April 25, 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-ZA00)

Dear Mr. Schlegel:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Financial Stability Oversight Council's (the "**Council**" or "**FSOC**") proposed interpretative guidance[1] on the approach the Council intends to take regarding the manner in which it will designate nonbank financial institutions as systemically important under section 113 of the Dodd-Frank Act.[2]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-six leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Committee has previously commented extensively on the issue of the Council's designation of nonbank financial institutions as systemically important.[3] The Committee

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[1] Fin. Stability Oversight Council; Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 9028 (Mar. 13, 2019).

[2] 12 U.S.C. § 5323. While the statute refers to a Council "determination" this letter will use the term "designation."

[3] *See, e.g.,* Letter from the Comm. on Capital Mkts. Reg. to Cristopher 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); 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); Letter from the Comm. on Capital Mkts. Reg. to Timothy F. Geithner, Chairman, Fin. Stability Oversight Council (Nov. 5, 2010); 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); Letter from Comm. on Capital Mkts. Reg. to Fin. Stability Oversight Council (Mar.

applauds the Council for revisiting its previously issued guidance on nonbank financial institution designations and the processes underlying such designations.

The Committee would like to comment on the Council's proposed prioritization of an activities-based approach to addressing potential risks and threats to U.S. financial stability. The Committee supports the proposed activities-based approach but wishes to emphasize several points. First, any activities-based regulation should be based on an empirical link between the activity or product and systemic risk, and based on evidence that the regulation will mitigate the risk effectively and efficiently. Second, FSOC should work in coordination with any primary regulator regarding any activities-based regulation and should primarily focus activities-based oversight on material new and emerging risks. Such risks would particularly warrant FSOC's attention if a primary regulatory authority does not exist. Third, given FSOC's statutory authority to designate specific nonbanks as systemically important, we reiterate our view that the designation of specific firms risks creating inefficiencies and competitive disadvantages in capital markets (both domestically and internationally), particularly with respect to activities that can readily shift to less regulated sectors, which is at odds with FSOC's statutory mandate to promote market discipline.

Activities-Based Approach

The Dodd-Frank Act authorizes the Council to designate a nonbank financial institution as systemically important and be subjected to Federal Reserve supervision and prudential regulation if either: (1) the Council determines that material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States; or (2) if the nature, scope, scale, size, concentration, interconnectedness, or mix of activities of the nonbank financial institution could pose a threat to U.S. financial stability.[4]

However, the designation power is just one of the tools that the Council can use to respond to potential risks to U.S. financial stability, and as the Council properly recognizes in its proposal, that designation power is a tool of last resort to be used only when other regulatory responses would be insufficient or impractical and where designation can be shown to be justified.[5] In fact, *before* considering designation, the Council should informally coordinate and collaborate with financial regulatory agencies on regulatory and supervisory issues and exercise its formal statutory authorities to make recommendations to primary financial regulatory agencies to apply new or heightened standards and

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, Comm. on Capital Mkts. Reg.); COMM. ON CAPITAL MKTS. REG., ROADMAP FOR REGULATORY REFORM (May 2017), https://www.capmktsreg.org/wp-content/uploads/2018/10/Roadmap-for-Regulatory-Reform.pdf. *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. 20, 2016).

[4] 12 U.S.C. § 5323.

[5] 84 Fed. Reg. 9028, 9030 ("The Council will pursue entity-specific determinations under Section 113 of the Dodd-Frank Act only if a potential risk or threat cannot be addressed through an activities-based approach.")

safeguards to a financial activity or practice presenting a systemic risk.[6] Doing so offers the potential for more timely, effective, and efficient regulation of a potential threat to U.S. financial stability than designation.

The Council's proposed interpretative guidance recognizes these various tools for addressing threats to financial stability and therefore states that "the Council will prioritize its efforts to identify, assess, and address potential risks and threats to U.S. financial stability through a process that emphasizes an activities-based approach," and will thus only pursue entity-specific designations "if a potential risk or threat cannot be addressed through an activities-based approach."[7]

Under the activities-based approach, the Council will: monitor the financial services marketplace for threats to U.S. financial stability in consultation with primary financial regulatory agencies; will evaluate products, activities, and practices that could pose a potential risk to U.S. financial stability in consultation with primary financial regulatory agencies; and, if potential risks are identified, will work with regulators to address the identified risk so that regulation or supervision of companies or markets is modified to mitigate the potential risk.[8]

The Committee commends the Council for adopting this activities-based approach. On numerous occasions the Committee has called for regulating systemic risk through a focus on systemically risky activities and products rather than the entity-based designation approach.[9] Importantly, we wish to reiterate our prior statements that any activities-based regulation should be based on an *empirical link* between the activity or product and systemic risk.[10] In addition, there should be an empirical demonstration that any activities-based regulation would mitigate the risk, with the regulation's benefits outweighing its costs.

Moreover, the Committee believes that where a regulator has primary authority over an activity, FSOC should coordinate with that regulator before determining whether an activity poses a significant risk to U.S. financial stability and if additional regulation or supervision is necessary with respect to that activity. The primary regulator may be 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 address potential risks. In addition, FSOC should primarily focus its activities-based oversight on

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[6] 12 U.S.C. §§ 5325, 5330, 5463; 84 Fed. Reg. 9028, 9039 n.5.
[7] 84 Fed. Reg. 9028, 9039.
[8] *Id.* at 9040.
[9] ROADMAP FOR REGULATORY REFORM, *supra* note 3, at 26 (calling for replacing nonbank financial company designations with an activities-based regulatory framework); Hal Scott Testimony, *supra* note 3, at 6 ("Regulating systemic risk requires a focus on systemically risky activities and products."); Letter to Neal S. Wolin dated Feb. 15, 2013, *supra* note 3, at 2 ("[The Council] should encourage financial regulators to perform their duties rather than simply designate individual financial institutions as [systemically important financial institutions].").
[10] ROADMAP FOR REGULATORY REFORM, *supra* note 3, at 26.

material new and emerging risks.[11] New and material emerging risks could arise, for example, from new activities and products or from material changes to existing activities, products and markets.[12] It is critical to emphasize that new and emerging risks should be large enough in magnitude and probability that additional regulation to mitigate the risk can be justified.

Importantly, the proposed interpretative guidance provides that the Council may designate a nonbank financial institution as systemically important, consistent with its statutory authority, if "the Council's collaboration and engagement with the relevant regulatory agencies does not adequately address a potential threat identified by the Council – or if a potential threat to U.S. financial stability is outside the jurisdiction or authority of financial regulatory agencies – and if the potential threat identified by the Council is one that could be addressed by a Council determination."[13] In a footnote in the proposed guidance, the Council states that it would "most likely" consider a designation "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."[14]

Because the Council retains statutory authority to designate nonbank financial institutions, the Committee wishes to emphasize its previously expressed position that individual designations have adverse market wide impacts. More specifically, making individual nonbank determinations of systemic risk 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."[15] Moreover, as the Committee has previously noted, the statutory factors to be applied in the designation determination are so vague that any designation will inevitably lead to costly and time-consuming litigation.[16] For example, what weight should the Council place on each of the various factors like scope, size, and scale of an activity and what do those terms precisely mean? It is the Committee's view that the size, scale, and scope of activities need to be thoughtfully and prudently construed so that the size and scale of a firm's activity or activities are not considered in isolation, but take into account the ability of other firms and market participants to readily provide such services if the firm were to fail. Because of the drawbacks, complexities, and difficulties of making a designation determination, the

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[11] *See, e.g.,* Letter to Neal S. Wolin dated Feb. 15, 2013, *supra* note 3, at 4–5 (expressing Committee's view that private equity funds and traditional insurance activities do not pose systemic risk issues).

[12] For example, Vice Chair for Supervision Quarles, recently remarked in his capacity as the Chair of the Financial Stability Board that "[b]oth the potential entry of large, established technology companies into financial services and the ability of technology to decentralize financial transactions raise a number of issues, some of which may touch on financial stability. Technological innovation offers the promise of a substantially more efficient financial system. But new systems, processes, and types of businesses will bring with them novel fragilities. We continue to be responsible for ensuring that the financial system be sufficiently resilient that businesses and households worldwide need not fear the collapse of the system that serves their needs." Remarks by Randal K. Quarles, Vice Chair for Supervision, Bd. Of Governors of the Fed. Res. System 9 (Mar. 28, 2019), *available at* http://www.fsb.org/wp-content/uploads/S280319.pdf.

[13] 84 Fed. Reg. 9028, 9041.

[14] *Id.* at 9045.

[15] Letter to Timothy Geithner dated Nov. 5, 2010, *supra* note 3, at 2. *See also* Letter to Lance Auer dated Feb. 22, 2011, *supra* note 3, at 2.

[16] Letter to Timothy Geithner dated Nov. 5, 2010, *supra* note 3, at 3.

Committee, therefore, believes that if designations are to be used, they should be used sparingly.

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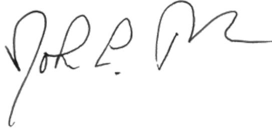
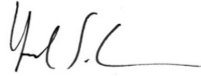
Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Prof. Hal S. Scott (hscott@law.harvard.edu), or Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,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