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November 5, 2010

By electronic submission to www.regulations.gov

Financial Stability Oversight Council
c/o United States Department of the Treasury
Office of Domestic Finance
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Docket number FSOC-2010-0001

Advance 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 Advance Notice of Proposed Rulemaking regarding the criteria 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 select banks and nonbank financial companies as systemically important.⁴

In the wake of the financial crisis, there are a vast number of changes underway that will reduce risk-taking and improve risk management, monitoring, and supervision of and by financial firms. These include implementation of the Dodd-Frank Act, ongoing international initiatives, and actions by various U.S. financial agencies and many industry participants. SIFMA encourages the Council to step back and consider all of these developments holistically, including how they will interact with each other to reduce systemic risk as well as risk at individual firms. If at all possible, the Council should take action in coordination with these various initiatives.

The determination that certain nonbank financial companies are systemically important and should be subject to Federal Reserve supervision is but one of numerous actions that the Council can take to reduce risk in the financial system. Other actions include designating certain financial activities as systemically important and working with primary supervisors to apply heightened standards to such activities;⁵ recommending heightened standards for systemically important bank holding companies;⁶ monitoring and commenting on financial regulatory developments;⁷ in certain circumstances imposing business restrictions on certain firms to mitigate risk;⁸ issuing public statements and providing reports to Congress;⁹ and collecting information, either directly or through the Office of Financial Research (the “OFR”).¹⁰

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).

⁵ See Section 120.

⁶ See Section 115.

⁷ See Section 112(a).

⁸ See Section 121.

⁹ See Sections 112, 113, 120, and 123.

¹⁰ See Section 112(a).

Deciding whether a nonbank financial company should be subject to Federal Reserve supervision is a decision of enormous significance to the affected company, its supervisors, the Federal Reserve, and the financial system. SIFMA encourages the Council to take a thoughtful and deliberate approach to making these decisions. It is not the goal of the Dodd-Frank Act, nor should it be the goal of the Council, to completely eliminate risk from the financial system. Rather, the significant authority given to the Council should be used judiciously, particularly given the other sweeping changes contained in the Dodd-Frank Act as well as those under consideration internationally. The Council has a multi-faceted job that at its core is to protect U.S. financial stability in the context of a global financial system. A cautious and deliberate approach will not only allow the Council to attend to this critical mission, but it will allow the Council to reflect more fully the impact of the Dodd-Frank Act, other domestic financial initiatives, and the international financial reform initiatives into its designation decisions.

Due to SIFMA's very broad membership, which includes securities firms, banks, and asset managers, coming together with a common view on this issue has been difficult. While we uniformly support efforts to address and reduce systemic risk, the statutory approach in the Dodd-Frank Act is not balanced between banks and nonbanks, which creates cross-cutting interests among financial firms with different business models. Nonetheless, recognizing that this issue is as challenging for the Council as it is for our membership, we suggest a framework that is principles-based and relies on input from the affected firms before any proposed systemic determinations are made.

We encourage the Council to form an industry Advisory Council to provide perspective and input on the significant policy decisions that will need to be made during the Council's start-up phase and on an ongoing basis. An Advisory Council would be able to provide helpful and practical input into issues such as the process and criteria for systemic designation, among others. We will provide the Council with more information and suggestions on an Advisory Council in a later letter.

In what follows, we propose a decision-making framework that includes an assessment of quantitative criteria to provide some element of clarity and transparency for the Council, combined with qualitative analysis and judgment to arrive at the decision of whether or not a nonbank financial company should receive Federal Reserve supervision.

II. Principles

SIFMA recommends that the Council adopt the following broad principles in determining which nonbank financial companies should be subject to Federal Reserve supervision.

- **The Council should provide clarity and predictability where appropriate.** Nonbank financial companies have an interest in knowing whether they are likely to fall under the “systemically significant” designation, as do the companies’ stakeholders. Aspects of the decision framework that are amenable to “bright lines” should be clearly communicated to the public.
- **The Council should incorporate qualitative factors and judgment in the decisions.** Few of the relevant criteria can be adequately captured by quantitative indicators. There will need to be a meaningful role for judgment, based on context, supervisory assessments and interaction of the criteria as well as dynamic considerations such as emerging risks and macroeconomic developments.
- **The Council should not impose unnecessary regulatory burdens.** The Dodd-Frank Act provides wide-ranging authority to the Council to make systemically significant designations, to subject firms to Federal Reserve supervision, to recommend new standards to primary regulators for firms and activities, and to collect information from companies. It is important for the Council to develop an approach that uses this authority resourcefully and effectively, with recognition of the cost and benefits.
- **The Council’s process should be transparent and open.** The public should be aware of the criteria that the Council uses, and the impacted nonbank financial companies should be able to provide information to assist the Council in its consideration of the factors involved in the decision.

We propose a framework that integrates these principles and quantitative and qualitative criteria into the decision-making process. We also discuss some key international considerations.

III. Identifying Systemic Significance

Section 113 of the Dodd-Frank Act gives the Council the authority to subject a nonbank financial company to Federal Reserve supervision and to enhanced prudential standards if the Council determines that “material financial distress at the ... company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the ... company, could pose a threat to the financial stability of the United States.”¹¹

There is no precise way to identify nonbank financial companies as potential threats to financial stability. The assessment of systemic significance is not a purely “by the numbers” activity, but one that requires experience and judgment. SIFMA believes

¹¹ See Section 113.

that the optimal way to structure the decision would be to develop an approach that combines transparent benchmarks with a process that also affords the Council the time and opportunity to carefully consider less quantifiable factors, including the firm's legal, supervisory, and market environment, its business model, and interaction of the designation criteria, to name just a few. It is also our strong view that the Council should be as transparent as possible about the process and the factors that are used in the decision.

IV. Criteria for Systemic Assessment

The Dodd-Frank Act provides eleven broad factors the Council must consider in determining whether a nonbank financial company presents a potential threat to U.S. financial stability.¹² These range from quantitative measures such as size, leverage, off-balance sheet exposures, concentrations and interconnectedness, to qualitative factors such as the ownership of the assets, the importance of the services offered to various customer groups, and whether and how the company is currently regulated.

A report to the G-20 Finance Ministers and Central Bank Governors in October 2009 (the “**G-20 Paper**”)¹³ articulated three broad criteria as important for identifying the systemic importance of financial institutions: *interconnectedness*, *size*, and *substitutability*. The Dodd-Frank Act factors that the Council must consider largely fit within these categories.

A. Interconnectedness

Interconnectedness is present when distress at one institution leads to distress at others. Where there are direct connections in the form of funding, guarantees, or cross-ownership, the failure of one firm will negatively impact other firms. Indicators of interconnectedness can include counterparty exposures, both on- and off-balance sheet, as well as linkages that may be less transparent, such as exposures to other highly interconnected institutions.

The problem of contagion also falls under interconnectedness, although it may be a harder risk to measure. Distress at one firm can cause an adverse market reaction at others, whether or not direct connections are present. The extent of a firm's short-term

¹² See Section 113(a),(b).

¹³ FINANCIAL STABILITY BOARD, INTERNATIONAL MONETARY FUND & BANK FOR INTERNATIONAL SETTLEMENTS, GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS, AND INSTRUMENTS: INITIAL CONSIDERATIONS (2009).

funding will be one important indicator, but it will need to be coupled with judgment of the firm's market circumstances and its vulnerability to adverse market reactions.

Interconnectedness plays out in a variety of ways, particularly at large, complex institutions. The G-20 Paper cites interconnectedness as one of the key considerations countries use to determine systemic significance, and provides numerous examples from the recent financial crisis.¹⁴

B. Substitutability

If an institution offers a financial service that is considered essential to U.S. financial stability, and is not readily available from other firms, at least to significant groups of customers, then its failure could be judged to present a risk to financial stability or the economy.¹⁵ Quantitative indicators of substitutability are not reliable, but could include measures of market share or concentration in business lines considered to be essential to the market. Qualitative considerations would be important to determine how essential the service is, the competing providers, whether the customers are retail and locally-limited, and the impact of a potential short-term disruption in the service.

C. Size

Size alone does not indicate systemic significance. A larger size could indicate a larger systemic impact in the presence of other factors such as interconnectedness or lack of substitutability. Depending on the nature of the business, size might be measured by volume of assets, liabilities, or transactions processed, or possibly off-balance sheet exposures.

¹⁴ The "Background Paper" to the G-20 Paper notes that the impact of the failure of Lehman Brothers Holding Company in September 2008 was amplified by its open derivatives positions and the securities it held as collateral that could not be readily accessed by clients. The report also noted that the U.S. government's assistance to AIG was based in significant part on the firm's vast interconnections to other parts of the financial system. These included \$50 billion of exposures held by global banks and investment banks, including loans and derivatives, and \$20 billion of commercial paper held by money market funds and others. FINANCIAL STABILITY BOARD, INTERNATIONAL MONETARY FUND & BANK FOR INTERNATIONAL SETTLEMENTS, GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS, AND INSTRUMENTS: INITIAL CONSIDERATIONS—BACKGROUND PAPER 19-23 (2009).

¹⁵ This could be said to be the reason that Title VIII of the Dodd-Frank Act requires the Council to designate certain financial market utilities and payments, clearing, and settlements services as systemically significant.

D. Interaction of Criteria

None of the criteria alone would likely be sufficient to consider a firm systemically significant. For example, a large institution that is not interconnected to other financial institutions is less likely to pose a risk to financial stability than an institution that is interconnected *and* large. Similarly, an institution that offers an essential financial service for which there are no readily available substitutes *and* is large could also be a systemic concern.

V. Application of Criteria to Nonbank Financial Firms

The same criteria should be used across all types of nonbank financial companies,¹⁶ although the criteria may be measured in different ways. Designating a firm as systemically significant is highly complex, involves a great deal of judgment and will likely change over time. In evaluating nonbank financial companies for designation, the lines of business and nature of risk will vary from firm to firm.

Some firms, of course, are highly complex with multiple lines of business, and these firms may in fact be more likely to be candidates for designation as systemically significant. The G-20 Paper defines complexity this way:

A complex institution is an institution or financial group that (a) operates diverse types of activities through numerous legal entities (e.g., simultaneously operating banking, insurance and securities subsidiaries); (b) operates across borders with centrally managed capital and liquidity (as opposed to simpler networks of national subsidiaries); and/or (c) has exposures to new and complex products and markets that have not been sufficiently tested.¹⁷

Like many of the criteria, complexity alone does not imply systemic significance (and could in fact imply reduced risk due to diversification effects), but a complex institution may be more likely to score high on the various criteria, particularly if opaqueness is also a problem such that some of the criteria cannot be measured well. In addition, consideration of institutions with cross-border operations should include careful coordination with foreign supervisors, which we discuss in Section VI.

¹⁶ We would support the application of the same criteria to the identification of systemically significant bank holding companies, in lieu of the bright-line asset test set forth in the Dodd-Frank Act.

¹⁷ GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS, AND INSTRUMENTS: INITIAL CONSIDERATIONS 13.

A framework that incorporates quantitative indicators and qualitative considerations to evaluate firms creates a process that makes use of available information and is reflective of current and changing market circumstances.

A. Quantitative Indicators

As we indicated earlier, SIFMA believes that quantitative measures should be used where possible. However, many quantitative indicators are at best rough proxies for systemic significance and some may not have a demonstrable relationship to financial stability. Still, there is value in utilizing quantitative indicators to assist in the decision, assuming further analysis and judgment would also be applied. Quantitative indicators that can be useful include, but are not limited to:

- Interconnectedness
 - Funding metrics
 - Extent of short-term funding (net of matched funding)
 - Extent of wholesale funding
 - Counterparty exposures including to systemically significant firms and payment systems
 - Cross-ownership measures
 - Intra-group exposures
- Substitutability
 - Indicators of market concentrations in credit and services markets considered essential to financial stability
- Size
 - Volume of proprietary assets/liabilities
 - Transactions processed
 - Risk-adjusted measures of off-balance sheet exposures

Not all indicators carry the same weight and each will be more relevant when there is interaction between more than one of the broad criteria of interconnectedness, substitutability, and size. We have not suggested specific calibrations or weights of the indicators, which itself will be a significant effort.

B. Qualitative Considerations

There are a number of qualitative considerations that should go into determining whether a nonbank financial company presents a potential threat to U.S. financial stability, including but not limited to:

- Information from the firm including, at the firm's discretion, data and analysis reflecting its interconnectedness, the substitutability of its financial services,¹⁸ and other factors relevant to the designation decision
- The importance of the company's provision of financial services to various constituent groups
- The vulnerability of the firm to contagion, including due to:
 - Extent of transparency
 - Reputation risk
- The firm's actions and/or experiences during the recent financial crisis that may reflect on its interconnections and vulnerability to contagion
- The corporate structure and complexity of the firm
- The nature of the firm's supervision (including prudential rules such as capital requirements) and its permissible activities
- The authority of the primary regulator to intervene during times of financial or other stress to wind down the firm to avoid collateral damage to the industry
- The existence of external risks including from:
 - Local and macro economic conditions
 - Events or risks within a particular sector or industry

Given the authority in the Dodd-Frank Act for the Council to designate nonbank financial companies and financial activities, the Council should look at the potential designation holistically. For example, if a company is under consideration for designation, the Council should also take into account whether the company engages in an activity that has been, or could be, designated as systemically significant. The Council has authority under Section 120 of the Dodd-Frank Act 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.¹⁹ Such a designation would result in heightened standards for the activity or practice. If a financial company is primarily engaged in an activity that has received a designation, the Council should factor that in and should not also designate the company without separate cause to do so. On the other hand, if a company is under consideration for designation, the Council could consider designating certain of its activities as systemically significant as an alternative to designating the entire company.

¹⁸ This could include business lines a firm has identified as a critical activity in the context of a resolution plan, if applicable.

¹⁹ Under Title VIII the Council can also designate payment, clearing, and settlement activities as systemically important. *See* Section 804.

Similarly, there may be situations where a large financial firm, either bank or nonbank, is comprised of numerous corporate entities, and the parent as well as one or more subsidiary could conceivably come under consideration for designation. In these cases, the Council should ensure that designations are not made twice to the same firm, but rather applied at the most appropriate level. We discuss the case of international firms, where more than one national regulator is involved, in the next section.

VI. International Considerations

While the Dodd-Frank Act provides for a foreign nonbank financial company to be designated as a systemically important company, there are certain mitigating factors that the Council, as a statutory matter, must take into account in making that designation. These factors limit the scope of the Council's review to mainly the U.S. operations of the company, require the Council to avoid duplicative regulation, and require the Council to consult with the foreign supervisor to the extent appropriate before making such a designation. In light of developing international standards and the activity of foreign regulators, and consistent with the Supreme Court's recent decision in *Morrison v. Nat'l Australia Bank Ltd.*,²⁰ we urge the Council to proceed cautiously before extending the reach of the statute extraterritorially to foreign nonbank financial companies.

The determination of whether a foreign nonbank financial company should be supervised by the Federal Reserve and subject to heightened prudential standards is made with reference to the company's impact on the financial stability of the United States.²¹ In making that determination, most of the statutory factors are specific to the company's operation in, and impact on, the United States.²²

²⁰ 130 S. Ct. 2869 (2010).

²¹ In making a determination whether a foreign nonbank financial company should be supervised by the Federal Reserve and subject to heightened prudential standards, the Council must determine that "material financial distress at the foreign nonbank financial company" or the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the foreign nonbank financial company, could pose a threat to the financial stability of the United States" (emphasis added). See Section 113(b)(1).

²² These factors include:

- the extent and nature of the United States related off-balance sheet exposures of the company;
- the importance of the company as a source of credit for United States households, businesses, and State and local governments and as a source of liquidity for the United States financial system;

In addition, the Council must consider “the extent to which the company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority.”²³ This mandatory consideration suggests that the Council should avoid duplicative supervision in the United States. This message is reinforced in other sections, which also require the Council to consider the extent to which the foreign nonbank financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States, including the sections on enhanced prudential standards recommended by the Council, risk mitigating actions by the Federal Reserve, and enhanced prudential standards imposed by the Federal Reserve.²⁴

Finally, the Council must “consult with appropriate foreign regulatory authorities, to the extent appropriate” in exercising its duties with respect to foreign nonbank financial companies.²⁵ This consultation requirement is reinforced elsewhere in the Title, including in the case of emergency designations, where the Council must consult with the appropriate home country supervisor, if any, of the foreign nonbank financial company that is being considered for such a determination.²⁶

The developing international standards around systemically significant companies are important for both foreign nonbank financial companies and U.S. nonbank financial companies. The Financial Stability Board and the Basel Committee on Banking Supervision are in various stages of adopting heightened requirements for large

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- the importance of the company as a source of credit for low-income, minority, or underserved communities in the United States, and the impact that the failure of such company would have on the availability of credit in such communities;
 - the amount and nature of the United States financial assets of the company; and
 - the amount and nature of the liabilities of the company used to fund activities and operations in the United States, including the degree of reliance on short-term funding.

See Section 113(b)(2).

²³ *See* Section 113(b)(2).

²⁴ *See* Section 115(b)(2); *see also* Sections 121(d), 165(b)(2).

²⁵ *See* Section 113 (i).

²⁶ *See* Section 113(f)(3). The statute specifically provides that before a foreign nonbank financial company is required to submit reports, the Council must “consult with the appropriate foreign regulator of such company, and whenever possible, rely on information already being collected by such foreign regulator.” *See* Section 112(d)(3)(C).

financial institutions,²⁷ as are various foreign regulators. This could result in foreign firms being subject to heightened regulation of their global operations from their home countries and of their U.S. operations from the United States. The need to avoid duplicative regulation and for coordination among regulators is true for both foreign and U.S. firms. This is reinforced in the Dodd-Frank Act which specifically states that the Council shall regularly consult with the financial regulatory entities and other appropriate organizations of foreign governments or international organizations on matters relating to systemic risk to the international financial system and that the Federal Reserve and the Treasury Secretary must consult with foreign counterparts and “through appropriate multilateral organizations to encourage comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies.”²⁸ We encourage the Council to coordinate with foreign regulators and await the development of international standards before applying stringent requirements on nonbank financial companies. This is also consistent with the Supreme Court’s recent decision in *Morrison* in which the Court has specifically directed that the extraterritorial application of any U.S. statute should be construed narrowly.

VII. Summary

To summarize the approach SIFMA is proposing, we recommend the Council use the following decision process to determine whether a nonbank financial company should be subject to Federal Reserve supervision.

The Council should evaluate the company against quantitative and qualitative factors. The quantitative indicators should be weighted and calibrated for the firm’s line of business. The qualitative considerations should be based on information and analysis from the firm’s supervisors – including foreign supervisors for global firms – and other sources, including the firm itself, the Council, and the OFR. The Council’s considerations should include discussions with management of the company to better understand its businesses, potential sources of risk and interconnectedness, and steps the company has taken to mitigate these risks. The Council should also consider what firm-related designations may have already been made, such as activity designations or foreign supervisory actions.

²⁷ The Financial Stability Board has indicated that it will recommend to the G-20 this month a policy framework for global systemically important financial institutions (“G-SIFIs”). The Basel Committee has said that it will develop a methodology of quantitative and qualitative factors to assist in assessing systemic importance of financial institutions by year end.

²⁸ See Section 175.

If on this basis the Council continues to have concerns about potential systemic risk, it should consider what steps it could take to satisfy those concerns, including working with the firm's primary supervisor to affect heightened standards. If the Council is not satisfied with this option, it could begin the formal designation process.

This approach will meet the original principles we set forth: to provide predictability where possible; to employ judgment where appropriate; to limit the extent to which new requirements and costs are imposed on government agencies and firms; and to be transparent and open. It attempts to simplify an extraordinarily complex mandate. It will be an enormous task to develop quantitative criteria for the various types of financial firms, and once developed, the criteria will need to be revised based on experience and market developments. However, this approach provides a relatively efficient, level starting place for the Council's firm-by-firm deliberations.

* * *

SIFMA appreciates the opportunity to comment on the designation process for nonbank financial companies and we consider the Council's Advance Notice of Proposed Rulemaking a promising start to an open, transparent, and fair process. Over the last few years, the financial system – and indeed the economy as a whole – has been through tumultuous times that no one wants to see repeated. The Dodd-Frank Act provides regulators with significant new tools and authorities, including the Council, to create a sound framework for addressing micro-prudential and systemic risk. We urge the Council to take a careful, deliberative approach. SIFMA would be pleased 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 black ink, appearing to read "Ken Bentsen", with a long horizontal line extending to the right.

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