GIBSON DUNN

FSOC Proposes Overhauling Its Standards for Designating Nonbank Companies as Systemically Important

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On April 21, 2023, the Financial Stability Oversight Council ("FSOC") proposed several changes to how the agency would designate nonbank financial companies as systemically important financial institutions ("SIFIs"), thereby subjecting them to supervision by the Federal Reserve and additional regulations. In the first of two proposed "interpretive guidance" documents, FSOC would "revise and update" its 2019 Interpretive Guidance on several fronts, with the expressed goal of eliminating "hurdles" to FSOC's ability to designate nonbank financial companies as systemically important. In the second proposed interpretive guidance document, FSOC sets forth an "analytic framework" that it would employ when assessing a company's "potential risk or threat to U.S. financial stability," and accordingly whether to designate the company as systemically important. FSOC has also issued factsheets for the first and second proposed interpretive guidances.

These new documents (together, the "Proposed Guidance"), if finalized, would implement several key changes to FSOC's current Interpretive Guidance. Under the current Guidance, adopted in 2019, FSOC employed an "activities-based approach" to assess risk and would designate individual entities as SIFIs only as a "last resort." The Proposed Guidance would eliminate any requirement to use an activities-based approach before designating individual entities. The Proposed Guidance would also remove any obligation that FSOC consider a company's likelihood of material financial distress before designating that company. Finally, the Proposed Guidance eliminates any requirement that FSOC conduct a cost-benefit analysis before designating companies as SIFIs. These changes would expand FSOC's ability to designate nonbank financial companies as SIFIs, and thus to subject them to additional regulation.

Below, we provide background information on FSOC's designation process; Gibson Dunn's challenge to FSOC's designation of MetLife; the key changes that the Proposed Guidance would implement; the likely implications of those changes; and, finally, the steps to be taken now by concerned parties.

I. Background of FSOC's Designation Process

Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") established FSOC and gave it the power to designate a nonbank financial company as a SIFI, meaning that FSOC has determined that material financial distress at the company, or the company's nature, scope, size, scale, concentration, interconnectedness, or mix of activities, could pose a threat to U.S. financial stability. 12 U.S.C. § 5323(a)(1). This designation imposes on the designated nonbank financial company Federal Reserve examination, supervision, and enforcement authority, as well as enhanced prudential standards—including heightened capital and liquidity requirements, leverage limits, resolution planning, concentration limits, and stress testing and early remediation requirements. *Id.*

In 2012, FSOC promulgated guidance describing the manner in which the agency would

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make designation determinations. This guidance provided, for example, that FSOC would assess the company's vulnerability to material financial distress before addressing the effect of that potential distress, and that the agency would assess the company's threat to U.S. financial stability. *See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21,637, 21,653 (Apr. 11, 2012).

In FSOC's thirteen years of existence, the agency has designated four nonbank financial companies as SIFIs: American International Group, Inc.; General Electric Capital Corporation; Prudential Financial, Inc.; and MetLife, Inc. Only MetLife challenged its designation.

Represented by Gibson Dunn, MetLife brought suit in federal district court, which court ruled that FSOC's designation of MetLife was arbitrary and capricious and ordered FSOC to rescind the designation. *See MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016). The district court first held that FSOC had violated its own rules by failing to consider whether MetLife was vulnerable to material financial distress, and whether hypothetical distress at MetLife would pose a threat to U.S. financial stability. *Id.* at 233–39. The district court also held that FSOC's designation decision was arbitrary and capricious because it failed to consider the costs of designating MetLife. *Id.* at 239–42. FSOC appealed the decision to the D.C. Circuit, but then voluntarily dismissed its appeal. *See MetLife, Inc. v. Fin. Stability Oversight Council*, No. 16-5086, 2018 WL 1052618, at *1 (D.C. Cir. Jan. 23, 2018). On remand, the district court denied a motion to vacate the portion of its opinion that held FSOC was required to perform a cost-benefit analysis. *See* Order, *MetLife, Inc. v. Fin. Stability Oversight Council*, No. 1:15-cv-00045-RMC, Dkt. 129 (D.D.C. Feb. 28, 2018).

By 2018, FSOC had rescinded all of its prior designations. Then, in 2019, FSOC amended its regulations, adopting many of the positions that MetLife had presented in the litigation. *See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 84 Fed. Reg. 71,740 (Dec. 30, 2019). In particular, the agency adopted an activities-based approach to assessing potential risks to U.S. financial stability, which focuses on working with other federal and state financial regulators to identify and regulate particularly risky activities, and considers designating individual companies to be a last-resort option. FSOC also committed to performing cost-benefit analyses during its designation decisions, and to assessing the likelihood that the entity would actually experience material financial distress.

II. FSOC's Proposed Guidance Changes

FSOC's new Proposed Guidance would disavow many of the changes that FSOC made in its 2019 Interpretive Guidance in response to the *MetLife* decision. As noted above, three changes in the Proposed Guidance would prove especially important.

First, FSOC's Proposed Guidance would abandon its activities-based approach to preventing material financial distress in the U.S. economy. Under that approach, FSOC monitors the economy and works with federal and state financial regulators to identify particular activities that could pose a risk to U.S. financial stability in certain contexts. Once they identify a risky activity, FSOC works with those regulatory bodies to address the identified potential risk, and considers designating a particular company to be a last resort. This approach enables regulators to promulgate consistent and predictable rules that govern a particular market as a whole, rather than singling out certain entities for unique treatment. The Proposed Guidance, however, would drop that approach in favor of more aggressively designating individual firms based on "non-exhaustive" risk factors contained in the new "analytic framework," including leverage, liquidity risk and maturity mismatch, interconnections, operational risks, complexity or opacity, inadequate risk management, concentration, and destabilizing activities.

Second, the Proposed Guidance would eliminate any requirement that FSOC consider a company's likelihood of material financial distress before designating that company as a

SIFI. The Proposed Guidance suggests that inquiring into the likelihood of material financial distress is neither "required [n]or appropriate" because such distress can be difficult to recognize or predict. Accordingly, when evaluating future designations, FSOC would "presuppos[e]" that a company is experiencing material financial distress—irrespective "of the likelihood" of such distress in the real world—and assess the impact that this hypothetical distress might have on the broader economy.

Third, the Proposed Guidance would eliminate any requirement that FSOC conduct a cost-benefit analysis before designating a nonbank financial company as a SIFI, despite the district court's ruling in *MetLife* that failure to conduct that analysis was arbitrary and capricious and violated the Supreme Court's ruling in *Michigan v. EPA*, 576 U.S. 743 (2015), which had held that when a statute allows an agency to regulate when "appropriate," the agency must consider the costs of its regulation. The Proposed Guidance posits that weighing the increased costs from regulatory burdens against the potential benefits of designation is not "useful or appropriate," given difficulties in assessing costs and the "potentially enormous" benefits of designation in averting financial crises. It portrays its loss in the district court as having no legal significance on this point. *See* FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* at 16 n.16 (Apr. 21, 2023).

III. Implications of the Proposed Guidance

The goal of the Proposed Guidance is to broaden—and accelerate—FSOC's ability to identify and designate certain nonbank financial companies as SIFIs, and thus to subject them to additional and potentially onerous supervision, examination, and regulation. The retreat from an activities-based approach would also limit companies' ability to know in advance what activities would risk designation, and thus to plan their future behavior. Recent statements by financial regulators suggest that the targets of FSOC's proposed approach may include traditional nonbank financial companies (for instance, insurers, hedge funds, open-end funds, and money-market funds), along with more recent market entrants (such as stablecoin issuers and other FinTechs engaged in financial activities, including nonbank peer-to-peer payments companies).

The Proposed Guidance may be vulnerable to many of the same objections that prevailed in the *MetLife* litigation. For example, footnote 16 of the Proposed Guidance asserts that FSOC need not conduct any cost-benefit analysis because *MetLife* was wrongly decided and has no "preclusive effect." But, as noted above, the district court rejected the government's attempt, after it had dismissed its appeal, to vacate the cost-benefit portion of the court's opinion. Moreover, the district court had explained that its cost-benefit decision was compelled by the Supreme Court's decision in *Michigan v. EPA*. *See MetLife*, 177 F. Supp. 3d at 240 (citing *Michigan*, 576 U.S. at 752). FSOC remains bound by the Supreme Court's *Michigan* decision and any designation that ignores cost-benefits considerations will be vulnerable to the same argument on which Gibson Dunn prevailed in *MetLife*.

Similarly, the district court held that the text of the Dodd-Frank Act itself mandates an inquiry into a company's likelihood of material financial distress, *see MetLife*, 177 F. Supp. 3d at 241 (citing 12 U.S.C. § 5323(a)(2)(K))—the same inquiry that the Proposed Guidance now seeks to discard.

IV. Next Steps

FSOC's Proposed Guidance is subject to public notice and comment for 60 days following publication of the Proposed Guidance in the Federal Register. Incisive comments may have an effect on the substance of the final documents, and may also form the basis for any future court challenges to FSOC's final guidance and to any nonbank financial company's potential designation.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please feel free to contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Administrative Law and Regulatory, Financial Institutions, or FinTech and Digital Assets practice groups, or the following authors:

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