



## Nonbank SIFI Designations\*

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The Financial Stability Oversight Council (FSOC) has re-issued for public comment a proposed rule related to the designation of “systemically important” nonbank financial firms. The proposal provides new detail on the process the agency will follow in making designations. It also includes some metrics that provide some insight into which nonbanking companies are most likely to be designated. Nonetheless, FSOC retains substantial discretion under the proposed rule, and how it will exercise this authority remains to be seen. This article provides a short summary of the proposed rule.

### Statutory Determination Standards and New Definitions

The Dodd-Frank Act establishes two standards for designating systemically important nonbank financial companies. First, a company will be so designated if “material financial distress” at the company could pose a “threat to the financial stability of the United States.” Alternatively, a company will be designated if the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company could pose a “threat to the financial stability of the United States.” This alternative standard can be met even if a company is not experiencing financial distress.

In a guidance accompanying the proposed rule, FSOC has, for the first time, defined what constitutes a “threat to the financial stability of the United States” and “material financial distress.” The guidance provides that a threat to the financial stability of the United States exists if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy. Such impairment might typically occur through various transmission channels including (i) exposures to other nonbank financial companies; (ii) disruptions in markets caused by rapid asset liquidations; or

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(iii) disruptions in markets caused by a failure to perform critical functions or services.

A company will be deemed to be experiencing material financial distress whenever the company is in imminent danger of insolvency or defaulting on its financial obligations. FSOC will assess this risk in the context of a period of overall stress in the financial services industry and a weak macroeconomic environment.

#### Three Part Process for Making Designations

FSOC has proposed a three part process for determining which non-bank financial companies might meet either of the foregoing standards for designation.

*Stage One* — FSOC has proposed a set of metrics to identify nonbank financial companies that should be subject to further evaluation. This Stage One analysis will not involve direct contact with a company. Instead, FSOC will determine if a company meets the metrics based upon an evaluation of public data and other information maintained by the members of the FSOC.

Under the proposed metrics, a company will be subject to continuing consideration if it has at least \$50 billion in assets (global assets for U.S. companies, U.S. assets for foreign companies), and meets *any one* of the following other thresholds:

- (i) \$30 billion in gross notional credit default swaps outstanding in which the company is the reference entity;
- (ii) \$3.5 billion in derivative liabilities (fair value of derivative contracts in a negative position after netting agreements and cash collateral is considered);
- (iii) \$20 billion in outstanding loans borrowed and bonds issued;
- (iv) leverage ratio of total assets to total equity of 15 to 1; and
- (v) a ratio of debt with a maturity of less than 12 months to total consolidated assets of 10 percent.

FSOC has reserved the right to modify these metrics, especially as new data sources become available. For example, beginning in 2012, advisers to

hedge funds, private equity firms, commodity pool operators, and commodity trading advisors will be required to make new data filings with the SEC. Additionally, existing data on derivative liabilities captures only current exposure and that new SEC and CFTC rules related to major swap participants and major securities-based swap participants could provide some insight into future exposures.

*Stage Two* — If a company passes the threshold established in Stage One, it will be subject to a “robust” analysis of the potential threat the company could pose to the financial stability of the U.S. Again, this analysis will be based upon public data and data maintained by regulators. It will involve a closer look at factors such as interconnectedness, substitutability, size, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The guidance accompanying the proposed rule lists various ways in which the agency might evaluate each of these factors. This analysis also will include qualitative factors, such as whether the resolution of a company could pose a threat to the financial stability of the U.S.

*Stage Three* — Following Stages One and Two, FSOC will decide whether to conduct a more detailed and individual review of a company. This Stage Three analysis will be triggered by a notice of consideration to the company. The notice will include a request that the company submit information to FSOC relevant to the evaluation. That submission may include written material contesting the basis for a designation. Information requests will be quantitative and qualitative, and will include an evaluation of the company’s resolvability. A company will receive a notice when the record for the Stage Three evaluation is complete. If FSOC does not make a proposed determination within six months of this notice, the company cannot be subject to a proposed determination without issuance of another notice of consideration.

#### Proposed Determination

Based upon the foregoing three part analysis, FSOC will decide whether or not to issue a proposed determination to a company. A proposed determination requires a two-thirds vote of the FSOC, including the Chair. When issued, a proposed determination will include an explanation of the basis for the determination. Within 30 days of the receipt of a notice of a proposed determination, a company may request a formal hearing to contest the proposed determination, and the hearing must be held within 30 days of the receipt of the request.

### Final Determination

FSOC must make a final determination no later than (i) 60 days after a hearing; (ii) 10 days after the date that a company could have requested a hearing; or (iii) 10 days after the date a company notifies FSOC that it will not request a hearing. Again, a final determination requires a two-thirds vote of FSOC, including the Chair. The final determination will include a statement of the basis for the determination and will be made public. Final determinations are subject to judicial review.

### Confidential Information

The rule provides that all information, data and reports provided to the FSOC will be treated as confidential. Moreover, the submission of material will not constitute a waiver of a privilege, and FOIA shield will apply.

### Backup Examination Authority

The rule gives the Board authority to conduct examinations of companies to determine if they should be subject to supervision by the Board.

### Emergency Waivers

FSOC can waive all notice and procedural requirements. It must provide a company with a written notice of waiver within 24 hours, and give a company an opportunity for a written or oral evidentiary hearing to contest the waiver. All waivers must be approved by a two-thirds vote of FSOC, including the Chair.

### Anti-Evasion

FSOC, on its own initiative or upon the request of the Board, may subject any company to Board supervision if either of the statutory standards for designation is met and the company has been organized to evade the application of Title I of Dodd-Frank.

### Reevaluations and Rescissions

Each year, FSOC must reevaluate each designation and rescind any if a company no longer meets the standards for designation. A rescission requires a two-thirds vote of FSOC, including the Chair.

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