ADVISORY | Dodd-Frank Act

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SYSTEMIC RISK REGULATION AND ORDERLY LIQUIDATION OF SYSTEMICALLY IMPORTANT FIRMS

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Act institutes the most wide-ranging changes to the banking, securities, derivatives, and financial services industries since the 1930s. This advisory briefly summarizes the new law's key provisions providing for systemic risk regulation and the orderly liquidation of systemically important firms.

Highlights of the Systemic Risk and Orderly Liquidation Provisions

- Establishes a new council of federal and state financial regulators (Financial Stability Oversight Council) to monitor risks to U.S. financial stability; designate systemically important financial firms for enhanced prudential regulation by the Federal Reserve; and make recommendations to primary financial regulatory agencies to apply new or heightened prudential standards to existing financial institutions or existing financial activities.
- Subjects both systemically important financial firms designated by the Council and bank holding companies with more than $50 billion in assets to enhanced prudential regulation, including enhanced risk-based capital, liquidity, leverage, risk-management, and resolution plan requirements.
- Establishes an orderly resolution regime outside of the traditional bankruptcy process, to be administered by the Federal Deposit Insurance Corporation (FDIC) as receiver, for systemically important financial firms.
- Assesses certain creditors, financial companies, and bank holding companies to pay for the orderly liquidation of a systemically important financial firm in the event that the costs of the liquidation exceed the firm's assets.

Systemic Risk Regulation

Financial Stability Oversight Council

- The Financial Stability Oversight Council is to be chaired by the Secretary of the Treasury, and its voting members consist of the Chairman of the Federal Reserve Board of Governors, Comptroller of the Currency, Director of the newly created Bureau of Consumer Financial Protection, Chairman of the Securities and Exchange Commission, Chairperson of the Federal Deposit Insurance Corporation, Chairperson of the Commodity Futures Trading Commission, Director of the Federal Housing Finance Agency, Chairman of the National Credit Union Administration Board, and an independent director with insurance expertise appointed by the President. The Council's non-voting members are the Director of the newly created Office of Financial

Research,[1] Director of the newly created Federal Insurance Office, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.

- The purposes of the Council are to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and to respond to emerging threats to the stability of the United States financial system.

Designation of Systemically Important Financial Firms for Federal Reserve Regulation

- The Council, by a vote of at least two-thirds of the voting members including an affirmative vote by the Secretary of the Treasury, may designate a "U.S. nonbank financial company" or "foreign nonbank financial company" for supervision and prudential regulation by the Federal Reserve (a Designated Company) if the Council determines that 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 "U.S. nonbank financial company" is a company incorporated or organized under the laws of the United States or any state that is predominantly engaged in financial activities. A "foreign nonbank financial company" is a company incorporated or organized in a country other than the United States that is predominantly engaged in, including through a branch in the United States, financial activities.
  - A company is "predominantly engaged in financial activities" if (1) the annual gross revenues of 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) represent 85 percent or more of the company's consolidated annual gross revenues or (2) 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) represent 85 percent or more of the company's consolidated assets.
- In designating a nonbank financial company for supervision and prudential regulation by the Federal Reserve, the Council must consider the company's leverage; the extent and nature of the company's off-balance sheet exposures; the extent and nature of the company's transactions and relationships with other significant nonbank financial companies and significant bank holding companies; 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 U.S. financial system; the importance of the company as a source of credit for low-income, minority, or underserved communities; the extent to which the company's assets are managed rather than owned by the company; the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; the degree to which the company is already regulated by a primary financial regulatory agency (e.g., the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Securities and Exchange Commission, the Commodity Futures Trading Commission), the amount and types of the company's liabilities, including the company's reliance on short-term funding; and any other risk-related factors that the Council deems appropriate.

[1] The Act establishes the Office of Financial Research within the Department of the Treasury to serve as the Council's economic and statistical research arm and to collect information on the U.S. economy and from systemically important financial firms.

- To avoid evasion of the Council's authority to designate nonbank financial companies, the Council is authorized upon a vote of at least two-thirds of the Council including an affirmative vote of the Secretary of the Treasury to subject any company's financial activities to supervision and prudential regulation by the Federal Reserve if (1) material financial distress at the company or the company's nature, scope, size, scale, concentration, interconnectedness, or mix of financial activities would pose a threat to U.S. financial stability and (2) the company is organized or operates in such a manner as to evade designation by the Council.
- The Federal Reserve is required to promulgate regulations on behalf of the Council setting forth criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision by the Federal Reserve.
- After the Council votes to designate a nonbank financial company for supervision and prudential regulation by the Federal Reserve, the Council must provide written notice of the proposed determination to the company. The company may request a written or oral hearing to contest the Council's determination within 30 days of receipt of the Council's written notice. If a hearing is requested, the Council is to provide one within 30 days of the request. The Council must make a final determination not later than 60 days after the hearing. The Council can waive or modify this timeframe if such waiver or modification is necessary or appropriate to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States. A nonbank financial company may, within 30 days of the Council's final determination, bring an action in the U.S. district court for the district in which the company's home office is located or in the U.S. District Court for the District of Columbia for an order requiring that the Council's final determination be rescinded on the grounds that the determination is arbitrary and capricious.

Enhanced Supervision and Prudential Regulation for Designated Companies and Bank Holding Companies with Over $50 Billion in Assets

- *Heightened Prudential Standards*. The Federal Reserve is required to establish for Designated Companies and bank holding companies with more than $50 billion in assets (an Interconnected Bank Holding Company) prudential standards with respect to risk-based capital, leverage limits, liquidity requirements, risk management requirements, resolution plans, credit exposure report requirements, and concentration limits that are more stringent than the standards applicable to financial companies and bank holding companies that do not present similar risks to U.S. financial stability. The Federal Reserve may also establish additional prudential standards with respect to contingent capital requirements, enhanced public disclosure requirements, and short-term debt limits. The Federal Reserve may establish an asset threshold above $50 billion in defining what is an Interconnected Bank Holding Company, but only in regard to requirements relating to contingent capital, resolution plans, credit exposure reporting, concentration limits, enhanced public disclosure, and short-term debt limits. The Council is authorized to make recommendations to the Federal Reserve concerning these prudential standards as well as an asset threshold higher than $50 billion for bank holding companies.
- *Reports, Examination, Enforcement*. The Federal Reserve may require Designated Companies to submit reports under oath to the Federal Reserve concerning the company's financial condition and compliance with the Act, and the Federal Reserve also can examine Designated Companies. The Federal Reserve is authorized to take enforcement action against a Designated Company in the same manner as if the Designated Company were a bank holding company.
- *Treatment as Bank Holding Companies*. Designated Companies are treated as bank holding companies for purposes of Section 3 of the Bank Holding Company Act regulating bank acquisitions.

- *Nonbank Acquisitions*. Designated Companies, as well as Interconnected Bank Holding Companies, must provide written notice to the Federal Reserve in advance of acquiring a direct or indirect ownership interest in a company with $10 billion in assets or more that is engaged in financial in nature activities.
- *Mitigation of Grave Threats to U.S. Financial Stability*. If the Federal Reserve determines that a Designated Company or Interconnected Bank Holding Company poses a grave threat to U.S. financial stability, the Federal Reserve, upon a two-thirds vote of the Council, may limit the company's ability to merge with, acquire, consolidate with, or become affiliated with another company; restrict the company's ability to offer certain financial product or products; require the company to terminate one or more activities; impose conditions on the manner in which the company conducts one or more activities; or, if these actions are inadequate, require the company to sell assets or off-balance-sheet items to unaffiliated entities.
- *Resolution Plan and Credit Exposure Reports*. The Federal Require is to require Designated Companies and Interconnected Bank Holding Companies to submit a plan for the company's rapid and orderly resolution in the event of material financial distress, as well as submit reports on the company's credit exposure to other Designated Companies and Interconnected Bank Holding Companies as well as other Designated Companies' and Interconnected Bank Holding Companies' exposure to the company. The Council may make recommendations to the Federal Reserve concerning this requirement.
- *Concentration Limits and Short-term Debt Limits*. The Federal Reserve is required to prescribe standards that prohibit Designated Companies and Interconnected Bank Holding Companies from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus of the company. The Federal Reserve also may prescribe limitations on the amount of short-term debt, including off-balance sheet exposures, that may be held by a Designated Company or Interconnected Bank Holding Company. The Council is authorized to make recommendations to the Federal Reserve concerning these requirements.
- *Risk Committee*. The Federal Reserve must require Designated Companies that are publicly traded to establish a risk committee to be responsible for the oversight of the enterprise-wide risk management practices of the Designated Company and that has a minimum number of independent directors as prescribed by the Federal Reserve.
- *Stress Tests*. Designated Companies and Interconnected Bank Holding Companies must submit to annual stress tests to be conducted by the Federal Reserve to evaluate whether the company has capital necessary to absorb losses that result from adverse economic conditions. In addition, all financial companies with more than $10 billion in assets and that are regulated by a primary Federal financial regulatory agency must conduct self-stress tests, to be prescribed and defined by regulations issued by such agencies.
- *Leverage Limitation*. The Federal Reserve must require Designated Companies and Interconnected Bank Holding Companies to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination that the company poses a grave threat to U.S. financial stability and that such requirement is necessary to mitigate risks presented by such company to U.S. financial stability.
- *Early Remediation Requirements*. The Federal Reserve, in consultation with the Council and FDIC, is to prescribe regulations establishing requirements for early remediation of financial distress at a Designated Company or Interconnected Bank Holding Company.
- *Establishment of Intermediate Holding Company*. The Federal Reserve may require Designated Companies that conduct both financial and non-financial activities to establish and conduct all financial activities in or through an intermediate holding company established by Federal

Reserve regulation. Internal financial activities, such as internal treasury, investment, and employee benefit functions, may continue to be performed in the Designated Company itself.

- *Study on Contingent Capital Requirement*. The Council is to conduct a study on the feasibility, benefits, costs, and structure of a contingent capital requirement for Designated Companies and Interconnected Bank Holding Companies.

Additional Standards Applicable to Activities or Practices for Financial Stability Purposes

- The Council may provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies, including state insurance regulators, to apply new or heightened standards and safeguards for a particular financial activity or practice conducted by a financial institution.

Leverage and Risk-Based Capital Requirements

- The Federal banking agencies are required to establish minimum leverage capital requirements and minimum risk-based capital requirements on a consolidated basis for insured depository institutions, depository institution holding companies, and Designated Companies. These minimum leverage capital requirements may not be less than the generally applicable leverage capital requirements currently in effect for insured depository institutions. In effect, these requirements restrict depository institution holding companies' and Designated Companies' ability to include in Tier 1 capital certain hybrid instruments such as trust-preferred securities.
- These minimum leverage and risk-based capital requirements are to be phased in over a three year period with respect to debt or equity instruments issued before May 19, 2010. In addition, depository institution holding companies with less than $15 billion in assets are permanently exempt from these new capital requirements with respect to debt or equity instruments issued before May 19, 2010.

Orderly Liquidation of Systemically Important Firms

Orderly Liquidation Regime

- The purpose of the orderly liquidation regime is to provide authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard. The Act requires such authority to be exercised in a manner so that creditors and shareholders bear the losses of the financial company, management responsible for the financial company's condition is not retained, and the appropriate agencies take steps to assure that all parties having responsibility for the financial company's condition bear losses consistent with that responsibility.
- The FDIC and the Federal Reserve are authorized to recommend that the Secretary of the Treasury appoint the FDIC as receiver for a financial company upon a vote of at least two-thirds of the members of the Federal Reserve Board of Governors and two-thirds of the members of the FDIC board of directors. Upon such recommendation, the Secretary is to appoint the FDIC as receiver for a financial company if the Secretary, in consultation with the President of the United States, determines that the financial company is in default or in danger of default; the failure of the financial company and its resolution under otherwise applicable Federal or state laws would have serious adverse effects on U.S. financial stability; no viable private sector alternative is available to prevent the financial company's default; any impact of taking action on the claims or interests of creditors, counterparties, and shareholders is appropriate; use of the orderly liquidation authority would avoid or mitigate such adverse effects; a Federal regulatory agency

has ordered the company to convert all of its convertible debt instruments that are subject to being converted by the regulatory order; and the company satisfies the definition of "financial company."

- For this purpose, a "financial company" is (1) a company incorporated or organized under any provision of Federal or state law, (2) that is a bank holding company, a Designated Company, a company engaged predominantly in financial activities (as defined in section 4(k) of the Bank Holding Company), or any subsidiary of any such company that is predominantly engaged in financial activities (except an insured depository institution or an insurance company), and (3) that is not a Farm Credit System institution, governmental entity, or a government-sponsored enterprise.
- A company is engaged "predominantly in financial activities" for purposes of the orderly liquidation authority if the company's consolidated revenues from financial activities constitute 85 percent or more of the total consolidated revenues of the company.

- A company for which the Secretary of the Treasury has made the required determination is referred to as a "covered financial company." Covered financial companies are subject to liquidation by the FDIC as receiver for the company;[2] they may not be rehabilitated. (Note, any financial companies that are not "covered financial companies" remain subject to traditional insolvency processes for resolution, with limited exception.) The FDIC takes over the covered financial company's assets and operates the company with all powers of the company's members, shareholders, directors, and officers. The FDIC must take action as receiver as necessary for purposes of U.S. financial stability and not for the purpose of preserving the covered financial company; ensure that the covered financial company's shareholders do not receive payment until all other claims and the Orderly Resolution Fund (discussed below) are fully paid; ensure that unsecured creditors bear losses in accordance with the priority of claims provisions in the Act; ensure that management and board members responsible for the condition of the covered financial company is removed; and not take an equity interest in or become a shareholder of any covered financial company.
- The FDIC is authorized as receiver to make additional payments, beyond the amount that would be allocated under the standard receivership process, to certain claimants (subject to claw back of such additional payments if necessary because available funds for orderly liquidation are otherwise insufficient).
- The FDIC's appointment as receiver expires after three years but may be extended on specified terms for an additional two years, for a total of five years.

Orderly Liquidation Fund

- The Act establishes an Orderly Liquidation Fund (Fund) to pay for the FDIC's costs and expenses in liquidating covered financial companies. The FDIC is authorized to issue obligations to the Secretary of the Treasury to initially fund the Orderly Liquidation Fund. Amounts in the Fund become available to the FDIC with regard to a covered financial company after the FDIC has developed for the company an orderly liquidation plan acceptable to the Secretary of the Treasury.
- The FDIC is authorized to charge risk-based assessments if such assessments are necessary to repay in full the obligations issued by the FDIC to the Secretary within 60 months of the obligations' date of issuance. The FDIC is first to charge assessments to claimants to the extent

[2] Covered financial companies that are brokers or dealers are subject to liquidation by the Securities Investor Protection Corporation as receiver for the company.

they received additional payments[3] from the FDIC as receiver (other than excess payments necessary to initiate or continue operations essential to implementation of the receivership) and is second to charge assessments to "eligible financial companies" and financial companies with total assets equal to or greater than $50 billion that are not eligible financial companies.

  - For this purpose, an "eligible financial company" is any Interconnected Bank Holding Company or Designated Company.

- In setting the amount of risk-based assessments, the FDIC is to take into account (1) economic conditions generally affecting financial companies so that assessments increase in more favorable economic conditions and decrease in less favorable economic conditions, (2) assessments imposed on a financial company or an affiliate of a financial company that is an insured depository institution, SIPC member, insured credit union, or insurance company subject to state assessments, (3) the risks presented by the financial company to the financial system and the extent to which the financial company has benefited from the orderly liquidation of a covered financial company, (4) any risks presented by the financial company during the 10-year period immediately prior to the appointment of the FDIC as receiver that contributed to the covered financial company's failure, and (5) other risk-related factors as the FDIC or Council deems appropriate.

Key Issues for Agency Rulemaking Phase

The Act leaves many critical issues to be fleshed out in rulemaking proceedings at the Federal Reserve, the FDIC, and other agencies. Among the key issues for the rulemaking phases relating to systemic risk regulation and liquidation of systemically important firms are the following:

Systemic Risk Regulation

- Definitional criteria for determining if a company is "predominantly engaged in financial activities" (to be promulgated by the Federal Reserve within 18 months of enactment of the Act).
- Enhanced prudential standards to apply to Designated Companies and Interconnected Bank Holding Companies (to be established by the Federal Reserve, with no statutory deadline).
- Criteria for exempting certain types or classes of nonbank financial companies from supervision by the Federal Reserve (to be promulgated by the Federal Reserve within 18 months of enactment of the Act).

Orderly Liquidation of Systemically Important Firms

- Method for determining whether a financial company is "predominantly engaged in financial activities" (to be promulgated by the FDIC in consultation with the Secretary of the Treasury, with no statutory deadline).
- System for assessing financial companies to cover any unrecovered amounts expended by the Orderly Liquidation Fund (to be promulgated by the FDIC in consultation with the Secretary of the Treasury within 18 months of enactment of the Act).

[3] Additional payments are amounts that claimants received that exceed the amount received by other similarly situated creditors.

If you would like to discuss the Act and our capabilities to assist you in the upcoming rulemaking process, please contact the following members of our firm:

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