FSOC Proposes Activities-Based Approach to Regulating Systemic Risk

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Financial Services

On March 6, 2019, the Financial Stability Oversight Council ("FSOC") voted unanimously to issue proposed interpretive guidance ("Proposed Guidance") that would significantly change its approach to designating nonbank financial companies that pose a risk to the financial stability of the United States ("nonbank SIFIs") for supervision and prudential regulation by the Board of Governors of the Federal Reserve System (the "Federal Reserve").[1]

The Proposed Guidance would implement an activities-based approach as FSOC's preferred method of identifying and addressing potential risks to U.S. financial stability in the first instance, and enhance the analytical rigor and transparency of FSOC's process for designating nonbank SIFIs in the event the activities-based approach proves incapable of addressing systemic risk in particular cases. According to the preamble of the Proposed Guidance, FSOC expects that its new approach would better enable it to: (i) leverage the expertise of financial regulatory agencies; (ii) promote market discipline; (iii) maintain competitive dynamics in affected markets; (iv) appropriately tailor regulations to cost-effectively minimize burdens; and (v) ensure FSOC's designation analyses are rigorous and transparent. The Proposed Guidance would replace FSOC's existing 2012 interpretive guidance on nonbank SIFI designations,[2] which did not address the concept of an activities-based approach.

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[1] Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, Proposed Guidance, 84 Fed. Reg. 9028 (March 13, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04488.pdf.

[2] *See* 12 C.F.R. part 1310, app. A. In April 2012, FSOC issued interpretive guidance as an appendix to a final rule that added a new part 1310 to Title 12 of the C.F.R. The Proposed Guidance would modify the appendix, but would not modify the final rule. The Proposed Guidance would also rescind FSOC's supplemental procedures to the 2012 final rule and interpretive guidance and its 2015 staff guidance regarding the methodologies used in stage 1 of the designation process. *See* Financial Stability Oversight Council, Supplemental Procedures Relating to Nonbank Financial Company Determinations (Feb. 4, 2015), *available at* https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf; Financial Stability Oversight Council, Staff Guidance, Methodologies Relating to Stage 1 Thresholds (June 8, 2015), *available at* https://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf.

This client alert summarizes the most significant themes of the Proposed Guidance in greater detail. Most notably, the Proposed Guidance would deemphasize nonbank SIFI designation as a tool for preventing and reducing systemic risk by prioritizing the activities-based approach. FSOC would have a more limited role under an activities-based approach, and would, in many instances, rely on relevant federal and state regulators to address products, activities, and practices it identifies as potentially posing a risk to U.S. financial stability. In addition, the Proposed Guidance is designed to incentivize companies conducting activities that present risks to U.S. financial stability to take steps to mitigate such risks to avoid designation as a nonbank SIFI or to have a designation rescinded. While this will be a welcome change for nonbank financial companies that were previously designated or evaluated for designation, the activities-based approach may lead to uncertainty for nonbank financial institutions (as well as banks) seeking to engage in new products and services that may not currently be subject to extensive regulation, but could become the focus of FSOC's reviews. The Proposed Guidance does not address whether the public will have transparency into the products, activities, and practices FSOC is evaluating.

The Proposed Guidance also includes a number of changes to increase the rigor and transparency of the analytical framework that FSOC uses to designate nonbank SIFIs. This would include removing elements of the process outlined in the 2012 interpretive guidance that created confusion or were not useful to FSOC's evaluations. The Proposed Guidance would also require FSOC, as part of the designation evaluation process, to conduct a cost-benefit analysis (including the costs to the nonbank financial company that would be designated) and evaluate not only the *impact* of the company's material financial distress, but also its *likelihood* of experiencing material financial distress.

Although FSOC has concluded that the notice and comment requirements of the Administrative Procedure Act ("APA") do not apply to the Proposed Guidance, FSOC has released the Proposed Guidance for public comment. Comments are due May 13, 2019. FSOC also contemporaneously published a final rule stating that it may not amend or rescind the Proposed Guidance, once finalized, without providing public notice and an opportunity to comment consistent with the APA.[3]

Background

The Dodd-Frank Act created FSOC with a mandate to: (i) identify risks to U.S. financial stability; (ii) promote market discipline; and (iii) respond to emerging threats to the stability of the U.S. financial system. FSOC is comprised of ten voting members and five nonvoting members. Its members include federal financial regulators, state regulators, and an independent insurance expert appointed by the President. FSOC's statutory duties include: (i) monitoring the financial services marketplace to identify potential threats to U.S. financial stability; (ii) recommending to FSOC member agencies general supervisory priorities and principles; (iii) recommending to

[3] Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, Final Rule, 84 Fed. Reg. 8958 (March 13, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04487.pdf.

primary financial regulatory agencies[4] to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among financial companies and markets; and (iv) designating nonbank financial companies for supervision and regulation by the Federal Reserve, including the application of prudential standards.

FSOC has previously issued rules, guidance, and other public statements regarding its process for evaluating nonbank financial companies for a potential nonbank SIFI designation. In July 2013, FSOC designated American International Group, Inc. ("AIG") and GE Capital Global Holdings, LLC ("GE Capital") as the first nonbank SIFIs. FSOC designated Prudential Financial, Inc. ("Prudential") in September 2013 and MetLife, Inc. ("MetLife") in December 2014. Additionally, industry observers viewed a September 2013 report by the Office of Financial Research as a potential prelude to designations of large asset managers as nonbank SIFIs.

FSOC voted to rescind the designations of GE Capital in June 2016, AIG in September 2017, and Prudential in October 2018. MetLife sued FSOC, arguing that its designation was unlawful because FSOC did not demonstrate the firm's actual likelihood of distress, and ultimately prevailed.[5] Under the Trump Administration, FSOC has not publicly taken any action towards designating additional firms as nonbank SIFIs.

In April 2017, President Trump directed the Secretary of the Treasury, who chairs FSOC, to review the nonbank SIFI designation process and make recommendations for regulatory or legislative changes to the process. Treasury's ensuing report, issued in November 2017, concluded that FSOC should focus more on identifying systemically risky activities than on designating individual firms, consult with regulators of companies engaging in such activities to address systemic risk, and designate individual companies only as a last resort.[6] As detailed below, the Proposed Guidance largely tracks the recommendations of Treasury's November 2017 report.

Shift to Activities-Based Approach

The Proposed Guidance would prioritize FSOC's mandate to identify and address potential risks to U.S. financial stability by addressing activities, rather than individual firms, that pose such risks. This activities-based approach is intended to enable FSOC to identify and address potential risks and emerging threats on a system-wide basis and "reduce the potential for competitive market distortions" that could arise from designating specific entities. The Proposed Guidance makes clear that FSOC would designate individual companies as nonbank SIFIs *only if* a potential risk or threat to financial stability cannot be addressed through an activities-based

[4] "Primary financial regulatory agency" is defined in section 2(12) of the Dodd-Frank Act to include a broad range of financial regulators, including federal and state prudential and market regulators. *See* 12 U.S.C. § 5301(12).

[5] FSOC and MetLife filed a joint motion in January 2018 to dismiss the appeal to the U.S. Court of Appeals for the District of Columbia Circuit of the March 2016 lower-court ruling that invalidated the MetLife designation.

[6] Report to the President of the United States Pursuant to the Presidential Memorandum Issued April 21, 2017, Financial Stability Oversight Council Designations (Nov. 17, 2017), *available at* https://www.treasury.gov/press-center/press-releases/documents/pm-fsoc-designations-memo-11-17.pdf.

approach. In a footnote, the preamble to the Proposed Guidance states that FSOC would be most likely to designate individual companies "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." This approach would be a significant departure from the Obama Administration's use of the designation authority, which focused on entity designations as a means to prevent emergency situations from arising in the first place.

The Proposed Guidance would establish a two-step process for the activities-based approach. In the first step, FSOC, in consultation with relevant financial regulatory agencies, would examine and monitor a broad scope of financial markets and market developments to identify products, activities, or practices that could pose risks to financial stability. Products, activities, or practices to be reviewed include those related to: (i) the extension of credit; (ii) the use of leverage or short-term funding; (iii) the provision of guarantees of financial performance; and (iv) other key functions critical to support the operation of financial markets. Examples of markets FSOC would monitor include: (i) corporate and sovereign debt and loan markets; (ii) equity markets; (iii) markets for other financial products, including structured products and derivatives; (iv) short-term funding markets; (v) payment, clearing, and settlement functions; (vi) new or evolving financial products, activities, and practices; and (vii) developments affecting the resiliency of financial market participants.

If FSOC identified a product, activity, or practice that could pose a potential "risk to U.S. financial stability"—defined as a risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy—FSOC would consult with relevant financial regulatory agencies to determine whether the potential risk merited further review or action.

The Proposed Guidance provides that FSOC would evaluate the extent to which certain characteristics, which themselves may not present risks to U.S. financial stability, could present such risks based on the combination or prominence of such characteristics in the products, activities, or practices being evaluated. Examples of such characteristics include: (i) asset valuation risk or credit risk; (ii) leverage, including leverage arising from debt, derivatives, off-balance sheet obligations, and other arrangements; (iii) liquidity risk or maturity mismatch, such as reliance on funding sources that could be susceptible to dislocations; (iv) counterparty risk and interconnectedness among financial market participants; (v) the transparency of financial markets, such as growth in financial transactions occurring outside of regulated sectors, among others; (vi) operational risks, such as cybersecurity risks and operational resilience; or (vii) the risk of activities that destabilize markets for particular types of financial instruments, such as trading practices that substantially increase volatility in key markets. FSOC would also evaluate various other factors that may exacerbate or mitigate systemic risks, such as the complexity or opacity of the activities, whether there are applicable regulatory requirements, the extent of risk management practices associated with the product or activity, and whether activities are significantly correlated with other financial products, highly concentrated, or significant and widespread.

Finally, the first step of FSOC's analysis would generally focus on four overarching framing questions:

1. how the potential risk could be triggered;

2. how adverse effects of the potential risk may be transmitted to financial markets or market participants;
3. what impact would the potential risk have on the financial system; and
4. whether the adverse effects of the potential risk could impair the financial system in a manner that could harm the non-financial sector of the U.S. economy.

In the second step, FSOC would in the first instance work with regulators to address the product, activity, or practice that it identified as a potential risk to financial stability, rather than designate an individual company as a nonbank SIFI. For example, the relevant federal and state financial regulatory agencies, which FSOC states generally possess greater information and expertise with respect to company, product, and market risks, may appropriately modify their regulation or supervision of companies or markets under their jurisdiction. Thus, if a particular type of financial product is identified, a regulator may elect to restrict or prohibit the product or require market participants to take additional risk management steps that address the identified risks associated with the product. FSOC would coordinate among its member agencies and follow up on supervisory or regulatory actions by relevant federal and state regulators to ensure the potential risk is adequately addressed. This coordination would generally involve informal nonpublic actions, such as increased information sharing between relevant regulatory agencies.

As necessary, FSOC could also take more formal public measures such as issuing recommendations to regulators or to the public, via supervisory guidance or in FSOC's annual report. If FSOC found that the regulators' actions were insufficient to address the identified potential risk to U.S. financial stability, it would use its statutory authority to "provide for more stringent regulation of a financial activity," following consultation with the primary financial regulatory agency and public notice inviting comments, by publicly issuing *nonbinding* recommendations to regulators to apply new or heightened standards and safeguards for a financial activity or practice conducted by companies under their jurisdictions. FSOC does not have the authority to supervise products, activities, or markets directly, thus its actions are limited to working with relevant federal and state regulators or issuing nonbinding supervisory or regulatory guidance.

If no primary financial regulatory agency exists for the company or companies conducting financial activities or practices identified as posing risks to financial stability, the Proposed Guidance states that FSOC could consider reporting to Congress on recommendations for legislation that would prevent such activities or practices from threatening U.S. financial stability.

Increasing Rigor of Nonbank SIFI Designation Analyses

If the activities-based approach would not adequately address potential risks to U.S. financial stability, FSOC may subject a nonbank financial company to review for an entity-specific designation. The Proposed Guidance would include a number of changes that are intended to increase the rigor of the analytical framework that FSOC uses to evaluate a nonbank financial company for a potential designation and FSOC's annual reevaluations of any such designations. Certain of these changes would also address legal deficiencies in FSOC's prior designation framework as identified in the United States District Court for the District of

Columbia's opinion in the *MetLife* litigation.[7] Accordingly, these changes would be expected to bolster FSOC's defenses against legal challenges to future nonbank SIFI designations.

The changes include the following:

- ***Cost-Benefit Analysis Requirement.*** Under the Proposed Guidance, FSOC would consider the benefits and costs of a nonbank SIFI designation for the U.S. financial system, the U.S. economy, and the nonbank financial company. FSOC would designate a nonbank SIFI only if the expected benefits justified the expected costs of the designation. The *MetLife* court held that FSOC is required under the Dodd-Frank Act to conduct such a cost-benefit analysis, and that its failure to do so when designating MetLife as a nonbank SIFI was "arbitrary and capricious" under the APA.
- ***Consideration of Probability of Distress.*** Under the Proposed Guidance, before designating a nonbank SIFI, FSOC would consider not only the *impact* of the company's material financial distress, but also its *likelihood* of experiencing material financial distress. While FSOC's 2012 interpretive guidance is less explicit about this issue, the *MetLife* court held that such guidance also requires FSOC to consider the likelihood of material financial distress. The court further held that FSOC had violated its own guidance by failing to consider MetLife's probability of distress in the designation process.
- ***Higher Bar to Pose Threat to Financial Stability.*** Under the Dodd-Frank Act, FSOC may designate a nonbank SIFI if it finds that the material financial distress of a nonbank financial company, or its activities, could pose a "threat to the financial stability of the United States." The Proposed Guidance would define "threat to the financial stability of the United States" as the threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict "severe damage" on the broader economy. The 2012 interpretive guidance uses the term "significant damage," which set a lower bar for systemic importance.
- ***Treatment of Asset Managers.*** Under existing FSOC standards that would remain in effect under the Proposed Guidance, one of the ways in which a nonbank financial company could pose a risk to U.S. financial stability is through the "exposure transmission channel" (*i.e.*, the direct or indirect exposure that creditors, counterparties, investors, or other market participants have to the company).[8] The Proposed Guidance states that, in the case of a nonbank financial company that manages assets on behalf

[7] *MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219, 242 (D.D.C. 2016). One of the questions in the preamble to the Proposed Guidance is whether FSOC should interpret its nonbank SIFI designation authority in a manner that is consistent with the District Court's decision.

[8] The Proposed Guidance, like the 2012 interpretive guidance, provides that FSOC's evaluation of a nonbank financial company for designation will focus primarily on how the negative effects of the company's material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could be transmitted to other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning. The Proposed Guidance enhances and clarifies FSOC's analyses under the three transmission channels identified in the 2012 interpretive guidance as most likely to facilitate the transmission of these negative effects: (1) the exposure transmission channel; (2) the asset liquidation transmission channel; and (3) the critical function or service transmission channel.

of third parties, the third parties' direct financial exposures for purposes of the exposure transmission channel are often to the issuers of the managed assets, rather than to the nonbank financial company managing those assets. This language will be welcome to large asset managers. Policymakers and industry observers were sharply critical of FSOC's review of the asset management industry for potential designations of nonbank SIFIs under the Obama Administration.[9]

Streamlining Nonbank SIFI Designation Process

The Proposed Guidance includes a number of changes designed to make the nonbank SIFI designation process more efficient for FSOC and nonbank financial companies under consideration as nonbank SIFIs. For example, the Proposed Guidance would eliminate the six-category analytical framework set forth in the 2012 interpretive guidance. The Dodd-Frank Act requires FSOC to take into account ten considerations when evaluating a company for a potential nonbank SIFI designation, and the 2012 interpretive guidance groups these ten considerations into six categories. FSOC has concluded that this grouping "has not proven useful" in guiding FSOC's evaluations.

Further, under the 2012 interpretive guidance, potential designation of a nonbank SIFI begins with the application of a set of uniform quantitative metrics to a broad range of nonbank financial companies in order to identify one or more nonbank financial companies for further evaluation. The Proposed Guidance would eliminate this step, which FSOC concluded has "generated confusion among firms and members of the public" and is incompatible with prioritizing an activities-based approach to addressing systemic risk.

Potential designation of a nonbank SIFI under the Proposed Guidance would instead begin with a nonpublic notice to a nonbank financial company that has been identified as potentially posing risks to U.S. financial stability. Additionally, at this stage, FSOC would endeavor to engage "extensively" with the nonbank financial company under consideration for a designation, as well as the company's regulators, all with the goal of collecting more data and higher quality data to review before making a designation. The Proposed Guidance states that FSOC members and their agencies and staffs will maintain the confidentiality of all such information in accordance with applicable law.

Another stated goal of the Proposed Guidance is providing a company under review with greater visibility into the process and enhanced engagement to enable the company to take actions to mitigate the risks FSOC has identified and avail itself of the designation "off-ramp" without incurring the higher costs associated with FSOC's in-depth evaluation in stage 2. Under the Proposed Guidance, FSOC's analysis in stage 2 would involve extensive engagement with the company, including meeting with the representatives of the company and notifying the company of any specific issues identified in stage 1. FSOC would also continue to engage with

[9] Critics of the potential designation of asset managers included former Congressman Barney Frank (D-MA), a principal author of the Dodd-Frank Act. According to Congressman Frank, "When we were writing the law, I certainly felt that it was entities that were engaged on their own in large bets facing serious risks for their money that were the likeliest to get into trouble. I was frankly surprised to see suggestions that the asset managers that are diversified and fairly stolid in their approach would be considered." Fidelity Not a 'Systemic Risk' in Barney Frank's Book, Financial Times (Dec. 7, 2013), *available at* https://www.ft.com/content/08f8d538-5ddb-11e3-8fca-00144feabdc0.

the company's regulators and encourage them to make changes during the designation process to address the identified risk, which may result in FSOC discontinuing the designation process. If FSOC voted to make a proposed designation, it would issue a nonpublic written notice and explanation of the proposed designation to the company that it would also provide to the company's regulators. If after the proposed designation, and any requested nonpublic written or oral hearing to contest the proposed designation, FSOC decided to make a final designation, it would similarly provide a nonpublic written notice and explanation to the company as well as its regulators, that, consistent with the 2012 interpretive guidance, it would endeavor to provide at least one business day before publicly announcing the designation.

Incentivizing Companies to Address Risks to Avoid Designation

As noted, the Proposed Guidance is intended to incentivize companies conducting activities that present risks to U.S. financial stability to take steps to mitigate such risks to avoid designation as a nonbank SIFI or to have a designation rescinded. Under the new entity designation process outlined in the Proposed Guidance, if a nonbank financial company is under review for designation, FSOC would increase its engagement with the company and its existing regulators. This engagement would provide the nonbank financial company with greater visibility into the aspects of its business that may pose risks to U.S. financial stability, and would enable the company to make changes to mitigate those risks prior to any designation, thereby providing a potential pre-designation "off-ramp." Enhanced engagement would also allow the nonbank financial company under review to provide FSOC with relevant information on a confidential basis, which would help ensure that FSOC is reviewing a full and diverse array of data in making designation decisions.

The Proposed Guidance also suggests that FSOC would be more inclined going forward to rescind designations of companies that address FSOC's concerns. The Proposed Guidance includes post-designation "off-ramp" procedures and states that FSOC "intends to encourage" a designated nonbank SIFI and its regulators to take steps to mitigate the potential risks FSOC identified when it designated the company. If a nonbank SIFI adequately addressed such risks, FSOC "should generally be expected to rescind its determination regarding the company" unless new material risks arose. FSOC is required to reevaluate a final designation at least annually, and the Proposed Guidance states that FSOC may also consider a request for an evaluation before the next evaluation in the event of an extraordinary change that materially decreases the threat to U.S. financial stability.

Conclusion

The Proposed Guidance represents a significant change to FSOC's use of its statutory authorities by deemphasizing the nonbank SIFI designation as a tool for preventing and reducing systemic risk. Under the Proposed Guidance, FSOC would have a more limited role, one where its primary functions include monitoring market developments; facilitating information sharing and regulatory coordination among agencies; bringing primary financial regulators together to identify and mitigate risks to financial stability; and, if necessary, taking more formal measures such as issuing public recommendations to address these risks or reporting to Congress. While nonbank financial companies that previously found themselves in FSOC's crosshairs will applaud this change in approach, FSOC under a future presidential administration may yet revert to the Obama Administration's more extensive use of the statutory designation authority. However, under the final rule published contemporaneously with the Proposed Guidance, a future FSOC would be required to engage in notice and comment rulemaking to do so—unless it chose first to rescind such rule.

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