MEMO# 24588

October 7, 2010

Council Of Financial Regulators Requests Comment On Designating Nonbank Firms For Heightened Supervision, Implementing Volcker Rule

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TO: ETF ADVISORY COMMITTEE No. 41-10
FEDERAL LEGISLATION MEMBERS No. 8-10
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 47-10
SEC RULES MEMBERS No. 97-10 RE: COUNCIL OF FINANCIAL REGULATORS REQUESTS COMMENT ON DESIGNATING NONBANK FIRMS FOR HEIGHTENED SUPERVISION, IMPLEMENTING VOLCKER RULE

On October 1, the new Financial Stability Oversight Council (Council, or FSOC) held its inaugural meeting. Established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Council is responsible for identifying risks to financial stability and responding to emerging threats to the U.S. financial system. [1] At its meeting, the Council approved notices seeking public comment regarding (1) the criteria the Council will consider in designating certain non-bank financial companies for heightened supervision and (2) implementation of the Volcker Rule. These notices, and other actions taken by the Council, are briefly summarized below. [2]

Designation of "Systemically Significant" Nonbank Financial Companies

Under the Dodd-Frank Act, the Council is responsible for identifying nonbank financial companies (both U.S. and foreign) for heightened supervision and regulation by determining whether material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to U.S. financial stability. In making these determinations, the Council must consider various factors, including among others:

- the extent of leverage of the company
- the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse
- the amount and nature of the financial assets of the company
- the amount and types of the liabilities of the company, including the degree of reliance on short-term funding
- the importance of the company as a source of liquidity for the U.S. financial system
- any other risk-related factors that the Council deems appropriate

The Council has issued an advance notice of proposed rulemaking, which is described as "an initial step in the process by which the Council intends to develop a robust and disciplined framework" for determining which nonbank financial companies should be subject to heightened supervision. [3] The notice poses 15 very detailed questions that address, for example, how the Council should "measure and assess" certain factors identified in the Dodd-Frank Act, whether the Council should take certain other factors into account, and whether some factors should be weighted more heavily than others. Of particular interest to the fund industry are questions such as the following:

- How should the Council take managed assets into consideration in making designations? How should the term "managed assets" be defined? Should the type of asset management activity (e.g., hedge fund, private equity fund, mutual fund) being conducted influence the assessment under this criterion? How should terms, conditions, triggers, and other contractual arrangements that require the nonbank financial firm either to fund or to satisfy an obligation in connection with managed assets be considered?
- During the financial crisis, some firms provided financial support to investment vehicles sponsored or managed by their firm despite having no legal obligation to do so. How should the Council take account of such implicit support?

Comments must be filed electronically with the FSOC no later than November 5.

Study and Recommendations on Implementing the Volcker Rule

The so-called "Volcker Rule" provisions in the Dodd-Frank Act generally prohibit any "banking entity" from engaging in "proprietary trading" and from acquiring or retaining an ownership interest in, or "sponsoring," a "hedge fund" or "private equity fund." The law also enumerates certain "permitted activities," including, among others: underwriting and market making-related activities, "to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;" risk-mitigating hedging activities; and trading securities or other instruments on behalf of customers. In addition, a banking entity that provides bona fide trust, fiduciary, or investment advisory services is permitted to organize and offer a private equity or hedge fund in connection with providing such services to its trust, fiduciary, or investment advisory customers, subject to various additional restrictions.

Under the Dodd-Frank Act, the Council is required to conduct a study and make recommendations on implementing the Volcker Rule provisions to achieve specified goals, such as protecting the safety and soundness of banking entities, protecting taxpayers and consumers, and enhancing financial stability. The Council's recommendations, which are due by January 22, 2011, must then be considered by the regulators charged with adopting implementing rules through coordinated rulemaking: the appropriate Federal banking agencies; the Federal Reserve; the SEC; and the CFTC.

The Council has issued a request for information to assist it in conducting the study and formulating its recommendations. [4] The notice poses several questions intended to elicit input as to the "factors and considerations" that the Council should take into account in making its recommendations. It also invites comment with regard to "any qualitative or quantitative factors" that should be considered, "as well as any analogous areas of law, economics, or industry practice, and any factors specific to the commenter's experience."

Comments must be filed electronically with the FSOC no later than November 5.

Other Actions

The Council adopted bylaws intended to "provide for a collaborative governance structure that promotes accountability" for its work, and a transparency policy intended to ensure "that the Council will engage stakeholders in an open process." The FSOC has also published an "Integrated Implementation Roadmap," which sets forth a timeline of actions to be taken by the Council and its member agencies to implement the Dodd-Frank Act. All of these documents are accessible through the Council's webpage (www.treasury.gov/FSOC).

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endnotes

[1] For more information, see Frequently Asked Questions About the Financial Stability Council, available on the Council's webpage at http://www.treasury.gov/FSOC/.

[2] See Financial Stability Oversight Council Holds Inaugural Meeting (press release dated Oct. 1, 2010), available at http://www.treasury.gov/press/releases/tg888.htm.

[3] Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61653 (Oct. 6, 2010), available at http://www.treasury.gov/FSOC/docs/2010-25321_PI.pdf.

[4] Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds, 75 Fed. Reg. 61758 (Oct. 6, 2010), available at http://www.treasury.gov/FSOC/docs/2010-25320_PI.pdf.