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Federal Reserve Board Proposal Defines Parameters of FSOC "Systemically Significant" Designation

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Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") extends the purview of federal bank regulators beyond the traditional supervision of insured depository institutions and their holding companies[1] to include oversight of systemically significant nonbank financial companies. Key to this new regulatory process is establishment of the Financial Stability Oversight Council ("FSOC"), pursuant to Section 111 of the DFA. The FSOC is chaired by the Secretary of the Treasury, and its voting members include the heads of the principal banking regulatory authorities.[2] Its principal responsibilities include identifying risks to the financial stability of the U.S., promoting market discipline, and responding to emerging threats to the U.S. financial system.[3] The FSOC is also responsible for determining which nonbank financial companies are deemed "systemically significant" and, thus, subject to regulation by the Federal Reserve Board ("FRB").[4] Pursuant to Section 113 of the DFA, the criteria for making this determination are established by the FRB.

The FRB considers the FSOC's ability to designate nonbank financial companies for regulation an important part of its responsibility to identify and close gaps in the financial regulatory system. In making its determination regarding a nonbank financial company, the FSOC is guided by certain considerations set forth under the DFA, including consideration of "the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies."[5] In this regard, the DFA requires the FRB to promulgate regulations to establish criteria to help define the terms surrounding the regulation of nonbank financial companies. On February 8, 2011, the FRB issued these regulations as proposed amendments to its Regulation Y ("Proposed Rule"), and requested comment on the Proposed Rule by March 30, 2011.

In issuing the Proposed Rule, the FRB is seeking to establish certain definitions relevant in determining when certain firms may be deemed "systemically significant" by the FSOC. Under the DFA, a "nonbank financial company" is defined to include a "U.S. nonbank financial company" and a "foreign nonbank financial company."[6] A U.S. nonbank financial company is defined as one that (i) is incorporated or organized under U.S. or any state law; and (ii) is "predominantly engaged in financial activity." Similarly, a foreign nonbank financial company is one that (i) is incorporated or organized outside of the U.S.; and (ii) is also "predominantly engaged in financial activity."[7] As described below, the Proposed Rule specifically seeks to establish criteria for determining whether a company is "predominantly engaged in financial activity" and for further defining "significant nonbank financial company" and "significant bank holding company."

"Predominantly Engaged in Financial Activities"

Predominantly Engaged

Title I of the DFA provides base definitions for "predominantly engaged" and activities that are "financial in nature."[8] Pursuant to the Proposed Rule, the FRB is seeking to further define these terms by providing criteria for determining whether a company is predominantly engaged in financial activities. In this regard, the Proposed Rule proposes a two-year test regarding whether a company is "predominantly engaged":

1. The consolidated gross financial revenues of the company in either of its two most recently completed fiscal years represent 85 percent or more of the company's consolidated annual gross revenues (as determined in accordance with applicable accounting standards) in that fiscal year; or

2. The consolidated total financial assets of the company as of the end of either of its two most recently completed fiscal years represent 85 percent or more of the company's consolidated total assets (as determined in accordance with applicable accounting standards) as of the end of that fiscal year.[9]

According to the FRB, a two-year look-back allows a systemically important company that may have had a down year in revenues and assets to still be designated by the FSOC for supervision. In applying the two-year rule, "consolidated gross financial revenues" are those revenues directly or indirectly *derived from* activities that are financial in nature or from ownership of an insured depository institution (including its subsidiaries). Similarly, "consolidated total financial assets" are those assets directly or indirectly *related to* activities that are financial in nature, including ownership of an insured depository institution (and its subsidiaries). Generally, the FRB attempts to use existing concepts already incorporated in Regulation Y, including, as described below, for the definition of "financial in nature," which ties directly into provisions of Regulation Y identifying activities "closely related to banking,"[10] "usual in connection with the transaction of banking abroad,"[11] and "financial in nature."[12] In addition, the FRB structured the two-year test to allow a company to use its fiscal year-end financial statements, thereby reducing regulatory reporting requirements given that most companies will already have audited financial statements available.

Two rules of construction – intended to further reduce regulatory burden – accompany the two-year test under the Proposed Rule. Under the first rule of construction, revenues derived from and assets related to an equity investment in another company (the "investee") that is not consolidated with the company in question must be included as financial assets or revenues of the company if the investee itself is predominantly engaged in financial activities according to the two-year test. The inclusion of all of the revenue and assets from the equity investment is a proxy for trying to determine the precise percentage of such investee's activities that are financial in nature and the portion, in turn, of the company's related revenues and assets that are financial revenues and financial assets.

A second rule of construction relates to *de minimis* equity investments. Under this rule, a company *may* treat derived revenues or related assets of an investee as revenues <u>not</u> derived from, or assets related to, financial activities if:

(i) the company owns less than five percent of any voting shares and less than 25 percent of the equity of the investee;

(ii) the investee's financial statements are not consolidated with the company;

(iii) the investee interest is not held in connection with the company's engagement in financial activities;

(iv) the investee is not a bank, bank holding company, broker-dealer or other regulated financial institution; and

(v) the aggregate amount of the company's revenues or assets treated as nonfinancial does not exceed five percent of the company's consolidated gross financial revenue or consolidated total financial assets of the company, respectively.

Recognizing that the two-year test may not necessarily capture all nonbank financial companies that should be included within the FRB's oversight, the Proposed Rule permits the FRB to determine that a company is "predominantly engaged in financial activities" on a case-by-case basis, based on all the facts and circumstances involving that company. This allows the FRB to determine at any time, and not necessarily based on fiscal year-end financial statements or a two-year look-back, if a company meets the 85 percent threshold established under the DFA.[13]

The concept of assets "related to" financial activities is not a concept that is clearly fleshed out by the FRB under the Proposed Rule and, thus, may require further refinement or definition in connection with the application of the two-year test. In addition, for some firms, a year-end asset measurement may not provide an accurate reflection of the company's asset position, particularly if year-end numbers are skewed by transactions or other events that may arise in two or more consecutive years. In this regard, a weighted average asset measurement may be more indicative of the true "financial nature" of the company. While a weighted average measurement would involve more than a single snapshot of the company's balance sheet, it would also be more burdensome; however, providing this as an alternative test could be attractive to certain companies.

Financial in Nature

The DFA looks to the Bank Holding Company Act of 1956, as amended ("BHCA"), for its source of what activities are deemed "financial in nature." As noted above, in defining "financial in nature" for purposes of the Proposed Rule, the FRB references all of the activities set forth in Regulation Y as "financial in nature" for purposes of Section 4(k) of the BHCA, including activities "closely related to banking,"[14] "usual in connection with the transaction of banking abroad,"[15] and "financial in nature."[16] In addition to these activities, Section 4(k) permits the FRB, in consultation with the Secretary of the Treasury, to designate additional activities as "financial in nature." An analysis of what activities have been captured under Section 4(k) is important to understand the breadth of the Proposed Rule.

Activities that have been deemed by the FRB to be "financial in nature" include the provision of "data processing, data storage and data transmission services, facilities, databases, advice, and access to such services, facilities, or databases by any technological means, with respect to financial data and, to a limited extent, nonfinancial data."[17] These and other activities deemed "financial in nature" are covered under the Proposed Rule regardless of where they are conducted and regardless of whether a provision of federal or state law would prohibit, restrict or place conditions on the activity.[18]

Adding to the breadth of the Proposed Rule, Section 113(c) of the DFA allows the FSOC to determine, on its own initiative or at the request of the FRB, that a company will be subject to supervision if such company is organized to evade supervision by the FSOC and "material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of, the financial activities conducted directly or indirectly" by the company would pose a threat to the financial stability of the

U.S.[19] Such a provision ensures that a company cannot alter its services and activities to avoid designation by the FSOC for supervision under Section 113.

The concept of "financial in nature" is a critical component of the Proposed Rule, and reviewers should consider whether the FRB's definition lacks any meaningful or reasonable constraints on the FRB's discretion to designate any company as subject to regulation and oversight. In particular, the FRB's discretion to consult with the Treasury Secretary to designate additional activities as "financial in nature" is worth reviewing. In particular, reviewers should pay close attention to the factors to be considered in this consultative determination. These are set forth in Section 4(k)(3) of the BHCA and include relatively broad concepts of "changes or reasonably expected changes in the marketplace," "changes or reasonably expected changes in the technology for delivering financial services," and whether an activity is "necessary or appropriate" to "compete effectively," "efficiently deliver information and services that are financial in nature through the use of technological means," and "offer customers any available or emerging technological means for using financial services."[20]

"Significant Nonbank Financial Company" and "Significant Bank Holding Company"

The Proposed Rule also defines "significant nonbank financial company" and "significant bank holding company" – terms relevant to identifying significant relationships between a nonbank financial company and such entities in determining whether the nonbank financial company should be deemed systemically significant and subject to FRB supervision under the Proposed Rule. Specifically, relationships between a nonbank financial company and one or more entities deemed a "significant nonbank financial company" or "significant bank holding company" is considered by the FSOC in its systemic risk determination of the nonbank financial company. In defining the relevant terms, the FRB is seeking to ensure a "transparent standard."[21]

In this regard, the FRB defines the term "significant nonbank financial company" as either a nonbank financial company supervised by the FRB or any other nonbank financial company with total consolidated assets of at least $50 billion as of its most recent fiscal year. Similarly, a "significant bank holding company" is defined as any bank holding company (or foreign bank treated as a bank holding company) with total consolidated assets of at least $50 billion as of its most recent calendar year, as reported to the FRB.

As noted in the Proposed Rule, a firm designated as a "significant nonbank financial company" or "significant bank holding company" is not subject to additional regulation or supervision by virtue of that designation. Rather, the designations are relevant to the FSOC in its determination of the systemic significance of other nonbank financial companies. In addition, these designations are used by the FRB in identifying the companies (i.e., significant nonbank financial companies and significant bank holding companies) required to file credit exposure reports to the FRB and Federal Deposit Insurance Corporation pursuant to Section 165(d)(2) of the DFA.

While designation as a "significant nonbank financial company" or "significant bank holding company" under the Proposed Rule appears largely an exercise in identifying relationships with other firms that may be subject to the Proposed Rule, it is instructive nonetheless for reviewers to note the possible breadth of the relationships that could be implicated by these definitions in the Proposed Rule. Also significant is the identification of these firms as companies that will be required to file credit exposure reports to the FRB and Federal Deposit Insurance Corporation pursuant to Section 165(d)(2) of the DFA.

Issues for Further Consideration

It is clear from the Proposed Rule and the FRB's supporting commentary that the agency is attempting to ensure a broad interpretation of the relevant definitions supporting the determination of systemic significance of nonbank financial companies under Section 113 of the DFA. The terms are defined so as to cast a wide net for potential designation by the FSOC, as well as to guard against evasion of

such potential designation. The inclusion of the "case-by-case" determination by the FRB relating to the definition of "predominantly engaged in," and the anti-evasion provision relating to activities that may be deemed "financial in nature," provides the FRB with significant flexibility and a level of unbridled discretion to capture nonbank financial companies that do not neatly fall into the other defined tests of Section 113.

Between the discretionary provisions of the Proposed Rule and the broad nature of the definitions – particularly with respect to the term "financial in nature" – it appears many nonbank financial companies could be subject to coverage by the Proposed Rule. In particular, nonbank financial companies that are not themselves "financial in nature," but that have significant relationships or operations with other financial institutions, could be captured under the financial stability provisions of Section 113. It is not clear at this time how far the reach of the FRB's supervision under Title I would extend, or what types of nonbank financial companies and areas of financial activities will receive the attention of the FSOC; however, it is clear that the Proposed Rule lays the groundwork for a fairly aggressive posture by the systemic regulators.

Request for Comments

Pursuant to the Proposed Rule, the FRB specifically seeks comment on the following issues:

1. With respect to the portions of the rule pertaining to whether a company is predominantly engaged in financial activities:
    a. Is the two-year test established in §§ 225.301(a)(1) and (2) appropriate, or are there other methods that should be used as a general matter to determine whether a company is predominantly engaged in financial activities?
    b. Is the use of consolidated year-end financial statements of a company prepared in accordance with GAAP or IFRS an appropriate basis for determining the company's annual gross consolidated financial revenues and consolidated assets? Are there other methods that should be permitted? If so, what are the potential benefits and drawbacks of such other methods?
    c. Are the definitions contained in the proposed rule appropriate?
    d. Are there any other activities that should either be included or excluded from the definition of activities that are considered to be financial in nature?
    e. Are there other matters that the Board should address as part of the rulemaking to establish the requirements for determining if a company is predominantly engaged in financial activities as required by section 102(b) of the Dodd-Frank Act?
2. With respect to the proposed definitions of significant entities:
    a. Are the definitions contained in the proposed rule appropriate?
    b. Are there other matters that the Board should address as part of the rulemaking to define the terms "significant nonbank financial company" and "significant bank holding company?"

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In the event you are interested in commenting on the Proposed Rule, you may contact any of the following members of the Paul Hastings Global Banking and Payment Systems practice for assistance in the preparation of comments on this proposal, as well as any of the numerous other proposals issued by the various federal financial regulatory agencies pursuant to the Dodd-Frank Act.

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[1] It should be noted that the scope of supervisory oversight of the federal bank regulators also extends to subsidiaries and entities deemed "affiliates" of an insured depository institution, as well as firms that provide services to an insured institution.

[2] Section 111(b)(1) of the Dodd-Frank Act. The voting members include the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve, Comptroller of the Currency, Director of the Bureau of Consumer Financial Protection, Chairman of the Securities and Exchange Commission, Chairperson of the Federal Deposit Insurance Corporation, Chairperson of the Commodity Futures Trading Commission, Director of the Federal Housing Finance Agency, Chairman of the National Credit Union Administration Board, and an independent member appointed by the U.S. President.

[3] *Id.* at Section 112(a)(1).

[4] *Id.* at Section 113.

[5] *Id.* at Section113(a)(2). Other considerations include the extent of the company's leverage, the nature and extent of off-balance-sheet exposure, the importance of the company as a source of credit to various parties, the nature and scope of the company's activities, the degree to which the company may already be regulated, and the amount and nature of the assets and liabilities of the company.

[6] *Id.* at Section 102.

[7] *Id.*

[8] *Id.* at Section 102(a). A company is "predominantly engaged in financial activities" if either (i) the annual gross revenues derived by the company and its subsidiaries from activities that are financial in nature (and, if applicable, from control of insured depository institutions) represents 85% or more of the consolidated gross revenues of the company; or (ii) the consolidated assets of the company and its subsidiaries related to activities that are financial in nature (and, if applicable, from control of insured depository institutions) represents 85% or more of the consolidated assets of the company. "Financial in nature" is defined under Section 4(k) of the Bank Holding Company Act of 1956, and is discussed later in more detail.

[9] Proposed Rule § 225.301(a)(1) and (2).

[10] 12 CFR §§ 225.28(b) and 225.86(a)(2).

[11] 12 CFR § 225.86(b).

[12] 12 CFR § 225.86(c).

[13] Predominantly engaged in financial activities if "(i) [t]he consolidated annual gross financial revenues of the company represent 85% or more of the company's consolidated annual gross revenues; or (ii) [t]he consolidated total financial assets of the company represent 85 percent or more of the company's consolidated total assets." (§ 225.301(a)(3) of the Proposed Rule).

[14] *See supra,* note 10.

[15] *See supra,* note 11.

[16] *See supra,* note 12.

[17] See p. 10 of the Supplementary Information to the FRB Proposed Rule.

[18] Proposed Rule § 225.301(d)(2).

[19] Section 113(c)(1) of the Dodd-Frank Act.

[20] 12 USC § 1843(k)(3).

[21] See p. 13 of the Supplementary Information to the FRB Proposed Rule.