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## A Whole New Ball Game: SIFI Designations in the Dodd-Frank Paradigm

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The process for designating systemically important financial institutions (“SIFIs”) under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) is moving forward apace. On April 3, 2012, the Financial Stability Oversight Council (“FSOC”) unanimously approved the release establishing final rules and guidelines (the “Final Release”) for how it will designate nonbank SIFIs.<sup>1</sup> Firms so designated will be subject to bank-like prudential supervision, including capital and liquidity requirements.

Notably, we expect the FSOC to begin issuing notices of consideration to potential SIFI designees this summer, with final designations occurring later this year.<sup>2</sup> Consequently, the first stages of the SIFI designation process are likely well underway.

Dodd-Frank left many of the most significant financial services policy determinations up to regulators. As a result, the rulemaking process has shifted to an ongoing dialogue with market participants and continuing Congressional oversight. The SIFI designation process is one of the clearest examples of the new dynamic. In this new environment, potential SIFIs need to assess the implications of being designated as a SIFI and should develop a strategic response that would likely involve engaging with regulators and other policymakers. This alert identifies critical questions for potential SIFIs; summarizes the legal framework of the SIFI designation process; and discusses key aspects of the Final Release.

### Critical Questions

Financial institutions should consider the following questions when developing a strategy for responding to the possibility of being designated a SIFI.

- Are we an Eligible Company (defined below)?
- Do we currently meet or exceed the quantitative thresholds under Stage 1 of the Guidance (defined below)?
- Even if we do not meet the Stage 1 quantitative thresholds, is there a reason that the FSOC would consider us for SIFI designation?
- When and at what level should we consider engaging policymakers?
- Are there steps we can take now to:
  - Reduce the risk that we will be designated a SIFI?
  - Shape the prudential standards that will apply to SIFIs?
  - Prepare to challenge a SIFI designation administratively or in court?

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### Legal Framework

#### *Eligible Companies*

Only a “nonbank financial company” is eligible for SIFI designation (an “Eligible Company”). A nonbank financial company is a company that is “predominately engaged in financial activities.”<sup>3</sup> A company is predominately engaged in financial activities if, on a consolidated basis, it derives at least 85 percent of its revenue from, or has at least 85 percent of its assets related to,<sup>4</sup> activities that are “financial in nature.”<sup>5</sup> Recently, the Federal Reserve proposed regulations codifying the list of activities that are financial in nature (“Financial Activities Rule”). The breadth of the Financial Activities Rule, capturing many activities that are not traditionally viewed as financial or systemically risky, means that the pool of Eligible Companies is larger than many may realize.<sup>6</sup> The Federal Reserve will accept public comments on the Financial Activities Rule through May 25, 2012.<sup>7</sup>

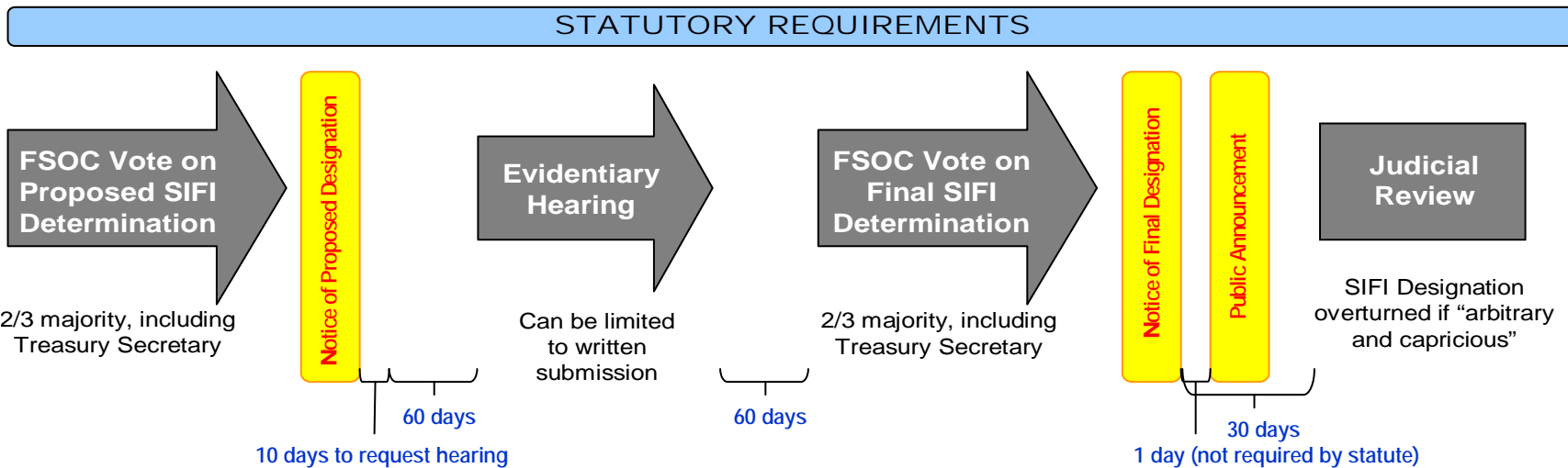
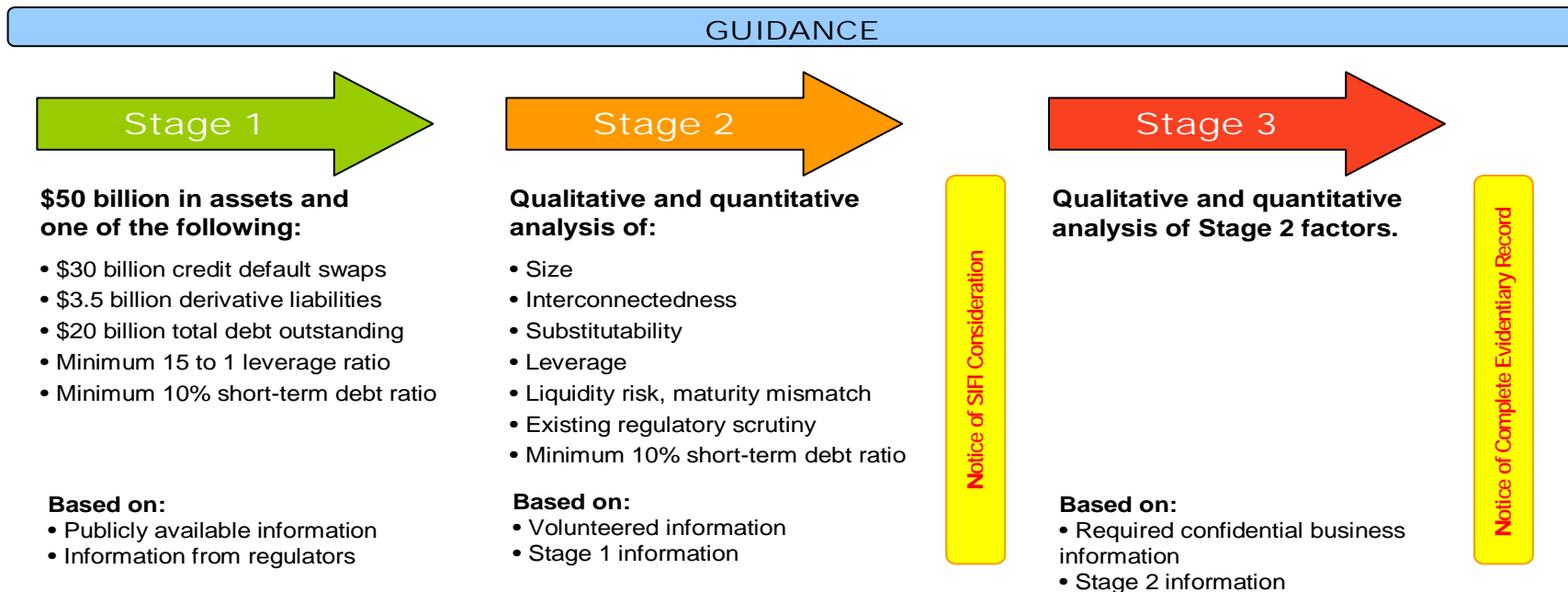
#### *SIFI Designation*

Dodd-Frank authorizes the FSOC to designate an Eligible Company as a SIFI if its material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities, could pose a threat to the financial stability of the United States.<sup>8</sup> The Final Release codifies in regulation the determination standards and certain factors and procedural steps required by the statute. The Final Release also contains an appendix (the “Guidance”) outlining three stages of review and various metrics the FSOC will apply to determine when an Eligible Company should be designated a SIFI. After FSOC staff analyze an Eligible Company in all three stages outlined in the Guidance, the FSOC must follow statutory requirements to designate a SIFI.

As outlined in the chart on the following page, the FSOC will perform most of its analysis without informing an Eligible Company that it is being considered for SIFI designation. Absent a proactive approach on the part of a possible SIFI designee, an Eligible Company will be notified that it is being considered for SIFI designation well after the FSOC has performed much of its quantitative and qualitative analysis.

#### *Prudential Standards for SIFIs*

After formal designation, a SIFI will be subject to consolidated supervision by the Federal Reserve and enhanced prudential standards.<sup>9</sup> These standards will impose risk-based capital requirements and leverage limits on SIFIs, which many have criticized as being inappropriate or unworkable. However, the Federal Reserve has discretion to tailor prudential regulation on an individual basis or by industry category.<sup>10</sup> Based on discussions with Federal Reserve staff, it is clear that the Federal Reserve intends to “scale” prudential regulation based on the specific risk characteristics of each SIFI. Consequently, engaging in a dialogue with the Federal Reserve on the impact of prudential standards applicable to each SIFI is essential.



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### Key Insights from the Final Release

#### *Conservative Estimate of 50 Impacted Companies*

The FSOC estimates in the Final Release that fewer than 50 Eligible Companies will meet the Stage 1 thresholds. Given the scope of the Financial Activities Rule, however, this number may be conservative. Eligible Companies that are not traditionally viewed as financial services companies also could be subject to SIFI designation if the FSOC takes an aggressive approach in the future. Political pressure could also encourage the FSOC to designate additional firms as SIFIs, as discussed further below.

#### *No Safe Harbor*

Even though Dodd-Frank allowed for a regulatory safe harbor that would exempt certain types or classes of Eligible Companies from SIFI designation,<sup>11</sup> the Final Release states that the FSOC “does not intend to provide industry-based exemptions” from SIFI designation. Instead, the FSOC will consider the threat an industry segment poses to financial stability as one of many factors when making individual SIFI designations.

#### *Guidance Not Binding*

According to the FSOC, the Guidance provides transparency as to how the FSOC intends to interpret the statute, but the Guidance does not necessarily bind the FSOC. The Guidance explicitly states that an Eligible Company that does not meet the Stage 1 thresholds could be moved to Stage 2 and ultimately be designated a SIFI “based on other firm-specific qualitative or quantitative factors.” The FSOC also reserves the right to change the Guidance without providing notice.

#### *Asset Management*

Dodd-Frank provides that, when evaluating an Eligible Company for SIFI designation, the FSOC “shall consider . . . 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.”<sup>12</sup> This language was intended to direct the FSOC to consider the distinct nature of mutual fund complexes and other asset managers when designating SIFIs. The FSOC, however, will still apply the Guidance to all Eligible Companies, including asset managers, private equity firms, and hedge funds, even though the Final Release acknowledges that the Guidance, especially the Stage 1 thresholds, may not be appropriate.

The FSOC will consider the “unique and distinct nature” of assets under management, compared to the asset manager’s own assets, when deciding whether to designate an asset manager a SIFI.<sup>13</sup> A recent statement by a senior Treasury Department official indicates that the FSOC will be less likely to designate an asset manager as a SIFI to the extent that the asset manager holds assets in custody on behalf of its customers.<sup>14</sup> Further, the FSOC may disregard separate corporate identities to aggregate the “risks posed by separate funds that are managed by the same adviser, particularly if the funds’ investments are identical or highly similar.”<sup>15</sup>

The Office of Financial Research (“OFR”), which is housed at the Treasury Department and effectively serves as the FSOC’s investigatory arm, is conducting a study to determine what threats to financial stability exist, “if any,” from asset management companies and “whether” SIFI designation or alternative regulatory measures would best mitigate those risks. Even though this language may suggest that the FSOC would not designate asset management companies as SIFIs, the FSOC emphasizes that it will evaluate asset managers under the current Guidance. In addition, the preamble

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to the Financial Activities Rule goes out of its way to assert that asset managers are eligible for SIFI designation, arguably even mischaracterizing certain aspects of the legislative history.<sup>16</sup>

In the future, the OFR and the FSOC may develop additional guidance tailored to asset managers. Any additional guidance would not displace the Final Release and would most likely establish additional thresholds, “potentially including factors related to assets under management.”<sup>17</sup>

### *Derivatives Liabilities*

According to the Final Release, the FSOC will calculate an Eligible Company’s Stage 1 derivatives liability by offsetting an Eligible Company’s derivatives exposure based on the fair value of out-of-the-money positions taking into account the effects of any master netting agreements or cash collateral held with the same counterparty on a net basis. To obtain this benefit, such master netting agreements or cash collateral must be publicly disclosed. The Stage 1 threshold for derivatives liabilities is \$3.5 billion.<sup>18</sup> The FSOC may also “revisit” the Stage 1 quantitative threshold for derivatives liabilities once the Commodity Futures Trading Commission and the Securities and Exchange Commission (“SEC”) begin gathering data on current and future exposure of an Eligible Company’s outstanding derivatives exposures.

### *SIFI Designation Threats Motivating Other Regulators to Act*

The Final Release notes that SIFI designation is only one of many tools the FSOC and its members can use to address systemic risk. Before the public vote approving the Final Release, Treasury Secretary Geithner, who serves as the Chairman of the FSOC, emphasized this point, citing federal regulation of money market funds as one of several examples. Traditionally, money market fund regulation has been viewed as the SEC’s exclusive responsibility. In the post-Dodd-Frank world, however, other regulatory agencies appear to have some level of influence over the SEC. Chairman Geithner’s comments, together with recent statements by senior officials from other FSOC member agencies, show that the FSOC is monitoring the money market fund reform debate occurring at the SEC and has a role in that dialogue.<sup>19</sup> The FSOC may be prepared to designate large money market funds as SIFIs if the SEC does not enact additional reform. This interplay between SIFI designation and the money market fund reform debate illustrates how financial services rulemaking has evolved from a linear process to an era requiring a more dynamic dialogue with and among policymakers.

## Conclusion

The Final Release provides limited transparency about the actual SIFI designation process. However, what is clear is that there are opportunities to influence both the SIFI designation and the scope of regulation applicable to such firms. Even after issuing the Final Release, members of the FSOC are still defining the scope of their authority. The OFR study on asset managers is one example of this dynamic and evolving process. Options for directly influencing the SIFI designation process include educating FSOC members on the risk characteristics of each Eligible Company, exhausting the administrative procedures established by Dodd-Frank and, ultimately, judicial review. Meanwhile, the Federal Reserve is finalizing the framework for prudential regulation of SIFIs, presenting an additional opportunity for engagement.

Importantly, Members of Congress are actively engaged in oversight with respect to FSOC designation of SIFIs through formal hearings and other forms of influence. Given the many uncertainties inherent in this process, and the ongoing interest of key Members of Congress, further change is possible. Eligible Companies should therefore engage members of the FSOC, the Federal

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Reserve, and other policymakers in order to favorably influence both the SIFI designation process and the regulations that will be applicable to each SIFI.

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<sup>1</sup> 77 Fed. Reg. 21637 (Apr. 11, 2012).

<sup>2</sup> Several factors lead us to conclude that the FSOC is rapidly advancing the SIFI designation process. The Final Release specifies how many firms may ultimately be considered SIFIs, suggesting that the FSOC has already determined how many firms will be preliminarily evaluated. Furthermore, beginning this summer, Federal Reserve funding for the FSOC and the Office of Financial Research will expire, after which future expenses must be covered through assessments on large bank holding companies and SIFIs. Finally, given the statutory waiting periods required for SIFI designation, the FSOC will need to act quickly to meet Chairman Geithner's goal of designating the first SIFIs by the end of this year. See Remarks on the State of Wall Street Reform by FSOC Chairman and Treasury Secretary Timothy Geithner (Feb. 2, 2012), available at <http://www.yorkcast.com/treasury/ondemand/asx/2012/02/02/TFGPresser.asx>.

<sup>3</sup> 12 U.S.C. § 5311(a)(4).

<sup>4</sup> For U.S. companies, global revenue and assets are considered when calculating the 85 percent thresholds. For foreign companies, only U.S. subsidiaries and U.S. activities, including activities conducted by remote affiliates, are included. 12 U.S.C. §§ 5311(a)(6), (c).

<sup>5</sup> 12 U.S.C. § 5311(a)(6).

<sup>6</sup> 77 Fed. Reg. 21494, 21503 (Apr. 10, 2012). The Federal Reserve has proposed that the following activities be considered financial in nature: (i) lending, investing, or safeguarding money or securities; (ii) insuring against loss, issuing annuities, and acting as broker for the foregoing; (iii) providing financial, investment, or economic advice; (iv) issuing or selling interests in pools of assets; (v) underwriting or dealing in securities; (vi) servicing loans; (vii) activities related to extending credit, including appraisal, check-guaranty, credit bureau, asset management, collection, and real estate settlement services; (viii) leasing personal or real property; (ix) operating nonbank depository institutions; (x) trust company activities; (xi) financial advisory activities; (xii) agency investment transaction services; (xiii) principal investment

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transactions; (xiv) management consulting; (xv) support services, including courier services for checks, commercial paper, audit, and accounting for financial media; (xvi) insurance underwriting; (xvii) community development activities; (xviii) issuing money orders; (xix) data processing, storage, and data transmission, if the data are financial, banking, or economic; (xx) providing administrative services to mutual funds; (xxi) owning shares of a securities exchange; (xxii) certifying digital signatures; (xxiii) providing employment histories to third parties; (xxiv) cashing checks and transmitting wires; (xxv) in connection with offering banking services, notary public services, selling postage stamps and postage-paid envelopes, vehicle registration services, and selling public transportation tickets; (xxvi) real estate title abstracting; (xxvii) management consulting services; (xxviii) operating a travel agency in connection with financial services; (xxix) sponsoring a mutual fund; (xxx) merchant or investment banking activities; (xxxi) controlling an insurance company; (xxxii) lending, investing, or safeguarding financial assets other than money or securities; (xxxiii) transferring money or other financial assets; and (xxxiv) facilitating financial transactions.

<sup>7</sup> 76 Fed. Reg. 7731 (Feb. 11, 2011), *as amended by* 77 Fed. Reg. 21494 (Apr. 10, 2012).

<sup>8</sup> 12 U.S.C. § 5323; *see* 12 U.S.C. § 5322(a)(2)(H).

<sup>9</sup> 12 U.S.C. §§ 5325, 5365.

<sup>10</sup> 77 Fed. Reg. 594, 597 (Jan 5, 2012). Although the formal comment period for the proposal on enhanced prudential standards closed on April 30, 2012, the Federal Reserve has the discretion to tailor such regulation on an individual or industry-wide basis.

<sup>11</sup> 12 U.S.C. § 5370.

<sup>12</sup> 12 U.S.C. § 5323(a)(2)(F).

<sup>13</sup> 77 Fed. Reg. 21637, 21645 (Apr. 11, 2012).

<sup>14</sup> Lance Auer, Deputy Assistant Secretary for Financial Institutions, Response to Congressman David Scott before the House Financial Services Financial Institutions Subcommittee (May 17, 2012).

<sup>15</sup> 77 Fed. Reg. 21637, 21645 (Apr. 11, 2012).

<sup>16</sup> The Federal Reserve claims that comments by Senator John Kerry (D-MA) suggest that Congress intended mutual funds to be eligible for SIFI designation and subject to Federal Reserve supervision. 77 Fed. Reg. 21494, 21495 (April 10, 2011). Senator Kerry's remarks, however, state the opposite: "There are large companies providing financial services that are in fact traditionally low-risk businesses, such as mutual funds and mutual fund advisers. We do not envision nonbank financial companies that pose little risk to the stability of the financial system to be supervised by the Federal Reserve." 156 Cong. Rec. S5902-03 (Jul. 15, 2010).

<sup>17</sup> 77 Fed. Reg. 21637, 21645 (Apr. 11, 2012).

<sup>18</sup> This threshold determination is intended to account for counterparty risk as a threat to the stability of the financial system. According to the Final Release, the FSOC intends to apply a separate threshold of \$30 billion in gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity. This is supposed to reflect that a large number of institutions may have synthetic exposure to the credit risk of a nonbank financial company and that a significant number of financial market participants may be affected if the nonbank financial company fails.

<sup>19</sup> Ben Bernanke, Chairman, Federal Reserve Board, Fostering Financial Stability (Apr. 9, 2012), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20120409a.htm>; Eric Rosengren, President and Chief Executive Officer, Federal Reserve Bank of Boston, Remarks at the Federal Reserve Bank of Atlanta's 2012 Financial Markets Conference ("Financial Reform: The Devil's in the Details") (Apr. 11, 2012), *available at* <http://www.bostonfed.org/news/speeches/rosengren/2012/041112/index.htm>; Mary Miller, Under Secretary for Domestic Finance, Department of Treasury, Remarks by Under Secretary for Domestic Finance Mary Miller at the Annual Conference of the National Federation of Municipal Analysts (Apr. 18, 2012), *available at* <http://www.treasury.gov/press-center/press-releases/Pages/tg1539.aspx>; Daniel Tarullo, Governor, Federal Reserve Board, Regulatory Reform since the Financial Crisis (May 2, 2012), *available at* <http://www.federalreserve.gov/newsevents/speech/tarullo20120502a.htm>.