

MEMO# 25583

October 25, 2011

FSOC Issues Second Rule Proposal Regarding "SIFI" Designations

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 74-11
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 56-11
SEC RULES MEMBERS No. 123-11 RE: FSOC ISSUES SECOND RULE PROPOSAL REGARDING "SIFI" DESIGNATIONS

Earlier this month, the Financial Stability Oversight Council ("FSOC") issued a second notice of proposed rulemaking ("Proposed Rule") and proposed interpretive guidance ("Proposed Guidance" and, together with the Proposed Rule, "Release") regarding the designation of certain nonbank financial companies for consolidated supervision and regulation by the Federal Reserve Board. [\[1\]](#) Among other things, the Release outlines the proposed process by which the FSOC intends to analyze whether particular companies should be designated as so-called systemically important financial institutions ("SIFIs"). Of particular note, it indicates that the FSOC is continuing to consider how to analyze potential threats to U.S. financial stability, if any, arising from asset management companies. A brief summary is provided below.

Background

The FSOC may designate a nonbank financial company for heightened supervision and regulation by determining that (1) material financial distress at the company, or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to U.S. financial stability (the "Determination Standards"). [\[2\]](#) The FSOC must consider certain factors specified in the Dodd-Frank Act and any other risk-related factor that it deems appropriate. In two prior comment letters, ICI provided its views on how the FSOC should consider certain factors, including in evaluating funds and investment advisers, and asserted that funds are at the "less risky" end of the spectrum when considering the potential for systemic risk. [\[3\]](#) ICI also argued that any further reforms to strengthen the resiliency of money market funds should be instituted on an industry-wide basis, not through use of the FSOC's SIFI designation authority.

Proposed Rule

The Proposed Rule largely tracks the Initial Rule Proposal. In particular, the text of the Proposed Rule reiterates the language in Section 113 of the Dodd-Frank Act regarding the FSOC's authority to designate nonbank financial companies for consolidated supervision and regulation by the Federal Reserve Board upon a finding that the company satisfies one of the Determination Standards. The list of factors that the FSOC must consider is taken directly from the statute. In addition, the Proposed Rule outlines many of the processes and procedures applicable to SIFI designations.

Proposed Guidance

The Proposed Guidance is presented as an appendix to the Proposed Rule. Among other things, the Proposed Guidance defines the terms "threat to U.S. financial stability" and "material financial distress," which are referenced in the Determination Standards. It also details the three-stage process by which the FSOC proposes to determine—in non-emergency situations—whether a nonbank financial company should be subject to SIFI designation.

Stage 1 - Initial Identification of Nonbank Financial Companies for Evaluation

In order to identify the range of nonbank financial companies requiring further (and company-specific) evaluation, the FSOC would apply uniform quantitative thresholds that are intended to measure (1) the susceptibility of a nonbank financial company to financial distress and (2) the potential for that company's financial distress to spread throughout the financial system. The proposed thresholds [\[4\]](#) are:

- \$50 billion or more in total consolidated assets ("asset threshold")
- \$30 billion in gross notional credit default swaps outstanding, for which the nonbank financial company is the reference entity
- \$3.5 billion of derivative liabilities
- \$20 billion of outstanding loans borrowed and loans issued
- Minimum leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1
- Short term debt ratio of 10% of total consolidated assets (excluding separate accounts)

A nonbank financial company meeting or exceeding the asset threshold and at least one other threshold would be subject to Stage 2 evaluation (described below). In applying each of the thresholds to investment funds managed by a nonbank financial company, the FSOC "may consider the funds as a single entity if their investments are identical or highly similar." Further, the FSOC reserves the right to evaluate any nonbank financial company—even if not identified in Stage 1—if the FSOC believes that further analysis is warranted to determine if the company could pose a threat to U.S. financial stability.

To conduct its Stage 1 analysis, the FSOC will use information available to it from existing public and regulatory sources.

Stage 2 - Evaluation of the Identified Nonbank Financial Companies

Each nonbank financial company identified in the Stage 1 process will be subject to a

“robust” evaluation of its risk profile and characteristics based on a wide range of qualitative and quantitative factors. The Stage 2 evaluation will include use of an analytical framework—first proposed in the Initial Rule Proposal—that is organized around six broad categories that the FSOC believes are relevant to assessing whether a company could pose a threat to U.S. financial stability:

- Size
- Lack of substitutes for the financial services and products the company provides
- Interconnectedness with other financial firms
- Leverage
- Liquidity risk and maturity mismatch
- Existing regulatory scrutiny

The Release explains that the first three categories seek to assess the potential for spillovers from the company’s distress to the broader financial system, and the last three categories seek to assess how vulnerable a company is to financial distress. Unlike the Initial Rule Proposal, the Release provides examples of the various metrics that the FSOC expects to use in analyzing a company under each of the six categories outlined above.

To conduct its Stage 2 analysis, the FSOC will use information available to it from existing public and regulatory sources, and will “begin the consultation process” with a nonbank financial company’s primary regulator. According to the Release, the FSOC intends to “rely whenever possible on information available through the Office of Financial Research or primary financial regulatory agencies before requiring the submission of reports from any nonbank financial company,” although it will also use “information obtained from the company voluntarily.”

Stage 3 - In-Depth Evaluation of a Nonbank Financial Company

Following its Stage 2 analysis, any company selected for in-depth review will receive a notice from the FSOC that it is being considered for possible SIFI designation. The review will focus on whether the nonbank financial company satisfies one of the Determination Standards.

Stage 3 would involve the evaluation of information collected directly from the nonbank financial company, in addition to the information considered during Stages 1 and 2. Such information may include confidential business information such as internal assessments, internal risk management procedures, funding details, counterparty exposure or position data, strategic plans, resolvability, potential acquisitions or dispositions, and other anticipated changes to the company’s business or structure that could affect the threat to U.S. financial stability posed by the company. The Release states that the FSOC and its member agencies “will maintain the confidentiality of such information to the fullest extent of applicable law.” The company will have the opportunity to submit written materials contesting the FSOC’s consideration of the company for possible SIFI designation.

Application to Asset Management Companies

The Release specifically mentions asset management companies several times. For example, according to the Release, the FSOC recognizes that the Stage 1 quantitative thresholds may not provide an appropriate means to identify a subset of nonbank financial companies for additional review across all financial industries and firms. In particular, the Release notes that certain types of nonbank financial companies, including asset management companies, “may pose risks that are not well-measured by the quantitative

thresholds approach.”

The Release further indicates that the FSOC, its member agencies, and the Office of Financial Research

. . . 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 [Federal Reserve Board] supervision, or whether they are better addressed through other regulatory means.

In addition, the Release states that the FSOC may issue for public comment further guidance on potential additional metrics and thresholds for asset managers.

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ICI intends to file a comment letter on this proposal. The deadline for comments to the FSOC is December 19.

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endnotes

[1] FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64264 (Oct. 18, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-10-18/pdf/2011-26783.pdf>. The Release supersedes a less detailed proposal issued by the FSOC last January. See FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4555 (Jan. 26, 2011) (“Initial Rule Proposal”).

[2] Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

[3] See Institute Memoranda [24696](#) and [24994](#), dated Nov. 10, 2010 and Feb. 25, 2011, respectively (summarizing ICI’s comment letters on the FSOC’s advance notice of proposed rulemaking and the Initial Rule Proposal).

[4] As reporting requirements evolve and new data about certain industries and nonbank financial companies becomes available, the FSOC expects to review the thresholds as appropriate based on the new information.