New York Law Journal

A NEW YORK LAW JOURNAL SPECIAL SECTION

An ALM Publication

Regulatory Reform

WWW.NYLJ.COM

MONDAY, DECEMBER 17, 2012

Oversight Council Pursued U.S. Financial Stability in 2012

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A key aspect of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was the establishment of a new entity—the Financial Stability Oversight Council (Council)—with the responsibility to address potential threats to U.S. financial stability.

In taking this action, Congress was responding to the perception that the financial crisis of 2008 revealed an absence of focused responsibility and authority in the U.S. government for protecting the nation against significant systemic problems in the financial services sector. Under the Dodd-Frank Act, the Council was given the responsibility to identify and monitor potential threats to U.S. financial stability and the power to take certain actions to mitigate such threats.

The Council is composed of 10 voting members and is chaired by the Secretary of the Department of the Treasury. Other voting members consist of the heads of various federal financial regulatory agencies and an independent member appointed by the president who has insurance expertise.

The Council spent 2010 and 2011 largely engaged in the process of establishing policies and procedures for various aspects of its operations. During 2012, the Council began to take a more active role in performing its assigned duties under the Dodd-Frank Act. It formally began the process to designate certain nonbank financial companies for supervision by the Board of Governors of the Federal Reserve Board (Federal Reserve), completed the designation process for an initial group of systemically important financial market utilities and commenced the process of considering making recommendations for the reform of the regulatory structure for money market funds (MMFs).

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Designation of SIFIs

The Dodd-Frank Act requires the Council to designate nonbank financial companies whose features or material financial distress could pose a threat to the financial stability of the United States. Such designated companies are referred to as systemically important financial institutions (SIFIs). The Dodd-Frank Act sets forth a number of statutory factors for the Council to consider in making such a designation. After an extended regulatory process, in April 2012 the Council adopted a final procedural rule and interpretive guidance setting forth how it will identify and review candidates for possible designation and how it will conduct the designation process. The interpretive guidance sets forth a three-stage process under which the Council identifies a group of companies to be reviewed for potential designation and the process for such review.

A SIFI designation has significant implications for a nonbank financial company. A SIFI will be subject to examination, supervision and enforcement actions by the Federal Reserve. Among other things, a SIFI will be subject to enhanced prudential standards established by the Federal Reserve for both SIFIs and large bank holding companies with $50 billion or more in assets. The Federal Reserve Board has proposed certain prudential standards, but it has acknowledged that those proposed standards are "bank-centric"—that is, they are based on factors that the Federal Reserve has observed and measures that it has developed as the primary federal banking regulatory agency for bank holding companies. The Federal Reserve has indicated that it will "tailor" its supervisory standards to the characteristics of each company that is designated as a SIFI. However, this approach does not provide potential SIFIs with either an opportunity to comment on the rules that may apply to them or the ability to plan for such requirements.

Although the Council does not make disclosures regarding companies that may be under consideration for final designation as a SIFI, news reports and company statements indicate that the Council, starting in September 2012, began informing a small number of companies that they had reached the third and final stage of the Council's initial evaluation process. At the Stage 3 level, the Council will contact a company directly to request information and will provide a company with an opportunity to submit additional information and arguments, if it so chooses, as to why it should not be designated.

The Council will not disclose to a company that is under Stage 3 review the basis on which

it is being considered for designation. Only after the Council makes a preliminary determination to designate a company will it inform the company of the reasons for its planned designation. At this stage, if a company is opposed to its designation, it may request a hearing, at which it may present evidence and arguments against designation. The FSOC has indicated that it will determine whether to grant an oral hearing and whether Council members or delegated Council staff will participate in any oral hearing.

After a hearing, if the Council decides to designate a company as a SIFI, it will issue a final order. The designated company may seek review of the order by a federal district court.

Other Designations

Similar to its provisions for the designation of SIFIs, the Dodd-Frank Act authorizes the Council to designate financial market utilities (FMUs) or payment, clearing or settlement activities that it determines are, or are likely to become, systemically important. An FMU is an entity that manages or operates a multilateral system for the purpose of transferring, clearing or settling payments, securities or other financial transactions among financial institutions or between financial institutions and the operator. Certain persons are excluded from consideration under certain circumstances, including national securities exchanges, swap execution facilities, designated contract markets, brokers, dealers, futures commission merchants and investment companies. A "payment, clearing or settlement activity" is an activity carried out by one or more financial institutions to facilitate the completion of certain financial transactions, and excludes the offer or sale of a security under the Securities Act of 1933 and certain related activities.

The Dodd-Frank Act provides several criteria for the designation of an FMU or a payment, clearing or settlement activity. With respect to FMUs, the Council has adopted a final rule to assist it in its deliberations. Together, the Dodd-Frank Act and the Council's regulation focus on the size and value of the transactions handled by an FMU and the exposure and relationships or interactions of an FMU, which may indicate that an FMU's failure or disruption could have a material effect on U.S. financial stability. On July 18, 2012, the Council designated eight FMUs as being systemically important and, in its 2012 annual report to Congress, the Council provided a detailed explanation of its reasons for the designation of each of the eight FMUs. The FMUs in the initial group are the Clearing House Payments Company (as operator of the Clearing House Interbank Payments System), CLS Bank International, Chicago Mercantile Exchange, the Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit, National Securities Clearing Corporation and the Options Clearing Corporation.

As a result of designation, the primary federal supervisory agency for each designated FMU is required to examine the FMU at least once annually and has enforcement authority over an FMU in the same manner and to the same extent as if an FMU was an insured depository institution and the agency was the appropriate federal banking agency under the Federal Deposit Insurance Act. In addition, the Council and the Federal Reserve may require any designated FMU to submit special or periodic reports in order to assess the safety and soundness of the FMU and the systemic risk it may pose to the financial system.

With respect to the designation of a payment, clearing or settlement activity as being systemically important, the FSOC has not proposed or adopted any regulations to guide its deliberations. Nor has the FSOC designated any payment, clearing or settlement activity as being systemically important.

Potential Recommendations

Another important aspect of the authority given to the Council is the ability to call for particular regulators to take specified actions to reduce potential threats identified by the Council. Specifically, §120 of the Dodd-Frank Act authorizes the Council to issue recommendations to the primary financial regulatory agency of a bank holding company or a nonbank financial company for the conduct of a financial activity or practice by such companies. In order to make a recommendation, the Council must determine that the conduct, scope, nature, size, scale, concentration or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit or other problems spreading among bank holding companies, nonbank financial companies, U.S. financial markets or low-income, minority or underserved communities.

On Sept. 27, 2012, Treasury Secretary Timothy F. Geithner, as chairman of the Council, issued a letter in which he urged his fellow Council members to exercise this authority to pursue MMF reforms. Geithner's letter followed a public statement by Chairwoman Mary L. Schapiro of the Securities and Exchange Commission (SEC) on Aug. 22, 2012, which announced that the SEC would not call a meeting to vote on a proposal for MMF reform that had been prepared by the SEC staff, in view of the fact that three of the other four SEC commissioners had informed Schapiro that they would not support the staff proposal.

On Nov. 19, 2012, the FSOC published its proposed MMF reform recommendations to the SEC for public comment. The FSOC set forth three potential alternatives for MMF reform. One alternative would require MMFs to move to the use of a floating net asset value (NAV), as other types of mutual funds commonly do. A second alternative would generally require MMFs to maintain an NAV buffer in an amount of up to 1 percent in excess of the assets needed for an MMF to maintain a $1.00 price per share. In addition, this alternative would generally require that 3 percent of an MMF investor's highest account balance in excess of $100,000 during the 30-day period prior to a share redemption be potentially subject to withholding for 30 days and to loss if the MMF "breaks a buck" during that period. The third alternative would require MMFs to maintain a risk-based NAV buffer of up to 3 percent, subject to reduction based on an MMF's asset composition. The deadline for comments on the proposed recommendations is Jan. 18, 2013.

Following its receipt of comments, the FSOC will decide whether or not to take further action on its proposed MMF reform recommendations. If it decides to adopt final recommendations, it will send them to the SEC. In that case, the SEC would be required to (i) impose the FSOC's recommendations, (ii) take similar actions that the FSOC deems acceptable, or (iii) explain in writing within 90 days to the FSOC why the SEC determined not to follow the FSOC's recommendations. The FSOC is required to report to Congress on any recommendations that it issues under §120 and on the implementation of such recommendations, or on the failure of the primary financial regulatory agency to implement such recommendations.

If the Council does not make a recommendation to the SEC, or if the SEC does not act on a recommendation, the letter from Secretary Geithner outlines additional actions that the Council may consider. These include designating MMFs, and possibly their sponsors or investment advisers, as SIFIs under the designation procedures described above, or determining that a payment, clearing or settlement activity that is conducted by MMFs is systemically important.

Conclusion

The Council has gained an increasingly high public profile during 2012 as much attention has been paid to its evolving process for SIFI designations. Most recently, the FSOC's consideration of potential recommendations to the SEC for MMF reform, as the potential first exercise of its authority to recommend that financial regulatory agencies take specific actions to mitigate a threat to financial stability, has highlighted the FSOC's significant and developing authority to identify perceived gaps in U.S. financial regulation and take action to seek to address them.