COMMITTEE ON CAPITAL MARKETS REGULATION

Revisiting FSOC's Power to Designate Nonbank SIFIs

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The Committee thanks its research staff, including John Gulliver (Executive Director) and Jessie Stefanik (Senior Research Fellow) for their role in the preparation of this report.

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Table of Contents

Introduction

The Committee on Capital Markets Regulation (the "**Committee**") believes that designating regulated nonbank financial companies as systemically important financial institutions ("**nonbank SIFIs**") and subjecting them to enhanced supervision and regulation by the Board of Governors of the Federal Reserve System ("**Federal Reserve**") is unworkable and harmful to U.S. financial markets and the economy. Our work over the past 15 years has emphasized our strong opposition to the Financial Stability Oversight Council's ("**FSOC**") authority to single out nonbanks for SIFI designation and has extensively explained why such a designation is unlikely to benefit financial stability.[1]

In this report, we begin by reviewing the history of FSOC, its powers, and the legal and regulatory framework for designating nonbank SIFIs. We next explain why entity-based designation and regulation by the Federal Reserve does not work to reduce systemic risk from a policy perspective. Notably, the Federal Reserve and the regulations it has designed for the banking sector are ill-suited to regulate nonbanks. We then explain our view of the proper role of FSOC—identifying and addressing activities-based systemic risks—and suggest a possible alternative designation process that would avoid many of the harms of the current framework. We conclude by strongly recommending that Congress act to repeal FSOC's power to designate nonbank SIFIs, or at the very least statutorily amend the designation process so that it can only be used in the extreme circumstance where an entity does not have an existing regulator, is performing a unique critical function, the risk stemming from that activity could not be adequately addressed by activities-based regulation, and designation would have a clear net benefit to financial stability that exceed the costs of designation.

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[1] *See, e.g.*, Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs and Blanche Lincoln, Chairman, Saxby Chambliss, Ranking Member, S. Comm. on Ag., Nutrition & Forestry (Apr. 26, 2010) [hereinafter 2010 Letter to Senate Members]; Memo from Hal S. Scott, Director, Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs (May 4, 2010) [hereinafter 2010 Scott Memo]; Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. (June 14, 2010); Letter from the Comm. on Capital Mkts. Reg. to Timothy F. Geithner, Chairman, Fin. Stability Oversight Council (Nov. 5, 2010) [hereinafter 2010 Letter to FSOC]; Letter from the Comm. on Capital Mkts. Reg. to Lance Auer, Fin. Stability Oversight Council (Feb. 22, 2011); Letter from the Comm. on Capital Mkts. Reg. to Lance Auer, Fin. Stability Oversight Council (Dec. 19, 2011); Letter from Comm. on Capital Mkts. Reg. to Neal S. Wolin, Acting Chairman, Fin. Stability Oversight Council (Feb. 15, 2013) [hereinafter 2013 Letter to FSOC]; Letter from Comm. on Capital Mkts. Reg. to Fin. Stability Oversight Council (Mar. 16, 2015); Due Process and Transparency in Non-Bank SIFI Designations, Hearing before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services, 114th Cong. (Nov. 19, 2015) (written testimony of Hal S. Scott, Director, CCMR); COMM. ON CAPITAL MKTS. REG., ROADMAP FOR REGULATORY REFORM (May 2017), https://www.capmktsreg.org/wpcontent/uploads/2018/10/Roadmap-for-Regulatory-Reform.pdf; Letter from the Comm. on Capital Mkts. Reg. to Mark Schlegel, Fin. Stability Oversight Council (Apr. 25, 2019) [hereinafter 2019 Letter to FSOC]; Letter from the Comm. on Capital Mkts. Reg. to Eric Froman, Fin. Stability Oversight Council (June 27, 2023) [hereinafter 2023 Letter to FSOC]. *See also* Letter from the Comm. on Capital Mkts. Reg. to the Secretariat, Fin. Stability Bd. (Apr. 7, 2014); Letter from the Comm. on Capital Mkts. Reg. to the Secretariat, Fin. Stability Bd. (Sept. 21, 2016); Letter from the Comm. on Capital Mkts. Reg. to Secretariat, Fin. Stability Bd. (May 29, 2015); *Data on Why SIFI Designation Is Not the Answer to Possible Herding Behavior by Asset Managers*, COMMITTEE ON CAPITAL MARKETS REG. (May 17, 2014), https://capmktsreg.org/why-sifi-designation-is-not-the-answer-to-possible-herding-behavior-by-asset-managers/.

I. FSOC's History and Regulatory Remit

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank Act**") established FSOC in response to the 2008 financial crisis to monitor and address risks to U.S. financial stability. Prior to the crisis, "[n]o single regulator had responsibility for monitoring and addressing broader risks to financial stability, which often involve different types of financial firms operating across multiple markets."[2] FSOC's purpose is threefold: (1) "to identify risks to the financial stability of the United States…;" (2) "to promote market discipline, by eliminating expectations… that the Government will shield [stakeholders] from losses in the event of failure [of large, interconnected bank holding companies or nonbank financial companies];" and (3) "to respond to emerging threats" to U.S. financial stability.[3]

Dodd-Frank granted FSOC a range of statutory tools to achieve these goals, including: (1) collecting information from regulatory agencies and requesting data and analysis from the Office of Financial Research; (2) facilitating information sharing and coordination between regulators regarding financial services policy; (3) identifying regulatory gaps and recommending general supervisory priorities and principles to its member agencies; (4) making policy recommendations to financial regulatory agencies and the Federal Reserve; (5) designating systemically important financial market utilities ("**SIFMUs**") or payment, clearing and settlement activities for enhanced regulation; and (6) designating nonbank SIFIs for enhanced regulation.[4]

As the above list demonstrates, FSOC's nonbank SIFI designation power is just one of the tools that it can use to respond to potential risks to U.S. financial stability. For example, FSOC may exercise its formal statutory authorities to "make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards" to a financial activity or practice presenting a systemic risk.[5] The primary financial regulatory agencies include the Federal banking agencies, the Securities and Exchange Commission, the Commodity Futures Trading Commission, state insurance authorities, and the Federal Housing Finance Agency, as defined by Dodd-Frank ("**primary regulators**").[6]

Nonbank SIFI designation is also distinct from FSOC's power to designate SIFMUs. A financial market utility is "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions" between financial institutions and other parties.[7] This includes clearing organizations and clearing agencies. As the Committee has previously explained, although centralized clearing reduces systemic risk, the failure of a clearinghouse could itself contribute significantly to systemic risk

[2] *About FSOC*, U.S. DEPARTMENT TREASURY, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/about-fsoc (last visited Feb. 18, 2025).
[3] 12 U.S.C. § 5322(a)(1).
[4] 12 U.S.C. § 5322(a)(2).
[5] 12 U.S.C. § 5322(a)(2)(K); 2019 Letter to FSOC, *supra* note 1, at 2-3.
[6] 12 U.S.C. § 5301(12).
[7] 12 USC § 5462(6)(A).

because it serves as a counterparty in each cleared transaction.[8] This report therefore does not focus on SIFMU designation.

[8] Letter from the Comm. on Capital Mkts. Reg. to Lance Auer, Fin. Stability Oversight Council 2 (May 13, 2011)*; see also* 2010 Letter to Senate Members, *supra* note 1, at 4.

II. Framework for Designating Nonbank SIFIs

Under Dodd-Frank, FSOC may designate a nonbank financial company for supervision by the Federal Reserve if it determines that it, "may pose risks to the financial stability of the United States in the event of [its] material financial distress or failure, or because of [its] activities."[9] Dodd-Frank specifies eleven characteristics FSOC must use in making its determination, including the: (1) extent of leverage; (2) nature of off-balance-sheet exposures; (3) relationships to other significant nonbank financial and bank holding companies; (4) importance as a source of credit and liquidity; (5) importance as a source of credit for low-income, minority, or underserved communities; (6) whether assets are managed or owned; (7) nature, scope, size, scale, concentration, interconnectedness, and mix of activities; (8) degree of existing regulation by primary financial regulatory agencies; (9) amount and nature of assets; (10) amount and nature of liabilities; and (11) "any other risk-related factors that [FSOC] deems appropriate."[10]

The Dodd-Frank Act then requires the Federal Reserve to establish enhanced prudential standards for designated nonbank SIFIs, including risk-based capital requirements, leverage limits, and liquidity requirements, although the Federal Reserve may tailor its approach to each individual company.[11]

In April 2012, FSOC adopted a rule relating to its nonbank SIFI designation authority which reiterates the statutory factors (the "**2012 Rule**") and also issued interpretive guidance (the "**2012 Guidance**"). In December 2019, FSOC replaced the 2012 Guidance with new guidance, adopting an "activities-based approach" and committing FSOC to conducting a cost-benefit analysis before designating a nonbank financial company as a SIFI (the "**2019 Guidance**").[12] Under the activities-based approach, FSOC would first seek to address a potential risk to financial stability through generally applicable regulation of the activity and would only pursue a nonbank SIFI designation if such activity-based regulation could not address the potential risk.[13]

In November 2023 FSOC again replaced its interpretive guidance (the "**2023 Guidance**").[14] The 2023 Guidance eliminates the "activities-based approach" whereby FSOC seeks to address potential systemic risks posed by nonbank financial institutions through general activity-wide regulation before considering whether to designate an institution as a SIFI.[15] The 2023 Guidance also states that FSOC will not conduct a cost-benefit analysis prior to designation.[16] FSOC contemporaneously issued a separate non-binding document "describ[ing] the [substantive] approach [FSOC] expects to take in identifying, assessing, and responding to certain potential risks

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[9] 12 U.S.C. § 5322(a)(2)(H).
[10] 12 U.S.C. § 5323(a)(2).
[11] 12 U.S.C. § 5365.
[12] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 88 Fed. Reg. 71,740, 71,742 (Dec. 30, 2019) (codified at 12 C.F.R. pt. 1310).
[13] *Id*. at 71,761.
[14] Guidance on Nonbank Financial Company Determinations, 88 Fed. Reg. 80,110 (Nov. 17, 2023) (codified at 12 C.F.R. pt. 1310).
[15] *Id.* at 80,119-80,120; *see also* 2023 Letter to FSOC, *supra* note 1, at 4.
[16] Guidance on Nonbank Financial Company Determinations, 88 Fed. Reg. at 80,121.

to U.S. financial stability," which it referred to as its "**Analytical Framework**."[17] The Analytical Framework sets out an "indicative [list] of the vulnerabilities and metrics [FSOC] expects to consider" to evaluate risks to financial stability, which is "not exhaustive or exclusive," including: leverage, liquidity risk and maturity mismatch, interconnections, operational risks, complexity or opacity, inadequate risk management, concentration, and destabilizing activities.[18]

[17] Analytical Framework for Financial Stability Risk Identification, Assessment and Response, 88 Fed. Reg. 78,026, 78,026 (Nov. 14, 2023).
[18] *Id.* at 78,033-34.

III. History of Non-Bank SIFI Designation

Since FSOC's creation a total of four nonbank SIFIs have been designated, and each has also been subsequently de-designated – GE Capital (designated July 2013–June 2016), AIG (July 2013–September 2017), Prudential (September 2013–October 2018), and MetLife (December 2014–March 2016).[19] GE Capital is a nonbank lender, while the remaining three firms are insurance companies.

MetLife was de-designated in 2016 after a successful court challenge, in which the federal district court found that FSOC's action to designate MetLife was arbitrary and capricious for not adhering to FSOC's own stated guidance and for failing to conduct a cost-benefit analysis as required by law.[20] Although MetLife was de-designated by the court, MetLife began to shrink in size while it lawsuit was pending, eventually spinning off $219 billion in assets into a new company in August 2017,[21] representing approximately 25% of MetLife's total assets at the time.[22]

The remaining three companies were de-designated after various reductions in size and activities, and a change in Administration.[23] After designation GE Capital announced plans to dramatically shrink its financial businesses in consultation with FSOC, with the stated goal of shedding its nonbank SIFI designation.[24] From the end of 2012, six months prior to its designation, to March 2016, when it formally requested de-designation, GE Capital reduced its total assets from $549 billion to $265 billion.[25] It also reduced its exposure to short-term commercial paper funding from $43 billion to $5 billion over the same time period.[26] In recognition of its restructuring and reduction in size, FSOC de-designated GE Capital in June 2016.[27]

AIG and Prudential were de-designated after a change in administration from the Obama Administration to the Trump Administration. AIG was de-designated in September 2017 after FSOC "identified changes" at the company, including reductions in "the amounts of its total debt outstanding, short-term debt, derivatives, securities lending, repurchase agreements, and total assets," and also revaluated its prior conclusions regarding the risk of distressed asset sales at the

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[19] MARC LABONTE, CONG. RSCH. SERV., FINANCIAL REGULATION: SYSTEMIC RISK 12 (Feb. 1, 2022).

[20] MetLife, Inc. v. Fin. Stability Oversight Council, 177 F. Supp. 3d 219 (D.D.C. 2016).

[21] Press Release, *Brighthouse Financial Completes Spin-Off from MetLife, Inc. and Celebrates First Day of Trading*, BRIGHTHOUSE FIN. (Aug. 7, 2017), https://investor.brighthousefinancial.com/news-releases/news-release-details/brighthouse-financial-completes-spin-metlife-inc-and-celebrates.

[22] *Fitch Downgrades Brighthouse Financial, Inc.; Outlook Stable*, FITCHRATINGS (May 31, 2017, 4:28 PM), https://www.fitchratings.com/research/insurance/fitch-downgrades-brighthouse-financial-inc-outlook-stable-31-05-2017; *see also* METLIFE, INC., FORM 10-Q (Nov. 6, 2017), https://www.sec.gov/Archives/edgar/data/1099219/000093783417000031/met-2017930x10q.htm.

[23] MARC LABONTE & BAIRD WEBEL, CONG. RSCH. SERV., AFTER PRUDENTIAL, ARE THERE ANY SYSTEMICALLY IMPORTANT NONBANKS? (Nov. 29, 2018).

[24] Press Release, GE, *GE to Create Simpler, More Valuable Industrial Company by Selling Most GE Capital Assets* (Apr. 10, 2015), https://www.ge.com/news/press-releases/ge-create-simpler-more-valuable-industrial-company-selling-most-ge-capital-assets.

[25] Ted Mann, *GE Files to End Fed Oversight After Shrinking GE Capital*, WSJ (Mar. 31, 2016, 3:28 PM), https://www.wsj.com/articles/ge-files-to-end-fed-oversight-after-shrinking-ge-capital-1459423851.

[26] *Id.*

[27] Ted Mann & Ryan Tracy, *GE Capital Sheds 'Systemically Important' Label*, WSJ (June 29, 2016, 7:11 PM), https://www.wsj.com/articles/ge-capital-sheds-systemically-important-label-for-too-big-to-fail-firms-1467205963.

company.[28] In a statement on the decision, then-Chair of the Federal Reserve Janet Yellen highlighted AIG's contraction in size, including a reduction in assets of over $500 billion since the financial crisis.[29] That reduction represented more than a 50% decrease in AIG's total assets.[30] However, the majority of AIG's restructuring occurred before it was designated,[31] and FSOC's de-designation opinion also noted that AIG was now "following a corporate strategy not to engage in the types of *activities*…. that were the primary source of its risks before the financial crisis."[32]

Prudential was de-designated in October 2018 and was the only nonbank SIFI that did not undertake any major restructuring, instead growing in size.[33] FSOC's decision to rescind Prudential's designation was multifactored and cited the company's increased holdings of highly liquid assets, reduction in leverage, reduction in exposures to large banks, and changes in New Jersey law which allowed the state insurance regulator to better supervise Prudential on a group-wide basis.[34] Prudential was de-designated one month after the U.S. Treasury Department announced that FSOC would be moving to an activities-based approach.[35]

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28 FIN. STABILITY OVERSIGHT COUNCIL, NOTICE AND EXPLANATION OF THE BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S RESCISSION OF ITS DETERMINATION REGARDING AMERICAN INTERNATIONAL GROUP, INC. (AIG) 5 (Sept. 2017) [hereinafter AIG RESCISSION].

29 Statement, Janet L. Yellen, Chair, Fin. Stability Oversight Council (Oct. 2, 2017), https://www.federalreserve.gov/newsevents/pressreleases/other20171002a.htm.

30 LABONTE & WEBEL, *supra* note 23, at 1.

31 *Id.* at 1-2.

32 AIG RESCISSION, *supra* note 28, at 5 (emphasis added).

33 LABONTE & WEBEL, *supra* note 23, at 1.

34 FIN. STABILITY OVERSIGHT COUNCIL, NOTICE AND EXPLANATION OF THE BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S RESCISSION OF ITS DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. (PRUDENTIAL) 7-8, 15 (Oct. 16, 2018); LABONTE & WEBEL, *supra* note 23, at 2.

35 *See* John Heltman, *Prudential, the Last Nonbank SIFI, Sheds the Label*, AM. BANKER (Oct. 17, 2018, 9:08 AM), https://www.americanbanker.com/news/prudential-the-last-nonbank-sifi-sheds-the-label.

IV. Analysis of Nonbank SIFI Designation

The Committee has long opposed labelling nonbank financial companies as systemically important, raising our objections to legislators during debates on the Dodd-Frank Act.[36] As the Committee has explained in several previous letters, designating individual nonbanks as SIFIs is unworkable and unfit for purpose, both in theory and in practice, for several reasons. First, there is no principled way to identify which nonbanks are systemically important. Second, designation and regulation by the Federal Reserve is not an appropriate way to mitigate any financial stability risk stemming from such entities. Third, FSOC's implementation of the nonbank SIFI designation power has been seriously flawed. We discuss each of these points below.

a. There is No Principled Way to Identify "Systemically Important" Firms

There is no principled way to single out nonbanks for designation. As the Committee has previously explained, we cannot tell which firms are systemically important *a priori*.[37]

In practice, the existing designation framework is severely flawed in this respect. The current standards are so general and vague that they could conceivably apply to any nonbank financial company. For example, it is unclear what weight should be placed on each of the various statutory factors like scope, size, and scale of an activity and what those terms mean precisely.[38] The criteria in FSOC's Analytical Framework – such as "inadequate risk management" and "destabilizing activities" – fail to add any meaningful specificity to the statutory language and do not provide nonbank financial companies with any ability to predict whether they are susceptible to classification as a SIFI.[39] Moreover, the Analytical Framework is nonbinding, as it provides only "indicative" criteria that FSOC "expects" to use, and FSOC itself states that any evaluation process will be "highly fact-specific."[40] Furthermore, by leaving too much discretion to FSOC, the vagueness of the criteria will inevitably lead to costly and time-consuming litigation. The Committee previously warned of this risk,[41] which was borne out by MetLife's successful legal challenge to its designation.[42]

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[36] *See* 2010 Letter to Senate Members, *supra* note 1, at 8; 2010 Scott Memo, *supra* note 1, at 1; Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. 5 (June 14, 2010).

[37] 2010 Letter to FSOC, *supra* note 1, at 2.

[38] 2019 Letter to FSOC, *supra* note 1.

[39] 2023 Letter to FSOC, *supra* note 1.

[40] Analytical Framework for Financial Stability Risk Identification, Assessment and Response, 88 Fed. Reg. 78,026, 78,033 (Nov. 14, 2023).

[41] *See, e.g.*, 2010 Letter to FSOC, *supra* note 1, at 2-3.

[42] *See* Redacted Cross-Motion for Summary Judgment and Memorandum of Points and Authorities in Support Thereof and in Opposition to Defendant's Motion to Dismiss or, in the alternative, for Summary Judgment, MetLife, Inc. v. Fin. Stability Oversight Council, No. 1:15-cv-45 (D.D.C. June 16, 2015), *available at* https://www.bloomberglaw.com/public/desktop/document/METLIFE_INC_v_FINANCIAL_STABILITY_OVERSIGHT_COUNCIL_Docket_No_115/8 (advancing arguments as to how the designation criteria should be applied); *see also* Christina Parajon Skinner, *Regulating Nonbanks: A Plan for SIFI Lite*, 105 GEORGETOWN L. J. 1379, 1398 (2017).

Furthermore, FSOC itself has had difficulty applying the designation framework due to its convoluted, complex and subjective nature.[43] From the time Dodd-Frank was enacted, it took FSOC three to four years to designate each of the four nonbanks that were designated as SIFIs.[44] Moreover, the same opaque criteria allowed FSOC to first designate and then de-designate Prudential, even though it had grown in size, suggesting just how subjective the process is.[45]

b. <u>Designation is Not an Appropriate Solution</u>

Even if "nonbank SIFIs" were capable of definition, designation and supervision by the Federal Reserve is not the proper solution to mitigate potential risks to financial stability arising from such entities. As we explain below, the Federal Reserve and the regulations it has developed for the banking sector are not well-suited to regulate nonbanking businesses. Furthermore, designation is unlikely to benefit financial stability, and designation in fact distorts markets and hinders efficiency.

i. The Federal Reserve is Not Well-Suited to Regulate Nonbanks

As the Committee has explained before, shoehorning a multiplicity of entities ranging from mutual funds to broker dealers to insurance firms into a regulatory schema implemented by the Federal Reserve would lead to suboptimal regulatory outcomes, particularly where those entities already have a primary regulator.[46] Such measures make the U.S.'s fragmented system of financial regulation even more convoluted and inefficient.

The Federal Reserve's expertise is in designing and implementing regulatory solutions for banks, which are not appropriate for nonbanks.[47] Under the current framework, the Federal Reserve must establish enhanced prudential standards ("**EPRs**"), including risk-based capital requirements and liquidity requirements for firms that have been designated as nonbank SIFIs.[48] However, bank capital and liquidity requirements were devised to enhance the stability of depository institutions, and their mechanics and calibration are specifically designed for banks. Applying these requirements to nonbanks would be unwarranted, as these institutions have different business models and asset and liability structures.[49]

Although the Federal Reserve may tailor the EPRs based on the characteristics of the designated entity,[50] if the Federal Reserve agrees that bank-like requirements are not appropriate, then it would need to design regulatory solutions outside its area of expertise. However, the primary regulator is in the best position to understand, analyze, and evaluate potential risks of entities and activities within its jurisdiction, and to understand and assess how current regulations

[43] *See* LABONTE, *supra* note 19, at 26.
[44] *Id.*
[45] *Id.* at 27.
[46] 2023 Letter to FSOC, *supra* note 1.
[47] *See, e.g.*, 2010 Scott Memo, *supra* note 1.
[48] 12 U.S.C. § 5365.
[49] COMM. ON CAPITAL MKTS. REG., ROADMAP FOR REGULATORY REFORM 28 (May 2017), https://www.capmktsreg.org/wpcontent/uploads/2018/10/Roadmap-for-Regulatory-Reform.pdf.
[50] 12 U.S.C. § 5365(a)(2)&(b)(1)(A)(i).

address potential risks.[51] It makes little practical sense to shift regulatory authority over nonbanks away from these expert primary regulators.

Federal Reserve regulation of designated nonbank SIFIs has also proven unworkable in practice, substantiating the Committee's assessment. Despite Dodd-Frank's requirement that the Federal Reserve develop EPRs for nonbank SIFIs, EPRs were never applied to any of the four designated firms because regulators were not able to adapt bank regulations to nonbank businesses.[52] This was in spite of the Federal Reserve having ample time to regulate, as most of the nonbank SIFIs were designated for multiple years. Indeed, Prudential was designated for over five years.[53]

ii. Designation Does Not Improve Financial Stability

Designating individual nonbanks as SIFIs is unlikely to address financial stability because systemic risk in capital markets is not confined to or concentrated in a few discrete entities. Rather, it shifts with capital flows, which themselves are driven by investor preferences and other market dynamics. Therefore, by singling out particular companies, FSOC will merely allow the risks posed by those companies to shift elsewhere, including to less regulated sectors. Indeed, as the Committee has explained before, a portion of the heightened compliance costs associated with SIFI designation is likely to be passed on to customers of the nonbank SIFI. Instead of bearing these costs, investors could simply shift their capital to other financial institutions that hold similar assets without the regulatory restrictions imposed on SIFIs.[54] This is particularly true when the nonbank SIFI is part of a highly competitive industry, since investors will have ample choice among service providers, making it easier for them to shift their capital to entities not supervised by the Federal Reserve. Thus, regulating any systemic risks posed by capital markets requires a focus on market infrastructure and on activities and products, rather than individual entities, as discussed further below.

While nonbank SIFI designation was implemented in response to perceived unregulated risk at nonbank entities during the 2008 financial crisis, an analysis of the crisis shows that entity-based designation is not the correct response as the root causes were the *activities* large entities engaged in. For example, AIG was designated as a nonbank SIFI, however, as the Committee has previously explained, the systemic risk posed by AIG in the 2008 financial crisis was not due to its traditional insurance activities but rather due to the credit protection that AIG Financial Products sold on collateralized debt obligations that were exposed to U.S. subprime mortgages and reinvestment of cash collateral in mortgage-backed securities by AIG's securities-lending subsidiary.[55] These are *activities* that have since been addressed by Dodd-Frank reforms to central

[51] 2019 Letter to FSOC, *supra* note 1, at 3.
[52] LABONTE, *supra* note 19, at 12.
[53] *Id.*
[54] Letter from the Comm. on Capital Mkts. Reg. to Secretariat, Fin. Stability Bd. (May 29, 2015); *Data on Why SIFI Designation Is Not the Answer to Possible Herding Behavior by Asset Managers*, *supra* note 1.
[55] 2023 Letter to FSOC, *supra* note 1, at 6; 2013 Letter to FSOC, *supra* note 1, at 4.

clearing of credit default swaps and additional regulation of securitizations as well as enhanced state regulation of insurance companies' capital requirements.[56]

iii. Designation Impedes the Efficient Functioning of Financial Markets

Individual nonbank determinations of systemic risk adversely impact the functioning of financial markets. As the Committee has previously explained, individual designations will increase moral hazard, introduce competitive distortions into the marketplace, and artificially lower the cost of funds borne by institutions that are branded as systemically important.[57] Specifically, designation signals that there is a high probability that the government would act to prevent some institutions from failing, since their failure would threaten the financial system. When the government provides such a safety net, the government creates moral hazard: systemically important firms are encouraged to engage in imprudent risk-taking and ill-informed decision-making because they are insulated from the repercussions of bad decisions.[58] Further, designating systemically important firms will distort competition by giving those firms substantial competitive advantages. For example, creditors will lend to systemically important firms at lower interest rates based on the perception that the federal government will ensure they get paid back.[59] Ironically, then, FSOC's purpose "to promote market discipline, by eliminating expectations… that the Government will shield [stakeholders] from losses in the event of failure [of nonbank financial companies]"[60] is directly undermined by the act of designating nonbank SIFIs.

Further, nonbank financial companies will seek to avoid designation to fend off heightened regulatory costs, potentially by restructuring or divesting assets.[61] Indeed, this was the case with both GE Capital, which reduced its financial assets by more than half after designation, and MetLife, which reportedly "'admitted that the risk of increased capital requirements steered it towards the decision to break up its businesses, among other factors . . . .'"[62] Such activity can negatively impact the efficient operation of financial markets and harm consumers, because large entities capturing economies of scale may be able to offer a greater variety of high quality products at lower cost than multiple small entities.[63]

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[56] *See, e.g.*, David S. Huntington et al., *Client Memorandum: Securitization Reform under the Dodd-Frank Act*, PAUL WEISS (Aug. 5, 2010), https://www.paulweiss.com/media/103242/5Aug10DF.pdf; *Foreign Statutory Minimum Capital and Surplus Requirements*, NAIC (Oct. 31, 2023), https://content.naic.org/industry/ucaa/chart-foreign-statutory-capital-surplus.
[57] 2010 Letter to FSOC, *supra* note 1, at 2; 2019 Letter to FSOC, *supra* note 1, at 4; *see also* Letter from the Comm. on Capital Mkts. Reg. to Lance Auer, Fin. Stability Oversight Council 2 (Feb. 22, 2011).
[58] 2010 Letter to Senate Members, *supra* note 1, at 31; *see also* Kevin Dowd, *The Case for Financial Laissez-Faire*, 106 ECON. J. 679 (1996).
[59] 2010 Letter to Senate Members, *supra* note 1, at 31.
[60] 12 U.S.C. § 5322(a)(1)(B).
[61] Parajon Skinner, *supra* note 42, at 1397.
[62] *Id.* at 1399 (quoting Lyle Adriano, *Metlife Breakup Could Sway AIG, Prudential to Follow Suit*, INS. BUS. (Jan. 15, 2016), https://www.insurancebusinessmag.com/us/news/breaking-news/metlife-breakup-could-sway-aig-prudential-to-follow-suit-28004.aspx).
[63] *Id.* at 1406-07.

iv. FSOC's Implementation of Non-Bank SIFI Designation is Flawed

FSOC has historically implemented the nonbank SIFI designation framework in a gravely flawed manner. In addition to promulgating the convoluted Analytical Framework discussed above, FSOC has also improperly failed to conduct a cost-benefit analysis as part of the designation process and has vacillated over applying an activities-based approach to regulation.

Undertaking a cost-benefit analysis as part of the designation process is crucial as a policy matter,[64] however, FSOC has repeatedly failed to incorporate such an analysis into its decision-making. FSOC first claimed that a cost-benefit analysis was not required under its initial 2012 Guidance and did not consider costs when it designated MetLife as a nonbank SIFI in 2014.[65] However, the federal court in *MetLife Inc. v. Fin. Stability Oversight Council* (2016) disagreed, holding that FSOC's action to designate MetLife was arbitrary and capricious for failing to consider costs, an element of administrative procedure which the court found was legally required under FSOC's 2012 interpretation of Dodd-Frank.[66] Subsequently, in the 2019 Guidance FSOC committed to conducting a cost-benefit analysis before making any designation.[67] At the time, FSOC acknowledged that "[d]etermining whether the expected benefits of a potential [FSOC] determination justify the expected costs is necessary to ensure that [FSOC]'s actions are expected to provide a net benefit to U.S. financial stability and are consistent with thoughtful decision making."[68] However, FSOC reversed this position in the 2023 Guidance, and now maintains that it will not conduct a cost-benefit analysis.

As the Committee has highlighted in the past, we believe a cost-benefit analysis is both legally required under Dodd-Frank and vital as a matter of policy.[69] The impact of designation could potentially involve "billions of dollars in costs,"[70] calling into doubt whether any marginal improvement in financial stability risk that an entity-based designation could offer is justified. If the costs of SIFI designation to the company and its customers outweigh the benefits to market participants in the form of increased financial stability, then SIFI designation serves no valid policy purpose.[71]

In addition, FSOC has failed to apply a consistent approach to nonbank SIFI designation, vacillating between entity-based and activity-based schemes, creating even more uncertainty among nonbank financial companies and rendering FSOC's regulatory authority less effective.

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[64] *See, e.g.*, Due Process and Transparency in Non-Bank SIFI Designations, Hearing before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Services, 114th Cong. 4 (Nov. 19, 2015) (written testimony of Hal S. Scott, Director, Comm. on Capital Mkts. Reg.) (urging FSOC to correct the inadequacy of failing to conduct a cost-benefit analysis under the 2012 Guidance); 2023 Letter to FSOC, *supra note* 1, at 8-9.

[65] MetLife, Inc. v. Fin. Stability Oversight Council, 177 F. Supp. 3d 219, 239 (D.D.C. 2016).

[66] *Id.* at 233-42 (applying Michigan v. EPA, 576 U.S. 743 (2015)); 2023 Letter to FSOC, *supra* note 1, at 8-9.

[67] Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71,740, 71,766 (Dec. 30, 2019) (codified at 12 C.F.R. pt. 1310).

[68] *Id.*

[69] 2023 Letter to FSOC, *supra* note 1, at 8-10.

[70] *Id.* at 8 (quoting *MetLife*, 177 F. Supp. 3d, at 241).

[71] *Id.* at 8-9.

V. Activities-Based Policy Solutions

The Committee supports FSOC's mandate to identify and address systemic risks, however, we believe FSOC's proper focus is on activities-based risks. Under an activities-based approach, such as that adopted under the 2019 Guidance, FSOC would: monitor the financial services marketplace for threats to U.S. financial stability in consultation with primary regulators; evaluate products, activities, and practices that could pose a potential risk to U.S. financial stability in consultation with primary regulators; and, if potential risks are identified, work with regulators to address the identified risk so that regulation or supervision of companies or markets is modified to mitigate the potential risk.[72] Eliminating the nonbank SIFI designation would streamline FSOC so it can direct its efforts to identifying and remediating these risks through tools such as making policy recommendations to primary regulatory agencies.

As the Committee has explained in prior letters, focusing on activities is preferable from a policy perspective for several reasons.[73] First, a focus on systemically risky activities and products is the preferable line of inquiry if the objective is to reduce systemic risk. An activities-based approach, where regulators evaluate and address risks from products, activities and practices through generally applicable regulation, can more readily identify and address a widespread systemically risky activity or product involving a large number of market participants that an entity-by-entity designation approach could fail to identify and address. Such a broad-based approach has already been employed with respect to the regulation of, for example, derivatives trading (e.g., central clearing and minimum margin requirements).[74] Indeed, the SEC has recently employed a similar approach to addressing risk posed by the U.S. Treasury markets by adopting mandatory clearing and enhanced transparency of trading in U.S. Treasuries.[75]

Second, an activities-based approach is more effective than an entity-specific approach at accurately communicating to markets the sources and extent of systemic risks. The activities of individual entities, as well as the relative size and importance of individual entities, change over time, such that an entity-specific classification can become increasingly irrelevant over time. By identifying activities and products that can create systemic risks, an activities-based approach is less susceptible to these changes. As a result, market participants will be in a better position to evaluate the risks and benefits of such activities and products, thus doing more to reduce overall risk in the system than merely designating a few large nonbank financial companies as sources of systemic risk.

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[72] Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. at 71,761-71,762; 2019 Letter to FSOC, *supra* note 1, at 3.

[73] 2023 Letter to FSOC, *supra* note 1, at 7-8; *see also* 2019 Letter to FSOC, *supra* note 1; 2013 Letter to FSOC, *supra* note 1; Letter from the Comm. on Capital Mkts. Reg. to the Secretariat, Fin. Stability Bd. 7-8 (Apr. 7, 2014).

[74] *See, e.g.*, *Derivatives Markets and Central Counterparties*, FIN. STABILITY BOARD (Dec. 5, 2024), https://www.fsb.org/work-of-the-fsb/market-and-institutional-resilience/derivatives-markets-and-central-counterparties/; 12 C.F.R. § 349.

[75] Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule with Respect to U.S. Treasury Securities, 89 Fed. Reg. 2,714 (Jan. 16, 2024) (codified at 17 C.F.R. pts. 240).

VI. Alternative Approach for Designating Nonbank SIFIs

As we have demonstrated throughout this report, designating nonbanks as SIFIs is unworkable and unfit for purpose, and should therefore be abandoned as a regulatory tool. However, if Congress prefers that FSOC retains this authority, a second-best alternative would be for Congress to substantially amend the nonbank SIFI designation power to ensure it is available only in the most exceptional and narrowly defined circumstances.

The language in the Dodd Frank Act allowing FSOC to designate a nonbank if it determines that such entity's material financial distress, or its nature and activities, could pose a threat to financial stability should be repealed, as should the eleven criteria FSOC must currently use to guide its determination.[76] Instead, the statute should be amended so that FSOC only has the ability to designate a nonbank financial company as systemically important if it determines the entity is likely to fail, its failure could pose a threat to U.S. financial stability, and all four of the following criteria are satisfied: (1) the company is not already regulated by one or more primary regulatory agencies at either the federal or state level; (2) the entity performs a unique critical function for the financial system; (3) FSOC has first sought to address a potential risk to financial stability through the activities-based approach; and (4) FSOC has conducted a cost-benefit analysis that finds that the financial stability benefits of designation clearly outweigh the costs.

First, the company must not have a primary regulator at either the federal or state level. As we have demonstrated extensively throughout this report, entities that have an existing regulator are better left under the remit of that regulator, who is an expert with respect to those entities, and which avoids the problems associated with trying to apply ill-suited prudential regulation to a non-bank. Instead, FSOC's proper role with respect to these entities should be to identify any potential activities-based risks they pose to financial stability and to make recommendations to primary regulators. Existing major nonbank financial companies have a primary regulator except for digital asset exchanges, which are not currently systemically important and for which a regulatory structure is presently being designed.[77]

Second, the entity must perform a unique critical function for the financial system, where such activity could not continue in bankruptcy or be transferred to another institution.[78] We note that this is distinct from entities involved in payment, clearing and settlement activities, which are already regulated as systemically important under FSOC's SIFMU framework.

Third, FSOC must first seek to address a potential risk to financial stability through generally applicable regulation of the activity posing the risk.[79] As we have explained, the risk purportedly posed by an entity may in fact be due to the activities it engages in, and an activities-

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[76] 12 U.S.C. § 5323(a)(1)&(2).

[77] *See, e.g.*, Sandy Carter, *U.S. Crypto And Digital Assets Top David Sacks' First Press Conference*, FORBES (Feb. 4, 2025, 7:18PM), https://www.forbes.com/sites/digital-assets/2025/02/04/us-crypto-and-digital-assets-top-david-sacks-first-press-conference/.

[78] *See* 2023 Letter to FSOC, *supra* note 1, at 6; 2019 Letter to FSOC, *supra* note 1, at 4-5; 2013 Letter to FSOC, *supra* note 1, at 1-2.

[79] *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71,740, 71,761-71,762 (Dec. 30, 2019) (codified at 12 C.F.R. pt. 1310); 2019 Letter to FSOC, *supra* note 1, at 3-4.

based approach is preferable because it better addresses market-wide risks and avoids a situation where problematic activity at a designated entity simply shifts to an undesignated entity.

Fourth, FSOC should be required to conduct a cost-benefit analysis prior to designating a firm as a nonbank SIFI. Designation may cost a company billions of dollars, trigger divestitures and restructurings which shrink the business, and result in market distortions which harm investors and consumers. There must be a clear net benefit to financial stability from designation that outweigh these costs.

Together, these guardrails will mitigate many of the issues associated with designating firms, ensuring that risky activities are the proper focus, and that designation will have a net benefit to financial stability. To our knowledge, there are presently no non-bank financial institutions that satisfy these four criteria.

Recommendation

Congress should repeal FSOC's power to designate nonbanks as SIFIs. Congressional action is the best means of addressing the flaws in the current statutory framework and ensuring that FSOC operates within appropriate guardrails. Eliminating nonbank SIFI designation will enable FSOC to more effectively address systemic risk by identifying systemically risky activities and making policy recommendations to primary regulators, which will allow risks to be properly remediated within the existing regulatory structure.

If Congress chooses not to eliminate the designation power, it should, at the very least, substantially amend it. The existing designation criteria should be repealed, and FSOC should only be able to designate nonbank SIFIs if, at a minimum, the following four criteria are met: (1) the company is not already regulated by one or more primary regulatory agencies at either the federal or state level; (2) the entity performs a unique critical function; (3) FSOC has first sought to address a potential risk to financial stability through the activities-based approach; and (4) FSOC has conducted a cost-benefit analysis that finds that the benefits of designation clearly outweigh the costs.

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