May 24, 2019

Financial Stability Oversight Council
ATTN: Mark Schlegel
1500 Pennsylvania Avenue, NW
Room 2208B
Washington, DC 20220

Re: Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, RIN 4030-AA00, 84 Fed. Reg. 9028 (Mar. 15, 2019)

Ladies and Gentlemen:

Better Markets Inc.[1] appreciates the opportunity to comment on the above-captioned notice of proposed rulemaking ("Proposal" or "Release"), issued by the Financial Stability Oversight Counsel ("FSOC").

The Proposal would replace the interpretive guidance FSOC issued in 2012 (as supplemented in 2015), which describes the approach FSOC would take in exercising its authority under Section 113 of the Dodd-Frank Act to designate non-bank financial firms for enhanced prudential supervision by the Federal Reserve.[2] Under the Proposal, FSOC would essentially abandon the use of that critically important designation authority, in favor of an "activities-based approach." It thus threatens to abolish one of the most important regulatory tools adopted in the Dodd-Frank Act for the purpose of addressing threats to the stability of our financial system and avoiding a recurrence of the devastating financial crisis that swept over the nation in 2008 and for years thereafter. The net result will be an increase in the likelihood and severity of another financial crisis. FSOC should withdraw this misguided and dangerous Proposal in its entirety.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 12 U.S.C. § 5323.

## BACKGROUND

The 2008 financial crisis was the worst financial disaster since the Great Crash of 1929, and it produced the worst economy our nation has seen since the Great Depression of the 1930s. It nearly collapsed our financial system, destroying millions of jobs, triggering a tidal wave of home foreclosures, and wiping out the savings of countless American households. The costs have been staggering: tens of trillions of dollars in lost GDP and inestimable human suffering, much of which continues to this day.[3]

Systemic risks arising from nonbank financial institutions were largely responsible for causing and spreading the 2008 crisis, as illustrated by the collapse of American International Group ("AIG"), Bear Stearns, Lehman Brothers, money market funds, and others. These firms and activities were capable of such enormous disruption due to a number of gaps in America's financial regulatory framework leading up to the crisis. For example, even a single firm like AIG, whose insurance business was subject to state regulatory oversight and whose thrift was subject to oversight by the now-defunct Office of Thrift Supervision, could accumulate a significant amount of risk in its then largely unregulated credit default swaps business, without any regulator having the jurisdiction, mandate, responsibility, or tools to monitor, regulate, and police the systemically dangerous conditions at that firm.[4] A fortiori, if no regulator had such authority regarding the condition of any single firm, no regulator had it regarding the entire financial system either.[5]

A related problem was the growth of the so-called "shadow banking" system. The post-Great Depression system of banking regulation that arose in the 1930s was largely focused on and tailored to the traditional banking system. However, as time went on and new and different financial firm business models arose, that system of bank oversight and regulation was overtaken by innovation and other industry developments. For example, a firm might engage in many bank-like activities and, importantly, pose similar types of risks as a bank, but not be regulated as a bank or even regulated at all. Accordingly, significant risk accumulated in non-bank financial firms that were not subject to similar regulatory regimes, particularly those concerning capital requirements.[6] As a result, when those unregulated, overleveraged, and undercapitalized companies suffered

3 Better Markets, *The Cost of the Crisis: $20 Trillion and Counting* (July 2015), *available at* https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis_1.pdf.

4 FSOC Accountability: Nonbank Designations, U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 25, 2015) (statement of Dennis M. Kelleher, President & CEO, Better Markets, Inc.), https://bettermarkets.com/sites/default/files/documents/Kelleher%20Testimony%203-25-15_1.pdf.

5 *Id.*

6 Of course, given that there were significant bank failures and near-failures during the crisis, and a large number of banks needed bailouts to survive, another lesson of the financial crisis was that even the regulations applicable to banks were insufficient. Those regulations were also strengthened in the Dodd-Frank Act.

financial distress, they helped trigger and spread the financial crisis—and required billions in taxpayer bailouts.

America's elected officials in the Legislative and Executive Branches responded to these historic events by enacting a comprehensive set of reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act.[7] At the very heart of these changes in our regulatory system was the creation of the FSOC, an agency that is unique in the history of financial regulation in design and importance. Comprised of representatives from virtually every financial regulatory authority in the federal government, as well as a broad spectrum of state representatives, its core mission is to monitor all sectors of the financial markets, identify risks to the financial stability of the United States wherever they may arise, and respond with a series of measures to mitigate those threats, particularly when they arise from systemically significant nonbanks.

Congress equipped FSOC with the tools necessary to carry out these difficult but critical tasks, and the centerpiece is the power to designate systemically significant nonbank financial companies for prudential supervision by the Board of Governors of the Federal Reserve ("Federal Reserve"). This designation authority has a uniquely important role in helping to prevent another financial crash and economic crisis and the taxpayer bailouts that inevitably come with them. Specifically, Dodd-Frank Act Section 113 authorizes FSOC to make a designation of nonbank financial firms whose "material financial distress…could pose a threat to the financial stability of the United States." A Section 113 designation necessarily results in regulation of the designated entity—it is a Congressional mandate—specifically subjecting the firm to supervision by the Federal Reserve. Importantly this includes capital and leverage requirements specifically designed to prevent a firm from failing even under stressed conditions. The Dodd-Frank Act also gives FSOC the authority to address certain types of risks posed by certain types of financial **activities**.[8] However, this authority is discretionary, and furthermore, it does not empower FSOC to subject those activities to regulation; FSOC is authorized only to make recommendations to relevant primary regulators regarding designated activities, which those primary regulators may accept or reject.[9]

Of course, Congress understood that subjecting nonbank financial institutions to prudential regulation would impose significant costs on those companies. But it made the judgment that the benefits of preventing widespread financial and economic turmoil would far outweigh those costs, and it therefore decided not to require FSOC to conduct any form of cost-benefit analysis as it evaluated nonbank firms for possible designation.

In 2012, FSOC issued guidance for the exercise of its entity designation authority,[10] and following that guidance, it has designated only four firms over the years. It is this extraordinarily

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7 Public Law No. 111-203, 124 Stat. 1376 (July 21, 2010) ("Dodd-Frank Act").

8 12 U.S.C. §§ 5312, 5330.

9 12 U.S.C. § 5330.

10 Better Markets commented on the proposals leading to the 2012 guidance. *See* Better Markets, Comment Letter on Proposed Rule and Proposed Interpretive Guidance on Authority to Require

important, carefully considered, and rarely used designation authority that FSOC now proposes to abandon with the Proposal.

## OVERVIEW OF THE PROPOSAL AND SUMMARY OF COMMENTS

The Proposal would, in FSOC's own words, "substantially transform" FSOC's approach to addressing nonbank systemic threats to the financial system.[11] It would accomplish this transformation with three major de-regulatory changes to the current guidance on entity-based designation.[12]

### Abandoning entity-based designation in favor of an activities-based approach.

First, the Release expressly declares that under the proposed guidance, FSOC would "identify, assess, and address potential risks and threats to U.S. financial stability through a process that emphasizes an **activities-based** approach."[13] The Release also declares that under the Proposal, FSOC would henceforth pursue **entity-specific designations** sparingly if at all, and "only if a potential risk or threat cannot be addressed through an activities-based approach."[14] The

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Supervision and Regulation of Certain Nonbank Financial Companies (December 19, 2011), https://bettermarkets.com/sites/default/files/documents/CL%20FSOC%20SIFIs%2012-19-11.pdf, and has also commented on other related FSOC releases; Better Markets, Comment Letter on Proposed Rule on Asset Management Products and Activities, (March 25, 2015), https://bettermarkets.com/sites/default/files/documents/FSOC%20-%20CL%20-%20Asset%20Management%20Products%20and%20Activities%203-25-2015.pdf; Better Markets, Comment Letter on Proposed Recommendations Regarding Money Market Mutual Fund Reform (February 15, 2013), https://bettermarkets.com/sites/default/files/documents/FSOC-%20CL-%20MMF%20Recommendations-%202-15-13.pdf; Better Markets, Comment Letter on Advance Notice of Proposed Rulemaking on Authority to Designate Financial Market Utilities as Systemically Important (May 27, 2011), https://bettermarkets.com/sites/default/files/documents/FSOC-%20Comment%20Letter-%20NPR-%20FMUs%20as%20Systemically%20Important-%205-27-11.pdf; Better Markets, Comment Letter on Advanced Notice of Proposed Rulemaking Authority to Designate Financial Market Utilities as Systemically Important (January 20, 2011), https://bettermarkets.com/sites/default/files/documents/FSOC-%20Comment%20Letter-%20ANPR-%20FMUs%20as%20Systemically%20Important.pdf; Better Markets, Comment Letter on Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds (November 5, 2010), https://bettermarkets.com/sites/default/files/documents/FSOC-%20Comment%20Letter-%20Volcker%2011-5-10.pdf

11 Release at 9029.

12 The Proposal would also amend the current guidance in other respects, primarily focused on changing the procedures applicable to the entity-designation process. This letter focuses on the most significant and damaging substantive changes in the guidance that are set forth in the Proposal.

13 Release at 9029 (emphasis added).

14 Release at 9029.

Release further marginalizes the entity-designation authority by observing that the "Council would be most likely to consider a determination under Section 113 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 financial regulatory agencies."[15]

The Release also explains that under the new activities-based approach, FSOC will address identified threats to the financial system through a combination of informal measures such as information sharing with other regulators; attempting to persuade other regulators to address the risks; or, at most, issuing nonbinding recommendations under Section 120 of the Dodd-Frank Act indicating that primary regulators should apply new or heightened standards to the activities in question—recommendations that those regulators may adopt or reject at their discretion.[16] Only **after** FSOC determines that the steps taken to mitigate the risks have been inadequate will it even **begin** to consider invoking its entity-designation authority under Section 113.

These changes represent a decision by FSOC essentially to abandon the entity-based designation approach in favor of an activities-based approach. **But this about-face conflicts with the language and intent of the Dodd-Frank Act: Nothing in Dodd-Frank suggests that Congress intended FSOC's exercise of its Section 113 designation authority to be subordinate to or contingent upon whether, in FSOC's judgment, it has adequately addressed risks to the financial system by first seeking more stringent regulation of certain activities**. In addition, the Proposal threatens to establish a far weaker mechanism for addressing and reducing systemic risk. The activities-based approach is wholly inadequate as a substitute, because it serves a different and more limited purpose than the Section 113 entity-designation process, it poses serious challenges in its application, and it promises to be far less effective, primarily because it is unenforceable.

The Release does not offer a persuasive rationale for this dramatic change in direction, explaining simply that the Proposed approach is consistent with the Council's "priorities" of identifying and addressing potential risks on a "system-wide basis, in order to reduce the potential for competitive market distortions that could arise from entity-specific determinations, and allow primary financial regulators to address identified potential risks."[17] The Release cites no legal or other authority for these supposed "priorities" centered on competitive markets or deference to primary regulators. In fact, Congress's preference or "priority" in the Dodd-Frank Act was the use of entity-based designation to control threats to the financial stability of the United States, and that preference constitutes an express rejection of deference to primary regulators.

**<u>Imposing Cost-Benefit Analysis.</u>**

Second, and in an apparent effort to extinguish any remaining life that the Section 113 designation authority might have, the Proposal announces that the FSOC will perform a cost-

15 Release at 9035 n.25 (emphasis added).
16 12 U.S.C. § 5330(c)(2).
17 Release at 9029.

benefit analysis prior to making any of its designation determinations. The Release explains that it will make a designation under Section 113 only if the expected benefits justify the expected costs that the designation would impose.[18] Further, the Release explains that FSOC will quantify costs and benefits where it can and will consider non-quantifiable costs and benefits as well. *Id.*

The purported justification for undertaking this new, onerous, imprecise, and statutorily unauthorized analysis is limited to a footnote citation to the district court's ruling in *MetLife, Inc. v. Financial Stability Oversight Council,*[19] along with a citation to the Supreme Court decision on which that district court erroneously relied. Nowhere does the Release discuss the well-established legal principles, statutory provisions, or cases making clear that Congress did not intend the FSOC to conduct cost-benefit analysis when considering designations under Section 113.[20] Moreover, cost-benefit analysis is an inherently burdensome and imprecise methodology that will render the exercise of the Section 113 designation authority almost impossible as a practical matter. At a minimum, it will set the stage for a successful legal challenge of any designation.

**<u>Imposing a duty to consider the likelihood that a firm will experience financial distress.</u>**

Third, and in yet another measure apparently designed to complete the gutting of the designation authority, the Proposal would require the FSOC to assess the likelihood of a company's material financial as it reviews the company for possible designation, quantifying that likelihood if possible.[21] Here too the rationale is almost nonexistent and contrary to express statutory direction. This aspect of the Proposal is set forth as an adjunct to the duty to conduct cost-benefit analysis, yet the Release simply and amorphously asserts that such an assessment is "consistent with sound risk regulation."[22] Nowhere does the Release mention or analyze the innumerable legal and policy reasons why this obligation was never intended by Congress. In fact, this requirement is found nowhere in Section 113. And needlessly embracing it ignores the painful lessons of the financial crisis, which taught that reliably predicting the likelihood of financial distress in a firm is extraordinarily difficult. It is not an exercise on which to condition the application of safeguards designed to prevent a financial crisis.

**<u>An overarching flaw: Failing to justify the profound changes to the current guidance being proposed in light of FSOC's prior position.</u>**

Finally, the Release is as significant for what it consistently omits as it is for its errant new provisions and requirements. It fails to address, let alone resolve, the stark conflict between each of these proposed changes to the current guidance and the FSOC's diametrically opposite positions

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18 Releases at 9034.

19 177 F. Sup. 2d 219, 242 (D.D.C. 2016).

20 *See* Brief Amicus Curiae of Better Markets, Inc. in Support of the Defendant-Appellant at 25, No. 16-5086 (D.C. Cir. June 23, 2016); Brief of Better Markets, Inc. as Amicus Curiae in Support of Defendant FSOC, *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d 219 (D.D.C. 2016) (15-cv-0045). *See also infra* note 13 and case cited therein.

21 Release at 9035.

22 *Id.*

just three years ago. When it was defending its designation of MetLife for enhanced supervision in court, the FSOC strenuously advanced well-founded legal and factual arguments that directly refuted each of the three core elements in the Proposal. Namely, FSOC then fought for the proposition that the designation authority was the "centerpiece" of the Dodd-Frank Act framework for addressing systemic risk; that FSOC was clearly **not** required to conduct cost-benefit analysis in the designation process; and that equally clearly, FSOC was under **no** duty in the designation process to assess the likelihood that a firm might experience material financial distress.[23]

Yet in the Proposal, the FSOC offers little or no justification for these requirements and turns a blind eye to the many persuasive arguments advanced in the litigation.[24] The Supreme Court has made clear that an agency changing course "must show that there are good reasons for the new policy," emphasizing "that a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy."[25] FSOC has not met that standard here, or even attempted to do so (which in any litigation challenging this Proposal as finalized would warrant summary judgment).

The sum total of the Proposal is that, if it is finalized in its current form,[26] FSOC is unlikely to ever again designate any nonbank financial firm as systemically significant regardless of the

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23 The briefs that FSOC filed in the MetLife litigation over the merits of the designation are hereby incorporated by reference as if fully set forth herein, including the following filings: Memorandum in Support of Defendant's Motion to Dismiss or, in the Alternative, for Summary Judgment, *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d 219 (D.D.C. 2016) (15-cv-0045), ECF No. 84-1; Memorandum in Support of Defendant's Motion to Dismiss, *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d 219 (D.D.C. 2016) (15-cv-0045), ECF No. 84-2; Brief for Appellant, *MetLife, Inc. v. FSOC*, No. 16-5086 (D.C. Cir. Jun. 16, 2016); Reply Brief for Appellant, *MetLife, Inc. v. FSOC*, No. 16-5086 (D.C. Cir. Sept. 9, 2016).

24 Noteworthy is the fact that the FSOC's advocacy on each of these three issues was never allowed to be finally resolved in the litigation. Once installed, the current Administration embarked on a carefully orchestrated charade designed to short-circuit the appeal in the D.C. Circuit and to avoid an expected reversal of the district court's rulings. Shortly after his inauguration, President Trump called for a study of the designation process; counsel for MetLife promptly moved for an abeyance in the appeal, even though the study was essentially irrelevant to the issues pending before the court; Treasury then issued a report that not surprisingly dovetailed with MetLife's attack on the designation process; and finally, FSOC abandoned its defense of the designation, culminating in a voluntary dismissal of the appeal without any decision on the merits. Better Markets detailed this highly questionable conduct and sought to allow the case to be decided on the merits. *See* Brief Amicus Curiae of Better Markets, Inc., in Opposition to MetLife's Motion to Hold Appeal in Abeyance, filed on May 8, 2017 in *MetLife v. Financial Stability Oversight Council*, 865 F. 3d 661 (D.C. Cir. 2017).

25 *F.C.C. v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009).

26 If the final version of the guidance strays too far from the Proposal, either in substance or in any proffered explanations or justifications, then under the principles governing proposed rules, it would be subject to challenge on the grounds that the process FSOC chose to follow with this guidance did not afford a meaningful opportunity to comment, requiring re-proposal. *Allina Health Servs. v. Sebelius*, 746 F.3d 1102, 1107 (D.C. Cir. 2014).

systemic threat it actually poses, and that threat, like those posed by AIG, Lehman Brothers, and so many other systemically significant nonbanks, will not be detected or addressed until it is too late. That unacceptable outcome will needlessly increase the likelihood and severity of another devastating financial crisis.[27]

## COMMENTS

### I. Abandoning entity-based designation in favor of an activities-based approach conflicts with the Dodd-Frank Act and threatens to establish a far weaker mechanism for limiting systemic risk.

#### A. Congress intended FSOC's entity-designation authority to be its primary tool for mitigating systemic risk

The language and structure of the Dodd-Frank Act make very clear that Congress intended the entity-based designation authority in Section 113 to be the primary tool—not a subordinate or last-resort measure—that FSOC would use for identifying and limiting risks to financial stability posed by nonbank financial institutions.

FSOC's entity designation authority in Section 113 is by far the most comprehensive and detailed set of provisions that Congress incorporated into the Dodd-Frank Act for the purpose of identifying and containing risks to the stability of the financial system from nonbanks. It is the leading substantive provision in the subchapter of Title 12 governing FSOC, following the basic sections that establish the Council and define its general powers and duties. It contains a thoughtful set of provisions that address every aspect of the designation process, including the authority to designate, the factors that FSOC must consider, the designation of foreign nonbank financial companies, an anti-evasion clause to ensure the widest possible scope of the designation authority, the process for re-evaluating and rescinding designations, notice and opportunity for hearing, emergency exceptions, FSOC's duty to consult with primary regulators, judicial review, and international coordination.[28] This was obviously a deliberate policy choice on the part of Congress—it was no particular activity that nearly turned a downturn in the housing market into a

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27 It seems apparent that reducing if not entirely eliminating the number of designations is the goal of the Proposal. If so, it is a solution in search of a problem. Since its creation, FSOC has only designated four firms pursuant to its Section 113 authority—far fewer than would have been expected given the number of nonbank financial firms that failed, received bailouts, or otherwise posed systemic risk—and each time only after a deliberative and careful process. See Better Markets Letter to Steve Mnuchin (June 6, 2017), https://bettermarkets.com/sites/default/files/Ltr%20Mnuchin%20re%20Treasury%20EO%206-6-17.pdf. Whatever concerns one might have about FSOC's current interpretive guidance, certainly absent from the list is the notion that FSOC has been too aggressive in its use of the designation authority.

28 *See generally* 12 U.S.C. § 5323.

global financial calamity, but overleveraged, undercapitalized, and insufficiently supervised banks and nonbanks that could not manage the material financial distress in which they found themselves.

In fact, Section 113 is also the **only** provision expressly adopted for the purpose of limiting risks to the overall financial stability of the United States posed by nonbank financial companies.[29] In contrast, and as discussed further below, the specifically limited statutory authority for activities-based designation is written and intended for the more narrow purpose of addressing the risk of "significant liquidity, credit, or other problems" spreading among institutions.[30] Indeed, the courts have seized on Section 113, not Section 120, as the very defining characteristic of the Dodd-Frank Act.[31]

Equally important, Congress, via Section 113, determined to limit FSOC's discretion by **mandating** specific FSOC action to mitigate possible systemic threats from nonbanks. Once FSOC determines that material financial distress at a nonbank financial company could pose a threat to the financial stability of the United States, the statute dictates that such a nonbank "**shall** be supervised by the Board of Governors and **shall** be subject to prudential standards."[32] By contrast, and as also discussed below, Congress provided FSOC simply with **discretionary** authority to recommend more stringent regulation of certain financial activities: Even if it makes the findings specified in Section 120, it need not necessarily issue recommendations to the primary regulators. Moreover, if FSOC does exercise its discretion and issues recommendations, it is entirely dependent upon the willingness of the primary regulators to follow the recommendations.[33] These clear differences in the mandatory and discretionary nature of Sections 113 and 120, respectively, provide further evidence that in Congress's judgment, Section 113 was the more important—and therefore the necessarily more potent—authority at FSOC's disposal.

The primacy of the mandatory section 113 designation authority is also reflected in its origins. Based on the lessons learned from the financial crisis, Congress's focus was appropriately on the need to better regulate nonbank financial institutions, such as AIG and others, that were unregulated and among the primary triggers of the crisis. FSOC itself persuasively traced these

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29 *See* 12 U.S.C. § 5322(a)(2)(H) and 5323(a)(1) (each referring to entity designation as the means for addressing threats to the financial stability of the U.S.).

30 *See* 12 U.S.C. §§ 5322(2)(K) and 5330(a).

31 *See, e.g., MetLife, Inc. v. Financial Stability Oversight Council*, 865 F. 3d 661, 663 (D.C. Cir. 2017) ("Congress passed the [Dodd-Frank Act] to mitigate the risks that *certain financial institutions* could pose to the stability of the national financial system.") (emphasis added); *State National Bank of Big Spring v. Lew*, 795 F. 3d 48, 52 (D.C. Cir. 2015) (in describing FSOC generally, singling out its "statutory authority to designate certain 'too big to fail' (as they are colloquially known) financial institutions for addition regulation in order to minimize the risk that such a company's financial distress will threaten the stability of the American economy.")

32 *See* 12 U.S.C. § 5323(a)(1) (emphasis added); *see also* 12 U.S.C. § 5322(a)(2)(H) (FSOC "shall *require* supervision by the Board of Governors" of financial companies that may pose risks to the financial stability of the U.S.).

33 12 U.S.C. § 5330.

foundations for Section 113 just a few years ago, when it continued to believe in and defend the entity-based designation approach:

> The 2008–09 financial crisis triggered the most severe recession since the Great Depression. After the collapse of the housing bubble, the nation's largest financial institutions were stuck with toxic assets on their balance sheets, without a sufficient cushion to absorb defaults. Credit markets seized up, as financial firms refused to lend. Blue-chip institutions collapsed in a matter of days. The sudden failures of financial companies triggered a cascade of other failures and near-failures, beginning with panic-fueled runs on firms and funds previously thought stable. Unprecedented infusions of government funds were needed to rescue other firms, including American International Group ("AIG"), whose failure would have been disastrous for the nation's economy. Over time, unemployment spiked. A mortgage crisis led to an unprecedented number of foreclosures. The Dow Jones dropped more than 50%. This crisis made palpably clear that disastrous events often do not occur in isolation, and the market cannot easily swallow the collapse of certain companies.
>
> The crisis also exposed numerous vulnerabilities in the U.S. financial system, including gaps in regulators' jurisdiction over large, complex "nonbank" financial companies—like AIG and the former Lehman Brothers—that play a significant role in the financial system. Many of these nonbank financial companies were not subject to effective consolidated supervision, as no single regulator supervised the parent company and all of its subsidiaries. **The crisis revealed that financial distress at banks and nonbanks alike can lead to a broad seizing up of markets, as well as stress at other financial firms, through market exposures and interconnections, all of which can threaten the financial stability of the nation.** It was against this backdrop that Congress enacted the [Dodd–Frank Act].[34]

Nothing in the text or history of Dodd-Frank suggests, as the Release suggests, that FSOC's Section 113 authority was intended to be used "only in rare instances such as an emergency situation."[35] In fact, that after-the-fact reactive approach to dealing with firms only once an emergency has arisen is precisely what Congress sought to avoid—Section 113 authority is statutorily required to be used proactively to prevent AIG-like bailouts.

Moreover, this statutory focus on specific nonbank entities that pose threats to financial stability parallels the approach Congress established for the enhanced oversight of the largest bank holding companies, another pillar of the Dodd-Frank Act.[36] Section 165 of the Dodd-Frank Act authorized the Federal Reserve to establish more stringent prudential standards for the largest bank

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34 Memorandum in Support of Defendant's Motion to Dismiss or, in the Alternative, for Summary Judgment at 1, *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d 219 (D.D.C. 2016) (15-cv-0045), ECF No. 84-1 (emphasis added).

35 Release at 9035 n.25.

36 *See* 12 U.S.C. § 5365.

holding companies. And it established an entity-based framework for identifying which BHC's should be subject to those enhanced standards, providing that the Board "may differentiate among **companies** on an individual basis or by category," taking into consideration their capital structure, riskiness, complexity, size, and other factors.[37]

In short, in terms of its unique breadth, scope, and strength, the Section 113 entity-based designation authority is the required primary mechanism that Congress mandated to safeguard the United States financial system from the threats to financial stability posed by nonbank financial institutions. And, it is the only mechanism that can adequately address those threats. Nowhere in Section 113—neither in the list of factors FSOC must consider nor in any other provision—is there any basis or even a hint that Congress intended the mandatory designation authority to be subordinate to or contingent upon the exercise of any other discretionary FSOC power or process, least of all the discretionary authority merely to recommend enhanced regulation of certain activities. The Proposal's attempt to sideline and effectively gut Section 113 authority is impermissible as a statutory matter, and it is an indefensible and unwise course of action, one that threatens to make another financial crisis more likely—highlighting one of the principal reasons that Congress rejected such a hands-off approach.

### B. The Section 120 authority to recommend more stringent regulation of certain activities cannot substitute for the mandated Section 113 actions, since Section 120 serves a different purpose, poses serious challenges in its application, and promises to be far less effective.

FSOC's attempt to substitute a discretionary, activities-based approach to designation in place of the statutorily mandated entities-based approach, as set forth in the Proposal, finds no support in the Dodd-Frank Act. The "activities" related provisions appear later in the subchapter, are less detailed and developed, and contain no language stating or even suggesting that the FSOC should rely on it first and foremost to limit potential systemic risks to financial stability. To the contrary, it **cannot** serve as an adequate substitute for the entity-based approach, since it advances different purposes, poses even greater challenges in application, and is virtually unenforceable.

As noted above, Congress established FSOC's authority to designate activities for more stringent regulation by primary regulators for a more narrow purpose. Its focus is not on threats to the overall financial stability of the United States, but on the more modest subset of threats arising specifically from the risk of "significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or undeserved communities."[38]

Reliance on the activities-based designation authority to contain systemic risk is misplaced for other reasons as well. For example, it poses the same inherent challenges that come with any complex and predictive activity, yet unlike Section 113, Section 120 provides no set of factors to

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[37] *Id.* at (a)(2)(A) (emphasis added).
[38] 12 U.S.C. § 5330(a).

guide the FSOC's analysis. It is also far weaker, in that FSOC can only recommend that primary regulators apply new or heightened standards and safeguards to identified activities. Crucially, Section 120 does not give FSOC any authority to mandate the regulation of **any** activity at all. Instead, Section 120 requires a lengthy consultation and notice-and-comment process, the end result of which is a nonbinding **recommendation** to primary financial regulators that they impose specific standards on an activity. That recommendation can be rejected by any primary financial regulator.[39]

The Proposal sets forth an approach that is even weaker than the tepid authority found in Section 120. FSOC does not contemplate exercising even its Section 120 authority to make recommendations in the first instance. Instead, FSOC proposes first an informal, collaborative effort with regulatory agencies to address risks posed by certain activities, and only if it determines that this collaboration has not resulted in adequate steps to address those risks might it formally invoke its Section 120 authority to make recommendations. And only after **that** process is deemed to have inadequately addressed the risk will FSOC even consider the entity-designation process.

The effectiveness of the Section 120 activities-based focus is yet further in doubt. First, in some instances, there may in fact be no primary regulator with jurisdiction over the company and activities at issue. In that event, the statute falls back on the ineffective remedy of a report to Congress.[40] And even if primary regulators can and do agree to act, success hinges on many factors. As a threshold point, if more stringent regulation over an activity is deemed necessary, then there has arguably been a presumptive failure on the part of the primary regulator to properly oversee that activity, and relying on those regulators to cure the problem should raise concerns. But even if a primary regulator commits to following the FSOC's recommendation, the outcome is far from clear, as it depends on a number of challenging variables, including, for example:

- the specific formulation of the more stringent standards;
- the ability of the primary regulator to ensure compliance through examination and enforcement, given its level of resources, staffing, and expertise;
- how the primary regulator will interpret ambiguities in the more stringent standards;
- the primary regulator's willingness to grant exemptive relief that might undermine the effectiveness of the rule; and
- the metrics that FSOC will use to determine whether the threats posed by the activity have been adequately addressed—something the Proposal does not address.

Simply put, in addition to its narrow scope and ineffective enforcement, too many uncertainties exist with respect to the adequacy of FSOC's exercise of its Section 120 discretionary, activities-based authority. For all of these reasons, in addition to the express

39 *See* 12 U.S.C. § 5330(c)(2) (providing that the primary regulator shall impose the recommended standards "or shall explain in writing to the Council . . . why the agency has determined not to follow the recommendation of the counsel").

40 12 U.S.C. § 5330(d)(3).

statutory mandate, it cannot serve as a substitute for, or a prerequisite to, the exercise of FSOC's Section 113 entity-designation authority.

### C. The Proposal offers vague and unsupported justifications for the dramatic change in approach.

The Proposal attempts to justify the new focus on activities as opposed to entities with this cursory explanation:

> This approach is consistent with the Council's priorities of identifying and addressing potential risks and emerging trends on a system-wide basis, in order to reduce the potential for competitive market distortions that could arise from entity-specific determinations, and allow primary financial regulatory agencies to address identified potential risks.[41]

However, while the FSOC hereby admits that these considerations are "the Council's priorities," those are not the priorities of Congress or the statute, which are controlling over a Council's subsequent "priorities." Put differently, the FSOC is required to implement Congress's "priorities" and preferences as set forth expressly in the statute. Moreover, the Council's "priorities" are neither explained nor supported.

As to "competitive market distortions," even if they were a cognizable "priority," the Release offers no specifics or concrete evidence supporting the speculative contention that entity-based designations distort competition, either in favor of or against the interests of the designated company. This is more than a purely formalistic point, as views differ widely on this issue, some claiming that designation confers an advantage on a company by indicating that it is too big to fail and hence subsidized by taxpayers, with others—notably MetLife—claiming that the designation is horrendously burdensome, even increasing the risk of material financial distress at the firm. In any event, "competitive market distortion" is found nowhere among the ten factors that Congress requires the FSOC to consider when evaluating specific companies for possible designation.[42] Nor is it mentioned in the provisions governing activities-based enhanced regulation under Section 120.[43]

As to the second notion that FSOC's priority is to allow primary regulators to address potential risks, the point suffers from a number of fatal flaws. First, the Proposal offers no details as to the origins or justifications for this "priority." Second, it conflicts with Congress's intentions as revealed in the Dodd-Frank Act, since the mandated and primary mechanism for addressing systemic risk is the entity-based designation approach that expressly dictates supervision by the Federal Reserve, not the primary regulator, wherever a nonbank institution threatens financial

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41 Release at 9029.

42 *See* 12 U.S.C. § 5323(a)(2).

43 *See* 12 U.S.C. § 5330(b)(2)(A) (stating only that the new or heightened standards governing activities must take "long-term economic growth into account").

stability within the terms of Section 113. Whatever FSOC's preferences may be in this regard, they conflict with the statute. Finally, this "priority" would appear to be, at best, a bootstrapping exercise. In answer to the question of whether FSOC should emphasize entity-based designation or activities-based designation, FSOC is simply positing the answer by stipulating that the latter approach is the "priority," without offering any extrinsic justification, analysis, or statutory basis. This is unacceptable.

## II. The proposed cost-benefit requirement conflicts with the Dodd-Frank Act and well-established principles of administrative law, and it will render the designation authority virtually unusable.

### A. Congress clearly did not require or intend that FSOC conduct cost-benefit analysis as a condition to entity designation.

Unfortunately, the Proposal not only attempts to subordinate the mandatory entity-based approach to an activities-based methodology, it also seeks to cripple the Section 113 designation process with a self-imposed duty to conduct cost-benefit analysis prior to making any of its designation determinations (however made). The Release explains that it will make a designation under Section 113 only if the expected benefits justify the expected costs that the designation would impose.[44] This approach is inconsistent with Congressional intent and the specific provisions of the Dodd-Frank Act governing FSOC, as well as long-standing precedents limiting an agency's duty to conduct cost-benefit analysis.

Whether or not an agency must conduct cost-benefit or economic impact analysis, and the exact nature of that analysis, is determined by what Congress has actually required in the agency's organic statute. The Supreme Court has declared that an agency's duty to conduct cost-benefit analysis is not to be inferred lightly or without a clear indication from Congress.[45]

Sometimes Congress insists on a rigorous cost-benefit analysis;[46] sometimes it requires an agency simply to consider certain economic factors;[47] and often, as in this case, it does not impose any cost-benefit or economic impact analysis obligation whatsoever on an agency.

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[44] Release at 9034.

[45] *Am. Textile Mfrs. Inst., Inc. v. Donovan,* 452 U.S. 490, 510-512 & n. 30 (1981) ("Congress uses specific language when intending that an agency engage in cost-benefit analysis."); *see also Inv. Co. Inst. v. Commodity Futures Trading Comm'n*, 720 F. 3d 370, 379 (D.C. Cir. 2013) ( "[w]here Congress has required 'rigorous, quantitative economic analysis,' it has made that requirement clear in the agency's statute, but it imposed no such requirement here."); *Nat'l Ass'n of Mfrs. v Sec. & Exch. Comm'n.*, 748 F. 3d 359, 369 (D.C. Cir. 2014).

[46] *See, e.g.,* 2 U.S.C. § 1532(a) (requiring the agency to "prepare a written statement containing . . . a qualitative and quantitative assessment of the anticipated costs and benefits," including "the costs and benefits to State, local, and tribal governments or the private sector" and "estimates by the agency of the [action's] effect on the national economy");

[47] *See* 7 U.S.C. § 19 (requiring the CFTC to "consider the costs and benefits of the action").

The provisions governing FSOC's Section 113 designation authority are devoid of any language suggesting that the agency must conduct cost-benefit or economic impact analysis when designating companies for enhanced supervision. Certainly, the FSOC's obligation to "consider" ten factors when making a designation determination does not impose any type of cost-benefit or economic analysis obligation on FSOC.[48] Under standard canons of statutory analysis, those ten factors explicitly chosen by Congress and set forth in the statute lead to the unmistakable conclusion that any cost benefit or economic analysis was intentionally omitted. None of the factors requires any consideration of the costs and benefits of a designation or consideration of the effects of designation on either the designated company, its shareholders or customers, or the wider economy. Rather, they all relate to the degree to which a company "could pose a threat to the financial stability of the United States." The final catchall factor is "**any other risk-related factors** that the Council deems appropriate," which confirms that all of the factors relate to risks posed by the company, not the costs or benefits of a designation.[49]

Two additional factors reinforce all of these conclusions. First, Congress knew how to require FSOC to evaluate the economic impact of its regulatory actions, and it did so in other provisions of the Dodd-Frank Act. For example, in Section 120, Congress required any new or heightened standards and safeguards to "take costs to long-term economic growth into account."[50] Against this affirmative instruction to FSOC in another context, the complete absence of any such requirements in Section 113 can only be read as a deliberate choice.

Second, Congress could not have intended FSOC to conduct the type of economic impact analysis reflected in the Proposal, since the nature and scope of any prudential supervision eventually applied to a designated company was to be determined not by FSOC but by the Federal Reserve, at a later point in time. Since FSOC, in its early stages at least, could not know at the time of designation what additional regulatory requirements the Federal Reserve might ultimately apply to a designated firm, it could not have been expected to conduct a meaningful economic impact analysis.

### B. Neither the flawed district court decision in *MetLife v. FSOC* nor the Supreme Court's holding in *Michigan v. EPA* support or justify the decision to require cost-benefit analysis for entity designations.

The sole justification in the Proposal for requiring cost-benefit analysis as a precondition for entity-based designations is a single footnote citing to the district court's deeply flawed decision in *MetLife v. FSOC* and to the Supreme Court case on which that district court mistakenly relied, *Michigan v. EPA*.[51] However, neither case justifies the Proposal's dramatic departure from Congress's intent, express statutory language, or the core principles governing agency cost-benefit

48 12 U.S.C. § 5323(a)(2).
49 12 U.S.C. § 5323(a)(2)(K) (emphasis added).
50 12 U.S.C. § 5330(b)(2)(A).
51 *See* Release at 9034 & n.22.

analysis discussed above.[52]

After MetLife challenged its designation by FSOC in federal district court, that court rescinded the designation, concluding it was arbitrary and capricious, in part because FSOC failed to consider of the cost of designation to MetLife. In so doing, the judge misinterpreted both the Dodd-Frank Act and the Supreme Court's decision in *Michigan v. Environmental Protection Agency*.[53] Although the court acknowledged that the Dodd-Frank Act nowhere expressly required the FSOC to conduct a cost-benefit analysis, the court fashioned a tortured chain of reasoning based primarily on the Supreme Court's holding in *Michigan*. There, the Court held that the statutory word "appropriate" may call for an agency to look at cost considerations when deciding whether to regulate. Keying off this decision, the district court in *MetLife* held that the FSOC's purely discretionary authority in Section 113 to consider other "risk-related factors that the Council deems **appropriate**" required it to consider the cost of designation to MetLife. To reach that highly implausible result, the court was left to reason that cost is a "risk-related factor" insofar as the costs of regulation imposed on a firm could make it more likely to experience financial distress in the first instance—even though that determination is not one that FSOC is actually required to make at any point in the designation process.

In its brief on appeal to the D.C. Circuit, the FSOC itself appropriately stressed the flawed logic in reading the ten factors (especially the catchall factor) in Section 113 as suggesting a nexus to cost-benefit analysis:

> In any event, the interpretation of "risk-related factor" adopted by the district court is untenable. The cost of complying with regulation bears no resemblance to any of the ten statutory factors that guide a designation decision. Those factors reflect Congress's determination that designation is proper when a financial company's material financial distress could threaten the stability of the U.S. financial system. **Keenly aware of the costs of inadequate regulation, Congress determined that the benefits outweigh the potential cost of regulations that are designed to improve the safety and soundness of the designated company as well as the stability of the financial system**.[54]

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52 The Release also cites to OMB Circular A-4 with respect to the manner in which FSOC proposes to conduct cost-benefit analysis, Release at 9034 n.23, and it includes cursory references to two executive orders directing "certain agencies to assess costs and benefits." *See* Release at 9038-39. Nowhere, however, does the Release state or analyze whether FSOC is actually one of those "certain agencies" subject to those executive orders—and it is not at all clear that it is, since only the traditional executive branch agencies must observe those requirements, not the independent agencies.

53 135 S. Ct. 2699 (2015); *see also* Better Markets, "Fact Sheet on the MetLife v. FSOC Decision" (Apr. 15, 2016), *available at* https://bettermarkets.com/sites/default/files/MetLife%20Decision%20Fact%20Sheet%204-15-16%20Final.pdf.

54 Brief of Appellant at 54, *MetLife, Inc. v. Financial Stability Oversight Council*, No. 16-5086 (D.C. Cir., June 16, 2016) (emphasis added).

A closer examination of the *Michigan* case confirms that the district court's reliance on the decision was in error—and that the FSOC's refutation of the district court's decision was correct. The Supreme Court concluded that the EPA was required to consider costs when determining whether regulation of power plant emissions was "appropriate and necessary" under the Clean Air Act.[55] However, the holding was highly contextual, with a number of specific factors leading to the Court's decision. For example, the EPA was operating in the context of numerous environmental statutory provisions and mandated studies that were heavily focused on cost assessments. In addition, the EPA was dealing with a specific mandate to determine whether to regulate at all, a point that figured prominently in the Court's decision: "Agencies have long treated cost as a centrally relevant factor when deciding whether to regulate."[56] Here of course, Congress has already and emphatically made the decision that the FSOC should designate nonbank financial institutions for additional regulation if they pose a threat to the financial stability of the United States.

The district court mistook the Supreme Court's opinion about one phrase in the Clean Air Act for a radical shift in administrative law that supposedly overturned an entire series of longstanding precedents governing agency cost-benefit analysis. But the basic proposition "that an agency need not undertake [cost-benefit analysis] absent congressional command,"[57] remains good law. Cases decided since *Michigan* prove the point. In *Lindeen v. SEC*,[58] the petitioners challenged a regulation promulgated by the SEC for allegedly failing to conduct sufficient cost-benefit analysis. The Circuit upheld the regulation: "We do not require the Commission 'to measure the immeasurable' and we do not require it to 'conduct a rigorous, quantitative economic analysis **unless the statute explicitly directs it to do so.**'"[59]

This outcome should come as no surprise, because *Michigan* itself was not as broad as the district court believed: "There are undoubtedly settings in which the phrase 'appropriate and necessary' does not encompass cost."[60] The district court's decision in MetLife, however, took *Michigan's* narrow holding and turned it into a sweeping proposition, on the sole basis of the shared "textual hook" of one word: "appropriate." That result was untenable as a matter of law and logic and it provides no basis on which FSOC can now justify its sudden infatuation with cost-benefit analysis.

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55 42 U.S.C. § 7412(n)(1)(A) (2012); *Michigan v. Envtl. Prot. Agency*, 135 S. Ct. 2699 (2015).
56 *Id.* (emphasis added).
57 *Id.* at 28.
58 *Lindeen v. Sec. & Exch. Comm'n*, 825 F.3d 646, 658 (D.C. Cir. 2016).
59 *Id.* (quoting *Nat'l Ass'n of Mfrs.*, 748 F.3d at 369 (emphasis added)).
60 135 S. Ct. at 2705.

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### C. Cost-benefit analysis is a burdensome and imprecise methodology that will eliminate any realistic chance that FSOC will ever use its entity-designation authority.

FSOC's proposal to insist upon cost-benefit analysis in the entity-designation process is not only bad law but also bad policy. Cost-benefit analysis is typically invoked by opponents of regulation seeking to slow, dilute, kill or, ultimately, legally challenge an agency's rulemaking or decisional process. Cost-benefit analysis, while often perceived as reasonable and objective, is almost invariably biased in favor of deregulation. When applied to financial regulation, cost-benefit analysis is more aptly described as "industry cost-only analysis," in which industry focuses exclusively on the costs of regulation while ignoring the benefits.[61] If FSOC implements this Proposal, it will be forcing itself to engage in an inherently inaccurate, time-consuming, and burdensome process that encumbers and delays FSOC's work, makes designations less likely, and creates a more inviting—and likely more successful—target for legal challenge in court.[62]

Designating a firm for enhanced regulation by the Federal Reserve lends itself to just this type of skewed cost-benefit analysis, as the designated entity will always be able to cite a long list of specific and allegedly quantifiable (if highly speculative and questionable in fact) costs that would appear to cast designation as unjustifiably burdensome. Yet viewed holistically, the benefits of designation are potentially enormous and, in many respects, incalculable, representing the tangible and intangible gains that come from averting another financial crisis, economic catastrophe, and untold trillions in taxpayer bailouts. As traditionally framed, however, cost-benefit analysis does not adequately capture these benefits and does not yield a balanced and accurate picture.[63]

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[61] Better Markets, *Setting The Record Straight On Cost-Benefit Analysis And Financial Reform At The SEC* (July 30, 2012), *available at* http://www.bettennarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf.

[62] This is yet another reason why Congress often decides not to require cost-benefit analysis, as it slows and weakens the process and increases the likelihood that its policy priorities will be overturned in court.

[63] In the context of recommending stronger regulation of money market mutual funds to the SEC, the FSOC previously displayed a keen appreciation of the need to assign appropriate weight to the benefit of systemic stability and avoidance of financial crises. *See* Proposed Recommendations Regarding Money Market Mutual Fund Reform, Docket No. FSOC-2012-0003, 77 Fed. Reg. 69,455 (Nov. 19, 20120) ("MMF Release"). Under Section 120, any new or heightened standards and safeguards applicable to activities must "take costs into to long-term economic growth into account." 12 U.S.C. § 5330(b)(2)(A). FSOC not only took into account the impact of the proposed recommendations on long-term economic growth, it quantified some aspects of that impact, and it correctly concluded that their impact would be overwhelmingly positive. The release explained that by reducing the risk of runs on MMFs, the Proposed Recommendations would decrease both the likelihood and severity of future financial crises. MMF Release at 69,481. The release further explained that because financial crises have such a profoundly damaging impact on economic activity and economic growth over an extended period, *id.*, "reforms that even modestly reduce the

Finally, a cost-benefit requirement will also make it easier for a designated company to litigate the designation, just as industry groups have relentlessly challenged Securities and Exchange Commission and Commodity Futures Trading Commission regulations relating to mutual fund governance, conflict minerals, and position limits, in large part on grounds that the agencies failed to conduct a sufficient analysis of costs and benefits. As these cases demonstrate, should FSOC force itself to conduct quantitative cost-benefit analysis, and should it actually undertake a Section 113 designation, the end result would more likely be judicial nullification.

This is precisely why Congress determined not to require FSOC to analyze the economic impact of its designation decision on a particular firm: Doing so would frustrate FSOC's ability to implement Congress's objectives and protect the financial system. Congress could not have intended that measures to protect our financial system from the ravages of another financial crisis should hinge on the costs that any particular company might have to shoulder in the reform process.

The D.C. Circuit has held that when Congress has established a regulatory regime to achieve certain ends that it considers beneficial, regulators cannot second-guess that legislative judgment. In *NAM*, the court found that Congress had "conclude[d], as a general matter, that transparency and disclosure would benefit the Congo," by helping to reduce the violence accompanying trade in certain types of minerals. The court held that the SEC could not "question the basic premise that a disclosure regime would help promote peace and stability in the Congo." Similarly here, Congress established the mandatory designation mechanism to prevent another devastating financial crisis, without regard to the collateral costs that companies might have to bear. The language of Section 113 makes that clear. FSOC cannot second-guess Congress by self-imposing a duty that has no basis in the law and that frustrates Congress's policy objectives.[64]

## III. <u>Requiring FSOC to assess the likelihood that a potential designee will experience material financial distress has no basis in the law or sound policy.</u>

### A. The Proposal's requirement that FSOC assess the likelihood of material financial distress is unaccompanied by any persuasive rationale and runs counter to the plain language and intent of Section 113.

In a final effort to extinguish any remaining vitality in the mandatory entity-designation process, the Proposal announces that FSOC will henceforth assess the likelihood of a company's

probability or severity of a financial crisis would have considerable benefits in terms of greater expected economic activity and, therefore, higher expected economic growth," *id.* at 69482. If FSOC finalizes the Proposal in its current form, and insists on conducting cost-benefit analysis in the entity-designation process, it must adhere to this same holistic approach.

64 In *NAM*, Congress had required the SEC to issue a rule to achieve humanitarian goals. Similarly here, FSOC's "purposes and duties" are, *inter alia*, to "require supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability of the United States." 12 U.S.C. § 5322(a)(1)(H).

experiencing material financial when deciding whether to designate a company for enhanced supervision, quantifying that likelihood if possible.[65] Once again, the rationale is obscure and contrary to express statutory directive. This aspect of the Proposal is included as a brief supplement to the discussion about cost-benefit analysis, yet the Release simply asserts that such an assessment is "consistent with sound risk regulation."[66]

However, this aspect of the Proposal, like the others, runs counter to the text of Dodd-Frank as well as Congressional intent. When and how FSOC must exercise its designation authority is a matter of statutory language, and on this point the language of Dodd-Frank Section 113(a)(1) is crystal clear:

> The Council…may determine that a U.S. nonbank financial company **shall** be supervised by the Board of Governors and **shall** be subject to prudential standards… 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.

The import of this language is plain: In making a designation determination with respect to a particular company, material financial distress at the company is to be **assumed** by FSOC, without any attempt at the extraordinarily difficult if not impossible task of calculating, quantifying, or estimating that likelihood. The question for FSOC to answer under Section 113 is whether such material financial distress, were it to occur, "could pose a threat to the financial stability of the United States." Removing any doubt, Section 113 specifies the ten factors that FSOC must consider when engaged in the designation process, and none of them require FSOC to assess the likelihood that the company will experience material financial distress. The Proposal ignores these statutory directives.[67]

### B. This aspect of the Proposal is also bad regulatory policy, one that ignores the lessons of the crisis and therefore increases the likelihood that history will repeat itself.

In addition to conflicting with Congress's clear direction, unnecessarily committing to assess the likelihood of material financial distress in making designation determinations is a grave

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[65] Release at 9035.

[66] Release at 9035.

[67] Nor, contrary to the district court's ruling in *MetLife*, does the **current guidance** call upon FSOC to assess the likelihood of a company experiencing material financial distress. FSOC effectively laid this argument to rest in its briefs defending its designation of MetLife in the district court and the D.C. Circuit as well. *See* Memorandum in Support of Defendant's Motion to Dismiss or, in the Alternative, for Summary Judgment, *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d 219 (D.D.C. 2016) (15-cv-0045), ECF No. 84-1; Memorandum in Support of Defendant's Motion to Dismiss, *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d 219 (D.D.C. 2016) (15-cv-0045), ECF No. 84-2; Brief for Appellant, *MetLife, Inc. v. FSOC*, No. 16-5086 (D.C. Cir. Jun. 16, 2016); Reply Brief for Appellant, *MetLife, Inc. v. FSOC*, No. 16-5086 (D.C. Cir. Sept. 9, 2016).

mistake as a matter of regulatory policy. One of the defining elements of the crisis was the extent to which not only regulators, but markets as a whole, were caught by surprise each time a venerable financial company was revealed to be in mortal trouble. For example, as of March 11, 2018, the SEC opined that the capital position of Bear Sterns was "fine."[68] By March 13, Bear informed the SEC that it "would be unable to operate normally" on March 14, and within days the government was orchestrating a fire sale to JP Morgan to prevent Bear Sterns from collapsing, a development that "stunned" top SEC regulators.[69] Similarly, on September 12, 2008 "experts from the country's biggest commercial investment banks…could not agree whether or not" Lehman Brothers was solvent.[70] By Monday, September 14, 2008, that question was answered conclusively when Lehman became the largest bankruptcy in history. And in August 2008, AIG's primary federal regulator, OTS, stated that it was "generally comfortable with" the firm's liquidity and that AIG "could access the capital markets with no problem if it had to."[71] One month later AIG received a massive bailout to prevent it from collapsing.

Not only regulators, but ratings agencies and the market misjudged the likelihood of "material financial distress" at each of these firms.[72] Moody's rated Bear Stearns as "A2 – Outlook Stable" in December 2007, and did not downgrade it further until March 14, 2008, after its distress was apparent.[73] On March 12, 2008—less than a week before it would be bought by JP Morgan for just $2 a share—Bear's stock closed at $61.58, and on March 14, 2008, after Bear's financial deterioration was clear, Bear's stock still closed at $30.85, over 15 times what JP Morgan would pay.[74] Moody's rated Lehman A2—"high quality and…subject to very low credit risk"—as of September 12, 2008, finally downgrading it **after** it filed for bankruptcy. S&P gave AIG an investment grade A-rating **one week before** it was bailed out by taxpayers.[75]

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68 Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report at 287 (2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

69 *Id.* at 290.

70 *Id.* at 324.

71 *Id.* at 346.

72 That investors and ratings agencies, whose very livelihood depends on correctly assessing the health of companies, so routinely failed to appreciate the dire straits of firms that failed and/or needed to be bailed out during the crisis, exposes a deep misconception in the Proposal. FSOC asserts in the Proposal that it "emphasizes the importance of market discipline, rather than government intervention, as a mechanism for addressing potential risks to U.S. financial stability posed by financial companies." But the entire financial crisis was a stunning rebuke to the notion that "market discipline" was in any way a reliable mechanism to address systemic risk, and FSOC's very existence reflects Congress's clear rejection of reliance on "market discipline" as the primary mechanism to address systemic risk.

73 https://www.moodys.com/credit-ratings/Bear-Stearns-Companies-LLC-The-credit-rating-97500.

74 https://www.reuters.com/article/us-bearstearns-chronology/timeline-a-dozen-key-dates-in-the-demise-of-bear-stearns-idUSN1724031920080317.

75 John Maxfield, Ratings Agencies Are Always the Last to Know (Mar. 14, 2012), MOTLEY FOOL, https://www.fool.com/investing/general/2012/03/14/ratings-agencies-are-always-the-last-to-know.aspx

The lesson, of course, is that a financial firm can go from apparently healthy to in danger of imminent collapse in a matter of months, weeks, or even days.[76] Making these predictions is inherently unreliable, and if they are to serve as a litmus test for designation and enhanced supervision, as indicated in the Proposal, then we are bound to suffer the gravest of consequences. Some firms that harbor the seeds of dramatic instability and potential collapse, with systemic implications, will undoubtedly be judged sound, the protections attending enhanced supervision will be set aside, and the sudden cascade of unforeseen financial instability will once again take hold of our financial system and our economy.

**CONCLUSION**

We hope these comments are helpful as you evaluate the Proposal.

Sincerely,

Dennis M. Kelleher
President & CEO

[76] FSOC's Proposal to conduct likelihood of distress assessments is fraught with other problems as well. It does not give any indication of the timeframe over which it will attempt to determine the likelihood of material financial distress (even as it acknowledges the difficulty of forecasting firm failures beyond a "very short time horizon."). The longer the period, the more useful in guarding against instability through the designation process, but the less reliable the prognostication will be. The Proposal never addresses this tension. Another potential issue is that, if "likelihood" of material financial distress at a firm is a factor in FSOC's designation decision, designation may become a self-fulfilling prophecy. By making a designation, FSOC would be sending a signal to the market that a firm is already in distress, which could very well precipitate the firm's failure before regulatory safeguards can be put in place. Indeed, this could occur if it is publicly revealed that a firm is even under consideration for designation. Essentially, if FSOC adopts this aspect of the Proposal, any action it takes towards making an entity-designation could itself pose a risk not only to the subject firm, but to the entire financial system. Needless to say, FSOC's prior designations—made and implemented in full accordance with the statutory language—did not lead to the failure of the subject firms or precipitate a financial crisis.

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