

FSOC Proposed Rulemaking on Fed Supervision of Nonbank Financial Companies: Congress Questions Transparency

May 23, 2011

For insurers following the latest developments with respect to the Financial Stability Oversight Council (FSOC) and the designation of nonbank financial companies subject to additional oversight pursuant to Section 113 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), a House Financial Services Subcommittee hearing provided some interesting insights into the next steps in the process. In particular, the FSOC has drawn increased scrutiny from Congress, including at the recent hearing, and criticism from the insurance industry with respect to transparency in developing the applicable criteria, lack of insurance industry input during the process, and ongoing debate on the appropriate number of companies which should be subject to heightened supervision. The Senate Banking Committee also held a less colorful hearing on the FSOC's systemic risk monitoring on May 12, 2011. We anticipate that the next meeting of the FSOC, possibly scheduled before the end of May, will reflect a response to some of the criticisms from Congress.

Background

The FSOC is developing specific criteria and a regulatory framework by which it will consider designating nonbank financial companies for supervision by the Board of Governors of the Federal Reserve System (Board). On January 18, 2011, the FSOC released a notice of proposed rulemaking (NPR) outlining 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.¹ Pursuant to the NPR, 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. Public comments to the NPR identified shortcomings with the FSOC's proposed framework and the lack of transparency in the process of developing the framework.

The concerns identified in the public comments, including those expressed by certain insurers and insurance industry associations, served as part of the backdrop for the hearing regarding oversight of the FSOC held by the House Financial Services Oversight and Investigations Subcommittee on April 14, 2011.²

¹ 76 Fed. Reg. 4555 (Jan. 26, 2011). The NPR was preceded by an advanced notice of proposed rulemaking issued on October 6, 2010. For a summary of the advanced notice of proposed rulemaking and the NPR, 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](#)). For a more comprehensive analysis of the public comments and reaction to the NPR, please see "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) ([Dodd-Frank Legal Alert](#)).

² Click [here](#) for a list of witnesses, links to testimony and an archived recording of the hearing.

House Hearing on the FSOC Operations and Progress

At the hearing, Republicans and Democrats criticized the FSOC for not providing financial firms that potentially face new oversight with a meaningful opportunity to provide feedback. Jeffrey A. Goldstein, Undersecretary for Domestic Finance at the U.S. Department of Treasury, testified that the final rule will offer more clarity and that he expected the final rule to be issued soon, although he declined to say whether specific metrics would be set forth in the final rule. Lawmakers on both sides of the aisle expressed disappointment with respect to the FSOC's timeline and approach, noting that the NPR simply restates the language and risk factors set forth in the Dodd-Frank Act without providing any specific information or quantitative standards that would help the public understand how the FSOC will apply the framework to its decisions. As several subcommittee members pointed out, firms that might become subject to additional regulation and oversight as a result of the rule would not have a chance to comment on the specific criteria the FSOC will use to designate a systemically significant firm for Board supervision. Subcommittee members were also disappointed to learn that the FSOC has discussed more specific criteria regarding thresholds for designation, but has not released this information for public comment.

Subcommittee members also cited the lack of coordination among FSOC's member agencies as an area that needs improvement. In his opening remarks, Rep. Randy Neugebauer (R-TX.), chairman of the Oversight and Investigations Subcommittee, chastised the member agencies for failing to abide by the statutory duty to facilitate coordination among member agencies regarding policy development and rulemaking. As an example of the lack of communication, Rep. Neugebauer, along with other subcommittee members, specifically pointed to discrepancies between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) rules regarding swaps.

Bipartisan criticism was also directed at the inadequate representation of the insurance industry on the FSOC. Specifically, subcommittee members cited the absence of a voting member with experience in the insurance industry. President Obama has yet to appoint anyone to that role. Michael McRaith, Director of the Illinois Department of Insurance, has been appointed to serve as head of the Federal Insurance Office and thus will be a non-voting member of the FSOC. However, he does not take that position until June. In addition, subcommittee members, such as Reps. Mike Fitzpatrick (R-PA) and Barney Frank (D-MA), noted that John Huff, Director of the Missouri Department of Insurance and member of the FSOC, has not been permitted to seek the counsel of other state regulators of insurance, and that inability was compromising his effectiveness as a representative of the insurance industry on the FSOC. Other FSOC representatives, such as Mr. Goldstein, cited confidentiality concerns as the reasoning for preventing Mr. Huff from using outside resources. Ultimately, the other FSOC representatives at the hearing said that they would work with Mr. Huff to ensure that he has all of the necessary resources available to him. It remains unclear, however, if he will be permitted to engage other state regulators as part of the process.

Following on the heels of the Subcommittee hearing, the Chairman (Rep. Neugebauer) and the Ranking Member (Rep. Michael Capuano) of the Subcommittee submitted a letter (Subcommittee Letter) to the members of the FSOC calling on them to resubmit the NPR for another round of notice and comment.³

³ Click [here](#) for a copy of the May 4, 2011, letter.

How Many Firms Will Be “Tagged”?

The question of the initial number of firms that should be subject to Board supervision has recently been debated among some agencies represented on the FSOC and was a topic at the hearing. A couple of weeks prior to the hearing, Board Governor Daniel K. Tarullo suggested that only a small number of firms will initially be designated as systemically significant by the FSOC and subject to heightened supervision.⁴ At the hearing, CFTC Chairman Gary Gensler agreed, commenting that the FSOC's initial list should be a short one. Sources indicate that the Federal Deposit Insurance Corporation (FDIC) favors a broader approach that would include many insurers, hedge fund managers and asset managers.⁵ Rep. Capuano (D-MA) cautioned that although he agreed the first group of firms designated as nonbank financial companies subject to Board supervision should be relatively small, there should be a larger private list of perhaps 200 or more firms that might attempt to evade designation by manipulating whatever system the FSOC puts in place. Such a secondary list would provide the FSOC with meaningful background information in the event that one of those firms becomes subject to designation in the future, and the ability to monitor the potential need for such designation.

Senate Banking Committee Hearing

On May 12, 2011, the Senate Committee on Banking, Housing and Urban Affairs held a hearing to discuss the implementation of the Dodd-Frank Act. Witnesses included Neal S. Wolin, Deputy Secretary of the U.S. Department of the Treasury; Ben S. Bernanke, Chairman of the Board; Sheila Bair, Chairman of the FDIC; Mary Schapiro, Chairman of the SEC; Gary Gensler, Chairman of the CFTC; and John Walsh, Acting Comptroller of the Currency.

Several topics relevant to the FSOC's role in reducing systemic risk were addressed at the hearing. In contrast to the vague responses given by the witnesses at the House Financial Services Subcommittee hearing in April, the witnesses at the Senate committee hearing agreed that the public deserved and will be given an opportunity to comment on more specific metrics that the FSOC will use in determining which nonbank financial companies will be subject to Board supervision pursuant to Section 113 of the Dodd-Frank Act. Chairman Bernanke noted that although the public would be able to comment on more specific criteria, the FSOC would not provide a formula for designation but rather would have the latitude to exercise reasonable judgment on a case-by-case basis. FSOC representatives also state that the case-by-case designation means that FSOC cannot guarantee that any particular industry will be excluded from designation for Board supervision. During the Senate hearing, there was little-to-no focus on the specific insurance-related issues that were discussed during the House Subcommittee hearing. The witnesses did not specify whether the public would be permitted to comment on a new notice of proposed rulemaking or on guidance, nor did any of them provide a timeline for the release of additional information regarding designation of nonbank financial companies.

During the Senate committee hearing, Chairman Bernanke also informed the committee members that the Board has been developing the prudential standards that will be applied to certain large banks and nonbank financial companies designated by the FSOC for Board supervision. He expects the Board

⁴ 96 BBR 619, April 5, 2011.

⁵ “Regulators Divided on Systemic Risk,” *Financial Times*, April 4, 2011.

to release related proposed rules for public comment this summer, in anticipation of meeting the January 2012 implementation deadline for the enhanced standards.

Possible Next Steps

Public comments have suggested that the FSOC will hold its next meeting later this month. The timeline for the release of the final rule relating to designation of nonbank financial companies subject to Board supervision remains unclear. After the Senate hearing, it is also unclear whether, as requested under the Subcommittee Letter, an additional period for industry comments will be opened. Mr. Goldstein had predicted during the Subcommittee hearing that the final rule would be issued relatively soon; however, several committee members cautioned that the FSOC should reconsider the approach it has taken with respect to the rule and indicated that there would be additional hearings to discuss the FSOC's progress and level of transparency.

Additional Developments Related to the Federal Regulation of Insurance

Living Will Rule Proposed. In related rulemaking news, the Board and the FDIC recently issued a joint notice of proposed rulemaking that would implement the requirements of Section 165(d) of the Dodd-Frank Act by requiring systemically significant bank holding companies and nonbank financial companies designated by the FSOC for Board supervision to submit annual resolution plans and quarterly credit exposure reports.⁶ The annual resolution plan would require companies to (i) describe the plan for an orderly resolution and how the plan fits into the overall corporate governance structure of the company, and (ii) provide a list and description of all significant interconnections and interdependencies among major business lines and operations of the company that could materially affect funding or operations of the company. Developing such a roadmap for dissolution, or "living will," will involve considerable expenditures of time and money. Quarterly credit exposure reports would describe the nature and extent of a company's credit exposure to other large financial companies. Comments are due by June 10, 2011.

Formation of a Federal Advisory Committee on Insurance. Using its powers granted under the Federal Advisory Committee Act, the Treasury Department has determined to establish a Federal Advisory Committee on Insurance (FACI).⁷ The purpose of the FACI is to provide advice and recommendations to the Federal Insurance Office to assist it with its discharge of responsibilities under the Dodd-Frank Act. The Treasury Department indicates that there is no other available resource of the federal government that can perform this role.

The FACI will be comprised of not more than 15 members, and the members will serve a two-year term. Appointments to the FACI will be made with the objective of reflecting a variety of backgrounds and viewpoints (e.g., regulators, academics, consumers, industry experts, agents and brokers) as well as a broad spectrum of the insurance industry (e.g., life insurance, property and casualty, reinsurance). The proposal calls for the FACI to meet regularly, and often publicly, with a stated goal of meeting four times per year. Candidates to serve on the FACI must submit their applications no later than May 31, 2011.

⁶ 76 Fed. Reg. 22648 (April 22, 2011). Click [here](#) to be directed to the joint request for comments.

⁷ Federal Advisory Committee on Insurance, 76 Fed. Reg. 28129 (May 13, 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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