

THE NEW REGULATORY FRAMEWORK FOR DESIGNATING “SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS” AND ITS APPLICATION TO PRIVATE EQUITY FIRMS AND FUNDS

April 19, 2012

To Our Clients and Friends:

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) established a council of regulators, the Financial Stability Oversight Council (“FSOC”), and charged it with identifying and monitoring risks to the stability of the U.S. financial system, including risks that might be presented by the failure or financial distress of non-bank financial institutions. As part of its mandate, the FSOC was empowered to designate financial companies – including potentially public and private investment firms and funds – as systemically important non-bank financial institutions (“SIFIs”), which would then be subject to enhanced supervision and regulation by the Federal Reserve Board (the “FRB”).¹

Earlier this month, federal regulators took two important steps toward finalizing the framework for designating SIFIs.² First, on April 2, the FRB supplemented an earlier proposed rule on the scope of activities that will be considered “financial” under the Dodd-Frank Act.³ This rule is important as a threshold matter because a company may only be designated a SIFI if it is “predominantly engaged in financial activities.” Second, on April 3,

¹ During this entire rulemaking process, Debevoise & Plimpton LLP was actively involved, on behalf of various financial institutions and trade associations, in meeting with regulators and commenting on the analytical framework and regulations that the FSOC and FRB have proposed to carry out their mandates under the Dodd-Frank Act. Among other things, we have argued that private equity firms and funds, individually and as a group, do not present systemic risk concerns and should not be designated as SIFIs, as further discussed in this update.

² Readers interested in a more comprehensive analysis of the regulatory measures may refer to New Federal Reserve Board And Financial Stability Oversight Council Releases Focus The Regulatory Framework For Systemically Important Financial Institutions, Debevoise & Plimpton Client Update (Apr. 17, 2012), available at <http://www.debevoise.com/newsevents/pubs/publications/detail.aspx?id=6168c366-f07a-4898-89e2-0c67862f52fb>.

³ 77 Fed. Reg. 21,494 (Apr. 10, 2012).

the FSOC approved a final rule and interpretive guidance establishing the process and considerations for designating SIFIs.⁴

With these two steps, the FSOC moves closer to designating the first SIFIs, which Treasury Secretary Geithner stated would occur this year.⁵ We do not believe that private equity funds or firms will be considered for designation as SIFIs this year, and there is no indication that the FSOC is targeting private equity funds or their advisers for SIFI designation. However, in the preamble to its rule and interpretive guidance, the FSOC stated that once private equity firms (and other private fund advisers) begin filing Form PF in June 2012, the FSOC may use that data to establish metrics or thresholds tailored to evaluating private funds and their advisers for possible SIFI designation.

The FRB's Supplemental Proposal

The FRB's proposed rulemaking seeks to establish the criteria for determining whether a company is "predominantly engaged in financial activities."⁶ Among other things, the FRB's proposal provides that investment activities are considered financial for purposes of the statutory test. Under the proposal, therefore, the activities of private equity funds, mutual funds and hedge funds all are likely to be considered "financial activities."

The FRB's proposal is consistent with what we already believed: namely, that the FRB intends to interpret the term "financial activities" broadly so as to widen the universe of companies that potentially could be designated as SIFIs.

The FSOC's Final Rule and Interpretive Guidance on SIFI Designation

The FSOC's final rule and interpretive guidance – which represents the culmination of a long and sometimes tortured process involving several rounds of proposed rulemakings – adopts a three-stage process for SIFI designation.⁷

⁴ 77 Fed. Reg. 21,637 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310).

⁵ Timothy Geithner, Sec'y, U.S. Dep't of the Treasury, Remarks on the State of Financial Reform (Feb. 2, 2012), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg1408.aspx>.

⁶ The FRB's action is actually a re-proposal of a previously issued notice of proposed rulemaking. 76 Fed. Reg. 7,731 (Feb. 11, 2011).

⁷ For additional discussion of the FSOC's proposed rules on SIFI designations, see FSOC Issues Proposal on Designation of Systemically Important Firms, Volcker Rule Study and Study on Financial Sector Concentration Limits, Debevoise & Plimpton Client Update (Jan. 28, 2011), available at <http://www.debevoise.com/newsevents/pubs/publications/detail.aspx?id=e1ffc9a1-a0b6-441b-a2f2-244766def31f>; FSOC Releases Proposed Rule and Guidance on its Process to Designate Non-bank Firms as Systemically

Stage 1: Quantitative Thresholds. During Stage 1, the FSOC will screen companies based on their size, interconnectedness, leverage and liquidity risk/maturity mismatch; the screens are presented in the Appendix to this memorandum. Specifically, as shown in the Appendix, the FSOC will seek to identify non-bank financial institutions with total consolidated assets of \$50 billion or more. If one of those large non-bank financial institutions meets one of the other five tests set forth in the rules, that institution will be further analyzed as a possible SIFI in Stage 2 and possibly Stage 3 of the FSOC's process. If a non-bank financial institution does not pass the asset test – or even if it satisfies that test but does not satisfy one of the other tests – it will not automatically move on to further analysis and, therefore, is unlikely to be designated as a SIFI. Nonetheless, in such a case, the FSOC has preserved the discretion to evaluate a firm in Stage 2 based on “other firm-specific qualitative or quantitative factors.”

In the guidance accompanying the new FSOC rule, the FSOC also stated that it is considering what threats, if any, may arise from asset management firms and noted that it may develop additional guidance regarding metrics and thresholds for asset managers, since most asset management firms (including private equity firms) are likely to fall outside the Stage 1 screens.

The FSOC also clarified that when it applies the Stage 1 quantitative tests to investment funds, it may consider the aggregate risk posed by separate funds that are managed by the same adviser, especially if the funds' investments are highly similar or identical. So, for example, the FSOC may consider two funds investing in parallel as a single fund for purposes of calculating whether those funds satisfy the \$50 billion total consolidated assets test.⁸ Helpfully, for purposes of applying the Stage 1 thresholds to private equity firms and other asset management firms, the FSOC also noted (as we and other commenters had urged it to do) that its analysis “will appropriately reflect the distinct nature of assets under management compared to the asset manager's own assets.”

Stage 2: Six-Category Framework. Firms that cross the Stage 1 thresholds will undergo an in-depth analysis in Stage 2. The FSOC will not provide notices to firms being evaluated in Stage 2; therefore, firms will not know whether they are undergoing Stage 2 evaluation by the FSOC.

Significant, Debevoise & Plimpton Financial Institutions Report (Nov. 2011), available at <http://www.debevoise.com/news-events/pubs/publications/detail.aspx?id=306bbe45-ff2a-4c8f-9aa8-b97a8a3a38fe>.

⁸ It is not clear whether, for purposes of the \$50 billion assets test, the FSOC would go so far as to consider two or more funds pursuing overlapping investment strategies (where those funds do not invest in lockstep) as one entity, or would consider a fund and any successor fund (i.e., a fund having the same investment strategy as the first fund but formed after the first fund was invested) as one entity.

The Stage 2 analysis will be based on a six-category framework. The first three relate to the potential impact of a company's financial distress on the broader economy, while the remaining three address the potential vulnerability of the company to distress.

- Interconnectedness. Interconnectedness is intended to capture the direct or indirect linkages between financial companies that could cause the negative effects of one company's distress to be passed on to another.
- Substitutability. Substitutability will capture the extent to which other firms could provide the same financial services as the company being evaluated and at a similar price and quantity if the company left a particular market.
- Size. Size will capture the amount of financial services or intermediation that a company provides.
- Leverage. Leverage will capture a company's exposure or risk in relation to its equity capital.
- Liquidity Risk and Maturity Mismatch. Liquidity risk will measure the risk that a company would not have sufficient funding to satisfy its short-term needs. Maturity mismatch will measure the difference in maturities of a company's assets and liabilities.
- Existing Regulatory Scrutiny. Lastly, the FSOC will consider the extent to which a company is subject to already-existing regulatory scrutiny, such as by state or home-country regulators.

The FSOC notes that, as part of its Stage 2 analysis, it may consider the relationship between the potential SIFI and these six factors in the "context of stressed market conditions."

On behalf of various private equity industry participants, we met with members of the FSOC, and prepared comment letters, arguing that private equity firms and funds do not present systemic risk concerns under any of the six factors to be considered in the Stage 2 analysis. Specifically, we pointed out that most private equity funds: (1) are not meaningfully interconnected with other financial institutions (because they have limited counterparty exposure); (2) do not present substitutability concerns because they number in the thousands and because they do not provide products or services necessary for the operation of the financial system (such as deposit taking or extension of consumer credit); (3) are small relative to other financial institutions; (4) typically are not leveraged at all at the fund level; (5) do not present liquidity risk because they do not rely on short-term credit and are not susceptible to "runs" (because they do not offer redemption rights); (6) do not create maturity mismatches because they invest in long-dated assets using capital provided pursuant to long-term capital

commitments and do not have material short-term liabilities; and (7) are subject to significant and appropriate state and federal regulation (including registration and regulation under the Investment Advisers Act and, starting later this year, systemic risk reporting on Form PF).

Stage 3: Company-Involved Review. If the FSOC determines that a potential SIFI should be evaluated in Stage 3, that company will receive a “Notice of Consideration,” which likely will request that the company provide information within a certain time frame. The FSOC has said it would give notified firms at least 30 days to respond to such an information request.

The FSOC states that the Stage 3 analysis will build on the Stage 2 analysis and will consider data from the company and other regulators. Stage 3 is intended to assess factors not easily quantifiable but that could mitigate or aggravate the potential that a company could pose a threat to U.S. financial stability, such as the opacity of a company’s operations and ease of resolvability.

Designations

The final rule requires the FSOC to confer and vote, by two-thirds majority, including the FSOC’s chairperson, the Secretary of the Treasury, on the proposed designation of a company as a SIFI. A company will be notified if it is designated at least one day before the FSOC publicly announces the designation. The company will be able to contest a designation, after which the FSOC will again vote, by two-thirds majority, including the Secretary of the Treasury, to determine whether to issue a final designation.

Designated companies will be reevaluated for their systemic importance annually. The FSOC has stated that, in the reconsideration process for a SIFI, it will not perform an analysis as detailed as the analysis that it undertook at Stages 2 and 3 of the initial designation.

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The FSOC’s first SIFI designations are expected later this year. Those designations and their accompanying notices likely will reveal more about the process and factors used by the FSOC, which, despite these rulemakings, remain somewhat opaque and subject to the FSOC’s substantial discretion. At least for now, there is no indication that private equity firms or funds are an important focus of the FSOC as it considers SIFI designations. That could change, of course, as the FSOC learns more about the industry through Form PF data and otherwise.

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Appendix: Stage 1 SIFI Screen

