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FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY

CLIENT PUBLICATION

May 8, 2013

The FSOC's Annual Report Suggests Potential Paths Forward

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The recently issued annual report of the Financial Stability Oversight Council ("FSOC" or "Council") indicates that the members continue to review the major unfinished business of financial regulatory reform and ramp up the process by which they determine where to focus their collective efforts going forward. While progress has been slow, the financial industry should monitor the Council's activities to see where new hot buttons might emerge, and ideally have some input while the efforts continue.

The FSOC's 2013 annual report may be most notable for what it is missing.[1] On two of the most significant issues facing the FSOC, the report was silent: it did not include an announcement of the designation of any nonbank financial companies ("**SIFIs**") as systemically important, nor did it include the announcement of any further progress on money market mutual fund reform ("**MMF**").

So, the questions remain: what will the Council focus on once Secretary Lew has settled in as Chairperson, the work of SIFI designations is complete, and MMF reforms have been proposed by the SEC, and how could these issues affect market participants?

The following discussion provides several potential answers to these questions.

[1] The FSOC is required by the Dodd-Frank Act to issue an annual report that, among other things, describes significant financial market and regulatory developments, potential emerging threats to financial stability, and its recommendations to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets, promote market discipline, and maintain investor confidence. *See* 12 U.S.C. § 5322(a)(2)(N). The 2013 annual report is available here.

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Living Wills

Section 165(d) of the Dodd-Frank Act provides that living wills shall be submitted to the Federal Reserve, FDIC, ***and*** FSOC. In contrast, the joint Federal Reserve and FDIC rule implementing the Dodd-Frank requirement for living wills provides that living wills shall be provided by the institutions required to submit them to the FSOC "upon request."[2] The joint rule does not provide further details regarding how this request might be made (for example, who may request the living wills? A single member agency? The Treasury Secretary as FSOC chairperson? The full Council?), and neither the statute nor the rule set out the specific purpose for which the FSOC should use the living wills. To date, the FSOC has not made any public statements about its intent to request the living wills, or what it believes the FSOC should do with the living wills if they are requested, although Representative Maxine Waters recently urged Secretary Lew to take action in this area.

The FSOC's approach to this issue could have far ranging impacts for market participants. For example, living wills include highly sensitive and confidential information, and the FSOC is subject to the Freedom of Information Act ("**FOIA**") and has published rules to implement its FOIA procedures.[3] Also, the FSOC has a wide ranging membership that introduces leak risks for this information. In addition, under Section 115 of the Dodd-Frank Act, the FSOC has authority to make recommendations to the Federal Reserve regarding enhanced prudential standards, including with respect to living wills.

Thus, increased FSOC involvement could lead to a recommendation under Section 115, or at the least, could lead to an interagency dialogue that influences the Federal Reserve and FDIC in how they review the living wills for completeness and credibility. The FSOC's other potential uses of the living wills could range from benign, such as a "check the box" request, to being used as information to evaluate whether to break up large banks under section 121 of the Dodd-Frank Act.

Contingent Capital and Bail-in Debt

In July 2012, the FSOC issued a study on the feasibility, benefits, costs, and structure of a contingent capital requirement for nonbank SIFIs supervised by the Federal Reserve System and for large, interconnected bank holding companies ("**BHCs**"), as required by section 115(c) of the Dodd-Frank Act.[4] The study concluded that the Federal Reserve and other financial regulators should "continue to study the advantages and disadvantages of including contingent capital and bail-in instruments in their regulatory capital

[2] 12 C.F.R § 243.3(f).

[3] 12 C.F.R. § 1301.

[4] Financial Stability Oversight Council, Report to Congress on Study of a Contingent Capital Requirement for Certain Nonbank Financial Companies and Bank Holding Companies (July 2012), *available at* http://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/Co%20co%20study[2].pdf.

frameworks."[5] Since then, Federal Reserve Governor Tarullo gave a speech in which he discussed the potential for a requirement for financial companies to hold a certain amount of long-term unsecured debt that could be "bailed-in" as a part of a Title II resolution.[6] Further, section 115 of the Dodd-Frank Act provides the FSOC authority to make recommendations regarding enhanced prudential standards that apply to large, interconnected BHCs and nonbank SIFIs, including a contingent capital requirement. As the discussions around contingent capital and bail-in debt continue, the FSOC may decide to further consider this issue and make recommendations to the Federal Reserve.

The 2013 annual report was silent on this point. Thus, as market participants engage in a dialogue with the Federal banking regulators regarding a requirement for bail-in debt, it may be advisable to consider engaging the broader FSOC membership to provide input in advance of any FSOC deliberations, discussions, or actions.

LIBOR and Information Sharing

The FSOC has discussed LIBOR and potential reforms at various meetings beginning in September 2012.[7] As noted above, the 2013 annual report shows that the FSOC continues to be interested in LIBOR reform. In addition, according to the minutes of the FSOC's December 3, 2012 meeting, the FSOC discussed "the question of US enforcement agencies sharing information discovered during the course of investigations that could have implications for financial stability."[8] The extent of the FSOC's continued involvement in the LIBOR debate, and sharing of information discovered during LIBOR enforcement inquiries, could have a significant impact for market participants affected by these issues and could set precedent for the sharing of information regarding future regulatory inquiries. FSOC member agencies are likely to have an initial instinct to defend their regulatory independence and avoid sharing enforcement-related information with each other.

However, the LIBOR inquiry presents a unique case, because a market regulator (the CFTC) is investigating the actions of banks, supervised by the banking regulators. Thus, the banking regulators may favor information sharing in this particular context so that they are able to have a complete picture of the activities of entities they supervise. Market participants should monitor the FSOC's activity in this area, and may want to consider requesting that the FSOC seek public comment on and formalize its information sharing protocols.

Tri-Party Repo

The FSOC has recommended reforms in the tri-party repo market in each of its three annual reports. In particular, the FSOC has stated that the tri-party repo market presents vulnerabilities to financial stability due to the reliance of market participants on intraday credit extensions from clearing banks, weakness in credit and liquidity risk management practices of many market participants, and a lack of a mechanism to ensure that tri-party repo investors are able to sell collateral in an orderly fashion following a broker-dealer's default. A lack of progress in this area could prod the FSOC to

5 *Id*. at 19.

6 Governor Daniel K. Tarullo, Evaluating Progress in Regulatory Reform to Promote Financial Stability (May 2012), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20130503a.htm.

7 *See, e.g.*, Minutes of the Financial Stability Oversight Council, Held Sept. 28, 2012, *available at* http://www.treasury.gov/initiatives/fsoc/Documents/September%2028%20FSOC%20Meeting%20Minutes.pdf.

8 Minutes of the Financial Stability Oversight Council, Held December 3, 2012, *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/December%203,%202012.pdf.

take a more direct and assertive action, either on its own initiative or in response to building pressure for its recommendations to lead to results.

Title VIII of the Dodd-Frank Act provides the FSOC authority to designate payment, clearing, and settlement ("**PCS**") activities as systemically important and to subject any such designated activities to heightened risk management and other standards.[9] At the time the Dodd-Frank Act was enacted, commenters viewed the PCS authority as being a new tool that regulators could use to address risks in the tri-party repo market. Banking regulators have been acutely focused on short-term funding issues for some time, and the FSOC's 2013 annual report notes that the risk of runs is a vulnerability to financial stability. Thus, after three years of making recommendations without seeing results, in 2013, the FSOC may consider whether to use its PCS authority to address these long-debated reforms and risks.[10] Perhaps as a signal in this direction, the FSOC recently revised its hearing procedures for designations processes to allow a financial institution engaged in PCS activities to request a hearing before the Council to argue that a proposed designation of PCS activities is not supported by substantial evidence.[11] On the other hand, while the FSOC has promulgated rules setting out its framework for determining whether SIFIs and financial market utilities ("**FMUs**") are systemically important, it has not promulgated a similar rule regarding PCS activities.[12] Thus, market participants should consider providing the FSOC input regarding whether it is appropriate for the FSOC to adopt a rule for PCS designations similar to the SIFI and FMU rules, the opportunities that market participants should have to contribute to the FSOC's deliberations regarding a PCS designation, and the appropriate factors the FSOC should consider when evaluating whether PCS activities are systemically important.

Other Observations Regarding the Annual Report

The report largely recycles recommendations from previous annual reports, or emphasizes initiatives that FSOC member agencies previously announced are currently underway. For example, the report recommends action on MMF reform (see 2011 and 2012) and that reforms be undertaken in the tri-party report market (see 2011 and 2012). The report also recommends reform to the housing finance system (see 2011 and 2012).

In addition to the recommendations for specific actions, the report urges that heightened risk management and supervisory attention be given to a number of issues. Again, many of these are repeats from prior years, for example: cybersecurity (see 2012); resilience to interest rate shifts (see 2011 and 2012); and capital, liquidity, and resolution planning (see 2011 and 2012).

[9] 12 U.S.C. § 5463.

[10] In September 2009, the Tri-Party Repo Infrastructure Task Force ("**Task Force**") was formed under the auspices of a private-sector body sponsored by the Federal Reserve Bank of New York ("**New York Fed**"). After several years, the Task Force failed to make meaningful progress in addressing risks in the tri-party repo market to the satisfaction of regulators. In February 2012, the Task Force released its final report, and the New York Fed announced that it would intensify its supervisory oversight of key tri-party market participants' efforts to implement the final report's recommendations in a timely fashion. For more information, see the Task Force's website, here.

[11] Financial Stability Oversight Council, Hearing Procedures for Proceedings Under Title I or Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20hearing%20procedures.pdf.

[12] *See* 12 C.F.R § 1310 (Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies) and 12 C.F.R. § 1320 (Authority to Designate Financial Market Utilities as Systemically Important).

The report's lack of new initiatives could reflect a number of factors. First, as suggested above, Secretary Jack Lew is relatively new to the Council, and may not yet have determined what his agenda for the Council will be. Second, the Council is probably devoting significant resources to evaluating SIFIs for designation, and therefore has not focused on its next moves. Moreover, the member agencies are busy implementing Dodd-Frank Act reforms and other initiatives, such as Basel III.

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