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A legal update from Dechert's Financial Institutions Group

Final U.S. Rule on Designation of SIFIs Emphasizes the Importance of Full Engagement in the Designation Process

The Financial Stability Oversight Council ("FSOC") recently issued a final rule and interpretive guidance regarding the standards and procedures that it will apply for the designation of nonbank financial companies that are systemically important for U.S. financial stability ("SIFIs"). Companies that are designated as SIFIs will be supervised by the Federal Reserve Board ("FRB") and will be subject to enhanced prudential standards imposed by the FRB.

Companies that may be considered for designation by the FSOC should now be preparing their response to a possible inquiry from the FSOC, including the steps that they may take now to diminish the likelihood of their being selected or increase their chances of successfully appealing a designation. The first step, however, is to consider thoroughly the impact that a SIFI designation might have on their business and operations.

The FSOC's rulemaking process on SIFI designation has been drawn out. It began in October 2010 with the issuance of an advance notice of proposed rulemaking, and a proposed rule was published in January 2011. However, in response to public comments and Congressional concerns, the FSOC did not finalize this proposal and issued a second proposed rule, including interpretive guidance, in October 2011. See our *DechertOnPoint*, FSOC Issues New Proposed SIFI Designation Rule. The FSOC's final rule and interpretive guidance were published on April 11, 2012 and will become effective on May 11, 2012.

The FSOC Has Acknowledged that the Final Rule and Interpretive Guidance Are Not Substantive Rules Binding on Third Parties

A significant issue throughout the rulemaking process was whether the FSOC has the authority to adopt a substantive rule that is binding on companies being considered for designation as SIFIs. In a comment filed with the FSOC in February 2011, Dechert asserted that Congress did not give the FSOC this authority in the Dodd-Frank Act. See our *DechertOnPoint*, Dechert Issues Comment Letter Regarding Financial Stability Oversight Council's Proposed Rule Regarding the Designation of Systemically Important Financial Companies.

In the preamble to its final rule, the FSOC effectively acknowledged this point. It stated that the final rule, which establishes time limits and other procedural requirements for the designation process, has been issued under the FSOC's authority to issue rules necessary for the conduct of the business of the FSOC and constitutes a rule of agency organization, procedure or practice. Such rules are distinct from substantive rules that

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are binding on the public. Related directly to the points made in the Dechert comment, the FSOC further stated that the interpretive guidance contained in an appendix to the final rule regarding the process that the FSOC will use in considering SIFI designations "does not impose duties on, or alter the rights or interests of, any company, nor does it relieve the Council of making specific determinations in accordance with the Dodd-Frank Act."[1]

What does all this mean in plain English? A company that is designated as a SIFI by the FSOC will have a better opportunity to challenge the designation in federal district court. In responding to an appeal of a final designation, the FSOC will not be in a position to rely on the interpretive guidance as providing the same level of legal support for a final designation that a substantive rule would provide. Instead, the FSOC will need to focus on the entire record of its review and determination to demonstrate that it has satisfied the statutory criteria for a SIFI designation and that its action was not arbitrary and capricious. Thus, a company challenging its designation may face a somewhat more level playing field than if the FSOC had made its determination under a substantive rule. Potential SIFIs should carefully plan their strategy throughout the FSOC evaluation and designation process to ensure that the record they create before the FSOC, particularly in response to a preliminary designation by the FSOC, which may ultimately be before a district judge, clearly and convincingly rebuts the statutory factors that would support its designation as a SIFI.

The Provisions of the Final Rule

The final rule largely restates the procedural aspects of the Dodd-Frank Act for the designation of SIFIs, while the interpretive guidance included in the appendix to the final rule contains the more qualitative and quantitative elements of the FSOC's designation process.

The FSOC will follow a three-stage process for the preliminary review of nonbank financial companies for potential designation, preceding the statutory process for final designation.

Stage 1 of the preliminary review is set forth in the greatest detail and includes a set of six quantitative factors or screens that the FSOC staff will use to identify companies that may merit further in-depth review. The primary screen is the requirement that a company must have $50 billion or more of global total consolidated assets (or, in the case of a foreign company, $50 billion or more of U.S. total consolidated assets). A company also must meet one or more of the other five screens, which measure credit default swaps outstanding for which the company is the reference entity, derivatives contracts into which the company has entered, total debt outstanding, leverage and short-term debt. The FSOC has indicated that it has circled the universe of companies identified by the Stage 1 criteria and is now moving to Stage 2, which consists of the review of public and supervisory information regarding the companies identified in Stage 1. Thereafter, according to the interpretive guidance, a company that is selected for Stage 3 review will receive notice of its status and may be asked to provide information to the FSOC, but will not be advised as to the basis for its potential SIFI designation.

Implications of the Preliminary Review for Managed Funds and Asset Managers

The Stage 1 review focuses on a company's consolidated asset size. Commenters on the FSOC's second proposed rule requested clarification as to the application of this test to asset managers and their managed funds. The FSOC's final rule contains several elements that indicate it has not reached a final position on this topic.

The FSOC has stated that when "applying the Stage 1 thresholds to an asset manager, the Council's analysis will appropriately reflect the distinct nature of assets under management compared to the asset manager's own assets."[2] This appears to suggest that funds managed by an asset manager would not be aggregated with the asset manager's own assets for purposes of determining whether the asset manager meets the $50 billion asset threshold.

With regard to the funds that are managed (including registered investment companies, private equity firms and hedge funds), however, the FSOC has stated that it may consider the aggregate risks posed by separate funds that are managed by the same adviser, particularly if the funds' investments are identical or highly

1 77 Fed. Reg. 21637, 21647 (April 11, 2012).

2 77 Fed. Reg. at 21645.

similar. The FSOC also has noted that it will be obtaining information regarding advisers to hedge funds and private equity funds to be filed under Form PF and that it will use this and other data in considering whether to establish an additional set of metrics or thresholds to evaluate hedge funds and private equity funds and their advisers.

Moreover, the FSOC has noted that it and its member agencies and the Office of Financial Research are analyzing the extent to which potential threats to U.S. financial stability may arise from asset management companies and, if such threats exist, whether they can be mitigated by SIFI designations or are better addressed through other regulatory measures. In this regard, the FSOC has indicated that it may develop additional guidance regarding potential metrics and threshold determinations regarding asset managers.

Finally, the FSOC has pointed out that it reserves the right to subject **any nonbank financial company** to further review if it believes that further analysis of the company is warranted to determine if it could pose a threat to U.S. financial stability, irrespective of whether the company meets the thresholds in Stage 1.

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