen, financial institutions, lawyers and other experts. They have questioned the Council's transparency, perspective and even authority to promulgate rules. With all this, based on the timelines suggested by the Council in its latest proposed regulations, the actual designation of significantly important financial institutions (SIFIs) is not likely to occur until later in 2012.

At the same time the Federal Deposit Insurance Corporation (FDIC) and Federal Reserve Board (FRB) have adopted unprecedented regulations requiring the filing of resolution plans (also known as living wills) by large banks, bank holding companies and as of yet undesignated SIFIs. Similarly, SIFIs and bank holding companies will be subject to a new resolution regime that will shift authority for their receivership and resolution from the bankruptcy courts to the FDIC.

Six agencies have likewise proposed regulations to implement the Volcker Rule, the length and complexity of which demonstrates the enormous difficulty that the agencies will have in applying a simple investment prohibition to the complex financial practices of large financial businesses.

Finally, pursuant to both Dodd-Frank and other regulatory reform initiatives on federal and state levels, mortgage origination, servicing and securitization models are being completely reconstructed through the introduction of risk retention and qualified mortgage rules, as well as the establishment of the Consumer Financial Protection Bureau.

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Make no doubt about it, these are the most sweeping regulatory changes since the Great Depression. They will require significant changes in the business models of the very largest to the very smallest banks and financial companies, impact the capital markets and the availability and cost of capital, and impose significant new compliance costs on financial companies. The big questions are: Will the cost of Dodd-Frank be offset by improvements in the safety and soundness of financial companies? Will the new system of regulation improve regulatory performance, recognize red flags and end "too big to fail"? Or will this be burdensome new regulation of financial markets and institutions targeted at the last crisis that will not prevent the next?

In the context of all of these changes, this article will focus on the first and perhaps most significant aspects of these regulatory reforms—systemic regulation and resolution plans.

Systemic Regulation

The first and foremost issue is how SIFI designation by the Council will impact the chosen companies. The list of new restrictions and regulatory limitations are daunting to domestic and foreign companies that have never been subject to federal bank regulation. Perhaps the most immediate concern is the fact that the FRB would be required to apply enhanced prudential regulation standards to these companies, which would include higher capital and liquidity requirements, and a capital tax on Volcker Rule activities (i.e., proprietary trading and investments in certain funds). SIFIs could also become subject to FDIC receivership and resolution authority, removing jurisdiction from federal bankruptcy courts. Finally, SIFIs would be required to satisfy FDIC and FRB requirements regarding the preparation and submission of living wills.

Where is the Council currently with respect to this process? It issued an advance notice of proposed rulemaking in October 2010, in which it sought public comments on how the statutory standards for SIFI designation should be applied. In January 2011, it issued a notice of proposed rulemaking (First Notice) that was criticized by commenters and members of Congress for not providing any indication of the Council's reaction to the public comments and providing little indication of how the Council would apply the statutory standards.

In October 2011, the Council issued a reproposed rule (Second Notice). The text of the Second Notice did not differ in any significant aspect from the text of the first proposed rule. The Council responded to the criticism of the First Notice by attaching an appendix to the proposed rule that provides guidance in the form of (i) an analytical framework for the statutory standards and (ii) a three-stage process for initially identifying eligible companies and ultimately determining whether to issue a notice of proposed determination of SIFI status to particular nonbank financial companies.

In the preamble of the First Notice, the Council organized the 10 statutory factors that may determine systemic significance into six categories. Three categories—leverage, liquidity risk and existing regulatory scrutiny—were intended to evaluate a company's susceptibility to financial distress. The other three categories—interconnectedness, sustainability and size—were intended to evaluate the impact that a company's material financial distress could have on the financial services industry and the broader economy. In the Second Notice, the Council placed this matrix in the appendix, together with a discussion of each category and of metrics that may indicate the presence of related risks. The appendix details a three-stage process for making a preliminary determination whether to designate a non-bank financial company as a SIFI. Since being challenged regarding its authority to write rules, the Council has not clarified the legal status of the appendix.

> Resolution plans, also known as living wills, must include a strategic analysis of how a covered company can be resolved under the U.S. Bankruptcy Code in a way that would not pose systemic risk to the financial system.

In Stage 1, the Council would use a set of quantitative tests, based on widely available data that would apply to companies in all sectors of the financial services industry, in order to identify companies requiring further scrutiny. The screening would be based on six factors. One factor—size—is paramount. A nonbank financial company must have $50 billion or more of total consolidated assets (or, in the case of a non-U.S. company, $50 billion or more of total U.S. consolidated assets) before the other factors are considered. A company must also satisfy at least one of the other five factors to be selected for further analysis:

1) $30 billion notional amount of credit default swaps outstanding for which the company is the reference entity;

2) $3.5 billion of exposure on all derivatives contracts after all netting agreements and cash collateral are taken into account;

3) $20 billion of outstanding borrowings, including bonds issued;

4) maximum leverage ratio of 15:1; or

5) short-term debt equal to 10 percent of total consolidated assets.

Why $50 billion? The Council has stated that this test is consistent with Dodd-Frank, which, in §165, uses the same amount to identify large bank holding companies subject to enhanced prudential standards. However, this explanation is curious given that in §113 Congress chose not to set any dollar threshold for SIFIs and listed size as only one of several factors without giving it any particular prominence. The Council has *not* articulated why $50 billion of either global or U.S. total consolidated assets is otherwise an appropriate measure.

Investment Funds. The Second Notice presumably refers to balance sheet assets with respect to the $50 billion asset threshold. Thus, assets under management generally would not be included. Notably, the Appendix states that the Financial Stability Oversight Council may apply the quantitative tests to investment funds managed by a nonbank financial company as if the funds were a single entity if their investments are identical or highly similar. This statement does not expressly address whether this consideration would have the effect of adding non-balance-sheet assets to the balance sheets of an asset manager for the purpose of calculating whether a company meets the asset threshold.

Alternative Tests and Alternative Supervision. The Council has acknowledged in the preamble of the Second Notice that the quantitative tests may not fully serve to identify companies in all sectors of the financial services industry for further review. For example, less data is available for hedge funds and private equity funds than for certain other types of nonbank financial companies, and so it will look at data to be provided by investment advisers on the hedge funds and private equity funds they advise on new Form PF and other data to help it decide whether to establish additional quantitative tests tailored to hedge funds, private equity funds and their advisers.

With regard to asset managers generally, the Council also indicated that it will analyze the extent to which there are potential threats to U.S. financial stability arising from asset management companies. This analysis will consider what threats exist, if any, and whether such threats can be mitigated by subjecting such companies to FRB supervision and prudential standards, or whether they are better addressed through other regulatory measures. There is little clarity to date about how asset managers will be evaluated, and how their different structure as managers compares to other large financial companies that are operating companies that own assets. In short, for purposes of determining a company's status as a SIFI, will the Council equate assets under management with assets owned?

Why credit default swaps? The fact that a company is the reference entity for a large volume of credit default swaps may indicate that it has issued a large amount of indebtedness, but there may be other ways to measure this that are not subject to the "noise" of third-party activity and to rapid fluctuations in the level of activity by these third parties.

Stages 2 and 3. So who will be designated as a SIFI? The rules so far leave much discretion in the hands of the Council and do not provide the clarity that companies are searching for to help them determine if they may be designated and, perhaps more importantly, what changes they can make to avoid designation.

In this regard, following the Council's Stage 1, a company that has been preliminarily identified or otherwise flagged would be subject in Stage 2 to more comprehensive and company-specific analysis complied by the Council and its Office of Financial Research, in addressing qualitative as well as quantitative factors. If the Council believed that further review was necessary, in Stage 3 it would review data requested directly from the company. Once a preliminary determination was made, the Council would notify the company and give it an opportunity to submit written materials. Based on the results of all three stages of review, the Council would make a preliminary determination whether a company should be designated a SIFI. It would then be required to formally notify the company, including the reasons for the decision. The company would have the opportunity to submit documents in response to the proposed determination and to request a hearing before the Council to contest its designation and subsequently challenge its decision in federal district court.

Inherent in this process are novel issues involving the target company, including:

- what it would be required under the federal securities laws to disclose about the process;
- how markets would react to those disclosures, particularly the impact of the company switching from a federal bankruptcy resolution to an FDIC resolution;
- how the company participates in the designation process;
- whether it appeals either to the Council or the courts, as provided for in Dodd-Frank; and
- the standards used by the courts to evaluate the deliberative processes of such a multi-headed agency.

Resolvability. The Council's latest appendix states that a Stage 3 analysis should include, among other things, an evaluation of a nonbank financial company's "resolvability." This would entail an assessment of several factors, including the complexity of a company's legal, funding and operational structure; obstacles to its rapid and orderly resolution while mitigating risks to financial stability; operational issues that must be resolved in order to divest business lines; and preparations that would need to be made to avoid disruptions of critical services.[2] This may have the effect of expanding resolution planning far beyond the designated companies subject to §165(d), possibly at significant expense to the companies involved. It also may be a hint to companies seeking to make balance sheet and other structural changes that can bolster their argument that they should not be designated as a SIFI. That suggests that a wide range of potential SIFIs have several reasons to become familiar with the new living will requirements.

Living Wills

Dodd-Frank, and the new regulations adopted by the FRB and the FDIC, requires each bank holding company with assets of $50 billion or more and each SIFI (which are yet to be designated by the Council) to report periodically on its plans for its rapid and orderly resolution in the event of its material financial distress or failure. That information, to be revised periodically, will be available to assist regulators to evaluate balance sheet risk, understand foreign operations and develop a comprehensive and coordinated cross-border resolution strategy. It will also provide a roadmap for the FDIC to the extent that it needs to prepare for the orderly liquidation of the covered company under Title II of the Dodd-Frank.

Living wills must include a strategic analysis of how a covered company can be resolved under the U.S. Bankruptcy Code in a way that would not pose systemic risk to the financial system. Curiously, the FDIC, as receiver for a SIFI or large bank holding company, would not, however, be required by Dodd-Frank to use the Code were it appointed receiver for such an entity. A covered company also must, among other things, map its core business lines and critical operations to its material legal entities and must analyze its corporate structure from the perspective of its core business operations.

Living will requirements will also apply to foreign corporations, raising the issue of jurisdictional confrontations, since various European countries are also requiring the submission of living wills so that they can protect the financial interests of their own economies. The final rule provides, however, that a foreign-based company may restrict the strategic analysis and informational elements of its resolution plan to its subsidiaries, branches, agencies, critical operations and core business lines that are domiciled or are conducted in whole or in material part in the United States. Nevertheless, the description and mapping of interconnections and interdependencies must include the foreign-based covered company and its foreign affiliates.

A covered company with less than $100 billion in total nonbank assets and whose insured depository institution subsidiaries account for at least 85 percent of its total consolidated assets (or, in the case of a foreign-based covered company, whose U.S. insured depository institutions and U.S. branches and agencies account for at least 85 percent of its U.S. total consolidated assets) would be permitted to submit a "tailored" resolution plan. Such a plan may include a strategic analysis and address organizational structure, corporate governance, management information systems and supervisory and regulatory information only with respect to the covered company's nonbanking operations. However, interconnections and interdependencies must be described and mapped for both its banking and nonbanking operations. 34 covered companies will be eligible to file tailored plans.

The final living will rule also provides some relief by providing for the staggered filing of initial living wills, based on a company's size, ranging from July 1, 2012 ($250 billion or more in total U.S. nonbank assets), to Dec. 31, 2013 (less than $100 billion in U.S. nonbank assets).

If a company does not submit a resolution plan that is acceptable to the FDIC and the FRB, they may jointly impose more stringent capital, leverage or liquidity requirements or restrict the company's growth or activities. After two years, and following consultation with the Council, they may order the company to divest certain assets or operations. Former FDIC Chairwoman Sheila C. Bair stated on several occasions that "downsizing" large bank holding companies and SIFIs is an essential power to exercise to ensure that no financial institution becomes "too big to fail." She further stated:

> [U]nless those large banks think that we are serious about using that authority, I think instead of getting credible resolution plans, we're going to get nice paper exercises to sit on the coffee table somewhere.

Divestitures may be more than a last resort.

Balancing the Interests

In light of the financial disasters of the last few years, there is no doubt that the system could benefit from increased regulatory tools, better risk management and solid preventative maintenance. Dodd-Frank provides that and more. However, too much of any of these good things could have an adverse impact on our economy for years to come. Potential SIFIs are taking very close note of the regulatory developments in this area and are realizing the significant difference designation will make in their lives. As always, the challenge for regulators is a question of balance.

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat 1376 (2010).

2. These and the other resolvability factors described in the appendix are the same factors set forth in the FDIC's and FRB's final rule under §165(d) of Dodd-Frank for evaluating a large bank holding company's or SIFI's living will.