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THE DODD-FRANK ACT: APPLICATION OF HEIGHTENED BANK-LIKE SUPERVISION AND REGULATION TO SYSTEMICALLY SIGNIFICANT FINANCIAL COMPANIES

To Our Clients and Friends:

Enacted on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") comprehensively reforms and restructures the U.S. financial regulatory system. As part of this effort, Title I of the Act establishes the new Financial Stability Oversight Council (the "Council"). The Council's purposes include: (i) identifying risks and responding to emerging threats to the financial stability of the United States and its financial system; and (ii) promoting market discipline by ending government loss shielding of shareholders, creditors and counterparties (that is, eliminating the concept of "too big to fail").

To this end, a main power of the Council is to designate systemically significant nonbank financial companies that will be subject to Federal Reserve Board (the "Federal Reserve") supervision. As a result, going forward under the U.S. financial regulatory system, the applicability of intensive bank-like supervision and regulation will no longer be limited to entities affiliated with a bank or that are part of a depository institution holding company system.

Instead, the kinds of companies subject to such supervision, regulation, examination and enforcement will be expanded to include any systemically significant nonbank company "predominantly engaged" in financial activities. [1] These companies will also be subject to "prudential standards" promulgated by the Federal Reserve. Such a "nonbank financial company" could be, for example: (i) an insurance company; (ii) a securities firm; (iii) a mutual fund group; (iv) a private equity or hedge fund group; or (iv) a finance or lending company.

Under the Act, the new Council will designate a systemically significant entity as a covered nonbank financial company if the Council determines that material financial distress at such an entity, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the entity, could pose a threat to the financial stability of the United States. The Act provides a nonexclusive list of items the Council must consider in making such a determination.

Most importantly, in addition to the specific items below, the list may include "any other risk-related factors that the Council deems appropriate." Accordingly, the range of factors that the Council may consider is open-ended and in the discretion of the Council. The specific items to be considered include:

1. The extent of the leverage of the company;

2. The extent and nature of the off-balance-sheet exposures of the company;

3. The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;

4. The importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;

5. The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

6. 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;

7. The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

8. The degree to which the company is already regulated by 1 or more primary financial regulatory agencies;

9. The amount and nature of the financial assets of the company; and

10. The amount and types of the liabilities of the company, including the degree of reliance on short-term funding.

In this connection, in October 2010, the Council issued an advanced notice of proposed rulemaking ("ANPR") seeking public comment on the criteria that should be used to apply these factors.[2] For example, the Council requested comment on "What metrics should the Council use to measure the factors it is required to consider when making determinations" under the Act? We will analyze the results of the ANPR and the future notice of proposed rulemaking when it is released.

As part of its decision-making process, the Council, acting through the also new Office of Financial Research, may require the submission of reports from entities to assist it in determining whether the entity is a covered nonbank financial company or for the purpose of assessing the extent to which a financial activity or financial market that the entity participates in poses a threat to the financial stability of the United States. The Council may also request that the Federal Reserve examine a company for these purposes.

The consequences of being deemed a nonbank financial company are extensive. Essentially, the corporate governance, management and operations of such an entity become subject to Federal Reserve oversight and approval. As part of its supervisory and regulatory authority, the Federal Reserve generally can take the following actions with respect to a nonbank financial company and any subsidiary thereof: (1) require submission of reports; (2) examine such companies; and (3) take enforcement actions against such companies.

Moreover, the Federal Reserve must establish so-called "prudential standards" for nonbank financial companies including increasingly stringent standards as the risk to the financial stability of the United States increases from such a company. The mandatory areas for which prudential standards must be adopted includes capital, leverage, liquidity, risk management, credit exposures, concentration limits, public disclosures, and short-term debt limits. This list is nonexclusive and the Federal Reserve may also impose any other prudential standard it believes to be appropriate. Accordingly, the Federal Reserve has plenary authority in this area.

In addition, the Federal Reserve's prior approval is required for a nonbank financial company to acquire, make certain investments in or have control relationships with (i) banks; and (2) nonbanking entities engaged in financial activities having total consolidated assets of $10 billion or more. A nonbank financial company is also subject to certain management interlock prohibitions with nonaffiliated entities.

Finally, if the Federal Reserve and the Council determine that a nonbank financial company poses a grave threat to the financial stability of the United States, the Federal Reserve shall:

1. Limit the ability of the company to merge with, acquire, consolidate with, or otherwise become affiliated with another company;

2. Restrict the ability of the company to offer a financial product or products;

3. Require the company to terminate one or more activities;

4. Impose conditions on the manner in which the company conducts one or more activities; or

5. If (1)-(4) are inadequate, require the company to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities.

Overall, for an entity that is designated as a nonbank financial company under the Act, in particular an entity not currently subject to government supervised enterprise-wide risk management or comprehensive consolidated supervision, it is difficult to conceive of a more traumatic conversion. Essentially, the management and operations of such an entity will have to be altered at all levels of the organization to take into account and satisfy its new regulatory regime.

[1] Section 102(a)(6) of the Act states: "A company is predominantly engaged in financial activities if--

(A) the annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, from the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated annual gross revenues of the company; or

(B) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated assets of the company."

[2] *See* 75 *Fed. Reg*. 61653 (October 6, 2010).

Gibson, Dunn & Crutcher lawyers are available to assist in addressing any questions you may have the issues discussed above. Please contact Christopher J. Bellini (202- 887-3693, cbellini@gibsondunn.com) in the firm's Washington, D.C. office or the Gibson Dunn attorney with whom you work.