

The Financial Stability Oversight Council Takes Action: New Insight into Determination of Which Insurers May Be Subject to Enhanced Oversight

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Recent proposed rulemakings from the Financial Stability Oversight Council (FSOC) and the Board of Governors of the Federal Reserve System (Board) substantially advance the mandate of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) to designate nonbank financial companies, like insurance companies, as subject to enhanced supervision and regulation by the Board. Section 113 of the Dodd-Frank Act grants the FSOC the authority to require certain United States and foreign nonbank financial companies, which are defined to include insurers, to be supervised by the Board. Such Board supervision will occur if the FSOC determines that the material financial distress at such company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities at the company, could pose a threat to the financial stability of the United States.¹

While the FSOC has met three times, to date, two key positions remain vacant. These positions would have a voice (both voting and non-voting) on the impact of Board supervision and any related proposals on the insurance industry. The insurance expert who will be a voting member of the FSOC is still to be appointed by President Obama and confirmed by the U.S. Senate. In addition, the Director of the Federal Insurance Office who will advise the FSOC as a non-voting member has not been appointed by the Secretary of the Department of the Treasury (Treasury). A third position that would advise the FSOC (also as a non-voting member) on insurance industry issues has been filled by the director of the State of Missouri Department of Insurance, John Huff. In light of the two open positions, U.S. Representative Barney Frank (D-MA), now the ranking member of the House Financial Services Committee, and several large insurance industry trade associations recently expressed concern about the application of new proposed rulemakings to the insurance industry without appropriate industry input and have urged deferring further action until both positions are filled.² This concern was reiterated in a recent letter to the Treasury Secretary that was also signed by Representative Frank as well as a bipartisan group comprised of House Financial Services Committee Chairman Spencer Bachus (R-AL) and Representatives Judy Biggert (R-IL) and Luis Gutierrez (D-IL), the chairwoman and ranking member, respectively, of the Financial Services Committee's Subcommittee on Insurance, Housing and Community Opportunity. Legislators and members of the insurance industry have also commented that standards and supervisory practices intended to apply to banks and similar institutions will be imposed on insurers without sufficient thought as to the interplay with state insurance regulations and supervision.

Proposed Rulemakings. On October 6, 2010, the FSOC issued an advance notice of proposed rulemaking seeking public comments on the development of specific criteria and a regulatory framework

¹ For a chart summarizing the key provisions and regulatory rulemakings of Title I, please click [here](#).

² Public Comment to the FSOC on the Proposed Rule for Designation by the American Council of Life Insurers, the American Insurance Association and the Reinsurance Association of America dated Feb. 9, 2011 and Letter to President Barack Obama and Secretary of the Treasury Timothy Geithner by the Property Casualty Insurers Association of America dated Jan. 17, 2011.

by which it will consider designating nonbank financial companies for supervision.³ The FSOC reviewed the 50 comments it received, many from insurers and their trade associations, and, on January 18, 2011, released a notice of proposed rulemaking (Proposed Rule for Designation) to implement Section 113 of the Dodd-Frank Act. The Proposed Rule for Designation outlines the criteria that will inform, and the process and procedures established under the Dodd-Frank Act for, the FSOC's designation of nonbank financial companies, as summarized below.⁴ Comments are due by February 25, 2011.

The Board released a notice of proposed rulemaking on February 8, 2011 (Proposed Rule on Definitions) that provides the definitions needed for the FSOC to make its determinations, including the regulations that outline the criteria for “*predominantly engaged in financial activities*” and the definitions of “*significant nonbank financial company*” and “*significant bank holding company*” for purposes of Title I of the Dodd-Frank Act.⁵ Comments are due by March 30, 2011.

Other recent actions taken by the FSOC include release of its study and recommendations on how best to implement Section 619 of the Dodd-Frank Act (commonly known as the “Volcker Rule”), and its report on concentration limits on large financial companies pursuant to Section 622 of the Dodd-Frank Act.

Determination of Nonbank Financial Companies Subject to Board Supervision

The Dodd-Frank Act sets forth 11 statutory factors that the FSOC must consider in making a determination as to the designation of nonbank financial companies that would be subject to Board supervision. The statutory factors are as follows: (1) the leverage of the company; (2) the off-balance-sheet exposures of the company; (3) the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;⁶ (4) 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 United States financial system; (5) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (6) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse; (7) the nature, scope, size, scale, concentration, interconnectedness, and mix of activities of the company; (8) the degree to which the company is already regulated by one or more primary financial regulatory agencies; (9) the financial assets of the company; (10) the liabilities of the company, including the degree of reliance on short-term funding; and (11) any other risk-related factors that the FSOC deems appropriate.

³ For a discussion of the FSOC's composition and inaugural meeting on October 1, 2010, see “The Financial Stability Oversight Council Holds Inaugural Meeting; Proposed Rulemakings on Nonbank Financial Companies and the Volcker Rule Will Impact Insurers” (Oct. 13, 2010) ([Dodd-Frank Legal Alert](#)).

⁴ 76 Fed. Reg. 4555 (Jan. 26, 2011). Click [here](#) to be directed to the FSOC's request for comments.

⁵ 76 Fed. Reg. 7731 (Feb. 11, 2011) Click [here](#) to be directed to the Board's request for comments.

⁶ The definitions of “significant nonbank financial company” and “significant bank holding company” are discussed below as part of the Proposed Rule on Definitions.

A “nonbank financial company” includes both a “U.S. nonbank financial company” and a “foreign nonbank financial company.” A “U.S. nonbank financial company” is any company, other than a bank holding company and certain other institutions designated in the Dodd-Frank Act, that is (1) incorporated or organized under the laws of the United States or any state, and (2) “predominately engaged in financial activities” as defined by Board regulation and discussed below as part of the Proposed Rule on Definitions. A “foreign nonbank financial company” is any company, other than a company that is, or is treated in the United States as, a bank holding company that is (1) incorporated or organized in a country other than the United States, and (2) “predominately engaged in financial activities” as defined by Board regulation and discussed herein. While the framework discussed in the Proposed Rule for Designation applies to both U.S. nonbank financial companies and foreign nonbank financial companies, the assessment categories focus only on the U.S. operations of a foreign nonbank financial company. Importantly, as described in more detail below, typical insurance company operations are clearly within the scope of the term “financial activities.”

The Proposed Rule for Designation distills the statutory factors enumerated above into an analytical framework consisting of the six broad categories identified below that reflect different factors with respect to a firm’s potential to experience material financial distress, as well as the nature, scope, size, scale, concentration, interconnectedness and mix of the company’s activities:

1. Size;
2. Lack of substitutes for the financial services and products the company provides;
3. Interconnectedness with other financial firms;
4. Leverage;
5. Liquidity risk and maturity mismatch; and
6. Existing regulatory scrutiny.

The FSOC asserts that the first three factors – size, lack of substitutes and interconnectedness – will be used to assess the potential for the firm’s distress to impact the broader financial system or economy. The second three factors – leverage, liquidity risk and maturity mismatch and existing regulatory scrutiny – will be used to assess how vulnerable a company is to financial distress. The FSOC would evaluate nonbank financial companies in each category, using quantitative data where possible. However, the proposed rule does not provide specific numeric thresholds for any of the categories. The FSOC plans a periodic review of the metrics and may revise them as appropriate.

The Proposed Rule for Designation also reinforced the FSOC’s authority pursuant to the anti-evasion provisions of Title I of the Dodd-Frank Act.⁷

⁷ Section 113(c) of the Dodd-Frank Act grants the FSOC authority to subject *any company* (as opposed to a nonbank financial company) to Board supervision and prudential standards if the FSOC determines that (1) material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of, the financial activities poses a threat to the financial stability of the United States, and (2) the company is organized or operates in a manner to evade the application of Title I of the Dodd-Frank Act. Such a designation requires the vote of no fewer than two-thirds of the voting members of the FSOC, including the Treasury Secretary as Chairperson of the FSOC (Chairperson). To facilitate the supervision of the financial activities conducted by such a company, the Board may require the company to establish an intermediate holding company that would be subject to Board supervision and prudential standards as if the intermediate holding company were a nonbank financial company supervised by the Board.

Process for Determination of Nonbank Financial Companies Subject to Board Supervision

The Proposed Rule for Designation includes some additional information on the process by which the FSOC will designate a nonbank financial company for Board supervision, although much of the content in the Proposed Rule for Designation simply restates the provisions of the Dodd-Frank Act itself.

Information Collection

The FSOC may request and receive information about nonbank financial companies from the Office of Financial Research, member agencies, the Federal Insurance Office, other Federal and State financial regulatory agencies and the nonbank financial company itself.

Notice, Opportunity for Hearing and Final Determination

After a nonbank financial company has been identified for possible designation, the FSOC will deliver written notice to such company indicating that the FSOC is considering whether to make a proposed determination, and providing the company with the opportunity to submit written materials to the FSOC on its behalf.

If the FSOC determines to proceed with a proposed determination, it must provide the nonbank financial company with written notice of the proposed determination and include an explanation of the basis for such determination. The proposed determination requires the vote of approval by two-thirds of the voting members of the FSOC, including the Chairperson.

A nonbank financial company may request a hearing, in writing, no later than 30 days after receiving a notice of proposed determination. The FSOC is required to set a hearing date that is within 30 days of receiving a hearing request. The nonbank financial company may submit written materials or, at the discretion of the FSOC, oral testimony and oral argument.

If a hearing is held, then within 60 days of the hearing, the FSOC must (1) make a final determination regarding whether the nonbank financial company should be supervised by the Board and subject to prudential standards, and (2) provide written notification to the company of the determination, including the basis for the FSOC's decision. Designation of the nonbank financial company for Board supervision requires a vote of approval from two-thirds of the voting members, including the Chairperson. If the nonbank financial company does not request a hearing, the FSOC must make its final determination within 10 days of the date by which such company could have requested a hearing and provide notification of the FSOC's decision to such company.

Emergency Exception

The Proposed Rule for Designation includes an emergency exception provision that permits the FSOC to waive or modify any of the notice, hearing or other requirements discussed above if it determines that doing so would be necessary to prevent or mitigate threats posed by the nonbank financial company to the financial stability of the United States. Any waiver or modification requires approval by no fewer than two-thirds of the voting members of the FSOC, including the Chairperson.

Judicial Review

If the FSOC makes a final determination, including pursuant to an emergency exception, that a nonbank financial company is subject to Board supervision and prudential standards, such company may, within 30 days of receiving the notice of final determination, bring an action in United States district court in the

district where such company's home office is located or in the United States District Court for the District of Columbia. The court's review is limited to whether the final determination by the FSOC was arbitrary and capricious.

Proposed Rule on Definitions

The Dodd-Frank Act requires the Board to issue regulations that establish the requirements for determining if a company is "*predominantly engaged in financial activities*" and to define the terms "*significant nonbank financial company*" and "*significant bank holding company*." If a company meets the definition of "significant nonbank financial company", it does not subject the company to additional supervision or regulation. Instead, relationships between "significant" nonbank financial companies and bank holding companies are a factor in determinations and information collection, such as reporting on such relationships for certain nonbank financial companies supervised by the Board.⁸

Insurance and Annuities Operations are "Financial Activities"

The Board's release accompanying the Proposed Rule on Definitions addresses in some detail conduct that would constitute financial activities. In particular, the release indicates that "acting as a principal or agent in the sale of insurance or annuities" would be considered a financial activity.⁹

Predominantly Engaged in Financial Activities

Under Section 102(a)(6) of the Dodd-Frank Act, a company is "predominantly engaged in financial activities" if either (1) the annual gross revenue derived by 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, as amended by the Gramm-Leach-Bliley Act)¹⁰, as well as from ownership or control of an insured depository institution, represent 85% or more of the consolidated annual gross revenues of the company; or (2) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature, as well as related to the ownership or control of an insured depository institution, represent 85% or more of the consolidated assets of the company. One activity previously defined through the Gramm-Leach-Bliley Act as financial in nature is acting as a principal or agent in the sale of insurance or annuities and, therefore, acting in such capacity will continue to be considered financial in nature under the Dodd-Frank Act.

The Proposed Rule on Definitions expands the proposed criteria by providing for a two-year test based on consolidated financial statements. A company will be considered to be engaged in financial activities if either (1) its consolidated annual gross financial revenues in either of its two most recently completed

fiscal years meets or exceeds the 85% threshold in that fiscal year; or (2) the consolidated total financial assets of the company as of the end of either of its two most recently completed fiscal years meets or

⁸ See Sections 115(d)(2) and 165(d)(2) of the Dodd-Frank Act.

⁹ 76 Fed. Reg. at 7736.

¹⁰ Section 225.86 of the Board's Regulation Y (12 CFR 225.86) references all of the activities that have been determined by statute, regulation or order to be financial in nature under Section 4(k) of the Bank Holding Company Act. Section 4(k) also authorizes the Board, in consultation with the Secretary of Treasury, to determine if additional activities are financial in nature.

exceeds the 85% threshold as of the end of that fiscal year.¹¹ The two-year test permits the FSOC to consider for designation as systemically important a firm whose financial assets and revenue traditionally meet the requirements, but that may experience a temporary decline in revenues or assets.

The Proposed Rule on Definitions also provides the Board with authority to determine, on a case-by-case basis and based on a facts and circumstances test, that a company is predominantly engaged in financial activities based on one of the 85% thresholds. The goal is to provide the Board with sufficient flexibility to take action quickly, and consequently, for the FSOC to make a determination, in response to significant and rapid changes impacting a company (including, for example, a merger, acquisition or other new transaction or activity that otherwise may not be reflected in the company's consolidated financial statements for several months).

Unconsolidated Entities

Revenues derived from, and assets related to, a company's equity investment in another company (investee company) whose financial statements are not consolidated would be considered as financial revenue or assets if the investee company is predominantly engaged in financial activities.

De Minimis Equity Investments

The proposed rule would permit a company to treat certain revenues and assets as not being derived from, or related to, activities that are financial in nature if (1) the company owns less than 5% of any class of outstanding voting shares, and less than 25% of the total equity, of the investee company; (2) the financial statements of the investee company are not consolidated with those of the company under applicable accounting standards; (3) the company's investment in the investee company is not held in connection with the conduct of any financial activity by the company or any of its subsidiaries; (4) the investee company is not a bank, bank holding company, broker-dealer, insurance company or other regulated financial institution; and (5) the aggregate amount of revenues or assets treated as nonfinancial under the rule of construction in any year does not exceed 5% of the company's annual gross financial revenues or consolidated total financial assets of the company.

Anti-Evasion Provision

As mentioned above, the FSOC has the authority to subject any company to Board supervision and prudential standards pursuant to Section 113(c) of the Dodd-Frank Act. A company engaged in activities that are financial in nature but that alters the manner in which those activities are conducted to evade designation by the FSOC may be subject to the FSOC's designation under the anti-evasion authority.

Significant Nonbank Financial Company and Bank Holding Company

The proposed rule provides definitions for significant nonbank financial companies and significant bank holding companies for purposes of Sections 113 and 165(d)(2) of the Dodd-Frank Act. The definition sets an asset threshold of \$50 billion in total consolidated assets, (1) in the case of a significant nonbank

¹¹ The Proposed Rule on Definitions defines "consolidated annual gross financial revenues" as the portion of the company's consolidated annual gross revenues, as determined in accordance with applicable accounting standards, that were derived, directly or indirectly, by the company or any of its subsidiaries from (1) activities that are financial in nature under Section 4(k) of the Bank Holding Company Act; or (2) the ownership, control or activities of an insured depository institution. Similarly, the "consolidated total financial assets" of a company is defined as that portion of the company's consolidated total assets, as determined in accordance with applicable accounting standards, that are related to (1) activities that are financial in nature under Section 4(k) of the Bank Holding Company Act; or (2) the ownership, control or activities of an insured depository institution. The proposed rule clarifies that revenues and assets attributable to a subsidiary of an insured depository institution are also considered to be financial in nature.

financial company, as determined in accordance with applicable accounting standards as of the end of its most recently completed fiscal year, or (2) in the case of a significant bank holding company, as reported on the applicable Federal Reserve form as of the end of its most recently completed calendar year. In addition, any nonbank financial company that is supervised by the Board automatically falls within the definition of significant nonbank financial company. Relationships between firms and significant nonbank financial companies and significant bank holding companies are a relevant factor in determinations made by the FSOC with respect to designation for supervision and regulation by the Board.

Please contact one of the Sutherland attorneys listed below if you would like more information about these or other Dodd-Frank Act proposed rulemakings. We will continue to monitor the implementation of the Dodd-Frank Act and will keep you updated on key events.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Eric A. Arnold	202.383.0741	eric.arnold@sutherland.com
B. Scott Burton	404.853.8217	scott.burton@sutherland.com
James M. Cain	202.383.0180	james.cain@sutherland.com
Daphne G. Frydman	202.383.0656	daphne.frydman@sutherland.com
Ling Ling	202.383.0236	ling.ling@sutherland.com
David A. Massey	202.383.0201	david.massey@sutherland.com
Stephen E. Roth	202.383.0158	steve.roth@sutherland.com
Mary Jane Wilson-Bilik	202.383.0660	mj.wilson-bilik@sutherland.com
Earl Zimmerman	212.389.5024	earl.zimmerman@sutherland.com