

## Federal Reserve Proposes Rule to Define the Nonbank Financial Companies It Could Supervise

The Board of Governors of the Federal Reserve System (Board) published for comment on February 11, 2011, a proposed rule (Proposed Rule) establishing the criteria for defining a “nonbank financial company” that could be subject to the supervision of the Board, upon the determination of the Financial Stability Oversight Council (FSOC). The Proposed Rule implements Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which requires the FSOC to determine “nonbank financial companies” that could pose a threat to the financial stability of the United States, and subject these designated companies to supervision by the Board (Systemic Importance Determination). A nonbank financial company subject to the Board’s supervision must adhere to prudential standards, reporting, and disclosure requirements.<sup>1</sup>

Under the Proposed Rule, a nonbank financial company would be a company predominantly engaged in financial activities (as defined by the Bank Holding Company Act), such that for *either* of the past two years, that company derived 85 percent or more of its annual gross revenues or consolidated assets from financial activities. In addition, under the Proposed Rule, the FSOC will consider a nonbank financial company’s transactions with other nonbank financial companies and bank holding companies, with total assets of US\$50 billion or more, in its Systemic Importance Determination.

In January 2011, the FSOC proposed the criteria for a Systemic Importance Determination of a nonbank financial company. The Board’s Proposed Rule subsequently provides tests for determining which companies are nonbank financial companies, and thus eligible to be subject to a Systemic Importance Determination. The Board has issued this Proposed Rule to allow the FSOC to promptly engage in Systemic Importance Determinations upon the FSOC’s final adoption of its determination criteria, likely during the second quarter of 2011.

<sup>1</sup> A summary of the Dodd-Frank Act requirements for nonbank financial companies supervised by the Board has been provided through a recent advisory (See “Dodd-Frank Act Addresses Systemic Risk,” available at: [http://www.arnoldporter.com/public\\_document.cfm?id=16151&key=17B3](http://www.arnoldporter.com/public_document.cfm?id=16151&key=17B3)).

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The Board has requested that comments on the Proposed Rule be received by *March 30, 2011*. The provisions of the Proposed Rule are summarized below.

## Tests for Determining a Nonbank Financial Company

Under the Dodd Frank Act, a “nonbank financial company” is defined by the extent to which the company is predominantly engaged in activities that are financial in nature. A company is predominantly engaged in activities that are financial in nature if, according to the Dodd Frank Act:

- The *annual gross revenues* derived by the company and all of its subsidiaries from activities that are financial in nature 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
- The *consolidated assets* of the company and all of its subsidiaries related to the activities that are financial in nature 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.<sup>2</sup>

Section 110(b) of the Dodd-Frank Act authorizes the Board to establish by regulation the requirements for determining if a company is predominantly engaged in financial activities. Under this authority, the Board has proposed two alternative tests for determining that a company is “predominantly engaged” in financial activities and therefore classified as a nonbank financial company.

- The first test, described as the Two-Year Test, examines the above criteria from the Dodd Frank Act for *either* of the two most recently completed fiscal years. Thus, if a company’s annual gross revenues or consolidated assets are financial in nature by 85 percent or more in either of the two most recently completed fiscal years, then that company is a nonbank financial company.
- The second test is a case-by-case determination by the Board. The Board may use the facts and

circumstances of a company to subjectively determine whether 85 percent or more of a company’s annual gross revenues or consolidated assets are financial in nature.

In determining whether a company is predominantly engaged in financial activities, the Proposed Rule has also provided additional considerations. First, if a company has an equity investment in another company but the two companies do not issue consolidated financial statements, then the investor company must consider its equity investment to be financial in nature if the investee company itself is predominantly engaged in financial activities under the Two-Year Test. This consideration reduces a company’s obligation to calculate the exact percentage of an investee company’s financial activities, but it may also force an investor company to consider the entire revenues or asset value of the equity investment as financial in nature. Second, the Proposed Rule permits a company to treat as nonfinancial the revenues and assets derived from de minimis equity investments. This consideration is subject to conditions limiting the amount of the equity investment, and the permissible investee company types.

## Accounting Standards for the Nonbank Financial Company Tests

The Board proposes to allow companies to use their consolidated, year-end financial statements as the basis for determining annual gross revenues and consolidated assets. The financial statements may be prepared according to generally accepted accounting principles (GAAP), or International Financial Reporting Standards. Also, the Board would allow a company to use an alternative accounting standard upon the Board’s approval and determination that the alternative accounting standard would be likely to ensure a fair and accurate presentation of the company’s revenues and assets in a manner similar to GAAP. This alternative would potentially allow the Board to evaluate the financial statements of foreign companies using customary accounting methods, and domestic insurance companies using statutory accounting methods.

<sup>2</sup> 12 U.S.C. § 5311(a)(6).

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## Activities Designated as Financial in Nature

The Board has clarified in its Proposed Rule that the list of activities that are financial in nature are those activities determined to be financial in nature under the Bank Holding Company Act<sup>3</sup> and listed in Regulation Y.<sup>4</sup> These activities, among others, include:

- Activities closely related to banking activities such as:
  - credit extension and debt collection activities;
  - real estate appraising;
  - asset management;
  - credit bureau services; and
  - check cashing and check guaranty activities.
- Activities determined by the Board to be usual in connection with the transaction of banking or other financial operations abroad such as:
  - management consulting services;
  - travel agency operations; and
  - the organization, sponsorship, and management of a mutual fund.
- Activities defined as financial in nature by the Gramm-Leach-Bliley Act such as:
  - insurance or annuity services provided in a principal or agent capacity;
  - securities underwriting, or making a market in securities; and
  - merchant banking activities used to control nonfinancial companies.

Similar to Regulation Y, the Proposed Rule also permits a company to request a determination of the Board as to whether a specific activity is financial in nature.

## Significant Nonbank Financial Companies

Finally, and most significantly for many nonbank companies, the Proposed Rule also defines the term “significant nonbank financial company.” The Board has defined the term as:

- Any nonbank financial company supervised by the Board; and

- Any other nonbank financial company that had US\$50 billion or more in total consolidated assets as of the end of its most recently completed fiscal year.

In addition, the Board has proposed the term “significant bank holding company” to mean any bank holding company with US\$50 billion or more in total consolidated assets at the end of the most recently completed calendar year.

The Dodd-Frank Act uses the term “significant nonbank financial company” as a classification for FSOC determination and reporting purposes. First, the extent and nature of a nonbank financial company’s transactions with significant nonbank financial companies and significant bank holding companies are factors in the FSOC’s consideration of a Systemic Importance Determination. Second, a nonbank financial company subject to a Systemic Importance Determination must submit a periodic credit exposure report that describes the nature and extent to which the supervised company has credit exposure to significant nonbank financial companies and significant bank holding companies.

\* \* \* \*

The Board has requested comments by *March 30, 2011* on the Proposed Rule. In particular, the Board requests comments on the appropriateness of the Proposed Rule, and any other provisions that should be included. Arnold & Porter LLP is available to respond to questions raised by the Proposed Rule or to provide any assistance in drafting comments. We also can assist in determining how these rule changes may affect your business and in ensuring that your business is compliant when the Proposed Rule is finalized.

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<sup>3</sup> 12 U.S.C. § 1843(k).

<sup>4</sup> 12 C.F.R. Pt. 225.

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