May 4, 2023

Financial Stability Oversight Council Proposes a New Process for Determining Nonbank Supervision by the Fed

Section 113 of the Dodd-Frank Act authorizes the Financial Stability Oversight Council (the "Council") to subject a "nonbank financial company" to supervision by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), including the Federal Reserve's prudential standards. The definition of a nonbank financial company in Section 102(a)(4) of the Dodd-Frank Act includes all registered investment companies, business development companies and registered investment advisers.[1]

To designate a nonbank financial company for Federal Reserve supervision, the Council must consider ten specific but non-exhaustive considerations under Section 113 and conclude either that (i) "material financial distress" at the nonbank financial company or (ii) "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of the nonbank financial company "could pose a threat to the financial stability of the United States." These are the Section 113 tests.

On April 21, 2023, the Council published a release (the "Release") containing proposed interpretive guidance (the "Proposed Guidance") regarding the process the Council would employ to determine whether a nonbank financial company should be designated as subject to the Federal Reserve's supervision.

Concurrent with the Release, the Council issued another release, titled *Analytic Framework for Financial Stability Risk Identification, Assessment, and Response*, for public comment (the "Proposed Analytic Framework") that explains the approach the Council expects to take to identify, evaluate and address potential risks to U.S. financial stability.

Overview

If adopted in its current form, the Proposed Guidance would replace existing interpretive guidance, adopted in 2019 (the "2019 Guidance"), regarding the designation process applicable to nonbank financial companies under Section 113.[2] Accordingly, much of the Release is dedicated to highlighting the "key changes" that the Proposed Guidance would make to the 2019 Guidance. In brief, the Proposed Guidance would:

- Eliminate a statement in the 2019 Interpretive Guidance to the effect that the Council would first rely on existing regulators – called an "activities-based approach" – before the Council would begin to consider a nonbank financial company for potential designation under Section 113 of the Dodd-Frank Act.
- Eliminate language in the 2019 Guidance stating that the Council will conduct a cost-benefit analysis and an assessment of the likelihood of a firm's material financial distress prior to making a designation under Section 113.

The Proposed Guidance is limited to the Council's procedures (instead of describing how substantive analyses are made) employed in nonbank financial company designations under Section 113 of the Dodd-Frank Act. The Council is concurrently proposing for public comment the Proposed Analytic Framework and, therefore, the Proposed Guidance would rescind the portion of the 2019 Guidance describing the Council's analytic approach to evaluating nonbank financial companies. The Proposed Analytic Framework, if adopted in its current form, would largely confirm that the Council's evaluations of nonbank financial companies under Section 113 are likely to be firm-specific analyses.

Process for Nonbank Financial Company Designations

The Proposed Guidance describes a detailed two-stage process that the Council would employ when evaluating a nonbank financial company under Section 113 of the Dodd-Frank Act.

Stage 1. In the first stage ("Stage 1"), a nonbank financial company under review would be notified and subject to a preliminary analysis, based on quantitative and qualitative information available to the Council primarily through public and regulatory sources and evaluated under the Proposed Analytic Framework. In Stage 1, the Council will permit, but not require, the company to submit relevant information. As required under Section 113, the Council will consult with the relevant primary financial regulatory agency and "will actively solicit the regulator's views regarding risks at the company and potential mitigants or aggravating factors."

- The Council would share with the regulator its preliminary views regarding potential risks at the company and request, among other things, that the regulator provide information about the extent to which the risks are adequately mitigated by existing regulation or the company's business practices.
- Throughout the determination process, the Council would encourage the regulator to address any risks to U.S. financial stability using the regulator's existing authorities. If the Council believes the regulator's or the company's actions have adequately addressed the potential risks that the Council identified, the Council may terminate its review of the company.

Based on the preliminary evaluation in Stage 1, the Council would vote whether to commence a more detailed analysis of the company by advancing the company to the next stage. If the Council votes not to advance the company to the next stage, the Council will notify the company in writing of the Council's decision.

Stage 2. The second stage ("Stage 2") involves an in-depth evaluation of a nonbank financial company to determine whether the nonbank financial company meets either of the two Section 113 tests. Any nonbank financial company that is selected for additional review would receive notice that it is being considered for a proposed designation for supervision by the Federal Reserve (a "Proposed Designation") and that the company will be subject to in-depth evaluation in Stage 2. Stage 2 would also include the evaluation of information provided by the nonbank financial company.

The Proposed Guidance additionally notes that:

- The Council would make staff members available to meet with the representatives of any company that enters Stage 2 to explain the evaluation process and the framework for the Council's analysis. In addition, the Council's staff would grant a request to meet with a company in Stage 2 to permit the company to present any information or arguments it deems relevant to the Council's evaluation; and
- Before making a Proposed Designation regarding a nonbank financial company, the Council would notify the company when the Council believes that the evidentiary record regarding the company is complete. At any point, the Council also would notify any nonbank financial company in Stage 2 if the company ceases to be considered for a determination.

At the conclusion of Stage 2, the Council would consider whether to make a Proposed Designation. Following an affirmative Proposed Designation, the Council would issue a written notice of the Proposed Designation to the nonbank financial company, including an explanation of the basis of the Proposed Designation.

Hearing. A nonbank financial company that is subject to a Proposed Designation may request a nonpublic hearing to contest the Proposed Designation in accordance with Section 113(e) of the Dodd-Frank Act.

Final Designation. After making a Proposed Designation and holding any requested hearing, the Council may make a "Final Designation" that the company will be subject to supervision by the Federal Reserve. If the Council makes a Final Designation, it would provide the company with a written notice of the Final Designation, including an explanation of the basis for the Council's decision.

Recourse to Federal Court. Consistent with Section 113(h) of the Dodd-Frank Act, a nonbank financial company that is subject to a Final Designation may bring an action in a U.S. district court for an order requiring that the Council's

designation be rescinded. Section 113(h) further provides that the court's review of such an action "shall be limited to whether the [Final Designation] made . . . was arbitrary and capricious."

The Proposed Guidance – Important Changes to the 2019 Guidance

As noted above, much of the Release is devoted to describing the key changes that the Proposed Guidance would make to the 2019 Guidance. These changes are described below.

1. Elimination of the Activities-Based Approach and Reliance on Primary Financial Regulators

The 2019 Guidance provides that the Council will:

- Prioritize its efforts to identify and address potential risks and threats to U.S. financial stability beginning with an activities-based approach, and will pursue entity-specific determinations under Section 113 of the Dodd-Frank Act only if a potential risk or threat cannot be adequately addressed through an activities-based approach; and
- Consider a nonbank financial company for a potential determination under Section 113 only in rare instances.

The 2019 Guidance additionally states that this approach is intended to reflect two priorities:

- Identifying and addressing, in consultation with relevant financial regulatory agencies, potential risks and threats on a system-wide basis and to reduce the potential for competitive distortions that could arise from entity-specific determinations; and
- Allowing relevant financial regulatory agencies, which generally possess greater information and expertise, to address potential risks, rather than subjecting the companies to new regulatory authorities.

The Release describes an activities-based approach for nonbank financial companies as an approach in which the Council seeks to address potential risks to financial stability using authority other than Section 113.The Proposed Guidance would reject the activities-based approach to prioritize the Council's efforts to identify and address potential risks and threats, clarifying that the Council may use any of its statutory authorities to address risks and threats to U.S. financial stability.

The Proposed Guidance also would rescind the portion of the 2019 Guidance stating that the Council would evaluate a company for designation only if a company's primary financial regulatory agency did not adequately address a potential risk identified by the Council. Instead, the Proposed Guidance explains the process by which the Council would preliminarily identify and assess potential risks to U.S. financial stability using the analytical methods described in the Proposed Analytic Framework.

2. Elimination of a Cost-Benefit Analysis

The 2019 Guidance states that (i) the Council will make a designation under Section 113 only if the expected benefits to financial stability justify the expected costs that the designation would impose and (ii) as part of this analysis, the Council will assess the likelihood of a firm's material financial distress to assess the extent to which a designation may promote financial stability.

The Proposed Guidance does not include cost-benefit language. The Release notes that the Dodd-Frank Act does not require a cost-benefit analysis prior to the designation of a nonbank financial company under Section 113. Instead, the statute instructs the Council to designate a nonbank financial company according to either of two tests. While Section 113 lists ten required considerations *(e.g.*, the extent of the leverage of the company), the costs and benefits of a designation are not listed considerations in the statute and are not similar to any of the listed considerations.

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With respect to the likelihood determination within the 2019 Guidance, the Release notes that Section 113's first designation standard – material financial distress at the nonbank financial company – does not require the Council to first analyze the likelihood of a company experiencing material financial distress before determining whether such distress could threaten U.S. financial stability.

As to the second designation standard, *i.e.*, relying on ten considerations used to determine whether the company is a threat to financial stability, the Release notes that Section 113's designation authority is prophylactic and is intended to "respond to emerging threats to the stability of the United States financial system." Therefore, requiring the Council to wait until there is a reasonable likelihood of a company's failure would negate the Council's designation authority.

3. Rescinding the 2019 Guidance Description of the Council's Analytic Approach

The 2019 Guidance discussed substantive analytic factors the Council applies in its assessment of nonbank financial companies under Section 113.The Proposed Guidance is instead limited to the Council's procedures regarding nonbank financial company designations, while the Proposed Analytic Framework describes the Council's approach and types of substantive analyses for identifying and evaluating potential risks to U.S. financial stability.

The Proposed Analytic Framework and Nonbank Companies

The Proposed Analytic Framework describes the substantive analytic approach that the Council will employ with respect to a nonbank financial company only in broad terms. Specifically, the portion of the Proposed Analytic Framework devoted to such companies merely states:

> The Dodd-Frank Act requires the Council to consider 10 specific considerations, such as the company's leverage, relationships with other significant financial companies, and existing regulation by primary financial regulatory agencies, when determining whether a nonbank financial company satisfies either of the determination standards. Due to the unique threat that each nonbank financial company could pose to U.S. financial stability and the nature of the inquiry required by the statutory considerations set forth in section 113, the Council expects that its evaluations of nonbank financial companies under section 113 will be firm-specific and may include an assessment of quantitative and qualitative information that the Council deems relevant to a particular nonbank financial company.(Footnote omitted).

The Proposed Analytic Framework does not contain any additional information regarding the analytic approach that the Council would employ with respect to nonbank financial companies.s

The ten specific considerations the Council must include in a Final Designation of a nonbank financial company appear in Section 113(b) of the Dodd-Frank Act and are reproduced in the Appendix to this Alert. Section 113(b) also permits the Council to include "any other risk-related factors that the Council deems appropriate" in its analysis of whether a nonbank financial company should be designated for supervision by the Federal Reserve.

Observations

The Proposed Guidance would reverse the changes made during the Trump Administration to the Section 113 nonbank financial company designation process. In her remarks that accompanied publication of the Release, Secretary of the Treasury Yellen said:

> We are proposing revisions to certain elements of the Council's existing guidance that have made it difficult to use its nonbank designation authority. The existing guidance – issued in 2019 – created inappropriate hurdles as part of the designation process. These additional steps are not legally required by the Dodd-Frank Act. Nor are they useful or feasible. . . . It has been estimated that a designation process with these steps could take six years to complete. That is an unrealistic timeline that could prevent the Council from acting to address an emerging risk to financial stability before it's too late.

SEC Chair Gensler, who has a seat on the Council, released a public statement in connection with the Release's publication in which he stated:

> I'm pleased to support today's recommendation, which would reinvigorate this Council's designation process – in line with Congress's vision for our work.
>
> As important as today's step is, I believe each of our agencies have important roles within our respective authorities to enhance the resiliency of the financial system. At the SEC, we're working along with fellow Council members to do just that – enhancing the resiliency of the U.S. Treasury markets, money market funds, open-end funds, private funds, clearinghouses, dealers, and with regard to cybersecurity. We also adopted a rule to shorten the settlement cycle in securities markets in half.(Emphasis added).

Despite Chair Gensler's endorsement, the SEC's timeline for action with respect to its December 2021 release, *Money Market Fund Reforms* (discussed in this Ropes & Gray Alert), remains unknown.[3] Whether he believes that regulations enhancing the resiliency of SEC registrants should come exclusively from the SEC – as the emphasized portion in his statement above may suggest – is only speculation.

Based on the public comments submitted in response to the SEC's November 2022 proposals to overhaul open-end funds' liquidity framework and to require mandatory swing pricing for all open-end funds except money market funds and ETFs (discussed in this Ropes & Gray Alert), there appears to be considerable aversion to those proposals within the industry, especially to the costs associated with those proposals if adopted. Whether there is any interplay between the various proposals is unknown.

While the Proposed Guidance would reverse the changes made during the Trump Administration, it is impossible to predict whether the Proposed Guidance merely reflects a reassertion of Council authority or additionally indicates that the Council would act in the near future regardless of the outcome of the SEC's proposals. The substance of supervision by the Federal Reserve for registered funds (which could start with money market funds), private funds and investment advisers, at least for the time being, remains to be seen.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

1. Specifically, a "nonbank financial company" is defined to include any "U.S. nonbank financial company." In turn, a U.S. nonbank financial company is "a company . . . registered with the [Securities and Exchange] Commission" that is incorporated or organized under the laws of the U.S or any state and predominantly engaged in financial activities. *See* 12 C.F.R. § 242 Appendix A ("Financial Activities for Purposes of Title I of the Dodd-Frank Act")]." The Release states that the Council "intends to interpret the term 'company' to include any corporation, limited liability company, partnership, business trust, association, or similar organization."
2. In 2012, the Council issued a final rule at 12 C.F.R. § 1310.1-23 (the "2012 Rule") setting forth certain procedures related to designations under Section 113. Attached to the 2012 Rule as Appendix A was interpretive guidance (the "2012 Guidance") setting forth additional information regarding how the Council makes determinations under Section 113. In 2019, the Council replaced the 2012 Interpretive Guidance with the 2019 Guidance. The Proposed Guidance would replace the 2019 Guidance found at Appendix A but would not modify the 2012 Rule, as amended.
3. Similarly, the SEC's timeline for its February 2022 proposed cybersecurity risk management rules for investment advisers and registered funds (discussed in this Ropes & Gray Alert) is unknown, although the comment period for the cybersecurity risk management rules was recently reopened until May 22, 2023.

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