REGULATION BY THREAT: UNDERSTANDING DODD-FRANK'S REGULATION OF SYSTEMICALLY SIGNIFICANT NON-BANK FINANCIAL COMPANIES

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Abstract: A central lesson of the global financial crisis is that banks are not the only types of financial firms that can pose dangers to the broader financial system. One of Dodd-Frank's primary mechanisms for responding to this reality is to empower a council of financial regulators to designate individual non-bank financial institutions as systemically risky. Although the Financial Stability Oversight Council (FSOC) has only exercised this authority four times, it has occasioned considerable controversy in court, in Congress, and among commentators. This Article defends the FSOC designation scheme, arguing that most of its critics misunderstand the mechanisms by which it helps to reduce systemic risk outside of the banking sector. FSOC designation does not, and cannot, precisely distinguish between firms that could pose a systemic risk and those that could not. FSOC's broad discretion to impose costly sanctions on designated firms instead advances two quite different goals. First, it deters non-bank firms from seeking out systemically risky strategies or activities. Second, it holds financial regulators to account b~~y~~ threatening to impose additional restrictions and supervision on the firms they regulate if they fail to address systemic risk on their own. We term this approach "regulation by threat," and suggest that it is appropriate when risks are hard to identify, the perils of mistake are great, and the downsides of misdiagnosis extreme. Systemic risk outside of the banking sector meets this description to a tee. Moreover, we argue that the Council's discretion is better cabined by its structure – which features diverse membership, voting, review, and political safeguards – than by insistence on particularly "hard look" judicial review, accompanied by the requirement of a cost benefit analysis for any individual designation decision. Similarly, the various reform proposals to limit FSOC's discretion or impose additional procedural limits on its operations generally threaten to undermine the Council's effectiveness by unnecessarily limiting its discretion, and thus its capacity to regulate by

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threat. The paper concludes with an assessment of how one of the threats FSOC can make – supervision by the Fed – has evolved in the wake of the financial crisis, giving it a more international role.

INTRODUCTION

A central lesson of the global financial crisis is that banks are not the only types of financial firms that can pose dangers to the broader financial system. In fact, some of the worst moments of the crisis – the surprising collapse of the country's largest insurance company on the same day that one of its oldest money market funds collapsed, and one day after two of its largest investment banks fell, for example – did not involve banks at all.[1]

The government responded to this experience with reform. It created a mechanism, the Financial Stability Oversight Council (the "council" or "FSOC") – a panel of the nation's most prominent financial regulators – to identify new and emerging threats to financial stability. And it gave that council the power to designate particular non-bank financial firms as systemically significant, a status that results in heightened anti-insolvency standards and supervision by the Federal Reserve.[2]

This power of the council, although it has only been utilized four

[1] On September 15, 2008, two investment banks were closed – Merrill Lynch was sold at a cut rate price, and Lehman Brothers went bankrupt. Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold*, N.Y. TIMES (Sept. 14, 2008), http://www.nytimes.com/2008/09/15/business/15lehman.html. One day later, the insurance giant AIG accepted an $85 billion bailout that gave the federal government a 79.9% stake in the company, and the Reserve Primary Fund, a large and trendsetting money market fund, "broke the buck." The term refers to the "net asset valuation" of money market shares, which are meant to approximate one dollar per dollar invested. *See* SEC v. Reserve Mgmt. Co. (*In re* The Reserve Fund Sec. & Derivative Litig.), 673 F. Supp.2d 182, 198 (S.D.N.Y. 2009). For a discussion, see Jill E. Fisch, *The Broken Buck Stops Here: Embracing Sponsor Support in Money Market Fund Reform*, 93 N.C. L. Rev. 935, 993 (2015). At the close of the second day, the Dow Jones Industrial Average had fallen 800 points since the start of the week. Brenna Maloney & Todd Linderman, *Five Days That Transformed Wall Street: Sept. 15-19, 2008*, WASH. POST (Sept. 20, 2008), http://www.washingtonpost.com/wpdyn/content/graphic/2008/09/20/GR2008092000318.html?sid=ST2008092001054. *See infra* notes __ and accompanying text for more about both firms. These events, involving very different institutions operating in different corners of the financial marketplace, came to be seen as related. *See, e.g.*, JEROME L. STEIN, STOCHASTIC OPTIMAL CONTROL AND THE U.S. FINANCIAL DEBT CRISIS 111 (2014) (suggesting that the government's decision to rescue the insurance company, AIG, was driven in part by the collapse of the money market fund, Reserve Primary).

[2] 12 U.S.C. § 5323(a)(1) (providing that the Financial Stability Oversight Council "may determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards").

times, has occasioned considerable controversy in court, in Congress, and among commentators.[3] The chair of the Senate Banking Committee has wondered whether the council's designation decisions are "sufficiently open, objective, data driven, and free from the influence of outside organizations."[4] The Republican Party's presidential platforms in both 2012 and 2016 have committed the party to revoking the council's powers.[5] And one court has reversed the council's designation of the country's largest life insurer as an arbitrary and capricious exercise of its authority.[6]

These critics typically assume that the core purpose of FSOC designation is to accurately and consistently identify non-bank financial firms whose collapse would threaten the financial system. They often imply that FSOC can only accomplish this by developing a detailed and analytically complete account of what factors render a non-bank financial firm systemically suspect, complete with a quantified and comprehensive cost-benefit analysis conducted in the course of any particular designation.[7]

The council has rejected these recommendations. Its designation decisions look less like the critics' preferred sort of precise determination, and more like an inference, based on a range of factors and evidence, that material financial distress at targeted firms "could" contribute to broader financial instability.

We defend the way the council regulates in this article. The council was created not to adjudicate between safe and risky businesses as a court might, or to create a mathematical formula that firms can apply to their balance sheets to see if they are risky. Instead, it was created to encourage

[3] *See, e.g.*, Peter J. Wallison, Op-Ed, *The Latest Twist in a Regulatory Sham*, WALL STREET J. (Sept. 10, 2014), http://www.wsj.com/articles/peter-j-wallison-the-latest-twist-in-a-regulatory-sham-1410389724 ("House Financial Services Committee Chairman Jeb Hensarling (R., Texas) has also called on the FSOC to "cease and desist" further designations until Congress has evaluated the economic effects of designating a nonbank financial firm as a SIFI. The House backed Mr. Hensarling in July by passing an appropriations-bill amendment that imposed a one-year moratorium on SIFI designations").

[4] Statement of Sen. Richard Shelby (R-AL) on Hearing on FSOC Accountability, Mar. 25, 2015, http://www.banking.senate.gov/public/index.cfm/2015/3/shelby-statement-at-hearing-on-fsoc-accountability.

[5] 2016 Republican Party Platform, *Restoring the American Dream*, https://www.gop.com/platform/restoring-the-american-dream/ (calling for repeal of the "regulatory nightmare" of the Dodd-Frank Wall Street Reform Act, and replacing it with "legislation to ensure that the problems of any financial institution can be resolved through the Bankruptcy Code.") 2012 Republican Party Platform, *We Believe in America*, http://www.presidency.ucsb.edu/ws/?pid=101961 ("A Republican Congress and President will repeal … the Dodd-Frank Act").

[6] Metlife, Inc. v. Fin. Stability Oversight Council, No. CV 15-0045 (RMC), 2016 WL 1391569, at *17 (D.D.C. Mar. 30, 2016).

[7] *Id.* (requiring the council to conduct a quantified cost benefit analysis of designation before designating any particular firm).

all financial firms to avoid taking excessive risks.[8] It has chosen to do this by taking action against some, and in so doing, warning the rest. The threat of FSOC designation – and the regime of enhanced regulatory requirements and supervision by the Federal Reserve that comes along with it – is meant to deter non-bank financial firms from actively seeking out risk. It is also designed to hold financial regulators to account by threatening to impose additional restrictions on the firms they regulate if they fail to account for systemic risk on their own.

We call this scheme regulation by threat. Regulation by threat means that a regulator will have the broad discretion to impose costly sanctions on those they regulate; done well, it will be a power the regulator wields rarely.

The council's regulatory powers fit this scheme well. It is capable of making effective threats that have a real deterrent effect *precisely because of* the discretion that it enjoys in applying a malleable standard to identify systemically important financial institutions (or "SIFIs"). Non-bank financial firms facing a risk of being deemed systemically significant by FSOC will tend to avoid embracing strategies that could create systemic risks because designation comes along with costly regulatory restrictions and supervisions. By contrast, non-banks that know that the Council would not designate them if they abided by pre-specified rules might take on risk to increase their odds of outsized gains, with, potentially, the promise of a bailout if things go wrong, with the attendant low cost of capital that accompanies the prospect.

Regulation by threat only works if designation is costly. Sanctions must bite if they are to deter.[9] The evidence so far suggests that both industry and regulators have changed their conduct to avoid costly council oversight. FSOC recently rescinded its designation of GE Capital as systemically significant after the firm sold off its operations related to short-term debt markets, which was a focus of FSOC's initial designation decision.[10] And investors or management in two of the three other designated firms – AIG and MetLife – have publicly floated the idea of

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[8] FSOC, *About The Financial Oversight Council*, https://www.treasury.gov/initiatives/fsoc/Pages/home.aspx ("The Council is charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States' financial system.").

[9] Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 1226 (2001) (arguing that "the central purpose of law enforcement is to reduce harmful activity. One way to accomplish this goal is through deterrence: the reduction in the commission of harmful acts through the threat of sanctions").

[10] FSOC, *Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding GE Capital Global Holdings, LLC,* available at https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE%20Capital%20Public%20Rescission%20Basis.pdf (June 28, 2016).

pursuing a similar strategy.[11] Indeed, the entire insurance industry has taken steps to lessen the prospect of designation by the council.[12] Moreover, regulators have worried about losing turf to the Fed. Here too, recent evidence – including a series of SEC rulemakings geared towards financial stability and emerging reforms in state insurance regulation – is illustrative.[13]

All of this reveals a scheme designed to further financial stability through broad grants of administrative discretion paired with penalties. One might normalize this approach as an example of standards-based regulation, as opposed to rules-based regulation, where the requirements for designation of nonbanks are kept broad and subject to interpretation.[14]

Nonetheless, FSOC's regime of regulation by threat is, as a matter of law, strange. We do not ordinarily associate the broad discretion to administer pain, sometimes on recipients surprised to be subjected to the treatment, with good government. As a first approximation, that power to surprise and penalize sounds like arbitrariness. Moreover, scholars have grumbled that permitting regulators to use threats of enforcement reduces their incentives to regulate through notice and comment rulemaking, which in turn permits them to evade judicial review.[15] This risk has led even

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[11] *See infra* notes 172~~170~~-173~~171~~ and accompanying text.

[12] In particular, the insurance industry has divested itself of much of its banking assets. As one lawyer has explained,

> "It's to get out from under federal regulation," Michael Byrne, a partner in Dewey & LeBoeuf LLP's insurance regulatory department, said of insurer sales of banking assets. "Banks and insurance companies are different in the risks they're taking on, so they should be treated differently."

Andrew Frye, *Bank-Wannabe Insurers Switch Strategies to Avoid Oversight*, BLOOMBERG, AUG. 3, 2011, http://www.bloomberg.com/news/articles/2011-08-03/bank-wannabe-insurers-seek-to-avoid-oversight (noting that "Hartford Financial Services Group Inc. struck a deal in May to sell the lender that it had acquired in 2009 to qualify for a bailout. American International Group Inc., which took a $182.3 billion rescue, sold its American General Finance lender last year at a loss.").

[13] *See infra* notes 194~~191~~-207~~204~~ and accompanying text.

[14] The dynamics of standards-based regulation has produced a voluminous literature across the firmament of legal disciplines. For some well-known administrative law examples, see Thomas W. Merrill, *The Mead Doctrine: Rules and Standards, Meta-Rules and Meta-Standards*, 54 ADMIN. L. REV. 807, 818-26 (2002) (looking and rules and standards based approaches to judicial review of agency action); James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 130-43 (2012) (evaluating rules-based and standards-based approaches to securities regulation); *see also* Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165, 209 (2015) (outlining the rules and standards debate, and highlighting some of the leading scholarly participants in it).

[15] *See, e.g.*, Jerry Brito, *"Agency Threats" and the Rule of Law: An Offer You Can't Refuse*, 37 HARV. J.L. & PUB. POL'Y 553 (2014); *see also* PHILIP HAMBURGER, IS ADMINISTRATIVE LAW UNLAWFUL? (2014) (worrying about the breadth of agency

scholars willing to live with threat-based regulation, such as Tim Wu, to conclude that it is "only legitimate in certain circumstances."[16]

We disagree and defend the sort of judicious deployment of regulation by threat that the council has adopted. Threats, deterrence, and the strict supervision of some is appropriate when risks are hard to identify, the perils of mistake are great, and the downsides of misdiagnosis extreme. These are characteristics of a mission to prevent financial crises from roiling the economy. The use of enforcement threats also can be an efficient use of regulatory resources. The council has quite rigorously overseen a vast industry by selecting four firms in that industry for particular attention.

More generally, the council's regulatory work might be thought of as the embrace of a precautionary principle in one of the contexts where such a principle is appropriate.[17] As Cass Sunstein has explained, two tests for evaluating when regulators should take a "better safe than sorry" approach are (i) where "regulators lack information about the likelihood and magnitude of a risk," and so "buy an 'option' to protect against irreversible harm until future knowledge emerges," and (ii) "when risks have extremely bad worst-case scenarios."[18] As we will see, and as other scholars have observed, information problems and severe downside risk are key features of crisis regulation.[19]

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enforcement powers); Appalachian Power Co. v. EPA, 208 F.3d 1015, 1020 (D.C. Cir. 2000) (describing how agencies evade judicial review by refusing to issue narrowing regulations and thereby retaining discretion to act as they choose in particular cases).

[16] Tim Wu, *Agency Threats*, 60 DUKE L.J. 1841, 1842 (2011) ("Threat regimes, …are best justified when the industry is undergoing rapid change--under conditions of high uncertainty.")

[17] Cass Sunstein outlines some of the features and problems of the generic precautionary principle as a tool of administrative law in CASS R. SUNSTEIN, LAWS OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE (2005). The principle originated in continental legal systems, and appears in the Treaty of the European Communities (EC) in article 174, though, as Jan Bohanes notes, in that treaty, a "definition of the precautionary principle, however, is missing." Jan Bohanes, *Risk Regulation in WTO Law: A Procedure-Based Approach to the Precautionary Principle*, 40 COLUM. J. TRANSNAT'L L. 323 n.25 (2002).

[18] Cass R. Sunstein, *Irreversible and Catastrophic*, 91 CORNELL L. REV. 841, 846 (2006).

[19] *See, e.g.*, Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 257 (2009) ("Failure of the financial system can generate social costs in the form of widespread poverty and unemployment, which in turn can destroy lives and foster crime... preserving stability [of the financial system] would prevent the breakdown [of the financial system] that could lead to health and safety concerns."); Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 178 (2013) (arguing for the use fo the precautionary principle in finanicial regulation).

We suggest that regulation by threat is more broadly an important part of any regulator's toolkit in such circumstances, a point worth remembering as more and more scholars call for more oversight of enforcement decisions by the government.[20] Sometimes regulators can and should act through notice and comment rulemaking.[21] But sometimes they must be permitted to regulate through enforcement, and example-making; it is a form of regulation that has a venerable pedigree, in, for example, policing tax evasion and antitrust violations.[22] We contend that the example of designation by the council is a testament to the potential of this sort of enforcement regulation.

The broader implications of the regulatory approach, however, do not distract us from a second aspect of the central question this article answers – whether the council's designation process is legal. That aspect requires a consideration of the checks on the council's power that do exist, given that some of the conventional constraints of administrative law – reducing discretion through ex ante rulemaking and requiring a cost-benefit analysis – are inappropriate for the council's mission.

The council is not without good governance checks, and the question we take up is whether these constraints make up for any of its limitations with regard to conventional administrative procedure. We conclude that they do. The council's discretion is better cabined by its structure, rather than by insistence on particularly "hard look" judicial review, accompanied by the requirement of a cost benefit analysis for any individual rulemaking or designation decision.[23] Although the council's procedures look like a rather unorthodox form of administrative law, they

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[20] Rachel Barkow, among other scholars, has worried that the enforcement discretion in in administrative law is worryingly uncabined. Rachel E. Barkow, Foreword, *Overseeing Agency Enforcement*, 84 GEO. WASH. L. REV. 1129, 1128 (2016) ("Throughout the federal system, agencies often use enforcement and adjudication (as opposed to rulemaking) to set norms, and there is reason to worry that agencies may misuse their discretion"). Others have argued that aspects of agencies like the Securities and Exchange Commission in civil enforcement actions also ought to be subject to more procedural constraints. *See* David Zaring, *Enforcement Discretion at the SEC*, 94 TEX. L. REV. 1155, 1158 (2016) (listing the critics, and observing that "agencies have always enjoyed unfettered discretion to choose their enforcement targets").

[21] So the D.C. Circuit, the country's foremost administrative court, has canonically suggested. *See* Nat'l Petroleum Refiners Ass'n v. FTC, 482 F.2d 672, 681 (D.C. Cir. 1973). ("courts are recognizing that use of rule-making to make innovations in agency policy may actually be fairer to regulated parties than total reliance on case-by-case adjudication").

[22] *See infra* notes 222~~219~~-223~~220~~ and accompanying text.

[23] *But see* Metlife, Inc. v. Fin. Stability Oversight Council, No. CV 15-0045 (RMC), 2016 WL 1391569, at *17 (D.D.C. Mar. 30, 2016) (reversing the council's designation of MetLife on "hard look" review, and requiring the council to conduct a cost benefit analysis). Obviously, we disagree with the court's analysis.

feature voting, review, and political safeguards, all of which support the case for the legitimacy of the way the council does designations.

First, and perhaps most importantly, FSOC is a council, not an agency, and designation requires a series of affirmative votes by super-majorities of the council's membership. This membership incorporates a number of diverse viewpoints and, unlike other committees of agencies, uniquely includes voices of state regulators in its mix. As a council with no independent regulatory turf of its own, it is immune from the regulatory temptation to grow its own programs.[24]

Second, although FSOC's substantive standard for designating non-banks as systemically important is indeed flexible, it was itself adopted through a process of notice and comment rulemaking and, partially as a result, includes a number of guideposts and safe-harbors that limit FSOC's discretion. For instance, FSOC's final rule on designation both identifies the factors on which the council will focus in making designation determinations and presumptively excludes from designation firms with less than $50 billion in total consolidated assets. These standards limit or eliminate the threat of designation for the vast majority of non-banks.

Third, the parallel processes of SIFI designation by international organizations like the Financial Stability Board provide an under-appreciated check on FSOC's exercise of its power.[25] Increasingly, financial regulators have made themselves, with Congressional approval and the president's support, part of an international web of regulation, meant to respond to the fact that capital easily crosses borders, and that these days financial institutions do as well.[26] The FSOC is not the only institution in this global environment that designates financial institution as systemically risky; this also limits its discretion.

Our analysis not only offers the benefit of making sense of the unorthodox regulatory remit of a powerful, new federal entity. It also answers many of the specific challenges to designation leveled by the FSOC's critics and helps resolve policy questions that have arisen as FSOC has done its business. For instance, it suggests that FSOC should retain its relatively unfettered hand to designate non-bank financial institutions if it is to fulfill its purpose. This requires rejecting calls from critics to require FSOC to engage in more detailed cost-benefit analysis, a requirement that

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[24] See, e.g., Jonathan Macey & Geoffrey Miller, *Reflections on Professional Responsibility in a Regulatory State*, 63 GEO. WASH. L. REV. 1105, 1119 (1993) (describing the turf-building problem).

[25] *See* David Zaring, *Finding Legal Principle in Global Financial Regulation*, 52 VA. J. INT'L L. 685, 700-01 (2012) (describing how the FSB makes decisions).

[26] *See* Jean Galbraith & David Zaring, *Soft Law As Foreign Relations Law*, 99 CORNELL L. REV. 735, 746 (2014) (describing this evolution).

risks imposing an impossible burden on the Council and thus neutering its capacity to deter the aggregation of systemic risk. We are not unwavering supporters of everything done under the Council's aegis, and could see it usefully being reformed in ways that would remove a degree of potential politicization among its decisionmakers, and expand the diversity of viewpoints available to it. But these improvements would affect the structure of the Council; its processes, we think, are entitled to respect.

In what follows, we in Part I outline the persistent, but difficult to detect and ever-changing, tendency of non-bank financial firms to take on systemic risk. In Part II, we describe FSOC's designation process and the inherent difficulties associated with any judgments about which firms could and could not prove systemically significant in the midst of a future crisis. In Part III, we explain how FSOC's designation process operates as a dual threat against individual non-bank firms that might seek out systemic risk and their primary regulators who might allow this to occur on their watch. Finally, Part IV defends the legality of the FSOC regulatory scheme.

I. UNDERSTANDING THE PROBLEM: NON-BANK SYSTEMIC RISK IN THE POST-2008 LANDSCAPE

Financial regulation classically divided financial institutions into three categories: banks, insurers, and securities firms. Within this tri-partite framework, only banking regulation was seriously concerned about systemic risk, or the possibility that banks could jeopardize financial stability or broader metrics of macro-economic health.[27] By contrast, both securities and insurance regulation focused on goals such as investor/policyholder protection and promoting robust capital/insurance markets.[28] Although fissures in this conventional framework emerged in the 1990s and early 2000s, the financial crisis shattered the notion that non-bank firms do not pose systemic risks. Section A explains how this came to be, describing the wide range of non-bank financial firms that played central roles in the crisis, including investment banks, mutual funds, and insurance-oriented financial conglomerates. The purpose of recapitulating these problems is to provide a factual basis for understanding why Congress gave the council a mandate to take on systemic risk in the non-bank sector, and to

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[27] The problems of systemic risk were noted by Walter Bagehot in *Lombard Street: A Description of the Money Market,* a book of advice offered to the Bank of England in the Victorian era. WALTER BAGEHOT, LOMBARD STREET (1873).

[28] The Securities and Exchange Commission, for example, identifies "investor protection" as an important part of its mission. SEC, *What We Do,* https://www.sec.gov/about/whatwedo.shtml ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.")

suggest that the crisis revealed how difficult it is to predict where risk in that sector will originate. It certainly revealed that nonbanks could be serious sources of systemic risk.

Section B then shows how the migration of systemic risk to non-bank institutions was largely a product of individual firms actively seeking to exploit the pre-crisis, fragmented regulatory scheme. Even more importantly, Section B explains how policymakers' management of the financial crisis increased non-bank firms' incentives to engage in regulatory arbitrage that can produce systemic risk, at least in the absence of regulatory reforms such as those contained in Dodd-Frank (discussion of which is postponed until Part II). By confirming that government actors will rescue non-bank firms whose failures could have significant spillover effects on the broader financial system, the 2008 bailouts increase the incentives facing non-bank firms to seek out systemic risk in order to decrease their cost of capital.

A. Systemic Risk, Non-Bank Financial Firms, and the Financial Crisis

Prior to 2008, financial regulation was largely premised on the assumption that banks are fundamentally different from other types of financial institutions.[29] According to this narrative, banks play a central role in the economy but are also uniquely susceptible to the risk of failure because depositors can withdraw funds on demand, creating the prospect of self-reinforcing bank runs.[30] By contrast, non-bank financial institutions – such as insurance companies, investment banks, and pooled investment companies like hedge funds and mutual funds – were conventionally thought to pose only limited risks to the broader financial system or macro-economy.[31] Perhaps most fundamentally, this was because none of these institutions funded themselves with demand deposits.[32] Nor did these non-

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[29] *See, e.g.*, E. Gerald Corrigan, *Are Banks Special?*, FED. RESERVE BANK OF MINNEAPOLIS ANN. REP. (Jan. 1982), http://www.minneapolisfed.org/pubs/ar/ar1982a.cfm; E. Gerald Corrigan, *Are Banks Special? A Revisitation*, FED. RESERVE BANK OF MINNEAPOLIS ANN. REP. (Mar. 1, 2000), http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3527; Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 306-07 (1987). For a recent historical account of how banks came to be separated from other types of financial institutions in Glass-Steagal, see Arthur E. Wilmarth Jr., *Prelude to Glass-Steagall: Abusive Securities Practices by National City Bank and Chase National Bank During the 'Roaring Twenties'*, 90 TUL. L. REV. 1285 (2016).

[30] *See generally* RICHARD CARNELL, GEOFFREY MILLER & JONATHON MACEY, THE LAW OF FINANCIAL INSTITUTIONS 49-60 (2013, 5th Ed.).

[31] *See* Christina Parajon Skinner, *Regulating Nonbanks*, 105 GEORGETOWN L.J. (forthcoming 2017), *available at* http://ssrn.com/abstract=2740424;

[32] *See* 12 U.S.C. § 24 (Seventh).

bank financial institutions focus on lending funds directly to individuals and businesses.

This conventional distinction between banks and non-bank financial institutions undergirded the pre-2008 regime of financial regulation. Banks, of course, were heavily regulated because of their fundamental role in the financial system and broader macro-economy. But the regulation of non-bank financial entities was predominantly focused on concerns other than financial stability, such as protecting consumers or investors or promoting capital formation or robust insurance markets.[33]

Although strains in this narrative started emerging in at least the 1990s,[34] it was not until after the financial crisis – the most significant financial crisis in nearly a century – that it became obvious that non-bank financial firms could indeed pose large systemic risks. Many of the most important institutions to fail or be bailed out in the financial crisis – including Bear Stearns, Lehman Brothers, AIG, the Reserve Primary Fund, and Fannie Mae – were not commercial banks at all.[35] Instead, they were non-bank financial institutions such as investment banks, insurance companies, mutual funds, and government-sponsored entities operating in mortgage markets.[36]

The non-bank financial firms that were most directly implicated in the financial crisis were the five “bulge bracket” investment banks, none of which currently exists in its pre-crisis form.[37] These firms contributed to the crisis in at least two ways: by producing the mortgage-backed securities that propagated throughout the broader financial system, and by failing or nearly

[33] *See* Daniel Schwarcz & Steven Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L REV. 1569, 1579-84 (2014) (describing how insurance regulation was not traditionally concerned with systemic risk); DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK 140-141 (2016) (noting that SEC has traditionally not focused on regulating for the purpose of limiting systemic risk).

[34] *See generally* Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, 13 J. OF ECON. PERSPECTIVES 189, 189 (1999),

[35] To be sure, a number of commercial banks, such as Wachovia, Washington Mutual, and IndyMac, did fail during the crisis, and the impact of the crisis on commercial banks was a first-order concern in the midst of the crisis. *See* Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 2042–49 (2014).

[36] *See* Skinner, *supra* note 31~~30~~, at Y (noting that shadow banking played a key role in the crisis and that many of the investment banks that were part of this system were not regulated like traditional banks).

[37] Two of these firms (Bear Stearns and Merrill Lynch) were purchased by commercial banks, one (Lehman Brothers) failed, and two (Goldman Sachs and Morgan Stanley) converted to bank holding companies. *See See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 491-95 (2009)

failing during the midst of the crisis.[38] Several common factors caused the failure or near-failures of these large investment banks.[39] First, most of these institutions relied substantially on short-term borrowing markets, particularly repo markets, to finance their operations.[40] In much the same way that depositors can run on a traditional bank by pulling their funds, lenders in these markets effectively "ran" on the large investment banks by collectively refusing to roll-over their short-term debt.[41] Second, all of these investment banks operated with extraordinarily high amounts of leverage.[42] As a result, they faced enhanced incentives to seek out risk and a decreased capacity to absorb losses.[43] Third, each of these institutions was substantially invested in securitized bonds that were ultimately linked to the health of the U.S. real estate market.[44]

More surprising than the troubles these five mega-investment banks faced during the crisis were the evident systemic implications of these firms' potential failures. This proposition was put to the test but once, when federal actors allowed Lehman Brothers to fail rather than bailing out the firm. This precipitated unanticipated panic throughout the financial system, and is often viewed as the most dramatic accelerant of panic during the entire crisis period.[45] In large part, these investment banks' systemic significance stemmed from their interconnections with the broader financial system. For instance, investment banks' primary counterparties included many of the largest commercial banks, meaning that their failure could have

[38] On the former point, which focuses on how these firms' activities generated systemic risk, see THE LEVIN-CORBURN REPORT 11 (2011) ("Investment banks were the driving force behind the structured finance products that provided a steady stream of funding for lenders originating high-risk, poor quality loans and that magnified risk throughout the financial system." For this reason, these investment banks "were a major cause of the financial crisis.").

[39] *See* Onnig H. Dombalagian, *Requiem For the Bulge Bracket? Revisiting Investment Bank Regulation*, 85 IND. L.J. 777 (2010).

[40] *See generally* Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 425 (2012).

[41] *See* Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843, 854-55 (2016).

[42] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xix (2011) ("For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1…"

[43] *See generally* ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES (2013).

[44] *See* Gorton & Metrick, *Securitized Banking*, *supra* note 40~~39~~, at Y.

[45] *See* BEN BERNANKE, THE COURAGE TO ACT (2015); FIN. CRISIS INQUIRY COMM'N, *supra* note 42~~41~~, at xix.

jeopardized the conventional banking system.[46] At the same time, the systemic significance of the five largest investment banks was also no doubt related to the inchoate perceptions and fears of individual actors within the financial markets, a consideration that obviously cannot be easily explained or quantified.

Many other central players in the crisis were neither commercial banks nor investment banks, but entirely different types of financial entities. AIG, for instance, was a financial services holding company that primarily engaged in the business of insurance.[47] The company's near-failure and subsequent bailout in 2008 was primarily attributable to two activities at the firm. The first involved the sale of Credit Default Swaps (CDS)—which essentially "insured" the risk faced by other major financial institutions that their mortgage-related securities would default—by the company's Financial Products division.[48] These CDS obligated AIG to post ever more collateral as payment default on the underlying securities became more likely and AIG's own financial health became more precarious. The second cause of AIG's near failure was the company's ill-fated securities lending program, whereby it lent out the assets of its insurers to a variety of large financial institutions in exchange for cash collateral, which it then invested in real-estate backed securities[49] These securities lending contracts were very short-term, thus allowing spooked counterparties to refuse to roll over the loans and demand a return of their cash collateral. Fatally to AIG, the risks associated with its securities lending and CDS programs were highly correlated, resulting in the company facing crises in these two settings at exactly the same time.[50] But once again, the most surprising element of AIG's sudden failure was that it threatened to promote contagion across the financial system, principally by exposing the company's CDS and securities lending counterparties to unknown and unanticipated losses.[51]

Another non-bank that played a central role in the unfolding of the financial crisis was the Reserve Primary Fund. As with all money market

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[46] *See* James Bullard, Christopher J. Neely, & David C. Wheelock, *Systemic Risk and the Financial Crisis: A Primer*, 91 FED. RES. BANK ST LOUIS REV. 403, 407 (2009).

[47] *See generally* William K. Sjostrom Jr, *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009).

[48] *See id.*

[49] See Hester Peirce, *Securities Lending and the Untold Story in the Collapse of AIG* (Mercatus Ctr., George Mason Univ., Working Paper No. 14-12, 2014), available at http://mercatus.org/sites/default/files/Peirce_SecuritiesLendingAIG_v2.pdf. Borrowers of these assets -- which consisted of a variety of different securities – could use them for a variety of financial transactions, including to facilitate short selling.

[50] *See* Daniel Schwarcz, *A Critical Take on State-Based Group Regulation of Insurers*, 5 U. Cal. Irvine L. Rev. 537 (2015).

[51] *See* Robert McDonald & Anna Paulson, *AIG in Hindsight*, 29 J. ECON. PERSP. 81 (2015).

mutual funds, the Reserve Primary Fund sought to maintain a stable net asset value of $1 by investing in short-term low-risk debt and using amortized cost accounting.[52] But as a result of Lehman Brothers' failure, the Reserve Primary Fund – which had invested about 1% of its holdings in Lehman's commercial paper – "broke the buck."[53] Investors that had previously perceived these funds to be absolutely safe panicked, swiftly seeking to redeem their shares. Reserve Primary's assets plunged more than 60 percent in two days.[54] Over the course of that week, panic spread to other money market mutual funds, with investors withdrawing over $170 billion.[55] This had real consequences for the broader economy; money market funds hoarded cash and stopped investing in large U.S. corporations' commercial paper, thus undermining these firms' ability to finance their working capital at a time when credit on that scale was largely unavailable.[56] The run on money market funds and cessation of their investments in short-term debt ended only after the Treasury and Federal Reserve announced the Temporary Guarantee Program for Money Market Funds.[57]

Yet another set of non-banks that played a vital role in the financial crisis were the Government-Sponsored Entities (GSEs) Fannie May and Freddy Mac.[58] In the run up to the crisis, these GSEs began purchasing increasingly risky loans and becoming ever more leveraged, following a similar trajectory to investment banks like Lehman Brothers and Bear Stearns.[59] And like these entities, the GSE's suffered ever-increasing losses on their portfolio of mortgage-backed securities throughout late 2007 and 2008, until they experienced their own liquidity shortfall because of their inability to borrow in the wholesale funding markets. By September 2008, policymakers were forced to place the GSEs in receivership and inject

[52] *See generally* William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WISC. L. REV. 1155.

[53] *Id.*

[54] *See* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 505 (2009) ("Reserve Primary's assets plunged more than 60% to $23 billion in two days"). Evergreen Investments, a money market fund owned by Wachovia, for example, had to be bailed out by its parent to avoid breaking the buck. *See* Daisy Maxey, *Wachovia to Bolster Evergreen Funds, More Support to Come*, DOW JONES NEWSWIRES, Sep. 15, 2008, *available at* http://www.smartmoney.com/news/ON/?story=ON-20080915-000776-1850.

[55] *See* Diana B. Henriques, *Treasury to Guarantee Money Market Funds*, N. Y TIMES, Sep. 19, 2008.

[56] *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 42~~41~~, at Y.

[57] *See* Money Market Fund Reform Final Rule, 75 Fed. Reg. 10,060, 10,060 (Mar. 4, 2010) (codified at 17 C.F.R. pts. 270, 274).

[58] *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 42~~41~~, at Y.

[59] *Id.* at 310.

hundreds of billions of dollars into them.[60] Failing to do so, most agree, would have substantially exacerbated the crisis: without the GSEs continuing to promote lending in the housing market, that market would have further deteriorated, producing losses both for ordinary homeowners and the rest of the financial sector that had invested so heavily in real estate linked securities.

The list of non-bank financial institutions that were centrally involved in the financial crisis could continue for some time. It would undoubtedly include some non-bank mortgage originators, such as Countrywide Financial, which were responsible for originating the loans that ultimately formed the basis of the toxic real estate assets that spread throughout the financial system.[61] It might well also include entities like the monoline financial guarantee insurers, whose troubles quite directly led to the seizing up of the $330 billion market for auction-rate securities that were relied on by municipalities, museums, schools, and similar entities.[62] And it would also likely include certain finance companies like GE Capital, which relied heavily on short-term funding that evaporated in the crisis and provided an important source of credit for ordinary consumers and household goods.[63] But the point should now be clear: not only can non-bank financial institutions pose systemic risks to the broader financial system, but they in fact played a central role in causing the most devastating financial crisis in this country since the Great Depression.

B. Market Evolution, Regulatory Arbitrage and the Migration of Systemic Risk

1. Market Change and Regulatory Arbitrage in the Run Up to the Crisis

The traditional notion that systemic risk is confined to the commercial banking sector worked well enough for about seventy years. Yet the prominent role of non-banks in the financial crisis was no fluke.

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[60] Steven Davidoff Solomon & David Zaring, *After The Deal: Fannie, Freddie and the Financial Crisis Aftermath*, 95 B.U. L. REV. 371 (2015) (discussing the fall of the two firms); Adam Badawi & Anthony Casey, *The Fannie and Freddie Bailouts Through the Corporate Lens* 26 (Coase-Sandor Institute for Law & Economics, Working Paper No. 684, 2014).

[61] *See generally* PAT MCCOY & KATHLEEN ENGEL, THE SUBPRIME VIRUS (2011) (discussing the role of non-bank mortgage originators like Countrywide in causing the 2008 crisis).

[62] *See* Schwarcz & Schwarcz, *supra*, note 33~~32~~, at 1586-87.

[63] *See* FIN. STABILITY OVERSIGHT COUNCIL, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING GENERAL ELECTRIC CAPITAL CORPORATION, INC. 2 (July 8, 2013).

Instead, it was the result of constant change in the underlying financial system, with non-bank firms engaging in new activities, offering new products, and adopting new strategies. In many cases, these innovations were specifically designed to exploit unappreciated, or under-appreciated, gaps in the tripartite regulatory regime that was premised on the lack of systemic risk outside of banking institutions.[64]

Regulatory arbitrage's role in causing systemic risk to migrate to non-bank institutions is easiest to appreciate with respect to money market mutual funds.[65] These funds originated out of a combination of high inflation in the 1970s and regulatory rules capping the interest rate that banks could pay on deposits. Money market mutual funds endeavored to provide an alternative to classical deposit accounts that were subject to Regulation Q, which limited the interest rates banks could pay their depositors. By purporting to work like bank accounts without being subject to bank regulation, money market funds could provide higher interest rates than banks could. To do so, they lobbied the SEC to adopt rules that allowed them to maintain a net asset value of $1, and to allow shareholders to write checks on the funds. In exchange, they agreed to invest in short-term, high quality, liquid securities such as commercial paper.[66] With these features in place, these funds largely replicated the economic characteristics of bank accounts, while avoiding the key regulatory restraints of banking. As described above, the result of these innovations was that investors could and did run en masse from these funds until the government created an ex post federal guarantee program analogous to FDIC insurance.[67]

The risks posed by the largest investment banks were also a result of dramatic changes in these firms' business models and the markets in which they operated. Investment banks were traditionally relatively conservative institutions, in part because they were organized as partnerships.[68] But as investment banks shed this status and became publicly-owned companies, they increasingly sought out greater sources of risk that could enhance their bottom line in the short term.[69] The evolution of securitization and repo markets starting in the mid 1980s and culminating in the financial crisis helped investment banks accomplish this objective by allowing them to

[64] *See generally* Dan Awrey, *Complexity, Innovation, and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235 (2012).

[65] *See generally* Birdthistle, *supra* note 52~~51~~, at Y.

[66] *See* Money Market Fund Reform Final Rule, 75 Fed. Reg. 10,060, 10,060 (Mar. 4, 2010) (codified at 17 C.F.R. pts. 270, 274).

[67] *See* Part I.A, *supra*.

[68] *See* CLAIRE A. HILL & RICHARD W. PAINTER, BETTER BANKERS, BETTER BANKS (2015).

[69] *See id.*

fund their operations with large amounts of relatively cheap credit.[70] The fact that this credit consisted of remarkably fragile, short-term, loans that creditors could refuse to roll-over at a moment's notice was largely overlooked by securities regulators, who assumed that these firms' own risk-management incentives were sufficient. Meanwhile, the firms themselves presumed that, in anything but the most dire circumstances, they could secure alternative financing, albeit at a higher cost – a straightforward misunderstanding of the financial environment. And to the extent that they even considered scenarios when such high-cost financing would not be available, they likely assumed either that the government would assist them or that they would be out of a job in any event; the costs of their risky behavior to them were substantial – but not as substantial as the costs to the broader economy.[71]

AIG's dramatic near-failure was also a product of the company exploiting regulatory blind spots to seek out short-term profit.[72] For instance, AIG's Credit Default Swap operations entirely avoided state insurance regulation because they were conducted from a foreign, non-insurance entity – AIG Financial Products.[73] Meanwhile, even though AIG's securities lending operations directly implicated the securities owned by its insurance companies, AIG avoided serious regulatory scrutiny of these operations by coordinating them through several non-insurance affiliates of the company.[74] This resulted in no individual insurance

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[70] *See generally* Gorton & Metrick, *Securitized Banking*, *supra* note 40~~39~~.

[71] *See* HILL & PAINTER, *supra* note 68~~67~~, at y.

[72] Although the U.S. Office of Thrift Supervision technically supervised AIG Financial Products, the office's pre-crisis regulatory oversight is generally understood to have been woefully deficient, in part because regulated firms had the option to shop for the Office as their regulator. *See, e.g.*, STAFF OF THE S. COMM. ON GOV'T SECURITY AND HOMELAND AFFAIRS, PERMANENT SUBCOMM. ON INVESTIGATIONS, 112TH CONG., WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE: MAJORITY AND MINORITY STAFF REPORT 208–39 (2011), available at http://1.usa.gov/1FxrNzt. This was particularly true with respect to non-banking products, for which the agency lacked expertise. *See* GOV'T ACCOUNTABILITY OFFICE, AGENCIES ENGAGED IN CONSOLIDATED SUPERVISION CAN STRENGTHEN PERFORMANCE MEASUREMENT AND COLLABORATION (2007) (describing the Office's relative lack of expertise in supervising financial activities like credit default swaps); *Causes of the Recent Financial and Economic Crisis*, Hearing Before the Fin. Crisis Inquiry Comm'n (Sept. 2, 2010) (statement of Chairman Ben S. Bernanke) (noting that the Office's supervision of AIG's derivatives activities in its financial-products unit was extremely limited in practice).

[73] *See* Schwarcz & Schwarcz, *supra* note 33~~32~~, at y.

[74] GOV'T ACCOUNTABILITY OFFICE, FINANCIAL CRISIS: REVIEW OF FEDERAL RESERVE SYSTEM FINANCIAL ASSISTANCE TO AMERICAN INTERNATIONAL GROUP, INC. 13 (2011) ("prior to mid-2007, state regulators had not identified losses in the securities lending program and the lead life insurance regulator had reviewed the program without major concerns.").

regulator taking primary responsibility for carefully scrutinizing that program, or appreciating that it subjected AIG to risk that was highly correlated with the firm's CDS activities.[75]

Although regulatory arbitrage was therefore a key ingredient in the increase in firms' systemic risk levels leading up to the crisis, plenty of nonbanks appear to have simply misapprehended the riskiness of what they were doing. For instance, Fannie and Freddie, with a wealth of experience in housing finance, were utterly unprepared for the collapse of the mortgage market. Similarly, Reserve Primary may have been investing in unsecured Lehman Brothers debt because it was chasing yield and loading up on risk, or it may have done so because it failed to understand how the short term debt markets worked, or both.

2. Post-Crisis Incentives of Non-Banks to seek out Systemic Risk

The financial crisis thus demonstrated not only that non-banks can be systemically risky, but that the precise ways in which this can occur are constantly shifting as a result of regulatory arbitrage and broader market trends. At the same time, policymakers' willingness to bailout non-banks in the midst of the crisis increased the incentives of non-bank financial firms to become systemically risky so as to benefit from this implicit government backstop. Throughout the financial crisis, government actors repeatedly bailed out non-bank financial firms and industries when they perceived that doing otherwise would cause the crisis to spread further.[76] Although these bailouts remain immensely unpopular among the general population, a majority of policymakers and experts agree that they ultimately helped prevent a much worse financial crisis that would have plunged the United States into a much deeper and more sustained recession.[77]

These facts tend to incentivize non-bank financial firms to become systemically significant so that they can enjoy the benefits of an implicit government guarantee.[78] By becoming systemically risky – or being perceived to be systemically risky by financial markets – a firm can now, in the post-crisis era, increase the perceived chances that it will be bailed out if

[75] Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States*, 5 U. CAL. IRV. L. REV. 537 (2015).

[76] *See* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L. J. 435 (2011).

[77] TIMOTHY F. GEITHNER, STRESS TEST (2014); BERNANKE, *supra* note 45~~44~~.

[78] John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 800 (2011) (arguing that some firms specifically sought out risk prior to the crisis so that they would be considered too big to fail); John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1050 (2012).

it comes close to failure during a broader period of financial instability. This, in turn, can decrease the costs to that firm of funding its operations, as creditors accept lower rates of return in exchange for a perceived implicit government guarantee that the debtor firm will not be allowed to fail in a subset of situations. Indeed, numerous studies demonstrate this effect, documenting that large financial firms enjoy lower borrowing costs than implied by their risk because of investor expectations of government support in tail-end situations.[79]

II. DODD-FRANK, FSOC DESIGNATION, AND IDENTIFYING SYSTEMICALLY RISKY NON-BANK FINANCIAL FIRMS

Dodd-Frank adopts a number of different approaches to responding to the risk that a non-bank financial firm might become systemically risky. For instance, it establishes new rules for risk-creating activities, such as derivatives trading, which apply regardless of the types of institutions that engage in those activities.[80] It also creates a new resolution regime for any non-bank financial firm whose failure would have systemic consequences, in an effort to limit the possibility that any individual firm's failure could have systemic ramifications that could only be avoided with a bailout.[81] However, Dodd-Frank's most direct approach to addressing the risks described in Part I is to empower the council to determine which specific non-banks pose a systemic threat.[82] Firms that are so designated are subject to enhanced prudential standards and supervision by the Federal Reserve.

Section A of this Part provides an overview of this designation regime. It describes how FSOC has developed a relatively malleable standard for identifying non-bank SIFIs, which incorporates a broad range of relevant quantitative and qualitative factors. This approach actively resists calls for a precise definition of systemically significant non-bank firms or for specific "off-ramps" for designated firms. At the same time, it seeks to limit uncertainty for non-bank firms by establishing a presumptive

[79] *See, e.g.*, Viral V. Acharya, Deniz Anginer Acharya, & A. Joseph Warburton, *The End of Market Discipline? Investor Expectations of Implicit State Guarantees*, (May 1, 2016), available at http://ssrn.com/abstract=1961656; GOVERNMENT ACCOUNTABILITY OFFICE, EVIDENCE FROM THE BOND MARKET ON BANKS' "TOO-BIG-TO-FAIL" SUBSIDY (2014).

[80] See, e.g., Kristin Johnson, *Beyond Cosmetic Reform: Regulating Over-the-Counter Derivatives Clearinghouses*, 77 BROOKLYN L. REV. 681 (2012).

[81] See, e.g., David Skeel, SINGLE POINT OF ENTRY AND THE BANKRUPTCY ALTERNATIVE, IN ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS (Hoover Institution, 2014).

[82] Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1088 (2015).

safe-harbor from designation for the vast majority of non-bank firms that do not surpass specific, quantitative thresholds.

Using the FSOC regime as a jumping off point, Section B then explores the key characteristics of non-bank SIFIs, as well as the residual uncertainty that currently exists about how best to identify these firms. In doing so, Section B emphasizes an inherent difficulty of FSOC designation: the distinction between non-bank firms that are systemically significant and those that are not is inherently murky. To be sure, broad consensus exists on many of the relevant factors for assessing whether an individual non-bank firm is systemically significant, most of which are incorporated into the FSOC designation regime. At the same time, Section B illustrates that it is literally impossible to predict with any modicum of certainty how any single firm's financial distress or range of activities might reverberate throughout the broader financial system in some hypothetical, future, financially-stressed world.

A. Overview of FSOC Designation Power

1. Dodd-Frank's Designation Mechanism

Dodd-Frank grants FSOC a broad range of authorities to collect and analyze information relating to systemic risk and to recommend regulatory or legislative reforms to Congress, federal and state agencies, and the public more generally.[83] But FSOC's primary substantive power is its authority to designate non-bank financial companies as "systemically important" (a term widely used in practice that does not, amusingly enough, appear in the statute itself).[84] Designation requires an affirmative vote of at least seven of FSOC's ten voting members, including its Chairperson, the Secretary of the Treasury.[85] When the Council exercises this power, it must explain the basis for its determination to the firm and public.[86]

Firms that are designated as systemically important by the Council are subject to enhanced prudential standards and supervision by the Fed.[87] Dodd Frank specifies that these prudential standards must be "more stringent" than those applicable to firms that do not present similar risks to financial stability.[88] It also mandates that they include requirements relating

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[83] *See* Dodd-Frank Act, §§ 112-120.

[84] *Id.* § 113. *See* Stavros Gadinis, *From Independence to Politics in Financial Regulation*, 101 CALIF. L. REV. 327, 369 (2013)

[85] Dodd-Frank Act § 113.

[86] *Id.*

[87] *Id.* § 165.

[88] *Id.* § 115.

to risk-based capital, liquidity, risk-management, resolution-planning, single-counterparty credit limits, and stress-tests.[89] However, Dodd-Frank grants the Fed broad discretion to craft these rules based on the specific risk profiles of designated firms, a fact that Congress clarified in post-Dodd-Frank legislation.[90] The Fed has recently started implementing this authority for systemically risky non-bank firms predominantly engaged in the business of insurance, issuing an Advanced Notice of Proposed Rulemaking that would establish distinct capital and liquidity standards for these companies.[91]

Congress constrained FSOC's authority to designate firms as systemically significant in several ways. First, it required FSOC to designate firms under one of two standards: FSOC must find that the firm "could pose a threat to the financial stability of the United States" either (i) in the event of its "material financial distress," or (ii) due to "the nature, scope, size, scale, concentration, interconnectedness, or mix of [its] activities."[92] Second, it enumerated ten different factors that FSOC shall consider in deciding whether a firm meets one of these two designation standards.[93] Third, it limited designation to firms "predominantly engaged

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[89] *Id.* § 165. The Fed is also authorized to adopt a broad range of additional prudential standards, such as contingent-capital and enhanced disclosure requirements. *Id.*

[90] *See* Insurance Capital Standards Clarification Act of 2014, Pub. L. No. 113-279 (2014).

[91] *See* Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631 (2016) (providing an advanced notice of proposed rulemaking regarding the design of the consolidated capital standards that will be applied to insurance-focused firms that are designated as systemically significant).

[92] Dodd-Frank Act § 113. FSOC has specified that these constitute two different designation standards. In each of its four designations, it has chosen to focus on the first designation standard, which analyzes on the potential impact of "material financial distress" at the company. In his dissent to the MetLife decision, Roy Woodall, the independent member with insurance expertise on FSOC, criticized the Council for relying on the first, rather than the second, designation standard. *See* FIN. STABILITY OVERSIGHT COUNCIL, VIEWS OF THE COUNCIL'S INDEPENDENT MEMBER HAVING INSURANCE EXPERTISE (Dec. 18, 2014).

[93] Dodd-Frank Act § 113. These are "(A) the extent of the leverage of the company; (B) the extent and nature of the off-balance-sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the degree to which the

in financial activities,"[94] thus exempting the Apples and Walmarts of the economy from fears of Fed supervision. Additionally, it provided that designated firms are to be subject to annual reviews to determine whether the designation is still appropriate.[95]

2. FSOC's Final Rule and Guidance

Congress required FSOC to consider a broad range of factors in deciding which non-bank firms "could pose a threat to the financial stability of the United States." FSOC's final implementing rule, adopted under standard notice and comment procedures, simplified this structure in some ways and elaborated on it others. Perhaps even more importantly, it established a three-stage process for the Council to exercise this authority.

With respect to the substantive standard for designation, FSOC's final rule and guidance reorganized Dodd-Frank's ten statutory factors into six broad categories: (1) size; (2) substitutability; (3) interconnectedness; (4) leverage; (5) liquidity risk and maturity mismatch; and (6) existing regulatory scrutiny.[96] The first three of these categories "seek to assess the potential impact of the nonbank financial company's financial distress on the broader economy."[97] The second three "seek to assess the vulnerability of a company to financial distress."[98] In recent litigation involving its designation of MetLife, FSOC has explained that vulnerability is relevant because it "shed[s] light on the effects that distress could have on the company, and on how the company may respond in the event of material financial distress."[99] According to FSOC, its use of the word "vulnerability"

company is already regulated by 1 or more primary financial regulatory agencies; (I) the amount and nature of the financial assets of the company; [and] (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding." *Id.*

[94] Dodd-Frank Act §§ 102(a), 113. Such firms must engage in insurance, lending, investment banking, asset management, and other capital market activities. Moreover, these firms had to derive 85 percent or more of their consolidated annual gross revenues from financial activities, or have 85 percent or more of their assets related to activities that are "financial in nature" to be subject to designation. *Id.* § 102(a).

[95] Id. § 113(d).

[96] Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (final rule April 11, 2012). FSOC's implementing rule further defined a threat to the financial stability of the United States to exist if "there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." *Id.* at 21657.

[97] *Id.* at 21658.

[98] *Id.*

[99] Brief for Appellant, MetLife v. Financial Stability Oversight Council 29, Case No. 16-5086 (D.C. Cir., June 16, 2016).

to describe the final three categories does not require it to conduct an independent assessment of designated firms' likelihood of failure.[100] In addition to these six categories, FSOC's guidance suggests a seventh relevant factor not directly contained in Dodd-Frank: the complexity and resolvability of the financial institution.[101] Above all, the council indicated it would look to see if the firm would, if it ran into trouble, "inflict significant damage on the broader economy" by disrupting the financial system.[102]

FSOC's final rule also described the ways that a firms' activities or material financial distress could spread throughout the financial system, which it describes as three "transmission channels."[103] Under the exposure channel, a firm's creditors, counterparties, investors, or other market participants could directly suffer losses due to the firm's losses.[104] Second, under the asset liquidation channel, a non bank financial company that quickly liquidated its assets could thereby "disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings."[105] Finally, a firm's activities or financial distress could reverberate throughout the larger financial system if that firm supplied a critical function or service to financial markets.[106]

In addition to clarifying the substantive standard for designation, the Council also established a three-stage procedure by which it planned to implement this standard.[107] Stage 1 of that process operates as a quantitative screening mechanism to identify, based on publicly available data, an initial set of non-banks that might be systemically important. For purposes of Stage 1, FSOC defined the following six "uniform quantitative thresholds:"

> "(i) $50 billion in total consolidated assets; (ii) $30 billion in gross notional credit default swaps outstanding for which a nonbank financial company is the reference entity; (iii) $3.5 billion of derivative liabilities; (iv) $20 billion in total debt outstanding;(v) 15 to 1 leverage ratio of total consolidated assets (excluding separate accounts) to total equity; and, (v) 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months to total consolidated assets (excluding separate accounts)."[108]

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[100] *Id.*
[101] 77 Fed. Reg. at 21646.
[102] *Id.* at 21657.
[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] *Id.* at 21641-21647.
[108] *Id.* at 21643.

Generally, FSOC will only evaluate non-banks in stage two if they meet both the first threshold (consolidated assets) and one of the additional five thresholds.[109] FSOC justified its selection and specification of these stage one quantitative thresholds in terms of their predictive capacity and their practicality. In particular, FSOC noted that these thresholds apply meaningfully to non-banks operating in a range of different industries, would have captured many of the non-bank financial firms that contributed significantly to systemic instability in the financial crisis, and could generally be assessed using publicly available information.[110] Nonetheless, FSOC emphasized that this quantitative screen is ultimately "an imperfect mechanism to identify all nonbank financial companies of which further review is warranted."[111] For this reason, FSOC reserved the possibility that it might elevate a non-bank firm for stage two review even if it does not satisfy this quantitative test.[112]

Those firms that pass through the Stage 1 quantitative screen are then subject to a Stage 2 evaluation, during which the council "prioritizes" its analysis of them. In doing so, the Council relies on "a wide range of quantitative and qualitative information" that it extracts from publicly available and regulatory sources.[113] Firms that pass the first two stages proceed to Stage 3, at which point they are informed that they are being considered for FSOC designation and invited to meet with council staff and submit relevant materials to the Council.[114]

3. FSOC's Designations to Date

Under these procedures, FSOC has to date designated a total of four non-bank financial companies as systemically risky non-bank firms. These include the country's three largest insurance-focused financial conglomerates – American International Group, Inc. (AIG),[115] Prudential Financial Inc.,[116] and MetLife Inc.[117] – and the financing arm of a major

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[109] *Id.*

[110] *Id.*

[111] *Id.* at 21642.

[112] *Id.* at 21643.

[113] *Id.* at 21642.

[114] *Id.* at 21645.

[115] FIN. STABILITY OVERSIGHT COUNCIL, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING AMERICAN INTERNATIONAL GROUP, INC. (July 8, 2013)

[116] FIN. STABILITY OVERSIGHT COUNCIL, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. (Sept. 19, 2013)

[117] FIN. STABILITY OVERSIGHT COUNCIL, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING METLIFE, INC. (Dec. 18, 2014)

industrial corporation, General Electric Capital Corporation, Inc. (GE).[118]

FSOC's designation of MetLife is illustrative of its designation process for all four firms, and is also the most well-documented due to MetLife's court challenge to FSOC's designation.[119] MetLife was notified in July 2013 that it was under consideration by the council, meaning that the firm had passed the first two stages of designation.[120] Over the next year, council staff met with MetLife's representatives twelve times, and held five meetings with two state insurance authorities with jurisdiction over MetLife's insurance subsidiaries.[121] Additionally, MetLife submitted over 21,000 pages of materials to the council.[122]

The council voted 9-1 to make a proposed determination about MetLife on September 4, 2014, and sent MetLife a notice and explanation of the basis for the proposed determination, including an extensive analysis of the risk that potential financial distress at MetLife could pose to financial stability.[123] Per the notice, MetLife requested a written and oral hearing, which was granted by the council.[124] MetLife submitted written materials in October 2014, and a hearing was held before the full council on November 3, after which more written materials were submitted.[125] The council considered materials submitted by MetLife both before and after the proposed determination, and on December 18, 2014, by a vote of 9-1, designated MetLife under Dodd-Frank Section 113.[126] At that time, the council provided MetLife with a detailed statement of the basis for its decision, including non-public information provided by MetLife to the council.[127]

FSOC's public basis determined that "material financial distress" at the company could produce financial instability, thus relying on the first rather than the second determination standard. In doing so, the Council focused on the potential consequences of material financial distress at MetLife "in the context of a period of overall stress in the financial services

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[hereinafter METLIFE DESIGNATION].

[118] FIN. STABILITY OVERSIGHT COUNCIL, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING GENERAL ELECTRIC CAPITAL CORPORATION, INC. (July 8, 2013)

[119] *See MetLife v. Financial Stability Oversight Council*, No. 15—0045, 2016 U.S. Dist. WL 1391569 (D.D.C. March 30, 2016).

[120] METLIFE DESIGNATION, *supra* note 117~~116~~, at 2.

[121] *Id.* at 2-3.

[122] *Id.* at 3.

[123] *Id.*

[124] *Id.*

[125] *Id.*

[126] *MetLife v. Financial Stability Oversight Council*, No. 15—0045, 2016 U.S. Dist. WL 1391569, at 6 (D.D.C. March 30, 2016).

[127] METLIFE DESIGNATION, *supra* note 117~~116~~, at 3.

industry and in a weak macroeconomic environment."[128] It explained that use of this vantage point was "consistent with the Council's mission under the Dodd-Frank Act to identify potential threats before they occur," given that "financial crises can be hard to predict and can have consequences that are both far-reaching and unanticipated."

Material financial distress, the Council determined, could be transmitted throughout the broader financial system through both the exposure and asset liquidation transmission channels.[129] In reaching this conclusion, FSOC's designation discusses each of the ten statutory factors in Dodd-Frank and the six categories contained in its final rule. For instance, the Council emphasized that MetLife was the largest insurance provider in the US by several measures and is "significantly interconnected to insurance companies and other financial firms through its products and capital markets activities."[130] These activities, including securities lending and funding agreement-backed notes, create liabilities "that increase the potential for asset liquidations by MetLife in the event of its material financial distress."[131] The Council also noted that "MetLife's complexity, intra-firm connections, and potential difficulty to resolve" could aggravate the risk that financial distress at the company could impair financial market functioning.[132] Additionally, while acknowledging that MetLife's operating insurers are subject to state insurance regulation, the council noted that this regulation is focused predominantly on protecting policyholders and does not include key elements of financial stability regulation, such as consolidated capital and liquidity requirements.[133]

B. Key Characteristics of Non-Bank SIFIs, and Residual Uncertainty in Identifying these Firms

Notwithstanding the apparent complexity of FSOC's designation regime, the distinction between non-bank financial firms that are systemically significant and those which are not is both murky and indeterminate. To be sure, broad agreement exists regarding many of the central characteristics of systemically risky non-bank financial firms. Each of the six categories specified in FSOC's final rule and guidance -- (1) size; (2) interconnectedness; (3) leverage; (4) liquidity risk and maturity

[128] *Id.* at 5.
[129] *Id.* at 16.
[130] *Id.* at 6-7.
[131] *Id.* at 9.
[132] *Id.*
[133] *Id.* at 26.

mismatch, (5) substitutability; and (6) existing regulatory scrutiny[134] -- are relevant to identifying whether a non-bank financial firm poses systemic risk. Indeed, some subset of these factors helps to explain the failure of each major non-bank financial firm failure that helped stoke the financial crisis. For instance, every one of these factors other than substitutability was arguably implicated in the demise of Lehman Brothers and Bear Stearns. These entities were large, highly-leveraged, companies that relied on short term debt and were deeply interconnected with the rest of the financial system.[135] But they were regulated primarily by the SEC, which viewed its mission predominantly in investor-protection rather than financial stability terms.[136] The sixth factor of "substitutability" was most obviously exemplified by the GSEs, which provided essential and irreplaceable support to the real estate market through their loan guarantees and purchases.[137] Of course, the GSEs were also leveraged to the hilt, relied on short-term financing, maintained massive balance sheets, and were subject to inadequate regulatory oversight.[138]

Additionally, many experts would probably agree that two of FSOC's six categories – (1) liquidity risk and maturity mismatch and (2) existing regulatory scrutiny – deserve special emphasis in the identification of non-bank SIFIs because they define the basic parameters of "shadow banking." Shadow banking is best defined as the combination of (i) short-term liabilities, (ii) backing potentially illiquid assets, (iii) where the traditional restrictions and back-stops of bank regulation are not present.[139]

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[134] *See* 77 Fed. Reg. at 21639.

[135] *See* Part I.A., *supra*.

[136] *See* Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 59-62 (2009). The same set of five factors were instrumental in explaining AIG's systemic implications: AIG was a massive financial conglomerate whose CDS portfolio and securities lending operations resulted in off-balance sheet leverage, massive interconnections with the rest of the financial system, and substantial maturity mismatch. *See* Part I.A., *supra*. Neither state insurance regulators nor the Office of Thrift Supervision adequately regulated the company on a consolidated basis by either. See Schwarcz, *A Critical Take*, *supra* note 50~~49~~, at 551-55 (describing the lack of consolidated regulation of AIG); GOV'T ACCOUNTABILITY OFFICE, GAO-07-154, AGENCIES ENGAGED IN CONSOLIDATED SUPERVISION CAN STRENGTHEN PERFORMANCE MEASUREMENT AND COLLABORATION (2007) (describing OTS's relative lack of expertise in supervising financial products like credit default swaps)

[137] *See* Steven Davidoff Solomon & David Zaring, *After the Deal: Fannie, Freddie, and the Financial Crisis Aftermath*, 95 B.U. L. Rev. 371, 378-87 (2015).

[138] *See id.*

[139] *See generally* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, Brookings Papers on Economic Activity 261 (2010); Zoltan Pozsar et al, *Shadow Banking*, 19 ECON. POL'Y REV. 1 (2013); JOHN AMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION (2016). This definition follows from the fact that it is the funding of long-

The first two factors describe what any bank does, and the third expresses the fact that the shadow bank is unregulated. Shadow banking played a particularly important role in the crisis, because it allowed spooked creditors to "run" on financial institutions like Lehman, money market mutual funds, and AIG by refusing to roll-over very short-term debt, in much the same way that spooked depositors can run on a bank by withdrawing deposits.[140] There is good reason to believe that such runs – which can generate self-reinforcing and contagious panic –constitute the sina qua non of systemic risk.[141]

The assessment of any particular firm's systemic significance, however, is inherently subject to substantial uncertainty. Fundamentally, this is because whether or not a firm is systemically significant depends on a nearly infinite array of variables that are impossible to anticipate with anything resembling precision.[142] For instance, the impact of a firm's financial distress on the broader financial system depends not only on the behavior of the firm's creditors, counterparties, and regulators, but also— and to a much larger extent— on these responses' secondary effects on other actors in the broader financial system. And that, in turn, would be influenced by these secondary actors' ever-changing perceptions of the financial system's health, not to mention the actions of lawmakers and regulators. Accurately anticipating each of these factors would require one arbitrary assumption after another.[143]

Revisiting regulators' understanding of Lehman Brothers during the financial crisis illustrates the inherent uncertainty associated with determining the impact that any single firm's failure or activities might have on the broader financial system. Although regulators had varying views regarding whether Lehman Brothers could or should be bailed out, hardly anyone predicted that allowing the firm to fail would trigger the sequence of events that followed its bankruptcy filing.[144]

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term assets (i.e. loans) with short-term liabilities (i.e. deposits) that fundamentally subjects banks or any other institution to the risk of a run. The lack of adequate regulation of, and associated guarantees against, this run risk is what causes it to migrate into the "shadows."

[140] *See* Gorton & Metrick, *Securitized Banking*, *supra* note 40~~39~~, at y.

[141] *See* MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2015).

[142] This point has been emphasized by critics of FSOC. *See, e.g.*, Hearing on The Growth of Financial Regulation and its Impact on International Competitiveness, H. Fin. Servs. Subcomm. on Oversight & Investigations, *The Financial Stability Oversight Council and the Financial Stability Board: Issues in International Regulation* 6 (Mar. 5, 2014) (statement of Peter J. Wallison) ("[I]t is impossible to know whether a particular institution's 'distress' would cause instability in the US financial system").

[143] *See* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 997-98 (2015).

[144] *See* BEN S. BERNANKE, THE COURAGE TO ACT (2015).

Yet Lehman Brothers' failure was perhaps the financial crisis's single most dramatic accelerant, directly causing a series of unexpected knock-on events, including the freezing of the commercial-paper market and runs on money-market mutual funds.[145] The nation's leading financial regulators, in other words, could not anticipate the impact of Lehman Brothers' failure on the financial system *immediately before it occurred*—in spite of their knowledge of Lehman Brothers' balance sheet at that time, as well as the state of the broader economy and financial system. In light of this reality, it is simply unrealistic to expect that FSOC or anyone else could correctly anticipate the precise impact of a firm's financial distress as a result of *hypothetical*, *future* losses incurred under *unknown* financial and economic conditions. Because financial crises are so unpredictable, the margin of error that supervisors need must be capacious.

Even putting to one side the inherent uncertainty involved in determining which non-banks could pose a risk to the broader financial system, there still remains a good deal of indeterminacy about the best way to assess which particular non-banks are most likely to be systemically significant, for at least three reasons. First, there is currently limited consensus about the complete set of firm-specific characteristics that are relevant to diagnosing systemic risk. For instance, it is hardly clear that the six categories identified by FSOC represent an exhaustive list of relevant factors or an ideal framing of these factors. Indeed, FSOC itself has suggested that an additional relevant factor involves the complexity and resolvability of a financial institution, reflecting both the emphasis in other parts of Dodd-Frank on promoting the quick and orderly resolution of failing firms and the lack of any such orderly resolution mechanism in the case of Lehman Brothers.[146] Similarly, internationally-developed frameworks for assessing the systemic risks posed by non-bank financial firms emphasize factors such as the number of different countries in which a firm operates, as well as a firm's involvement in specific activities that are "non-traditional" for firms in that sector.[147]

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[145] *See* FIN. CRISIS INQUIRY COMM'N, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 324-44 (2011).

[146] *See* Part II.A., *supra*.

[147] *See* INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, GLOBAL SYSTEMICALLY IMPORTANT INSURERS: FINAL INITIAL ASSESSMENT METHODOLOGY 12 (July 18, 2013) ("the assessment approach centers around segmenting the business portfolio of insurance companies and insurance-dominated groups and conglomerates in traditional insurance, semi- and non-traditional insurance activities as well as non-insurance financial and non-insurance industrial activities, as the systemic importance of the aforementioned business activities ranges from marginal (in traditional insurance) to potentially significant (in noninsurance financial activities, e.g. banking).").

Second, myriad questions remain about how to measure or assess those factors that are clearly centrally important to identifying systemically risky non-banks. Some relevant factors – such as existing regulatory scrutiny and substitutability – are not readily susceptible to reliable quantitative assessment.[148] Their appraisal will therefore inevitably vary on the perspectives and assumptions of the assessor. Moreover, many of the other relevant factors can be assessed quantitatively in a large variety of ways, none of which perfectly captures the linkage between the relevant characteristic and systemic risk concerns. For instance, FSOC itself identifies seven different potential measures of interconnectedness, four potential measures of leverage, and seven different measures of maturity mismatch.[149] Even the seemingly straight-forward category of size can be measured in multiple ways, ranging from total consolidated assets to total consolidated liabilities to total risk-in-force.[150] Making matters even more complicated, the most appropriate measurement of any particular factor will in most cases depend on numerous secondary considerations.

Third, even among the firm characteristics that are broadly recognized as relevant to the systemic risk inquiry – such as the six FSOC categories – and that can be reliably measured, there is no single agreed-upon approach to assessing their relative importance. [151] As above, it is likely that the relative importance of any particular firm's characteristics itself depends on the broader context.[152] For instance, while (as suggested earlier) maturity mismatch is perhaps the most important characteristic of a SIFI, the systemic implications of this characteristic almost certainly depend on size and interconnectedness as well. A run on a financial institution of any type will likely have limited systemic consequences if the institution is not big enough or inter-connected enough to transmit panic elsewhere in the system. Thus, the run on Lehman and Bear resulted in broader panic predominantly because these institutions were large and so interconnected with the broader financial system.[153]

[148] *See* 77 Fed. Reg. at 21639.

[149] *See id.*

[150] *See id.*

[151] Some international bodies have attempted to specify relative weights to systemic risk factors have placed elevated importance on other factors, particularly inter-connectedness. For instance, the IAIS's methodology for identifying systemically significant insurers specifies the relative weights of each of its risk factors. It devotes primary weight to inter-connectedness and the firm's participation in "non-traditional activities." This latter category certainly includes activities that create an asset-liability mismatch. But it might also include a number of other activities as well. *See* INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, *supra*, note 147~~146~~.

[152] *See* 77 Fed. Reg. at 21639 (noting that each firm can pose systemic risks in unique ways).

[153] *See* Part I.A., *supra*. Similarly, the run on AIG would likely not have been

Not only is maturity mismatch not a sufficient condition for diagnosing non-bank SIFIs, it is also not a necessary condition. This point is easiest to see for institutions that serve fundamental and irreplaceable roles in the context of the larger financial system. For instance, the failure of GSEs such as Fannie and Freddie would almost certainly generate immense financial instability even if they were not subject to any type of run, given the fundamental role that these institutions play in the mortgage markets.[154] Moreover, it is hardly inconceivable that an institution could prove systemically risky even if it was not subject to a clear "run" by short-term creditors. This possibility was arguably illustrated by the S&L crisis, which dragged on for years without any acute period of destabilizing runs and nonetheless required massive bailouts to avoid potentially grave damage to the larger macro-economy.[155]

For all these reasons, it is currently not possible to precisely define when non-bank firms may pose systemic risks to the broader financial system. FSOC itself comes close to acknowledging as much, explaining that it is not possible to "reduce[] to a formula" the identification of firms as systemically significant "due to the unique threat that each nonbank financial company may pose to U.S. financial stability and the qualitative nature of" many of the relevant factors.[156] But the difficulty is even greater than this acknowledgement suggests: ultimately the process of identifying non-bank SIFIs is inherently indeterminate and contestable, at least with respect to the subset of firms that fall relatively close to the border in either direction.

III. Regulation by Threat: The Logic of FSOC's Regulatory Architecture

Parts I and II raise a seemingly intractable problem of regulatory design. How can non-bank firms such as AIG be prevented from becoming systemically risky when this risk is ever changing, non-bank firms have more incentive than ever to affirmatively seek out systemic risk, and we do not know precisely how to diagnose systemically risky non-banks? This

systemically significant were it not for AIG's sheer size, as well as the fact that its major counterparties in both its CDS and Securities lending portfolios were many of the other largest financial institutions in the country. Even the run on the Prime Fund would not have produced the panic it did if investors did not reasonably believe that the Fund' portfolio of investments was likely correlated with the investments of most other money market funds. *See id.*

[154] *See* Davidoff & Zaring, *supra* note 54~~53~~, at 484-91.

[155] *See* Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC Banking Rev. (2000).

[156] 77 Fed. Reg. at 21641.

Part argues that FSOC's basic structure does an impressive job at solving this challenge by operating as a dual threat against both individual firms who would seek out systemic risk and against their primary regulators who would permit this to happen under their watch.

Section A of this Part develops the first point, showing how FSOC's designation power combined with the Council's refusal to reduce designation to a simple formula or to articulate firm-specific "off-ramps" for designation effectively prevents non-bank firms from seeking out systemic risk. The reason, we argue, is that the threat of designation – and the "enhanced supervision and prudential standards" that come along with it – deters firms from embracing strategies that could render them systemically significant. This is clearly evidenced by the actions of firms that have been designated as systemically significant to date.

To be sure, the amorphous nature of FSOC's designation regime creates uncertainty for some firms on the borderline of the systemic risk designation.[157] But this uncertainty is a necessary downside of an FSOC regime whose primary goal is not to correctly identify every systemically significant non-bank firm, but is instead to reliably prevent most non-bank firms from taking on the pre-crisis systemic risk profiles of firms like AIG, Lehman Brothers, or Bear Stearns. In this sense, the FSOC regime is an embodiment – an appropriate one in this case – of the not always appropriate precautionary principle.[158] That principle, when applied to regulation, provides that regulatory scrutiny should be particularly high in the face of substantial uncertainty about the costs of the conduct being regulated, along with the substantial prospect of an extreme downside.[159] As Hilary Allen has observed, precautionary approaches make particular sense when it comes to finanicial regulation; she argues that "financial regulatory agencies should take a precautionary approach in drafting and implementing rules that relate to financial stability, and the courts should show deference when reviewing precautionary acts by financial regulatory agencies."[160] As applied here, FSOC's use of the designation threat to instill caution in firms leaves regulators with a margin of safety, even if they cannot forecast with great reliability which

[157] As we suggest later, the actual scope of this uncertainty is not as significant as many FSOC critics suggest. *See* Part IV, B, *infra*.

[158] We, like most of the world's scientists and the World Trade Organization's Appellate Body find the European Union's invocation of the precautionary principle to ban GMOs from the United States to be unpromising. On the other hand, no one doubts that some applications of a precautionary principle are appropriate. The old rule of thumb about the criminal justice system – better that ten guilty men go free rather than one innocent man be convicted

[159] *See generally* CASS R. SUNSTEIN, LAWS OF FEAR: BEYOND THE PRECAUTIONARY PRINCIPLE (2005).

[160] Hilary J. Allen, *A New Philosophy for Financial Stability Regulation*, 45 LOY. U. CHI. L.J. 173, 178 (2013).

specific non-bank financial institutions will be implicated in the next financial crisis; as we have observed, the council's context is precisely the sort of area where observers like Cass Sunstein – no fan of the precautionary principle in most cases – finds a variant of it to be compelling.[161] While this Part focuses on the effectiveness and necessity of the FSOC designation regime as regulation by threat, we reserve to Part IV the related issue of whether this method is a legitimate way to approach a regulatory enterprise.

Section B then turns to the second element of FSOC's dual threat, describing how FSOC's designation authority allows it to operate as an effective and credible watchdog over non-bank firms' primary financial regulators. As noted above, Dodd-Frank created new rules for both certain specific non-bank financial companies, such as hedge funds, and for financial activities that are engaged in by a variety of different types of non-banks, such as derivatives trading. But these rules require extensive development and enforcement, leave unaddressed key issues, and will inevitably be gamed by firms. FSOC's designation authority threatens non-bank firms' primary regulators with the prospect of losing regulatory turf to the Fed if they fail to effectively develop, enforce, and fill in these rules, both in the near term and in the future. Here again, we suggest that this fact is clearly evidenced by various regulatory reforms that have evolved since Dodd-Frank's passage.

A. FSOC Designation and Firm-Level Deterrence

1. The Deterrent Force of Designation

As implemented and applied, the FSOC designation regime incentivizes non-banks to eschew activities and strategies that they anticipate would subject them to designation. This is a direct result of the panoply of mandatory enhanced prudential standards imposed on systemically important firms, including requirements relating to risk-based capital, liquidity, risk-management, resolution-planning, single-counterparty credit limits, and stress-tests.[162] These rules have the obvious potential to impose huge costs on designated firms, both in terms of (i) direct compliance costs and (ii) binding restrictions that would alter the firms' decisions and strategies.[163] Indeed, Dodd-Frank itself specifies that

[161] *See infra* notes 17-18 and accompanying text.

[162] *See supra*.

[163] *See* Skinner, *supra* note 31~~30~~ at y ("Financial institutions have good reason to expect that a SIFI label will bring with it negative consequences for the business" in part because "nonbank institutions likely estimate that heightened capital and liquidity

the rules for non-bank SIFIs must be "more stringent" than those that apply to non-designated firms.

However, the actual costs to designated firms of these enhanced prudential standards depend crucially on how much "more stringent" they are than the prudential rules that the non-bank would otherwise face. Firms that are already subject to the types of regulation and supervision that Dodd-Frank imposes on non-bank SIFIs might well believe that the marginal costs of designation would be minimal. By contrast, the marginal costs stemming from designation would be large indeed with respect to non-banks that are very lightly regulated in their baseline regime.

For non-banks that are not substantially engaged in the business of insurance, the costs and constraints of the enhanced prudential standards resulting from FSOC designation are almost certain to be immense. This is because these firms' ordinary regulatory regimes are focused predominantly on investor protection, with only limited prudential rules that are different in kind from those accompanying designation. For instance, while broker-dealers do face capital requirements in the form of net capital rules, these requirements are not risk-based at all and there is no regime for regulators to affirmatively monitor broker-dealers' capital levels and to shut down firms with dangerously-low capital.[164] Similarly, broker-dealers are not ordinarily subject to any liquidity requirements, stress tests, or resolution planning requirements whatsoever.[165] The same basic points apply to investment advisors and the various different types of pooled investment vehicles that they offer to their clients, such as mutual funds and hedge funds. At least until recently proposed and enacted reforms, these firms have not been subject to most of the types of prudential standards that Dodd-Frank requires for systemically important non-bank firms, such as risk-based capital requirements, stress tests, or resolution planning.[166]

Although the marginal costs of the enhanced prudential standards that follow from designation are less obvious for firms that are predominantly engaged in insurance, they are nonetheless almost certain to be quite large. Unlike many types of non-bank financial firms, insurers are indeed subject to most – though not all[167] – of the types of mandated

requirements will be costly").

[164] *See generally* CARNELL, MILLER & MACEY, FINANCIAL REGULATION.

[165] Although they are subject to margin requirements, where serve as a sort of substitute for at least the capital rules, though not the stress tests.

[166] The SEC has long imposed liquidity and leverage restrictions on registered funds, though these rules do not apply to unregistered funds like hedge funds. See FSOC update. However, FSOC has recently questioned the robustness of these restrictions for registered funds for purposes of financial stability. *See* FSOC, Update on Review of Asset Management Products and Firms 6 (2016).

[167] State insurance regulation has limited liquidity-oriented requirements, though some

prudential standards applicable to designated firms, including risk-based capital rules, stress tests, investment restrictions, and single-counterparty credit limits.[168] But even apart from the specific content of these rules– which are still under construction at the present time – there is a crucial distinction between the prudential standards imposed by state insurance regulation and those required of systemically significant firms. Dodd-Frank requires all of its prudential requirements to apply across an entire consolidated financial entity.[169] By contrast, essentially all of the prudential rules imposed by state insurance regulation focus exclusively on individual insurance companies, while ignoring their holding companies and non-insurer affiliates.[170] Thus, the prudential regime imposed on insurance-focused non-bank SIFIs would indeed come along with a fundamentally different set of restrictions than those that exist in the baseline state regime.

The evidence to date strongly supports the conclusion that most non-bank financial firms have powerful financial incentives to avoid FSOC designation. First, market reactions to MetLife's successful challenge to its designation confirm the large marginal costs imposed on designated firms. When the District Court's decision finding FSOC's designation of MetLife to be arbitrary and capricious was publicly released, MetLife's stock jumped 5 percent and the stock of Prudential, a fellow insurance-focused SIFI, advanced 1.6 percent.[171] These increases in firm value almost certainly understate the actual value to the firms of avoiding designation.[172] The district court judge had earlier indicated her skepticism of FSOC's designation, meaning that at least some of the benefit to MetLife of potentially winning its case was already baked into its stock price. And even after the district court opinion, there remains a reasonable chance that the decision may be over-turned on appeal or else that FSOC might again

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of the financial monitoring that the NAIC performs for states arguably promoted liquidity. State insurance regulation also does not have clear resolution-planning requirements analogous to a living will, although it does have an "Own Risk Solvency Assessment" that may partially serve an overlapping function.

[168] *See generally* KENNETH ABRAHAM & DANIEL SCHWARCZ, INSURANCE LAW AND REGULATION (2015 6th ed.).

[169] *See* Daniel Schwarcz, *A Critical Take on State-Based Group Regulation of Insurers*, 5 U. CAL. IRV. L. REV. 537 (2015). It does allow for the creation of intermediate financial holding company so that the prudential rules do not apply to legal entities not engaged predominantly in financial activities.

[170] *See id.*

[171] See Andrew M Harris, *MetLife Judge Called FSOC Review Process 'Fatally Flawed*,' Bloomberg, (4/7/16), available at http://www.bloomberg.com/news/articles/2016-04-07/metlife-judge-found-fault-with-fsoc-too-big-to-fail-review

[172] It reveals, at least, that designation has costs, either because it prevents systemically risky firms from taking risks that they idiosyncratically would prefer to take, or because it imposes large compliance costs.

attempt to designate MetLife.

Second, at least three of the four designated firms have seriously entertained proposals to radically alter their structure and activities so as to achieve de-designation, in an effort to avoid the costs of designation. Consider MetLife, which, prior to successfully defeating its designation in district court, announced the sale of three of its insurers that sell variable annuities and the cessation of its future variable annuity sales.[173] This "significant strategic shift" in the company's operations was driven substantially by MetLife's hope that it would assist the company in shedding its designation.[174] Consistent with these explanations, MetLife has repeatedly claimed that its SIFI designation "risks [exposing MetLife to] higher capital requirements that could put it at a significant competitive disadvantage."[175]

GE Capital has taken even greater steps to reduce its risk profile, an effort that was rewarded in June of 2016 when it became the first firm to have its designation rescinded by FSOC.[176] Between its designation and that time, GE Capital fundamentally transformed its business model. Most notably, it substantially reduced its reliance on commercial paper, thus largely eliminating its use of short-term financing. It also reduced its assets 52%, from $549 billion to $265 billion, largely exited the business of giving loans to consumers, and sold off its FDIC insured subsidiaries as well as its commercial leasing business. Additionally, the firm dramatically reduced the number of its subsidiaries, making the firm less complicated, and if necessary, easier to resolve.[177] After taking these measures, the firm submitted a written request that the council rescind its final determination.[178] In granting that request, the Council found that "GE

[173] Kerry Pechter, *MetLife to Let VA Liabilities Go*, (1/14/16), available at http://retirementincomejournal.com/issue/january-14-2016/article/metlife-to-let-va-liabilities-go

[174] Fitch, MetLife Move has Implications for Global Insurers, (1/13/16), available at https://www.fitchratings.com/site/pr/997834. See also John Heltman, *MetLife To Break Itself Up, Citing 'Regulatory Environment*, Am. Banker, Jan. 12, 2016.

[175] See MetLife to Ask Federal Court to Review SIFI Designation, (1/13/15), available at https://www.metlife.com/about/press-room/us-press releases/2015/index.html?compID=155136

[176] FINANCIAL STABILITY OVERSIGHT COUNCIL, DEPARTMENT OF THE TREASURY, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S RESCISSION OF ITS DETERMINATION REGARDING GE CAPITAL GLOBAL HOLDINGS, LLC (2016), https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE%20Capital%20Public%20Rescission%20Basis.pdf

[177] *GE Capital Files Request for Rescission of Status as a Systemically Important Financial Institution*, (3/31/16), available at http://www.genewsroom.com/press-releases/ge-capital-files-request-rescission-status-systemically-important-financial

[178] FSOC BASIS FOR RESCISSION, *supra* 176~~174~~.

Capital's smaller size, the company's limited scale of activities in key funding markets, the decreased direct and indirect exposures to the company, and GE's assumption and guarantee substantially reduce the risk that GE Capital's material financial distress could spread contagion in U.S. financial markets."[179]

AIG has also seriously considered fundamentally altering its structure in order to achieve de-designation, though it appears to have rejected this option for now. In 2015, activist investors Carl Icahn and John Paulson proposed that AIG become "a smaller, simpler company with a path to" de-designation.[180] Although these proposals were ultimately rejected by AIG management, AIG's explanation emphasized both the efficiencies of operating at a large scale as well as the "false premise" that breaking itself up would allow it to shed its designation as a SIFI.[181] By contrast, it did not contest the costs to the firm of the enhanced prudential standards and supervision to which it is subject as a result of designation.

2. Firm-Level Deterrence and the Reduction of Systemic Risk

Both theory and evidence therefore suggest that FSOC's designation regime causes non-bank firms to avoid strategies that they believe are likely to expose them to designation as a SIFI. To critics, however, this conclusion only begs the question of whether non-bank firms' changes in behavior actually reduce systemic risk, and at what cost. Critics often contend that it is exceedingly difficult for non-bank firms to discern meaningful guidance from FSOC's decisions and broad framework. As a result, non-bank firms must frequently resort to guessing about what activities or strategies FSOC might believe would make them systemically risky. Not only does this produce substantial market uncertainty for firms, but it may well deter activities and strategies that FSOC itself might not believe to be systemically risky were it to consider the issue carefully in the context of the specific firm at issue. AIG's response to shareholders' break up proposals illustrates this point well: AIG's management disputed that it could shed designation by breaking itself up, but analysis of this issue was simply guesswork. AIG was thus forced to make a major strategic decision on the basis of uncertain information about how its actions would be perceived by FSOC.

Understanding FSOC designation as regulation by threat suggests that

[179] *Id.* at 8.

[180] Cark Ichan, Open Letter to AIG Board, (1/19/16), available at http://carlicahn.com/open-letter-to-aig-board/.

[181] Stephen Gandel, *AIG CEO: Carl Icah's Breakup Plan is Based on a False Premise*, (1/27/16), *available at* http://fortune.com/2016/01/27/aig-ceo-carl-icahn/

these concerns, while eminently reasonable, are both inevitable and of second-order importance. This is because the key benefit and purpose of FSOC designation does not involve its impact on firms that are close to the murky and indeterminate line separating systemically risky firms from those which are not systemically risky. Instead, the key benefit of FSOC designation is that it reliably prevents non-bank firms from making business decisions in the future that will result in them being firmly on the systemically risky side of this dividing line. With FSOC's designation regime in place, there is little risk that any non-bank firm will take on the pre-crisis systemic risk profiles of AIG or the large investment banks like Lehman or Bear.[182] This is particularly important given the point, developed above, that – in the absence of countervailing regulatory initiatives – the 2008 bailouts gave non-bank firms both an affirmative incentive to seek out systemic risk and a road-map for how to accomplish this.[183]

The very same standard-like malleability of FSOC designation that generates the ire of FSOC's critics is essential to ensuring that FSOC designation achieves this primary goal of deterring non-bank firms from seeking to become the next AIG, Lehman Brothers, or Bear Stearns. Although FSOC's embrace of a malleable standard, rather than a formulaic rule, does indeed create uncertainty for non-bank firms close to the line of designation, it also makes the FSOC regime relatively resistant to the type of regulatory arbitrage that was so prominent among non-banks in the run up to the crisis.[184] As with all standards, FSOC's relatively flexible and adaptive designation standard empowers its members to look past any attempts by firms to re-characterize transactions, activities, or products in a way that will generate systemic risks.[185] To be sure, the Council's capacity to accomplish this depends on its level of knowledge, expertise, and understanding. But if the members of FSOC – the leading experts on financial regulation in the country, supported by the resources of each of their member agencies – cannot detect a firm's efforts to exploit regulatory loopholes or blindspots, then there is little hope that anyone else could reliably do so.

[182] One important exception here involves the GSEs. But these are a special case, because they are under conservatorship and are generally viewed as being essential to the mortgage market in their present form. Moreover, the ongoing debate about how to reform their role in the mortgage markets has seemingly exempted them from designation as SIFI's by FSOC.

[183] *See* Part I.B., *supra*.

[184] *See* Part II.A, *supra*. See, e.g., Testimony of Daniel Schwarcz before the Senate Subcommittee on Securities, Insurance, and Investments regarding "Examining Insurance Capital Rules and FSOC Process" April 30, 2015.

[185] *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L J. 557 (1992).

Moreover, the requests by regulated industry for more guidance from the council is, even if a problem, one that will be ameliorated by time. When the council makes more decisions about what constitutes systemically risky behavior, it will provide industries with examples of firms that have, in its view, gone too far.

But like any common law court, or agency that acts through adjudication rather than rulemaking, for that matter, the council has chosen to identify risk beyond the pale on a case by case basis. The fact that uncertainty exists at the beginning of the process of fleshing out a new policy program is not a reason to forbid courts and regulators from taking things one case at a time. Rather, the discretion that agencies have to choose between rulemaking and adjudication is one of the fundamental principles of administrative law.[186]

In fact, we believe that FSOC's designation decisions to date amply demonstrate FSOC's capacity to use its broad framework to target activities and strategies that exploit regulatory arbitrage in ways that may create new forms of systemic risk. Consider just one example. In its designations of Prudential, AIG, and MetLife, FSOC highlighted these firms' use of captive reinsurance transactions, also known as "shadow insurance."[187] In these transactions, an insurer purchases reinsurance from an affiliated company that is subject to more limited regulatory scrutiny because it is organized as a "captive insurer" rather than an ordinary insurer. State regulators generally allow the insurer to treat this claim from its affiliate as reliable only if it is supported by a third-party guarantee. But these guarantees are often supplied by banks, in the form of a letter of credit. These banks, moreover, frequently retain the right to look to the parent company of the insurers or one of their affiliates for repayment if the letter of credit is triggered.

As one of us has argued extensively in other work, these shadow insurance transactions represent a form of regulatory arbitrage that has the potential to result in large insurance-focused entities becoming systemically risky.[188] For instance, they expose insurers to substantial asset-liability

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[186] *See, e.g.*, NLRB v. Bell Aerospace Co., 416 U.S. 267, 294 (1974) (an agency "is not precluded from announcing new principles in an adjudicative proceeding and [] the choice between rulemaking and adjudication lies in the first instance within the Board's discretion").

[187] *See generally* Daniel Schwarcz, *The Risks of Shadow Insurance*, 50 GA. L. REV. 163, 175-76 (2015).

[188] *See id. See also* Ralph Koijen & Motohiro Yogo, *Shadow Insurance*, 84 Econometrica (2016); Ralph Koijen & Motohiro Yogo, *Risk of Life Insurers: Recent Trends and Transmission Mechanisms*, October 28, 2016). THE ECONOMICS, REGULATION, AND SYSTEMIC RISK OF INSURANCE MARKETS, (2017 Forthcoming), available at SSRN: https://ssrn.com/abstract=2662840

mismatch risk because the letters of credit that back these transactions are generally relatively short-term, even though the underlying liabilities they back are long-term. They also increase interconnectedness risk by increasing the connections between the insurance and banking sectors. Perhaps most obviously, they increase the complexity and resolvability of large insurance firms. By targeting these shadow insurance transactions in its designations of insurance-focused non-banks, FSOC illustrates how its standard for designation can be used to counteract new and emerging forms of regulatory arbitrage that have the potential to render a non-bank firm systemically risky.[189]

Perhaps even more importantly, FSOC can effectively deter non-bank firms from seeking out systemic risk through regulatory arbitrage even if it misses some systemically risky forms of such arbitrage while incorrectly identifying others. So long as FSOC presents a credible threat to non-banks that systemically risky arbitrage strategies will result in designation, it will deter efforts by firms to test this system. As amply illustrated by financial firms' complaints regarding the uncertainty generated by FSOC's designation regime, financial firms have strong reasons to avoid regulatory uncertainty, which can threaten not only the standard regulatory costs, but also negative publicity and executives' jobs.

Contrary arguments that FSOC's designation regime will affirmatively prompt regulatory arbitrage are, we believe, unpersuasive. For instance, Cristina Skinner has suggested that the binary nature of the FSOC designation standard will lead firms to engage in regulatory arbitrage to avoid designation.[190] In particular, Skinner suggests that the extreme consequences of designation will cause some firms to shop for an alternative regulator than the Fed, and then attempt to claim that designation is not warranted because they are already adequately regulated.[191] We find this argument unconvincing, because FSOC has the authority to designate

[189] A consolidated regulatory capital standard such as that proposed by the Fed for designated firms in its Advanced Notice of Proposed Rulemaking, *see supra* note 91~~90~~, would eliminate the regulatory arbitrage benefits of shadow insurance because it would be insensitive to the placement of individual assets and liabilities in different legal entities within the larger conglomerate.

[190] *See* Skinner, *supra* note 31~~30~~. We also note that the FSOC designation regime is not, in fact, as binary as Professor Skinner suggests. While Professor Skinner is surely correct that there are no intermediate categories between firms that are designated and firms that are not, there are multiple different regulatory consequences for designated firms. Most notably, as Congress recently clarified, designated insurance-focused financial firms must be subject to tailored prudential standards that reflect the particular risks associated with their business models. Additionally, there are a number of firms that have not been designated, but that are almost certainly being periodically reviewed by FSOC in Stage Three of its process.

[191] *See id.*

any non bank financial firm as a SIFI, irrespective of who that firm's regulator is. As such, the only way that a firm could decrease its chances of being designated by shopping for a regulator would be if FSOC deemed that regulator to be effective with respect to systemic risk. This point is amply illustrated by the MetLife case, where FSOC specifically rejected MetLife's arguments that it was sufficiently regulated by noting the ways in which state insurance regulation does not address systemic stability.[192] More generally, the standard-like nature of the relevant criterion – which examines the adequacy of existing regulation – limits the capacity of firms to rely on arbitrage strategies involving regulator shopping to avoid FSOC designation.

Because of the uncertainties of predicting the future in finance – an art that no one has been able to master with any reliability – there is little doubt that FSOC will err on occasion in its assessment of whether any particular non-bank is systemically significant or in its explanation for this conclusion. But there is not, at the present time, any reasonable alternative for definitively determining when a non-bank is systemically significant, and any attempt to devise such a test would ultimately suffer the same fate as the pre-crisis distinction between banks and non-banks.[193]

More importantly, understanding FSOC's designation process as regulation by threat means that it does not actually need to be completely accurate to achieve its broader purpose of preventing non-banks from becoming systemically risky. Assuring precision in placing each financial institution on the correct side of the riskiness line is less important than the ability of FSOC to draw a line with a margin of safety.

B. FSOC Designation and the Adaptation of Primary Financial Regulations

The big stick of designation not only deters financial firms from

[192] See FSOC DESIGNATION OF METLIFE, *supra*.

[193] To be sure, there are a large number of quantitative tests that aim to measure systemic risk, including SRisk. *See generally* Monica Billio, et al, *Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors*, 104 J. FIN. ECON. 535, 536 (2012); Acharya, Viral; Engle, Robert; Richardson, Matthew, *Capital Shortfall: A New Approach to Ranking and Regulating Systemic Risks*, 102 AM. ECON. REV. 59 (2012). Although these measures provide one important perspective on systemic risk, there is also little doubt that they are also quite limited in their capacity to accurately and reliably distinguish between systemically significant institutions and those which are not systemically significant. *See generally* LARS PETER HANSEN, CHALLENGES IN IDENTIFYING AND MEASURING SYSTEMIC RISK (2012). This is precisely why no existing regulatory regime has tethered its approach to these quantitative measures, even if they no doubt consider them as one relevant factor in their analysis.

seeking out excessive risk. It also deters primary regulators of non-banks from shirking in their efforts to account for systemic risk. Such shirking could come in the form of primary regulators' lackluster efforts to implement or enforce Dodd-Frank's various reforms aimed at limiting systemic risk outside of the banking sector, such as its reform of derivatives markets or new reporting rules for hedge funds. Alternatively, it might come in the form of failing to address issues left unresolved in Dodd-Frank, such as reform of Government-Sponsored Entities or money market mutual funds. Perhaps most importantly, primary financial regulators might shirk by ignoring unanticipated changes in financial markets that require a change in their regulatory approach.

Although Dodd-Frank tasks FSOC with broad responsibility for identifying and responding to actual or emerging risks to the financial stability of the United States, it grants FSOC remarkably limited power to accomplish this outside of the designation process for individual non-banks.[194] To be sure, Dodd-Frank does provide FSOC with a broad range of data gathering and analysis tools, the most important of which is its authority to provide direction to, and request data from, a new Office of Financial Research ("OFR") housed within the Treasury Department.[195] The OFR, in turn, has the authority to require nonbank financial companies to submit data or periodic reports to the office, so long as that data is not available directly from the firm's primary financial regulator.[196]

But FSOC does not itself have the power to set supervisory priorities for member agencies or to develop new or revised regulations regarding activities or practices that are under their jurisdiction. Instead, FSOC simply has persuasive authority with respect to these key elements of the financial regulatory universe. For instance, FSOC can "recommend" that member agencies apply "new or heightened standards and safeguards for financial activities or practices that could" generate systemic risk.[197] But member agencies need not accept these recommendations, so long as they provide an explanation for their decision.[198] Similarly, FSOC must annually report and testify to Congress on a host of issues, including regulatory developments and its recommendations for improving financial stability.[199]

FSOC's designation power nonetheless operates as an effective

[194] *See* Dodd-Frank Section 112(A)(1). FSOC does have the authority to "identify systemically important financial market utilities and payment, clearing, and settlement activities." FSOC has indeed exercised this authority to designate a number of financial market utilities, resulting in enhanced regulation of these utilities.

[195] *See id.* at 112(a) (2).

[196] *See id.* at 112(d)(3)

[197] *See id.*

[198] *See id.* at 120.

[199] *See id.*

threat against primary financial regulators who refuse to follow FSOC's suggestions and do not offer a convincing explanation for this decision. This is because designation – while it is generally aimed at specific non-bank firms – simultaneously operates as a deterrent to that firm's regulator by threatening to intrude on its regulatory turf. Even though FSOC designation does not strip a primary regulator of its authority over a designated firm, it no doubt diminishes the authority and power of that primary regulator. For instance, "more stringent" prudential rules imposed by the Fed as a result of designation will in many cases obviate parallel restrictions imposed by the primary regulator, as firms must generally focus their compliance efforts on the most stringent regulations they face. Relatedly, enhanced regulation by the Fed may effectively eliminate the capacity of a firm's primary financial regulators to grant that firm waivers or exemptions to regulatory requirements, or to approve non-standard transactions or activities. Few agencies relish the prospect of losing control over firms and industries that they traditionally regulate, and so this constraint is a real one.

FSOC designation of a firm threatens to intrude on the power and authority of the firm's primary regulator in a second, and distinct, way. Recall that FSOC designation comes along not just with enhanced prudential standards crafted by the Fed, but also by enhanced supervision conducted by the Fed.[200] As a result, many of the decisions that a primary financial regulator makes in connection with its supervision of a designated firm are essentially subject to simultaneous oversight and assessment by the Fed itself. If, for instance, a primary regulator approves a designated firm's accounting treatment of a transaction, but the Fed does not, then the implicit (or perhaps explicit) message is that the primary financial regulator erred. In a very real sense, then, the Fed becomes the supervisor of both the designated firm itself, as well as that firm's primary financial regulator.

FSOC would also have good reason to respond to a primary financial regulator's refusal to adopt its recommendations by designating some of the firms that the regulator oversees. As discussed above, existing regulatory scrutiny is one of the six designation categories in FSOC's designation framework, as well as one of the ten Dodd-Frank categories.[201] Thus, it would stand to reason that a primary financial regulator's refusal to accept an FSOC recommendation would increase the potential for the Council to conclude that some of the firms overseen by that regulator are, in fact, systemically significant.

This capacity of FSOC's designation power to incentivize regulators to better account for systemic risk is perfectly illustrated by FSOC's

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[200] *See* Part II.A, *supra*.
[201] *See id.*

successful campaign to induce the SEC to regulate money market funds more carefully for systemic risk. Recall the crucial role that money market funds played in the financial crisis, after the reserve Primary Fund broke the buck.[202] The industry itself was opposed to new regulations, particularly those that might require it to adopt a so-called “”floating” net asset value, meaning that shares in the funds could vary in price, rather than being tied to a somewhat fictional “one dollar, one share” price. Faced with this opposition, the commission dithered. Enter the Council. Pursuant to section 120 of Dodd-Frank, it requested that the SEC redouble its efforts to pass regulation reforming the money market fund industry.[203] The agency was not obligated to embrace to the Council’s request, but it ultimately largely did so, adopting wide-ranging reforms of the basic type suggested by the Council.[204]

In all likelihood, the SEC would have refused to accept FSOC’s recommendations on Money Market Funds were it not for the Council’s designation power. There is, in fact, strong evidence that the Council had explicitly threatened the SEC with the prospect of designating large money market funds and their advisors, thus placing them under the supervision of the Fed. As the minutes to a 2012 FSOC meeting on money market funds indicated, the Treasury Secretary “urged the Council to take parallel steps to consider authorities under Title I … of the Dodd-Frank Act in the event that the SEC is unwilling to act in a timely and effective manner.”[205] Title One is the part of the act where the council’s designation power lies. Treasury urged the council to “closely consider whether funds” meet the criteria for designation.[206] If nothing else, of course, FSOC would have had a ready-made case that these funds and their advisors are not subject to effective systemic risk regulation if the SEC had failed to act.[207]

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[202] *See* part I, *supra*.

[203] See FSOC, Proposed Recommendations Regarding Money Market Mutual Reform, (November, 2012).

[204] *See generally SEC Adopts Money Market Fund Reform Rules, Press Release*, (7/23/14).

[205] *See* Minutes of The Financial Stability Oversight Council (9/28/12), https://www.treasury.gov/initiatives/fsoc/Documents/September%2028%20FSOC%20Meeting%20Minutes.pdf

[206] Letter from Timothy Geithner to Members of the Financial Stability Oversight Council, available at http://online.wsj.com/public/resources/documents/Sec.Geithner.Letter.To.FSOC.PDF

[207] To be sure, it is not entirely clear that the SEC did everything the council would have preferred. *See* Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087 (2015) (describing the SEC’s final product as “much more limited scale than any of the FSOC's proposals”).

The SEC has also apparently been influenced by FSOC – and its capacity to designate firms subject to the SEC’s oversight – in connection with its newly proposed rules

IV. The Legitimacy of Regulation By Threat

In this part of the article, we defend regulation by threat more generally as a legitimate regulatory tool, and in particular in the way the council has deployed it. We then expand upon the ways that the structure of the council provides good governance checks that make up for its relatively unfettered designation discretion. Finally, we discuss some of the implications for current policy debates that our analysis has for the council and its members.

A. The Legitimacy of Regulation By Threat In Financial Supervision, And Elsewhere

Supervising an industry by singling out some institutions for particularly rigorous regulation to, in part, convey a message to other institutions somewhat like them requires justification. The same goes with threats to replace regulators with the Fed. Our justification turns on the fact that although the council's operations are unique, they are not beyond the pale of precedent.

The problem posed by the council's procedures might be characterized as one of consistency. Treating likes alike is thought to be a fundamental underpinning of fairness, and fairness is of course an important component of a legitimate government program.[208] But FSOC's designation system arguably treats similar firms (and competing regulators) differently.

Moreover, a traditional response to claims of arbitrariness in administrative law turns not just on the reasonableness of a particular decision, but also on the process used to make decisions.[209] The council is

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governing liquidity for mutual funds and Exchange Traded Funds. These rules, which were proposed in September 2015, are designed to improve liquidity management directly, increase disclosure about liquidity risk, and allow funds to implement mechanisms to pass on to redeeming investors the transactions costs associated with redeeming shares in order to eliminate any first-mover advantage. Although the link between FSOC designation and the SEC's actions is not as clear in this case as it is in the Money Market Mutual Fund space, FSOC has suggested reform of these types of issues for some time with asset managers. Moreover, the chairperson of the SEC has publicly acknowledged that "FSOC's current review of the potential risks to the stability of U.S. financial system of asset managers is a complement to the work we are now undertaking." See Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (12/11/14), available at https://www.sec.gov/News/Speech/Detail/Speech/1370543677722#_ftnref27

[208] *But see* Kenneth I. Winston, *On Treating Like Cases Alike*, 62 CALIF. L. REV. 1, 5 (1974) (arguing that the treat-likes-alike principle is "incomplete").

[209] Ronald J. Krotoszynski, Jr., *"History Belongs to the Winners": The Bazelon-Leventhal Debate and the Continuing Relevance of the Process/substance Dichotomy in*

not unfamiliar with notice, comment, or judicial review. [210] But when it has used notice and comment in spelling out its approach to designation, it has preserved for itself a quantum of discretion in applying the designation factors to address new and different risks, as we have seen.[211] It has also rejected invitations from industry to preform a quantitative cost-benefit analysis of its rules.[212] It offers its explanations in a writing, rather than a spreadsheet.

We are untroubled by this regulatory approach. Any enforcement scheme depends on singling out some unlucky wrongdoers from a larger pool of candidates.[213] As Judge Richard Posner has observed, our legal system has never required the law to be enforced "with Prussian

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Judicial Review of Agency Action, 58 ADMIN. L. REV. 995, 998 (2006) ("An agency that ignores process values invites presumably unwanted judicial scrutiny. Conversely, an agency that scrupulously observes fundamentally fair processes will receive a higher measure of deference from a reviewing court."); see also Loren A. Smith, *Judicialization: The Twilight of Administrative Law*, 1985 DUKE L.J. 427, 429 (1985) ("We have come to believe that public hearings, public disclosure of all documents relevant to a given issue, and trial-type methodologies for testing ideas will lead to 'better' social and economic policies by government decisionmakers having power over large sections of the economic and social life of the nation.").

[210] *See infra* Part II.B; *see also* Financial Stability Oversight Council, *Nonbank Designations – FAQs*, U.S. DEP'T OF THE TREASURY (Feb. 4, 2015), https://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx#4 ("Before adopting its rule and interpretive guidance on nonbank financial company designations, the FSOC voluntarily solicited public comment three times over an 18-month period. This notice and comment process benefited from input from companies and trade organizations representing a broad array of financial sectors, as well as academics and public interest groups.").

[211] *See id.*

[212] There are a number of scholars who have called for quantitative cost benefit analysis to inform as many rules as possible. *See, e.g.* Eric A. Posner & E. Glen Weyl, *The Case for Cost-Benefit Analysis of Financial Regulations*, REGULATION (Winter 2013-2014); Cass R. Sunstein, *Is Cost-Benefit Analysis for Everyone?*, 53 ADMIN. L. REV. 299, 299-300 (2001) (favoring, in large part, cost benefit analysis, and observing that recent presidential administrations have moved toward making cost-benefit analysis the basis for all decisions), RICHARD L. REVESZ & MICHAEL A. LIVERMORE, RETAKING RATIONALITY: HOW COST-BENEFIT ANALYSIS CAN BETTER PROTECT THE ENVIRONMENT AND OUR HEALTH 9-10 (2008). But there are many who disagree. *See* Jon C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, YALE L.J. 553, 882-1011 (2012); Lisa Heinzerling, *Regulatory Costs of Mythic Proportions*, 107 YALE L.J. 1981, 2042 (1998) (decrying "The Perils of Precision").

[213] The Treasury Department has indicated that its tax enforcement scheme looks in particular for high profile tax avoiders, and does not purport to prosecute every tax cheat. Tax threats themselves are traditional tools in the regulatory arsenal. *See* Internal Revenue Service, Internal Revenue Manual, Policy Statement 20-1 (2004), https://www.irs.gov/irm/part1/irm_01-002-020.html ("Penalties are used to enhance voluntary compliance.").

thoroughness as the price of being allowed to enforce them at all."[214] The Supreme Court has emphasized that an "agency generally cannot act against each technical violation of the statute it is charged with enforcing."[215]

Given these constraints, prioritizing administrative action against high-profile targets who meet the statutory criteria, and who might deter others from illegality might be considered good regulatory practice.[216] Daniel Bailis & Robert MacCoun have noted "high-profile enforcement efforts create an exaggerated perception of legal risks, promoting compliance with the law," and in our view this is an advantage.[217] Regulators always need to choose who they enforce against, and they often – entirely appropriately – prioritize high profile defendants, in an effort to deter others who might find themselves in their shoes.[218]

Even the idea of regulation by threat is not new – social scientists have written about "regulatory threat,"[219] and it is particularly well-known to those who study financial regulation, where warnings and even threats to the banking industry are part and parcel of how informal financial regulation gets done.[220] Part of what has animated the campaign against

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[214] Hameetman v. City of Chicago, 776 F.2d 636, 641 (7th Cir. 1985). Cf. Oyler v. Boles, 368 U.S. 448, 456, 82 S.Ct. 501, 506, 7 L.Ed.2d 446 (1961) ("the conscious exercise of some selectivity in enforcement is not in itself a federal constitutional violation").

[215] Heckler v. Chaney, 470 U.S. 821, 831, 105 S. Ct. 1649, 1656, 84 L. Ed. 2d 714 (1985).

[216] One SEC commissioner observed that "High profile cases generate significant returns on the SEC's enforcement dollars by sending very public messages of deterrence." *Casey Reviews Current Enforcement Challenges*, SEC. EXCH. COMM'N. TODAY 9384944.

[217] Daniel S. Bailis & Robert J. MacCoun, *Estimating Liability Risks with the Media As Your Guide,* 80 JUDICATURE 64, 65 (1996).

[218] Sometimes lawmakers threaten to tax behavior that they want less of, an idea associated with the economist Arthur Pigou, who suggested that "[i]t is, however, possible for the State . . . to remove the divergence . . . by "extraordinary encouragements" or "extraordinary restraints. . . ." ARTHUR CECIL PIGOU, THE ECONOMICS OF WELFARE 183-203 (4th ed. 1932). For a discussion, see Barak Y. Orbach, *The New Regulatory Era-an Introduction*, 51 ARIZ. L. REV. 559, 568 (2009); Eric W. Orts, *Reflexive Environmental Law*, 89 NW. U. L. REV. 1227, 1242 (1995) ("a modern Pigouvian approach assesses taxes or charges to activities that are environmentally harmful.")

[219] Victor Stango, *Strategic Responses to Regulatory Threat in the Credit Card Market*, 46 J.L. & ECON. 427, 430 (2003); *cf.* Guy Halfteck, *Legislative Threats*, 61 STAN. L. REV. 629, 638 (2008) ("compliance with legislative threats is, in essence, an implicit and informal political bargain in which the legislator barters the non-use of legislative power with respect to a particular issue in return for a firm's (or an industry's) commitment to change its conduct").

[220] As Saule Omarova has observed, "a credible threat of targeted government intervention, such as a direct ban on complex financial products, and the creation of functional substitutes for public-interest-group monitoring of the industry's performance may serve as important external checks on the industry." Saule T. Omarova, *Wall Street As Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411,

FSOC is thus a discomfort with a form of regulation that in many ways is quite traditional.

Moreover, the council's refusal to provide industry segment safe harbors – an announcement that, say, asset management firms could never grow too big to fail – looks entirely consistent with the administrative practice of other law enforcement agencies that must supervise an entire industry, and so are accordingly unwilling to issue free passes to parts of it.[221]

Every agency will regulate to some degree by rule and in other ways by what it chooses to prioritize in enforcement. In cases where law-breaking is difficult to catch, as in antitrust[222] and tax evasion,[223] the discretion to single out some in an effort to deter others might be defensible. In cases where the downside risk is high, as with nuclear power plants or hygiene in meat processing plants, regulatory discretion might be welcome. And in cases where the right approach for policymakers is uncertain, a zone of discretion is appropriate – this might explain why diplomacy and monetary

475 (2011).

[221] FSOC has retained its flexibility here, noting that it "believes financial stability concerns may arise from liquidity and redemption risks in pooled investment vehicles, particularly where investor redemption rights and underlying asset liquidity may not match." Financial Stability Oversight Council, Department of the Treasury, *Statement on Review of Asset Management Products and Activities* (2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0431.aspx.

[222] At least, this has been the history in antitrust enforcement. *See, e.g.,* B. Zorina Khan, *Federal Antitrust Agencies and Public Policy Toward Antitrust and Intellectual Property*, 9 Cornell J.L. & PUB. POL'Y 133, 141 (1999) (in a sample of cases brought between the 1970s and the present, "the correspondence in the identity of antitrust firms with a list of firms that are household names suggests the possibility that antitrust authorities are pursuing a 'big bang' policy, where limited resources are allocated towards the prosecution of cases that are most likely to generate attention"); Joan T.A. Gabel et. al., *Letter vs. Spirit: The Evolution of Compliance into Ethics*, 46 AM. BUS. L.J. 453, 459 (2009) ("A series of high-profile antitrust prosecutions in the late 1950s and early 1960s brought the first expansive adoption of corporate compliance programs in the United States."); Clifford A. Jones, *Exporting Antitrust Courtrooms to the World: Private Enforcement in A Global Market*, 16 LOY. CONSUMER L. REV. 409, 410 (2004) (observing that the historical "perception that the new antitrust legislation was vigorously enforced from the outset derives from a few high-profile cases").

[223] The idea is explicitly one of deterrence: "high-profile cases emphasize the abilities and enforcement power of the IRS's criminal investigators, sending the message that 'If the IRS can get these untouchables, certainly they can get me.'" Stephen W. Mazza, *Taxpayer Privacy and Tax Compliance*, 51 U. KAN. L. REV. 1065, 1127 (2003); *see also* Kelly Phillips Erb, *IRS Investigations, Prosecutions For Tax Crimes Up In 2013*, FORTUNE, Feb. 24, 2014,http://www.forbes.com/sites/kellyphillipserb/2014/02/26/irs-investigations-prosecutions-for-tax-crimes-up-in-2013/#444d1ba04197 (noting the increasing in high profile criminal tax prosecutions of, among others, the mayor of Detroit).

policy have not been subjected to the discipline of the APA.[224]

To be sure, the council might be considered to be an epitome of discretion retention. But, as we have observed, it has retained that discretion in a context where a deep well of discretion is required. It has been charged with preventing financial crises from occurring, and despite centuries of experience with them, regulators and financiers have found them impossible to predict.[225]

As for the conventions for important administrative actions, the traditions of ex ante precision and ex post cost benefit analysis are not a sine qua non of good regulation. Some of the most effective regulations ever passed, such as the rule banning the widespread sale of leaded gasoline,[226] or the rules requiring the disclosure of information a reasonable investor would want to know before deciding whether to buy or sell to all market participants, rather than a select few,[227] lacked these characteristics. The council's approach is no outlier when compared to these successful regimes.

B. The Limited Uncertainty of the Council's Threats

We have already explained how the administrative law scheme adopted by the council works in parts II and III of this paper, and in this section will not recount the sense of it again.

It is nonetheless worth emphasizing here three reasons why FSOC's discretion in designating non-bank SIFIs does not mean that the regulated industry is operating without guidance.

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[224] *See* 5 U.S.C. § 553 (exempting foreign and military affairs from APA rulemaking requirements); David Zaring, *Law and Custom on the Federal Open Market Committee,* 78 L. & CONTEMP. PROBS. 158 (2015) (describing the administrative law of the committee, and observing that it is not onstrained by the APA).

[225] *See infra* Part II.A.1.

[226] Craig N. Oren, *When Must EPA Set Ambient Air Quality Standards? Looking Back at Nrdc v. Train,* 30 UCLA J. ENVTL. L. & POL'Y 157, 181 (2012) ("the leaded gasoline rules were the chief cause of a ninety-nine percent reduction in lead emissions to the air from 1970 to 2005, clearly a record of success").

[227] 17 C.F.R. § 243 (2000).; Commissioner Laura S. Unger, Securities and Exchange Commission, *Special Study: Regulation Fair Disclosure Revisited* (December 2001), https://www.sec.gov/news/studies/regfdstudy.htm (Noting that the rule was proposed in January 2000 and adopted in August 2000, this report reviewing the rule one year after implementation contains no cost-benefit analysis). For an overview, see Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 163 (2002) ("[Regulation FD] prohibits senior executives of publicly traded issuers from privately disclosing material nonpublic information to any of a carefully defined class of persons, most notably investment analysts").

First, not every financial institution need live in fear. We have observed that the council has notified individual firms that it considered them for designation and ultimately chose not to designate them.[228] These firms can generally rest assured that they will not be designated in the future if they do not substantially alter their balance sheet and activities. Additionally, FSOC uses quantitative guidelines that exempt most financial firms from the second and third steps of the designation process.[229] Consequently, FSOC's malleable approach to designation only creates market uncertainty for non-bank firms that are plausibly close to the SIFI designation line. The vast majority of non-banks are not in this position and can confidently determine this for themselves by relying on FSOC's presumptive pass for non-bank firms that do not meet the stage one quantitative threshold test.

Second, residual uncertainty regarding the prospect of FSOC designation does persist for firms in certain industries where the regulatory rules are themselves shifting. This is perhaps most notable for firms that engage in substantial asset management activities, where the SEC's rules are still in development and FSOC has thus taken a rather explicit "wait and see" approach about designating the largest asset mangers, such as Black Rock.[230] The same uncertainty no doubt applies in the context of the GSEs, as FSOC has to date refrained from designated any of the GSEs because of the uncertainty regarding the regulatory environment that these firms face.[231] But in both instances, this uncertainty is likely to be a temporary result of the fact that core elements of the primary regulatory regime for these entities are still under development. Once essential questions are resolved about how regulation of these types of firms and the activities in which they engage is resolved, then the non-banks that populate these industries will have substantially more certainty about their status as a non-bank SIFI.

Third, it is worth underscoring that the council's broad remit to impose financial safeguards on a broad array of firms is necessary to the project of avoiding systemic risk. We now know that the financial crisis was exacerbated, and in some ways may have been precipitated, by the risky activities of an unpredictable array of different non-bank financial actors.[232] The only way to regulate finance – with its ever lower barriers to entry and

[228] *See supra* Part II.A.
[229] *See id.*
[230] *See* FSOC, Update on Review of Asset Management Products and Activities, (4/18/16), available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf
[231] See FSOC, Annual Report (2016) (recommending housing finance reform).
[232] *See infra* Part II.A.

ever larger number of institutions interested in providing it – is with flexibility, and with credible warnings. The financial sector is not just full of knowns, or known unknowns, but with its share of unknown unknowns, at least from the perspective of the regulator.[233] The very liquidity characteristic of the American capital markets require a vast number of participants offering a vast array of products. Identifying which of these participants are the risky ones in advance has never been possible in the past, and is even more unlikely today.

C. *The Novel Curbs On The Council's Discretion*

Although we find the council's adoption of regulation by threat to be reasonable in the context of the industry it regulates, the case for its legitimacy is bolstered by the novel protections that Congress has given to its administrative scheme. It has voting requirements, a seat at the table for different kinds of regulators, including, almost uniquely, state regulators, an international check not shared by many federal agencies, along with, of course, some standard procedural protections. These procedural checks help offset any rule-of-law concerns associated with the council's retention of flexibility in the designation process as well as its refusal to assess costs and benefits in connection with individual designation decisions; we review them here in turn.

The structure of the council, which includes a diverse array of agencies, helps. Each of the heads of the nine federal agencies on the council, along with an independent member with insurance expertise, must vote before any designation is made. A designation is finalized only with an affirmative vote from ten of these FSOC members, which must include the Treasury secretary.[234] With the exception of the independent member, all of these FSOC members are financial regulators, but they regulate very different aspects of the financial system. The Fed, OCC, NCUA, and FDIC regulate banks or bank-like institutions.[235] The SEC and CFTC supervise the capital

[233] "[A]s we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns — the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones." Department of Defense, *Transcript of DoD News Briefing- Secretary Rumsfeld and Gen. Myers* (February 12, 2002), http://archive.defense.gov/transcripts/transcript.aspx?transcriptid=2636.

[234] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed.Reg. 21,637, 21,646 (Apr. 11, 2012).

[235] Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1094 (2009) ("Federal banking agencies--the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), … the

markets.[236] The FHFA regulates the government sponsored mortgage securitization giants.[237] The head of the CFPB is charged with protecting the interests of consumers.[238] And the Treasury Secretary is a political appointee with a vast array of diverse responsibilities.[239]

It is in many ways a team of rivals, comprised of agencies that have struggled against one another for turf, and in some cases, for budgets.[240] The SEC and CFTC have been at loggerheads since their founding.[241] Banks may choose their regulator by choosing who issues their bank charter; moreover they can switch charters, and regulators, as they see fit, creating a competition of sorts between the agencies that bolster their budgets from fees from the number of banks they supervise.[242]

Almost all of these agencies have no reason to defer to a decision allocating supervision to the Fed. In fact, FSOC is in this was at least a partial example of a regulatory contrarian enterprise – a regulatory process that includes diverse opinions and even devil's advocates in an effort to provide checks on regulation before matters come to the courts.[243]

There are other reasons to believe that the way the council practices administrative law is, if different, not wrong. The council has essentially no budget and almost no employees, which renders it unlikely to be moved by the prospect of regulatory turf-building.[244] It does not even have its own

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Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA)--regulate depository institutions.").

[236] *See* Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2012); 7 U.S.C. § 2(a)(1) (2012).

[237] Housing and Economic Recovery Act of 2008 § 1311(b), 12 U.S.C. §4511(b) (2012).

[238] *See* Consumer Financial Protection Act of 2010 § 1011-1012, 12 U.S.C. §5491–5492.

[239] 31 U.S.C. § 301(b), 321 (2012).

[240] *See* DORIS K. GOODWIN, TEAM OF RIVALS: THE POLITICAL GENIUS OF ABRAHAM LINCOLN (2005).

[241] *See, e.g.*, John Manley, *U.S. Market Regulators in Bid to End Turf War*, REUTERS FINANCIAL REGULATORY FORUM (Sept. 2, 2009), http://blogs.reuters.com/financial-regulatory-forum/2009/09/02/us-market-regulators-in-bid-to-end-turf-war.

[242] Dain C. Donelson & David Zaring, *Requiem for a Regulator: The Office of Thrift Supervision's Performance During the Financial Crisis*, 89 N.C. L. REV. 1777, 1779 (2011), http://www.nclawreview.org/documents/89/5/zaring.pdf; *see* Marcelo Rezende, *The Effects of Bank Charter Switching on Supervisory Ratings*, FEDERAL RESERVE BOARD DIVISIONS OF RESEARCH & STATISTICS AND MONETARY AFFAIRS (2014), https://www.federalreserve.gov/pubs/feds/2014/201420/201420pap.pdf.

[243] Brett McDonnell, Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629, 1675 (2011).

[244] *See* EVA BECKER, KNOWLEDGE CAPTURE IN FINANCIAL REGULATION: DATA-, INFORMATION- AND KNOWLEDGE-ASYMMETRIES IN THE U.S. FINANCIAL CRISIS 108 (2016).

office building; its staff is housed in the Treasury Department.[245] Nor does the Council supervise the firms that it designates – that job is delegated to the Fed. Its decision to require regulation does not create a regulatory program of its own that it could grow – one of the standard stories told about regulatory waste involves this sort of struggle for size, and there is no reason to believe that the council would engage in it.[246] FSOC lacks this famous incentive to regulate, in other words, because there is no advantage to the council in doing so.

Another source of FSOC's process legitimacy stems from the political accountability of its member agencies. The chair of the council is the Treasury Secretary, a political appointee removable from his job at will, and, as such, is accountable to the President. Moreover, the Treasury secretary has a veto right against designation.[247] It is a role that underscores Gillian Metzger's argument that "[t]he creation of the FSOC can be seen as part of an effort to inject more political accountability into financial-system oversight," Rather than less.[248]

Most of the other members of the council are independent regulators; they are not subject to presidential oversight, but by putting the heads of those agencies on the council, Dodd-Frank has created a council full of Senate-confirmed, presidentially appointed voting members. This is not a particularly unique facet of agency leadership, but by making each of the financial regulators with voting rights subject to senate confirmation, which requires the approval of not just the banking committee, but other committees that oversee other regulatory members, like the agriculture and commerce committees, the legislative stakeholders in the council's enterprise are larger than they are in the case of other agencies.

It is accordingly no surprise that designations do not look like an obscurantist technocratic exercise. In the case of MetLife, the council looked at practicalities as well as at the risks posed by MetLife. It observed, for example, that MetLife's current state regulators "have never been tested

[245] "The FSOC is distinguishable from the more substantial regulatory bodies led by its members because it has only a small dedicated staff,170 and a relatively small budget." Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087, 1114–15 (2015) (noting that the council has a dedicated staff of 25 employees and a budget of less than $10 million).

[246] It is true that it must review designate firms on an annual basis to see if they are still systemically risky, but it is hard to see how this builds turf for the council, as it relies on staff from its member agencies to conduct these reviews. *See* FSOC, *Non-Bank Designations – Frequently Asked Questions,* (July, 2015), https://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx.

[247] *See supra* note 9.

[248] Gillian E. Metzger, *Through the Looking Glass to a Shared Reflection: The Evolving Relationship Between Administrative Law and Financial Regulation*, 78 LAW AND CONTEMPORARY PROBLEMS 129, 146 (2015).

by the material financial distress of an insurance company of the size, scope, and complexity of MetLife's insurance subsidiaries."[249] When rescinding the designation of GE Capital, the council made both technocratic and practical findings. It observed that "GE Capital has decreased its total assets by over 50 percent, shifted away from short-term funding, and reduced its interconnectedness with large financial institutions," terms of regulatory art.[250] But it practically observed that these changes also meant that it was no long acting like a bank: "the company no longer owns any U.S. depository institutions and does not provide financing to consumers or small business customers in the United States."[251]

Yet another source of process legitimacy stems from the unique diversity of the council's decision-making process. State insurance, securities, and banking commissioners play a role in designation decisions – they are each non-voting members, along with the heads of the Federal Insurance Office and the Office of Financial Research.[252] This state representation adds an alternative perspective to the enterprise, a perspective that other federal agencies cannot match; none of them include state representatives in the same way.[253] There are many regulatory projects that are enterprises in which the states and the federal government must

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[249] FINANCIAL STABILITY OVERSIGHT COUNCIL, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING METLIFE, INC. 27 (2014), https://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20 Basis.pdf.

[250] FINANCIAL STABILITY OVERSIGHT COUNCIL, BASIS FOR FINANCIAL STABILITY OVERSIGHT COUNCIL'S RESCISSION OF ITS DETERMINATION REGARDING GE CAPITAL GLOBAL HOLDINGS, LLC 2 (2016), https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE%20Capital%20Public%20Rescission%20Basis.pdf.

[251] *Id.*

[252] Financial Stability Oversight Council, *Who is on the Council?*, DEPARTMENT OF THE TREASURY (Aug. 10, 2016, 5:33 PM), https://www.treasury.gov/initiatives/fsoc/about/council/Pages/default.aspx.

[253] While we have been unable to find examples of state officials placed in command of federal agencies, even agencies that manage dams or borders, state officials often enjoy powers delegated to them by Congress, a fact that has worried some scholars who take the nondelegation doctrine particularly seriously. *See, e.g.*, Thomas W. Merrill, *Rethinking Article I, Section 1: From Nondelegation to Exclusive Delegation*, 104 COLUM. L. REV. 2097, 2181 (2004) ("Delegations to state entities may be permissible in circumstances in which delegations to private entities would not be."); Evan Caminker, The Unitary Executive and State Administration of Federal Law, 45 U. KAN. L. REV. 1075, 1077 (1997) (assessing how the "unitary executive theory appears to be implicated when Congress conscripts or even authorizes state officials to implement federal programs"); Steven G. Calabresi & Saikrishna B. Prakash, *The President's Power to Execute the Laws*, 104 YALE L.J. 541, 570-99 (1994); Harold J. Krent, *Fragmenting the Unitary Executive: Congressional Delegations of Administrative Authority Outside the Federal Government*, 85 NW. U. L. REV. 62, 72-77 (1990).

cooperate – EPA relies on the states to come up with local plans to deal with water and air pollution, the Affordable Care Act relies in part on state-run exchanges, and so on – but these relationships do not put state regulators at the leadership table of a federal enterprise. By including states on the council, FSOC is unique.

As Metzger has observed, it is a particular difference for finance; the "incorporation of state regulators is a departure from the dual banking system that long dominated the nation."[254] Instead, FSOC looks more like a coordination exercise of independent and politically accountable regulators, with limited powers to force each other to act or vote in a particular way.

Finally, the council's designation process is part of a global effort to identify systemically risky firms and do something about them. Others have criticized this international constraint as one that removes power from the council; in our view, it acts as an additional, and novel, constraint on the council's discretion.[255]

If the Financial Stability Board, an international body of financial regulators, to which America sends representatives, but at which the council has no formal role, believes that an American financial institution is systemically risky, it can make its own designation.[256] The FSB has promulgated a list of so-called G-SIBs, or globally systemically important banks,[257] and, intriguingly, G-SIIs, or globally systemically important insurers, of whom there are currently nine, three of which are the American insurers MetLife, Prudential, and AIG.[258]

This independent designation process limits the ability of the council to let "national champions" become systemically risky in an effort to gain global market share or represent American interests. Moreover, it is consistent with the purpose of international economic law, which might be broadly characterized as seeking to reduce regulatory barriers and facilitate trade among them. The World Trade Organization, for example, has as one of its "pillars" a commitment to "national treatment," or treating foreign and

[254] Gillian E. Metzger, *Through the Looking Glass to a Shard Reflection: The Evolving Relationship Between Administrative Law and Financial Regulation*, 78 LAW & CONTEMP. PROBS. 129, 150 (2015).

[255] *See infra* Part III.B.

[256] The FSB's methodology for identifying systemically significant insurers is described in footnote 143 & 147, supra.

[257] Financial Stability Board, *2015 Update of List of Global Systemically Important Banks (G-SIBs)* (2015), http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf.

[258] Financial Stability Board, *2015 Update of List of Global Systematically Important Insurers (G-SIIs)* (2015), http://www.fsb.org/wp-content/uploads/FSB-communication-G-SIIs-Final-version.pdf.

domestic firms the same way.[259]

To be sure, some have criticized the council for hewing too closely to the designations of the Financial Stability Board.[260] Two of the four designations made by the council were first made by the international entity.[261] But one would expect government bodies on the lookout for systemic risk to evaluate risk in similar ways; the correlation between international designations and council designations is not exact, and, of course, the council, through its members, has a voice in the international process itself.

There is no question that the quantum it has retained has upset its critics, but in assessing whether the council's activities are arbitrary it is worth noting the many bounds on the council's inquiry. First, only financial institutions are subject to council regulation, which means that by statute 85 percent of their activities must be "financial in nature."[262] Accordingly, the council cannot designate, say, Apple even though it processes payments on its phones. Second, the council has created the panoply of stage one quantitative triggers, which give guidance to financial firms as to whether they will even be subject for consideration, including, perhaps most importantly, the $50 billion asset threshold.[263]

Third, the council has also established, with some elaboration, the procedures for designation, which include a right to a hearing.[264] Fourth, Congress gave the council ten factors to consider when making designations; the council interpreted those factors to encourage it to focus on six particular facets of any firm's role in the financial markets.[265] And finally, the council has only wielded its designation powers four times and has already rescinded one of those designations.[266]

None of this looks supports a narrative that the council is a roving commission of unconstrained apparatchiks.[267] The council has retained a

[259] *See* RAJ BHALA, THE WORLD TRADE ORGANIZATION xi (2006) (describing national treatment as one of four pillars of the WTO).

[260] *See supra* note 4 and accompanying text.

[261] *See id.*

[262] FSOC can only designate a company if it is "predominantly engaged in financial activities," which in turn requires that revenues from activities that are "financial in nature ... represents 85 percent or more of the consolidated annual gross revenues of the company." Dodd-Frank. § 101(a)(6).

[263] *See infra* part II.

[264] *See id.*

[265] *See id.*

[266] *See infra* part III.

[267] Unlike the National Industrial Recovery Act, which Justice Benjamin Cardozo famously describe as "delegation running riot," giving the President "a roving commission to inquire into evils and upon discovery correct them." Schechter Poultry Corp. v. United States, 301 U.S. 308, 321-22 (1937) (Cardozo, J., concurring).

degree of discretion, but when it comes to a matter of assessing the arbitrariness of agency actions, the council's discretion must be conceded to lie in narrow and cabined areas.

D. Implications for Policy

Ever since it first began to do business, the council has been on the receiving end of criticism from the financial industry worried about its regulatory power. Congress has indicated some receptivity to these concerns.[268] The council has faced threatened legislation that would undo much of its useful work in making the regulatory system safer; we think that the council's governing statute should not be amended.[269] This final part of the section contributes to the policy debate by explaining why the reforms proposed for the council are unlikely to contribute to the success of its mission, once the way it has been constructed is fully understood. Those more interested in the council as an example of regulation by threat may be less interested in our proposals here. It is the part of the article for those most interested in right-sizing the council. Our bottom line is that none of the reforms that have been proposed for the council look worth pursuing.

For example:

- There have been jurisdictional proposals. The Senate has considered increasing the asset threshold for automatic designation as a systemically important financial institution from 50 billion dollars to 500 billion dollars.[270]
- There have been a variety of procedural reforms proposed. Legislation introduced by the chair of the Senate Banking Committee would permit all of the members of various agencies that are part of the council to attend meetings (currently, it is only the chair who may attend), along with members of congressional oversight committees.[271] Also introduced have been procedural reforms for non-bank designation determinations. These would require more notice and comment

[268] *See infra* notes 270~~261~~-276~~267~~ and accompanying text.

[269] *See id.*

[270] Victoria McGrane & Ryan Tracy, *Sen. Shelby to Unveil Legislation Heightening Fed Security*, WALL STREET JOURNAL (May 11, 2015), http://www.wsj.com/articles/sen-shelby-to-unveil-legislation-heightening-fed-scrutiny-1431393248. This presumptive safe-harbor incorporated into State One's quantitative thresholds avoids the risk of gamesmanship that comes along with any formulaic rule by clearly erring on the side of over-inclusiveness: the vast majority of firms with assets in the range of $50 Billion are indeed too small to be systemically significant. Attempting to increase the threshold to match the actual asset levels of firms that have been designated to date would directly undermine this approach.

[271] *Id.*

about designation standards, and an entitlement by any institutions to a hearing before designation.[272] Targeted institutions would have additional opportunities to meet and confer with the council before designation.[273] The council would also have to give a targeted firm an opportunity to file a remedial plan addressing the concerns raised by the regulators.[274] That plan could be paired with action by the primary regulator of the targeted firm.[275]

- Finally, the international constraints on the council have been criticized. Some proposals would preclude the council and its members from operating internationally without first going through domestic notice and comment.[276]

The net effect of these rules would make it more difficult for the council to designate non-bank firms as systemically significant. They would represent an effort to tie the hands of the council in advance of future designations. They also would make those designations easier to challenge in court – more rulemaking requirements and more procedural requirements risk ossifying the council's processes, and create tripwires that aggressive courts could police harshly.[277]

We have already explained why this sort of precision is antithetical to the problems faced by the council. A systemic risk regulator must have the power to seek out new forms of risk in the financial system, and pinning the council down would stymie this purpose.[278] It would offer financial firms blank checks to take on risky activity, and increase the risk of a crisis – which, if it occurred, might impel the government to somehow arrange for a bailout of these firms.

International efforts, after all, can constrain domestic action, as we have seen. Much of what goes on at international institutions is a negotiation, and American representatives must have the ability to participate in those negotiations. Requirements that proposed international deals on other aspects of what the council does be published in the Federal Register is a needless layering on of notice and comment on top of notice and comment. Domestic regulators must and do bring international agreements back home

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[272] *Id.*

[273] *See id.*

[274] *See id.*

[275] *See id.*

[276] *Legislation Addressing International Insurance Standards Introduced in U.S. Congress*, MAYER BROWN NEWSLETTER (Mayer Brown), Aug. 7, 2015. https://www.mayerbrown.com/pt/publications/detailprint.aspx?publication=11593.

[277] For some of these concerns, see Thomas O. McGarity, *Some Thoughts on "Deossifying" the Rulemaking Process*, 41 DUKE L.J. 1385, 1403—07 (1992).

[278] *See infra* part III.

for notice and comment before implementing them – and the council has put plenty of rules through the notice and comment process.[279] And we have seen plenty of examples of cases where domestic notice and comment regularly changes the content of international agreements – the Fed's two-track implementation of the second version of the Basel capital accords is an example.[280] Few negotiation experts advise people to regularly make public disclosures of their goals and how they think the negotiations are going.[281]

Nor does it make sense to impose nakedly burdensome open government requirements on the council or its members; one of the useful lessons of the efforts to change the council's governing legislation is that they include a very large number of transparency measures that are obviously designed to slow regulation, rather than improve it. It is a corrective to those who believe that more sunshine is always better.[282]

Public observer access for stakeholders to working groups and committee meetings also limits the ability of negotiators to in fact negotiate – it risks creating the problems for international regulators that the well-intentioned Government in the Sunshine Act has created for domestic regulators such as the Securities and Exchange Commission, whose commissioners cannot meet privately to hash out their differences.[283] If, for example, every state insurance commissioner could attend a council meeting when insurance companies are being considered by designation, it is difficult to see how that adds value, given that a state insurance commissioner already attends meetings of the council as a non-voting member.[284] If every state commissioner attended, they would vastly outnumber everyone else in the room.

We therefore enter the policy debates by recommending against the

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[279] *See* David Zaring, *Sovereignty Mismatch and the New Administrative Law*, 91 WASH. U. L. REV. 59, 80–81 (2013); *see also* FEDERAL REGISTER, FINANCIAL STABILITY OVERSIGHT COUNCIL, https://www.federalregister.gov/agencies/financial-stability-oversight-council.

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[281] Kevin R. Schock, *Getting to Yes: Remembering Roger Fisher*, 5 Y.B. ON ARB. & MEDIATION 422, 434 (2013) (describing the limited reasons why a negotiator might want to disclose her bottom line).

[282] *The Ayes Have It*, THE ECONOMIST, Apr. 28, 2012, http://www.economist.com/node/21553484 (discussing a German political party with a transparency "fetish" that has made its "elected representatives… useless.").

[283] Jim Rossi, *Participation Run Amok: The Costs of Mass Participation for Deliberative Agency Decisionmaking*, 92 NW. U. L. REV. 173, 230 (1997) ("The Sunshine Act's requirements impair the ability of agency members to deliberate, adversely affect the establishment of agency agendas, and promote inefficient practices within agencies.").

[284] *See supra* notes 252~~249~~-254~~251~~ and accompanying text (describing the role and importance of state regulators).

legislative proposals designed to reign the council in, because reigning is not what the council needs – it needs discretion.

We are not unblinking apologists for the regulatory state. Although we defend the Council's discretion in the article, and the way it has exercised that discretion, we do not proffer it as the best of all possible government institutions. The fact that it is a committee of regulators obviously reflects compromises with the the path dependent realities of financial regulation as it existed before Dodd-Frank, rather than a perfect reimagining of those agencies.[285]

The problems do not end there. There is something to be said for the chairmanship of the Secretary of the Treasury – it makes the council more politically accountable.[286] But the secretary's role, as a politically appointed actor overseeing a technocratic exercise, does not come without costs.[287]

Moreover, all of the other voting council members are the chairs of their commissions, which means that means that they have all been appointed by the sitting president, and will all be members of his party. We could imagine a council that made room for different sorts of voices, perhaps by including voting roles for state officials, or a somewhat broader composition, without making every member of every financial regulatory board a voting member of the council. Votes that include different political perspectives may be more likely to create better, or at least more broadly palatable, policies, but the council as currently constituted does not offer this sort of diversity.[288]

These changes, however, would affect the *structure* of the council and

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[285] The Treasury Department released a report in 2008 calling for a total reorganization of the regulatory field. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 1 (2009), available at http:// online.wsj.com/public/resources/documents/finregfinal06172009.pdf.

Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009).

[286] See infra part ????

[287] As a former Comptroller of the Currency recently observed, "In prior decades, Congress, as a matter of public policy, had been deeply wary of giving this kind of authority to a Treasury Secretary, a member of the President's Cabinet whose position is inherently political in nature." Eugene A. Ludwig, *Assessment of Dodd-Frank Financial Regulatory Reform: Strengths, Challenges, and Opportunities for A Stronger Regulatory System*, 29 YALE J. ON REG. 181, 195 (2012).

[288] The benefits of diverse groups of policymakers, after all, is behind the requirement that agency boards include members from different parties. Moreover, Cass Sunstein and Thomas Miles have argued that "there is more reason to trust the outcomes of mixed panels than the outcomes of unified panels" in administrative law cases, whether at the agency or judicial level." Cass R. Sunstein & Thomas J. Miles, *Depoliticizing Administrative Law*, 58 DUKE L.J. 2193, 2229 (2009)

not its decision-making *process* or its *discretion*, both of which we defend.

V. THE THREAT: THE CURIOUS INTERNATIONALISM OF THE FEDERAL RESERVE

This section of the paper considers one of the threats that the Council must wield – the threat of supervision by the Fed. In the wake of the crisis, that supervision has become increasingly international, in both content and origin. On the other hand, the Fed sometimes ignores international commitments when it makes policy. Its unique approach to regulation has worried nonbank financial institutions and the regulators whom it can displace. We do not consider every aspect of the Fed's style of supervision here, but we can consider a case study relevant to this conference – the Fed's post-crisis international policies.

A. The Fed As Global Collaborator

The sort of work done by the Fed in the wake of the crisis exemplifies the new commitment to the possibilities of international regulatory efforts, along with more of a commitment to transparency and political oversight in enacting those efforts. In particular, it has redoubled its efforts to work on improved capital and other regulatory standards through the Basel Committee, and supported the effort to empower a new, and more politically responsive overseer for the committee, the Financial Stability Board (FSB).

In short, the Fed has continued to practice cosmopolitanism when it comes to financial regulation, and it has done so in ways that have worried recent congresses, who worry that American financial regulation has been outsourced to its international counterparts. Both members of the House and Senate have introduced legislation that would forbid American financial regulators from setting regulatory standards through an international process.[289] Despite this, the Fed has continued to rely on Basel and the FSB to set the standards for safety and soundness that it applies to American banks.

In our view, the way that financial regulation has evolved after the crisis has underscores how international it has become. The Fed had supported efforts to encourage international standards for financial companies that it oversees partly because it is difficult to see how it could enact a coherent

[289] Victoria McGrane & Ryan Tracy, *Sen. Shelby to Unveil Legislation Heightening Fed Security*, WALL STREET JOURNAL (May 11, 2015), http://www.wsj.com/articles/sen-shelby-to-unveil-legislation-heightening-fed-scrutiny-1431393248.

regulatory program without doing so.

As Fed board member Lael Brainard has observed, cooperation is now "under way internationally across the major financial jurisdictions and the international standard-setting bodies under the umbrella of the Financial Stability Board (FSB)"[290] Little is omitted from the purview of these international efforts, and the Fed has participated in all of them. Even Fed critics like Peter Wallison have admitted that there are reasons for "close collaboration between the Federal Reserve and the FSB."[291]

The way that the FSB and Basel Committee have taken the lead on the regulation of banks and other financial firms in the wake of the financial crisis illustrates how international the Fed's perspective has become.

The FSB, unlike Basel, was not all but created by the Fed. Instead the G-20 – the annual meeting of the heads of state and finance ministers of 20 of the world's largest economies – produced the institution. The G-20 did so by transforming a relatively quiet old international initiative, the Financial Stability Forum, into a vigorous 'network of networks,' that has become the G-20's coordinator and conduit for transmitting its policies to the networks of financial regulators like the Basel Committee and those created in Basel's image.[292]

The FSB is comprised of all of the principal financial regulatory networks, principally the Basel Committee, along with the securities market and insurance company regulators.[293] The G-20 also added two important treaty-based international organizations to the FSB's membership – the World Bank and IMF.[294] These institutions were not added to augment the legitimacy or legality of the FSB, however; they have been added to make it a more threatening enforcer of international financial regulatory norms, and a more far-seeing lookout for future financial crises.

As a reviewer and supervisor of financial regulatory networks, and as an international institution designated to take the gestalt perspective on global finance, it is fair to say that there is nothing quite like the FSB. It exemplifies the desire of regulators to create a new international system with a coherent organizational chart, and a degree of political supervision by the G-20.

The FSB has tried to pursue its monitoring function through cajoling

[290] https://www.federalreserve.gov/newsevents/speech/brainard20141203a.htm#f9

[291] http://www.banking.senate.gov/public/_cache/files/7aa7a014-6aac-4f94-a1e9-d842552e0a95/23C6AE00CC53D93492511CC744028B5E.wallisontestimony78150.pdf

[292] As Chris Brummer has explained, the FSB has evolved into one of the fulcrums of post-crisis financial oversight and "given a mandate to monitor global financial stability and promote medium-term reform." Brummer, *Post-American Securities Regulation*, 98 CAL. L. REV. 327 (2010), at 359-60.

[293] *See id.*

[294] *See id.*

and peer review, bolstered by the institutionalized financial sector reviews performed by the IMF.[295] Once its members pass rules that the FSB, or the networks under it, have adopted, presumably for their prospect of promoting financial stability, the Board conducts regular reviews of both the membership, on a country-by-country basis, and on particular issues for all the FSB members at once.[296] Peer review requires the members of the board to report on their implementation progress to the Board, and also benefits from the parallel and related IMF regulatory supervision review process, the FSAP.[297] Its mandate also provides for the ability to review 'the policy development work of the international standard-setting bodies to ensure that their work is timely coordinated, focused on priorities and addressing gaps,' and while it rides herd over the standard-setting bodies, it also is charged with 'assessing vulnerabilities affecting the global financial system' which requires it to review the work of its member states.[298] But the Board has suggested that it may, on occasion, pursue those goals by promulgating its own rules.

The Basel Committee, which, as we have seen, the Fed helped to found, has in the aftermath of the financial crisis (though this process began before it as well) hypertrophied into a number of committees concerned with many of the most important aspects of banking supervision; operating out of Basel is, in addition to Basel itself, is the Committee on Payment and Settlement Systems, a Committee on the Global Financial System (CGFS), and a governing body for these three committees. The CGFS is designed to monitor financial stability and, as the Basel Committee puts it, "support[] central banks in the fulfillment of their missions of monetary and financial

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[295] For more about peer review, ??? and accompanying text.

[296] It also has conducted peer reviews on particular members, including for example, in February 2011 Spain and Italy. The FSB claims other objectives as well. Its first article declares that it is supposed to 'coordinate at the international level of the work of national financial authorities and international standard-setting bodies' and declares in that article that the Board will "address vulnerabilities affecting financial systems in the interest of global financial stability" but these objectives seem to be quite closely related to those already expressed.

[297] *See* Int'l Monetary Fund, *Integrating Stability Assessments Under the Financial Sector Assessment Program into Article IV Surveillance* 23-24 (2010), *http://www.imf.org/extemal/np/pp/eng/2010/082710.pdf*. As Sean Hagan has explained, "for the past 10 years the Fund has conducted a periodic detailed analysis of individual members' financial systems, referred to as the Financial Sector Assessment Program (FSAP). These assessments are conducted on a voluntary basis and, accordingly, are a technical service provided by the Fund." Hagan, Enhancing the IMF's Regulatory Authority, 13 J. INT'L ECON. L. 955 (2010), at 959. For a supportive analysis, see Brummer, 'How International Financial Law Works (and How It Doesn't)', 99 *Geo. L.J.* (2011) 257, at 327.

[298] Article 2(1)(a).

stability.[299] Basel has also introduced a governing body, the GHOS, or Governors and Heads of Supervision, which is comprised of the central bankers and heads of supervision of the committee members who, in theory, provide the political oversight check on the otherwise technocratic efforts of the work of the committee itself.[300]

Basel itself has published an increasing number of principles, all of which it has opened for comment; it is this embrace of administrative proceduralism that has characterized the committee as much as has its redoubled efforts in the wake of the financial crisis. It has adopted notice and comment for all of its most important efforts.[301] The committee has also published speeches, agendas, white papers, and other documents on its website.[302]

The Basel Committee's principal effort since the financial crisis, however, has been the revision of the Capital Adequacy Accord, now known as the Basel III Accord.[303] Basel III returned to the approach of the first capital accord, where supervisors set hard standards for banks, and moved away from the use of the internal risk models of banks emphasized by Basel II. It also introduced a complicated array of quantitative measures of bank balance sheets, and required banks to meet the standards of each of them to be considered well-capitalized. It raised capital requirements, introduced a leverage ratio to serve as an alternative to the risk-based capital measure, and added a short-term liquidity coverage ratio and a longer term structural net stable funding ratio requirement.[304]

All of these standards are quite elaborate, and substantially impact the bottom line of the banks subject to them.[305] As we have seen, intertwined

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[299] *http://www.bis.org/publ/arpdf/ar2011e7.pdf*.

[300] As the Basel Committee has described the group, "The Group of Central Bank Governors and Heads of Supervision is the governing body of the Basel Committee and is comprised of central bank governors and (non-central bank) heads of supervision from member countries. The Committee's Secretariat is based at the Bank for International Settlements in Basel, Switzerland." *http://www.bis.org/press/p100912.htm*.

[301] For example, it took comments for its June 2011 *Principles Of Operational Risk Management*. *http://www.bis.org/publ/bcbs195.pdf*. Similarly, its July 2011 *Disclosure Standards For Remuneration* built on a consultative document and comments also announced in December 2010. *http://www.bis.org/press/p110701.htm*. While it would be inaccurate to characterize these principles as particularly specific, it is the case that they represent finer grained incursions into the practice of banking supervision.

[302] www.bis.org/bcbs.htm.

[303] Kenneth Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581 (2010), at 627-628 ('Since the subject is capital adequacy regulation, an amendment to the Basel agreements will be required.')

[304] For a summary of the requirements of the lengthy Basel III document, see King, *Basel III: An Overview*, BANKING & FIN. SERVICES POL'Y REP. (2011) , at 1.

[305] For other discussions of Basel III, see Coffee, *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795 (2011), at 843.

with these substantive efforts to coordinate the global regulation of finance has been a developing agenda making improvements in the procedures followed in international financial regulation. After becoming established as the principal mechanism for coordinating global financial regulation, reform of international financial regulation focused on imposing procedural regularity and political oversight on a process that did not used to feature either.

The Fed has pushed for much of this reform, somewhat ironically, because it is hardly the American agency most identifiable with regularized administrative procedure.[306]

It is at this point in our story that some modest qualifications must be introduced. Although the through line of the Fed's global regulatory policy has been to engage in collaboration, it has not always consistently embraced the practice. It was slow to implement the second iteration of the Basel Accord for its smaller banks – to the consternation of the other members of the Basel Committee.[307] It also has both pursued global financial standards in the wake of the crisis, and created a means by which it can apply its own standards to foreign banks doing substantial business in the US. Moreover, foreign banks doing business in the US have failed the Fed's stress tests of their crisis resiliency, but American banks have not, worrying some that a double standard has been applied.[308] There have even been cases where the double standard has arguably gone the other way, in favor of the foreign banks.[309] This record suggests that Fed

[306] David Zaring, *Law and Custom on the Federal Open Market Committee*, 78 L. & CONTEMP. PROBS. 158 (2015).

[307] As Pierre Verdier has explained, "U.S. regulators announced in 2003 that, contrary to previous expectations, they would only apply Basel II to a small number of internationally active banks…. In 2007, U.S. regulators … announced that the advanced Basel II approaches would apply to large, international 'core' banks." Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT'L L. 113 (2009).

[308] In June 2016, the Fed announced "that…Germany's Deutsche Bank and Spain's Santander had failed an annual stress test, citing weaknesses in their capital planning and risk management." AFP, *Deutsche Bank, Santander Fail US Fed Stress Test*, DAILY MAIL (June 29, 2016), http://www.dailymail.co.uk/wires/afp/article-3666756/Deutsche-Bank-Santander-fail-US-Fed-stress-test.html. This was Santander's third consecutive year failing the Fed's stress test, and Deutsche Bank's second. *Id.* To be sure, however, foreign banks are not currently subject to tests as intensive as performed on U.S. banks, at least not yet. Nathanial Popper & Michael Corkery, *Nearly All U.S. Banks Pass Fed's Stress Test*, N.Y. TIMES (June 29, 2016), http://www.nytimes.com/2016/06/30/business/dealbook/nearly-all-us-banks-pass-feds-stress-test.html?_r=0.

[309] It is not entirely clear how the equities would work, but in October 2015, the Fed

cosmopolitanism is not unmitigated, and that, as we would expect, national interest does not get disregarded, even when it comes to matters of regulatory cooperation. It is a caveat worth remembering in the service of the nuanced picture of foreign relations that this article has presented.

The Fed's treatment of foreign financial holding companies (or FHC, a term meant to stand for, roughly, financial conglomerates engaged in a number of financial activities, including, potentially, commercial banking, investment banking, insurance, and so on) that owned American bank holding companies (or BHC, roughly, companies that own a number of banks) illustrates the way that the Fed can depart from international practice. Before the financial crisis, the Fed decided that in certain cases "a U.S. BHC that is owned and controlled by a foreign bank that is an FHC that the Board has determined to be well-capitalized and well-managed will not be required to comply with the Board's capital adequacy guidelines."[310]

In December 2012, the Fed decided to change course, and proposed a rule to "require foreign banking organizations with a significant U.S. presence to create an intermediate holding company over their U.S. subsidiaries," that would be subject to US capital requirements.[311] Foreign regulators protested,[312] and foreign bankers argued that the requirements

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proposed a rule to implementing the total loss absorbing capacity requirements adopted by the multinational Financial Stability Board, http://www.fsb.org/2015/11/tlac-press-release/, that appears to require less of the largest domestic institutions than it does of the largest foreign ones. Press Release, Bd. of Governors of the Fed. Res. (Oct. 30, 2015), http://www.federalreserve.gov/newsevents/press/bcreg/20151030a.htm. Namely, domestic large banks "would be required to hold at a minimum: [a] long-term debt amount of the greater of 6 percent plus its GSIB surcharge of risk-weighted assets and 4.5 percent of total leverage exposure; and [a] TLAC amount of the greater of 18 percent of risk-weighted assets and 9.5 percent of total leverage exposure," while foreign large banks "generally would be required to hold at a minimum: [a] long-term debt amount of the greater of 7 percent of risk-weighted assets and 3 percent of total leverage exposure and 4 percent of average total consolidated assets; and [a] TLAC amount of the greater of 16 percent of risk-weighted assets and 6 percent of total leverage exposure and 8 percent of average total consolidated assets." *Id.*

310 Fed. Res. Ltr. SR 01-1 (Jan. 5, 2001), https://www.federalreserve.gov/boarddocs/srletters/2001/sr0101.htm.

311 Press Release, Bd. of Governors of the Fed. Res. (Dec. 14, 2012), http://www.federalreserve.gov/newsevents/press/bcreg/20121214a.htm.

312 For example, then-European internal markets commissioner Michel Barnier wrote a lengthy letter to Fed Chairman Ben Bernanke, requesting "a globally-coordinated response to regulation, criticising [*sic*] US unilateral regulation, and demanding that the US come forward with final rules to implement the Basel III reforms." *In Full: Barnier's Letter to Bernanke*, FINANCIAL NEWS (Apr. 23, 2013), http://www.efinancialnews.com/story/2013-04-23/barnier-letter-to-bernanke-on-regulation; *see also UK and Germany Join Warnings of US's Bank Proposals*, FINANCIAL TIMES (Apr. 29, 2013), https://www.ft.com/content/2c92e3d6-b0f1-

would change the supposedly level playing field that harmonized banking regulation is supposed to create by, as the *New York Times* put it creating an environment where "American banks are not required to lock up capital at their American operations, like the Europeans will have to" or suffer the restructuring expenses "that the Europeans will most likely have to bear."[313]

The Fed, nonetheless finalized the rule in February 2014, maintaining the intermediate holding company requirement for foreign banks.[314]

This evolution, both procedural and substantive, make for a compelling story about a global regulatory enterprise with few peers. Elsewhere, one of us has traced the emergence of a legal-ish system of oversight of the global financial system, which looks to be one of the principal accomplishments of international governance of the modern era.[315] It is one that has developed through regulation, rather than through more traditional mechanisms of public international law.[316]

B. The Fed As America Firster

The domestic political consequences of the Fed's unconventional policies have been stark. Most Republicans now viewed Ben Bernanke not as one of their own, but as an inflationary "dove" who had gone to the dark side. As had the bailouts before them, the Fed's unconventional monetary policies inflamed public opinion against them.

But opinions against the Fed weren't limited to domestic political opponents. Foreign central bankers—usually part of the close network we have described earlier in this article—came out in criticism of the Fed's quantitative easing in direct, nationalistic terms. These criticisms came in

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11e2-9f24-00144feabdc0?siteedition=intl. (warning the Fed that warned the Fed that the proposed rule "would cause significant disruption to many foreign banks and fuel a further fragmentation of global banking and its regulation").

[313] Peter Eavis, *Exporting U.S. Rules for Foreign Banks*, N.Y. TIMES (Jan. 22, 2014), http://dealbook.nytimes.com/2014/01/22/exporting-u-s-rules-for-foreign-banks/?_r=0. Michael Kemmer of the Association of German Banks stated: "'This is a considerable competitive handicap for European banks, as their U.S. competitors aren't subject to any equivalent requirements in the EU.'" Geoffrey Smith, Ryan Tracy & Stephanie Armour, *Fed, European Banks Face Off on New Rule*, WALL STREET JOURNAL (Feb. 19, 2014), http://www.wsj.com/articles/SB10001424052702303636404579393342680443 15.

[314] Press Release, Bd. of Governors of the Fed. Res. (Feb. 18, 2014), https://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm.

[315] David Zaring, *Finding Legal Principle in Global Financial Regulation*, 52 VA. J. INT'L L. 683 (2012).

[316] *Id.*

two flavors: first, that the Fed was engaged in "currency wars" through quantitative easing, since these unconventional policies had the consequence of depreciating the U.S. dollar at the expense of export-oriented economies. Second, that there were significant spillovers in the use of quantitative easing that could and would have dramatically bad consequences for the economic wellbeing of other countries.

First, the "currency wars." The idea suggests a beggar-thy-neighbor kind of unilateral policy whereby a government artificially manipulates the value of its currency to support its export-oriented industries. When the currency is weaker—that is, when the market perception of the currency suggests that it doesn't hold value as well—then the currencies of trading partners are in turn stronger. That means that foreign currencies can buy more goods from the exporting country: good news if your economy is primarily an exporter, bad news for the importer.

In 2010, Brazilian finance minister Guido Mantega responded to the latest round of quantitative easing with hostility: "We're in the midst of an international currency war," he said, with reference not only to the Fed but also other major foreign central banks that had engaged in similar policies. Given how squarely accusations against other countries—China, for example, is a perennial target—the accusation that the Fed is engaging in a currency war is a strong suggestion of a muscular, nationalistic foreign policy.

Interestingly, former Fed Chair Ben Bernanke effectively demurs on the question. In a lecture before the International Monetary Fund, Bernanke did not deny that "monetary easing usually leads to a weaker currency and thus greater trade competitiveness," including in the U.S. But he pointed to the empirical evidence that suggests that such devaluation is offset by the increase in domestic income, "which in turn raises home demand for foreign goods and services."[317] Bernanke's point is that he wasn't convinced that there had been an asymmetric devaluation of the currency, but even if there had been he was comfortable with the fact that "along with economic conditions in our respective countries, our perceived interests began to diverge." Bernanke felt no obligation to consider the international consequences of domestic policies: his was a statutory mandate to focus on U.S. domestic macroeconomic indicators.

The second critique was even more substantive, and Bernanke's response even more quasi-nationalistic. Reserve Bank of India Governor Raghuram Rajan had regularly insisted that quantitative easing and other unconventional monetary policies were damaging emerging markets, and that the Fed should consider those consequences in making monetary

[317] Bernanke, Mundell-Fleming lecture, November 2015.

policies. "At what point does the domestic mandate get trumped by international responsibility? ... If it never gets trumped, then let's stop talking about international responsibility," Rajan complained.[318]

To this, Bernanke strongly took issue:

> monetary and exchange-rate policies should focus on macroeconomic objectives, with the problem of spillovers being tackled by regulatory and macroprudential measures, possibly including targeted capital controls, and through careful sequencing of market reforms. Financial regulation and supervision are areas in which the Fed and other central banks should cooperate (and to an important extent already do) to reduce financial risks.

The point is, while coordination and cooperation should take place in regulatory matters, monetary policy was a different beast.

Is Bernanke right? Should central banks stick to their own nationalistic knitting? Or should they engage in greater coordination with their counterparts to ensure better global harmony of monetary policy? These questions aren't easily and permanently answerable. But they are deeply intertwined with the country's foreign relations with its allies. The decision to coordinate policy or not is not made in the White House, and it is not made in Congress. It is made at the Federal Reserve.

Quantitative easing did not only irritate our foreign compatriots; it also has arguably worked at cross-purposes with the Treasury Department's efforts to reduce the national debt, or at least so a paper co-authored by Lawrence Summers, a former Treasury Secretary, has argued.[319] The program was designed to reduce the length of time investors had to hold securities while the

Treasury Department was, in constrast, operating "a kind of reverse quantitative easing, replacing money-like short-term debt with longer-term debt."[320]

Investors mused about the inconsistencies; during a 2010 meeting of the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association, "a member asked … whether the Fed and the Treasury were working at cross purposes, given that Treasury [was] extending the average maturity of the portfolio while the Fed [was]

[318] http://www.marketwatch.com/story/rajan-accuses-rich-countries-of-flouting-currency-manipulation-rules-2015-04-16

[319] Robin Greenwood, Samuel G. Hanson, Joshua S. Rudolph, & Lawrence H. Summers, Government Debt Management at the Zero Lower Bound 18-19, (Hutchins Ctr. on Fiscal & Monetary Pol'y at Brookings, Working Paper No. 5, 2014), https://www.brookings.edu/wp-content/uploads/2016/06/30_government_debt_management_zlb.pdf. at 2.

[320] *Id.*

expected to purchase longer-dated securities."[321] In response, "[i]t was pointed out by members that the Fed and the Treasury are independent institutions, with two different mandates that might sometimes appear to be in conflict. Members agreed that Treasury should adhere to its mandate of assuring the lowest cost of borrowing over time, regardless of the Fed's monetary policy."[322]

It is a tension that is ever present, but difficult to solve. As Summers and his co-authors have observed, "[t]o the extent that the Federal Reserve and Treasury ever publicly mention the other institution's mandate, it is usually in the context of avoiding the perception that one institution might be helping the other achieve an objective. Specifically, the Fed does not want to be seen as monetizing deficits, while the Treasury has been reluctant to acknowledge the Fed as anything more than a large investor."[323]

To consider how remarkable the Fed's unilateral foreign policy is in this discussion, consider how deeply political—and diplomatic—is the question of currency manipulation when the target of the accusation isn't the United States by, say, China. The Chinese have faced the accusation for decades, from both sides of the U.S. political scene. The Bush Administration faced steep criticism from Democrats, principally New York Democratic Senator Chuck Schumer, urging the Administration to rebuke China for manipulating the currency. And accusations against China's currency have animated Donald Trump's presidential campaign from the beginning.

Importantly, though, even as these issues find uneasy resolution in our relationship with China, that process is squarely within the purview of Congress and the Administration. It fits the classic mode of thinking about foreign affairs. The Fed is different. When the U.S. is the target of these accusations, politicians can conveniently dodge the issue by displacing these policies to the Federal Reserve. Doing so is not merely a question of autonomous monetary authority. It becomes one of the Fed's semi-autonomous foreign relations.

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[321] Press Release, Department of the Treasury, Minutes of the Meeting of the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association (Nov. 3, 2010), https://www.treasury.gov/press-center/press-releases/Pages/tg942.aspx.

[322] *Id.*

[323] Robin Greenwood, Samuel G. Hanson, Joshua S. Rudolph, & Lawrence H. Summers, Government Debt Management at the Zero Lower Bound 18-19, (Hutchins Ctr. on Fiscal & Monetary Pol'y at Brookings, Working Paper No. 5, 2014), https://www.brookings.edu/wp-content/uploads/2016/06/30_government_debt_management_zlb.pdf. at 3.