

ClientAlert

Financial Markets Developments

July 2010

[Dodd-Frank Wall Street Reform and Consumer Protection Act](#)

Systemic Nonbank Financial Companies

1. Does Dodd-Frank create a new class of organizations subject to Federal Reserve supervision?

Yes, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 does create a new class of organizations to be supervised by the Board of Governors of the Federal Reserve System (the “Federal Reserve”). Prior to Dodd-Frank, the Federal Reserve supervised state member banks, bank holding companies (“BHCs”) and their nonbank subsidiaries, foreign banks with US branches, agencies or commercial lending subsidiaries and Edge corporations.

Under Dodd-Frank, certain nonbank companies and their subsidiaries will be subject to Federal Reserve prudential supervision. Some of these organizations may already be subject to supervision and regulation in the United States or in their home countries. For them, Dodd-Frank adds an additional layer of supervision.

2. What nonbank companies would be covered?

Companies incorporated in or outside the United States that are “predominately engaged” in “financial activities.”¹ Financial activities include the activities that the Federal Reserve has determined to be financial in nature and may be engaged in by financial holding companies.² A company will be predominately engaged in financial activities if it and its subsidiaries aggregate annual gross revenues or its consolidated assets represent 85 percent or more of the consolidated gross revenue or assets of the company.

The covered companies are “nonbank” companies. Nonbank is not a defined term. While BHCs and companies that are treated as BHCs with assets of US\$50 billion or more in assets will be subject to enhanced supervision, savings and loan holding companies of that size are not included in that group. This raises the question whether a savings and loan holding company will be regarded as a nonbank financial company.

The statute gives no indication as to which level in a corporate structure these tests are to be applied. They could be applied at an intermediate level. For example, Manufacturer A has a finance subsidiary, Finance Subsidiary B. While Manufacturer A might not fall within the 85 percent test, Finance Company B might do so.



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3. What organizations are excluded?

With respect to foreign nonbank financial companies, excluded are BHCs and companies that are treated as BHCs—foreign banks with branches, agencies, or commercial lending subsidiaries in the United States.³ The term “company” is not defined, raising a question whether the Federal Reserve’s BHC Act definition would be applied or whether the Council (as defined below) will come up with its own definition. There does not appear to be a requirement that the foreign company have a physical presence in the United States.

A number of organizations or classes of organizations are excluded from the definition of “US nonbank financial company,” including: Farm Credit institutions, national securities exchanges or their parents,⁴ clearing agencies or their parents, security-based swap execution facilities or data repositories, boards of trade designated as a contract market or their parents, derivatives clearing corporations or their parents, a swap execution facility or data repository. Excluded from the excluded are government sponsored enterprises, broker/dealers, futures commission merchants, insurers, or finance companies.

4. What activities of a foreign nonbank financial company are covered?

Unless a provision states otherwise, only the US activities and US subsidiaries of a foreign nonbank financial company are covered with respect to supervisory matters.⁵ However, all activities and subsidiaries will be considered in determining whether the company should be subject to Federal Reserve supervision.

In addition, the nonfinancial activities of a foreign nonbank financial company are not subject to Federal Reserve supervision.⁶

5. Who selects nonbank financial companies?

The statute creates a new federal agency—the Financial Stability Oversight Council (the “Council”).⁷ This Council is composed of the chairs of the various federal supervisory/regulatory agencies, chaired by the Secretary of Treasury, and has nonmembers that include representatives of state supervisory/regulatory agencies.

One of the key functions of the Council is to require Federal Reserve supervision of nonbank financial companies that may pose a risk to the financial stability of the United States in the event of their material financial distress or failure.⁸ To assist it in this endeavor, the Council has extensive information gathering abilities and powers.⁹

Although the statute is silent on the point, there may be discussions between an organization targeted to be deemed a nonbank financial company and the staff of the Council. In any event, the Council will have to decide if an organization is to be deemed a nonbank financial company.

6. What criteria are to be applied in making these determinations?

The criteria to be applied to organizations by the Council are fairly much the same, except that in a number of cases the criteria applicable to a foreign organization are applied to its US activities.¹⁰ The criteria applicable to foreign organization do not all require that there be US operations. Only one criterion—liabilities used to fund operations in the United States—seems to require a physical operational presence in the United States. The criteria focus on the impact of financial matters in the United States.¹¹

The criteria include:

- Leverage.
- Off-balance-sheet exposures
- Extent of transactions with “significant nonbank financial companies” and “significant BHCs.”
- Credit provided to consumers, business and state and local governments, and liquidity provided to the US financial system.
- Credit provided to low-income, minority, and underserved communities.
- Assets managed rather than owned, and the extent to which ownership of managed assets is diffuse.
- The degree to which the organization is regulated by a primary federal regulator or subject to consolidated prudential supervision by a comparable foreign supervisor in its home country.
- Nature and amount of assets.
- Amounts and types of liabilities, including reliance on short-term funding and any other factors deemed appropriate.

The great imponderable here is how many organizations will be deemed nonbank financial companies. Some suggest that the inclusion of leverage is a key factor and would result in the exclusion of mutual funds. Many of the organizations that would fit these criteria are BHCs or foreign banks that are treated as BHCs. In any event, it seems that the organization would have to be a sizable one.

If in its deliberations the Council is having difficulty determining, based on the reports available to it, whether the financial activities of an organization pose a threat to US financial stability, the Federal Reserve may examine the organization to assist in this determination.¹² It will be interesting to see if this procedure is ever used.

In addition, while information of the Council is to be treated confidentially,¹³ a Federal Reserve examination would likely become public.

7. How does the Council make a determination?

In order for an organization to be deemed a nonbank financial company, an affirmative vote of two-thirds of the Council's members is required. In addition, the chair of the Council—the Secretary of the Treasury—must make an affirmative vote.¹⁴

If the organization or one of its subsidiaries has a primary federal regulatory agency—the Federal Reserve, Office of the Comptroller of the Currency, Securities and Exchange Commission, Commodity Futures Trading Commission, or state insurance authority of the domiciliary state—the Council must consult with the primary agency before making a final determination.¹⁵ An interesting question is who may act on behalf of the Council. The statute imposes responsibilities on the Council; can or will these responsibilities be delegated to its detailed staff?¹⁶

In the case of a foreign organization, the Council may consult with the appropriate foreign regulatory authorities.¹⁷

8. What happens if an organization is regarded as evading a nonbank financial company determination?

If an organization somehow structures itself to evade being deemed a nonbank financial company, the Council may, on its own or at the request of the Federal Reserve, and only upon an affirmative vote of two-thirds of the Council, including the Treasury Secretary, (1) apply the criteria spelled out above, (2) determine that the organization would pose a threat to the financial stability of the United States, and (3) subject the company to Federal Reserve prudential supervision on the basis of that determination.¹⁸ Again, it will be interesting to see whether this procedure will ever be used.

9. What due process is provided?

An organization deemed to be a nonbank financial company is provided with the ability to challenge the determination.¹⁹ The company will receive written notice of a proposed determination along with the basis for the determination. The company may seek a written or oral hearing. Within 60 days of the hearing,

the Council must make a final determination. The time period may be waived in exceptional circumstances. If the company has a home-country supervisor, it will be informed of these developments. Finally, the organization may challenge the determination in a US District Court.²⁰

In the early years of the BHC Act, it was not uncommon for BHCs to bring judicial actions against the Federal Reserve: that practice has disappeared. It will be interesting to see if any company will avail itself of its right to challenge a determination.

10. Is the determination of a nonbank financial company permanent?

The Council may determine that an organization should be deemed a nonbank financial company at any time. However, at least annually, the Council must reevaluate its determination. And, with a 2/3 vote, including that of the Treasury Secretary, the Council can determine that the company no longer meets the criteria for a nonbank financial company.²¹

11. What happens if the determination becomes final?

Within 180 days after a final Council determination, the nonbank financial company must register with the Federal Reserve.²² This could be a fulsome task if the Federal Reserve seeks detailed information on the company's structure and financial composition.

12. Will a nonbank financial company subject to Federal Reserve Supervision have to reorganize?

The Federal Reserve can require a nonbank financial company to establish an intermediate holding company that would be supervised as a nonbank financial company subject to Federal Reserve supervision.²³

If the nonbank financial company supervised by the Federal Reserve conducts activities other than those that are financial in nature or incidental thereto,²⁴ the Federal Reserve may require the company to engage in those activities in or through an intermediate holding company.²⁵ The Federal Reserve may also require a nonbank financial company supervised by the Federal Reserve to establish an intermediate holding company to appropriately supervise activities that are financial in nature, or incidental thereto, without supervising commercial activities.²⁶ The company's internal financial activities undertaken for the company and its affiliates and non-affiliates are not included in this requirement, so long as two-thirds of the company's assets or revenues are attributable to the company and its affiliates.²⁷ All of this is consistent with the Federal Reserve's unease with the mixing of finance and commerce.

The company that controls the intermediate holding company must serve as a source of strength to the holding company.²⁸

13. What role does the Council have in setting prudential supervision of nonbank financial companies supervised by the Federal Reserve?

The Council may make recommendations to the Federal Reserve regarding the establishment or refinement of prudential standards, reporting and disclosure requirements applicable to nonbank financial companies supervised by the Federal Reserve, and to large inter-connected BHCs that present risks that could arise from severe financial distress, failure, or ongoing activities of large interconnected financial institutions.²⁹ The Federal Reserve would be hard put to reject a recommendation of the Council.

The Council's recommendations can differentiate among companies based on capital structure, riskiness, complexity, financial activities, size, and other factors.³⁰ It also can increase the asset size threshold for BHCs subject to enhanced supervision.³¹ The Council must take into consideration the nonfinancial activities of the company and whether the company owns a financial institution.³² In doing this, the Council is cautioned to make small changes that would not result in sharp, discontinuous changes in the Federal Reserve's prudential standards.³³ The statute contains a list of prudential standards with respect to which the Council can make recommendations.

In addition, the Council may recommend and publish for comment new or heightened standards for nonbank financial companies.³⁴ If the Federal Reserve does not impose any such standard, it must explain its decision not to do so and the Council will report on that to Congress.

14. Must the Council's recommendations regarding foreign nonbank financial companies supervised by the Federal Reserve treat foreign organizations differently?

Perhaps. The Council must give due regard to the principle of national treatment and equality of competitive opportunity.³⁵ In addition, the Council must take into account the extent to which a foreign nonbank financial company or a foreign-based BHC is subject to home-country consolidated supervision standards, comparable to those applied to US financial companies.³⁶

15. What is the so-called Hotel California Rule?

Congress was concerned that some BHCs with consolidated assets of US\$50 billion or more as of January 1, 2010, and that participated in the Treasury's Capital Purchase Program under TARP would (1) divest their banks, (2) cease to be holding companies, and (3) thereby cease to be subject to enhanced Federal Reserve supervision. Therefore, if such a company ceases to be a BHC after January 1, 2010, it will be treated as if the Council made a determination that the company shall be treated as a nonbank financial company supervised by the Federal Reserve.³⁷ The company is provided due process to challenge this result.

In this case the company is automatically treated as a nonbank financial company supervised by the Federal Reserve. One question may be whether that result is subject to an annual review by the Council.

16. How will the Federal Reserve supervise a nonbank financial company?

The Federal Reserve will require periodic reports from a nonbank financial company subject to its supervision.³⁸ The Federal Reserve must use information available from other supervisors/regulators. The nonbank financial company and its subsidiaries will be subject to Federal Reserve examination.³⁹ Once again, the Federal Reserve must use reports of examination from other supervisors/regulators. The directors and senior management of the nonbank financial company will receive a portion of the examination report. One portion is confidential and provided only to supervisors/regulators. The other portion is sent to the company. A response to criticisms or recommendations may be required. The chief examiner may request a meeting with the company's board of directors.

The Federal Reserve is also granted the same remedial authority over nonbank companies that it has over BHCs.⁴⁰ This authority would include memoranda of understandings or MOUs (which are not publicly disclosed), written agreements, and cease and desist orders. If the company is functionally regulated by a primary federal regulator, the Federal Reserve will recommend that the regulator initiate a remedial proceeding. If the regulator does not proceed, the Federal Reserve may take the remedial action.⁴¹

17. Are nonbank financial companies subject to management interlock limitations?

A nonbank financial company supervised by the Federal Reserve will be treated as a BHC for purposes of the depository management interlock prohibition.⁴² The Federal Reserve cannot use its exemptive authority to permit an interlock with a BHC with US\$50 billion or more in assets, or with an unaffiliated nonbank financial company supervised by the Federal Reserve.

18. What are the enhanced prudential supervisory provisions that will be imposed on a nonbank financial company supervised by the Federal Reserve.

These provisions are the same as those that will be imposed on BHCs with US\$50 billion or more in assets and are discussed in a separate client alert.

1. Financial Stability Act of 2010 § 102(a)(4). This Act is Title I of Dodd-Frank.
2. BHC Act §§ 4(k)(4)(A)—(E), (H), (I); Regulation Y § 225.85(c).
3. 12 U.S.C. § 3601(a).
4. Parent companies that are BHCs are excluded.
5. Financial Stability Act of 2010 § 110(c).
6. Financial Stability Act of 2010 § 113(c)(6).
7. Financial Stability Act of 2010 § 111(a).
8. Financial Stability Act of 2010 § 112(a)(1)(H).
9. Financial Stability Act of 2010 § 112(d).
10. Compare Financial Stability Act of 2010 § 113(a)(2) with § 113(b)(2).
11. Financial Stability Act of 2010 §§ 112(b)(2)(J).
12. Financial Stability Act of 2010 § 112(d)(4).
13. Financial Stability Act of 2010 § 112(d)(5).
14. Financial Stability Act of 2010 §§ 113(a)(1), (b)(1).
15. Financial Stability Act of 2010 § 113(g).
16. Financial Stability Act of 2010 § 111(j).
17. Financial Stability Act of 2010 § 113(i).
18. Financial Stability Act of 2010 § 113(c).
19. Financial Stability Act of 2010 § 113(e).
20. Financial Stability Act of 2010 § 113(h).
21. Financial Stability Act of 2010 § 113(d).
22. Financial Stability Act of 2010 § 114.
23. Financial Stability Act of 2010 § 113(c)(3)(B).

19. Is a nonbank financial company supervised by the Federal Reserve subject to the nonbanking activity limitations of the BHC Act?

No.⁴³

20. Is a nonbank financial company supervised by the Federal Reserve subject to a special liquidation procedure?

Yes. This procedure is discussed in a separate client alert regarding Title II of Dodd-Frank.

21. Can the FDIC examine a nonbank financial company supervised by the Federal Reserve?

As described in a separate client alert on the orderly liquidation procedure, the Federal Deposit Insurance Corporation has the primary role in the liquidation process. In order to prepare for a company's liquidation, the FDIC can undertake a special examination of a nonbank financial company supervised by the Federal Reserve.⁴⁴

24. It may be of interest to note that the Federal Reserve considered, but never found, that real estate brokerage and management are financial in nature or incidental thereto. Statement of Governor Laurence H. Meyer before the House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services (May 2, 2001).
25. Financial Stability Act of 2010 § 167(b)(1)(A).
26. Financial Stability Act of 2010 § 167(b)(1)(B).
27. Financial Stability Act of 2010 § 167(b)(1)(B)(2).
28. Financial Stability Act of 2010 § 167(b)(1)(B)(3).
29. Financial Stability Act of 2010 § 115(a).
30. Financial Stability Act of 2010 § 115(a)(2)(A).
31. Financial Stability Act of 2010 § 115(b)(2)(A).
32. Financial Stability Act of 2010 § 115(b)(3)(A).
33. Financial Stability Act of 2010 § 115(b)(3)(B).
34. Financial Stability Act of 2010 § 120.
35. Financial Stability Act of 2010 § 115(b)(2)(A).
36. Financial Stability Act of 2010 § 115(b)(2)(B). The statutory language here is not limited to companies supervised by the Federal Reserve.
37. Financial Stability Act of 2010 § 117(a).
38. Financial Stability Act of 2010 § 161(a).
39. Financial Stability Act of 2010 § 161(b).
40. Financial Stability Act of 2010 § 162(a).
41. Financial Stability Act of 2010 § 162(b).
42. Financial Stability Act of 2010 § 164.
43. Financial Stability Act of 2010 § 167.
44. Financial Stability Act of 2010 § 172.

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