July 27, 2023

VIA ELECTRONIC SUBMISSION
Financial Stability Oversight Council
Attn: Eric Froman, Office of General Counsel, Treasury
1500 Pennsylvania Avenue NW
Room 2308
Washington, D.C. 20220

**Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (RIN 4030-XXXX), and Analytic Framework for Financial Stability Risk Identification, Assessment, and Response (RIN 4030-XXXX)**

Dear Mr. Froman:

On behalf of our members, the American Investment Council (AIC) is pleased to submit the following comments on the Financial Security Oversight Council's (FSOC) proposed interpretive guidance (Proposed Guidance)[1] and analytic framework (Proposed Analytic Framework).[2]

AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, AIC develops, analyzes, and distributes information about the private equity and private credit industries and their contributions to the U.S. and global economy. AIC's members are the world's leading private equity and private credit firms, united by their commitment to growing and strengthening the businesses in which they invest.[3]

AIC fully supports efforts to protect U.S. financial stability and has a strong interest in ensuring the resiliency and effective functioning of financial markets. However, AIC believes that the departures from FSOC's prior guidance under the Proposed Guidance and Proposed Analytic Framework ultimately run counter to the promotion of stable and competitive U.S. financial markets, as well as fundamental principles of administrative law. We are also concerned that the proposals reduce transparency and objectivity, and

[1] *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 88 Fed. Reg. 26,234 (Apr. 28, 2023).

[2] *Analytic Framework for Financial Stability Risk Identification, Assessment, and Response*, 88 Fed. Reg. 26,305 (Apr. 28, 2023).

[3] In this letter, we generally refer to private equity and private credit fund advisers as "private equity advisers" and the funds such advisers manage as "private equity funds."

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create unintended ambiguity about the potential to designate companies that pose no systemic risk under any reasonable approach.

In particular, AIC has the following concerns:

- The Proposed Guidance fails to consider the likelihood of a company's material financial distress when making a company designation, when both Section 113 of the Dodd-Frank Act and sound policy require it.
- The Proposed Guidance's rejection of cost-benefit analysis is both contrary to Section 113 and arbitrary.
- The Proposed Guidance makes the exercise of FSOC's designation discretion arbitrary by having FSOC designate an entity *before* identifying what the consequences of designation will be.
- The Proposed Guidance's elimination of the definition of "threat" is arbitrary and risks removing an important measure of objectivity in the designation standard.
- The Proposed Guidance's abandonment of the activities-based approach is inconsistent with its status as an *oversight* committee rather than a primary regulator. And, an activities-based approach is the more appropriate mechanism to identify and address systemic risk outside of the banking sector.
- The Proposed Guidance undercuts procedural protections for companies facing potential designation and circumvents the nondelegable duty of FSOC voting members to decide whether to designate a company.
- The Proposed Analytic Framework's list of "vulnerabilities" is vague, and it is unclear how they relate to the factors FSOC must consider under Section 113.
- AIC's members, and the private equity industry generally, pose no threat to U.S. financial stability. In particular, they are not subject to on-demand investor redemptions or withdrawals, making bank-style supervision of them particularly inappropriate.

## DISCUSSION

## I. Proposed Guidance

### A. Likelihood of Material Financial Distress

The Proposed Guidance fails to consider the likelihood of a company's material financial distress when making a company designation, claiming that the Dodd-Frank Act presupposes the company is already in distress. But this is plainly inconsistent with the text of the Act.

Section 113 of the Dodd-Frank Act permits FSOC to designate a company if "material financial distress" at the company "could pose a threat to the financial stability of the United States."[4] This provision necessarily requires FSOC to consider (1) to what extent there is a risk of material financial distress at the company and (2) the effect of any such distress on the broader financial system. Both considerations are necessary, because if a company faces minimal to no likelihood of financial distress, there is no threat that distress at the company will harm U.S. financial stability.

A hypothetical makes this point clear. Suppose a Senator at a congressional hearing were to ask the Director of the U.S. Geological Survey, "Do you think that volcanoes could pose a threat to the long-term economic growth of Washington, D.C.?" Because there is no likelihood of a volcano erupting near D.C., the only reasonable answer is no. It would not make sense for the Director to start describing what might happen in the counterfactual world where a volcano erupted on the National Mall, on the assumption that the Senator's question presupposes the likelihood of such an event. Rather, just the opposite is true. Any reasonable judgment about the threat volcanic eruptions pose includes a judgment about how likely they are to occur.

Further, FSOC is statutorily authorized to designate a company for Federal Reserve Board (Board) supervision if the company's material financial distress could pose a threat to the financial system, *or* if its "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" does so.[5] On FSOC's proposed reading, this separate enumerated basis for designation would be reduced to mere surplusage. If a company's activities are so large, concentrated, or interconnected that by themselves they could threaten the financial system, then obviously the material distress of such a company could pose a threat too. For the two bases to do independent work, the material financial distress basis must take into account the likelihood of distress.

In addition, several of the statutory risk-related factors—such as the "extent" of "leverage" and "off-balance-sheet exposures"—that FSOC is required to consider under any exercise of its designation authority bear on the likelihood of a company experiencing material financial distress.[6] This indicates Congress expected FSOC to consider likelihood of a nonbank company's financial distress as a component of FSOC's nonbank designation authority. The 2012 Guidance recognized as much.[7] The Proposed Guidance, by contrast, does not address these statutory indications of Congressional intent.

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[4] 12 U.S.C. § 5323(a)(1).

[5] *Id.*

[6] *Id.* § 5323(a)(2)(A), (B).

[7] *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21,637, 21,641 (Apr. 11, 2012) (2012 Guidance) (noting that three of its six analytic framework categories "seek to assess the vulnerability of a nonbank financial company to financial distress").

At a minimum, the likelihood of material financial distress is an "appropriate" "risk-related factor" under any reasonable construction of that term.[8] "Risk" is defined as "the possibility of injury" or "loss."[9] And the likelihood of financial distress is an essential component of the probability of harm that would follow from that distress. The statute simply does not permit FSOC to ignore the likelihood of a nonbank financial company's material financial distress.

Even if Section 113 could bear the reading FSOC now proposes, FSOC's history of contrary guidance establishes a high legal bar to adopting the Proposed Guidance's new interpretation. Until now, FSOC's guidance regarding the nonbank designation authority under Section 113 of the Dodd-Frank Act has, since first being adopted, required FSOC to take into account a company's likelihood of material financial distress before designating it for Board supervision. To change course now, FSOC must "display awareness that it *is* changing position" and "show that there are good reasons for the new policy."[10] As described below, however, the Proposed Guidance fails to satisfy either requirement.

The Proposed Guidance claims that FSOC's "original understanding" was that "the 2012 Interpretive Guidance did not contemplate the consideration of the likelihood of a nonbank financial company's material financial distress."[11] That makes, in FSOC's current view, the 2019 Guidance[12] an aberration that "altered the Council's approach."[13] FSOC now believes the 2019 Guidance is mistaken because FSOC cannot afford to "[w]ait[] to act until there is a reasonable likelihood of a company's failure"; for Board oversight and prudential standards "to be most effective, they must be in place well before material financial distress appears to be likely."[14]

These characterizations contradict what the 2012 and 2019 Guidances actually said. For example, the 2012 Guidance recognized that a threat determination includes "assess[ing] the vulnerability of a nonbank financial company to financial distress."[15] Indeed, when FSOC tried in *MetLife* to make the same argument that it need not consider

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[8] 12 U.S.C. § 5323(a)(2)(K).

[9] *Risk*, *Oxford English Dictionary* (3d ed. 2010).

[10] *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009).

[11] Proposed Guidance, 88 Fed. Reg. at 26,239 n.21.

[12] *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 84 Fed. Reg. 71,740, 71,754 (Dec. 30, 2019) (2019 Guidance).

[13] *Id.*

[14] *Id.* at 26,239.

[15] 2012 Guidance, 77 Fed. Reg. at 21,641.

likelihood of material financial distress, the court held it was "undeniably inconsistent" with the 2012 Guidance then in force.[16]

Similarly, FSOC's assertion under the Proposed Guidance that it cannot wait "until there is a reasonable likelihood of a company's failure" to act is consistent with the 2019 Guidance, not a reason to scrap it. The 2019 Guidance rejected a requirement "to determine that distress is reasonably likely to occur" before FSOC could act, "because it would impose an unduly high burden on the Council's ability to designate a nonbank financial company."[17] Instead, it identified "likelihood of material financial distress" as *a* relevant factor it would consider when making designation decisions.[18] Moreover, the 2019 Guidance defined "likelihood of material financial distress" not just to mean a prediction of imminent distress, but more generally as "vulnerability" to distress based on its characteristics.[19] By mischaracterizing what its currently-in-force Guidance actually requires, FSOC has not displayed sufficient "awareness" of its change in position.[20]

FSOC mistakenly frames the choice before it as either (1) retaining a novel, rigid requirement to make a finding of reasonable likelihood of distress in every case, or (2) to take no account of likelihood of distress at all. It overlooks the possibility of maintaining its actual historic position—deeming the likelihood of material financial distress a relevant "risk-related" factor. This failure to consider a reasonable "alternative" is arbitrary.[21] It simply does not follow that, because a precise "likelihood of financial distress" threshold is unworkable, that FSOC should be utterly indifferent to the likelihood of material distress, and thus the reality of any threat to the financial system.

Nor is the Proposed Guidance's invocation of Lehman Brothers persuasive.[22] Lehman Brothers may have collapsed quickly. But even if the precise timing of its downfall was hard to foresee, an entity like Lehman Brothers could still be deemed "vulnerable" to distress based on, for instance, its "leverage," "degree of reliance on short-term funding,"

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[16] *MetLife, Inc. v. FSOC*, 177 F. Supp. 3d 219, 234 (D.D.C. 2016).

[17] 2019 Guidance, 84 Fed. Reg. at 71,754.

[18] *Id.* at 71,767.

[19] *Id.*

[20] *Fox*, 556 U.S. at 515.

[21] *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 48 (1983) ("an agency rule would be arbitrary and capricious if the agency … entirely failed to consider an important aspect of the problem").

[22] *See* Proposed Guidance, 88 Fed. Reg. at 26,239 (identifying Lehman Brothers as proof that a "financial company can go from seemingly healthy to in danger of imminent collapse in a matter of months, weeks, or even days").

"risks from exposures to counterparties," and other factors, without FSOC having to make a prediction about whether it is on the verge of collapse.[23]

Likewise, FSOC's concerns about a determination of the likelihood of a designated nonbank financial company's financial distress triggering a "run" on a company's assets are also unwarranted.[24] To begin with, many nonbank companies' assets, such as private equity and private credit firms, are not susceptible to runs because, for example, they engage in only limited borrowing, whether short- or long-term, and are subject to contractual restrictions significantly limiting a lender's ability to request prepayment or an early unwind of a loan (*e.g.*, upon the occurrence of an event of default and usually not solely as a result of reputational concerns relating to the borrower). Nor are private equity funds subject to on-demand investor redemptions or withdrawals. This is fundamentally different from the liability structures of insured depository institutions that make them at risk of a "run." In any event, FSOC need not make public its precise findings on material financial distress. And, as FSOC recognized in its 2019 Guidance, "the marketplace" already "will, in most cases, consider the same fundamental factors that FSOC evaluates for purposes of independently assessing the likelihood of material financial distress at a company that is being evaluated for a potential determination."[25] The Proposed Guidance ignores that consideration.

Finally, before it can adopt new guidance, FSOC must also "address whether there was 'legitimate reliance' on" its previous guidance and, if so, "take[]" those "reliance interests … into account."[26] In response to the 2012 and 2019 Guidances, nonbank financial companies across a variety of industries have taken actions to enhance their resilience, such as raising additional capital, simplifying their entity structure, and enhancing their enterprise-wide risk management. Eliminating all consideration of the likelihood of material financial distress risks rendering the benefits of (and significant costs incurred relating to) those efforts irrelevant.

### B. Consideration of Costs

FSOC's rejection of cost-benefit analysis is both contrary to the statute and arbitrary.

Under the Administrative Procedure Act, agencies have a duty to engage in "reasoned decisionmaking."[27] That means the agency's decisions are "reasonable and

[23] *See* 2019 Guidance, 84 Fed. Reg. at 71,767.

[24] *See* Proposed Guidance, 88 Fed. Reg. at 26,239.

[25] 2019 Guidance, 84 Fed. Reg. at 71,754–55.

[26] *Dep't of Homeland Sec. v. Regents of the Univ. of Cal.*, 140 S. Ct. 1891, 1913 (2020).

[27] *State Farm*, 463 U.S. at 52.

reasonably explained."[28] A fundamental requirement of reasonableness is assessing the benefits and costs of a proposed course of action. "One would not say that it is even rational, never mind 'appropriate,' to impose" large "costs in return for a few … benefits."[29] Sometimes Congress so narrowly limits the relevant factors an agency must consider that the agency need not consider costs. But Section 113 is not one of them. The factors it requires FSOC to consider are open ended, and the statute explicitly reaffirms that FSOC must comply with the ordinary requirements of "arbitrary and capricious" review.[30]

Two provisions in particular require FSOC to consider costs. *First*, is the requirement to consider "any other risk-related factors that FSOC deems appropriate."[31] Under Supreme Court precedent, the term "appropriate" is "the classic broad and all-encompassing term that naturally and traditionally includes consideration of all the relevant factors," including "at least some attention to cost."[32] Applying that precedent, *MetLife* held that "FSOC [must] consider the cost of designating a company for enhanced supervision."[33]

To be sure, under the catchall provision, the cost must be "risk-related" to be relevant.[34] But there are many risk-related costs whose consideration the Proposed Guidance would prohibit. For instance, designation may foreclose other regulatory approaches that accomplish the same benefit for financial stability more cheaply or to a greater degree.[35] Designation may have unintended consequences, such as activities shifting from one sector to another or substantially reducing the availability of particular financial products or services, that may cause market disruption and consolidation adverse to the interests of the customers these businesses serve and thereby increase risk to financial stability in aggregate. Imposing onerous costs on the designated company may not only outweigh the benefits, but designation may bring about the very material distress it aims to guard against. Cost-benefit analysis would ensure that designation is truly the best approach for handling the particular risk to financial stability the company poses.

FSOC asserts that it need not consider whether designation would increase a company's likelihood of material distress—and, indeed, implies *MetLife* was wrong to

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[28] *FCC v. Prometheus Radio Project*, 141 S. Ct. 1150, 1158 (2021).

[29] *Michigan v. EPA*, 576 U.S. 743, 752 (2015).

[30] 12 U.S.C. § 5323(h).

[31] *Id.* § 5323(a)(2)(K).

[32] *Michigan*, 576 U.S. at 752.

[33] 177 F. Supp. 3d at 241.

[34] *Id.*

[35] This cost is also relevant under the factor "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies." 12 U.S.C. § 5323(a)(2)(H).

"assume[]" this was the case—because "the likelihood of a company's material financial distress" is "not … a consideration in a designation under section 113."[36] As discussed above, however, FSOC's premise that its designation authority presupposes a company's financial distress without requiring an assessment by FSOC of the likelihood of that company's financial distress is unfounded.[37] FSOC's proposed position would be analogous to a ship regulator disregarding whether requiring heavier lifeboats would cause ships to capsize, because its sole concern was minimizing the harm caused by sinking once the ship has already begun to sink. Plainly, this approach would not be consistent with Congress's aim of promoting financial stability.

*Second*, consideration of costs is also required because designation is ultimately discretionary. If FSOC determines that a company's material distress or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities could pose a threat, it "*may* determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards."[38] "The word 'may' clearly connotes discretion."[39] The statute contains no explicit limits on how that discretion is to be exercised. Thus, even more than the term "appropriate," this provision conveys a "broad and all-encompassing" discretion in which "at least some attention to cost" is necessarily relevant.[40]

Since the discretion authorized by this provision is not limited to "risk-based" considerations, it requires FSOC to consider whether—apart from concerns about systemic risk—the costs that designation imposes on the subject company are simply too onerous for the benefits conferred. Financial stability is of course a weighty governmental interest. But even very weighty government interests have to be balanced against the interests of the private parties that bear the costs of regulation. For instance, although protecting the environment is an interest of the highest order, the EPA cannot "require industry … to spend billions to save one more fish or plankton."[41] So too, then, FSOC cannot impose outsize costs on an individual company in exchange for unspecified or very slight abstract and hypothetical benefits to financial stability.

As the above discussion shows, FSOC is mistaken when it claims that Congress itself made a cost-benefit judgment about any particular designation.[42] To the extent the

[36] Proposed Guidance, 88 Fed. Reg. at 26,238 n.16. As already discussed, this view is based on a faulty reading of the statute; properly interpreted, Section 113 requires consideration of the likelihood of material distress and does not presuppose its existence.

[37] *Supra* at 2.

[38] *Id.* § 5323(a)(1).

[39] *Fogerty v. Fantasy, Inc.*, 510 U.S. 517, 533 (1994).

[40] *Michigan*, 576 U.S. at 752.

[41] *Entergy Corp. v. Riverkeeper, Inc.*, 556 U.S. 208, 226 (2009).

[42] Proposed Guidance, 88 Fed. Reg. at 26,238.

threat determination requires FSOC to consider appropriate risk-related factors, it requires consideration of costs. Once FSOC makes a threat determination, it still must decide whether to designate the company as a matter of discretion. And the reasoned exercise of that discretion necessarily includes consideration of costs.

Nor is it infeasible for FSOC to weigh costs and benefits. FSOC asserts that financial crises are difficult to predict and that the costs of a financial crisis are also difficult, if not impossible, to measure.[43] Agencies, however, are required to assess difficult-to-measure costs and benefits all the time. The EPA, for instance, must weigh costs and benefits in its regulations.[44] Yet there is no simple or purely objective way to compare the value of the continued existence of an endangered species with the costs on regulated industry. Nor is there some straightforward way of predicting the precise effect of any one environmental regulation on climate change. Still, the agency is not absolved from the requirements of reasoned decisionmaking.[45]

In applying the APA, courts do not ask the impossible. Agencies may "evaluate qualitatively costs that are difficult to quantify."[46] They may "hazard a guess" in their predictive judgments when there is conflicting evidence.[47] FSOC's concerns about the great harms of financial crises and the difficulty of measuring them do not show that cost-benefit analysis is impossible. They just show that, to the extent hard quantitative estimates are difficult to come by, FSOC may be justified in performing a qualitative analysis. But to free FSOC from considerations of cost or justification of the burden imposed by designation would be to sanction the disregard of legal requirements. Further, FSOC's unwillingness to engage in a cost-benefit analysis shows an indifference to and disregard of the compliance costs and business-altering impact that a designation entails.[48]

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[43] *Id.*

[44] *See Michigan*, 576 U.S. at 752–53.

[45] For an economic analysis of the Proposed Guidance and Proposed Analytic Framework, including the feasibility of a cost-benefit analysis, see Craig M. Lewis, *FSOC's Proposed Interpretive Guidance on the Supervision and Regulation of Certain Nonbank Financial Companies* (July 27, 2023), attached hereto.

[46] *Ctr. for Sustainable Econ. v. Jewell*, 779 F.3d 588, 611 (D.C. Cir. 2015).

[47] *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1150 (D.C. Cir. 2011).

[48] In addition to the burden of Board supervision, which examination alone can be costly and distracting, FSOC may recommend and the Board shall impose risk-based capital requirements, leverage limits, liquidity requirements, resolution planning requirements (with the potential for second order restructuring effects), concentration limits, and overall risk management requirements. *See* 12 U.S.C. § 5325(b)(1). FSOC need only look to prior Board orders prescribing these enhanced prudential standards to previously-designated companies. *See, e.g.*, *Final Order Applying Enhanced Prudential Standards and Reporting Requirements to General Electric Capital Corporation*, 80 Fed. Reg. 44,111 (July 24, 2015).

### C. Failure to Define Prudential Standards

The Proposed Guidance also disregards the need to reasonably assess costs and benefits by having FSOC designate an entity *before* identifying what the consequences of designation will be. FSOC cannot reasonably exercise its discretion if it does not know what it is voting for. Nor can it reasonably explain why the benefits of designation justify its costs if there is no way of knowing what those benefits and costs are at the time the decision is made. This is particularly troubling given FSOC's duty to "take into account differences among nonbank financial companies" and to "adapt its recommendations as appropriate in light of any predominant line of business of [a designated] company."[49] If the appropriate prudential standards vary significantly based on the individual company in question, it is even less reasonable to suppose that FSOC can generally determine that prudential standards are warranted without knowing what they will be.

### D. Definition of "Threat"

By eliminating the definition of "threat," the Proposed Guidance again mischaracterizes the 2019 Guidance, ignores the 2012 Guidance, and does not consider reasonable alternatives.

The existence of a "threat" to financial stability is the objective finding FSOC must make to designate a company under the material-distress provision of Section 113(a).[50] Because of the vagueness of the term and its importance in the statutory scheme, FSOC has always defined it to give meaningful notice to regulated parties. The 2012 Guidance provided that a threat exists "if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."[51] The 2019 Guidance now defines "threat" as "the threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy."[52]

FSOC now claims the 2019 definition "contrasts sharply" with the language of Section 113.[53] "The definition," FSOC notes, "requires the Council to determine that the economy 'would' be severely damaged," whereas the statute "calls on the Council to determine whether there 'could' be a threat to financial stability."[54] However, nothing in the 2019 Guidance attempts to replace the "could" in the statute with "would." Yes, a threat exists only if there *would* be severe damage to U.S. financial stability resulting from a

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[49] 12 U.S.C. § 5325(b)(3).

[50] *Id.* § 5323(a)(1).

[51] 2012 Guidance, 77 Fed. Reg. at 21,657.

[52] 2019 Guidance, 84 Fed. Reg. at 71,763.

[53] 88 Fed. Reg. at 26,236.

[54] *Id.*

company's material financial distress. But the statute does not require FSOC to find that there *is* a threat to designate a company, only that there *could be* a threat. In other words, the 2019 Guidance's standard is met if distress at a company *could* lead to a situation where there *would* be severe damage to the economy. That is entirely consistent with the statute.

The Proposed Guidance once again ignores the continuities between the 2012 and 2019 Guidances. Although the 2019 Guidance established a higher threshold for threat, the definitions have in common that a threat exists if there "would be" at least "significant" damage to the economy.[55] This is the very feature of the 2019 Guidance that the Proposed Guidance finds offensive, yet in criticizing the 2019 Guidance's definition, the Proposed Guidance claims it is somehow an inappropriate departure from the 2012 Guidance's definition.[56]

The Proposed Guidance also once again adopts a misguided all-or-nothing approach. In criticizing the 2019 Guidance's definition, the Proposed Guidance does not acknowledge that FSOC has always defined "threat" in its guidances. Even if *this* definition is too stringent, that does not explain why *no definition at all* is appropriate. Indeed, given FSOC's proposed loosening of other restraints on its discretion, retaining a concrete definition of "threat" to U.S. financial stability is all the more important to preserve a meaningful and achievable measure of objectivity in FSOC's designation procedures. In addition, by maintaining this measure of objectivity, a clear definition of "threat" to financial stability would allow market participants to determine properly and effectively how to manage their businesses, and incur necessary and recommended costs, to reduce their systemic risk profile, which would improve financial stability in a market-determined and cost-efficient manner.

### E. Activities-Based Approach

The Proposed Guidance's abandonment of an activities-based approach is arbitrary. The activities-based approach set forth in the 2019 Guidance reasonably recognizes FSOC's role as a non-supervisory interagency body, implements Dodd-Frank's purposes, and avoids distortions caused by unnecessary company-specific designations. The Proposed Guidance does not consider these points in rejecting the activities-based approach.

FSOC is not a "primary financial regulatory agency."[57] Its job, in other words, is not to be one financial regulator among many. As its name indicates, it is meant to provide financial stability *oversight* through the coordination of the primary regulators that constitute its members in order to promote financial stability. Rather than directly promulgate and enforce regulations, its duties are to "facilitate information sharing and

[55] *See* 2012 Guidance, 77 Fed. Reg. at 21,657.

[56] Proposed Guidance, 88 Fed. Reg. at 26,236 n.10.

[57] *See* 12 U.S.C. § 5301(12).

coordination," "recommend … priorities," "identify gaps in regulation," and so forth.[58] FSOC's unique structure reflects this. With the exception of the independent member, no voting member of FSOC's full-time job is to be part of FSOC; every member holds the position by virtue of holding some other office that directly involves financial regulation and that is that member's primary responsibility.[59]

By conferring the designation power, Congress has recognized that there may be situations where protecting financial stability requires FSOC to make a direct, individualized determination that a particular company needs to be regulated to a greater extent. However, Congress conferred this power in a manner consistent with FSOC's status as a secondary financial regulator. FSOC cannot designate a company without considering "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies."[60] And FSOC cannot act without an extraordinary degree of direct involvement and consensus by its members not typically required of an administrative agency. Namely, FSOC cannot designate a company without a "nondelegable" vote by its members, a two-thirds supermajority, and "an affirmative vote by the Chairperson."[61] These extraordinary procedural safeguards indicate that designation is an extraordinary measure. It is meant to be used only where more informal coordination among primary regulators is inadequate to address the threat to financial stability.

The 2019 Guidance's adoption of an activities-centered approach effectively implements these textually based principles. It ensures FSOC remains in an oversight role rather than becoming simply one more financial regulatory agency among many. It keeps designation on the table, but as a last resort, when the agencies whose job is to regulate directly are unable to address the threat to financial stability on their own.[62] It appropriately recognizes that designation is a blunt tool: singling out individual nonbank companies for bank-like regulation creates competitive distortions among companies and markets, among other drawbacks. And it transparently communicates to regulated parties how FSOC will wield its authority.

In rejecting the activities-based approach, the Proposed Guidance focuses exclusively on the need for flexibility, noting that different regulatory interventions are appropriate for different types of threats.[63] But an activities-based approach does not preclude flexibility. It simply structures the order in which various approaches will be

[58] *Id.* § 5322(2).

[59] *Id.* § 5321(b)(1).

[60] *Id.* § 5323(a)(2)(H).

[61] *Id.* § 5323(a)(1).

[62] The primary regulator of the private equity industry, the Securities and Exchange Commission (SEC), has a panoply of existing regulatory authorities to address any concerns and a history of using them. *See infra* Part III.

[63] Proposed Guidance, 88 Fed. Reg. at 26,237.

considered to remain faithful to the principle that FSOC is not a primary financial regulator. The Guidance does not consider this point, nor does it address the need for avoiding mission creep, for transparency and predictability, and for avoiding the distortionary effects of an entity-based approach that led FSOC to adopt the activities-based approach in the first place.

Furthermore, by abandoning the activities-based approach, FSOC is actually departing from the more appropriate mechanism to identify and address systemic risk outside of the banking system. Under the activities-based approach, FSOC monitors the economy and works with federal and state financial regulators to identify particular activities that could pose a threat to U.S. financial stability, then coordinates to issue consistent and predictable rules that govern a particular market as a whole, instead of singling out individual entities for unique disfavor. In the case of AIC's members, the SEC already possesses sufficient statutory authority under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*, to address any potential FSOC concern. *See infra* Part III.

In place of an activities-based approach, the Proposed Guidance encourages designation as a default tool whose use is guided only by the vague, non-exhaustive risk factors contained in the Proposed Analytic Framework. *See infra* Part II. The result is to replace predictable, generally applicable rules with the unpredictable application of onerous, entity-specific supervision, examination, and regulation. Instead of looking to their primary regulators for guidance, nonbank companies will be left guessing about FSOC's intentions and bereft of the information necessary to make informed decisions about their businesses.

### F. Abbreviated Determination Process

Further exacerbating matters, the Proposed Guidance undercuts procedural protections for companies facing potential designation and circumvents the *nondelegable* duty of FSOC voting members to decide whether to designate a company.

Despite the enormous consequences of designation and duty of FSOC's voting members to *themselves* determine whether it is appropriate, the Proposed Guidance allows FSOC staff to make the decision whether to proceed with Stage 1 of the determination process.[64] Once FSOC members do get involved, they are entitled to request a "page-limited summary of the company's submissions."[65] If designation decisions are to be personally made by voting members, they must review companies' submissions themselves. Companies are given a mere 60 days' notice before the critical vote to Stage 2

[64] *Id.* at 26,241–42.

[65] *Id.* at 26,242.

occurs. And the primary regulators, who are the ones that would actually enforce any resulting prudential standards, are barely part of the process at all.[66]

The proposed substantial reduction in procedural protections, combined with the proposed changes to prior guidance facilitating FSOC's designation of specific companies, increase the risk that FSOC would make an unnecessary and counterproductive firm designation that could result, on balance, in more costs than benefits to U.S. financial stability. Further, the risk of such a counterproductive designation by FSOC could contribute to operational uncertainty by many companies, and result in adverse impacts to those companies, the markets in which they function, and the customers that they serve.

FSOC should expand rather than eliminate due process protections. Among other reforms, FSOC principals (rather than staff or deputies) should be required to vote to commence the review of a nonbank in Stage 1. Nonbanks should be given an opportunity and ample time to review and correct the evidentiary record on which FSOC will base its decision to move to Stage 2 or Proposed Determination. FSOC principals should be available to meet with nonbanks throughout the process, along with FSOC member agency staff and FSOC staff. The primary financial regulatory agency of the nonbank under review should be involved throughout FSOC's review process as well, rather than merely consulted by FSOC staff from time to time. These and other procedural reforms could help protect the rights of nonbanks during the determination process and enhance FSOC governance, credibility and accountability.

## II. Analytic Framework

FSOC's Proposed Analytic Framework is also arbitrary. The framework purports to help the public "better understand" how FSOC "will perform certain of its duties," including designation.[67] To that end, it identifies a number of "vulnerabilities" that are indicative of a potential threat to financial stability.[68] However, FSOC is already required to consider ten distinct factors in Section 113(a)(2), along with any other risk-related factors it deems appropriate, when making a designation determination.[69] And it is not at all clear how the "vulnerabilities" the framework enumerates relate to those factors.

For instance, some of the Section 113(a)(2) factors, like "the extent of leverage,"[70] appear to correspond to a "vulnerability," like "leverage."[71] But other statutory factors, like

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[66] *Id.*

[67] Proposed Analytic Framework, 88 Fed. Reg. at 26,307.

[68] *See id.*

[69] 12 U.S.C. § 5323(a)(2).

[70] *Id.* § 5323(a)(2)(A).

[71] Proposed Analytic Framework, 88 Fed. Reg. at 26,307.

"the extent to which assets are managed rather than owned by the company,"[72] have no analogue in the Proposed Analytic Framework. And the framework includes some vulnerabilities, like "complexity or opacity," that have no analogue in Section 113(a)(2).[73]

To make matters even more confusing, the Proposed Analytic Framework purports to be relevant for multiple FSOC functions, such as formal recommendations of additional regulatory standards under Section 120.[74] But to issue such recommendations, FSOC is required to consider a distinct set of factors that differ from those in Section 113(a)(2).[75] Failure "to consider a statutorily mandated factor" is "arbitrary and capricious."[76] Yet the Proposed Analytic Framework appears to establish a single one-size-fits-all set of considerations applicable across distinct statutory duties with distinct mandated considerations.

Even if it were clear how FSOC plans to use them, the Proposed Analytic Framework's vulnerability categories are of limited use because they are vague and overly broad. Each category is fleshed out only with a high-level qualitative description, with no indication of whether or how FSOC will take it into consideration in a rigorous, empirically grounded manner. In this respect, FSOC stands in stark contrast to other organizations dedicated to assessing systemic financial risk. For instance, in assessing the systemic risk posed by individual insurers, the International Association of Insurance Supervisors (IAIS) assigns a percentage weight to each specific risk category in its analysis to produce an overall score for each company. And many of the specific categories are explicitly tied to quantitative measures of the company's status.[77] The Proposed Analytic Framework offers no comparable guidance on how FSOC will assess each vulnerability or the importance of each vulnerability relative to each other. It fails to provide meaningful transparency on how FSOC will assess the risk posed by any particular company and essentially leaves FSOC to make designation decisions without transparency or consistency.

The "vulnerability" of "destabilizing activities" in particular is circular and should not be included.[78] The whole point of listing "vulnerabilities" is to identify which activities and characteristics are destabilizing. By including at the end a grab-bag category of

[72] 12 U.S.C. § 5323(a)(2)(F).

[73] Proposed Analytic Framework, 88 Fed. Reg. at 26,308.

[74] 12 U.S.C. § 5330.

[75] *See id.* § 5330(a).

[76] *Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004).

[77] *See* IAIS, *Holistic Framework for Systemic Risk in the Insurance Sector* 20–21 (Nov. 2019); IAIS, *Global Systemically Important Insurers: Updated Assessment Methodology* (June 16, 2016).

[78] *See* Proposed Analytic Framework, 88 Fed. Reg. at 26,308.

activities that are "by their nature" destabilizing without further elaboration undercuts any discipline the listing of vulnerabilities would impose on FSOC's determinations.[79]

## III. Private Equity

AIC urges FSOC to consider the stability-promoting activities of its members and of the private equity industry generally. In light of their long-term funding and investment structure, private equity firms and the funds they sponsor pose no threat to U.S. financial stability. Various legal entities within these firms have long been regulated by the SEC, and the SEC has identified no risk to U.S. financial stability from them.

As an initial and very important prefatory matter, large U.S. private equity firms are registered with, and regulated by, the SEC, an FSOC member, which operates a robust regulatory program. The Investment Advisers Act of 1940, and rules adopted thereunder by the SEC, impose a wide-ranging suite of fiduciary obligations on private equity firms and other registered investment advisers, many of which serve to reduce the likelihood that private equity firms would present systemic risk. Among other protections, as registered investment advisers, private equity firms must comply with the following suite of SEC rules addressing risk:

- **Examination by the SEC, Section 203A:** SEC staff have statutory authority to conduct on-site examinations of private equity firms and other registered investment advisers. The examination and enforcement staff accounts for about half of all the staff of the SEC, and is located in eleven regional offices and in Washington, D.C.[80] The SEC's Division of Examinations expressly states that its mission is to protect investors and ensure market integrity by monitoring for risk, among other things.[81]

- **Custody Rule, Rule 206(4)-2:** The Advisers Act custody rule requires segregation of client assets to prevent them from risk associated with pooling assets with other advisory clients.

- **Compliance Program Rule, Rule 206(4)-7:** Private equity firms are required to establish extensive compliance programs to help avoid and identify violations of the U.S. securities laws.

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[79] *Id.*

[80] SEC, *Fiscal Year 2022 Agency Financial Report* (p. ii), available at https://www.sec.gov/files/sec-2022-agency-financial-report.pdf#chairmessage.

[81] SEC, *About the Division of Examinations*, available at https://www.sec.gov/exams/about.

- **Form PF Reporting Rule 204(b)-1:** Private fund advisers are required to report regulatory assets under management to FSOC on a Form PF, for risk monitoring.

- **Form ADV Reporting, Rules 203-1 and 204-1:** Investment advisers are required to provide extensive information about their businesses and the private funds they manage on Form ADV.

In addition to the primary and comprehensive role of the SEC, AIC respectfully asserts that private equity firms' business models serve to reduce—not create—systemic risk. Private equity funds generally are not leveraged at the level of other financial institutions, and are legally structured to prevent exposure for the fund itself beyond the capital committed by investors. Funds generally take the legal form of a limited partnership comprising a general partner and the limited partners who are the investors in the fund. These limited partners—typically pension funds, endowments and other long-term, sophisticated investors—have a contractual obligation to contribute capital to the fund upon request to make equity investments in the fund's portfolio companies or loans to small to medium enterprises. Unlike bank depositors or investors in vehicles like money market mutual funds, limited partners have no right to redeem their capital upon demand other than upon the occurrence of certain delineated contractual events or contractual breaches; on the contrary, capital contributions by limited partners are typically "locked-up" by contract in the funds for years.

Private equity funds do sometimes borrow money, but the fund's governing documents typically will place restrictions on the fund creating exposures beyond its total committed capital. For example, a private equity fund generally is permitted to borrow on a short-term basis for purposes of efficient investor cash flow management, *i.e.*, to bridge the period from when an investment is made by the fund to when money is received from investors following the issue of a draw down notice on already committed capital. Amounts borrowed at the fund level for these purposes are typically capped and secured for their duration against the undrawn (but legally binding) commitments of investors and, therefore, do not increase the aggregate amount available for investments at the fund level. This arrangement does not result in any exposure to the private equity fund, as any such borrowing is typically matched with a corresponding legal commitment from investors.

As a result of the above, private equity firms do not exhibit the vulnerabilities identified in the Proposed Analytic Framework. In addition, private equity firms have the following risk-mitigating characteristics:

- Private equity funds are not subject to on-demand investor redemptions or withdrawals. If a fund investor wishes to exit its fund investment (particularly in closed-end funds), it typically will find another buyer of that investor's fund interest. To the extent that a fund investor is permitted to withdraw its investment from certain types of private equity investment

vehicles, the investor's withdrawal rights would typically be materially limited (*e.g.*, through redemption limits, limited redemption periods and maximum redemption frequencies). These structures allow private equity investment vehicles to minimize maturity mismatches and minimize the risk of a liquidity squeeze, and investors in such investment vehicles are generally unable to force the rapid unwind, and corresponding asset fire sales, of the investment vehicles.

- Private equity firms are not interconnected with each other. Even within a large private equity or credit business, the firm and the funds that it manages are not interconnected because such a firm and its funds neither pledge their assets as security for, nor do they guarantee, each other's obligations.

- Most private equity firms have relatively simple structures compared to large financial institutions. As previously noted, funds are pooled investment vehicles, most frequently organized as limited partnerships. Their private equity advisers are registered with the SEC as investment fund advisers or exempt reporting advisers and subject to extensive regulation. Indeed, many of the applicable regulatory requirements have been added since the 2012 Guidance.

- Finally, private equity funds are not concentrated. Rather, they are quite small in size relative to large banks, broker-dealers, and advisers to registered investment companies. For the same reason, their activities are not large or interconnected enough to be destabilizing by nature.

Recent statements from financial regulators confirm that private equity funds do not pose systemic risk. The Board—the very entity that would supervise a private equity fund were it designated—concluded in its latest *Financial Stability Report* that "[o]verall, the financial stability vulnerabilities posed by private credit funds appear limited. Most private credit funds use little leverage and have low redemption risks, making it unlikely that these funds would amplify market stress."[82] And Secretary Yellen has testified that "designation of companies" is not "appropriate" for "asset management."[83]

* * *

[82] Board of Gov'rs of the Fed'l Res. System, *Financial Stability Report* 54 (May 2023).

[83] The Quarterly CARES Act Report to Congress: Hearing Before the S. Comm. On Banking, Housing, & Urban Affairs, 117th Cong. (Mar. 24, 2021) (answer of Sec. Janet L. Yellen in response to Sen. Elizabeth Warren), https://www.banking.senate.gov/hearings/03/17/2021/the-quarterly-cares-act-report-to-congress ("With respect to asset management, rather than focus on designation of companies, I think it's important to focus on an activity like that and to consider what the appropriate restrictions are.").

AIC appreciates the opportunity to comment on FSOC's Proposed Guidance and Proposed Analytic Framework. FSOC should make unmistakably clear that private equity firms do not pose a systemic risk warranting designation. And it should avoid promulgating guidelines that, by imposing no meaningful constraints on FSOC's discretion, could create unnecessary uncertainty and disruption in the financial services market and adversely affect the supply of financial services to U.S. consumers and businesses.

Sincerely,

/s/ Rebekah Goshorn Jurata
General Counsel
American Investment Council

# ATTACHMENT

# *FSOC's Proposed Interpretive Guidance on the Supervision and Regulation of Certain Nonbank Financial Companies*

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July 27, 2023

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# I. Introduction

1. The role of the Financial Stability Oversight Council ("FSOC") is to identify risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the U.S. financial system.[1] FSOC has authority to designate a nonbank financial company for Federal Reserve supervision and prudential standards if it determines that financial distress at the company could pose a threat to U.S. financial stability.[2] In April 2023, FSOC proposed amendments to its existing interpretive guidance governing the designation of nonbank financial companies for supervision by the Federal Reserve Board ("2023 Proposed Guidance")[3] and a high-level description of an "analytic framework" for identifying, assessing, and responding to financial stability risks ("2023 Proposed Analytic Framework").[4]

2. The 2023 Proposed Guidance describes the procedures FSOC would apply in reviewing a nonbank financial company for potential designation. The need for revised guidance is unclear, as FSOC has yet to convincingly identify a significant systemic risk that cannot be successfully addressed by its existing guidance. At its core, the 2023 Proposed Guidance represents an attempt to remove many of the economic requirements associated with rulemaking to make it easier for FSOC to designate entities that it "believes" may pose systemic risk. The "watering-down" of the designation process represents an ill-considered effort to remove economic elements of the current interpretive guidance that MetLife, Inc. used to successfully challenge FSOC's attempt to designate it as a nonbank Systemically Important Financial Institution ("SIFI").[5]

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[1] U.S. Department of the Treasury, "Financial Stability Oversight Council," available at https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc.

[2] Financial Stability Oversight Council, "Fact Sheet," April 21, 2023, available at https://home.treasury.gov/system/files/261/FSOC-2023-Nonbanks-Guidance-Fact-Sheet.pdf.

[3] "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies," Federal Register 88, no. 82, April 28, 2023, pp. 26234–26244, ("2023 Proposed Guidance").

[4] "Analytic Framework for Financial Stability Risk Identification, Assessment, and Response," Federal Register 88, April 28, 2023, pp. 26305–26311, ("2023 Proposed Analytic Framework"), p. 26306.

[5] Sealed Opinion, *MetLife, Inc. v. Financial Stability Oversight Council,* March 30, 2016, available at https://www.govinfo.gov/content/pkg/USCOURTS-dcd-1_15-cv-00045/pdf/USCOURTS-dcd-1_15-cv-00045-0.pdf, p. 23 ("FSOC did indeed commit to 'evaluat[ing] the…likelihood of material financial distress' at a target company….FSOC's arguments to the contrary ignore its own straightforward Guidance."); pp. 26–27 ("This Court cannot affirm a finding that MetLife's distress would cause severe impairment of financial intermediation or of financial market functioning…when FSOC refused to undertake that analysis itself…. Ultimately it is clear that FSOC did not…apply the standard announced in the Guidance.")

3. I was commissioned by the American Investment Council ("AIC") to (1) assess the soundness of economic arguments developed by FSOC in the 2023 Proposed Guidance, and (2) opine on whether the 2023 Proposed Analytic Framework provides enough information to understand how FSOC will determine whether a nonbank financial company experiencing financial distress could represent a threat to U.S. financial stability.

4. I was specifically tasked with assessing the economic validity of FSOC's reasons for removing the requirements for a cost-benefit analysis and the estimation of the likelihood of a nonbank financial company's potential financial distress during a review for potential designation. I was also asked to evaluate whether the vulnerabilities categories described by FSOC to assess potential risks to financial stability associated with nonbank financial companies provide enough information "to help market participants, stakeholders, and other members of the public better understand how the Council expects to perform certain of its duties."[6]

5. I find that FSOC fails to demonstrate how removing the two requirements previously mentioned would improve FSOC's capability to recognize threats to U.S. financial stability, encourage market discipline, and react to new risks to the U.S. financial system's stability.

6. FSOC should conduct a cost-benefit analysis to show that the expected benefits of a designation could justify the expected costs. This economic tool would also improve the clarity and the transparency of the process. Without a cost-benefit analysis, FSOC could designate a nonbank financial company without evidence that its potential financial distress could have a likely and significant impact on U.S. financial stability, while the designated company would bear the potential costs of this designation.

7. The 2023 Proposed Guidance does not include a cost-benefit analysis requirement because FSOC asserts that uncertainty exists in the estimation of these benefits and costs. I note that FSOC does not provide detailed information about the sources of uncertainties. Uncertainty is not a sufficient reason not to conduct a cost-benefit analysis. When the data is imperfect, quantification may be possible by making plausible assumptions that need to be explained. Moreover, when costs and benefits are not quantifiable, a qualitative analysis of these costs and benefits should be conducted, and this analysis should include a discussion about the strengths and limitations of the qualitative information that is used. As I show

[6] 2023 Proposed Analytic Framework, p. 26306.

below, this approach is consistent with the academic literature and the guidance on economic analysis provided by other regulators.

8. Also, the 2023 Proposed Guidance does not include an estimation of the likelihood of a nonbank financial company's potential financial distress because FSOC contends that nonbank financial companies can unexpectedly and quickly experience material financial distress and, to be effective, the designation must occur before material financial distress appears likely. To support this argument, FSOC provides three examples of companies that experienced material financial distress: Lehman Brothers Inc. ("Lehman Brothers"), Silicon Valley Bank, and Signature Bank. These examples are not particularly relevant because Silicon Valley Bank and Signature Bank are not nonbank financial companies and, regarding Lehman Brothers, there were market concerns about its solvency months before its collapse. These concerns were reflected in the credit default swaps related to Lehman Brothers' debt that included estimates of the likelihood of default. Determining estimates of this nature are commonplace and should be well within the expertise of the financial regulators that comprise FSOC.

9. Another reason provided by FSOC not to include an estimation of the likelihood of a nonbank financial company's potential financial distress is that if the designation includes such an assessment, then it could cause a run on this company by its creditors and counterparties. Such a claim is unsubstantiated. Presumably, sophisticated market participants already consider and evaluate these risks, and FSOC fails to explain how a run on nonbank financial companies could occur as it is unclear that creditors and counterparties can liquidate their positions on demand.

10. Finally, the eight vulnerabilities and metrics that are mentioned in the 2023 Proposed Analytic Framework to assess potential risks to financial stability are too vague to understand how FSOC will use these factors to determine whether a nonbank financial company represents potential risks to financial stability. At a minimum, FSOC should provide illustrative examples of how the vulnerabilities will be used individually and in combination with each other to make this determination. Another possibility to further clarify the proposed methodology is to explain how these vulnerabilities and metrics would apply to past attempts to designate nonbank financial companies.

## II. Overview of Some of the Key Changes in the 2023 Proposed Guidance on Nonbank Financial Company Determination and Their Economic Effects

11. In December 2019, FSOC's final interpretive guidance ("2019 Final Guidance") was issued and includes information about its approach to determining whether a nonbank financial company could represent a threat to the stability of the U.S. financial system and whether this company should be supervised by the Federal Reserve System, among other things.[7] This section provides an overview of the key changes between the 2019 Final Guidance and the 2023 Proposed Guidance I was asked to evaluate and their economic effects.

12. My review of these key changes reveals that the 2023 Proposed Guidance fails to explain how the proposed changes would lead to an economically superior outcome. It is unclear how these changes would enhance FSOC's capability to recognize threats to U.S. financial stability, encourage market discipline, and react to new risks to the U.S. financial system's stability. Essentially, the 2023 Proposed Guidance not only removes many of the economic inputs to the process for labeling nonbank financial companies as systemically important, but it also considerably diminishes the role of regulatory subject matter experts by not relying first on existing regulators under the "activities-based approach."[8] It also introduces further opacity into the designation process and makes it more difficult for firms to contest designations by removing analytical steps such as the cost-benefit analysis intended to compel FSOC to clearly justify its reasons for a designation.

### A. The 2023 Proposed Guidance Indicates That FSOC Would Not Use a Cost-Benefit Analysis to Determine Whether a Nonbank Financial Company Should Be Designated

13. The 2019 Final Guidance states that FSOC will conduct a cost-benefit analysis before making any determination and that it will propose to make a determination "only if the expected benefits justify the expected costs that the determination would impose."[9]

14. Two types of benefits are considered in the 2019 Final Guidance. The first type of potential benefit is related to financial stability. FSOC will evaluate whether the determination may reduce "the likelihood or severity of a financial crisis."[10] The second type

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[7] "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies," Federal Register 84, no. 249, December 30, 2019, pp. 71740–71770 ("2019 Final Guidance").
[8] 2023 Proposed Guidance, p. 26235.
[9] 2019 Final Guidance, p. 71753.
[10] 2019 Final Guidance, p. 71753.

of benefit is specific to the company being considered for designation. The 2019 Final Guidance requires FSOC to assess whether the company may obtain benefits from the designation, such as a "lower cost of capital or higher credit ratings."[11] With respect to costs, FSOC is expected to consider costs related to risk-management requirements, supervision and examination, and liquidity requirements.[12] It would also consider costs related to the U.S. economy such as the impact of the determination on "the availability and cost of credit or financial products in relevant U.S. markets."[13]

15. As shown below, the 2019 Final Guidance mirrors numerous key principles highlighted in the "Current Guidance on Economic Analysis in SEC Rulemakings" ("SEC Guidance") produced by the U.S. Securities and Exchange Commission (the "SEC" or the "Commission").[14] The SEC Guidance emphasizes that "[t]he Commission has long recognized that a rule's potential benefits and costs should be considered in making a reasoned determination that adopting a rule is in the public interest."[15] The SEC Guidance states that there is no specific legal mandate requiring the Commission to carry out a formal cost-benefit analysis, it nonetheless conducts an economic assessment "as a matter of good regulatory practice whenever it adopts rules."[16]

16. Performing an objective economic analysis is more than just a way to enhance transparency around rulemaking. If conducted following standards such as those described in the SEC Guidance, the economic analysis serves as a protective measure to safeguard against legal challenges to FSOC's designations, which could assert that such designations are arbitrary and capricious without such analysis.

17. The 2019 Final Guidance indicates that uncertainty regarding the evaluation of benefits and costs should be discussed. FSOC, when possible, will quantify benefits and costs by using data and using "ranges, as appropriate."[17] The use of ranges provides a way to quantify the benefits and costs under uncertainty. Once again, the 2019 Final Guidance is consistent with the SEC Guidance by acknowledging that when an estimation based on data

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[11] 2019 Final Guidance, p. 71753.
[12] 2019 Final Guidance, p. 71753.
[13] 2019 Final Guidance, p. 71753.
[14] Memorandum, "Re: Current Guidance on Economic Analysis in SEC Rulemakings," March 16, 2012, pp. 1–17, available at https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf ("SEC Guidance").
[15] SEC Guidance, p. 1.
[16] SEC Guidance, p. 3.
[17] 2019 Final Guidance, p. 71753.

is not always possible, FSOC should explain why such quantification is not possible.[18] Importantly, FSOC is also expected to consider a qualitative assessment of costs and benefits and attempt to determine the relative weight of these qualitative considerations.[19] While FSOC acknowledges that it may not be possible to estimate with "any degree of certainty" these costs and benefits, the 2019 Final Guidance indicates that FSOC "will perform a cost-benefit analysis before making any determination…."[20]

18. In contrast, the 2023 Proposed Guidance claims that a cost-benefit analysis is "not useful or appropriate."[21] FSOC contends that "it is not feasible to estimate with any certainty the likelihood, magnitude, or timing of a future financial crisis" that could be triggered by a nonbank financial company's failure.[22] FSOC further argues that the costs of any particular future financial crisis, and consequently, the benefits of its prevention through designation or other measures, cannot be forecasted.[23] While the prospect of a future financial crisis and the associated costs are inherently uncertain, FSOC should be able to articulate why a particular nonbank financial institution is systemically risky and substantiate such a claim with rigorous data analysis. For instance, if FSOC is concerned about interconnectivity and the potential for a nonbank financial company's failure to cause ripple effects in the wider economy, it should be capable of quantifying the range and magnitude of potential counterparty risks. A rigorous economic analysis does not necessarily require a *dollar* estimate but can use rigorous data analysis or fundamental economic principles to help inform and justify a determination, even in the absence of costs or benefits that could be estimated in dollars. In addition, with respect to costs, FSOC claims that the cost of designation to a nonbank financial company depends on the regulatory requirements set by the Federal Reserve and these requirements are decided after the designation. This argument is problematic. As a voting member of FSOC, and the regulator designated to prudentially supervise a designated non-bank financial company, the Federal Reserve should play an active role in any designation. The Federal Reserve's intended regulatory requirements can and should be a part of FSOC's deliberations, otherwise the designation would be blind to the efficacy of the efforts to mitigate systemic risk posed by the nonbank financial company.

[18] 2019 Final Guidance, p. 71754.
[19] 2019 Final Guidance, p. 71754.
[20] 2019 Final Guidance, p. 71753.
[21] 2023 Proposed Guidance, p. 26235.
[22] 2023 Proposed Guidance, p. 26238.
[23] 2023 Proposed Guidance, p. 26238.

19. The 2023 Proposed Guidance does not include a cost-benefit analysis requirement because "evaluating the potential costs and benefits of a designation with reasonable specificity is not possible before a designation."[24] FSOC should not merely assert claims without detailed explanations concerning the complexities of performing a cost-benefit analysis. Instead, it ought to deliver explicit, persuasive explanations rooted in solid economic principles when considering the potential designation of nonbank financial companies. FSOC's decision to remove a crucial "show your work" requirement from the 2023 Proposed Guidance injects an element of potential bias into the designation process by fostering intentional opacity. It is essential to ensure clarity and transparency in these processes.

### B. The 2023 Proposed Guidance Indicates That FSOC Would Not Assess the Likelihood of Material Financial Distress to Determine Whether a Nonbank Financial Company Should Be Designated

20. In addition to an assessment of the likelihood and severity of a financial crisis caused by the potential failure of a nonbank financial company, the 2019 Final Guidance includes an assessment of the likelihood of material financial distress of a nonbank financial company, which represents the likelihood that the risk associated with a nonbank financial company will materialize. As explained in the 2019 Final Guidance, "[c]onsistent with sound risk regulation, the Council will consider not only the impact of an identifiable risk, but also the likelihood that the risk will be realized." To conduct this analysis, FSOC considers "a period of overall stress in the financial services industry and a weak macroeconomic environment."[25]

21. In contrast, in the 2023 Proposed Guidance, FSOC indicates that it would no longer assess the likelihood of material financial distress of a nonbank financial company. A key reason provided by FSOC for this change is that a financial company can unexpectedly and quickly experience material financial distress and, to be effective, the designation must occur before material financial distress appears likely. FSOC argues that implementing the tools used by the Federal Reserve to prevent or mitigate risks to financial stability may take some time. Another argument developed by FSOC is that if designation includes an assessment of the likelihood of material financial distress, it could "create a run on the company by its creditors and counterparties."[26]

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[24] 2023 Proposed Guidance, p. 26238

[25] 2019 Final Guidance, p. 71754.

[26] 2023 Proposed Guidance, p. 26239.

22. As previously mentioned, the 2019 Final Guidance does not require FSOC to estimate "unidentifiable" material risks. Instead, FSOC is only required to assess the likelihood of an "identifiable risk" that could result in material financial distress. This is an estimate that should be well within the expertise of the financial regulators that comprise FSOC. Estimates of this nature are commonplace. For example, buyers and sellers of credit default swaps ("CDS") regularly price the risk of material financial distress.[27]

23. The 2023 Proposed Guidance claims that an assessment of the likelihood of material financial distress is inherently unreliable because financial companies can unexpectedly and quickly jump to default. Several examples were provided in the 2023 Proposed Guidance — Lehman Brothers, Silicon Valley Bank, and Signature Bank — none of which are particularly relevant. First, Silicon Valley Bank and Signature Bank are not nonbank financial companies. Second, not only was the collapse of Lehman Brothers an event that occurred prior to the establishment of FSOC and the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, but there were also market concerns about Lehman Brothers' solvency months before its collapse.[28] The Financial Crisis Inquiry Commission ("FCIC") report indicates that "[a]fter the demise of Bear Stearns in March 2008, most observers…viewed Lehman Brothers as the next big worry among the four remaining large investment banks [and] some institutional investors believed it was a matter not of whether Lehman would fail, but when."[29] The FCIC report also indicates that "on March 18, the day

[27] For context, CDS are financial instruments that allow the transfer of credit risk among market participants. A CDS is a contract where a "protection buyer" agrees to make payments over a certain number of years to a "protection seller" in exchange for a payment from the protection seller in the event of default by a particular company. Market participants use CDS quotes to assess investors' perception of the credit risk associated with the reference entity. A key element underlying CDS prices is market's assessment of the probabilities of default of the reference entity at different points in time. See, e.g., Robert L. McDonald, *Derivatives Markets,* (Upper Saddle River, NJ: Addison Wesley, 2008), pp. 826–833.

[28] Lehman Brothers Holdings Inc. announced its intent to file a Chapter 11 bankruptcy petition on September 15, 2008. The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010 and the first FSOC meeting occurred in October 2010. See Monique Wise and Shaun Butler, "Lehman Brothers Holdings Inc. Announces It Intends To File Chapter 11 Bankruptcy Petition; No Other Lehman Brothers' U.S. Subsidiaries Or Affiliates, Including Its Broker-Dealer And Investment Management Subsidiaries, Are Included In The Filing," Lehman Brothers Press Release, September 15, 2008, available at https://web.archive.org/web/20080920202914/http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf; U.S. Department of the Treasury, "Financial Stability Oversight Council will Hold First Meeting on October 1," September 23, 2010, available at https://home.treasury.gov/news/press-releases/tg870.

[29] Financial Crisis Inquiry Commission, "Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," The Financial Crisis Inquiry Report, January 2011, pp. 1–633, p. 325.

after JP Morgan announced its acquisition of Bear Stearns, the market (through credit default swaps on Lehman's debt) put the cost of insuring $10 million of Lehman's five-year senior debt at $310,000 annually; for Merrill Lynch, the cost was $241,000; and for Goldman Sachs, $165,000." Therefore, on March 18, 2008, market participants correctly believed that Lehman Brothers' debt was riskier than that of Merrill Lynch and Goldman Sachs.

24. FSOC also claims that including an assessment of the likelihood of material financial distress in the designation process for a nonbank financial company could cause a run on this company by its creditors and counterparties. Such a claim is unsubstantiated. Presumably, sophisticated market participants already consider and evaluate these risks. FSOC acknowledges this in its 2019 Final Guidance: "The council believes that the marketplace will, in most cases, consider the same fundamental factors that the Council evaluates for purposes of independently assessing the likelihood of material financial distress at a company that is being evaluated for a potential determination."[30] It is unclear how FSOC's assessment of the likelihood of material financial distress would change investor and creditor behavior enough to trigger a "run" since this possibility is already considered and priced. If anything, it could have the opposite effect; "public awareness of designation (or its mere possibility)" could reduce the perceived likelihood of financial distress, and, if anything, reduce run risk.[31]

25. Moreover, FSOC fails to explain how a run on nonbank financial companies could occur as it is unclear that creditors and counterparties can liquidate their positions on demand. FSOC needs to provide a more detailed discussion.

## III. A Cost-Benefit Analysis Is a Critical Analytical Tool for Regulators Even When Uncertainty Exists regarding the Estimation of Costs and Benefits

26. As explained above, FSOC states that a cost-benefit analysis is not useful and appropriate because assessing the potential costs and benefits of a designation with "reasonable specificity is not possible before a designation." Without a cost-benefit analysis, FSOC could designate a nonbank financial company with no evidence that its potential financial distress could have a likely and significant impact on U.S. financial stability, while the designated company would bear the potential costs of this designation.

27. I note that the sources of uncertainty provided by FSOC are vague. For example, FSOC argues that "it is not feasible to estimate with any certainty the likelihood, magnitude, or timing of a future financial crisis…. The benefits of designation are potentially enormous

[30] 2019 Final Guidance, pp. 71754–71755.
[31] 2023 Proposed Guidance, p. 26239.

and, in many respects, incalculable, representing the tangible and intangible gains that come from averting a financial crisis and economic catastrophe."[32] A more detailed discussion is needed to describe precisely what FSOC would analyze to estimate these potential benefits and why there is a high-level of uncertainty related to these analyses.

28. Other regulators, unlike FSOC in the 2023 Proposed Guidance, use a cost-benefit analysis as a critical tool for regulatory analysis even when uncertainty exists regarding the estimation of costs and benefits. These regulators have developed procedures to address uncertainty that range from a precise qualitative description of the benefits and costs to making quantitative estimates that provide some context for their magnitude, even if they lack precision.

29. When I was at the Commission, a cost-benefit analysis was a tool used for rulemaking, and it included an analysis of unquantifiable costs and benefits. For example, Commissioner Walter mentioned during her opening statement, in April 2012, before the release of the new rules and interpretive guidance to further define the meaning of the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant:"

> "[T]he Commission's decision-making has been characterized by efforts to find the regulatory solution that best protects investors while not imposing unnecessary costs. That is the essence of robust cost-benefit analysis…. The staff…have identified, analyzed and considered quantifiable data when it is available, and also expressly recognized that there are many programmatic benefits and costs to regulation that are not quantifiable. But, as this release demonstrates, unquantifiable does not mean 'unimportant.' Indeed, the mandate in Dodd-Frank for establishing a regulatory regime for security-based swaps indicates that Congress believes that many expected and not currently quantifiable programmatic benefits — the reduction of systemic risk and the increase in investor protection, among others — are critically important."[33]

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[32] 2023 Proposed Guidance, p. 26238.

[33] Commissioner Elisse B. Walter, "Opening Statement for Title VII Intermediaries Release – April 18, 2011," SEC, April 18, 2012, available at https://www.sec.gov/news/statement/2012-04-18-open-meeting-statement-ebw; "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participants,'" Federal Register 77, no. 100, pp. 30596–30764, p. 30596. Regarding the focus of the Commission on cost-benefit analysis for rulemaking, See also Commissioner Daniel M. G. Gallagher, "Statement at Open Meeting on Rule Defining Swaps-Related Terms for Regulating Derivatives," SEC, April 18, 2012 available at https://www.sec.gov/news/statement/2012-04-18-open-meeting-statement-dmg; Commissioner Troy A. Paredes, "Statement at Open Meeting to Adopt the Joint Final Rule, Joint

30. In the sections below, I show that the academic literature recognizes the importance of the estimation of costs and benefits even when uncertainty exists. I also provide examples of regulators that developed guidance that includes a discussion about uncertainty in the context of cost-benefit analysis.

### A. The Academic Literature Recognizes the Importance of Cost-Benefit Analysis in the Regulatory Process When Uncertainty Exists

31. A strand of the academic literature discusses cost-benefit analysis as an important part of sound rulemaking, in particular when cost and benefit estimates are subject to uncertainty.

32. For instance, Cochrane (2014) states that "[t]he concepts of cost-benefit analysis, as understood by economists, are the right way to think about financial regulation."[34] It also discusses the challenges related to cost-benefit analysis in the context of financial regulation. The article indicates that uncertainty is a critical part of financial regulation, and that it is not a reason to avoid quantifying costs and benefits. Cochrane (2014) suggests that an analysis of the statistical and methodological uncertainties should be included in a cost-benefit analysis.[35] In other words, it emphasizes the importance of "design[ing] those [cost-benefit] procedures to reflect the nature and uncertainties of financial costs and benefits" and argues that "[a]t a minimum, a successful cost-benefit analysis framework must do something very unusual in Washington: it must embrace uncertainty, of both numbers and channels of analysis."[36] Cochrane (2014) also highlights the role of qualitative analysis in cost-benefit analysis.[37]

33. Another example is a 2016 article published in the Cornell Law Review that argues that "[u]ncertainty should not be an insurmountable barrier to agency action, but it should not

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Interim Final Rule, and Final Interpretations Regarding the Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' etc.," SEC, April 18, 2012, available at https://www.sec.gov/news/statement/2012-04-18-open-meeting-statement.

[34] Cochrane, John H. (2014), "Challenges for Cost-Benefit Analysis of Financial Regulation," *Journal of Legal Studies*, Vol. 43, No. S2 ("Cochrane (2014)"), pp. S63–S105 at p. S100.

[35] Cochrane (2014) at pp. S78; S99.

[36] Cochrane (2014) at pp. S78–S99.

[37] Cochrane (2014) at p. S102 ("So I conclude that we must imagine and construct a new, flexible cost-benefit process, one that is constantly retrospective, is transparent, includes information from the academic and policy analysis community, focuses as much on qualitative understanding of cause-and-effect channels as the conventional attempt to create numbers that nobody believes, and quantifies its uncertainties, with judicial review as a last gasp for regulations gone seriously awry.").

be used to provide cover for regulation that cannot be justified."[38] The article by Masur and Posner (2016) argues that, when facing uncertainty, agency staff should use their experience and knowledge to estimate costs and benefits, and updating these priors when new information is available represents "an institutional solution to the problem of regulatory uncertainty."[39]

### B. Regulators Rely on Cost-Benefit Analysis for Their Rulemaking

#### 1. The Office of Management and Budget Includes a Cost-Benefit Analysis in Its Guidance for Regulatory Analysis and Discusses the Treatment of Uncertainty

34. The Office of Management and Budget ("OMB") "evaluates, formulates, and coordinates management procedures and program objectives within and among Federal departments and agencies," among other things.[40] In September 2003, OMB provided guidance to Federal agencies regarding the development of regulatory analysis ("2003 OMB Guidance").[41] In April 2023, OMB proposed an update to this guidance ("2023 OMB Proposed Guidance").[42]

35. In both documents, OMB discusses the use of cost-benefit analysis for regulatory analysis and indicates that a cost-benefit analysis is an important tool used for regulatory analysis.[43] OMB also states that regulatory analysis is needed to inform policymakers and the public about the likely effects of regulatory actions.[44] The 2023 OMB Proposed Guidance includes a quote from Executive Order 12866 that emphasizes the importance of a cost-benefit analysis even when costs and benefits cannot be quantified.

> "Costs and benefits shall be understood to include both quantifiable measures (to the fullest extent that these can be usefully estimated) and qualitative measures of costs and benefits that are difficult to quantify, but nevertheless essential to consider."[45]

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[38] Jonathan S. Masur and Eric A. Posner (2016), "Unquantified Benefits and the Problem of Regulation Under Uncertainty," *Cornell Law Review*, Vol. 102, No. 1 ("Masur and Posner (2016)"), pp. 87–137 at p. 136.

[39] Masur and Posner (2016), pp. 92–93.

[40] Federal Register, "Management and Budget Office," available at https://www.federalregister.gov/agencies/management-and-budget-office.

[41] Office and Management and Budget, Circular A–4, September 17, 2003 ("2003 OMB Guidance").

[42] Office and Management and Budget, Update to Circular A–4, April 6, 2023 ("2023 OMB Proposed Guidance").

[43] 2003 OMB Guidance, p. 2; 2023 OMB Proposed Guidance, p. 2.

[44] 2023 OMB Proposed Guidance, p. 2.

[45] 2023 OMB Proposed Guidance, p. 2.

36. OMB acknowledges that it may be difficult to quantify benefits and costs and recommends analyzing the uncertainties associated with the regulatory analysis.[46] In the 2023 OMB Proposed Guidance, OMB states that "[a]n effect of regulation should not be excluded from a regulatory analysis because its estimation is highly uncertain."[47]

37. OMB indicates that when cost and benefit estimates are uncertain, under certain circumstances, the combination of plausible assumptions with data and models may help develop a probability distribution of costs and benefits.[48] In this scenario, it is necessary to discuss the quality of the available data, the assumptions, and any inferences resulting from the analysis.[49]

38. In addition, OMB recognizes that lack of knowledge or other reasons may prevent the construction of probability distributions. In these circumstances, estimates of benefits and costs should be developed using plausible scenarios based on qualitative information.[50]

39. Moreover, OMB states that if no quantification of costs and benefits is possible, unquantified benefits and costs should be discussed using qualitative information and the "strengths and limitations of the qualitative information" should be analyzed.[51]

### 2. The SEC Guidance on Economic Analysis Includes a Cost-Benefit Analysis and Discusses the Treatment of Uncertainty

40. The SEC Guidance highlights that "[h]igh-quality economic analysis is an essential part of SEC rulemaking" because it ensures that decisions include the potential economic consequences of a rule.[52] Specifically, the Commission recognizes that a cost-benefit analysis is an important tool to consider.[53]

41. The Commission's guidance on conducting a cost-benefit analysis provides guiding principles:

1. "identify and describe the most likely economic benefits and costs of the proposed rule and alternatives;"
2. "quantify those expected benefits and costs to the extent possible;"

[46] 2003 OMB Guidance, p. 38.
[47] 2023 OMB Proposed Guidance, p. 66.
[48] 2003 OMB Guidance, pp. 18, 38.
[49] 2003 OMB Guidance, p. 39.
[50] 2003 OMB Guidance, pp. 18, 39.
[51] 2003 OMB Guidance, p. 27.
[52] SEC Guidance, p. 1.
[53] SEC Guidance, pp. 1, 3.

3. "for those elements of benefits and costs that are quantified, identify the source of method of quantification and discuss any uncertainties underlying the estimates;" and
4. "for those elements that are not quantified, explain why they cannot be quantified"[54]

42. When uncertainty exists regarding the estimations of costs and benefits, the Commission indicates that a cost-benefit analysis should still be conducted. When the data is imperfect, then "quantification may be possible by making and explaining certain assumptions."[55] In addition, when it is determined that the "costs and benefits cannot reasonably be quantified," the Commission states that the reasons explaining why the quantification is not possible should be discussed and that a qualitative analysis of the costs and benefits should be conducted.[56] This qualitative cost-benefit analysis should include a discussion about the strengths and limitations of the information that is used for this analysis.[57]

43. This approach is consistent with Court decisions regarding the economic analysis conducted by the Commission: "And, as we have just seen, uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself — and hence the public and the Congress — of the economic consequences of a proposed regulation before it decides whether to adopt the measure."[58]

### 3. The Guidance of the U.S. Commodity Futures Trading Commission Regarding Cost-Benefit Analysis Discusses the Treatment of Uncertainty

44. The U.S. Commodity Futures Trading Commission ("CFTC") provided its guidance related to cost-benefit analysis for rulemaking in two documents: "Guidance on and Template for Presenting Cost-Benefit Analyses for Commission Rulemakings" in September 2010 ("CFTC Guidance on Commission Rulemakings") and "Staff Guidance on Cost-Benefit Considerations for Final Rulemakings under the Dodd-Frank Act" in May 2011 ("CFTC

[54] SEC Guidance, pp. 9–10.
[55] SEC Guidance, p. 12.
[56] SEC Guidance, pp. 13–14.
[57] SEC Guidance, pp. 13–14.
[58] SEC Guidance, fn. 34.

Guidance for Final Rulemakings").[59] The CFTC Guidance on Commission Rulemakings acknowledges that a qualitative assessment of costs and benefits is possible: "[The CFTC] cannot consider the costs and benefits of an action unless they are presented either quantitatively or qualitatively."[60]

45. Moreover, the CFTC Guidance for Final Rulemakings indicates that "[c]osts and benefits should be quantified when it is reasonably feasible and appropriate to do so."[61] In this document, the CFTC discusses uncertainty related to the estimations of costs and benefits "[w]hen quantitative data is not readily available, or it cannot be gathered with specificity with reasonable effort."[62] In these instances, "estimates or ranges may be used, provided there is a reasonable basis for such estimates or ranges. The methodology used to estimate costs and benefits should be discussed in the rulemaking."[63] The CFTC also recognizes that "in some areas quantification is not possible, and in these areas qualitative measures should be used instead."[64]

## IV. The Vulnerabilities Categories in the 2023 Proposed Analytic Framework That Would Be Used to Assess Whether a Nonbank Financial Company Represents Potential Risks to U.S. Financial Stability Are Vague and Do Not Provide Sufficient Information

46. In the "Assessing Potential Risks" section of the 2023 Proposed Analytic Framework, FSOC provides a list of eight vulnerabilities and metrics that "most commonly contribute" to potential risks to financial stability.[65] A review of these vulnerabilities and metrics described in the 2023 Proposed Analytic Framework reveals that the information provided by FSOC is

[59] "A Review Of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act," U.S. Commodity Futures Trading Commission Office of the Inspector General, Exhibit 1, "Guidance on and Template for Presenting Cost-Benefit Analyses for Commission Rulemakings," September 29, 2010, pp. 1–3, available at https://www.cftc.gov/sites/default/files/idc/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf ("CFTC Guidance for Commission Rulemakings"); "A Review Of Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act", U.S. Commodity Futures Trading Commission Office of the Inspector General, Exhibit 2, "Staff Guidance on Cost-Benefit Considerations for Final Rulemakings under the Dodd-Frank Act," May 13, 2011, pp. 1–12, available at https://www.cftc.gov/sites/default/files/idc/groups/public/@aboutcftc/documents/file/oig_investigation_061311.pdf ("CFTC Guidance for Final Rulemakings").

[60] CFTC Guidance for Commission Rulemakings, p. 1.

[61] CFTC Guidance for Final Rulemakings, p. 7.

[62] CFTC Guidance for Final Rulemakings, p. 7.

[63] CFTC Guidance for Final Rulemakings, p. 7.

[64] CFTC Guidance for Final Rulemakings, p. 7.

[65] 2023 Proposed Analytic Framework, p. 26307.

too vague to understand how FSOC will use these factors to determine whether a nonbank financial company represents potential risks to financial stability. At a minimum, FSOC should provide illustrative examples of how the vulnerabilities will be used individually and in combination with each other to make this determination. Another possibility to further clarify the proposed methodology is to explain how these vulnerabilities and metrics would apply to past attempts to designate nonbank financial companies

47. The 2023 Proposed Analytic Framework includes numerous statements illustrating the vague nature of the so-called "analytic framework." These include: "[T]he Council may assess each of these vulnerabilities using a variety of quantitative and qualitative factors. The following list is not exhaustive but is indicative of the vulnerabilities and metrics the Council expects to consider…The Council uses metrics such as those cited above… as well as other factors, as appropriate, in its analyses."[66]

48. To illustrate the lack of clarity around how these vulnerabilities will be evaluated, consider Leverage. The 2023 Proposed Analytic Framework defines Leverage as:

> "*Leverage.* Leverage can amplify risks by reducing market participants' ability to satisfy their obligations and by increasing the potential for sudden liquidity strains. Leverage can arise from debt, derivatives, off-balance sheet obligations, and other arrangements. Leverage can arise broadly within a market or at a limited number of firms in a market. Metrics relevant for assessing leverage may include ratios of assets, risk-weighted assets, debt, derivatives liabilities or exposures, and off-balance sheet obligations to equity."[67]
>
> "[R]isks from a single company whose leverage is outsized relative to other firms in its market may be considered for an entity-specific response."[68]
>
> "A rapid liquidation of financial assets can pose a threat to U.S. financial stability…. The potential risk is greater, for example, if leverage…is higher…."[69]

Unfortunately, no specific information is provided regarding how this metric should be used to determine whether the leverage of a nonbank financial company poses a potential risk to financial stability. It is not possible to make this determination without a thorough analysis and an understanding of the tradeoffs between leverage and, for example, the company's assets (safe and liquid or risky and illiquid), the nature and the size of the liabilities (short or

[66] 2023 Proposed Analytic Framework, pp. 26307–26308.
[67] 2023 Proposed Analytic Framework, p. 26307.
[68] 2023 Proposed Analytic Framework, p. 26308.
[69] 2023 Proposed Analytic Framework, p. 26308.

long term), and the number of creditors. Also, FSOC does not include a discussion in the 2023 Proposed Analytic Framework regarding how it intends to quantitatively assess when the leverage of a specific company is "outsized" relative to other firms in its market. For the framework to be useful, it should provide a detailed discussion about how FSOC should conduct these analyses.

49. Similarly, the "Inadequate risk management" vulnerability lacks specificity.

> "*Inadequate risk management.* A risk may be exacerbated if it is conducted without effective risk management practices, including the absence of appropriate regulatory authority and requirements. In contrast, existing regulatory requirements or market practices may reduce risks by, for example, limiting exposures or leverage, increasing capital and liquidity, enhancing risk-management practices, restricting excessive risk taking, providing consolidated prudential regulation and supervision, or increasing regulatory or public transparency. Relevant metrics may include amounts of capital and liquidity."[70]

50. Metrics related to the amount of capital and liquidity are insufficient to determine whether the risk management practices of a nonbank financial company are inadequate. There is no discussion of how to quantitatively assess whether these metrics indicate an issue with the risk management practices of a specific company. In addition, it seems unlikely that such a determination can be made without a detailed analysis of the risk management plan in place at the time of the review and how specific parts of this plan may or may not be sufficient to mitigate the materialization of the specific risks that are relevant for this company. Finally, how will metrics measuring the amount of capital held be applied to funds and other nonbank financial companies? What specific measures of liquidity are important to funds and other nonbank financial companies? Again, a more detailed framework is needed to understand how FSOC would analyze this potential vulnerability.

51. The 2023 Proposed Analytic Framework also includes "Liquidity risk and maturity mismatch" as a vulnerability.

> "A shortfall of sufficient liquidity to satisfy short-term needs, or reliance on short-term liabilities to finance longer-term assets, can subject market participants to rollover or refinancing risk. These risks may force entities to sell assets rapidly at stressed market prices, which can contribute to broader stresses. Relevant metrics may

[70] 2023 Proposed Analytic Framework, p. 26308.

> include the ratio of short-term debt to unencumbered short-term high-quality liquid assets, and amounts of funding available to meet unexpected reductions in available short-term funding."[71]

52. Again, there is no discussion to explain how the concept of mismatch between short-term liabilities and longer-term assets is relevant for the different types of nonbank financial companies. Banks can use clients' deposits to finance the purchase of assets and there could be a mismatch between the maturity dates of the assets and when clients could withdraw their deposits. FSOC does not explain why this concept is applicable to nonbank financial companies such as hedge funds that can typically limit withdrawals from their investors.[72]

53. Moreover, the description of the "Destabilizing activities" vulnerability is vague and does not provide any information to identify the activities that could fall in this category.

> "Certain activities, by their nature, particularly those that are sizeable and interconnected with the financial system, can destabilize markets for particular types of financial instruments or impair financial institutions. This risk may arise even when those activities are intentional and permitted by applicable law, such as trading practices that substantially increase volatility in one or more financial markets, or activities that involve moral hazard or conflicts of interest that result in the creation and transmission of significant risks."[73]

54. FSOC simply explains that certain activities can destabilize markets without providing any detail regarding the metrics or the procedures that should be used to identify these activities. Additional information is needed to understand how FSOC will conduct the analyses related to this vulnerability.

55. A similar lack of specificity applies to all eight vulnerabilities. The 2023 Proposed Analytic Framework essentially defines terms but fails to provide a true analytic framework. It is so vague that it effectively gives FSOC the power to designate nonbank financial companies as systemically risky without having to do much more than assert it to be the case.

[71] 2023 Proposed Analytic Framework, p. 26307.

[72] George O. Aragon (2007), "Share restrictions and asset pricing: Evidence from the hedge fund industry," *Journal of Financial Economics*, Vol. 83, No. 1, pp. 33–58 at p. 34. ("[M]any hedge funds impose restrictions on investor redemptions, thereby making hedge funds an illiquid investment.")

[73] 2023 Proposed Analytic Framework, p. 26308.