

## FSOC Proposed Rulemaking on Fed Supervision of Nonbank Financial Companies: Critics Submit Comments and Ask Who is Speaking on Behalf of the Insurance Industry

March 7, 2011

Recent notices of proposed rulemaking published by the Financial Stability Oversight Council (FSOC) and the Board of Governors of the Federal Reserve System (Board) to advance the regulatory process of implementing Section 113 of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) have raised questions among members of Congress, state regulators and the insurance industry. In particular, there is a concern about the development and imposition of new standards that would apply to certain insurers and subject them to Board supervision without sufficient input from the insurance industry and its regulators.

The FSOC issued an advanced notice of proposed rulemaking on October 6, 2010, seeking public comments on the development of specific criteria and a regulatory framework by which it will consider designating nonbank financial companies for supervision. The FSOC reviewed the 50 comment letters submitted, many from insurers and their trade associations, and, on January 18, 2011, released the notice of proposed rulemaking (NPR). The NPR outlines the criteria that will inform, and the process and procedures established under the Dodd-Frank Act for, the FSOC's designation of certain United States and foreign nonbank financial companies, which are defined to include insurers, to be supervised by the Board.<sup>1</sup> The FSOC can require such Board supervision if it determines that the material financial distress at a particular firm, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities at the firm, could pose a threat to the financial stability of the United States.<sup>2</sup> Public comments to the recent NPR from the FSOC identify shortcomings and potential flaws with the FSOC's proposed framework and the lack of transparency in the process of developing the framework. The comment period ended February 25, 2011.

Comment letters submitted by several insurance industry associations including, for example, the American Council of Life Insurers (ACLI) and the Reinsurance Association of America, cite two broad criticisms of the NPR. First, the comment letters submitted by the members of the insurance industry echo the concern expressed by some members of Congress in recent weeks that two positions on the FSOC reserved for individuals who have insurance expertise remain vacant and ask for these positions to be filled before the FSOC moves forward with any regulation that could impact the insurance industry.<sup>3</sup> In addition, the sole insurance-related designee currently serving as a member of the FSOC, Missouri Insurance Director John Huff, appears to have been marginalized by the other members of the FSOC. Huff is a nonvoting member of the FSOC who was selected through the National Association of Insurance

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<sup>1</sup> 76 Fed. Reg. 4555 (Jan. 26, 2011). Click [here](#) to be directed to the FSOC's request for comments. For a summary of the proposed rule, please see "The Financial Stability Oversight Council Takes Action: New Insight into Determination of Which Insurers May be Subject to Enhanced Oversight" (Feb. 18, 2011) ([Dodd-Frank Legal Alert](#)).

<sup>2</sup> For a chart summarizing the key provisions and regulatory rulemakings of Title I, please click [here](#).

<sup>3</sup> The insurance expert who will be a voting member of the FSOC is still to be appointed by President Obama and confirmed by the U.S. Senate. In addition, the Director of the Federal Insurance Office who will advise the FSOC as a nonvoting member has not been appointed by the Secretary of the Department of the Treasury (Treasury).

Commissioners (NAIC) to serve as the state insurance representative. However, the NAIC in a recent letter claimed that Treasury has taken a position, which is inconsistent with Congressional intent, that Huff represents the Missouri state insurance department only and not the state insurance regulatory system as a whole. Moreover, the NAIC states that Huff's attempts to consult with insurance regulators from other states and NAIC resources have been met with resistance and delay from the FSOC, and the FSOC will not permit him to engage the state regulators on a confidential basis.<sup>4</sup>

The second broad criticism of the NPR, which was raised in many of the comment letters, is that the standards that the FSOC intends to use to evaluate nonbank financial companies under Section 113 are too vague to provide guidance or certainty, and there is no indication of how the standards will be applied across different industries. In particular, the NPR provides only a loose framework that restates the statutory language but does not provide objective standards. While recognizing that the FSOC needs to maintain flexibility, some of the comment letters cite the need for clarity with respect to the metrics that the FSOC will use in determining whether certain nonbank financial companies will be subject to Board supervision and the methodology to apply those metrics across different industries. The failure of the FSOC to identify specific standards and criteria in the NPR is of particular concern to insurers and their regulators because of the current insufficient representation of the insurance industry on the FSOC.

In addition to the broad concerns identified in the comment letters discussed above, several of the comment letters offer specific suggestions regarding the framework that the FSOC proposes in the NPR. The most common critique is that the size of a firm is not an appropriate metric and does not itself create systemic risk. Rather, size is only important if the firm is engaged in certain interconnected activities that may result in systemic risk. While citing the need for more quantitative metrics, these comment letters urge that the FSOC not unduly rely on specific size thresholds, but rather concentrate on how nonbank financial companies are interconnected to the broader financial markets as well as characteristics such as leverage and risk profiles.

Many of the public comment letters expressed a negative reaction to the NPR. In particular, firms filing comment letters advocate for the FSOC to adopt more specific criteria, to develop a more transparent framework for applying the criteria to particular industries and industry sectors, and to allow for a more thorough public comment process on all aspects of the framework. A few comment letters have raised the possibility that the FSOC may violate due process if it implements a rule containing specific criteria on which the public has not had an opportunity to comment. For example, the ACLI comment letter takes issue with the analytical framework that is articulated in the NPR release but is not included in the rule itself. Other comment letters suggest that the NPR violates a recently announced Executive Order because, among other things, the proposed rule does not promote predictability, competitiveness or economic growth and does not reduce uncertainty.<sup>5</sup> For example, one comment letter from a law firm representing many large nonbank financial service companies claims that the NPR is entirely defective and should be withdrawn because the FSOC does not have the authority to promulgate the rule and, even if such authority had been delegated to the FSOC, the FSOC has not appropriately allowed for a meaningful public comment process or provided any guidance to potentially regulated companies.

The FSOC has not publicly announced the next steps it will take with respect to the NPR or the date of its next meeting. The comment letters that were filed offer a range of ideas from

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<sup>4</sup> [Letter](#) from the NAIC to Treasury Secretary Timothy Geithner dated Feb. 9, 2011.

<sup>5</sup> [Executive Order](#) dated January 18, 2011, "Improving Regulation and Regulatory Review."

extending the comment period on the NPR for an additional 30 days to providing additional clarification on specific criteria for public comment to immediately withdrawing the NPR.

In a related rulemaking, the Board released a notice of proposed rulemaking on February 8, 2011, that provides some of the definitions needed for the FSOC to make its determinations under Section 113, including the regulations that outline the criteria for “*predominantly engaged in financial activities*” and the definitions of “*significant nonbank financial company*” and “*significant bank holding company*” for purposes of Title I of the Dodd-Frank Act.<sup>6</sup> The comment period closes on March 30, 2011.

Please contact one of the Sutherland attorneys listed below if you would like more information about these or other Dodd-Frank Act proposed rulemakings. We will continue to monitor the implementation of the Dodd-Frank Act and will keep you updated on key events.



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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<sup>6</sup> 76 Fed. Reg. 7731 (Feb. 11, 2011) Click [here](#) to be directed to the Board’s request for comments.