FINANCIAL STABILITY OVERSIGHT COUNCIL ISSUES PROPOSAL ON DESIGNATION OF SYSTEMICALLY IMPORTANT FIRMS, VOLCKER RULE STUDY AND STUDY ON FINANCIAL SECTOR CONCENTRATION LIMITS

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To Our Clients and Friends:

Last week, the Financial Stability Oversight Council ("FSOC") met and issued three long-awaited documents. First, it released a proposed rule that, at least nominally, is designed to clarify FSOC's approach to designating U.S. and foreign nonbank financial companies as systemically important and, thus, subject to enhanced prudential standards and supervision by the Federal Reserve Board ("FRB"). Second, FSOC issued a study and recommendations to the regulatory agencies ("Agencies") charged with implementing the Volcker Rule ("Study"). Third, FSOC issued a study and recommendations on financial sector concentration limits ("Concentration Study").

Each of these documents represents one more step in the long and winding regulatory process by which the Dodd-Frank Act is being implemented. Each of the above releases will be followed by additional regulatory actions, with opportunities for industry input along the way.

PROPOSED RULE ON DESIGNATION OF SYSTEMICALLY IMPORTANT FIRMS

FSOC's proposed rule seeks to implement and clarify both FSOC's authority to designate nonbank financial companies as systemically important and the procedures surrounding such designation. The proposed rule follows a prior advance notice of proposed rulemaking ("ANPR"), issued in October 2010, in which FSOC sought comment on what specific criteria it should consider in designating financial firms.

What is most notable about the proposed rule is how little it adds to the statutory language. Indeed, after soliciting comments from industry, FSOC makes no apparent use of those comments in the proposed rule text. Rather, FSOC merely summarizes the 50 comments it received in response to its ANPR but takes no position on the approaches and views contained in the comment letters. With respect to which nonbank financial companies will be designated and the criteria that will be used to make such determinations, the proposed rule tracks almost verbatim the language of the Dodd-Frank Act and gives the marketplace little new information beyond that which is contained in Section 113 of the statute itself.

In the preamble to the proposed rule, FSOC notes that its proposed framework for assessing systemic importance is organized around six broad categories that incorporate the more specific statutory factors to be considered. The six analytic categories are intended to reflect different dimensions of a firm's potential to experience material financial distress and/or impact the financial stability of the United States. The six categories are: size; lack of substitutes for the financial services and products provided by the company; interconnectedness with other financial firms; leverage; liquidity risk and maturity mismatch; and existing regulatory scrutiny.

FSOC also says that, where possible, it will employ quantitative metrics to make systemic firm designations, but those metrics are not specified, and it is clear that FSOC intends to base its designations, at least to a degree, on internal judgments that stem from an analysis of the six broad categories. Perhaps more than anything else, the broad nature of the proposed rule's language indicates that regulators are focused on preserving flexibility and ensuring broad discretion to designate nonbank financial companies going forward. Given that Treasury Department staff and others signaled this approach in meetings with industry groups, that outcome is not surprising.

The proposed rule was published in the Federal Register on Wednesday, January 26, 76 *Federal Register* 4555 (2011), and is open for public comment until February 25, 2011. Regulators have signaled that a final rule may be expected in April and that, barring unforeseen events, designations of systemically important firms will not take place until after that final rule is issued.

VOLCKER RULE STUDY

FSOC's much-anticipated Study calls for "robust implementation" of the Volcker Rule and provides generalized guidance to the Agencies (which include the FRB, Office of the Comptroller of the Currency, Federal Deposit Insurance Corp., Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission) that will embark on rulemaking to implement the Volcker Rule. The Study suggests a number of points that the Agencies should consider when drafting their rules but generally stops short of taking more definitive positions, thereby leaving the regulatory agencies with ample discretion in the rule-writing process. To this end, many interpret the Study as generally adopting the approach favored by the FRB staff, which had been rumored to seek to preserve such discretion, other than in a few specific areas where the Study establishes clearer recommendations.

The Study addresses both the proprietary trading restrictions and limitations on dealings with hedge and private equity funds found in the Volcker Rule. The predominant focus of the Study, however, is the proprietary trading limits, to which the Study devotes 55 of its 70 pages. Yet, several of the Study's clearer (and less equivocal) points are contained in its private equity and hedge fund discussions.

Proprietary Trading. The Study calls for prohibiting proprietary trading throughout a banking entity, and not just within certain business units (such as proprietary trading desks). At the same time, the Study acknowledges the challenge of distinguishing impermissible proprietary trading from market making, hedging, underwriting and other transactions on behalf of customers. The Study recommends the Agencies consider certain indicia of permitted market making, hedging and underwriting activities, in certain cases by recommending adoption of pre-existing SEC definitions. One important principle that the Study acknowledges is that permitted hedging activities may not be tied to a specific risk exposure but that, instead, "much hedging is done on a portfolio basis." To the same end, the Study recognizes that banks conduct asset-liability management to manage risk profiles, and the Study states clearly that such activities are intended to be permissible.

To restrict proprietary trading and distinguish such trading from permitted activities, the Study recommends that banking entities be required to implement comprehensive compliance programs, including internal policies and procedures, quantitative and other controls, testing and training. The Study recommends that the policies and procedures establish: authorized risks and products, to ensure trading stays within authorized frameworks; processes to analyze revenues, to discern the nature of trading activities; limits that ensure risk-taking is constrained and that disallow impermissible activities; and stop-loss limits to trigger reviews and cessation of activities when limits are exceeded. The Study also calls on the Agencies to "strongly consider" imposing obligations on boards of directors and CEOs to ensure that they are "effectively engaged in and accountable for" their institution's compliance programs. To this end, the Study recommends the Agencies "strongly consider" having banking entity CEOs attest publicly to the ongoing effectiveness of the compliance regimes – a suggestion that brought a fair degree of negative industry reaction.

The Study recommends that banking entities, as part of their compliance regimes, maintain records and provide reports to supervisors on a periodic basis. The Study suggests the Agencies consider requiring banking entities to report certain quantitative metrics, and the Study identifies four "promising" categories of such metrics: revenue-based metrics, which may allow a determination as to the nature of trading activities; revenue-to-risk metrics, because, according to the Study, permitted activities are likely to have greater revenue-to-risk ratios than impermissible proprietary trading; inventory metrics, as holding inventories in excess of customer demand may be indicative of proprietary trading; and customer-flow metrics, as trader-initiated, rather than customer-initiated, order volume could indicate proprietary trading activities are occurring.

The approach taken by the Study, if adopted by the Agencies, likely will impose significant compliance and systems burdens on banking entities. The Study acknowledges the challenges that banking entities may face in complying with these requirements, noting that

current risk infrastructures – which were designed for other purposes – are insufficient for this compliance objective.

Hedge and Private Equity Funds. In several respects, the Study takes the same approach to hedge and private equity funds that it does with respect to proprietary trading. For example, the Study calls, once again, for establishment of programmatic compliance regimes, with investment and risk oversight, public attestation by the CEO and board of directors engagement.

The Study also provides some rare clarity on certain key questions. First, the Study recommends that the Agencies exempt venture capital funds from the scope of the Volcker Rule's prohibition. To distinguish venture capital funds from private equity and hedge funds, the Study appears to suggest that the Agencies consider the SEC's definition of venture capital fund in that agency's recent proposal to exclude advisers to such funds from the registration requirements of the Investment Advisers Act of 1940. Second, the Study acknowledges that the statutory definition of hedge and private equity funds, which refers to vehicles that rely on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, is overly broad. To this end, the Study recommends that the Agencies "narrow the statutory definition … in some cases." Third, the Study accepts that the statutory term "banking entity" – to which the Volcker Rule's restrictions apply – could capture entities such as funds-of-funds and controlled funds; the Study suggests that the Agencies implement the term to avoid such unintended results.

On the topic of funds-of-funds, the Study recognizes that banking entities may establish funds to provide their customers with access to third-party private equity and hedge funds. The Study states that banking entities may do so but suggests that conflicts of interest may arise when a banking entity directs a proprietary fund investment in a third-party fund with which the banking entity has other business relationships. The Study suggests the Agencies consider approaches to limit such conflicts, including through affiliate-transaction restrictions (such as Sections 23A and 23B of the Federal Reserve Act).

Finally, the Study acknowledges that Volcker Rule implementation raises special issues in the case of insurance companies covered by the rule. The Study recommends the Agencies consult with state insurance commissioners to craft appropriate requirements for insurers. The Study also suggests the Agencies consider separate account assets, but the Study does not provide any greater specificity on that subject.

Next Steps. The Study appears to represent a set of consensus positions taken by the constituent agencies that form the FSOC, and it leaves many detailed and difficult interpretive questions to the Agencies. Under the Volcker Rule, the Agencies have nine months to fashion implementing regulations – a daunting task. The FRB's website indicates that the Agencies will aim to produce an inter-agency proposed rule in the second quarter;

that rulemaking will be open for public comment, and it will be important for industry participants to pay close attention to this process.

STUDY ON CONCENTRATION LIMITS

Section 622 of the Dodd-Frank Act establishes a concentration limit that generally prohibits a financial company from merging or consolidating with, or acquiring, another firm if the resulting company's consolidated liabilities (generally defined by reference to risk-weighted regulatory assets and capital calculations) would exceed 10% of the aggregate liabilities of all financial companies. As the Concentration Study points out, Section 622 applies to banking organizations and non-bank SIFIs, but not to insurers and securities firms unaffiliated with insured depository institutions or to foreign banks without a U.S. banking office. Section 622's concentration limit is subject to, and may be modified by, recommendations issued by FSOC and, thereafter, is to be implemented through FRB rulemaking.

Generally, the Concentration Study supports Section 622's objectives and requirements, noting that the "concentration limit will have a positive impact on U.S. financial stability." The Concentration Study posits that the limit will help stabilize the financial system by preventing acquisitions that make financial companies increasingly difficult to manage, discipline and supervise. FSOC's view is that the concentration limit will restrict financial companies to a size that effectively allows managers to better understand and, thereby, effectively manage their own firms. Also, given that the concentration limit does not restrict organic growth and will affect only a small number of large banking organizations, FSOC believes that Section 622 generally will not affect the efficiency and competitiveness of U.S. financial markets.

That said, the Concentration Study acknowledges that the limit treats acquisitions by U.S-based firms and foreign-based firms unequally because Section 622 includes the global consolidated liabilities of U.S. firms but only the U.S. liabilities of foreign firms. The Concentration Study suggests that the FRB should monitor and report back to the FSOC on these competitive issues. According to the Concentration Study, if it is determined that there are significant negative effects, the FSOC would request that Congress revisit the matter.

The Concentration Study includes three recommendations:

- The Concentration Study notes that some firms subject to Section 622 do not calculate assets and capital on a risk-based approach used by banking entities. Accordingly, the Concentration Study recommends that the FRB develop a "hybrid approach" to the calculation of liabilities, which approach would allow companies not subject to risk-based capital rules to use GAAP standards or, where GAAP is not applicable, other appropriate accounting standards.

- Section 622 calls for the concentration limit to apply at the end of each calendar year. The Concentration Study recommends that this test be modified to use the average of the final aggregate liabilities as of the prior two years, which approach is designed to ease volatility and administrative concerns.

- The Concentration Study recommends that the statutory limit – which contains an exception for acquisitions of failing "banks" – be modified to include an exception for the acquisition of any insured depository institution in default or in danger of default, if the FRB grants its prior written consent.

These recommendations are subject to a 30-day comment period after publication of the Concentration Study in the Federal Register.

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Please feel free to contact any of the undersigned with questions on FSOC's proposed rule or studies.

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