



February 25, 2011

By electronic submission to www.regulations.gov

Financial Stability Oversight Council
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Docket number FSOC-2011-0001

Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (“**SIFMA**”)¹ thanks the Financial Stability Oversight Council (the “**Council**”) for the opportunity to provide our views in connection with the Council’s Notice of Proposed Rulemaking “**NPR**” or “**proposed rule**”) regarding the criteria and process that should inform the Council’s designation of nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System (the “**Federal Reserve**”) under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”).²

I. Introduction and Summary

SIFMA is strongly supportive of taking steps to strengthen the soundness and resiliency of financial firms and of improving the government’s capacity to monitor and reduce systemic risk. SIFMA was an early advocate of a systemic risk regulator

¹ SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

² All section references in this comment letter are to sections of the Dodd-Frank Act.

following the financial crisis.³ During the debate leading up to the Dodd-Frank Act, we supported the principle of identifying, as appropriate, certain bank and nonbank financial companies as systemically important.⁴

In this letter we will make the following points:

- The Council should take a thoughtful, deliberative approach to designating nonbank financial firms for Federal Reserve supervision and heightened standards.
- The Council should provide more detail regarding the criteria it plans to use in making the determinations.
- If the Council notifies a firm that it is being considered for designation, it should provide at least 60 days for the firm to respond with information.
- The Council should make every effort to ensure the confidentiality of information provided to it by the nonbank firms.

Determining whether a nonbank financial firm should be subject to Federal Reserve supervision is a responsibility of significant impact, affecting the Federal Reserve, which will take on major new supervisory responsibilities; designated firms, which will face new more restrictive standards and considerable compliance costs; the financial markets in which those firms participate; and the U.S. economy as a whole. We have serious concerns about the pace with which the Council appears to be moving, particularly in light of the lack of specificity in the NPR.

Our comments fall into four categories. First, we recommend that the Council take a thoughtful, deliberate approach to the designation of financial firms for Federal Reserve supervision. This authority is new, of enormous impact, and interconnected with many other aspects of Dodd-Frank implementation. As we will elaborate upon below, a cautious and deliberate approach will allow the Council to reflect more fully other related initiatives of the Dodd-Frank Act, as well as related international financial reform initiatives, into its designation decisions.

Second, we looked forward to the NPR with anticipation that we would learn more about this important and unprecedented government decision-making process. By and large, however, we find the NPR says little that is not already contained in the statute and the ANPR. While the broad criteria that the Council proposes to use in the determination of which nonbank firms receive Federal Reserve supervision are presented, there is no indication of how the criteria will be evaluated. If the rule is

³ See *Systemic Regulation, Prudential Matters, Resolution Authority and Securitization: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 5-6 (2009) (statement of T. Timothy Ryan, Jr., President and CEO of the Securities Industry and Financial Markets Association).

⁴ See *Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 8 (2009) (statement of Randolph C. Snook, Executive Vice President of the Securities Industry and Financial Markets Association).

finalized as proposed, the Council will have created a process that is as opaque as it is significant. To the extent that the Council's process involves considering certain indicators as suggested in the NPR, we believe such indicators should be subject to public comment and that the Council should make the final framework used in the decision-making process transparent.

Third, while SIFMA applauds the Council's proposal to provide firms that might be designated an opportunity to provide information, we believe that the 30-day timeframe may be limiting. We urge the Council to consider a more flexible approach.

Fourth, while SIFMA would like more clarity and transparency as to the information and approach used by the Council in the designation decision, it is extremely important that sensitive firm-specific information be protected from disclosure. We urge the Council to address this issue early in its deliberations.

II. Deliberate and Comprehensive Approach

The Council has indicated that it intends to begin designating nonbank financial firms for Federal Reserve supervision shortly after finalizing the proposed rule. It is impossible to tell from the NPR how many firms the Council will review or how soon any designations might take place. While we appreciate the importance of moving ahead with the regulation of systemic risk, the fact is that there are a number of interrelated mandates within the Dodd-Frank Act that should be considered when making a designation decision. These include:

- Section 120 of the Dodd-Frank Act gives the Council the authority to designate a financial activity or practice as systemically important if it finds that the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading throughout the financial system.⁵ Such a designation would result in heightened standards for the activity or practice, which could be relevant in determining whether designation of an entity is appropriate. For example, application of heightened standards to an activity could well affect the leverage and/or liquidity of a firm engaging in this activity; leverage and liquidity are among the proposed criteria for Council designation. In addition, designation of an activity or practice would necessarily affect the degree of existing regulatory scrutiny, another criterion which the Council has said it will consider under Section 113.
- The Federal Reserve, under Section 165, is mandated to require enhanced supervision and prudential standards for nonbank firms subject to Federal Reserve supervision. Without the existence of these standards – and without

⁵ Under Title VIII the Council can also designate payment, clearing, and settlement activities as systemically important. *See* Section 804.

knowing the contours of the Federal Reserve's supervision program that will apply to designated nonbank firms – the Council would be unable to know the practical consequences of subjecting the nonbank firms to Federal Reserve supervision.

- Under Section 113, one of the criteria the Council is directed to use in making the determination to subject nonbank firms to Federal Reserve supervision is “the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies.”⁶ However, the Council will not be able to evaluate this criterion until the Federal Reserve has defined “significant nonbank financial companies” and “significant bank holding companies”, and the data becomes available. Although the Federal Reserve published a Notice of Proposed Rulemaking in the Federal Register defining these terms on February 11, 2011,⁷ there is no final rule yet and, once a final rule is issued, it will take some time for transactional and relationship data to become available.⁸
- Under Section 170, the Federal Reserve is to promulgate a regulation on behalf of, and in consultation with, the Council setting forth criteria exempting certain classes or types of nonbank financial companies from Federal Reserve supervision. Determining – with the benefit of public comment – the characteristics of nonbank financial companies that **will not** be designated as systemic seems to be an integral part of deciding what the characteristics are of nonbank financial companies that **will** be designated.

In addition to the issues noted above, the Council itself is not fully constituted. Appointments have not yet been made for two voting members: an independent member with insurance expertise, and the Director of the new Consumer Financial Protection Bureau. In addition, two non-voting seats are still vacant: the Director of the new Federal Insurance Office and the Director of the new Office of Financial Research. The Council would benefit from the expertise and knowledge of these

⁶ Section 113 (a)(2)(C).

⁷ See *Federal Reserve Board, Notice of Proposed Rulemaking Regarding Definitions Of “Predominantly Engaged In Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company*, 76 Fed. Reg. 7731 (Feb. 11, 2011).

⁸ In addition, while less of an issue for SIFMA members, another missing piece of the puzzle is the universe of nonbank financial companies possibly subject to designation under Section 113. Again, although the Federal Reserve published a Notice of Proposed Rulemaking in the Federal Register on February 11, 2011, defining what it means to be predominantly engaged in financial activities – and thus eligible for designation – it will take the Federal Reserve as well as industry stakeholders time to assess the scope of nonbank financial companies, particularly given the complexity surrounding the treatment of minority equity investments in unconsolidated entities and the definition of financial activities.

members when finalizing the designation process and making designations under Section 113.

Finally, the fact is that the designation decision is a difficult and complex one, which requires a great deal of research, analysis, and discussion. The lack of specificity in the NPR suggests that the Council is not yet ready to apply the criteria to specific firms in a way that will reflect consistent principles and standards. There is no statutory deadline for making the systemic designation decisions. As the Council refines its approach, more of the Dodd-Frank Act-related prudential and reporting framework will fall into place, allowing the Council to undertake a more informed decision-making process. We urge the Council to take a deliberate and comprehensive approach to designation especially since the Council has full authority to make a systemic designation at any time if it considers any particular situation urgent.

III. Transparent Criteria

The NPR states that the determination of which nonbank financial firms will be subject to Federal Reserve supervision will include consideration of both quantitative and qualitative criteria. SIFMA agrees with this approach; neither quantitative nor qualitative factors are sufficient on their own to characterize the systemic nature of a firm. SIFMA appreciates the need to incorporate judgment into the decision, including judgment about how the various factors interact as well as the potential systemic nature of a firm in normal markets versus times of stress. We also appreciate the importance of developing quantitative measures, where possible, to reflect the criteria in a consistent and objective way.

In the commentary preceding the text of the proposed rule, the NPR presents six broad categories within which the eleven statutory factors would be considered: size; interconnectedness; lack of substitutes; leverage; liquidity risk and maturity mismatch; and existing regulatory scrutiny. Quantitative indicators can be developed for most of these six categories. In fact, the NPR mentions that the Council will use quantitative metrics where possible, that the metrics will vary across types of financial businesses, and that the metrics will be periodically revised. However, the NPR provides no discussion of what data will be reviewed, how the criteria will be weighted or prioritized, or what definitions and measurement methodologies will be used for the metrics.

For example, while leverage is generally defined as the ratio of capital to assets, there are many ways to measure both capital and assets. Once the ratio is defined, it is unclear what level of leverage the Council would consider to be associated with systemic significance. And even if that were known, it is unclear how important the leverage criterion is relative to the other five criteria. We understand that not all of these aspects can be specified ahead of time. Certainly there is a role for judgment, for example, in considering the combined impact of the various criteria. But we also

believe – as suggested in the NPR – that the Council will begin with objective indicators that are presented consistently, at least within industry sectors.⁹

We believe the framework of indicators the Council uses to evaluate nonbank financial firms for potential designation as systemically significant, and any periodic changes thereto, should be subject to public comment and that the final framework used in the decision process should be made transparent. Similarly, more information should be provided on the qualitative criteria – for example, their relative importance, as well as specific aspects that the Council considers indicative of the presence of systemic risk. If the Council does not want the detailed indicators of the criteria embedded in a regulation, where frequent updates could be cumbersome, it could use other approaches, such as procedural guidance that is issued for comment before being finalized and made public once final. There is ample precedent for this approach. The banking agencies use both industry and examiner guidance in many instances to convey more granular expectations than contained in regulations on the same topic. It is not uncommon for the agencies to issue such guidance in draft form for comment before finalizing it.

Whatever the method, nonbank financial firms should be able to understand more about the contours of the analysis applied to them than is included in the NPR. At a minimum, firms should be able to know what indicators the Council will look at to judge whether a firm meets any of the six criteria. To be very clear, SIFMA does not expect, or even support, that the Council disclose the *values* of the metrics it considers indicative of systemic risk, because judging the systemic risk of a company is not a black-or-white endeavor. Rather, SIFMA supports that the Council disclose *how* it will measure size, interconnectedness, substitutability, leverage, liquidity and maturity mismatches, and regulatory scrutiny. We also support elaborating on the Council's views about how the factors could interact to create systemic risk.

If the final rule contains the same lack of transparency as does the NPR, this has potential consequences not just for the nonbank financial firms, but also for their stakeholders -- creditors, shareholders, counterparties, and customers. The uncertainty over whether a firm may be subject to a stricter level of supervision and regulation could affect the attractiveness of its equity as well as the firm's funding costs. In essence, the uncertainty can create added risk to nonbank firms considered by the market to be eligible for possible designation, which is an ironic outcome considering that one of the primary functions of the Council is to reduce systemic risk.

⁹ In testimony to the Senate Banking Committee on February 17, 2011, FDIC Chair Sheila Bair noted that "A staff committee working under the FSOC has segmented the nonbank sector into four broad categories: 1) the hedge fund, private equity firm, and asset management industries; 2) the insurance industry; 3) specialty lenders; and 4) broker-dealers and futures commission merchants. The Council has begun developing measures of potential risks posed by these firms." *Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs*, 112th Congress, 2011. (Statement of Sheila Bair, Chairman of the Federal Deposit Insurance Corporation.)

IV. Designation Notice and Timeline

SIFMA supports the inclusion in the NPR of an opportunity for a firm to provide information to the Council prior to a final designation decision. However, given the potential enormity of the consequences to a nonbank firm of being subject to Federal Reserve supervision, we would support a period of at least 60 days for information submission. We would also encourage the Council to include in a written notice to a firm that is under consideration for designation, the reasons it is under consideration. This is particularly important if the Council does not provide any more clarity on its approach to designation in the final rule and/or published guidance. Otherwise it would be difficult for a firm to present helpful and pertinent information to aid in the Council's final decision. And, as discussed in the previous section, the more transparency the Council provides regarding the criteria being used in the decision-making process, the better the chance that a firm can submit relevant information.

V. Information Confidentiality

Nonbank financial companies expect that as the Council and the Office of Financial Research ("OFR") gather information about them and their sectors to inform the Council's decision-making process that they will be asked to provide confidential and competitively sensitive business and proprietary data to the Council and the OFR. This confidential information could be provided in reports as requested by the OFR, in information requests from the Council in connection with pre-designation notices or discussion or otherwise. Our members expect that the confidential data that will come from their primary supervisors will be subject to an exemption from disclosure to the public as a result of the confidential supervisory exemption under the Freedom of Information Act. A number of members, however, have expressed concern that confidential information given to the Council will not be strongly protected under the trade secrets or confidential business information exemptions under the Freedom of Information Act. We ask the Council and the OFR to make strong statements about the extent to which they intend to safeguard confidential business data and supervisory data. We are concerned that without such statements, the kind of open and frank exchange necessary for the Council to make an informed decision will be more difficult. We also ask that the Council give advance notice to a designated firm before announcing its designation in order to allow the firm a reasonable period to prepare public communications and any required disclosures.

VI. Summary and Conclusion

To summarize SIFMA's recommendations, we urge the Council to clarify substantially its proposed process for designating nonbank financial firms for Federal Reserve supervision and heightened standards. First, we encourage the Council to designate firms – absent an emergency – only after numerous other related initiatives come to conclusion, including the supervisory and policy framework that would apply

to such firms, the definition of “significant” bank and nonbank financial firms, the approach to designating activities as systemically significant, and the safe harbor regulation indicating which types of firms are exempted from designation. Second, it is SIFMA’s position that the specific criteria used should be published for comment and that the final framework should be disclosed as well. The current NPR is little more than a black box, where neither the nonbank financial firms nor their stakeholders have any idea as to how they will be evaluated. Third, we recommend that if a firm is notified that it is under consideration for designation by the Council, that the timeframe for submitting information be at least 60 days. Fourth, we urge the Council to establish early on an approach to information confidentiality that ensures protection of sensitive information provided to the Council by firms or their supervisors.

We appreciate the complexity of the mandate given the Council. SIFMA stands ready to assist the Council in any way that we can to achieve an optimal, workable outcome for the financial system, financial firms, and supervisors.

If you have any questions, please do not hesitate to call me at 202-962-7400 or SIFMA’s regulatory advisor, Susan Krause Bell, Promontory Financial Group, at 202-249-1823.

Sincerely,

A handwritten signature in blue ink, appearing to read "K. Bentsen, Jr.", with a stylized, cursive script.

Kenneth E. Bentsen, Jr.
Executive Vice President, Public Policy and Advocacy
Securities Industry and Financial Markets Association