CLEARY GOTTLIEB

ALERT MEMORANDUM

FSOC Proposes Changes to SIFI Designation Process

March 11, 2019

On March 6, 2019, the Financial Stability Oversight Council ("FSOC") issued new proposed guidance (the "Proposal") regarding the designation of nonbank financial companies as "systemically important financial institutions" ("SIFIs").[1] The Proposal makes substantial changes to FSOC's existing designation approach by shifting its focus away from an "entity-based" approach towards an "activities-based" approach. Designation of an individual firm would only occur if FSOC determined that efforts to address the financial stability risks of that firm's activities by the primary federal and state regulators have been insufficient.

In summary, the Proposal:

— Requires FSOC to focus in the first instance on regulating activities that pose systemic risk, through actions by primary regulators, rather than designations of individual firms.

— Shortens the designation process by removing the first stage from the three-stage process.

— Invites participation from firms under consideration for designation beginning in the first stage of the designation process to provide greater transparency and opportunity for engagement.

— Requires a cost-benefit analysis prior to making a designation, which must include an analysis of the likelihood of the potential systemic impact actually occurring.

— Clarifies the "off-ramp" process for designated firms.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

WASHINGTON D.C.

Derek M. Bush
T: +1 202 974 1526
dbush@cgsh.com

Katherine M. Carroll
T: +1 202 974 1584
kcarroll@cgsh.com

Michael H. Krimminger
T: +1 202 974 1720
mkrimminger@cgsh.com

Patrick Fuller
T: +1 202 974 1534
pfuller@cgsh.com

NEW YORK

Hugh C. Conroy, Jr.
T: +1 212 225 2828
hconroy@cgsh.com

BRUSSELS

Allison H. Breault
T: +32 2 287 2129
abreault@cgsh.com

[1] Financial Stability Oversight Council, https://home.treasury.gov/system/files/261/Notice-of-Proposed-Interpretive-Guidance.pdf (Mar. 6, 2019).

clearygottlieb.com

© Cleary Gottlieb Steen & Hamilton LLP, 2019. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

The SIFI designation process has been controversial since its inception, with critics arguing for greater transparency and accountability, and also more focus on addressing risky activities rather than potentially distorting the market by singling out individual firms. All four of the previously designated firms have had their designations removed – MetLife won its court battle over designation in 2016, GE Capital was de-designated that year following a restructuring, and AIG and Prudential were removed in 2017 and 2018, respectively.

The changes in the Proposal are consistent with those suggested by the Treasury Department in November 2017 in response to a Presidential Memorandum urging a reevaluation of FSOC's designation process. The Treasury Department identified five goals that guided its review and recommendations: leverage the expertise of primary financial regulatory agencies, promote market discipline, maintain a level playing field among firms, tailor regulations to minimize burdens, and ensure the designation process is rigorous, clear and transparent.

Activities-Based Approach

— Under the "activities-based" approach, FSOC would examine "a diverse range of financial products, activities and practices" ("Activities"), many of which FSOC typically identifies in its annual reports, to identify those that pose risks to financial stability.

— Examples of the types of Activities FSOC will evaluate include those related to the extension of credit, market making practices and trading, and other activities critical to the functioning of financial markets. The Proposal cites examples of potentially relevant risks from FSOC's 2018 annual report, including cybersecurity risk, concentration of risk in central counterparties, and the transition away from LIBOR, among others.

— If FSOC identifies an Activity that poses a potential risk to U.S. financial stability, meaning a risk that could impair financial intermediation or financial markets such that it inflicts "significant damage" on the broader economy, FSOC will collaborate with the appropriate primary financial regulator to address the issue.

— If the primary financial regulator fails to take adequate action, FSOC may issue a public, nonbinding recommendation under Section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act that the regulator apply heightened standards and safeguards to the firms under its jurisdiction to address the risks caused by the Activities. Generally, the regulator must follow the recommendations unless it provides a reason as to why it will not.

SIFI Designation Process

— FSOC will only pursue a designation if another primary financial regulator does not, or cannot, properly address the risk.

— To streamline the determination process, the Proposal reduces the process from three-stages to two, by cutting out the first stage where FSOC applied quantitative thresholds to a large sampling of financial entities to decide if any merited further evaluation.

— The Proposal would similarly abandon the six quantitative thresholds FSOC had relied on in the first stage, although the statutorily required considerations for designations that informed the thresholds still apply during the new two-stage review process.

— The proposed two-stage process is similar to the second and third stages of FSOC's current review process.

— During the first proposed stage, FSOC will use information from public and regulatory sources to evaluate a firm and collaborate with the firm's primary financial regulator, as appropriate. The firm is welcome to participate in the first stage, although it is not required to provide any information in order to "reduce the burdens of review on the company."

— If FSOC determines during the first stage that a company warrants further investigation, FSOC

will conduct a more in-depth review of the company in the second stage. During the second stage, FSOC would continue to consult with relevant financial regulators and would engage directly with the company, including making information requests.

— Although a company is only required to engage with FSOC in the second stage, the Proposal encourages firm involvement at every stage, with the possibility that a company may avoid designation if it adequately addresses the risks identified by FSOC during the review.

Cost-Benefit Analysis

— The Proposal restricts FSOC from making a designation unless the expected benefits justify the expected costs. Currently, FSOC is not required to undertake a cost-benefit analysis.

— The new calculation would consider the quantifiable and non-quantifiable benefits and costs to the firm, the U.S. financial system and the broader U.S. economy. It would require that FSOC's analysis reflect the likelihood that the identified risk will be realized.

Takeaways

Adoption of the activities-based approach, together with the fact that there are no longer any designated firms, raise questions about the scope of FSOC's role going forward. While FSOC still has the statutory authority to designate nonbank SIFIs, such designations appear highly unlikely in the short to medium term. The Proposal emphasizes FSOC's role as a coordinating agency, and that may be its primary function with SIFI designations apparently becoming a tool of last resort.

…

CLEARY GOTTLIEB