COMMITMENT | EXCELLENCE | INNOVATION

ARNOLD & PORTER LLP

ADVISORY July 2010

Dodd-Frank Act Addresses Systemic Risk

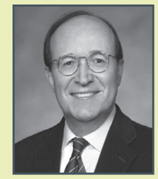
One of the most-cited impetuses behind the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) efforts has been the need to curtail the systemic risk potentially posed by large, interconnected firms—both those traditionally subject to financial regulation, such as bank holding companies, as well as certain nonbank financial companies. These types of firms, due to their influence and impact on the nation's financial stability, may be considered "too big to fail." In response to these concerns, Title I of the Act, entitled the "Financial Stability Act of 2010," creates a framework to identify, monitor, and address potential risks to financial stability and to regulate complex companies engaged in activities and practices determined to pose systemic threats to the US economy. Nonbank financial companies deemed systemically significant may be brought under the regulatory oversight of the Federal Reserve Board (Federal Reserve), and, along with large bank holding companies already subject to Federal Reserve supervision under the Bank Holding Company Act of 1956, as amended (Bank Holding Company Act), be required to meet heightened prudential standards, refrain from engaging in certain financial activities, restrict their ability to merge with or acquire other entities, or even sell or transfer specific assets, all in order to prevent or remove "grave threat[s] to the financial stability of the United States."

The Financial Stability Oversight Council

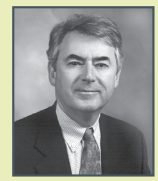
At the core of Dodd-Frank's systemic risk monitoring and mitigation framework lies the Financial Stability Oversight Council (FSOC), chaired by the Secretary of the Treasury (Treasury Secretary) and consisting of 15 members: 10 voting and 5 nonvoting. The voting members, in addition to the Treasury Secretary and an independent member with insurance expertise appointed by the President, are the heads of:

- The Federal Reserve;
- The Office of the Comptroller of the Currency;
- The Securities and Exchange Commission;

Contacts



Kevin F. Barnard
+1 212.715.1020

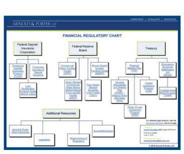


A. Patrick Doyle
+1 212.715.1770
+1 202.942.5949

Alan Avery
+1 212.715.1056

Beth S. DeSimone
+1 202.942.5445

Kathleen Scott
+1 212.715.1799



Financial Regulatory Chart

Financial Regulatory Reform: *For Arnold & Porter's latest resources on this topic including Advisories, upcoming events, and publications, please visit Financial Regulatory Reform. Also visit our Financial Regulatory Chart, which aggregates information on US government programs.*

- The Federal Deposit Insurance Corporation (FDIC);
- The Commodity Futures Trading Commission;
- The Federal Housing Finance Agency;
- The National Credit Union Administration Board; and
- The newly created Consumer Financial Protection Bureau.

In addition to the 10 voting members, the nonvoting members are the Director of the Federal Insurance Office established under Title V of the Act, a state insurance commissioner, a state banking supervisor, a state securities commissioner, and the Director of the Department of the Treasury's newly established Office of Financial Research.

The FSOC is charged with identifying systemic risks and gaps in regulation, making recommendations to regulators to address threats to financial stability, and promoting market discipline by eliminating the expectation that the US federal government will come to the assistance of firms in financial distress. The FSOC will be supported by the newly established Office of Financial Research, whose accountants, economists, lawyers, former supervisors, and specialists will gather and analyze data critical to the FSOC's mission. While the FSOC holds no independent enforcement powers, given the breadth of the scope of its authority, its impact on all who engage in or with the financial services sector could be significant.

Defining Systemic Risk

Under the standards set forth in section 113 of the Act, a US or foreign "nonbank financial company" poses a potential systemic risk if "material financial distress at the [company], or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the [company], could pose a threat to the financial stability of the United States." A US nonbank financial company is a company formed in the United States (except for a bank holding company and certain other exempt entities such as a national securities exchange) that is "predominantly engaged in financial activities." A foreign nonbank financial company is a company formed outside the United States (except for a foreign bank that is treated as a bank holding company) that is predominantly engaged in financial activities in the United States, including through a US branch.

A company is "predominantly engaged in financial activities" if 85 percent or more of the consolidated gross revenues or assets of all the company's constituent entities are "financial in nature" as defined in Section 4(k) of the Bank Holding Company Act. Financial activities include banking, securities, insurance, and passive merchant banking activities.

The task of designating a particular nonbank financial company as systemically significant falls to the FSOC, which must make this determination by a two-thirds vote, including the affirmative vote of the Treasury Secretary. In making this determination of systemic risk, the FSOC is directed to consider:

- The extent of the company's leverage;
- The extent and nature of the company's off-balance-sheet exposures;
- The extent and nature of the company's relationships and transactions with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit to households, businesses, and state and local governments, and as a source of liquidity for the US financial system;
- The company's importance as a source of credit for low-income, minority, or underserved communities and the effect that failure of such a company would have on the availability of credit in such communities;
- The proportion of assets that are managed rather than owned by the company as well as the composition and diversity of those managed assets;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the company's activities;
- The existing regulation of the company by one or more of the primary financial regulatory agencies;
- The amount and nature of the company's financial assets and liabilities, including the degree of its reliance on short-term funds; and

- Any other risk-related factors the FSOC deems appropriate.[1]

The determination that a nonbank financial company is of systemic risk, and thus should be supervised by the Federal Reserve, must be made by the FSOC on a company-by-company basis. It is expected that the FSOC will issue regulatory guidance on how these factors will be weighted in a systemic risk determination.

In order to prevent evasion of the requirements of Title I, if the FSOC, on its own initiative or at the request of the Federal Reserve, determines, with a two-thirds vote, including the affirmative vote of the Treasury Secretary, that material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of (i) the financial activities conducted directly or indirectly by *any* US company (even one that does not meet the definition of a "financial company" noted above); or (ii) the financial activities conducted in the United States by a non-US company, would pose a threat to the financial stability of the United States, based on consideration of the same factors discussed above, *and* that the company is organized or operates in such a manner so as to "evade" the application of Title I, then the financial activities of that company also will be supervised by the Federal Reserve in the same manner as the nonbank financial companies deemed by the FSOC to be of systemic risk.

If the FSOC makes such an "anti-evasion" determination, the company in question may elect to establish an intermediate holding company through which to conduct the financial activities that would otherwise subject the entire company to Federal Reserve supervision.

In addition, the Federal Reserve may require a company determined to be of systemic risk to establish such an intermediate holding company to segregate its financial activities. Moreover, the Federal Reserve *must* require that such a company establish an intermediate holding company if the Federal Reserve determines that such action is necessary to monitor appropriately the company's financial activities and to ensure that Federal Reserve supervision does not extend to the company's nonfinancial commercial activities. This intermediate holding company would be supervised by the Federal Reserve and be subject to the prudential standards applicable to nonbank financial companies under Federal Reserve oversight. The Federal Reserve also may promulgate regulations establishing restrictions or limitations on transactions between the intermediate holding company and its affiliates in order to prevent unsafe and unsound practices.

The FSOC must provide a company that is under review for a systemic risk determination (whether for a nonbank financial company or another company under the anti-evasion provision) with written notice of the proposed determination. The notice must describe the basis for the designation and the effect of such designation, including the possibility of heightened prudential requirements. Within 30 days of receipt of such notice, the nonbank financial company may request a written or oral hearing before the FSOC to protest the designation. This hearing must be scheduled within 30 days of receipt of the request, and, within 60 days of the hearing, the FSOC must issue its final determination with an explanation of its decision. If the nonbank financial company does not contest the designation, the FSOC must issue a final decision within 40 days of receipt of the initial notice.

These administrative notice-and-hearing procedures may be modified or waived if the FSOC, by a two-thirds vote, including the affirmative vote of the Treasury Secretary, concludes that such modification or waiver is "necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States." Under these conditions, the FSOC must alert the nonbank financial company within 24 hours of the emergency exception, after which the company will have 10 days to request a hearing; the hearing will then be scheduled within 15 days of receipt of the request, with final determination to be issued by the FSOC within 30 days of the hearing.

All determinations that a nonbank financial company is of systemic risk must be reevaluated at least annually, and the

1 With respect to a foreign nonbank financial company, the FSOC will consider the same factors as for a US nonbank financial company, and also the extent to which the company is subject to prudential standards in its home country. In addition, the Council also will evaluate the specific impact of the company's activities on the US economy, including the amount and nature of the company's US financial assets and liabilities, and any other factors the FSOC deems appropriate.

FSOC may, by a two-thirds vote, including the affirmative vote of the Treasury Secretary, decide to rescind any such determinations. In addition, a nonbank financial company may appeal any final determination in the district court of its home office, or in the District Court of the District of Columbia, requesting an order requiring that the final determination be rescinded. The district court will review the FSOC's decision under the "arbitrary and capricious" standard.

In addition, the Act requires the Federal Reserve, in consultation with the FSOC, to issue regulations establishing "safe harbor" criteria for exempting certain types or classes of US or foreign nonbank financial companies from Federal Reserve supervision. These safe harbor rules are to be reexamined at least every five years.

In addition to the extensive latitude granted to the FSOC in making firm-by-firm systemic risk decisions, the Act authorizes the FSOC to recommend that the primary financial regulatory agencies (defined as the federal banking, securities, commodities, and housing regulators and state insurance commissioners) impose new or more stringent standards or restrictions on certain classes and types of financial activities engaged in by bank holding companies (with no limitation on size) and nonbank financial companies under their respective jurisdictions. Thus, if the FSOC determines that "the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities," the FSOC may recommend that the primary financial regulatory agency issue rules or standards to restrain and control such practices. Any company subject to the jurisdiction of a primary financial regulatory agency potentially could become subject to the FSOC's recommendations regarding this particular type of financial activity (even if the company itself is not determined to be of systemic risk).

As noted above, the Act appears to presume that "large bank holding companies"—defined as bank holding companies with more than $50 billion in total consolidated assets as of January 1, 2010—pose potential systemic risks to the country's financial stability and thus should be regulated by the Federal Reserve under a framework similar to that used for nonbank financial companies determined to be of systemic risk, rather than under the usual supervisory and regulatory system for a bank holding company under the Bank Holding Company Act. According to data compiled from bank holding company reports to the Federal Reserve, there were approximately 36 bank holding companies that held assets in excess of $50 billion as of January 1, 2010, and therefore would be subject to such treatment, including the possibility of heightened regulatory requirements and activity restrictions.

The Act also includes the so-called "Hotel California" provision: if a large bank holding company (i.e., a bank holding company having total consolidated assets equal to or greater than $50 billion as of January 1, 2010) that received Troubled Asset Relief Program (TARP) assistance through the Capital Purchase Plan ceases to be a bank holding company by shedding its banking subsidiaries and reverting to nonbank status, it (and any successor entity) still will be subject to Federal Reserve regulation as a nonbank financial company determined to be of systemic risk.

Impact of Systemic Risk Designation

Heightened Prudential Standards. Once an institution has been deemed to present a potential systemic risk to the US's financial stability, the Federal Reserve may, with or without the recommendation of the FSOC, subject it to heightened prudential standards. These heightened prudential standards include more stringent risk-based and contingent capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, concentration limits, disclosure rules, short-term debt limits, and overall risk management requirements. These enhanced standards may differ among institutions on an individual basis or by category of company or activity depending upon the level of risk the Federal Reserve determines an institution poses to US financial stability.

In formulating the new stringent liquidity and capital requirements for large bank holding companies and systemically significant nonbank financial companies, members of the FSOC and the Federal Reserve are likely to track the global capital and liquidity standards being negotiated and established for banks through the so-called "Basel III" process and use those standards as the base from which to develop these new standards. While these Basel III proposals will not be finalized by the Basel Committee on Banking Supervision of the Bank for International Settlements until the end of the year, the negotiations are expected to result in an international harmonization of banking rules around more stringent capital requirements and definitions and liquidity levels.

Restrictions on Activities. Moreover, if the Federal Reserve determines that a large bank holding company or nonbank financial firm determined to be of systemic risk presents a "grave" threat to US financial stability, the FSOC, by a two-thirds vote, may approve the Federal Reserve's decision to:

- Restrict the company's ability to merge with, acquire, consolidate with, or otherwise become affiliated with another company;
- Limit the company's ability to offer certain financial products;
- Require that the company cease engaging in certain activities; or
- Impose restrictions on the manner in which the company engages in certain activities.

In addition, if the aforementioned actions are considered inadequate to address the threat presented, the Federal Reserve may, with the FSOC's approval, require the company to sell or otherwise transfer assets or off-balance-sheet items to unaffiliated entities.

Early Remediation. In order to minimize the possibility that financial distress at a systemically significant company will lead to insolvency and eventually undermine the country's financial stability, large bank holding companies and nonbank financial companies determined to be of systemic risk may be subject to regulations, promulgated by the Federal Reserve in consultation with the FSOC and the FDIC, that provide for early remediation in the event that such financial distress occurs. Similar to prompt corrective action regulations in place for banking organizations, these remediation regulations must define specific prudential measures for the company to take, such as increasing capital and liquidity, that grow increasingly stringent as the company's financial condition declines. However, the US government is prohibited from providing financial assistance to the company.

Stress Tests. Title I also requires the Federal Reserve, in coordination with the appropriate primary financial regulatory agency, to conduct annual stress tests on each nonbank financial company determined to be of systemic risk and each large bank holding company to determine if the company has the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions. Each of these companies also must conduct a stress test of its own semi-annually.

All other financial companies with consolidated assets of at least $10 billion that are regulated by a primary federal financial regulatory agency must conduct annual stress tests. The methodology for these self-stress tests will be determined by regulations issued by each primary federal financial regulatory agency, in coordination with the Federal Reserve and the Federal Insurance Office.

Living Wills. Nonbank financial companies determined to be of systemic risk and large bank holding companies must develop and submit to regulators a resolution plan that has been referred to as a "living will." The purpose of the resolution plan is to provide for the rapid and orderly resolution of the company in the event of material financial distress or failure and must include:

- Information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;
- Full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company;
- Identification of any cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged; and
- Any other information that the Federal Reserve and the FDIC may jointly require by rule or order.

The Federal Reserve is to require each nonbank financial company determined to be of systemic risk and each large bank holding company periodically to submit a copy of its resolution plan to the Federal Reserve, the FSOC, and the FDIC. The FSOC may make recommendations to the Federal Reserve concerning implementation of this requirement.

The Federal Reserve and the FDIC are required to review each plan, and if, after review, the two agencies jointly determine that a particular plan is either not credible or would not facilitate an orderly resolution of the company under the US Bankruptcy Code, the agencies must notify the company of the deficiencies of the plan and require the company to resubmit a revised plan by a specified date that will demonstrate to the agencies that its plan indeed is credible and would result in an orderly resolution under the US Bankruptcy Code, including details of any proposed changes in business operations and corporate structure to facilitate implementation of the plan.

If the company fails to meet that deadline or again submits an insufficient plan, the Federal Reserve and the FDIC may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until the company submits a plan that meets the approval of the agencies. If after two years of these more stringent requirements, the company still has not provided a resolution plan satisfactory to the Federal Reserve and the FDIC, the two agencies jointly, and in consultation with the FSOC, may impose their own resolution plan on the company by jointly requiring the company to divest assets or operations identified by the two agencies in order to facilitate an orderly resolution of the company.

In the event of a dissolution of the company, the resolution plan is not binding on a bankruptcy court, the FDIC, or any entity that is authorized or required to liquidate or otherwise resolve the company, or any subsidiary or affiliate of the company. There also is no private right of action based on any resolution plan submitted by a company

The Federal Reserve and the FDIC have up to 18 months after the date of the Act's enactment to promulgate rules implementing these requirements regarding the preparation and submission of resolution plans.

In addition, based upon the results of the stress tests mentioned above, the Federal Reserve could require a nonbank financial company determined to be of systemic risk or a large bank holding company to update its resolution plan if the Federal Reserve deems it appropriate.

Implementation

Will the systemic risk determination process and the ability of the Federal Reserve and other federal regulators to intervene proactively in these nonbank companies in order to address material risks to the US financial system avert another economic crisis such as the one that started two years ago? Perhaps not completely, but the regulators now will have at their disposal more tools than the federal government has had in the past to handle a situation with a financial company that is in financial distress. As we have seen in the past two years, at times the federal government has appeared to have only two choices: either infuse massive amounts of taxpayer money into systemically significant companies (such as AIG), or stand by and let such a company file for bankruptcy protection (such as Lehman Brothers). If all the new tools provided under Title I still prove ineffective to deal with a systemically significant yet troubled financial company, Title II of the Act[2] provides for the US government to close and liquidate the troubled company.

One comment made about the new systemic risk provisions in Title I is that many of the new authorities are not really new. With respect to nonbanking financial companies that are not otherwise subject to ongoing government oversight and supervision, the power of the Federal Reserve to supervise such an entity certainly is new. For regulated nonbank financial companies such as insurance companies and securities firms, some of the requirements could be within the current supervisory authority of insurance and securities regulators but likely not to the extent that the Act will provide to the Federal Reserve.

However, for bank holding companies and their insured depository institutions, many of these requirements are not

2 Title II of the Act is discussed in detail in an advisory, "Dodd-Frank Act Creates New Resolution Process for Systemically Significant Institutions," *available at:* http://www.arnoldporter.com/public_document.cfm?id=16155&key=12F3.

new. In particular, the imposition of more stringent prudential standards such as capital and liquidity, could have been imposed by the Federal Reserve and other banking regulators under their current powers, on a case-by-case basis, through enforcement orders issued to ensure the safety and the soundness of the particular bank holding company and its insured depository institution companies. Other requirements, such as the resolution plan requirements and the "Hotel California" provision, are new.

There has been criticism of the banking regulators that their failure to adequately supervise the institutions under their jurisdiction, and to make full use of their supervisory and enforcement powers, led in part to the recent crisis. These critics may be right in part. If nothing else, the Act forces the Federal Reserve to be a more effective systemic risk regulator, gives the Office of the Comptroller of the Currency and the FDIC authority over additional banking institutions, and abolishes the Office of Thrift Supervision, which had been perceived by some as the least effective federal banking regulator preceding the recent crisis.

Another issue left open in the Act is whether the definition of "predominantly engaged in financial activities" leaves outside the ambit of the Act companies that should be subject to review by the Council to determine their systemic significance. Large conglomerates with subsidiaries that engage in significant financial activities may, dollar-wise, have very significant revenues or assets from financial activities, yet still fall below the 85 percent threshold. Those companies still could pose a systemic risk, but it will not be the FSOC that will have the authority to determine it.

As much of the systemic risk determination process is required to be fleshed out in regulations, the regulatory rulemaking process is the next step for the industry to tackle. While the legislative battle is over, the regulatory battle is just beginning.

Arnold & Porter, LLP has long represented large bank holding companies, foreign banks and financial services companies in resolving their regulatory and supervisory issues. We have been assisting such companies during the legislative process in understanding the implications of the Act and in various changes that were made or attempted to be made to the legislation during the last several months. We are available to respond to questions raised by the Act, or to help guide your business in responding to it. For further information, please contact your Arnold & Porter attorney or:

A. Patrick Doyle
+1 212.715.1770
+1 202.942.5949
A.Patrick.Doyle@aporter.com

Kevin F. Barnard
+1 212.715.1020
Kevin.Barnard@aporter.com

Richard M. Alexander
+1 202.942.5728
Richard.Alexander@aporter.com

John D. Hawke, Jr.
+1 202. 942.5908
John.Hawke@aporter.com

Alan W. Avery
+1 212.715.1056
Alan.Avery@aporter.com

Brian C. McCormally
+1 202.942.5141
Brian.McCormally@aporter.com

Beth S. DeSimone
+1 202.942.5445
Beth.DeSimone@aporter.com

Kathleen A. Scott
+1 212.715.1799
Kathleen.Scott@aporter.com

Lindsey Carson*
+1 202.942-6796
Lindsey.Carson@aporter.com

* Admitted only in Pennsylvania; practicing law in the District of Columbia pending approval of application for admission to the DC Bar and under the supervision of lawyers of the firm who are members in good standing of the DC Bar.