IX. Proposed Rules For Systemically Important Financial Institutions (SIFIs)

A. Introduction

Following the 2008 financial crisis, Congress initiated financial reform. In the Dodd-Frank Act ("Act”), Congress identified non-bank financial institutions as a threat to the entire system, labeling them systemically important financial institutions (“SIFIs”) in lieu of “too big to fail.”[1] For at least one hundred years, large institutions have benefitted from a safety net of some fashion. In 1907, tycoon J.P. Morgan privately rescued banks suffering from the copper-instigated Great Panic.[2] In recent years, aid to such institutions has come from public coffers during crises. For example, the U.S. Department of Treasury provided cash to facilitate JPMorgan Chase’s acquisition of Bear Stearns. Regulators labored under the belief that Bear Stearns was so highly interconnected that its demise would lead to contagion and produce negative externalities. Such fears supposedly manifested with systemic shock when Lehman Brothers, a similarly large institution, collapsed because it did not receive a cash injection.[3] Ideally, rather than ex

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 804, 124 Stat. 1376, 1807-09 (2010) (to be codified at 12 U.S.C. § 5463).

[2] ROBERT F. BRUNER & SEAN D. CARR, THE PANIC OF 1907 (John Wiley& Sons, Inc., 2007), *available at* http://www.npr.org/ templates/story/story.php?storyId=14004846 (providing an excerpt in the NPR article dated Aug. 28, 2007 entitled *Lessons from Wall Street’s ‘Panic of 1907’*).

[3] DOUGLAS J. ELLIOT & ROBERT E. LITAN, IDENTIFYING AND REGULATING SYSTEMICALLY IMPORTANT, FINANCIAL INSTITUTIONS: THE RISKS OF UNDER AND OVER IDENTIFICATION AND REGULATION 2 (Brooking Institution, 2011), http://www.brookings.edu/~/media/Files/rc/papers/2011/0116_regulating_sifis_elliott_litan/0116_regulating_sifis_elliott_litan.pdf; Xavier Freixas & Jean-Charles Rochet, *Taming SIFIs* (2011), at 2, *available at* http://www.federalreserve.gov/events/conferences/2011/rsr/papers/FreixasRochet.pdf; *see generally* Dimitrios Bisias et al., *A Survey of Systemic Risk Analytics* 1 (U.S. Dep’t of Treasury: Office of Fin. Research, Working Paper No. 001, 2012), *available at* http://www.treasury.gov/ initiatives/wsr/ofr/Documents/OFRwp0001_BisiasFloodLoValavanis_ASur

post crisis management with bailouts, legislation could address the risk with an "early warning system."[4] Alas, identifying the institutions that threaten the economy before it is too late practically requires clairvoyance.

As "prediction is very difficult, especially about the future,"[5] Congress deferred to a newly created regulator, the Financial Stability Oversight Council ("Council"), to conceptualize and define SIFIs under Title I of the Act.[6] Once regulators identify the menacing institutions, Title VIII will subject these institutions to additional regulations similar to those imposed on banks.[7] The Council released its second set of proposed rules for evaluating SIFIs in October of 2011, providing two months for public comment.[8] The rules set out a

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veyOfSystemicRiskAnalytics.pdf (summarizing the various definitions of systemic risk).

[4] The Dylan Ratigan Show, *Megapanel with Vern McKinley* (MSNBC television broadcast Feb. 6, 2012), *available at* http://www.youtube.com/watch?v=nyYkci_tLAg (discussing the role of regulators for the financial system and comparing the regulators in 2008 with the Council).

[5] Matthew Herper, *Peering into Pfizer's Future*, FORBES, Mar. 31, 2011, http://www.forbes.com/sites/matthewherper/2011/03/31/peering-into-pfizers-future/ (attributing the famous quote "to Yogi Berra, Neils Bohr, and Samuel Goldwyn Mayr").

[6] Bisias et al., *supra* note 3, at 1 (explaining the "three broad mandates" of the Council as "identify[ing] risk," "promot[ing] market discipline," and "respond[ing] to emerging threats.").

[7] *The Dodd-Frank Wall Street Reform and Consumer Protection Act*, FIN. SERV. ADVISORY (Alston & Bird), July 23, 2010, at 6, 14, http://www.alston.com/files/Publication/4afc64ee-b4f6-482c-8166-70f8687eaaf1/Presentation/PublicationAttachment/5b760f08-51cb-4218-87e5-dd74b4349157/Financial%20Reform%20Advisory.pdf.

[8] *Continued Oversight of the Implementation of the Wall Street Reform Act: Hearing on the Wall St. Reform Act Before the S. Comm. on Banking, Hous. & Urban Affairs,* 112th Cong. 8-9 (2011) (statement of Martin J. Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Home (navigate to Dec. 6, 2011).

three-stage quantitative and qualitative assessment.[9] Congress believes that additional regulation will mitigate future crises.[10]

B. Regulatory Framework

The Act envisions the Council creating a framework for designating SIFIs, which will face heightened regulation.[11] Specifically, the Act provides two standards to assess the threat a non-bank financial institution presents to the entire system: internal financial distress and interconnectedness.[12] Although either standard may suffice, regulators during the 2008 financial crisis appeared most concerned with institutions that embodied both standards. For example, the internal hemorrhaging of Bear Stearns caused it to suffer an economic stroke that affected other financial limbs due to interconnectedness.

C. Proposed Rules: Designation

In its proposed rules, the Council articulates a three-stage process for evaluating and designating SIFIs.[13] The first two stages involve quantitative and qualitative analysis of available financial records. If the Council chooses to move to the third stage, it can request a company's records to perform a more in-depth examination. The scheme involves an elimination process where the

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[9] William McConnell, *Regulators Set 3-Step Process for Picking SIFIs*, THE DEAL PIPELINE, (Oct. 12, 2011, 3:15 PM), http://www.thedeal.com/content/regulatory/the-financial-stability-oversight-council.php.

[10] *See* Joe Nocera, *A Dubious Way to Prevent Financial Crisis*, NY TIMES, June 4, 2010, http://www.nytimes.com/2010/06/05/business/05nocera.html ("Indeed, watching Congress struggle just to pass even these timid reforms gives one a greater appreciation for what Congress accomplished during the Great Depression. The current bills tinker with the status quo.").

[11] Sylvia Mayer & Christopher Linden, *FSOC Three Step: Financial Stability Oversight Council Issues Notice of Proposed Rulemaking Outlining Criteria for Designating Nonbank SIFIs*, FIN. REGULATORY REFORM CENTER (Weil), http://financial-reform.weil.com/federal-reserve-board/fsoc-step-financial-stability-oversight-council-issues-notice-proposed-rulemaking-outlining-criteria-designating-nonbank-sifis.

[12] *Id*.

[13] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64,264, 64,269-70 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310).

initial analysis is objective, but becomes more subjective through the second and third stages. The Council has not addressed whether the criteria will evolve over time.[14] Should market conditions change or the framework not capture menacing institutions, what will be the process for amending the criteria?

1. Quantitative Analysis: the Weeding Out Process

Stage one primarily involves quantitative analysis to weed out institutions. The Council applies an asset test and examines other quantitative rubrics such as leverage ratio.[15] It must find that the institution exceeds the limits of both criteria in order to evaluate it under the second stage. For quantitative measures, the Council has not explained the values and Congress specifically did not set a threshold value.[16] While Congress may have chosen to defer to the Council, the Council should still be responsible for providing better justification for the chosen values.

In the first half of stage one, the Council will subject each institution to an asset test. Bank holding companies registered in the United States with more than $50 billion in global assets will remain under the Council's scrutiny for SIFI analysis if they also surpass one of the other quantitative measures.[17] Likewise, foreign entities with

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[14] Letter from Kathleen P. McTighe, Senior Counsel, Am. Bankers Ass'n, to Lance Auer, Deputy Assistant Sec'y, Fin. Stability Oversight Council 6 (Dec. 19, 2011), *available at* http://www.aba.com/NR/rdonlyres/DC65CE12-B1C7-11D4-AB4A-00508B95258D/74544/cl_SIFIs2011Dec.pdf.

[15] Mayer & Linden, *supra* note 11.

[16] *See* Thomas P. Vartanian & Stephen H. Bier, *The Dawning of Systemic Regulation: Dodd-Frank Monitors the Economy From an Overall Point of View*, N.Y. L.J., Jan. 9, 2012, at 2, http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202537650694; *see also* Letter from David T. Hirschmann, President and Chief Exec. Officer, Ctr. for Capital Mkt. Competitiveness, to Lance Auer, Deputy Assistant Sec'y, Fin. Stability Oversight Council 9, 12 (Dec. 19, 2011), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2011-12-19-FSOC-SIFI-Letter.pdf.

[17] *The FSOC SIFI Designation Proposal for Nonbank Financial Companies,* A CLOSER LOOK: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (Price Waterhouse Coopers, De), Dec. 2011, at 5, *available at* http://www.pwc.com/en_US/us/financial-services/regulatory-

$50 billion in consolidated U.S. assets may face additional review.[18] While this asset test does not necessarily represent either the standard of financial distress or interconnectedness, it exploits the notion of "too big."

Assets alone do not make a SIFI. In the second half of stage one, the Council will evaluate a company's credit default swaps, derivative liabilities, borrowings, leverage ratio, and debt-to-asset ratio.[19] The institution need only satisfy one of these conditions and the asset test to face additional scrutiny. These criteria incorporate debt analysis because regulators consider high debt and low liquidity as root causes of the financial crisis.[20] Credit default swaps carry third-party risk because they involve "a promise by one party to pay another party in the event that a third party defaults on its debt," and therefore regulators include it as a measure with $30 billion as the limit.[21] Credit default swaps particularly concern regulators given their role in the AIG debacle where the contracts involved multiple parties and led to high interconnectivity.[22] Credit default swaps may not accurately indicate interconnectivity because they may distract from the measure with the "'noise' of third-party activity . . . ."[23]

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services/publications/assets/closer-look-fsoc-sifi-proposal-for-nonbank-financial-companies.pdf.

[18] David S. Katz & Scott R. Tkacz, *Dodd-Frank Designation of Nonbank Financial Companies- FSOC Releases Proposed Rule*, METRO.CORP. COUNSEL, Nov. 21, 2011, http://www.metrocorpcounsel.com/articles/16718/dodd-frank-designation-nonbank-financial-companies-%E2%80%93-fsoc-releases-proposed-rule.

[19] Mayer & Linden, *supra* note 11.

[20] Eric Roiter, Lecturer in Law, Boston University School of Law, Remarks on "Where Do We Go From Here?" Panel at the Boston University School of Law's Review of Banking and Financial Law Symposium on Shadow Banking (Feb. 24, 2012).

[21] Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 52 (2011), *available at* http://www.harvardjol.com/wp-content/uploads/2011/02/49-94.pdf; *FSOC Issues New Proposed SIFI Designation Rule*, DECHERT ON POINT (Dechert, Washington, DC), Oct. 2011, at 2, *available at* http://www.dechert.com/files/Publication/f69d0d19-47b2-485b-8a55-92b429109371/Presentation/PublicationAttachment/1834460b-bbcf-48bb-8694-981df0d77df3/FI_12_10-11_FSOC_Issues_New_Proposed_SIFI_Designation_Rule.pdf.

[22] *See* Kress, *supra* note 21, at 60.

[23] Dechert, *supra* note 21, at 3.

The next three factors attempt to address the internal financial distress standard. The derivative liability threshold is $3.5 billion.[24] Nonetheless, derivative numbers are not readily ascertainable from financial statements and the proposed guidelines do not clearly elaborate what constitutes a derivative (e.g. whether guarantees in insurance policies count).[25] Furthermore, "loans and bonds outstanding" cannot exceed $20 billion.[26] A fifteen to one leverage ratio measured by consolidated assets is another quantitative limit.[27]

Finally, ten percent short-term debt justifies further SIFI evaluation.[28] Banking involves short-term borrowing and long-term lending, but short-term borrowing can pose "roll-over risk" and perhaps instigate financial crisis.[29] Although this criterion should exclude certain institutions like insurance companies that typically have long-term liabilities,[30] industry professionals still urge the Council to consider differences in business models. [31]

Even experts with the Office of Financial Research recognize the challenges of measuring systemic risk in discourse about the multitude of quantitative measures.[32] Given such difficulty, financial analyst Vern McKinley claims that these challenges contribute to the

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[24] *Id.* at 2.
[25] Letter from Julie A. Spiezio, Senior Vice President, Am. Council of Life Insurers, to Timothy F. Geitner, Sec'y, U.S. Dep't of the Treasury 5 (Dec. 19, 2011), *available at* http://www.acli.com/Newsroom/News%20 Releases/Documents/ACLI_FSOC_121911.pdf.
[26] Geoffrey Etherington et al., *Federal Regulation of Insurance: Recent Developments*, *in Dodd-Frank: The Road Ahead*, BLOOMBERG LAW REPORTS, Jan. 6, 2012, at 42, *available at* https://www. bloomberglaw.com/files/2012/01/bloomberg-law-reports-dodd-frank-the-road-ahead-1-2012.pdf.
[27] *Regulation of Systemically Important Financial Institutions*, NEWSLETTER (Skadden), Nov. 17, 2011, at 11, *available at* http://skadden.com/ newsletters/Regulation_of_Systematically_Important_Financial_Institutions .pdf.
[28] *Id.*
[29] *See* Efraim Benmelech & Eyal Dvir, *Does Short-Term Debt Increase Vulnerability to Crisis? Evidence from the East Asian Financial Crisis*, J.INT.ECON. 1 (2012), *available at* http://www.economics.harvard. edu/faculty/benmelech/files/BD_JIE_2012.pdf.
[30] *See* Spiezio, *supra* note 25, at 5-6.
[31] *Id.* at 4.
[32] Bisias et al., *supra* note 3, at 1.

Council's inability to detect problems before distress occurs.[33] For example, the Council did not identify MF Global as a significant threat until it declared bankruptcy.[34] Nonetheless, the Council is still in its infancy and the proposed rules were not yet in force at the time of the bankruptcy. Regardless, MF Global would likely have been a candidate for SIFI designation, and yet its failure did not create economic anarchy.[35] Its collapse represents the philosophical divide over whether the cost of imposing regulations is necessary compared to the cost of collapse. Arguably, the rules reallocate costs across the system rather than allowing the market to discipline those that have taken risk by facing their downsides. In fact, regulation may also produce moral hazard where large institutions may see the quasi-governmental support as an incentive to undertake riskier opportunities, and thus yield even greater costs to the system.[36]

2. Qualitative Analysis: Beyond Bean Counting

In the second stage of SIFI designation, the Act outlines ten factors for a more "robust analysis" of an institution.[37] The rules synthesized the factors into six—grouping them into size, interconnectedness, lack of substitutes, leverage, liquidity risk and maturity mismatch, in addition to existing regulatory scrutiny.[38] Although this second phase of evaluation incorporates both standards, it emphasizes the interconnectedness standard. The factors

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[33] The Dylan Ratigan Show, *supra* note 4; *see* Vern McKinley, *Financing Failure: the State of Bailouts,* WASHINGTON TIMES, Jan.18, 2012, http://www.washingtontimes.com/news/2012/jan/18/financing-failure-the-state-of-bailouts/.

[34] The Dylan Ratigan Show, *supra* note 4.

[35] Catherine Dunn, *MF Global: Just the Right Size to Fail?*, CORPORATE COUNSEL, Nov. 2, 2011, http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202521560153.

[36] *See* Freixas & Rochet, *supra* note 3, at 3; *Getting to Grips with SIFIs: The Future for Systemically Important Financial Institutions*, FRONTIERS IN FIN. (KPMG), Apr. 2011, at 1, *available at* http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Frontiers-in-Finance/PublishingImages/FrontiersInFinance25April11/january2011/19015.html.

[37] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64,264, 64,282 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310).

[38] Dechert, *supra* note 21, at 2.

should help identify "a company's susceptibility to financial distress" and "the impact that a company's material financial distress could have on the financial services industry and the broader economy."[39] This second stage analysis still significantly depends on quantitative measures, although it purports to include qualitative factors "such as whether the resolution of a company could pose a threat to the financial stability of the U.S."[40] Within the proposed rules commentary, the Council provides examples for its stage two analysis such as examining changes in ratios.[41]

The second stage, however, seems to cast the net quite widely. For example, although the commentary touches upon other factors such as pre-Dodd-Frank Act regulation, the discussion is quite cursory.[42] In fact, the commentary states, "the Council may consider whether a nonbank financial company is subject to consolidated supervision."[43] It is unclear how the Council will actually evaluate the other regulations. Particularly, mutual funds and insurance organizations already face specialized rules. It is unclear how the regulations will relate and whether such increased regulation would harm these industries. If designating an institution as a SIFI yields Title VIII bank-like regulation, does that mean that a currently regulated mutual fund will also be regulated as a bank or simply that some of the additional bank regulations will be imposed upon it? Industry participants argue that given such difficulties the Council should not attempt to attach additional regulation because a company in a regulated industry is unlikely to pose systemic risk (e.g. the insurance industry is more likely to wind down institutions safely given their highly regulated nature).[44] Likewise, some companies

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[39] *Id.*

[40] Jim Sivon, *Nonbank SIFI Designations*, OUR PERSPECTIVES (Barnett, Sivon & Natter, Washington, DC), Oct. 2011, at 3, *available at* http://www.bsnlawfirm.com/newsletter/OP1011_Sivon.pdf.

[41] *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. at 64,282.

[42] *See generally* Letter from John D. Hawke Jr., Counsel at Arnold & Porter, Federated Investors, to Mary Schapiro, Chairman, U.S. Sec. and Exch. Comm'n 8 (Dec. 15, 2011), *available at* http://www.sec.gov /comments/4-619/4619-112.pdf; Spiezio, *supra* note 25, at 2.

[43] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. at 64,280.

[44] *See* Spiezio, *supra* note 25, at 1 ("First, the core business activity of most life insurers involves providing policyholder coverage for long-term risks, and matching those long-term, illiquid liabilities with assets appropriate to

must also conform to international rules within the Basel framework and it is unclear how the Council expects these companies to navigate both Basel and Dodd-Frank.[45] At some point, excessive regulation not only becomes ineffective, but harmful as well.

Furthermore, because the qualitative analysis is so broad, institutions may want a more involved and informed role in the process. Yet, as proposed, the Council will not notify companies that they are under stage two evaluation despite the possibility that the review could last a long period of time given the lack of a designated timeline in the rules.[46] While there is a risk of exposing companies through public announcement, market participants can conduct their own stage one quantitative analysis of companies because the information is publicly available, and therefore participants may speculate on which firms that they believe to be under stage two review.[47] Furthermore, as the Richmond Federal Reserve commented, there is a "potential for inconsistency" between reviewing and designating where an institution that begins to fail can still receive SIFI treatment; thus, an institution may succumb to

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ensure that those liabilities can be met. This is fundamentally different than other types of financial institutions that are more dependent on short-term, on-demand funding, and are thus potentially subject to a "run on the bank" in periods of stress. Second, core life insurance activities do not lead to high interconnectedness with other financial institutions. While many insurers use derivatives as part of their life insurance and annuity businesses, these derivatives are primarily used to hedge risk, not to speculate or to generate increased returns. Third, life insurers are highly regulated.").

[45] *See* Press Release, The Geneva Ass'n, Expert Submission to the Financial Stability Oversight Council (FSOC) on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies 4 (Dec. 19, 2011), *available at* http://www.genevaassociation.org/PDF/General_Information/GA2011-PR-16-11.pdf.

[46] *See* Hirschmann, *supra* note 16, at 15.

[47] DAVID A. PRICE, SIFTING FOR SIFIS, RICHMOND FEDERAL RESERVE 7 (2011), http://www.richmondfed.org/publications/research/region_focus/2011/q2/pdf/federal_reserve.pdf ("In practice, while it may be possible to conceal the consideration process from public view, the actual designation of a firm would be unlikely to remain secret. As James Thomson of the Cleveland Fed notes in an August 2009 paper, markets would probably be able to infer which firms are on the SIFI list by looking at differences in capital structure, balance sheet entries and footnotes, and intensity of regulatory scrutiny.").

moral hazard, believing it can undertake additional risk because of a federal safety net.[48]

3. Council Determination: Peeking Inside Company Files

Upon requesting company financial information under this third stage, the Council "formally notif[ies]" the company that it is under review as a SIFI.[49] Upon determination, the company will have an opportunity for a hearing.[50] Within sixty days after the hearing, the Council will provide in writing to the institution its final determination of designation.[51] Although the company can contest the designation through a Council process, it also has the opportunity to seek judicial review.[52] Whether judicial review will offer a real remedy to companies is yet to be seen. Some fear that courts will simply defer to the Council.[53]

The Council has significant discretion[54] and its process presents potential confidentiality issues.[55] First, the Council not only sets the quantitative values without explanation, but provides exceptions for itself.[56] Furthermore, once it determines that a company satisfies the quantitative measures, the analysis becomes quite subjective. Second, the Council has not soothed companies about its handling of confidential information. Although regulators cursorily reference the Freedom of Information Act's ("FOIA") exemptions, the rules do not clarify which exemption would apply or address how to determine which information would not be exempt from disclosure.[57] The government may not have the safeguards in

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[48] *Id.* at 7-8.
[49] Mayer & Linden, *supra* note 11, at 3.
[50] Authority to Designate Financial Market Utilities as Systemically Important, 12 C.F.R. § 1320.12 (2011).
[51] 12 C.F.R. § 1320.15.
[52] Skadden, *supra* note 27, at 14 (citing Dodd-Frank §113(h)).
[53] *See* Hirschmann, *supra* note 16, at 6.
[54] *Dodd-Frank Rulemaking: Volcker Rule and SIFI Proposals*, COMMENTARY AND INSIGHTS (Skadden), Nov. 17, 2011, at 56, 69, *available at* http://skadden.com/evites/NY/Dodd_Frank_Rule_Making_Volcker_Rule_and_SIFI_Proposals_111711.pdf.
[55] McTighe, *supra* note 13, at 3; *see* Dechert, *supra* note 21, at 4, Hirschmann, *supra* note 16, at 21.
[56] *See* Spiezio, *supra* note 25, at 5.
[57] Dechert, *supra* note 21, at 4; *see* Hirschmann, *supra* note 16, at 21.

place to prevent the information from leaking to competitors. Receiving thousands of FOIA requests each year, executive agencies sometimes disseminate material that officials should have redacted. Once the Council discloses its review of a company, disclosure may really mean exposure of confidential information and the fears of economic shock may be realized.

D. Conclusion

The proposed rules aim to identify threats to the system and empower the new Council to have better tools, both quantitative and qualitative, to evaluate institutions. The three-stage process requires a close analysis of large institutions and those that are interconnected. During the public comment period, industry experts voiced their criticism that the process does not accurately capture either financial distress or interconnectedness of institutions. Designation is only the beginning; mitigation of future crises will also depend on the effectiveness of the heightened regulation.

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