

January 2, 2020

Financial Stability Oversight Council

FSOC Finalizes Changes to Nonbank SIFI Designation Guidance

SUMMARY

On December 4, 2019, the Financial Stability Oversight Council (the “*Council*”) voted unanimously to finalize amendments to its interpretive guidance (the “*Final Guidance*”) on designating nonbank financial companies as “systemically important financial institutions” (“*SIFIs*”).¹ The Final Guidance, which will replace the Council’s interpretive guidance on SIFI designations issued in April 2012 (the “*Prior Guidance*”),² implements an “activities-based” approach to identifying and addressing potential risks to financial stability, and is intended to enhance the “analytical rigor and transparency” of the Council’s process for designating SIFIs.

The Final Guidance, which adopts the amendments proposed by the Council in March 2019 (the “*Proposed Guidance*”)³ with some modifications, implements the following key revisions to the Prior Guidance:

- **Prioritize Activities-Based Approach:** The Council will prioritize its efforts to identify, assess, and address potential risks to U.S. financial stability through an activities-based approach, which is intended to “reduce the potential for competitive market distortions that could arise from entity-specific [designations], and allow relevant financial regulatory agencies to address identified potential risks.”
- **Entity Designation As a Last Resort:** The Council stresses that it will pursue entity-specific designations “only if a potential risk or threat cannot be adequately addressed through an activities-based approach.”
- **Revisions to Entity Designation Process:** The Final Guidance largely preserves the Council’s existing entity-specific designation process, but makes certain key modifications:
 - **Cost-Benefit Analysis:** Before making any SIFI designation, the Final Guidance directs the Council to consider the benefits and costs of a designation to the U.S. financial system, the U.S. economy, and the nonbank financial company. The Council will designate a nonbank financial company as a SIFI only if the expected benefits “justify the expected costs that the determination would impose.”

- **Assess Likelihood of Material Financial Distress:** When evaluating a firm for a potential designation, the Final Guidance directs the Council to assess the likelihood of a nonbank financial company's material financial distress by considering "not only the impact of an identified risk, but also the likelihood that the risk will be realized."
- **Revise Designation Process and Enhance Transparency of Designations:** The Final Guidance makes several changes to the Council's current process for entity-specific SIFI designations, with the aim of increasing engagement and transparency to firms and their regulators, and creating pre-designation and post-designation "off-ramps" to encourage firms and their regulators to mitigate identified systemic risks and potentially prevent or remove a SIFI designation. The Final Guidance also condenses the current three-stage designation process into two stages by eliminating the current "Stage 1" under which a set of uniform quantitative metrics are applied to a broad group of nonbank financial companies in order to identify firms that may be subject to further evaluation.
- **Cost-Benefit Analysis for Recommendations to Regulators:** The Final Guidance also provides that the Council, before issuing any nonbinding recommendations to a primary financial regulatory agency under section 120 of Dodd-Frank, must first ascertain whether the primary financial regulatory agency "would be expected to perform a cost-benefit analysis of the actions it would take in response to the Council's contemplated recommendation." Where the regulatory agency would not be expected to conduct such an analysis, the Council itself would conduct an analysis and only make a recommendation under section 120 if the Council believes the results of its cost-benefit assessment support the recommendation.

The Final Guidance will become effective January 29, 2020.

BACKGROUND

A. DESIGNATION AUTHORITY

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*") empowers the Council, an interagency body created by Dodd-Frank and chaired by the Secretary of the Treasury (the "*Secretary*"), to designate certain nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System (the "*Federal Reserve*") and application of enhanced prudential standards.⁴ A nonbank financial company may be designated by the Council for enhanced supervision under either of two determination standards: (i) when "material financial distress" at the company "could pose a threat to the financial stability of the United States," or (ii) when the "nature, scope, size, scale, concentration, interconnectedness, or mix of the [company's] activities" could pose the same threat.

In addition to its designation authorities, the Council has the authority under section 120 of Dodd-Frank to make recommendations to primary financial regulatory agencies that they consider applying new or heightened standards and safeguards to financial activities or practices conducted by bank holding companies or nonbank financial companies under the jurisdiction of such agencies if the Council determines that the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among financial institutions and U.S. financial markets.⁵

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B. PRIOR SIFI DESIGNATIONS AND DE-DESIGNATIONS

Previously, the Council had designated four nonbank SIFIs: American International Group, Inc. (“AIG”); General Electric Capital Corporation (“GECC”); Prudential Financial, Inc. (“Prudential”); and MetLife Inc. (“MetLife”), none of which currently remains so designated.

A federal district court order rescinded MetLife’s SIFI designation in March 2016, finding that the Council’s basis for designating MetLife was “fatally flawed” in at least three respects. First, the court held that the Council deviated from the Prior Guidance without explanation by failing to assess MetLife’s actual vulnerability to financial distress. Second, the court held that the Council failed to establish a basis for a finding that MetLife’s material financial distress would cause “an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy,” within the meaning of the Prior Guidance. Third, the court held that the Council failed to weigh the perceived benefits of designating MetLife against the possible costs of taking such action, including the possibility that “imposing billions of dollars in cost could actually make MetLife more vulnerable to distress.”⁶

Although the district court order was initially appealed by the Council, and the appeal argued in October 2016, following a change in the administration as a result of the November 2016 U.S. presidential elections and the U.S. Department of the Treasury’s (the “Treasury”) release of its report on the Council’s SIFI designation process (discussed below), MetLife and the Council filed a joint motion on January 18, 2018 to dismiss the Council’s appeal and, on January 23, 2018, the case was dismissed.⁷

In the time since MetLife’s SIFI designation was rescinded by the federal district court, the Council voted to rescind the designations of GE Capital Global Holdings, LLC (the successor to GECC) in June 2016, AIG in September 2017, and Prudential in October 2018.⁸

C. PRIOR ACTIVITY-BASED PROPOSALS

In addition to its SIFI designations, the Council has taken actions relating to potential industry-wide systemic risks, but to date it has not exercised its recommendation authority under section 120 of Dodd-Frank. Actions to date have focused on the asset management industry. For example, the Council’s research arm, the Office of Financial Research, issued a report in 2013 on potential systemic risk in the asset management industry that was widely criticized by the asset management industry and led to increased engagement between industry participants and regulators, including the Council, in an effort by industry participants to demonstrate the limited potential for systemic risk in the asset management industry. In December 2014, the Council published a notice seeking public comment on whether and how certain asset management products and activities (as distinguished from specific managers or firms) could pose potential risks to U.S. financial stability. On April 18, 2016, the Council, led by then-Secretary Jacob J. Lew, unanimously approved a public statement on its review of potential risks to U.S. financial stability that may arise from asset management products and activities, but did not take any action under section 120.⁹

D. THE TREASURY REPORT

On November 17, 2017, the Treasury issued a report (the “*Treasury Report*”) recommending a number of changes to the Council’s evaluation and designation processes for nonbank financial companies.¹⁰ The Treasury Report was issued pursuant to President Trump’s Memorandum for the Secretary, released April 21, 2017, which directed the Treasury to evaluate and provide recommendations regarding the Council’s SIFI designation processes.¹¹ The key recommendations included prioritizing an activities-based approach, increasing the analytic rigor of entity-specific designation analyses, enhancing engagement and transparency in the entity-specific designation process, and providing a clear off-ramp for designated entities.

E. RELATED INTERNATIONAL DEVELOPMENTS

Parallel developments with respect to systemic risk assessment have taken place at the international level, including establishment of an assessment methodology for designating “global systemically important financial institutions” (“*G-SIFIs*”), and development of enhanced policy measures for the group-wide supervision of G-SIFIs. For example, the Financial Stability Board (“*FSB*”), in consultation with the International Association of Insurance Supervisors (the “*IAIS*”) and national authorities, identified an initial list of nine “global systemically important insurers” (“*G-SIIs*”) in 2013 using an assessment methodology developed by the IAIS, and set forth the policy measures that should apply to G-SIIs.¹² The FSB and IAIS have defined G-SIIs as insurers whose distress or disorderly failure, because of their size, complexity, and interconnectedness, would cause significant disruption to the global financial system and economic activity. In February 2017, the IAIS announced a shift in its approach with the development of an activities-based approach to mitigate systemic risk in insurance, in contrast to the entity-based approach that had formed the basis of the IAIS’ G-SII Assessment Methodology and annual identification of G-SIIs. In light of the IAIS’ development of an activities-based approach to systemic risk, the FSB decided not to publish a list of G-SIIs for 2017, and has not done so since. Confirming that shift, on November 14, 2019, the IAIS adopted the Holistic Framework for Systemic Risk in the Insurance Sector (“*Holistic Framework*”). The Holistic Framework, which is slated for implementation in early 2020, moves away from the previous binary approach, in which a set of pre-determined policy measures applied to only a small group of G-SIIs and, instead, “promotes a proportionate application of an enhanced set of supervisory policy measures and powers of intervention for macroprudential purposes to a broader portion of the insurance sector.”¹³ In November 2022, the FSB will review the need to either discontinue or re-establish an annual identification of G-SIIs based on the initial implementation of the Holistic Framework.

With respect to the asset management industry, the FSB and the International Organization of Securities Commissions (“*IOSCO*”) undertook a review of the asset management industry in early 2014 and initially issued two consultative documents proposing methodologies for designating asset managers and/or investment funds as “non-bank non-insurer global systemically important financial institutions.”¹⁴ Both of these consultative documents received heavy criticism from the asset management industry, leading both

the FSB and IOSCO to focus on reviewing asset management activities before finalizing a joint assessment methodology for asset management under a G-SIFI framework.¹⁵ On January 12, 2017, the FSB published policy recommendations to address structural vulnerabilities from asset management activities, and IOSCO has since issued consultative recommendations to address certain of these structural vulnerabilities (liquidity and leverage), but no further action has been taken to date with respect to establishing an assessment methodology for designating asset managers or investment funds as G-SIFIs.¹⁶

F. THE PROPOSED GUIDANCE

On March 6, 2019, the Council unanimously approved the Proposed Guidance, which included a request for public comment and included a series of questions, in order to “enhance the Council’s transparency, analytical rigor, and public engagement.” In total, the Council received 26 comments from, among others, advocacy groups, participants and trade associations in the asset management and insurance industries, and prior Chairpersons of the Council and Chairmen of the Federal Reserve. According to the Council, the vast majority of the comments were “generally supportive” of the Proposed Guidance.

FINAL GUIDANCE FOR FSOC DESIGNATION PROCESSES

The Final Guidance, which adopts the Proposed Guidance with some modifications described below, revises the Prior Guidance, but not the related final rule issued in 2012 by the Council in relation to section 113 of Dodd-Frank.¹⁷ The Council states that, except to the extent the Final Guidance sets forth rules of agency organization, procedure, or practice, the guidance is not a binding rule and that the Council “retains discretion, subject to applicable statutory requirements, to consider factors relevant to the assessment of a potential risk or threat to U.S. financial stability on a case-by-case basis.” The Final Guidance indicates, however, that if the Council were to depart from the guidance, “it would need to provide a reasoned explanation for its action, which would ordinarily require acknowledging the change in position.” Further, in March 2019, the Council adopted a rule stating it would not amend or rescind its interpretive guidance without providing public notice and an opportunity to comment consistent with the Administrative Procedures Act.¹⁸

Below is a summary of the key revisions made to the Prior Guidance by the Final Guidance.

A. ACTIVITIES-BASED APPROACH

As noted above, the Final Guidance embodies an “activities-based” approach to systemic risk regulation that requires the Council to consider the potential systemic risk of activities and to pursue entity-specific designations only in limited circumstances. This activities-based approach involves a two-step process undertaken by the Council in consultation with other financial regulators.

1. Identifying Potential Risks from Products, Activities or Practices

In the first step, the Council will “monitor diverse financial markets and market developments, in consultation with relevant financial regulatory agencies, to identify products, activities, or practices that could pose risks to financial stability.”¹⁹ The Final Guidance notes that the types of activities the Council will evaluate are often identified in the Council’s annual reports, and include activities related to the extension of credit, maturity and liquidity transformation, market making and trading, and other key functions critical to support financial market functioning.²⁰

If the Council identifies a product, activity, or practice that could pose a potential “risk to financial stability,”²¹ it will evaluate the extent to which certain characteristics “could amplify” these potential risks. These characteristics may include, among others, asset valuation risk or credit risk, leverage (including leverage arising from debt, derivatives, off-balance sheet obligations, and other arrangements), liquidity risk or maturity mismatch, counterparty risk, transparency of financial markets, and operational risks (including cybersecurity and operational resilience). In evaluating such characteristics, the Council generally will focus on four “framing questions”: (1) triggers of potential risks (e.g., significant credit losses or sharp reductions in the valuation of particular classes of financial assets); (2) how adverse effects of a potential risk may be transmitted to financial markets or participants; (3) the effects a potential risk could have on the financial system (e.g., the concentration and magnitude of impact on companies and markets); and (4) whether these effects could impair the financial system in a manner that could harm the non-financial sector of the U.S. economy (e.g., extension of credit to non-financial companies). The Council will engage other regulators “in a collaborative discussion” as part of conducting its first step of analysis.

In response to comments received on the Proposed Guidance, the Council revised the Final Guidance to clarify that the Council will consult with the relevant financial regulatory agencies and consider existing laws and regulations that may mitigate potential risks to U.S. financial stability, as well as the “risk profiles and business models” of entities engaging in the products, activities, or practices being evaluated.

2. Working with Regulators to Address Identified Risks

If the Council identifies a potential risk to financial stability, it would then move to the second step of the activities-based approach, in which it would work with relevant financial regulatory agencies at the federal and state levels to seek the implementation of actions to address the identified potential risk and coordinate among the Council members and member agencies to ensure the potential risk is adequately addressed.

The Council expects that much of this engagement and initial identification and assessment of risks will be “informal and nonpublic in nature” and that measures taken to address an identified risk will typically take the form of “relatively informal actions, such as information sharing among regulators,” but could include formal actions, such as the public issuance of recommendations to regulators or the public, including those made in the Council’s annual report.

3. Nonbinding Recommendations Under Section 120 of Dodd-Frank

If, after this engagement, the Council concludes that regulators' actions are "inadequate to address the identified potential risk to U.S. financial stability," the Final Guidance notes that the Council retains authority under section 120 of Dodd-Frank to publicly issue nonbinding recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards. However, the Council "intends to make recommendations under section 120 only to the extent that its recommendations are consistent with the statutory mandate of the relevant primary financial regulatory agency."

Further, in response to "several commenters," the Council revised the Final Guidance to "provide clarity" and "increase the rigor" of recommendations made under section 120, noting that the Council will make recommendations "only if it determines that the conduct, scope, nature, size, scale, concentration or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, U.S. financial markets, or low-income, minority or underserved communities." Further, before making any recommendation under section 120, the Council must determine whether the primary financial regulatory agency "would be expected to perform a cost-benefit analysis of the actions it would take in response to the Council's contemplated recommendation" and, if the regulatory agency would not be expected to conduct such an analysis, the Council itself must conduct the analysis. Where the Council conducts its own analysis, it may make a recommendation "only if it believes the results of its assessment of benefits and costs support the recommendation."

B. ENTITY-SPECIFIC DESIGNATIONS

1. Entity Designation Standards

If the Council determines that (1) the collaborative efforts during the activities-based approach do not "adequately address" the potential risk identified by the Council, or if the potential threat is "outside the jurisdiction or authority" of financial regulatory agencies, *and* (2) the potential threat is one that could be "effectively addressed" by a Council designation regarding one or more nonbank financial companies, the Council may evaluate one or more nonbank financial companies for an entity-specific designation. The Final Guidance stresses, however, that the Council will pursue entity-specific determinations "only if a potential risk or threat cannot be adequately addressed through an activities-based approach."

The Final Guidance further states that the Council would consider potential entity-specific designations "only in rare instances." While the Final Guidance does not, unlike the Proposed Guidance, include an "emergency situation" as an example of such a rare instance for a potential designation, the Council notes that the Final Guidance does not limit the Council's ability to waive or modify the procedural requirements for the designation process as it deems "necessary or appropriate to prevent or mitigate threats posed by a nonbank financial company to U.S. financial stability."

2. Revisions to Designation Process

In addition to prioritizing the activities-based approach, the Final Guidance makes key changes to the Council's existing processes and guidance with respect to SIFI designations "to ensure the Council's work is clear, transparent, and analytically rigorous, and to enhance the Council's engagement with companies, regulators, and other stakeholders."

a. Statutory Standards and Considerations

Dodd-Frank authorizes the Council to designate a nonbank financial company as a SIFI if it determines that (1) material financial distress at the company could pose a threat to U.S. financial stability or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company could pose a threat to U.S. financial stability (collectively, the "*Determination Standards*"). The Final Guidance focuses primarily on the first Determination Standard "because risks to financial stability (such as asset fire sales or financial market disruptions) are most commonly propagated through a nonbank financial company when it is in distress."

As with the Prior Guidance, the Final Guidance clarifies several terms that are not defined in Dodd-Frank, including "company," "material financial distress" and "threat to the financial stability of the United States."²² The Final Guidance defines "threat to the financial stability of the United States" by reference to the potential for "severe damage on the broader economy," in contrast to the definition in the Prior Guidance, which refers to "significant" damage. Consistent with the Prior Guidance, for purposes of considering whether a nonbank financial company could pose a threat to U.S. financial stability, the Council "intends to assess the company in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment," although the Final Guidance clarifies that such context includes "market developments such as increased counterparty defaults, decreased funding availability, and decreased asset prices."

In response to commenters, the Council revised its proposed interpretation of the term "nonbank financial company" as including any "successor of a company that is subject to a final determination of the Council," agreeing that this interpretation was "overly broad." The Final Guidance includes a narrower interpretation that considers a nonbank financial company as one that "acquires, directly or indirectly, a majority of the assets or liabilities of a company that is subject to a final determination of the Council." However, the Final Guidance also notes that any such acquirer can use the Council's designation reevaluation process "to seek a rescission of the determination upon consummation of its transaction."

In addition, the Final Guidance eliminates the six-category framework set forth in the Prior Guidance for the Council to consider the ten statutory considerations required under section 113 of Dodd-Frank²³ because, according to the Council, the six-category framework "did not prove useful in guiding [its] evaluations, and unnecessarily complicated the framework for [its] analysis."

b. Revisions to Transmission Channels

In addition to the ten statutory considerations, in evaluating a nonbank financial company for potential designation, the Council focuses on so-called “transmission channels,” which assess “how the negative effects of a company’s material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities, could be transmitted to or affect other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning.” The Final Guidance retains the three transmission channels identified in the Prior Guidance—the exposure channel, the asset liquidation channel, and the critical function or service channel—but “substantially enhances and clarifies” the Council’s analyses under these three channels. As a general matter, the Final Guidance contains more detail around each of the transmission channels than the Prior Guidance.

Under the exposure transmission channel, the Council will evaluate whether a nonbank financial company’s creditors, counterparties, investors, or other market participants have direct or indirect exposure to the company that is “significant enough to materially and adversely affect” those or other creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability. Unlike the Prior Guidance, the Final Guidance expressly states that the Council will also consider factors that mitigate potential risks posed by exposures to a company, such as whether exposures are collateralized by high quality, highly liquid securities, existing regulatory requirements, and the use of “insurance funds” to limit counterparty exposures. The Final Guidance further notes that the Council will consider the extent to which assets are managed, as opposed to owned, by a company “in recognition of the distinct nature of exposure risks when the company is acting as an agent rather than as principal.”²⁴ In addition, the Final Guidance provides that the Council will evaluate “the potential for contagion” among other financial institutions and markets and will, in this light, consider relevant industry-specific historical examples, the scope of the company’s interconnectedness with large financial institutions, and market-based or regulatory factors that may mitigate the risk of contagion.

Under the asset liquidation transmission channel, the Council will consider whether a nonbank financial company holds assets that, if liquidated quickly, could cause a fall in asset prices and, as a consequence, “significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings.” The Council may also consider whether asset pricing or market functioning disruptions could lead to a cycle of asset sales resulting in further market disruptions. The Final Guidance groups analysis under this transmission channel into three central factors: (1) liquidity of the company’s liabilities; (2) liquidity of the company’s assets; and (3) potential fire sale impacts. As in the Prior Guidance, the asset liquidation channel “would likely be most relevant for a nonbank financial company that could be forced to liquidate assets quickly due to its funding and liquid asset profile.” With respect to the liquidity of a company’s liabilities, the Final Guidance (unlike the Prior Guidance) requires the Council to: quantitatively identify the scale of potential liquidity needs that could plausibly arise at the company; apply

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counterparty and customer withdrawal rates based on historical examples and other relevant models to assess the scope of plausible withdrawals; and assess the ability of the company or its financial regulators to impose stays on counterparty terminations or withdrawals as a relevant factor in potentially reducing the company's liquidity needs in the event of material financial distress. With respect to the liquidity of a company's assets, the Council "expects that this assessment will focus on the size and liquidity characteristics of the company's investment portfolio." In assessing the potential effects of the company's asset liquidation on markets and market participants (*i.e.*, fire sale impacts), the Council will "apply quantitative models to assess how the company could satisfy the identified range of potential liquidity needs by rapidly selling its identified liquid assets," including assessing the order in which the company may liquidate its various assets. As with the exposure transmission channel, the Final Guidance revises the Prior Guidance to include consideration of factors that may limit the transmission of risk, including existing regulatory requirements, collateralization, and guarantee funds.

Finally, under the critical function or service transmission channel, the Council will consider the potential for a nonbank financial company to become "unable or unwilling to provide a critical function or service that is relied upon by market participants and for which there are no ready substitutes." As in the Prior Guidance, this transmission channel will focus on issues of substitutability of products and services and the competitive landscape involved.

In addition to the three transmission channels, and in large part in alignment with the Prior Guidance, the Council will consider (1) a nonbank financial company's complexity, opacity, and resolvability when evaluating whether the company poses a risk to U.S. financial stability, including "any obstacles to the rapid and orderly resolution" of the company, and (2) the degree to which a company is already regulated by one or more primary financial regulatory agencies. According to the Final Guidance, when considering this last factor, the Council may weigh considerations such as the extent to which the company's primary financial regulator has imposed risk-management standards relevant to the type of company and regulators' processes for inter-regulator coordination.

c. Cost-Benefit Analysis

Citing the federal district court's decision in the MetLife litigation, the Final Guidance requires the Council to determine that, before making any proposed entity-specific designation, the "expected benefits justify the expected costs that the determination would impose." According to the Final Guidance, the relevant benefits may include U.S. financial system-wide and long-term economic growth benefits, such as whether the designation "enhances U.S. financial stability and mitigates the severity of economic downturns by reducing the likelihood or severity of a potential financial crisis," as well as entity-specific benefits, such as whether the designated firm may derive benefits from enhanced supervision, including, for example, a lower cost of capital or higher credit ratings upon meeting its post-designation regulatory and supervisory requirements.

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The Final Guidance notes that “the loss of any implicit ‘too big to fail’ or similar subsidy would be considered a benefit to the economy, even if it increases the nonbank financial company’s cost of capital.”

With respect to costs, entity-specific costs identified include risk-management requirements (*e.g.*, capital planning and stress testing), supervision and examination, increased capital requirements and liquidity requirements.²⁵ Similarly to the benefits, the relevant costs might include not only the costs to the nonbank financial company from enhanced regulatory requirements in connection with the designation, but also costs to the U.S. economy. To consider these types of costs, the Final Guidance provides that the Council will assess the impact of the designation on the availability and cost of credit or financial products in the relevant U.S. markets, as well as “the extent to which any reduction in financial services provided by the nonbank financial company would be offset by other market participants.”

The Final Guidance also includes language not in the Proposed Guidance that, according to the Council, makes clear that it will “quantify reasonably estimable benefits and costs, using ranges, as appropriate, and based on empirical data when available,” as well as consider costs and benefits qualitatively.

d. Likelihood of Material Financial Distress

When evaluating a nonbank financial company for a potential designation, the Final Guidance requires the Council to assess the likelihood of a nonbank financial company’s material financial distress: “[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.” Although this concept was included in the Proposed Guidance, the Council states that, in response to public comments, it revised its description of the “analytical process” for conducting this assessment.

The Final Guidance provides that the Council, in conducting the assessment, will consider a company’s vulnerability to a range of factors, which may include leverage (both on- and off-balance sheet), potential risks associated with asset reevaluations (whether such reevaluations arise from market disruptions or severe macroeconomic conditions), reliance on short-term funding or “other fragile funding markets,” maturity transformation, and risks from exposures to counterparties or other market participants. The Final Guidance also permits the Council to consider the results of any stress tests previously conducted by the entity or its primary financial regulatory agency. In addition, the Council may rely upon “historical examples regarding the characteristics of financial companies that have experienced financial distress, but may also consider other risks that do not have historical precedent.”

e. Elimination of Old “Stage 1” Thresholds; the Designation Process

The Final Guidance condenses the current three-stage designation process into two stages by eliminating the old “Stage 1,” under which a defined set of quantitative metrics were applied to a broad group of nonbank financial companies in order to identify firms for further evaluation and to provide clarity for firms that likely will not be subject to further evaluation for designation. Under Stage 1 of the Prior Guidance,

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companies were first assessed under several specific metrics, including the holding of \$50 billion or more in total consolidated assets and other numerical thresholds based “solely on information available through existing public and regulatory sources”²⁶ (*i.e.*, credit default swaps outstanding, derivative liabilities, total debt outstanding, leverage ratio, and short-term debt ratio) for potential further analysis by the Council. The Final Guidance eliminates the old Stage 1 because, according to the Council, “it generated confusion among firms and members of the public and is not compatible with the prioritization of an activities-based approach.”

According to the Council, the Final Guidance also “enhances” the designation process by making “numerous procedural improvements and incorporating several provisions of the 2015 Supplemental Procedures, which were intended to facilitate the Council’s engagement and transparency.”²⁷ For example, in response to comments received on the Proposed Guidance, the Final Guidance requires a vote of the Council, not its Deputies Committee, to commence a review of a company in the new Stage 1 (*i.e.*, the old Stage 2 under the Prior Guidance). Companies identified as potentially posing risks to U.S. financial stability would, under the new Stage 1, be notified and the Council would conduct a preliminary analysis based on information available primarily through public and regulatory sources. A company under review also may voluntarily submit to the Council any information it considers relevant to the Council’s evaluation and may, upon request, meet with staff of Council members and members agencies “who are leading the Council’s analysis.”

In addition, for any company under review in the new Stage 1, the Final Guidance provides that the Council will consult with the company’s primary financial regulatory agency before it votes on whether to advance the company to the in-depth evaluation of Stage 2 (*i.e.*, the old Stage 3 under the Prior Guidance). A goal of the “enhanced engagement” in this stage, according to the Council, is to give companies under review more information and tools to mitigate identified risks prior to any Council designation, allowing a company to take actions in response to the Council’s concerns and thereby providing a pre-designation “off-ramp.”

Following the preliminary evaluation in Stage 1, the Council may decide not to evaluate the company further, or it may begin a more detailed analysis of the company by advancing it to the in-depth evaluation in the new Stage 2. At the end of this second stage, the Council may consider whether to propose to designate the firm as a SIFI and, if a proposal is made, the nonbank financial company may request a hearing before the Council, after which the Council may vote to make a final determination. The procedural steps related to the Council’s proposed determinations, subsequent hearings, and final determinations are similar to those set forth in the Prior Guidance and section 113 of Dodd-Frank.

f. Annual Reevaluations

The Council is required by Dodd-Frank to reevaluate each SIFI designation at least annually, and to rescind a designation if the Council determines that the company no longer meets the statutory standards for a designation. The Final Guidance incorporates a number of additional procedural steps for annual

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reevaluations intended, according to the Council, to “enhance engagement with companies and their regulators, and to increase transparency.” Under the Council’s regulations, SIFI designation and de-designation each requires the vote of two-thirds of the Council members then serving, including the affirmative vote of the Chairperson.²⁸

The Final Guidance clarifies the post-designation “off-ramp” process for a SIFI, enabling the company to identify changes it could make to address the potential threat to financial stability identified by the Council and receive feedback from the Council on whether those changes address the Council’s concerns. The Council states that, when it makes a final determination, it intends to “encourage” the company or its regulators to take steps to “mitigate the potential risks identified in the Council’s written explanation of the basis for its final determination.” The Final Guidance states that, except where “new material risks” arise over time, if the designated company “adequately addresses” the potential risks identified by the Council at the time of the final designation and in subsequent reevaluations, the Council “should generally be expected to rescind its determination regarding the company.” The Council describes this “off-ramp” process as “intended to incentivize designated companies to address the key factors that led to designation, which would promote the Council’s goal of reducing risks to U.S. financial stability.”

The Final Guidance stresses that, while the Council’s annual reevaluation of a company subject to a final designation will “generally focus on changes since the Council’s previous review, the ultimate question the Council will seek to assess is whether changes in the aggregate since the company’s designation have caused the company to cease meeting the Determination Standards.” The final designation process in the Final Guidance also incorporates several procedural steps in the 2015 Supplemental Procedures, *e.g.*, the Council will provide each designated SIFI with an opportunity for an oral hearing before the Council once every five years at which the company can contest the designation.²⁹

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ENDNOTES

- ¹ Final Interpretive Guidance, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71,740 (Dec. 30, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-12-30/pdf/2019-27108.pdf>; Press Release, Financial Stability Oversight Council Issues Final Guidance on Nonbank Designation (Dec. 4, 2019), <https://home.treasury.gov/news/press-releases/sm844>.
- ² See 12 C.F.R. § 1310 App. A; Final Interpretive Guidance, Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (Apr. 11, 2012), <https://www.govinfo.gov/content/pkg/FR-2012-04-11/pdf/2012-8627.pdf>.
- ³ Notice of Proposed Interpretive Guidance, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 9028 (Mar. 13, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04488.pdf>.
- ⁴ The voting members of the Council are the Secretary, the Chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection, the Chairman of the Securities and Exchange Commission, the Chairperson of the Federal Deposit Insurance Corporation, the Chairperson of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and an independent member with insurance expertise who is appointed by the President and confirmed by the Senate. There are also five non-voting members representing the Federal Insurance Office, the Office of Financial Research and state banking, insurance, and securities regulators.
- ⁵ In addition, one of the duties of the Council set forth in section 112 of Dodd-Frank is to make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among financial markets and companies.
- ⁶ For further information, see our Client Memorandum, D.C. District Court Rescinds FSOC's Designation of MetLife as Systemically Important: Decision Cites "Fundamental Violations of Established Administrative Law," Including a Failure to Consider the Costs of Regulation and Unexplained Deviations From Prior Regulatory Guidance, dated April 7, 2016, https://www.sullcrom.com/siteFiles/Publications/SC_Publication_D.C._District_Court_Rescinds_FSOCs_Designation_of_MetLife_as_Systemically_Important.pdf.
- ⁷ See U.S. Dept. of the Treasury, Secretary Mnuchin Statement on the *MetLife, Inc. v. Financial Stability Oversight Council* Appeal (Jan. 18, 2018), <https://home.treasury.gov/news/press-releases/sm0254>; MetLife, MetLife Statement on Court Decision to Dismiss Appeal in SIFI Litigation (Jan. 23, 2018), <https://www.metlife.com/about-us/newsroom/2018/january/metlife-statement-on-court-decision-to-dismiss-appeal-in-sifi-li/>.
- ⁸ See Basis for the Financial Stability Oversight Council's Rescission of its Determination Regarding GE Capital Global Holdings, LLC (June 28, 2016), <https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE%20Capital%20Public%20Rescission%20Basis.pdf>; Notice and Explanation of the Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding American International Group, Inc. (AIG), (Sept. 29, 2017), https://www.treasury.gov/initiatives/fsoc/designations/Documents/American_International_Group_Inc._Rescission.pdf; Notice and Explanation of the Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding Prudential Financial, Inc. (Prudential) (Oct. 16, 2018), <https://home.treasury.gov/system/files/261/Prudential-Financial-Inc-Rescission.pdf>.
- ⁹ For further information, see our Client Memorandum, Asset Management and Financial Stability: Financial Stability Oversight Council Publishes Statement on Asset Management; Focuses on Liquidity, Leverage; Creates "Interagency Working Group" on Hedge Fund Leverage, dated

ENDNOTES (CONTINUED)

- April 25, 2016, https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Asset_Management_and_Financial_Stability_04_25_2016.pdf.
- 10 U.S. Dept. of the Treasury, Financial Stability Oversight Council Designations (Nov. 17, 2017), <https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf>.
- 11 For further information, see our Client Memorandum, U.S. Treasury Report on FSOC Designations; FSB Decides Not to Publish List of Global Systemically Important Insurers for 2017, dated November 27, 2017, https://www.sullcrom.com/siteFiles/Publications/SC_Publication_US_Treasury_Report_on_FSOC_Designations_FSB_Decides_Not_to_Publish_List_of_Global_Systemically_Important_Insurers_for_2017.pdf.
- 12 The FSB published a list of designated G-SIIs each year from 2013 to 2016, and each such list included the same U.S. insurance groups that had been designated by the Council as SIFIs (*i.e.*, AIG, MetLife, and Prudential). Note that the standards issued by the FSB and/or the IAIS are not binding on the United States or other jurisdictions unless and until the relevant local governmental bodies or regulators adopt appropriate laws and regulations.
- 13 For further information, see our Client Memorandum, IAIS—International Capital Standard, ComFrame, Holistic Framework for Systemic Risk in the Insurance Sector, dated December 18, 2019, <https://www.sullcrom.com/iais-adopts-global-frameworks-for-insurance-supervision>.
- 14 See Financial Stability Board, “[Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies](#)” (Jan. 8, 2014), and “[Consultative Document \(2nd\) Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies](#)” (Mar. 4, 2015).
- 15 See [Letter from Mark Carney, FSB Chairman to G20 Finance Ministers and Central Bank Governors](#) (Feb. 22, 2016) (“Once the . . . activity-based work is complete, the FSB, jointly with IOSCO, will conduct further analysis and finalise the assessment methodology for asset management under the global systemically important financial institutions (G-SIFI) framework.”).
- 16 See Financial Stability Board, “[Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities](#)” (Jan. 12, 2017).
- 17 The final rule is set forth at 12 C.F.R. §§ 1310.1 to 1310.23. The Prior Guidance sets forth the assessment methodologies to be used by the Council in its SIFI designation process; the final rule, on the other hand, sets forth the Council’s authority and purpose under section 113 of Dodd-Frank; the considerations to be used in making SIFI designations (mirroring the statutory criteria set forth in section 113 of Dodd-Frank); rules relating to Council information collection, consultation, confidentiality, evidentiary hearings, and other procedural matters relating to designations; procedural rules regarding the reevaluation and rescission of SIFI designations; and certain emergency exceptions to the SIFI designation procedures. The Final Guidance also replaces the Council’s 2015 supplemental procedures related to the conduct of hearings before the Council in connection with proposed designations and the 2015 staff guidance relating to the Stage 1 thresholds used in connection with the SIFI designation process. See *Financial Stability Oversight Council Supplemental Procedures Relating to Nonbank Financial Company Determinations* (Feb. 4, 2015), <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf> (“2015 Supplemental Procedures”); *Financial Stability Oversight Council Staff Guidance Methodologies Relating to Stage 1 Thresholds* (June 8, 2015), <https://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf>.
- 18 Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 8958 (Mar. 13, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04487.pdf>.

ENDNOTES (CONTINUED)

- ¹⁹ According to the Final Guidance, references to “relevant financial regulatory agencies” may encompass a broader range of regulators than those included in the definition of “primary financial regulatory agency” set forth in section 2(12) of Dodd-Frank. Presumably, under the activities-based approach the Council will engage as need be with any relevant financial regulators that have supervisory authority over firms engaged in potentially systemic activities, as opposed to only engaging with the primary or “lead” financial regulators of an activity or type of firm.
- ²⁰ The Council’s 2019 annual report highlighted, among other things, cybersecurity attacks on financial institutions, exposures to central counterparties and large, complex, interconnected financial institutions, the transition from LIBOR to alternative reference rates, nonbank mortgage origination and servicing, and financial innovation. See Council, 2019 Annual Report (Dec. 2019), <https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf>.
- ²¹ The term “risk to financial stability”, which was undefined in the Prior Guidance, is defined in the Final Guidance to mean “a risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy.”
- ²² The definitions of “company” and “material financial distress” remain the same as those set forth in the Prior Guidance. “Material financial distress” of a nonbank financial company is defined to mean when such nonbank financial company is in imminent danger of insolvency or defaulting on its financial obligations.
- ²³ See Dodd-Frank § 113(a)(2). The ten statutory considerations are applicable to U.S. nonbank financial companies. With respect to foreign nonbank financial companies, the Council is required to take into account a very similar list of considerations, in some cases limited to the companies’ U.S. business or activities. See Dodd-Frank Act § 113(b)(2). The Council may also consider “other risk-related factors that the Council deems appropriate.” See Dodd-Frank §§ 113(a)(2)(K) and 113(b)(2)(K).
- ²⁴ The Council further states that “[i]n particular, in the case of a nonbank financial company that manages assets on behalf of customers or other third parties, the third parties’ direct financial exposures are often to the issuers of the managed assets, rather than to the nonbank financial company managing those assets.”
- ²⁵ The Final Guidance notes that, because the Federal Reserve is required to tailor its prudential standards to nonbank financial companies following a designation, any new requirements resulting from the Council’s designation “will not be known to the Council when conducting its analysis of the company.” Accordingly, where the company under review “primarily engages in bank-like activities,” the Final Guidance provides that the Council may consider, “as a proxy, the costs that would be imposed on the nonbank if the Federal Reserve imposed prudential standards similar to those imposed on bank holding companies with at least \$250 billion in total consolidated assets under section 165 of the Dodd-Frank Act.”
- ²⁶ 12 C.F.R. § 1310 App. A; Final Interpretive Guidance, Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,660 (Apr. 11, 2012).
- ²⁷ See supra note 17.
- ²⁸ See 12 C.F.R. § 1310.10(b)(2).
- ²⁹ See supra note 17.

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