

Proposed Rules and Guidance Regarding Federal Reserve Oversight of Nonbank Financial Companies

On October 11, 2011, the Financial Stability Oversight Council (the “Council”) released a second notice of proposed rulemaking and interpretive guidance regarding the process by which the Council will determine, with respect to each “nonbank financial company,” whether such company could pose a threat to U.S. financial stability and therefore should be supervised by the Board of Governors of the Federal Reserve (the “Board”) and be subject to prudential standards. The Council has the authority to make this determination under the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. The Council expects to review all types of nonbank financial companies, including asset management companies, hedge funds, financial guarantors, and private equity firms.

In determining which companies will be subject to the Board’s supervision and subject to prudential standards, the Council identified three stages of review. To pass Stage 1, a nonbank financial company would have to have at least \$50 billion in total consolidated assets and additionally would have to meet or exceed one of the following five other thresholds: (i) \$30 billion in gross notional credit default swaps for which the company is the reference entity, (ii) \$3.5 billion of derivative liabilities, (iii) \$20 billion of outstanding loans borrowed and bonds issued, (iv) a 15-to-1 leverage ratio of total assets to total equity, or (v) short-term debt measuring 10% of total assets.

The Council stated in its rulemaking release that it intends to apply the Stage 1 thresholds to asset management companies, hedge funds, and private equity firms (as well as other nonbank financial companies), but noted that in the Council’s view these companies may pose risks that are not well measured by the quantitative thresholds approach. With respect to hedge funds and private equity firms, the Council indicated that it may establish an additional set of thresholds tailored to hedge funds, private equity firms, and their advisers, based in part on information provided by fund advisers on Form PF beginning in 2012. See Ropes & Gray’s previous [alert](#) on proposed Form PF. In addition, the Council plans to analyze the extent to which asset management companies may pose potential threats to U.S. financial stability and whether such threats can be mitigated by subjecting such companies to Board supervision and prudential standards, or whether they are better addressed through other regulatory measures.

Under the proposed rule, if a nonbank financial company meets the quantitative thresholds in Stage 1, or if the Council otherwise determines further review is warranted, in Stage 2, the Council would use information available through public and regulatory sources to analyze the company’s risk profile and characteristics by considering six categories: size (including off-balance sheet assets and assets under management), interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. Three of the six categories (size, interconnectedness, and substitutability) seek to assess the potential impact of a nonbank financial company’s financial distress on the broader economy. The other three categories (leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) seek to assess the vulnerability of a nonbank financial company to financial distress.

In Stage 3, the Council would issue a formal notice to a company still under consideration with an accompanying request for further information. After an in-depth review of the information submitted by the nonbank financial company and consultation with the company’s primary regulatory agency, if any, the Council would vote on whether to subject such company to supervision by the Board and prudential standards. If the Council were to determine that a nonbank financial company should be subject to such supervision and prudential standards, the company would have the right to a hearing to contest the determination and, subsequent to the hearing, a right to petition the federal courts.

The Council's release regarding the proposed rule may be found [here](#). The Council will accept comments on the proposed rule until December 19, 2011.

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If you would like to learn more about the issues raised in this alert, please contact the Ropes & Gray attorney with whom you regularly work.