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Comment of Legal Scholars on Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, Financial Stability Oversight Council RIN 4030-AA00

Daniel Schwarcz
University of Minnesota Law School, schwarcz@umn.edu

Patricia A. McCoy
Boston College Law School, patricia.mccoy@bc.edu

Jeremy Kress
University of Michigan Ross School of Business, kressj@umich.edu

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Submitted electronically

Financial Stability Oversight Council
Attn: Mark Schlegel
1500 Pennsylvania Avenue, N.W.
Room 2208B
Washington, D.C. 20220

Dear Mr. Schlegel:

Please see the submission below in response to the notification of the interpretive guidance titled ***Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, RIN 4030-AA00,** proposed by the Financial Stability Oversight Council (FSOC or the Council). We are legal scholars specializing in financial regulation and systemic risk.[*] Thank you for the opportunity to submit these comments for your consideration.

Jeremy C. Kress
Assistant Professor of Business Law, University of Michigan Ross School of Business
Former Attorney, Legal Division, Board of Governors of the Federal Reserve System

Patricia A. McCoy
Professor of Law, Boston College Law School
Former Assistant Director, Mortgage Markets, Consumer Financial Protection Bureau

Daniel Schwarcz
Fredrikson & Byron Professor of Law
University of Minnesota Law School

[*] Our affiliations are for identification only and do not necessarily represent the views of our universities.

EXECUTIVE SUMMARY

We urge the Council not to adopt its proposed interpretive guidance, which would substantially overhaul its approach to nonbank systemic risk. The proposed guidance would diminish FSOC's capacity to respond to financial stability threats by effectively eliminating entity-based nonbank systemic risk regulation and substituting an ineffectual activities-based approach. It would thereby expose the financial system to the same risks that it experienced in 2008 as a result of distress at nonbanks like AIG, Bear Stearns, and Lehman Brothers.

We make three main points in this letter:

First, the Council should not rely primarily or exclusively on an activities-based approach to nonbank systemic risk. An effective activities-based approach is not possible in the United States because FSOC lacks legal authority to implement activities-based reforms directly. Moreover, pervasive jurisdictional fragmentation in the current U.S. regulatory framework will undermine efforts to enact and enforce uniform, consistent activities-based rules.

Second, the Council must retain a robust entity-based designation approach to effectively mitigate the risk of systemic nonbank failures. Designations of systemically important nonbank financial institutions (SIFIs) are uniquely capable of preventing systemic insolvencies of nonbanks through consolidated prudential regulation and supervision. Moreover, an entity-based approach is better suited to deterring nonbanks from seeking out systemic risk and is easier to implement than an activities-based approach.

Third, the Council should not adopt ill-advised procedural barriers to nonbank SIFI designations. Mandatory quantitative cost-benefit analyses and assessment of a firm's vulnerability to distress would make it nearly impossible for the Council to designate new nonbank SIFIs and for any such designations to survive judicial review. Furthermore, the proposed guidance misconstrues nonbank SIFI designations as an emergency response tool, when in fact such designations must be used prophylactically to mitigate nonbank systemic risk.

Accordingly, we strongly urge FSOC to reject the proposed guidance and instead rigorously police the financial system for systemic risks under its current procedures. The comments that follow are substantially based on our forthcoming law review article,[1] companion book chapter,[2] and congressional testimony on entity- and activities-based approaches to nonbank systemic risk.[3]

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[1] *See* Jeremy C. Kress, Patricia A. McCoy & Daniel Schwarcz, *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk,* 92 S. CAL. L. REV. (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3238059.

[2] Jeremy C. Kress, Patricia A. McCoy & Daniel Schwarcz, *Activities Are Not Enough!: Why Nonbank SIFI Designations Are Essential to Prevent Systemic Risk*, *in* SYSTEMIC RISK IN THE FINANCIAL SECTOR: TEN YEARS AFTER THE GREAT CRASH (Douglas W. Arner, Emilios Avgouleas, Danny Busch & Steven L. Schwarcz eds.,

The 2008 financial crisis demonstrated unequivocally that nonbank financial firms such as investment banks and insurance companies can propagate systemic risk throughout the financial system. In response to the crisis, Congress created FSOC and gave it two complementary tools with which to address nonbank systemic risk. First, under section 113 of the Dodd-Frank Act, FSOC has the authority to designate an individual nonbank SIFI for enhanced regulation if the Council determines that the firm's material financial distress or "the nature, scope, size, scale, interconnectedness or mix of [its] activities" could pose a threat to U.S. financial stability.[4] This is FSOC's so-called "entity-based" approach. Second, under section 120 of Dodd-Frank, FSOC may recommend that the primary financial regulatory agencies adopt "new or heightened standards or safeguards" for any financial activity that could propagate systemic risks.[5] This is FSOC's "activities-based" approach.

At first, FSOC embraced its entity-based SIFI designation authority, identifying four firms—Prudential, AIG, MetLife, and GE Capital—as systemically important. But now, just five years later, the Council has reversed all of its original nonbank SIFI designations. These de-designations appeared to be part of a concerted effort by the Council to de-emphasize—or permanently eliminate—nonbank SIFI designations as a regulatory tool.[6]

These concerns were confirmed when, in March 2019, FSOC issued the proposed guidance. The Council's proposal would effectively replace nonbank SIFI designations with a near-exclusive emphasis on activities-based nonbank systemic risk regulation. Indeed, the Council states that it "will prioritize its efforts to identify, assess, and address potential risks and threats to U.S. financial stability through a process that emphasizes an activities based approach."[7] Entity-based nonbank SIFI designations, on the other hand, would be relegated to an afterthought and used "only in rare instances such as an emergency situation or if a potential threat to U.S. financial stability is outside the jurisdiction or authority of the financial regulatory agencies."[8]

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forthcoming 2019).

[3] *See Financial Stability Oversight Council Nonbank Designations: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 116th Cong. (2019) (testimony of Professor Jeremy Kress); *The Federal Government's Role in the Insurance Industry: Hearing Before the Subcomm. on Hous. and Ins. of the H. Comm. on Fin. Servs.*, 115th Cong. (2017) (testimony of Professor Daniel Schwarcz) [hereinafter Schwarcz Testimony].

[4] 12 U.S.C. § 5323(a)(1).

[5] 12 U.S.C. § 5330(a).

[6] *See, e.g.*, Gregg Gelzinis, *Don't Put SIFI Designations on the Back Burner*, AM. BANKER (Jan. 29, 2018), https://www.americanbanker.com/opinion/dont-put-sifi-designations-on-the-back-burner.

[7] Financial Stability Oversight Council, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, Proposed Guidance*, 84 Fed. Reg. 9,028, 9,039 (March 13, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04488.pdf [hereinafter Proposed Guidance].

[8] *Id.* at 9,035.

This proposal is dangerously misguided. An effective activities-based approach to nonbank systemic risk is not currently feasible because FSOC lacks statutory authority to order activities-based measures on its own and because jurisdictional gaps and fragmentations in the U.S. regulatory framework will severely hamper the reach of any activities-based regulation that does take place. Nonbank SIFI designations, on the other hand, are uniquely capable of preventing the types of catastrophic insolvencies the financial system experienced in 2008 through consolidated prudential regulation and supervision of potentially systemic nonbanks.

The Council insists that its proposed activities-based approach would merely supplement, rather than displace, nonbank SIFI designations. But make no mistake: procedural barriers to nonbank SIFI designations contained in the proposed guidance would make it nearly impossible for the Council to designate new nonbank SIFIs and for any such designation to survive judicial review. Moreover, the Council's apparent enthusiasm for activities-based nonbank regulation rings hollow given that the FSOC has not used its existing statutory authority to recommend a single activities-based rule in more than two years under its current leadership.

With the activities-based approach being unrealistic and entity-based designations, for all intents and purposes, consigned to the graveyard, we are deeply concerned that the proposed guidance will topple virtually the entire U.S. system of nonbank systemic risk regulation, for the reasons that we explain in this comment.

I. AN EFFECTIVE ACTIVITIES-BASED APPROACH IS IMPOSSIBLE IN THE CURRENT U.S. REGULATORY FRAMEWORK

Activities-based systemic risk regulation faces three significant obstacles in the United States. First, FSOC lacks legal authority to order activities-based regulation on its own. The proposed guidance would exacerbate that lack of authority by not using the minimal authority that the Council does have. Second, jurisdictional gaps and fragmentation among the primary financial regulators will impede efforts to curb nonbank systemic risk through activities-based regulation. Third, FSOC's ability to monitor risks to financial stability from financial activities has been hampered by staff and budget cuts at the Office of Financial Research (OFR).

A. *FSOC Cannot Implement Activities-Based Regulation Directly*

FSOC faces a threshold challenge in implementing an activities-based approach: the Council has no legal authority to promulgate activities-based rules. Instead, FSOC's activities-based authority is solely precatory. Furthermore, under the guidance as proposed, FSOC will not even invoke that limited authority except under extraordinary circumstances.

1. FSOC Lacks The Power To Order Activities-Based Regulation

The Council should not rely primarily or exclusively on an activities-based approach to nonbank systemic risk because its activities-based authority is quite weak. Under section 120 of Dodd-Frank, FSOC may *recommend* that the primary financial regulators adopt specific activities-based standards.[9] But nothing requires an agency to follow FSOC's recommendation. Rather, the agency is free to decline FSOC's suggestion after "explain[ing] in writing" why the agency determined not to follow it.[10]

An agency might resist implementing activities-based regulations at FSOC's urging for several reasons. For one, the agency might be captured by the financial sector it is supposed to regulate.[11] Second, an agency might decline a recommendation by the Council to protect its regulatory turf. Third, an agency might not be inclined to spend its resources and political capital on drafting, implementing, and enforcing a rule that the Council believes is necessary.[12] Fourth, an agency might prioritize a conflicting regulatory objective to preventing nonbank systemic risk, especially if it has not historically been a macro-prudential regulator.

Because its activities-based authority is solely precatory, FSOC's only recourse when an agency declines to follow its recommendation is to designate—or threaten to designate—nonbanks within the agency's jurisdiction.[13] The threat of such a designation might convince an agency to adopt the Council's proposed activities-based regulations because "few agencies relish the prospect of losing control over firms . . . that they traditionally regulate."[14] However, if FSOC relegates the entity-based approach to a measure of last resort and establishes onerous procedural barriers to SIFI designations, such threats will lack credibility. As a result, agencies will be able to resist the Council's activities-based recommendations with impunity.

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[9] 12 U.S.C. § 5330(a).

[10] *Id.* § 5330(c)(2).

[11] When the Securities and Exchange Commission (SEC) initially resisted FSOC's recommendation for stronger regulation of money market mutual funds (MMMFs), for example, some commentators attributed the SEC's intransigence to the MMMF industry's influence over SEC policymaking. *See* Stewart L. Brown, *Mutual Funds and the Regulatory Capture of the SEC*, 19 U. PA. J. BUS. L. 101, 107–10 (2017); Jill E. Fisch, *The Broken Buck Stops Here: Embracing Sponsor Support in Money Market Fund Reform*, 93 N.C. L. REV. 935, 940–41 (2015).

[12] That appears to be what happened when FSOC urged the SEC to adopted heightened regulations for MMMFs. In response to FSOC's recommendation, the SEC implemented modest MMMF regulations that were not as strong as FSOC had initially proposed. Key members of FSOC expressed displeasure that the SEC's rules did not go as far as FSOC intended. *See* Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1119 (2015).

[13] Notably, Treasury Secretary Timothy Geithner warned the SEC that FSOC would consider designating certain asset managers as nonbank SIFIs if the SEC did not implement stricter regulations for MMMFs. *See* Martha L. Cochran et al., *Money Market Fund Reform: SEC Rulemaking in the FSOC Era*, 2015 COLUM. BUS. L. REV. 861, 916–40 (2015). This threat convinced the SEC to adopt parts of FSOC's recommended MMMF regulations, but many observers criticized the SEC for weakening the Council's proposal. *See, e.g.*, Sarah N. Lynch, *SEC's Long Path to Money Market Fund Reform Ends in Compromise*, REUTERS (July 23, 2014), https://www.reuters.com/article/us-sec-moneyfunds-idUSKBN0FS08E20140723.

[14] Daniel Schwarcz & David Zaring, *Regulation by Threat: Dodd-Frank and the Nonbank Problem,* 84 U. CHI. L. REV. 1813, 1861 (2017).

2. The Proposed Guidance Erects Misguided And Artificial Hurdles To Invoking FSOC's Section 120 Authority

FSOC's activities-based power is feeble to begin with. In an ill-advised step, the proposed guidance would further weaken the Council's authority by mandating artificial procedural hurdles before the Council could formally recommend new activities-based rules.

Under ideal circumstances, activities-based systemic risk rulemaking is a lengthy process. By law, any activities-based rules FSOC recommends under section 120 must first go through time-consuming notice and comment.[15] After that, one or more federal financial regulators must then adopt a new rule, following notice in the *Federal Register* and public comment. Normally, a *fast-track* rulemaking takes two years and most rulemakings take longer. Moreover, most rules take additional time before they go into effect. Thus, even if all the planets aligned, FSOC made its recommendation quickly, and the agency or agencies involved concurred and promulgated an expedited rule, the rule's effective date would be at least three years off.

The proposed guidance, however, would unnecessarily draw out this process even further. According to the proposal, if FSOC identified a product, activity, or practice creating a potential risk to financial stability in *step one* of the activities-based approach, in *step two* it would "work with the relevant financial regulatory agencies at the federal and state levels to seek the implementation of actions" to address that risk."[16] This cooperative effort, as FSOC envisions it, would be anemic in nature, consisting of "information sharing among regulators" (which is decidedly *not* regulation) or publishing recommendations in the Council's annual report (with the delay that that would entail).[17] In *step three*, only if the regulators dragged their feet and FSOC later concluded that their actions were insufficient to address the risk to U.S. financial stability, would the Council consider issuing a section 120 recommendation.[18]

The three-step process is ineffectual by design and establishes an unnecessary procedural prerequisite to a section 120 recommendation. As such, the proposal sends a strong and worrisome signal that FSOC is not serious about implementing an activities-based approach. In further evidence that this signal is ominously correct, FSOC has recommended no new activities-based regulation whatsoever under its current leadership.

The potential consequences for the nation's financial system are grave. If and when an activities-based regulation of an imminent risk became imperative, FSOC would lack the flexibility to move quickly. Even worse, the time-consuming nature of the three-step process

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[15] 12 U.S.C. § 5330(b)(1).

[16] Proposed Guidance, *supra* note 7, at 9,040; Jeremy Kress, *Prudential Hasn't Earned the Right to Shed SIFI Label*, AM. BANKER (Mar. 13, 2018), https://www.americanbanker.com/opinion/prudential-hasnt-earned-the-right-to-shed-sifi-label.

[17] Proposed Guidance, *supra* note 7, at 9,031.

[18] *Id.* at 9,040.

could well prevent needed activities-based regulation for systemic risk from ever materializing. That, combined with FSOC's proposal to de-prioritize entity-based regulation, means that both pillars of nonbank systemic risk regulation by FSOC are poised to crumble.

B. *Fragmented U.S. Financial Regulation Precludes An Effective Activities-Based Approach*

Even if FSOC could order federal regulators to adopt activities-based rules, jurisdictional barriers would prevent an activities-based approach from effectively curbing nonbank systemic risk. As currently configured, the fragmented U.S. regulatory structure is simply incapable of overseeing systemically important financial activities on a system-wide basis.

Jurisdictional fragmentation is pervasive in U.S. financial regulation, with both gaps and overlaps in the regulatory framework. In some cases, no federal regulator has the requisite authority to impose activities-based regulations on relevant nonbank actors, leading to potentially systemic activities going unpoliced. In other cases, multiple federal regulators share jurisdiction, which can produce inconsistent enforcement and implementation patterns as well as critical information gaps.

This Section details these critical structural deficiencies in the United States' capacity to regulate potentially systemic financial activities. To do so, it focuses on eight areas where FSOC has identified activities that could potentially threaten U.S. financial stability. Each of these activities has one thing in common: there is no single federal regulator that can oversee them for systemic risk across the entire financial sector. Therefore, even if FSOC were to make an activities-based recommendation under section 120, jurisdiction fragmentation could prevent the primary financial regulators from adequately addressing nonbank systemic risk.

1. Gaps In The U.S. Regulatory Framework Undermine Regulation Of Systemic Activities

Important segments of the financial sector lack effective systemic risk regulatory oversight because of gaps in the U.S. regulatory framework. This Section examines how gaps in insurance, hedge fund, and fintech oversight preclude an effective activities-based approach to nonbank systemic risk. Under the proposed guidance, these gaps would emasculate activities-based regulation of the affected activities because FSOC will not make section 120 recommendations where there is "no primary financial regulatory agency . . . for the company conducting financial activities or practices identified by the Council as posing risks . . ."[19] Nowhere in the proposal, however, does FSOC come to grips with the enormity of leaving such major financial activities as insurance, hedge funds, and nonbank fintech services outside

[19] *Id.* at 9,041; *see also id.* at 9,031. FSOC does say, in that event, that the Council "can consider reporting to Congress on recommendations for legislation that would prevent such activities or practices from threatening U.S. financial stability." *Id.* Even with that, FSOC does not commit itself to making those legislative recommendations.

of the activities-based regulatory perimeter.

a. Insurance Activities

Gaps in insurance regulation demonstrate the limits of FSOC's activities-based authority. Since the financial crisis, FSOC has identified a wide range of insurance company activities as potentially systemically risky—for example, life insurance policies with cash surrender or redemption rights, guaranteed investment contracts, captive reinsurance, and financial guaranty insurance.[20] Yet effective activities-based regulation of these types of transactions for systemic risk is virtually impossible because of jurisdictional gaps in U.S. insurance regulation.

The states have traditionally regulated U.S. insurance companies, with minimal federal involvement. States' dominance in insurance regulation is rooted in the reverse preemption provision of the McCarran-Ferguson Act, which provides that no federal law may invalidate, impair, or supersede state laws governing the business of insurance unless the federal law specifically relates to the business of insurance.[21]

This system of state-based insurance regulation creates critical blind spots with respect to the regulation of potentially systemic activities. First, not only is FSOC powerless to directly address potentially systemic insurance activities like the cash redemption or surrender terms of life insurance policies, but so too are all other federal financial regulators. McCarran-Ferguson's strictures against federal insurance oversight strip federal agencies of almost all authority to implement an FSOC recommendation regarding traditional insurance activities.

Second, even if states were inclined to adopt an FSOC recommendation to regulate an insurance company activity more stringently, they would face severe coordination problems. States cannot consistently regulate potentially systemic activities of insurance carriers due to the independent legal authority of each individual state to regulate insurers conducting business in its jurisdiction. Although states attempt to coordinate their laws, regulation, and enforcement through the National Association of Insurance Commissioners, these efforts are often inconsistent. States often refuse to implement reforms, or else implement them differently than other states.[22]

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[20] *See, e.g.,* FSOC, 2016 ANNUAL REPORT 97–98 (2016), https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC%202016%20Annual%20Report.pdf; FSOC, 2011 ANNUAL REPORT 62 (2011), https://www.treasury.gov/initiatives/fsoc/Documents/FSOCAR2011.pdf; FSOC, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING METLIFE, INC. at 9 n.9, 11–14, 16–18, 22–23 (2014).

[21] Pub. L. No. 79-15, 59 Stat. 33–34 (codified at 15 U.S.C. §§ 1011–1015 (2012)).

[22] *See* KENNETH S. ABRAHAM & DANIEL SCHWARCZ, INSURANCE LAW AND REGULATION 112 (2015). And even when state laws and regulations are harmonious, their enforcement by states often is not. FED. INS. OFFICE, U.S. DEP'T OF THE TREASURY, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES 33–34 (2013).

Meanwhile, most states lack the legal authority to implement FSOC-recommended regulations for activities conducted outside of chartered insurance subsidiaries. Although several states have enacted laws purporting to authorize their insurance commissioners to *supervise* insurance groups domiciled in their states on a consolidated basis, these statutes do not clearly permit commissioners to *regulate* noninsurance or group-wide conduct.[23] Even for those states with the legal authority to regulate activities conducted outside of insurance entities, some of those activities are nevertheless off-limits due to federal preemption.[24] And for activities that states *could* reach at the group level, it is hardly clear that they would enforce such regulation vigorously. State insurance commissioners have limited experience scrutinizing activities conducted within an insurance conglomerate's noninsurance subsidiaries, a task they did not even attempt prior to the financial crisis.[25] Further, states lack the system-wide information on exposures outside of insurance that effective financial stability oversight demands. Due to weak and untested group-wide supervision, insurance conglomerates face few restrictions in conducting systemically risky activities within their non-insurance affiliates, as occurred with AIG's CDS and securities lending operations.[26]

In sum, gaps in group-wide regulation of insurance conglomerates would render an activities-based approach to insurance activities impotent. In the absence of nonbank SIFI designations, therefore, FSOC cannot effectively mitigate systemic risk arising from the insurance sector.

b. Hedge Fund Activities

Regulatory gaps would likewise undermine an activities-based approach to hedge funds. The near-failure of Long-Term Capital Management in 1998 and its need for a government-orchestrated private bailout underscored the potential risk that hedge fund activities can pose to the larger financial system.[27] In recognition of this continued threat, FSOC created an

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[23] *See* Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance,* 5 U.C. IRVINE L. REV. 1389, 1425-29 (2015). The Council completely and unlawfully ignored this distinction between the states' supervisory and regulatory powers in its de-designation of Prudential Financial, Inc. *See* Jeremy C. Kress, *The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial*, 71 STANFORD L. REV. ONLINE 171, 179-81 (2018).

[24] For instance, in 2008, state insurance regulators lacked jurisdiction over the CDS activities of AIG Financial Products because the U.S. Office of Thrift Supervision exerted field preemption over those activities.

[25] The FSB concluded that the U.S. state-based system of insurance regulation lacks the capacity for consolidated group supervision. FIN. STABILITY BD., PEER REVIEW OF THE UNITED STATES 32–38 (2013), http://www.fsb.org/wp-content/uploads/r_130827.pdf. In recent years, states have implemented a variety of reforms intended to improve their group-level regulation. But these reforms rely almost exclusively on qualitative rather than quantitative constraints and are susceptible to coordination problems among state regulators. *See* Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States*, 5 U.C. IRVINE L. REV. 537, 550 (2015). Moreover, these reforms are new, still developing, and largely untested. *See* Schwarcz Testimony, *supra* note 3.

[26] *See* Schwarcz, *supra* note 25, at 551–55.

[27] *See* PRESIDENT'S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENt 10–17 (1999), https://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

interagency working group to monitor systemic risk in the hedge fund industry.[28] Because of statutory exemptions, however, hedge funds could avoid activities-based systemic risk regulation absent congressional action.

Before the financial crisis, hedge funds largely escaped SEC regulation because they operated outside of the purview of the federal securities laws. Hedge fund managers were not required to register with the SEC, nor were the funds themselves subject to leverage limits and other prudential rules that applied to other investment companies, like mutual funds.[29] After the crisis, Dodd-Frank imposed modest regulatory requirements on hedge fund managers for the first time. Dodd-Frank required hedge fund managers to register with the SEC, undergo periodic examinations, and file confidential reports containing information on their funds' leverage, counterparty identities and exposures, and trading strategies.[30]

Dodd-Frank did not, however, impose prudential requirements on hedge funds, nor did it authorize the SEC to adopt such regulations. Thus, hedge funds remain exempt from the Investment Company Act of 1940—the statutory authority that permits the SEC to regulate mutual funds and other investment companies. The SEC, therefore, currently lacks power to adopt activities-based reforms for hedge funds, such as restrictions on specific trading practices.[31] Even if FSOC wanted to recommend prudential activities-based regulations for hedge funds' activities, it would be unable to do so because the SEC does not itself have the authority to implement such rules.

c. Fintech

Similarly, gaps in the U.S. regulatory framework would impede an activities-based approach to emerging risks in the fintech sector. FSOC has warned about financial stability threats from marketplace lending, payment systems, virtual currencies, and other fintech innovations.[32] Despite these risks, the U.S. Government Accountability Office (GAO) reports that "some fintech companies may not be subject to *any* . . . financial oversight."[33] Accordingly,

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[28] FSOC, UPDATE ON REVIEW OF ASSET MANAGEMENT PRODUCTS AND ACTIVITIES 20–21 (2016), https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf.

[29] *Id.* at 14; Marco Bodellini, *From Systemic Risk to Financial Scandals: The Shortcomings of U.S. Hedge Fund Regulation*, 11 BROOK. J. CORP. FIN. & COM. L. 417, 456–59 (2017).

[30] 15 U.S.C. § 80b-4 (2012).

[31] Bodellini, *supra* note 29, at 456–59.

[32] *See* FSOC, 2017 ANNUAL REPORT 126-27 (2017), https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/FSOC_2017_Annual_Report.pdf. [hereinafter FSOC 2017 ANNUAL REPORT]. For a discussion of fintech's potential threats to financial stability, see Hilary J. Allen, *Driverless Finance*, 10 HARV. BUS. L. REV. (forthcoming 2019); Rory Van Loo, *Making Innovation More Competitive: The Case of Fintech*, 65 UCLA L. REV. 232, 251 (2018); Saule T. Omarova, *New Tech v. New Deal: Fintech as a Systemic Phenomenon*, 36 YALE. J. REG. (forthcoming 2019).

[33] GAO, GAO-18-254, FINANCIAL TECHNOLOGY: ADDITIONAL STEPS BY REGULATORS COULD BETTER PROTECT CONSUMER AND AID REGULATORY OVERSIGHT 38 (2018) [hereinafter GAO FINTECH REPORT] (emphasis added).

activities-based systemic risk regulation of fintech would face serious challenges because, at least in some cases, no primary federal financial regulatory agency would have authority to implement FSOC's activities-based recommendations.[34]

Rapid innovations in the fintech sector have revealed problematic gaps in the oversight of these new technologies. Online nonbank marketplace lenders like LendingClub and Prosper, which provide financing to consumers and small businesses, are subject to a patchwork of state-based licensing requirements but no federal regulation for safety and soundness or systemic risk. Likewise, nonbank payment services like PayPal and Venmo face inconsistent state oversight, and some fintech payments firms could escape federal and state regulation entirely.[35] Meanwhile, Bitcoin, Ether, and other cryptocurrencies avoid comprehensive federal oversight by the CFTC and SEC, whose legal authority to regulate such products is debatable.[36] Because federal jurisdiction in these areas is unclear at best, activities-based systemic risk regulation might be unable to reach important segments of the fintech market.

2. Fragmentation In The U.S. Regulatory Framework Impedes Activities-Based Regulation

While some parts of the nonbank financial sector fall within regulatory interstices, other areas suffer from the opposite problem: they are subject to regulation by multiple agencies. This fragmentation poses serious challenges for activities-based systemic risk regulation. Troublingly, the proposed guidance fails to grapple with this problem.

Even if FSOC were to recommend activities-based regulations, jurisdictional fragmentation would undermine regulators' ability to enact and enforce uniform, consistent rules in five ways. First, because each financial regulator focuses narrowly on its jurisdiction, no agency has a complete view of the risks within the larger financial system. Highly fragmented regulators therefore lack sufficient information to implement a holistic, activities-based approach. Second, while FSOC could attempt to coordinate among regulators, different agencies may nonetheless issue different and sometimes incompatible rules for the same risk. Third, even if the agencies did adopt uniform rules, differences in how the agencies interpret and enforce regulations could undermine the goal of a uniform, consistent approach to systemic risk. Fourth, regulators may engage in a race-to-the-bottom by adopting less stringent regulations than other agencies, as each regulator competes to expand its jurisdiction. Finally,

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[34] For a discussion of gaps in fintech supervision, see Rory Van Loo, *Digital Market Perfection*, 118 MICH. L. REV. (forthcoming 2019) (manuscript at 47), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3308524.

[35] *See* Brian Knight, *Federalism and Federalization on the Fintech Frontier*, 20 VAND. J. ENT. & TECH. L. 129, 144, 153-61 (2017); GAO FINTECH REPORT, *supra* note 33, at 34, 38.

[36] *See Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 115th Cong. 103 (2018) (statement of J. Christopher Giancarlo, Chairman, CFTC); Anna Irrera, *U.S. SEC Official Says Ether Not a Security, Price Surges*, REUTERS (June 14, 2018), https://www.reuters.com/article/us-cryptocurrencies-ether/u-s-sec-official-says-ether-not-a-security-price-surges-idUSKBN1JA30Q.

under these circumstances, financial institutions may seek out opportunities for regulatory arbitrage by moving activities to less-regulated parts of the system.

These challenges vastly complicate activities-based regulation of nonbank systemic risk. By way of example, this Section examines regulatory fragmentation of five activities that pose potential financial stability risks: mortgages, securities, derivatives, short-term funding, and cybersecurity. It concludes that fragmentation would create serious challenges if FSOC were to attempt an activities-based approach in any of these areas.

a. Mortgages

The central role of mortgages in both the 2008 financial crisis and the 1980s savings and loan crisis epitomizes a larger historical trend: the worst global financial crises have involved real estate bubbles fueled by lax credit.[37] Given the prominence of mortgage credit in financial crises, one might expect to find a robust, unified framework for systemic risk oversight of mortgages in the United States. To the contrary, federal mortgage regulation is highly fragmented.[38] This fragmentation renders an activities-based approach to mortgage regulation practically unworkable.

Considerable fragmentation stems from differences in the regulation of commercial and residential mortgages. Commercial mortgages are subject to lighter federal regulation than their residential counterparts. Banks, which dominate commercial mortgage lending, are supervised by the Federal Reserve, the FDIC, or the OCC, depending on their charters, for solvency risk. Separately, commercial mortgage-backed securitizations and REITs undergo SEC regulation for risk to investors.[39] Commercial mortgages originated by independent nonbank lenders generally are not subject to significant federal oversight.

Residential mortgages are subject to most of the same federal regulation as commercial mortgages, plus more. For example, the CFPB regulates residential mortgages—by depository institutions and nonbank lenders alike—for market conduct risk to consumers. The CFPB has virtually exclusive rulemaking authority in that respect, but shares responsibility for supervision and enforcement with the federal prudential banking regulators and the Federal Trade Commission. Although the CFPB Director sits on FSOC and the CFPB's rules play an important role in constraining systemic risk from home mortgages,[40] the Bureau frames its

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[37] *See, e.g.*, CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY xliv–xlv, 158–62 (2009).

[38] There is some systemic risk regulation of mortgages, but it is limited in reach. The mortgage activities of systemically important depository institutions and nonbank SIFIs are subject to financial stability oversight by the Federal Reserve. Meanwhile, the joint risk retention rule requires sponsors of certain mortgage-backed securities to retain risk. Joint Press Release, Bd. of Governors of the Fed. Reserve Sys. et al., Six Federal Agencies Jointly Approve Final Risk Retention Rule (Oct. 22, 2014).

[39] *See, e.g.*, 17 C.F.R. pt. 229 (2018).

[40] *See* Patricia A. McCoy & Susan M. Wachter, *Why The Ability-to-Repay Rule Is Vital To Financial Stability*, ___ GEO. L.J. (forthcoming 2020).

mission in terms of protecting consumers, not mitigating threats to financial stability.

Additional federal regulation of residential mortgages comes from two main financing channels: the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac, and the federal insurers and guarantors. The GSEs, under the auspices of their regulator and conservator, the Federal Housing Finance Agency (FHFA), impose extensive requirements on the origination and servicing of the residential mortgage loans they buy.[41] Meanwhile, the Federal Housing Administration, the Department of Veterans Affairs, the Department of Agriculture, and the Rural Housing Service (plus their financing arm, Ginnie Mae), heavily regulate the home loans they insure or guarantee.[42] In light of this fragmentation, even if FSOC sought to implement consistent activities-based mortgage regulation for systemic risk, it would be hard-pressed to succeed because that jurisdiction is divided among so many federal agencies.

b. Securities

U.S. securities regulation is likewise divided because Congress ceded jurisdiction over some securities activities of commercial banks to the federal prudential banking regulators—the FDIC, OCC, and Federal Reserve.[43] This dispersed authority over securities regulation must be taken into account in any appraisal of an activities-based approach to systemic risk, given the role of banking groups in securitization and the reorganization of leading investment banks as financial holding companies under the watch of the Federal Reserve.

In the banking sector, jurisdiction over securities regulation is split between the SEC and federal banking regulators, and some federal securities laws do not apply to banks at all. Congress exempted banks from important provisions of the Securities Act of 1933 (Securities Act), the Securities Exchange Act of 1934 (Exchange Act), the Investment Company Act of 1940, and the Investment Advisers Act of 1940 because banks are subject to a comprehensive scheme of federal banking regulation.[44] In other cases, depository institutions *are* bound by

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[41] *See Single Family, Access the Single Family Guides*, FANNIE MAE (2018), https://www.fanniemae.com/singlefamily/index; *The Guide and Forms*, FREDDIE MAC (2018), http://www.freddiemac.com/singlefamily/guide/; *About FHFA*, FED. HOUS. FIN. AGENCY (2018), https://www.fhfa.gov/AboutUs.

[42] *See, e.g.*, U.S. DEP'T OF HOUS. & URBAN DEV., SINGLE FAMILY HOUSING POLICY HANDBOOK 4000.1 (2018), https://www.hud.gov/program_offices/housing/sfh/handbook_4000-1; GINNIE MAE, STATUTES AND REGULATIONS (2018), https://www.ginniemae.gov/about_us/what_we_do/Pages/statutes_regulations.aspx.

[43] This discussion of securities regulation jurisdiction is heavily informed by Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441 (1998).

[44] For example, banks are exempt from broker-dealer registration, examination, and regulation, 15 U.S.C. §§ 78c(a)(4)–(a)(6),78*o*, 78*o*-5(a)(1)(A)–(a)(1)(B) (2012), some SEC registration of clearing activities, *id.* § 78c(a)(23)(B); *see id.* §§ 78c(a)(23)(A), 78q-1(b)(1), SEC regulation, supervision, and regulation of common investment funds maintained in a fiduciary capacity, *id.* § 80a-3(c)(3), (c)(6); *see id.* § 80a-8, and SEC registration, supervision, and regulation as investment advisors, *id.* § 80b-2(a)(11)(A); *see id.* § 80a-2(a)(20).

federal securities laws, but Congress entrusted oversight of those provisions with respect to banks and sometimes thrifts to federal prudential banking regulators, not the SEC.[45]

This division of federal securities jurisdiction among the SEC and three federal banking regulators impedes activities-based regulation of securities for systemic risk. It creates one system of securities regulation for independent nonbank securities market actors (who are regulated by the SEC) and another one for banking companies (whose securities activities are regulated by federal banking regulators and are sometimes exempt from federal regulation altogether). These two systems produce inconsistent rules and openings for regulatory arbitrage that obstruct a unified approach to systemic risk in securities regulation.

c. Derivatives

A similar fragmentation problem bedevils derivatives regulation. Throughout their histories, the SEC and the Commodity Futures Trading Commission (CFTC) have clashed repeatedly in jurisdictional battles over securities and commodities markets.[46] Since Dodd-Frank, the combative agencies now share legal authority for derivatives that previously had been traded over-the-counter (OTC), without regulation. In deference to the historic division of authority between the CFTC over futures and the SEC over securities, Congress gave jurisdiction over swaps to the CFTC and security-based swaps to the SEC. The two agencies jointly regulate "mixed swaps."[47] Notably, while the SEC and CFTC have attempted to coordinate with one another,[48] they are not required to treat functionally or economically similar swap products or entities in an identical manner.[49]

This fragmented oversight of derivatives markets creates the risk of inconsistent regulations, regulatory arbitrage, and a race-to-the- bottom, as discussed above. If FSOC recommended new activities-based derivatives rules, jurisdictional feuds and potentially inconsistent rules and

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[45] 15 U.S.C. § 78*l*(i). For covered banks and thrifts, federal prudential banking regulators administer Exchange Act Sections 10A(m) (audit committee requirements), 12 (registration requirements for securities traded on national securities exchanges), 13 (periodic reporting requirements), 14(a) and 14(c) (on proxy solicitations), 14(d) and 14(f) (on tender offers), 15C (government securities brokers and dealers), 16 (on short swing profits), and 17A (on transfer agents). 15 U.S.C. §§ 78j-1(m), 78*l*, 78m, 78n(a), (c)–(d), (f), 78*o*-5(g)(2), 78p, 78q-1(d); *see id.* § 78c(a)(34)(B) (defining "appropriate regulatory agency").

Sometimes the SEC and federal prudential banking regulators share authority. For instance, banks and thrifts that do not qualify for the exemption for clearing activities must register with the SEC. *Id.* § 78q-1(b)(1); *see id.* § 78c(a)(23)(B). However, the prudential banking regulators exercise rulemaking, supervision and enforcement jurisdiction over those activities. *Id.* §§ 78c(a)(34)(B), 78q-1(d).

[46] *See* Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537, 574–81 (2009).

[47] *See, e.g.*, 15 U.S.C. § 8302(a)(8), (b)(1)–(2).

[48] *See, e.g.*, MEMORANDUM OF UNDERSTANDING BETWEEN THE U.S. SECURITIES AND EXCHANGE COMMISSION AND THE U.S. COMMODITY FUTURES TRADING COMMISSION REGARDING COORDINATION IN AREAS OF COMMON REGULATORY INTEREST AND INFORMATION SHARING (June 28, 2018). Congress anticipated that this division of authority would produce tension between the two historic rivals and enacted a host of provisions to mediate future disputes. *See* 15 U.S.C. § 8302(a), (b)(1)–(b)(2), (c), (d)(1), (d)(3).

[49] *Id.* § 8302(a)(7)(B).

enforcement by the SEC and CFTC could thwart effective systemic risk regulation.

d. Short-Term Securities Financing

Fragmented regulatory jurisdiction would likewise undercut an activities-based approach to short-term securities financing, such as repo agreements and securities lending. These short-term liabilities pose real threats to financial stability, as an institution's rapid loss of such funding can spread systemic risk. Recognizing these risks, FSOC has warned that short-term securities financing "must be carefully managed and subjected to appropriate oversight."[50] Comprehensive, activities-based oversight of short-term securities financing is nearly impossible, however, because jurisdiction over repo and securities lending is fractured among a multiplicity of regulators.

Fragmented jurisdiction over short-term securities financing stems from its near-ubiquitous use in different financial sectors. Broker-dealers, hedge funds, banks, pension funds, mutual funds, insurance companies, central banks, sovereign wealth funds, and endowments commonly borrow through repo or securities lending.[51] Many of these same institutions also participate on the opposite side of these transactions by providing short-term funding to counterparties. Indeed, insurance companies, pension funds, mutual funds, MMMFs, banks, governments, GSEs, securities dealers, and hedge funds are major cash investors in both repo and securities lending.[52]

Given the diversity of institutions that engage in short-term securities financing, numerous federal and state regulators assert jurisdiction over this conduct. For example, the SEC oversees the repo activities of registered investment companies and U.S. broker-dealers, often in tandem with the Federal Reserve, which regulates the BHC parent companies of many broker-dealers.[53] Federal prudential banking regulators oversee the repo activities of banks, while state insurance commissioners supervise repo transactions by insurance firms. Jurisdiction over securities lending is similarly fragmented along entity and sectoral lines, with the SEC, Federal Reserve, OCC, FDIC, Department of Labor, and state insurance commissioners all playing prominent roles.[54]

This decentralized oversight creates thorny problems for implementing activities-based oversight of repo and securities lending. Just monitoring these markets for systemic risk is

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[50] FSOC, 2012 ANNUAL REPORT 10 (2012), https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf.

[51] *See* VIKTORIA BAKLANOVA ET AL., FED. RESERVE BANK OF N.Y., REFERENCE GUIDE TO U.S. REPO AND SECURITIES LENDING MARKETS 15–16, 22 (rev. ed. Dec. 2015), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr740.pdf; *see also* FSOC 2017 ANNUAL REPORT, *supra* note 32, at 52.

[52] *See* BAKLANOVA ET AL., *supra* note 51, at 17, 29.

[53] *See* Paolo Saguato, *The Liquidity Dilemma and the Repo Market: A Two-Step Policy Option to Address the Regulatory Void*, 22 STAN. J.L. BUS. & FIN. 85, 94–95 (2017).

[54] *See, e.g.*, BAKLANOVA ET AL., *supra* note 51, at 31, 34–35, 54-56.

difficult because the reporting requirements differ by sector.[55] Any activities-based approach to regulating short-term securities financing—such as limits on the aggregate amount of this activity at any firm or requirements that they be paired with liquid assets—would inevitably result in inconsistent implementation and an unlevel competitive playing field that would present opportunities for regulatory arbitrage.[56] Although an activities-based approach might theoretically be able to resolve this problem, there is no way to implement such an approach consistently given the current fragmentation of regulatory authority in this domain. Meanwhile, coordination problems would thwart a crisis response if a securities dealer defaulted on its repo loans because no single regulator would have the authority to oversee an orderly sale of the collateral in its creditors' hands, increasing the chances of a run.[57] In sum, this web of competing rules and agency fiefdoms, arbitrage incentives, and coordination problems would make a uniform set of activities-based rules for systemic risk nearly impossible in the repo and securities lending space.

e. Cybersecurity

Cybersecurity is another potentially systemic threat where jurisdictional fragmentation would undermine an activities-based approach. As FSOC has noted, a cyberattack or outage could disrupt market trading, paralyze the operations of a key financial hub, interrupt clearing and settlement, and shatter customers' confidence in the financial system.[58] This system-wide risk demands an overarching approach that focuses on the larger structure of financial markets and the weak links within them. U.S. regulation of financial market cybersecurity falls woefully short of this goal.

In the financial arena, cyber regulation is siloed among various state and federal regulators. At the federal level, nine financial regulators and the Treasury Department have direct jurisdiction over cybersecurity at financial firms.[59] State banking, insurance, and securities regulators have concurrent authority over state-chartered financial companies.[60] Adding to this, the Department of Homeland Security has lead responsibility for the federal response to cyber threats, while other federal agencies and departments, including the Federal Communications Commission

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[55] *See id.* at 46–60.

[56] *See* Benjamin Munyan, *Regulatory Arbitrage in Repo Markets* 1–7, 11–12 (OFR, Working Paper No. 15-22, 2015), https://www.financialresearch.gov/working-papers/files/OFRwp-2015-22_Repo-Arbitrage.pdf.

[57] *See* FSOC, 2015 ANNUAL REPORT 115 (2015), https://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/2015%20FSOC%20Annual%20Report.pdf; FSOC 2017 ANNUAL REPORT, *supra* note 32, at 12, 124.

[58] FSOC 2017 ANNUAL REPORT, *supra* note 32, at 127–28; Proposed Guidance, *supra* note 7, at 9030 n.13.

[59] *See Cybersecurity Regulation Harmonization: Hearing Before the S. Comm. on Homeland Sec. & Gov't Affairs*, 115th Cong. (2017) (statement of Christopher F. Feeney, Pres., BITS/Fin. Svcs. Roundtable) [hereinafter Feeney Testimony]; OFR, *Cybersecurity and Financial Stability: Risks and Resilience*, OFR VIEWPOINT 17-01, 7–10 (2017) [hereinafter OFR VIEWPOINT].

[60] Feeney Testimony, *supra* note 59; *see, e.g.*, *Cybersecurity*, NAT'L ASS'N INS. COMMISSIONERS: CENTER INS. POL'Y & RES., https://www.naic.org/cipr_topics/topic_cyber_risk.htm (last updated July 11, 2018).

and the Department of Justice, oversee other discrete aspects of cybersecurity.[61]

This cybersecurity tower of Babel seriously impedes a system-wide approach to cyber threats against financial firms. There is no single financial regulator with sight lines into the IT infrastructure of the entire financial sector or umbrella jurisdiction to address the sectoral threat. Alarmingly, cooperation among federal regulators has mostly been limited to "sharing information about cybersecurity threats."[62] OFR has warned that current "[r]egulatory boundaries may limit regulators' perspectives on key parts of financial networks" and that "[p]otential blind spots include third-party vendors, overseas counterparties, and cross-border service providers."[63] To exacerbate matters, the welter of regulators has resulted in a proliferation of cybersecurity rules, guidelines, and frameworks that are marred by inconsistency and complexity.[64]

In light of system-wide risks, an activities-based approach to cybersecurity would make eminent sense. Currently, however, the jumble of overlapping jurisdictional lines makes a unified approach to activities-based regulation of cyber risk for systemic risk impossible.

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Jurisdictional complexities in the U.S. regulatory framework thus render an activities-based approach to systemic risk unworkable. Even if FSOC were to recommend activities-based regulation for systemically important activities, the primary financial regulators would be unlikely to enact uniform, effective rules because of gaps and fragmentation in the regulatory structure. Remarkably, not one of the potentially systemic activities discussed in this section has an umbrella federal regulator that can oversee conduct across the entire financial sector. In some cases, like insurance activities, hedge funds, and fintech, federal regulators lack authority to impose systemic risk constraints. In other cases, like mortgages, derivatives, securities, short-term financing, and cybersecurity, federal regulation is divided among multiple agencies, all with different rules and approaches. These are just a few examples of potential weaknesses in the U.S. regulatory framework, and additional jurisdictional problems are certain to arise in the future. It is therefore unrealistic to imagine that regulators could implement uniform activities-based rules to curb risk for systemically important financial activities, absent significant reforms to the U.S. regulatory framework.

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[61] Feeney Testimony, *supra* note 59.

[62] OFR, 2016 FINANCIAL STABILITY REPORT 47 (2016), https://www.financialresearch.gov/financial-stability-reports/files/OFR_2016_Financial-Stability-Report.pdf.

[63] OFR VIEWPOINT, *supra* note 59, at 10.

[64] *See* Feeney Testimony, *supra* note 59.

C. *Staff And Budget Cuts At OFR Hamper FSOC's Ability To Monitor The Financial System For Activities Posing Systemic Risk*

In the preamble to the proposed guidance, FSOC states that "[a]s part of its activities-based approach, the Council will examine a diverse range of financial products, activities, and practices that could pose risks to financial stability."[65] Without this type of monitoring and risk assessment, no activities-based approach can be effective. Yet FSOC, in its proposal, is silent about its diminishing capacity to conduct robust monitoring and risk assessment.

Congress mandated OFR's creation to provide FSOC with a centralized research arm having specialized expertise in systemic risk. OFR has always been small relative to its statutory charge to detect and gauge systemic risk. But between fiscal year 2017 and the first month of fiscal year 2019, OFR's leadership cut the Office's workforce from 210 employees to about 112, a staff reduction of 46%. In fiscal year 2018, OFR's budget was slashed by 18%.[66] These cuts to an already small agency make it substantially harder for FSOC to deliver on its promise to monitor activities for potential systemic risk.

Strikingly, FSOC says little about OFR's monitoring role in the proposed guidance. Instead, FSOC contemplates that the "staffs of Council members and member agencies will likely be responsible for much of the market monitoring, risk identification, information sharing, and analysis in the activities-based approach."[67]

However, there is still no clear division of duties for monitoring systemic risk. In 2012, GAO made a formal recommendation that FSOC and OFR clarify the "responsibility for implementing statutory requirements for monitoring and reporting on threats to U.S. financial stability, including the responsibilities of member agencies."[68] Just last month—fully seven years later—GAO reported that FSOC and OFR have yet to work out the division of responsibility among OFR and the federal financial regulators for monitoring threats to financial stability.[69] Part of the problem appears to be the reluctance of front-line federal financial regulators to fully share data with OFR or with all of FSOC's staff members.[70] In view of that, FSOC's expectation that it "will regularly rely on data, research, and analysis from Council member agencies" to monitor markets may be a pipe dream.[71]

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[65] Proposed Guidance, *supra* note 7, at 9,030.

[66] *See* OFR, ANNUAL REPORT TO CONGRESS 2018, at 54-55 (2018) (computations by authors).

[67] Proposed Guidance, *supra* note 7, at 9,031.

[68] GAO, GAO-12-886, FINANCIAL STABILITY: NEW COUNCIL AND RESEARCH OFFICE SHOULD STRENGTHEN THE ACCOUNTABILITY AND TRANSPARENCY OF THEIR DECISIONS 52 (2012).

[69] GAO, GAO-19-325SP, PRIORITY OPEN RECOMMENDATIONS: DEPARTMENT OF THE TREASURY 2 (April 3, 2019).

[70] *See* GAO, GAO-16-175, FINANCIAL REGULATION: COMPLEX AND FRAGMENTED STRUCTURE COULD BE STREAMLINED TO IMPROVE EFFECTIVENESS 71-75 (2016).

[71] Proposed Guidance, *supra* note 7, at 9,040.

Finally, FSOC's proposal to scrap the current stage 1 in the nonbank designation process would shut down an important, real-time source of information about potentially systemic activities at large nonbanks. In the current stage 1, FSOC applies "a set of uniform quantitative metrics . . . to a broad group of" nonbanks.[72] The Council's current proposal fails to address the potential consequence of losing that vital source of information about systemically important activities by major nonbank financial providers.[73]

II. EFFECTIVE SYSTEMIC RISK REGULATION REQUIRES A ROBUST ENTITY-BASED APPROACH

The proposed guidance not only indicates that FSOC will prioritize an ineffectual activities-based approach to nonbank systemic risk, it also suggests that FSOC will substantially de-emphasize entity-specific designations of individual nonbank financial companies under section 113 of the Dodd-Frank Act. This approach, which FSOC has already largely embraced through its de-designation of previously designated firms and its failure to designate any new nonbanks as systemically important, is a significant mistake. That is because, in contrast to the activities-based approach the proposed guidance relies on, an entity-based approach can be reasonably well designed to limit the risk that firms will experience systemic insolvencies.

A. Preventing Systemic Insolvencies Requires An Entity-Based Approach To Regulating And Supervising Potentially Systemic Nonbanks

The 2008 financial crisis demonstrated unequivocally that the collapse of large, interconnected nonbank financial firms can threaten the global economy. The failure or near failure of numerous nonbank financial firms—including Bear Stearns, Lehman Brothers, and AIG—left no doubt about such firms' systemic importance. When housing prices across the country declined, these nonbanks were among the first to fail, triggering the broader panic and necessitating massive government bailouts. The financial crisis, in sum, demonstrated that the collapse of nonbank financial firms can pose the very same types of systemic risk that were once thought to be exclusive to banking.

Entity-based regulation and supervision is necessary to prevent similar systemic insolvencies in the future. First, and most importantly, entity-based regulation is essential because it inherently focuses on the cumulative impact of a firm's activities across the entire financial conglomerate, as well as interactions between its assets and liabilities. For instance, consolidated risk-based capital requirements and leverage limits ensure that SIFIs maintain sufficient capital cushions to absorb potential losses. Liquidity rules require a SIFI to hold a minimum amount of liquid assets to protect against runs and reduce the likelihood that it will have to sell illiquid assets in a fire sale. Stress tests simulate adverse economic conditions to

[72] *Id.* at 9,030.

[73] For additional arguments against eliminating stage 1 of the current designation process, see *infra*, Section III.A.3.

ensure that SIFIs could withstand a severe downturn. Corporate governance reforms focus on improving enterprise risk management across SIFIs' operations. Finally, supervision of nonbank SIFIs by the Federal Reserve is inherently focused on the prospect that a firm's cumulative risk profile could result in a systemic insolvency.[74]

This type of consolidated, entity-centric approach is essential to preventing the excessive accumulation of systemic risk outside of the banking sector because the risk that a firm will experience a systemic failure is inherently a product of the interrelations among its various activities. Individual activities may pose limited systemic risk in isolation, but much greater systemic risk when combined at an individual firm.

Consider, for instance, a firm's susceptibility to a "run," which is perhaps the single most important characteristic of systemically important financial firms. To be vulnerable to a run, a firm normally must fund itself with some form of short-term liabilities payable in cash. Yet there are nearly infinite ways to structure short-term borrowing arrangements. Examples include repo transactions, securities lending, warehouse lines of credit and commercial paper. Firms that pair such short-term liabilities with long-term illiquid assets are vulnerable to run-like dynamics because they may be required to dump their illiquid assets at fire-sale prices in order to raise enough cash to meet creditor demands. Knowing this, creditors may rush to claim repayment before the firm's cash reserves run out, in a classic case of the prisoner's dilemma. Creditors' uncertainty about the firm's true financial health often exacerbates this stampede.

Not only are there innumerable potential types of short-term borrowing, but short-term borrowing is not the only type of liability that can generate a run. For instance, the crisis illustrated that run risk can also arise from any transaction that potentially requires a firm to post increasing amounts of cash collateral. AIG's CDSs are the poster child for this type of cash-collateral driven run.[75] These derivatives allowed counterparties to insist on increasing amounts of cash collateral to back the firm's insurance-like promises as either the firm's credit rating declined or the mortgage-backed securities they referenced decreased in value. The redeemable equity issued by MMMFs is yet another type of liability that generated runs in the crisis but that was not short-term borrowing. Instead, it constituted equity that investors could redeem on demand, at the fund's net asset value, causing investors to run from these funds by seeking to withdraw their funds *en masse* once one large MMMF "broke the buck," disclosing that the value of its assets had fallen below the one dollar threshold.

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[74] *See* Governor Daniel K. Tarullo, Speech on Insurance Companies and the Role of the Federal Reserve (May 20, 2017), https://www.federalreserve.gov/newsevents/speech/tarullo20160520a.pdf. Additionally, the Federal Reserve's uniquely prominent role in financial regulation means that it often has the capability to observe both sides of a nonbank SIFI's counterparty transactions.

[75] *See* Schwarcz, *supra* note 25, at 553–54. A CDS insures against the risk that securities referenced in the agreement will fare poorly. *See id.*

So far, this litany of activities that create run risk consists of examples that precipitated runs during the crisis. But innumerable potential activities that were not prominent during the crisis could also create run risk. For instance, many life insurers sell products that provide policyholders with an immediate right to withdraw their investment or borrow against their policy value. Other examples include guaranteed investment contracts, funding agreements, and certain variable annuity contracts.[76] As insurers' product designs change in the future, still other innovations could trigger a run.[77]

The fact that numerous known and unknown activities can create run risk highlights the importance of entity-based regulation because an individual firm's exposure to a run ultimately depends on its aggregate reliance on all activities that create run risk. The inherently cumulative nature of run risk follows from the fact that all of a firm's potential sources of run risk are likely to be triggered when it faces acute financial distress. This point is nicely illustrated by the collapse of AIG. As AIG's precarious financial position became clear throughout 2008, its CDS counterparties insisted that it post cash collateral on its derivatives at the same time that its securities lending counterparties terminated their transactions.[78] It was hardly fortuitous that this run on AIG implicated two different activities operated out of different subsidiaries; as AIG's counterparties realized the extent of the firm's troubles, they ran however they could to avoid experiencing losses if AIG defaulted.

A firm's susceptibility to a run further depends on yet another entity-centric concept: the interactions between its liabilities and assets. For instance, a seemingly reasonable amount of short-term debt might create dangerous run risk for a firm that over-invests in highly illiquid assets. As such, even a single activity that creates potential short-term liabilities may have a very different valance when it is combined with other activities that are not ordinarily considered systemic in isolation. An entity-based approach can respond to such interactions because it is focused on both the asset and liability sides of firms' balance sheets.[79]

We focus on the inherently cumulative nature of run risk here both because runs are one of the central ways that an entity can become systemically risky and because an activities-based approach does indeed have some potential strengths in addressing this risk. But various additional criteria are, of course, relevant to the prospect that an individual firm will prove

[76] *See* Robert McMenamin et al., *How Liquid Are U.S. Life Insurance Liabilities?*, CHI. FED. LETTER, Sept. 2012, http://www.chicagofed.org/publications/Chicago-fed-letter/2012/September-302.

[77] *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1619-23 (2014).

[78] *See* Schwarcz, *supra* note 25, at 554.

[79] In connection with the activities-based approach, FSOC states that it would consider whether the combination of characteristics such as asset valuation risk, credit risk, liquidity risk, and lack of transparency in discrete products, activities, or practices "warrants further scrutiny." Proposed Guidance, *supra* note 7, at 9,030-31. This is no assurance, however, that the Council will consider interaction effects *among* products, activities, or practices. In view of the infinite number of unique configurations of combined activities and practices observable among complex individual firms, the activities-based approach is no substitute for the entity-based approach.

systemically significant in a crisis. These include a firm's size, connections to other major financial institutions, and preexisting regulatory scrutiny, especially at the enterprise level.[80] And like run risk, all of these additional indicia of systemic significance can only be meaningfully policed by an entity-based approach. A firm's interconnectedness, for instance, necessarily depends on the cumulative impact of its activities. Innumerable financial activities—ranging from ordinary borrowing, to securities management, to derivatives, to the issuance of insurance policies—expose a nonbank firm's counterparties to the risk that the firm might fail.

On its own, an activities-based approach fails to address the risk that a combination of activities—none of which creates excessive short-term liabilities individually—might generate excessive run risk in the aggregate. Activities-based regulation generally seeks to limit the risks of an activity that creates short-term liabilities by, for instance, requiring that firms engaging in the activity maintain specified levels of liquid assets or creating mechanisms by which counterparties' capacity to run is suspended.[81] In doing so, activities-based regulation sets these safeguards only by reference to the prospect that the underlying activity, considered in isolation, might generate a run. In the absence of a complementary entity-based regime, however, activities-based regulation cannot calibrate customized safeguards for an individual firm's cumulative activities, in the aggregate.

B. Only An Entity-Based Approach Can Deter Nonbank Firms From Seeking Out Systemic Risk

Second, entity-based nonbank SIFI regulation can also prevent systemic insolvencies indirectly, by causing designated firms to shed risk in an effort to jettison their SIFI designations. The 2008 financial crisis demonstrated not only that nonbanks can be systemically risky, but that they have good reason to affirmatively seek out systemic risk so as to increase the likelihood that they will be bailed out in the midst of a crisis. This, in turn, can decrease the costs to such a firm of funding its operations, as creditors accept lower rates of return in exchange for a perceived implicit government guarantee that the debtor firm will not be allowed to fail in a subset of situations.

The entity-based approach helps to counteract this incentive by imposing various extra regulatory restrictions and costs on firms that are designated as systemic.[82] This, in turn, incentivizes nonbanks that are designated as SIFIs to limit activities that may create the prospect of a systemic failure. This reality has been vividly demonstrated with respect to firms

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[80] In this regard, we are concerned by FSOC's statement that the Council "*may* consider the company and its subsidiaries together, to enable the Council to consider the potential risks arising across the consolidated organizations." Proposed Guidance, *supra* note 7, at 9,036 (emphasis added). This ignores the critical importance of assessing risks throughout the enterprise. FSOC should instead make enterprise risk assessment the default position.

[81] The SEC's reforms of MMMFs provide examples of these strategies. *See supra* notes 11–13.

[82] Schwarcz & Zaring, *supra* note 14, at 1835–38.

that have been designated as SIFIs by FSOC: GE Capital and AIG both restructured their businesses in successful bids to shed their status as nonbank SIFIs. Even MetLife, which embraced a successful legal and political strategy to escape its status as a nonbank SIFI, simultaneously reduced its participation in certain potentially systemic activities.

Not only does an entity-based approach incentivize systemically significant nonbanks to de-risk, it also discourages nonbanks from seeking out systemic risk in the first place. This is because the mere prospect of being designated as a SIFI—and thus facing increased regulatory restrictions and compliance burdens—creates real risks and uncertainties for firms, which they will seek to avoid. In this way, entity-based approaches help counteract the moral hazard that persists as a result of the 2008 bailouts of nonbank firms.

By contrast, an activities-based approach in isolation affirmatively incentivizes nonbanks to engage in regulatory arbitrage by seeking out activities that have not been identified or appropriately regulated. Doing so offers all the ordinary potential benefits to firms of systemic risk—the ability to reap the upside reward of risk, while externalizing some of the downside—but only limited downside. This is because the firm does not bear the full costs of engaging in such an activity until it is regulated appropriately. Financial firms are accustomed to adjusting as the regulatory landscape changes, and they can choose either to cease engaging in a newly identified systemic activity or to conform to the new regulatory standards. And unlike in an entity-based regime, either choice can be implemented immediately because they do not usually require affirmative approval by regulators.

C. An Entity-Based Approach Is Relatively Easy To Implement Effectively

Third, identifying systemically significant nonbank firms is much more manageable than correctly identifying all systemically significant activities *ex ante*. As discussed above, it is extremely difficult for regulators to anticipate new and emerging systemic activities. That explains why, in contrast to assertions by several FSOC members, the Council's proposed activities based approach does not "back test" well. The experience of the President's Working Group on Financial Markets (PWG), in fact, demonstrates that a primarily activities-based approach failed to prevent the 2008 financial crisis. The PWG was essentially a precursor to FSOC, with a mandate to address systemically risky activities. While the financial sector amassed mortgage-related risks during the mid-2000s, however, PWG focused on issues entirely unconnected to the looming crisis. It was not until March 2008 that PWG finally recommended improved standards for mortgage origination, securitizations, and derivatives—the week before Bear Stearns failed.[83] PWG's experience during the mid-2000s underscores that regulators face serious challenges in identifying the specific activities that will transmit systemic risks.

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[83] *See* THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (2008), https://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf.

Relative to these difficulties, FSOC is much more likely to be able to consistently and accurately identify nonbank SIFIs. Although the distinction between firms that are systemically significant and those that are not can be blurry, it is generally straightforward to identify which firms are plausibly close to the line and which are clearly on one side or the other.[84] Moreover, both U.S. and international actors have developed detailed frameworks for identifying systemically significant firms, which have produced similar results as alternative methodologies.[85]

Perhaps even more importantly, FSOC need not perfectly distinguish between nonbanks that are systemically significant and those which are not to deter nonbanks from seeking out systemic risk. To the contrary, so long as the designation process is even roughly accurate, nonbank firms will have strong incentives to avoid pursuing strategies that could result in their failure propagating systemic risk.

Implementing an entity-based designation regime in settings where a nonbank firm's baseline sectoral regime is not oriented to systemic risk concerns is relatively straightforward. This is because the entity-based approach layers enhanced macroprudential regulation on top of an entity's baseline regulatory regime. Although this creates some coordination challenges between the Federal Reserve and a firm's baseline regulator, these challenges are generally manageable and have improved gradually as the Federal Reserve has developed working relationships with designated firms' sectoral regulators, particularly state insurance regulators.[86]

Finally, there is nothing unusual about an entity-based approach to financial regulation. To the contrary, the entity-based approach mirrors traditional financial regulation, which attaches different regulatory regimes to different types of financial firms, with investment banks subject to one set of regulatory restrictions, insurers a second set, and commercial banks a third. FSOC's entity-based approach departs from this tradition because its enhanced regulation applies to all nonbank SIFIs, regardless of their charter types. But aside from this design feature, FSOC's entity-based approach fits comfortably within traditional entity-based schemes of financial regulation, while addressing systemic risk.

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[84] *See* FSOC, Guidance for Nonbank Financial Company Determinations, 12 C.F.R. pt. 1310, app. A, § II (2018) [hereinafter 2012 Guidance].

[85] *See* Acharya et al., *Measuring Systemic Risk*, 30 REV. FIN. STUD. 2, 39 (identifying Bear Stearns, Lehman Brothers, Morgan Stanley, Goldman Sachs, and Merrill Lynch among the top 10 systemically risky financial firms in 2006–07 in back-testing of authors' marginal expected shortfall approach to systemic risk); Christian Brownlees & Robert F. Engle, *SRISK: A Conditional Capital Shortfall Measure of Systemic Risk*, 30 REV. FIN. STUDS. 48, 62–63 (2017) (finding that back-testing of authors' SRISK metric identified Morgan Stanley, Bear Stearns, Lehman Brothers, Fannie Mae, and Freddie Mac as top systemic risk contributors as early as the beginning of 2005).

[86] *See Insurance Regulation: Hearing Before the Subcomm. on Hous. and Ins. of the H. Comm. on Fin. Servs.*, 115th Cong. (2016) (testimony of Thomas Sullivan, Associate Director, Division of Banking Supervision and Regulation).

D. *An Entity-Based Approach Can Increase The Effectiveness Of An Activities-Based Approach*

Fourth, an entity-based approach to financial stability can also complement activities-based regulation by helping regulators to identify potentially systemic activities *ex ante*, and by allowing them to assess how well activities-based reforms are curbing risk. An entity-based approach produces these benefits through regular on- and off-site supervision of nonbank SIFIs. Continuous monitoring—a hallmark of entity-based systemic risk oversight—allows officials to observe the impact of different activities across time.[87] This unique vantage point allows them to more quickly identify troubling activities. For instance, if supervisors observe that several nonbank SIFIs are suddenly engaging in a new activity at accelerating rates, this is likely to trigger enhanced scrutiny of the activity itself, in a way that might otherwise be overlooked. Likewise, firm-wide examinations and continuous off-site monitoring can help supervisors detect when nonbank SIFIs respond to activities-based rules by changing their business models to continue taking systemic risks. In this way, regular entity-based nonbank SIFI supervision can help overcome some of the limitations inherent in an activities-based approach.

E. *An Entity-Based Approach Can Limit The Consequences Of A Systemic Nonbank Failure*

Fifth, entity-based regulation not only reduces the likelihood that a systemically important nonbank will fail, it also limits the macroeconomic consequences if such a firm were to experience distress. Dodd-Frank established the Orderly Liquidation Authority (OLA) to resolve financial firms that prove systemically important while limiting the harm to the broader economy. The OLA is unlikely to succeed, however, without *ex ante* entity-based nonbank regulation. This is because only designated nonbanks are required to prepare in advance for the firm's OLA resolution by developing an annual resolution plan, or "living will," explaining how the firm could be wound down.[88] A nonbank SIFI's living will provides regulators crucial insight into the firm's legal entity structure, its key operations, and management information systems that allows the FDIC to plan, in advance, if it must resolve the firm through OLA. Moreover, if the FDIC or Federal Reserve concludes that the nonbank SIFI is too complex to be resolved in an orderly fashion, the agencies may object to its living will and compel the firm to simplify its organizational structure. Thus, *ex ante* entity-based regulation enhances the likelihood that a systemically important nonbank can be resolved with minimal systemic externalities.

E*x ante* entity-based regulation also helps ensure that nonbank SIFIs hold sufficient financial resources to facilitate their orderly resolution. In an OLA proceeding, the FDIC would convert

[87] *See* BD. GOVS. FED. RES. SYS., SR 12-17, CONSOLIDATED SUPERVISION FRAMEWORK FOR LARGE FINANCIAL INSTITUTIONS 9–10 (2012) (discussing Federal Reserve supervision of nonbank SIFIs).

[88] *See* 12 U.S.C. § 5365(d)(1) (2012). Bank holding companies with total consolidated assets of $250 billion or more must also prepare living wills. *Id.*

the original holding company's long-term creditors into equity holders in a new bridge company. This recapitalization allows the holding company's subsidiaries—for instance, its commercial bank, broker-dealer, or insurance companies—to continue operating. If, however, the holding company does not have sufficient long-term debt to recapitalize the bridge company, then the firm's subsidiaries will be shut down and resolved under applicable insolvency laws—the precise outcome that the OLA seeks to avoid. Under Dodd-Frank, the Federal Reserve may require a designated nonbank SIFI to issue minimum amounts of long-term debt to enhance its resolvability.[89] Without *ex ante* entity-based regulation, however, a systemically important nonbank is unlikely to hold the financial resources necessary for an orderly resolution.

Additionally, *ex ante* entity-based oversight gives the Federal Reserve advance warning of an impending failure through the supervision process and fuller information about counterparties' exposure to the firm. This would help prevent a repeat of the situation with Bear Stearns and AIG in 2008, where the Federal Reserve had to fly blind when both companies approached it for emergency bailouts because it was neither company's supervisor. In today's framework, *ex ante* supervision would help policymakers assess whether such a firm should be placed into OLA.

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In sum, entity-based systemic risk regulation is uniquely capable of preventing catastrophic nonbank failures. This is because the content of entity-based regulation—such as capital, liquidity, and risk-management requirements—is inherently focused on the cumulative impact of a firm's activities. Moreover, an entity-based approach is a more effective deterrent against firms taking on systemic risk than an activities-based approach, as firms can quickly adjust to new activities-based rules through regulatory arbitrage. An entity-based approach is also inherently more reliable than the alternative, as identifying systemically significant firms is substantially easier than identifying systemically significant activities *ex ante*. Entity-based nonbank SIFI designations are therefore critical to prevent a recurrence of the systemic nonbank insolvencies from 2008. Accordingly, the Council should decline to adopt the proposed guidance, which would misguidedly put nonbank SIFI designations on the back burner.

III. PROPOSED CHANGES TO THE DESIGNATION PROCESS UNDERMINE FSOC'S ABILITY TO DESIGNATE NONBANK SIFIS

The Council insists that its activities-based approach would merely supplement, rather than displace, nonbank SIFI designations. But the Council's proposed changes to its designation

[89] *See* 12 U.S.C. § 5365(b)(1)(B)(iv) (authorizing Federal Reserve to establish prudential standards as it deems appropriate for nonbank SIFIs). The Federal Reserve has mandated that global systemically important banks hold minimum amounts of unsecured long-term debt and other loss-absorbing instruments. *See* 12 C.F.R. § 252.62 (2017). The Federal Reserve has not yet proposed comparable standards for nonbank SIFIs.

process belie this contention. In practice, the proposed new procedures would make it nearly impossible for the Council to designate new nonbank SIFIs and for any such designation to survive judicial review. Moreover, the Council's proposal to prioritize an activities-based approach and resort to nonbank SIFI designations only in an emergency fundamentally misconstrues the purpose of nonbank SIFI designations and the need for entity-based regulation.

A. Proposed Procedural Changes Would Render Nonbank SIFI Designations Impracticable

The Council's proposed guidance would make several ill-advised changes to the SIFI designation process. First, the proposal would require the Council to assess the likelihood of a potential designee's material financial distress. Second, the guidance would subject any future SIFI designation to mandatory cost-benefit analysis and other quantitative assessments. Third, the Council would eliminate Stage 1 of the current designation process, wherein the Council applies quantitative thresholds to identify nonbank financial companies for closer evaluation. For the reasons explained below, each of these changes, if enacted, would substantially undermine FSOC's ability to designate nonbank SIFIs and thereby increase systemic risk.

Several of these proposed procedural changes find their origins in the district court opinion in *MetLife, Inc. v. Financial Stability Oversight Council*.[90] The Council has requested comment on whether it should interpret its SIFI designation authority in a manner that is consistent with the *MetLife* opinion.[91] We strongly urge the Council not to do so. As a district court opinion, the *MetLife* ruling holds limited precedential value and in no way binds FSOC in the future.[92] Even the *MetLife* court itself acknowledged that its opinion was limited to the unique facts of that case.[93] Moreover, the court's legal reasoning was fatally flawed for all of the reasons the Council cited in its appeal before abruptly reversing its position after the 2016 presidential election.[94] Accordingly, the *MetLife* district court decision should not influence the Council's future use of its SIFI designation authority.

1. Likelihood Of Material Financial Distress

The proposed guidance states that the Council will consider the likelihood of a company's material financial distress when evaluating the firm for potential designation.[95] The Council should reconsider this procedural change for two reasons. First, the proposal is impermissible

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[90] 177 F. Supp.3d 219 (D.D.C. 2016).

[91] *See* Question 26 of the Proposed Guidance, *supra* note 7, at 9,035.

[92] *See, e.g.*, Camretta v. Greene, 563 U.S. 692, 709 n.7 (2011).

[93] *See* MetLife, Inc. v. Financial Stability Oversight Council, No. 15-0045 (D.D.C. Feb. 28, 2018) (order denying Joint Motion to Vacate in Part March 30, 2016 Order and Opinion) ("This Court is one of 94 United States District Courts, comprising several hundred judges, and its Opinion is not binding on others. The Opinion stands on its own persuasive value, to the extent it has any.").

[94] Brief for Appellant, MetLife, Inc. v. Financial Stability Oversight Council, No. 16-5086 (D. C. Cir. June 16, 2016).

[95] Proposed Guidance, *supra* note 7, at 9,044-45.

under the Council's authorizing legislation. Second, even if permissible under the statute, the proposal would undermine FSOC's ability to prevent a systemically-significant failure through designation.

As a threshold matter, the Council's proposal to consider a company's likelihood of material financial distress conflicts with the text of the Dodd-Frank Act. The statute instructs FSOC to *assume* that a firm is in distress and analyze whether that distress could pose a threat to U.S. financial stability.[96] Dodd-Frank unambiguously directs the Council to assess the potential consequences of a company's material financial distress, not the likelihood that it would experience such distress in the first place. Thus, in answer to question 29 of the proposed guidance, the Council must observe the express language of section 113.

Congress had good reason for instructing FSOC to conduct its designation analysis by assuming financial distress at a company. It wanted FSOC to take a precautionary approach by considering designation where a nonbank financial firm *could*—not would—threaten U.S. financial stability. This safeguard is eminently sensible, because the FSOC designation process is inherently lengthy. As FSOC's prior experience demonstrates, it can take years for the Council to evaluate a nonbank for potential designation, for the Federal Reserve to establish regulations appropriately tailored to a nonbank SIFI's business model, and for a designated nonbank SIFI to bring itself into compliance with those safeguards. Thus, waiting to designate a nonbank until it is vulnerable to distress in all likelihood would be too late. By the time the relevant capital, liquidity, and other safeguards associated with designation went into effect, the nonbank SIFI may already have collapsed.

Moreover, conditioning a firm's designation on its vulnerability to distress could actually hasten its collapse. The Proposed Guidance would redefine the term "material financial distress" to mean "imminent danger of insolvency or [of] defaulting on [the firm's] financial obligations."[97] Any SIFI designation issued under this standard would signal that the Council views the company as in imminent risk of failure, potentially triggering a run and creating the very instability that SIFI designations are designed to prevent. Accordingly, assessing a company's likelihood of distress would not only undermine FSOC's ability to prevent a systemically-significant failure through designation, it might perversely contribute to such a collapse.

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[96] 12 U.S.C. § 5323(a)(1) ("The Council … may determine that a U.S. nonbank financial company shall be supervised by the Board … if the Council determines that material financial distress at the U.S. nonbank financial company … *could* pose a threat to the financial stability of the United States.") (emphasis added). FSOC proposes restricting the meaning of the term "threat to the financial stability of the United States" to mean the potential for "*severe* damage on the broader economy," rather than "significant" damage, as the 2012 Guidance states. Proposed Guidance, *supra* note 7, at 9,032 (emphasis added). The Council does not justify any need for that change. Recharacterizing the standard in this way could raise the evidentiary burden for future SIFI designations and thereby restrict FSOC's ability to designate nonbank firms.

[97] Proposed Guidance, *supra* note 7, at 9,034.

2. Cost-Benefit And Other Quantitative Analyses

The proposed guidance would also require the Council to perform a series of quantitative assessments as part of any future designation. Most significantly, the proposal would require the Council to conduct a quantitative cost-benefit analysis and proceed with a designation only if the expected benefits outweigh the costs. Moreover, the Council's inquiry about adopting the *MetLife* precedent suggests that FSOC might insist on various statistical analyses designed to illustrate how a firm's distress would reverberate throughout the U.S. financial system.[98] If FSOC were to interpret its section 113 authority in a manner consistent with the *MetLife* opinion, the Council would effectively require statistical estimates of the systemic consequences of a firm's material financial distress as a condition of its SIFI designation.[99]

The Council should refrain from codifying these mandatory quantitative assessments. Quantifying the costs and benefits of nonbank SIFI designations and empirically estimating the effects of a firm's financial distress poses serious analytical challenges. Any such empirical analyses would be susceptible to *ex post* second-guessing by a reviewing court, thereby creating litigation risk for the Council and potentially deterring it from even attempting to use its SIFI designation authority.

It is extraordinarily difficult for the Council to assess the costs and benefits of nonbank SIFI designations with any degree of reliability. The stability-enhancing benefits of financial regulations are notoriously difficult to calculate accurately. As many scholars have recognized, quantifying the benefit of a crisis averted is nearly impossible.[100] Because of the infrequency of financial crises, moreover, financial regulatory cost-benefit analyses are highly sensitive to crude economic loss and discount rate assumptions.[101] Unpredictable financial market dynamics, including future regulation and adaptation by financial firms, further complicate any attempt to quantify the effects of designating any particular nonbank as systemic.[102]

For these reasons, quantitative cost-benefit analysis is susceptible to *ex post* second-guessing by a reviewing court.[103] Indeed, courts have increasingly overturned agencies' rules "on the

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[98] *See* Question 26 of the Proposed Guidance, *supra* note 7, at 9,035.

[99] 177 F. Supp.3d 219, 233-39 (D.D.C. 2016). Because FSOC used the word "likelihood" in the 2012 Guidance, the court required it to statistically estimate the losses to MetLife's counterparties if MetLife experienced financial distress, "based on reasoned predictions." *Id.* at 237. The court insisted that "a summary of exposures and assets is not a prediction." *Id.* Effectively, the court insisted that FSOC use multivariate regression analysis, not descriptive statistics, to analyze how a firm's distress could impact the broader financial system. To also foreclose this problem going forward, we urge FSOC to avoid using the word "likelihood" in its prospective new guidance.

[100] *See* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 960–69 (2015); Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43. J. LEGAL STUD. S351, S373–75 (2014).

[101] *See* Coates, *supra* note 100, at 947, 962, 972.

[102] *See* Gordon, *supra* note 100, at S373–75.

[103] *See* Coates, *supra* note 100, at 920.

ground that [the] court[] would conduct its guesstimated [cost-benefit analysis] differently than [the] agency would."[104] As a result, the uncertainty and discretion inherent in quantitative cost-benefit analyses create litigation risk for financial regulators. Accordingly, requiring FSOC to perform quantitative cost-benefit analyses would hold the Council to an impossible standard and render future SIFI designations vulnerable to legal challenge. With U.S. financial stability hanging in the balance, that legal risk must be avoided, particularly because Section 113 does not mandate or contemplate a cost-benefit test. Furthermore, the prospect of FSOC having to conduct such a demanding cost-benefit analysis when a nonbank systemically risky firm is on the brink of insolvency[105] conjures images of fiddling while Rome burns.[106]

Similar to assessing the costs and benefits of nonbank SIFI designations, quantifying the systemic consequences of a firm's material financial distress—as the *MetLife* court insists—poses intractable analytical challenges. Calculating the statistical likelihood of a firm experiencing material financial distress that could trigger a chain reaction, or quantifying the precise pathways of such a chain reaction, would be Herculean demands. This is because systemic failures only occur when the broader financial system is unstable and other financial firms are too weak to survive losses.[107] As a result, the likelihood of systemic failure cannot be modeled without predicting the chance that crisis conditions will arise in the larger financial system.

It is impossible, however, to estimate statistically the likelihood, magnitude, or timing of a future financial crisis. Sample size is one barrier. Unless the sample is sufficiently large, reliable statistical inferences cannot be drawn. This problem is insurmountable when it comes to nonbank firms, which did not manifest systemic risk (with rare exceptions) before 2008 and thus are relatively new objects of systemic concern.

Further complicating the statistical task, analysts would have to consider far too many potential explanatory variables to draw inferences with confidence. In the systemic risk context, there are a virtually infinite number of explanatory factors that can predict a future financial crisis or losses to a firm's counterparties. Innumerable permutations of events might make financial companies fragile. Some of those scenarios are known from past experience, but others are as yet unknown and cannot be anticipated, making any forecast too conservative. Moreover, because the timing of crises is hard to predict, statisticians would have to compute their

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[104] *Id.* at 919–20.

[105] FSOC states that it will only conduct a cost-benefit analysis after the Council has concluded that "the company meets one of" the two determination standards under Section 113. Proposed Guidance, *supra* note 7, at 9,034. Practically speaking, this means that in virtually every case, FSOC would have already determined that the company was in imminent danger of failure before undertaking the cost-benefit analysis.

[106] Furthermore, the cost-benefit test is asymmetrical in that FSOC would require one to designate a SIFI, but would not undertake a cost-benefit analysis in order to de-designate a company.

[107] FSOC acknowledged this when it stated in the Proposed Guidance that its "analysis of the likelihood of a nonbank financial company's material financial distress will be conducted taking into account a period of overall stress in the financial services industry and a weak macroeconomic environment." Proposed Guidance, *supra* note 7, at 9,035.

projections for multiple and often distant points in the future.

The analysis could not stop there, because financial crises have a large behavioral element. Next, statisticians would have to predict how other market participants would react if the counterparties' solvency was in doubt and the counterparties' responses to those reactions. The often irrational nature of market actors' reactions and the many assumptions that would need to be made would relegate any such projections to guesswork. In short, there would be far too many potential explanatory variables to make accurate predictions under these circumstances, particularly given the small sample size available.

Because material financial distress (in the systemic sense) cannot occur outside of crisis conditions, any attempt to model statistically an individual company's systemic distress would be subject to question. Further, even if a financial catastrophe could be forecast, that forecast would only apply to financial firms in the aggregate, not to specific firms. Nothing in that forecast would tell us that MetLife, for instance, would be the one to trigger that crisis instead of other firms. Even Treasury has conceded this point, stating: "There is no proven method for predicting with precision the effect that the failure of any nonbank financial company will have on financial stability."[108]

To summarize, the proposed guidance and *MetLife* precedent would require the impossible of FSOC by insisting that it statistically calculate the costs and benefits of a potential designation, as well as the precise pathways by which the firm's material financial distress might spread. Codifying these procedural hurdles would seriously undermine the Council's ability to designate nonbank SIFIs and open up any future designations to the prospect of judicial reversal.

3. Eliminating Stage 1 Of The Current Designation Process

The proposed guidance would eliminate Stage 1 of the current designation process, wherein the Council applies quantitative thresholds to identify nonbank financial companies that merit closer evaluation. Instead of applying these established quantitative thresholds to identify nonbanks that might pose a systemic risk, the proposed guidance would apparently leave to the Council's discretion when to begin the determination process. The current Stage 1 quantitative thresholds are a valuable pre-commitment mechanism that ensures the Council reviews a broad range of firms that might plausibly threaten U.S. financial stability. Eliminating the current Stage 1 thresholds and replacing them with unspecified, discretionary identification tools would therefore be unwise.

[108] DEP'T OF THE TREASURY, FINANCIAL STABILITY OVERSIGHT COUNCIL DESIGNATIONS 23 (2017), https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf.

The Stage 1 thresholds, as currently implemented, ensure that the Council actively evaluates a nonbank's systemic risk whenever the requisite thresholds are triggered.[109] Without this pre-commitment device, the Council might not proactively identify potentially risky nonbank financial companies or emerging systemically risky activities. This fear is especially salient today, given the infrequency with which the Council convenes, and the perfunctory nature of most of its meetings.[110] Absent the current Stage 1 thresholds, some nonbank financial companies will undoubtedly escape more detailed review that could expose potential risks. Accordingly, the Council should not eliminate this important screening step in the determination process.

Doing away with the current Stage 1 screening would not only hinder the efficacy of FSOC's designation process, it would also reduce the clarity and predictability of nonbank SIFI designations. As currently defined, the Stage 1 thresholds provide transparency about what factors trigger the enhanced review of a nonbank financial firm. In doing so, these thresholds provide nonbank financial firms an effective safe harbor for avoiding the Council's scrutiny. If firms remain below the Stage 1 thresholds, they can be relatively certain they will not be further analyzed for potential designation. Getting rid of the Stage 1 thresholds, however, will obfuscate FSOC's review process and reduce clarity about what triggers the Council's enhanced review. Thus, in contrast to its stated goal of increasing transparency in the designation process, eliminating the current Stage 1 screening mechanism would make the FSOC designation process more opaque.

B. De-Emphasizing Nonbank SIFI Designations And Mischaracterizing Them As An Emergency Response Tool Will Increase Systemic Risk

Finally, the Council's proposal to prioritize an activities-based approach—and consider nonbank SIFI designations only as a last resort—would dramatically slow the process of designating a nonbank SIFI, even when conditions clearly warrant such a designation. The designation process that the Council envisions would involve multiple rounds of consultation and coordination among the relevant regulatory agencies before the Council would potentially consider nonbank SIFI designations. FSOC would build in more time to allow a Stage 1 company to "take actions" to de-risk and avoid designation.[111] This multi-step process would take so long in practice that by the time FSOC even considered addressing escalating risks through nonbank SIFI designations, it could be too late.

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[109] The Council elevates a nonbank financial company to Stage 2 if it has $50 billion in total consolidated assets and meets at least one of the other thresholds relating to credit default swaps outstanding, derivative liabilities, total debt outstanding, leverage, and short-term debt. 2012 Guidance, *supra* note 84, 12 C.F.R. pt. 1310, app. A.

[110] *See* Ryan Tracy, *Risk of Bank-Like Regulation Fades for Big Financial Firms,* WALL ST. J. (Oct. 17, 2018), https://www.wsj.com/articles/u-s-regulators-rescind-federal-oversight-of-prudential-financial-1539783308 (noting the short duration of recent FSOC meetings).

[111] Proposed Guidance, *supra* note 7, at 9,036.

The SIFI designation process is already lengthy, with extensive evaluation and ample opportunity for the relevant company to present evidence to the Council. Moreover, it takes additional time for the Federal Reserve to develop appropriately-tailored rules for any company designated as a nonbank SIFI, and even more time for the company to bring itself into compliance with those safeguards. Further delaying the designation process by mandating that the Council first exhaust all activities-based remedies is therefore highly inadvisable.

The proposed guidance mistakenly views nonbank SIFI designations as an emergency response to be used if activities-based regulation fails to address systemic risks. Indeed, the guidance would bind FSOC to considering a nonbank SIFI designation "only in rare instances such as an emergency situation…."[112] This view gravely misconstrues the purpose of nonbank SIFI designations. A nonbank SIFI designation is not an emergency tool; instead, it is a prophylactic strategy to protect a systemically important nonbank from experiencing distress in the first place.[113] In order for the capital, liquidity, resolution planning, and other safeguards associated with nonbank SIFI designations to have their intended effect, FSOC must proactively use nonbank SIFI designations as an *ex ante* crisis-prevention strategy, not as a belated crisis response.

It is clear that Congress did not intend FSOC's SIFI designation authority to be an emergency response tool based on the fact that it established a separate mechanism to resolve failing financial companies. As discussed above, Dodd-Frank created the OLA to resolve a failing financial firm in case of emergency.[114] Indeed, the OLA's mechanisms for establishing a bridge financial company and recapitalizing the bridge company through convertible debt are uniquely suited to responding to the risks of imminent financial collapse.[115] By contrast, the prudential regulations accompanying nonbank SIFI designations are generally designed to prevent nonbank financial firms from experiencing distress in the first place. It is therefore apparent that Congress expected FSOC to use SIFI designations as an *ex ante* crisis prevention strategy that was analytically distinct from the *ex post* emergency response tool that the Council envisions in the proposed guidance.

[112] Proposed Guidance, *supra* note 7, at 9,045 n.21.
[113] *See* Gelzinis, *supra* note 6.
[114] *See supra* Section II.E.
[115] By law, firms that are resolved through the OLA need not have been previously designated as nonbank SIFIs. As discussed above, however, the OLA process is unlikely to work as intended if the Council has not designated the relevant nonbank as a SIFI far in advance of its distress.