

# COMMITTEE ON CAPITAL MARKETS REGULATION

February 22, 2011

Lance Auer  
Financial Stability Oversight Council  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4555 (RIN 4030-AA00)

Dear Mr. Auer:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the Financial Stability Oversight Council's (FSOC or Council) Proposed Rules<sup>1</sup> regarding its authority to require supervision and regulation of certain nonbank financial companies under §113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>2</sup> The Committee previously commented on FSOC's Advance Notice of Proposed Rulemaking,<sup>3</sup> and wishes to reiterate the thrust of that letter. In short, the Proposed Rules offer no guidance because identifying particular institutions as systemically important is an intractable problem.

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled, *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains 57 recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.<sup>4</sup> Since then, the committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

The Dodd-Frank Act allows the Council to designate nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System if the Council determines that a company, if met with financial distress, "could pose a threat to the financial stability of the United States."<sup>5</sup> The Act specifies eleven characteristics the Council should use in making its determination.

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<sup>1</sup> Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4555 (proposed Jan. 26, 2011) (hereinafter Proposed Rules).

<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376, §113(a)(1).

<sup>3</sup> Comm. on Capital Mkts. Regulation, comment to Financial Stability Oversight Council Advance Notice of Proposed Rulemaking, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 75 Fed. Reg. 61,653 (filed Nov. 5, 2010) (hereinafter CCMR Comment Letter).

<sup>4</sup> COMM. ON CAPITAL MKTS. REG., *THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM* (May 2009), <http://www.capmksreg.org/research.html>.

<sup>5</sup> Dodd-Frank Act §113(a)(1).

In October 2010, the Council issued an advance notice of proposed rulemaking regarding this authority and provided an opportunity for comment. The Committee filed a comment letter showing that there is no principled way to single out particular firms as systemically important and that doing so would increase moral hazard, introduce market distortions, and inevitably lead to legal challenge.<sup>6</sup> The Committee recommended that the Council avoid making any such designations at all or, if the Council was determined to designate firms for enhanced supervision by the Federal Reserve, that it use a single, objective factor: total assets.<sup>7</sup>

### **Individual Determinations**

The Dodd-Frank Act lists the eleven factors to be considered in making these determinations:

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 the Council deems appropriate.”<sup>8</sup>

The FSOC Proposed Rules list the same eleven considerations.<sup>9</sup> In its discussion of the Proposed Rules, the Council suggests a framework comprised of two groups and six categories to be used in making these determinations:

Group I: Potential for spillover to the broader financial system or real economy

1. size;
2. lack of substitutes;
3. interconnectedness;

Group II: Vulnerability to financial distress

4. leverage;
5. liquidity risk and maturity mismatch;
6. existing regulatory scrutiny.<sup>10</sup>

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<sup>6</sup> CCMR Comment Letter, *supra* note 3.

<sup>7</sup> *Id.*

<sup>8</sup> Dodd-Frank Act §113(a)(2).

<sup>9</sup> Proposed Rules §1310.10(c), 76 Fed. Reg. at 4563–64.

<sup>10</sup> FSOC Proposed Rules, 76 Fed. Reg. at 4560.

This framework, however, is not incorporated into the actual rules. Rather, these Proposed Rules, developed after reviewing all of the comments FSOC received on its earlier release, add essentially nothing beyond what the Dodd-Frank Act sets out.

Both the eleven measures and the framework of two groups with six factors suffer from several problems.<sup>11</sup> First, several terms are too ambiguous to provide any meaningful guidance. Other terms, such as source of credit for undeserved communities (captured within “lack of substitutes” in the framework), are irrelevant to the issues of systemic risk or financial stability. Overall the criteria’s ambiguity leaves too much discretion to the Council, renders the identification of particular financial institutions intractable, and in turn will make the Council’s determinations susceptible to legal challenges.

In its letters dated June 14, 2010<sup>12</sup> and November 5, 2010,<sup>13</sup> and on several prior occasions,<sup>14</sup> the Committee noted its opposition to labeling financial institutions as systemically important. Making individual determinations of systemic risk will adversely impact markets by increasing moral hazard and introducing uncertainties and distortions. Moreover, doing so on the basis of vague standards will prompt costly and time consuming legal challenges.

### **Asset Thresholds**

To be clear, the Committee believes it is unwise even to attempt to designate firms as systemically important. But if FSOC is going to do so, then asset thresholds are the only sensible method. This objective approach would reduce or avoid moral hazard, market uncertainty, and the attachment of any stigma, particularly if the threshold is over-inclusive. In its letter dated November 5, 2010, the Committee provided data revealing the number of firms across a variety of industries that would exceed a hypothetical threshold of \$20 billion in net assets.<sup>15</sup>

### **Uncertainty of Regulatory Plan**

The Dodd-Frank Act allocates the ability to make these determinations to the Council, yet delegates the authority to regulate the designated institutions to the Federal Reserve, which has not yet announced how it plans to supervise them. The concerns we have expressed are only exacerbated by this uncertainty. It is difficult to create a plan to designate certain firms for a solution when the solution itself is undetermined. Once again, the Committee recommends that no designations be made, but if they are to be made, at the very least they should be reserved until the Federal Reserve has developed its supervisory plan.

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<sup>11</sup> *Id.* at 4563–64.

<sup>12</sup> Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Member, H. Comm. on Fin. Servs. (June 14, 2010).

<sup>13</sup> CCRM Comment Letter, *supra* note 3.

<sup>14</sup> *See* Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs (May 4, 2010) (addressing the formulation of key legislative provisions of the Dodd-Frank Act); Letter from the Comm. on Capital Mkts. Regulation 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 Agric., Nutrition & Forestry (Apr. 26, 2010).

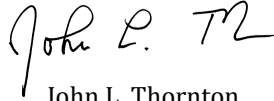
<sup>15</sup> CCRM Comment Letter, *supra* note 3.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

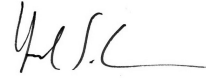
Respectfully submitted,



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