THE FINANCIAL SERVICES ROUNDTABLE

Via E-Mail

April 30, 2012

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies

File Number: FR Doc. 2011-33364

Dear Ms. Johnson:

The Financial Services Roundtable[1] ("The Roundtable") and the Securities Industry and Financial Markets Association[2] ("SIFMA") welcome the opportunity to provide the Board of Governors of the Federal Reserve System (the "Board") with comments on the proposed rules[3] (the "Proposed Rules") implementing section 165 and section 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Roundtable and SIFMA are submitting comments jointly with The Clearing House Association L.L.C. ("The Clearing House"), and the American Bankers Association (the "ABA") on various aspects of the Proposed Rules as they relate

1 The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

2 SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

3 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012).

to "covered companies" generally.[4] In this letter, we offer additional comments on various aspects of the Proposed Rules as they relate specifically to nonbank financial companies ("NFCs") potentially subject to designation by the Financial Stability Oversight Council (the "Council") under section 113 of the Dodd-Frank Act.

Executive Summary

The Proposed Rules purport to implement the enhanced prudential standards provisions of section 165 of the Dodd-Frank Act and the early remediation provisions of section 166 of the Dodd-Frank Act applicable to bank holding companies with total consolidated assets of $50 billion or more ("BHCs") and NFCs that are designated by the Council. The text of the Proposed Rules as well as statements in the preamble to the Proposed Rules indicate that the Board intends to apply the same standards and requirements to BHCs and NFCs designated by the Council.[5] The approach that the Board takes to NFCs in the Proposed Rules is bad policy, contrary to Congressional intent, and in direct conflict with the language of the Dodd-Frank Act. To correct these defects, the Board should exclude NFCs from the Proposed Rules and commence a separate rulemaking to establish a process for designing appropriate standards under section 165 and section 166 for any designated NFCs.

The Board's approach in the Proposed Rules with respect to the application of enhanced standards to NFCs is deficient as a matter of policy. The *fundamental* differences in the capital structures, risk profiles, and activities of NFCs as compared to BHCs, as well as the diversity among NFCs themselves make the Board's "one-size-fits-all" approach ill-conceived, unworkable, and ineffective. In its recently promulgated final rule[6] (the "Final Designation Rule"), the Council itself recognized that a one-size-fits-all approach to the designation of NFCs is flawed as a policy matter. Acknowledging the "unique nature of the threat"[7] each designated NFC could pose to U.S. financial stability, the Council in the Final Designation Rule recognized that its analysis regarding the designation of particular NFCs would need to be tailored to that NFC's particular characteristics. It is thus surprising, and indeed disconcerting, that the Board takes the opposite approach to its application of enhanced standards to NFCs.

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[4] *See* Letter from The Clearing House, the ABA, The Roundtable, and SIFMA, to the Board (April 27, 2012) ("Joint Trade Letter").

[5] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 597.

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

[7] *Id.* at 21,646.

The historical record clearly indicates that the Board's proposed approach is inconsistent with the policy analysis that Congress undertook prior to the enactment of the Dodd-Frank Act. In 2009, when Congress and the Executive Branch evaluated various options for the reform of the financial system in the wake of the crisis, the U.S. Treasury Department in its white paper *Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation*,[8] proposed that all large financial companies should be regulated as if they were bank holding companies. The Treasury Department seemed to believe that the optimal path for reform would be to subject systemically important NFCs to the same bank-centric prudential regulatory framework that the Board applied to large, complex bank holding companies. This view is the same as that expressed by the Board in the text of the Proposed Rules in that the Board proposes to apply the same set of bank-centric enhanced standards to both NFCs and BHCs.

As clearly evidenced by the legislative history and the text of Title I, Congress *rejected* this approach and instead chose to enact a carefully crafted Title I framework that is intended to achieve the optimal policy outcome: the development of a set of enhanced standards that would be *tailored* to any NFC designated by the Council. This intent is clearly evidenced *inter alia* by section 115(b)(3), which contemplates that the Council will make recommendations to the Board as to the development of tailored standards for NFCs, and section 165(b)(3), which *requires* that the Board take into account differences between NFCs and BHCs when developing enhanced standards for NFCs. Congress thus required the Board not to treat NFCs as if they were bank holding companies.

Despite the abundant evidence in the legislative history and the structure and text of Title I, both the Board in the Proposed Rules and the Council in the Final Designation Rule disregard this Congressional intent. In the Proposed Rules, the Board has chosen to ignore the long list of factors that it is required to consider under section 165 and instead has simply decided to treat NFCs as if they were bank holding companies. In the Final Designation Rule, the Council has chosen to ignore the authority that Congress gave the Council not just to identify the threat presented by a designated NFC, but also to recommend standards that the Board should apply to the NFC to mitigate the threat. The Council in the preamble to the Final Designation Rule indicates that it "does not generally intend to make company-specific regulatory recommendations to the Board" regarding the application of enhanced standards to NFCs.[9] This abdication of

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[8] *See* U.S. Dep't. of the Treasury, *Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation* (June 2009), *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

[9] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, *supra* note 6, at 21,647.

responsibility by the Council places even greater responsibility on the Board to tailor its application of the enhanced standards to the capital structure, risk profile, and activities of any designated NFCs.

Designation is not an end, it is a means to an end. Designation of an NFC does not reduce the threat that the NFC might present; careful design of a prudential regime by the Board based on recommendations from the Council is necessary to mitigate the threat. Both the Board and the Council would abdicate their responsibilities with the approaches they seem to propose. It is inconceivable that the Council would designate an NFC without considering how the threat it identified would be mitigated by the standards to be applied by the Board and what it would mean for the NFC and the financial system. It is likewise inconceivable that the Board would propose to apply bank-centric standards reflexively to the diverse range of NFCs.[10] Congress has provided clear directions that the prudential standards applicable to NFCs must be tailored to reflect their varying business models, structures and risk profiles. The Council and the Board must comply with those directions.

Considered together, (i) the Council's assertion that it generally will designate NFCs without recommending company-specific prudential standards to the Board; (ii) the Board's proposal to treat NFCs as if they were bank holding companies; and (iii) the failure by the Council and the Board to conduct any cost-benefit analysis regarding the designation of NFCs or the imposition of bank standards on their nonbank businesses raise serious concerns about the continued viability of designated NFCs and the adverse collateral impacts that these actions will have on the financial system and the real economy. Ironically, the Council and Board could create the result that they were seeking to avoid by designating an NFC in the first place. Treating one or more large NFCs as if they were bank holding companies could create financial distress at the very companies that the Council has determined could threaten U.S. financial stability if they experienced financial distress. When implementing an authority such as this one that is intended to impact the financial system, it is incumbent upon the Board to take a more reasoned, thoughtful and measured approach – one that is consistent with sound policy, seeks to maximize benefits and minimize costs, and follows Congressional instructions clearly provided in the Dodd-Frank Act.

10 We note that in the preamble to the Proposed Rules, the Board has said that it *may* decide to tailor the application of the standards to different companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size and other risk-related factors. 77 Fed. Reg. at 597. This statement in the preamble, nonbinding as it is, appears to suggest that the Board has the discretion to decide whether to tailor the application of the standards to NFCs. As discussed below, we submit that the Board is *required* to tailor the application of the standards to NFCs. In any event, the Proposed Rules themselves apply the same prudential standards to NFCs and BHCs and in so doing expressly provide that an NFC shall be treated "as if it were a bank holding company." 77 Fed. Reg. at 645.

The Proposed Rules as applied to NFCs are also deficient as a matter of law. Specifically, the Proposed Rules are in direct conflict with the provisions of section 165(b)(3), which require the Board to take into account differences among NFCs and BHCs and to adapt the standards as appropriate to the predominant line of business of the NFC. Notwithstanding these clear directions in the statute, the Proposed Rules apply the same standards and requirements to NFCs and BHCs. The Proposed Rules fail to tailor the standards to the business models, capital structures or risk profiles of NFCs and instead apply standards, which the Board acknowledges were designed for BHCs, to both BHCs and NFCs.[11] Applying standards designed for BHCs to NFCs by default is inappropriate not only because it is in conflict with the language and intent of the statute, but also because applying standards that are not designed for the businesses or structures of the NFCs will necessarily result in ineffective and inefficient risk mitigation.[12]

To correct these basic defects in the Proposed Rules, the Board should exclude NFCs from the Proposed Rules and commence a separate rulemaking to establish a process for designing appropriate standards under sections 165 and 166 for any designated NFCs. The process established by this separate rulemaking should ensure that the Board's efforts to design appropriate standards for any designated NFCs are closely coordinated with the Council's designation process under section 113 to allow the Council to make recommendations to the Board with respect to the tailoring of the standards to NFCs, as specifically envisioned by section 115(b)(3) and section 165(b)(3)(C). The rulemaking should also formalize the consultation process between the Board and the Council members that supervise any functionally regulated subsidiaries or depository institution subsidiaries of the designated NFC as required by section 165(b)(4). To ensure appropriate coordination between the Council and the Board and effective implementation of section 113 and section 165, the Board should complete its separate rulemaking under section 165 prior to any designation of NFCs by the Council, but in no event later than the date on which the NFC must register with the Board pursuant to section 114 of the Dodd-Frank Act. An appropriate phase-in of the standards as tailored to NFCs through the separate rulemaking should also be provided based on an approach comparable to that adopted in any U.S. rulemaking process implementing Basel III, but with a minimum phase-in period for all standards of at least eight quarters.

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11 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 597 ("this proposal was largely developed with large, complex bank holding companies in mind").

12 *See* Daniel K. Tarullo, Governor, Board, *Remarks at the 2011 Credit Market Symposium: Regulating Systemic Risk* 4 (Mar. 31, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm ("treating financial firms of all sorts as banks could be both ineffective and inefficient") [hereinafter *Tarullo March 2011Remarks*].

I. Implementation Process for Sections 165 and 166

A. Separate Rulemaking for NFCs

Section 165(a)(1) provides that the Board, on its own or pursuant to recommendations from the Council under section 115, shall establish enhanced prudential standards for NFCs supervised by the Board and for BHCs. Section 165(a)(2) provides that in prescribing the enhanced standards, the Board may, on its own or pursuant to a recommendation from the Council under section 115, differentiate among companies on an individual basis or by category, taking into account various factors, including the financial activities of the company and its subsidiaries. Section 165(b)(3) further provides that in prescribing enhanced prudential standards, the Board *shall* take into account differences among NFCs supervised by the Board and BHCs, *shall* take into account recommendations from the Council under section 115, and *shall* adapt the standards as appropriate in light of the predominant line of business of the company. Section 165(b)(4) also provides that the Board *shall* consult with each Council member that supervises a functionally regulated subsidiary or a depository institution subsidiary of an NFC before imposing prudential standards or any other requirements pursuant to section 165 that are likely to have a significant impact on such subsidiary. Section 166 provides that the Board in consultation with the Council and the Federal Deposit Insurance Corporation (the "FDIC") shall prescribe regulations establishing requirements to provide for the early remediation of financial distress of an NFC supervised by the Board or a BHC.

The Proposed Rules are intended to implement the provisions of section 165 and section 166. However, notwithstanding the clear statutory directives to the contrary, the Proposed Rules apply the same standards and requirements to NFCs and BHCs. This is in direct conflict with the language of section 165 and the statutory intent that the standards should be tailored and adapted to reflect the differences between NFCs and BHCs. It also ignores the obvious differences between BHCs and the businesses and structures of most NFCs which underlie the statutory directives. The effect of the Proposed Rules would be to impose on NFCs, by default, rules that have been designed by the Board for BHCs, are inappropriate for most NFCs, and are likely to be both ineffective and inefficient in mitigating any threat to U.S. financial stability that an individual NFC may present.

In order to comply with the requirements of section 165, the Board should exclude NFCs from the Proposed Rules and commence a separate rulemaking to establish a process for tailoring the standards and requirements under section 165 and section 166 specifically for any designated NFC. In the separate rulemaking, the Board should clearly describe how it will take into account the differences among NFCs and BHCs, take into account recommendations from the Council under section 115, adapt the standards as appropriate in light of the predominant line of business of the NFC, as required by section 165(b)(3), and consult with individual Council members as required

by section 165(b)(4). The approach taken in the Proposed Rules satisfies none of these requirements. Moreover, to ensure appropriate coordination between the Council process under sections 113 and 115 and the Board process under section 165, the Board should complete its separate rulemaking for NFCs under section 165 and section 166 prior to any designation of an NFC by the Council.

Establishing a process for tailoring the standards and requirements applicable to NFCs in a separate rulemaking process will provide clarity to NFCs and the markets, allow the Board to demonstrate that it will engage in the consultation and tailoring for NFCs consistent with Congressional intent clearly reflected in the requirements of section 165, and allow the public to provide meaningful input on that process. A separate rulemaking approach is also consistent with the approach taken by the Board with respect to foreign banking organizations. As the Board notes in the preamble to the Proposed Rules, the Proposed Rules do not apply to foreign banking organizations that are otherwise subject to section 165.[13] Instead, the Board intends to issue a separate proposal to apply the standards and requirements of sections 165 and 166 to those foreign banking organizations. Like foreign banking organizations, NFCs present significantly different and more difficult issues than domestic BHCs. The Board must approach the process of designing and tailoring standards and requirements under sections 165 and 166 for NFCs with the same care and regard for differences in operations and regulatory regimes as the Board has shown for foreign banking organizations.

B. Consideration of Existing Regulatory Frameworks

As a preliminary matter, we believe that the process established by the Board as part of the separate rulemaking should account for and consider the utility of existing regulatory frameworks applicable to the NFC and its subsidiaries. In particular, the Board should refrain from applying enhanced standards to an NFC if the threat to U.S. financial stability that it presents can be more effectively or efficiently addressed through other means, such as an existing regulatory framework applicable to that NFC. In its notice of proposed rulemaking published on October 18, 2011[14] and in the preamble to the Final Designation Rule, the Council noted that the Dodd-Frank Act provides the Council with "numerous authorities and tools to carry out its statutory duty to monitor the financial stability of the United States."[15] As the Council further noted, in addition to designation authority under section 113, the Dodd-Frank Act provides the Council with

[13] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 595, 598.

[14] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64,264 (Oct. 18, 2011).

[15] *Id.* at 64,267; Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, *supra* note 6, at 21,639.

authority under section 120 to make formal recommendations to the primary financial regulatory agencies to apply new or heightened standards to BHCs and NFCs. Furthermore, section 165(b)(4) requires the Board to consult with each Council member that supervises a functionally regulated subsidiary or a depository institution subsidiary of an NFC before imposing prudential standards or any other requirements pursuant to section 165 that are likely to have a significant impact on such subsidiary.

The provisions of those sections clearly reflect a Congressional judgment that regulators should both consider responding to any threats that may be associated with a product or an activity conducted by NFCs by using existing regulatory regimes specifically designed for those products or activities or for the NFCs by their primary financial regulatory agencies and consider the impact of new regulations on the NFCs and the regulatory regimes that already apply to them. Governor Tarullo appears to have been referring to this general approach in his comments on regulating systemic risk when he observed that "prudential standards designed for regulation of bank-affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions"[16] and that "a more targeted, industry-wide response would be preferable"[17] for different forms of financial institutions. Governor Tarullo cited money market funds as an example of a financial institution for which prudential standards designed for banks might not be useful.[18] The corollary of these observations in the section 165 context is, as Governor Tarullo himself observed, that "treating financial firms of all sorts as banks could be both ineffective and inefficient."[19]

We agree with each of Governor Tarullo's observations and urge the Council and the Board to evaluate explicitly the potential for industry-wide approaches to the mitigation of threats to U.S. financial stability both when considering whether designation would be appropriate and when designing the regulatory approach to any designated NFCs. As discussed above, this risk mitigation could be achieved by the enhancement of existing regulatory frameworks applicable to NFCs. Such an approach would better address any threats to financial stability that may be presented by an industry sector and would avoid the problem identified by Governor Tarullo that the Board will otherwise be required to ignore fundamental differences between BHCs and NFCs as well as statutory requirements, or distort the bank regulatory regime beyond the

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[16] *Tarullo March 2011Remarks*, *supra* note 12, at 3.

[17] *Id.* at 4.

[18] *Id.* at 3. He noted, for example, that while money market funds engage in maturity transformation, unlike banks money market funds have essentially no leverage. *Id.* He also noted that the options for reform of money market funds identified by the President's Working Group on Financial Markets showed that bank-centric standards might not be the optimal form of regulation for such funds. *Id.*

[19] *Id.* at 4.

bounds of its utility and appropriate application in order to develop new capital and other prudential regimes for different segments of the U.S. financial system within the constructs of that regime.

C. <u>Tailoring of Enhanced Prudential Standards for NFCs and Coordination with the Designation Process</u>

A separate rulemaking to establish a process for tailoring the enhanced prudential standards for any designated NFCs is essential to ensure that the tailoring required by section 165 will be done at the appropriate time and with the appropriate input from the Council, its individual members and ultimately the public. In the preamble to the Proposed Rules, the Board itself notes the provisions of section 165 that provide for such tailoring. As the Board notes in the preamble to the Proposed Rules, the Board has the authority, on its own or in response to a recommendation from the Council, "to tailor the application of the enhanced standards to different companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size and other risk-based factors that the Board deems appropriate."[20] As the Board further notes in the preamble, this authority is "particularly important in applying enhanced standards to specific [NFCs] designated by the Council that are organized and operated differently from banking organizations."[21] As the Board also notes in the preamble, "the types of business models, capital structures, and risk profiles of companies that would be subject to designation by the Council could vary significantly."[22] As the Board further notes in the preamble, in applying enhanced standards under section 165(b)(3), it is required to take into account differences among BHCs and NFCs.[23] Finally, as the Board notes in the preamble, it is also required as appropriate to "adapt the required standards in light of any predominant line of business of a nonbank financial company for which *particular standards may not be appropriate*."[24]

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[20] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 597.

[21] *Id.*

[22] *Id.*

[23] *Id.* at 596.

[24] *Id.*, n. 13 (emphasis added).

Each of these provisions in section 165 is essential to the effective and appropriate implementation of the Dodd-Frank Act regime for any NFC designated by the Council. Applying bank-centric rules to an NFC without the required coordination with the Council and its individual members and without due regard for the existing regulatory regimes that apply to the NFC not only would be inappropriate and inefficient because it would add rather than refine regulations and fail to leverage existing regimes and expertise, it would also be counterproductive by increasing homogeneity in the financial services industry and correlation among the risk management techniques across financial services sectors. Experts and regulators alike have identified increased homogeneity in the banking sector and in the risk management systems promoted by the banking regulators as contributing to systemic risk and have suggested that the regulators should be promoting more "diverse diversification."[25] The extension of bank-centric rules and standards to NFCs would compound the trend towards homogeneity and correlation of risk management approaches that already exists in the banking sector.

We believe that the separate rulemaking should establish a process for applying the requirements of section 165 to any designated NFC that provides for close coordination with the Council and its individual members during the designation process under section 113. In the preamble to the Proposed Rules, the Board notes that following designation of an NFC by the Council, the Board would "thoroughly assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards and early remediation requirements should apply."[26] We submit that the Council itself will have to engage in the same thorough assessment of the business model, capital structure, and risk profile of an NFC together with the other factors specified in section 113 as a predicate to any designation of an NFC. This process under section 113 should thus be coordinated with the Board's process of tailoring the requirements of section 165 to NFCs.

In this respect, we envision that the Council's process under section 113 would involve a two-pronged approach. First, the Council would identify the specific threat to U.S. financial stability presented by the NFC that the Council is considering for designation. Second, the Council would determine how the enhanced standards contained in section 165 as applied to the NFC and its predominant line or lines of business would mitigate that threat. This two-pronged approach is consistent with the

[25] *See, e.g.*, Nicholas Beale, *et al*, *Individual versus systemic risk and the Regulator's Dilemma*, 108 PNAS 12647 (2011); Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, *Comments at the Institute of Regulation & Risk, Hong Kong: The $100 billion question* (Mar. 30, 2010); Haldane, *Speech delivered at the Financial Student Association, Amsterdam: Rethinking the Financial Network* (Apr. 2009).

[26] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 597.

legislative intent underlying sections 115 and 165.[27] Sections 115 and 165 specifically envision that the Council will make recommendations to the Board on how the enhanced standards under section 165 should take into account differences among NFCs and BHCs and how the Board should adapt the standards to account for the capital structure, risk, complexity, financial activities, size, interconnectedness, predominant business line and existing regulation of the NFC. It is critically important that the Council assess both how the enhanced standards would mitigate the threat(s) to U.S. financial stability identified by the Council and how the Board should tailor those standards to the threat(s) and the characteristics of the NFC.

Congress clearly envisioned that the Council would have an integral role in shaping the prudential standards to be applied under section 165. Section 115 provides a detailed schema for the Council to make recommendations on the prudential standards to be applied under section 165. Section 115 anticipates that the Council based on its designation process work will be in a unique position to make recommendations to the Board, particularly on the tailoring of the prudential standards to NFCs. Among the various provisions in section 115 relating to recommendations on the prudential standards to be applied under section 165 are those in subsection (b)(3) of section 115, which essentially track the language of section 165(b)(3) relating to differences among NFCs and bank holding companies and adapting the standards in light of the predominant line of business of the NFC.

It is not surprising that Congress would anticipate that the Council would provide recommendations to the Board. The Council is composed of all the primary federal financial regulatory agencies and an independent expert on insurance, providing expertise on a broad range of NFCs, an expertise that the Board itself lacks. The Board has developed its historic expertise with respect to banks and holding companies of banks. Prior to changes made in the Dodd-Frank Act, principal responsibility for and expertise relating to functionally regulated subsidiaries of bank holding companies resided in the functional regulator of that subsidiary, who now is either a voting member of the Council or represented by a non-voting member of the Council. So it is natural that Congress would expect the Council to make, and the Board to receive, recommendations on how

27 This two-pronged assessment approach would also appear to be required by section 113(e)(1), which provides that the Council shall provide an NFC with written notice of a proposed determination of the Council, "including an explanation of the basis of the proposed determination of the Council, that a nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards in accordance with this title." 12 U.S.C. § 5323(e)(1). This notice is intended to provide the NFC with an opportunity to contest the proposed determination. An NFC will not have an effective opportunity to contest the determination unless the explanation of the "basis" of the proposed determination provided by the Council includes an explanation of how the (cont . . .) application of prudential standards in section 165 to the NFC will mitigate the threat to U.S. financial stability presented by the NFC.

the prudential standards under section 165 should be applied to an NFC designated by the Council.

The two-pronged assessment approach referenced above should take place as part of Stage 3 of the proposed Council designation process. As noted in the Final Designation Rule, the designation process will involve an increasingly in-depth analysis of individual NFCs through three stages. In Stage 3, the Council will apply the analytic framework outlined in the Final Designation Rule with active involvement of the NFC in providing additional qualitative and quantitative information. Stage 3 will invariably require the Council itself to "thoroughly assess the business model, capital structure, and risk profile" of an NFC as part of the designation decision together with all the other factors described in section 113(a).

Section 165(b)(3), which specifically provides that the Board shall take into account the factors described in section 113(a), confirms that the factors described in section 113(a) are relevant not only to the question of *whether* a particular NFC should be designated, but also to the question of *how* the prudential standards listed in section 115 and section 165 should be applied to a particular NFC. As part of the designation process, the Council is required to consider all of the factors listed in section 113(a). The Final Designation Rule contemplates an analytic framework that is designed to incorporate each of these statutory factors. Thus, the Council will be considering how the nature, scope, size, concentration, interconnectedness and mix of activities in an NFC could pose a threat to the financial stability of the United States. Each of these factors will also relate to how prudential standards should be applied to the NFC to mitigate any identified threat. These factors will almost certainly vary in nature and degree among NFCs and thus the prudential standards to be applied in response to any determination of a possible threat will have to vary in nature and degree.[28] Uniform prudential standards (as envisioned in the Proposed Rules for all covered companies) for BHCs and NFCs would be inconsistent with the language and intent of section 113 and section 165 and not responsive to the purpose of the designation process. As the Council itself notes in the Final Designation Rule, each designated NFC will presumably pose a "unique threat" to U.S. financial stability, and thus it would be inappropriate to impose the same set of standards on the diverse set of NFCs.

The Council has provided further confirmation of these basic propositions in its Final Designation Rule. As part of the analytic framework outlined in the Final

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[28] Governor Tarullo's comments on regulating systemically important financial firms also appear to reflect an appreciation of the need for tailoring enhanced standards to the degree of risk posed by institutions that are deemed to be of systemic importance. *See* Daniel K. Tarullo, Governor, Board, *Remarks at the Peter G. Peterson Institute of International Economics: Regulating Systemically Important Financial Firms* 3 (June 3, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm ("Systemic importance is not a binary determination, but one of degree.") [hereinafter *Tarullo June 2011 Remarks*].

Designation Rule, the Council would, for example, consider whether the company is already subject to comprehensive regulation by a primary financial regulatory agency and presumably how existing regulatory regimes affect the need for or scope of any additional prudential standards.[29] As provided in section 113(g), the Council must also consult with the primary financial regulatory agency for each NFC or subsidiary of an NFC that is being considered for designation.[30] As part of its analytic framework, the Council would also examine whether the NFC is subject to an effective resolution framework that could decrease the *ex post* threat to financial stability presented by the failure of the NFC, and presumably how the existence of such a resolution framework affects the need for or scope of any additional prudential standards.

The analytic framework, the in-depth analysis of the individual NFC, and the consultation process with the primary financial regulatory agencies provide the basis for the recommendations to be made by the Council to the Board under section 115. These recommendations from the Council under section 115 are an integral and critical part of the process envisioned for the designation of an NFC and for the implementation of specific enhanced standards for an NFC.

D. Objectives of Separate Rulemaking for NFCs

We submit that the separate rulemaking for NFCs should accomplish two principal objectives. First, it must describe the process by which the Board will meet its statutory obligations under section 165 to tailor the standards and requirements applicable to NFCs. In particular, it must describe how the Board will take into account the analysis conducted during the designation process, including recommendations issued by the Council under section 115, recommendations that should be tailored, at a minimum, to the predominant line of business of the NFC and, as appropriate, to the individual NFC itself. It must also describe how the Board will consult with each Council member that primarily supervises a functionally regulated subsidiary or a depository institution

[29] Similarly, for foreign NFCs, the Council would consider the extent to which the foreign NFC is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority, as specified in section 113(b)(2)(H). We note that the Proposed Rules as drafted would not apply to foreign NFCs. We make this comment in anticipation of any future rulemaking by the Board with respect to foreign NFCs.

[30] We note that in Appendix A to the Final Designation Rule the Council has said that it "intends" to consult with the primary financial regulatory agency, if any, of each "significant" subsidiary of the nonbank financial company "to the extent the Council deems appropriate." The Council appears to be suggesting limitations on its consultation obligations that do not appear in section 113(g) itself. Language in the preamble to the Final Designation Rule also suggests that the Council reads section 113(g) as not requiring such consultation in all cases notwithstanding the language of section 113(g). *See* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, *supra* note 6, at 21,646. We respectfully submit that the language of section 113(g) requires such consultation in all cases.

subsidiary as required under section 165(b)(4) as to the impact of any proposed standards on such subsidiaries. If the Board chooses to adopt enhanced standards tailored to an NFC's predominant line of business, the rule must describe the process by which the Board will determine that the tailored standards are appropriate to mitigate the specific threats to U.S. financial stability presented by the predominant business line of the NFC, and how the standards implement any recommendations issued by the Council and the consultation with the individual Council members supervising the affected subsidiaries. If the Board chooses to adopt enhanced standards specifically tailored to an individual NFC, the rule must describe the process by which the Board will determine that the standards specifically tailored to an individual NFC are appropriate to mitigate the specific threats to U.S. financial stability presented by that NFC and how the standards implement any recommendations issued by the Council and the consultation with the individual Council members supervising the affected subsidiaries.

Second, the separate rulemaking must provide for appropriate opportunity for comment by NFCs on any proposed standards as applied to a predominant line of business of an NFC or on an individual basis. If the separate rulemaking for NFCs provides for tailoring based on the predominant line of business of the company, the separate rulemaking should provide that any proposed rules based on a predominant line of business would be subject to public notice and comment. If in addition or alternatively the separate rulemaking provides that the Board may tailor the standards on an individual basis by order or otherwise under its supervisory process, the separate rulemaking should provide a mechanism as part of the supervisory process by which the individual NFC will be provided with notice and an appropriate opportunity to provide written comments on any proposed standards to be applied to that individual NFC.

E. Implementation and Phase-In

In addition to the importance of a separate rulemaking establishing a process for tailoring the standards for NFCs, we believe that the Board must provide for an appropriate phase-in period for NFCs that recognizes the fundamental differences between NFCs and BHCs. As currently drafted, the Proposed Rules do not provide for an appropriate phase-in period, and instead provide that an NFC will be subject to certain of the enhanced standards such as the minimum capital and leverage requirements as early as 180 days after it is designated by the Council. The longest phase-in period for any of the standards in the Proposed Rules is five quarters for both BHCs and NFCs.

An extended phase-in of all the requirements for NFCs is warranted in light of the implementation burdens associated with complying with the Proposed Rules. It is clear that both BHCs and NFCs will be required to make significant changes in management information systems ("MIS systems") and other infrastructure to bring themselves into compliance with the Proposed Rules. They will be required to make these significant changes at the same time that they will be required to make many other changes in response to other Dodd-Frank Act initiatives and requirements. Because NFCs have

developed MIS systems and risk infrastructure that are tailored to their particular business models, lines of business and mix of activities (which will likely differ significantly from those of BHCs), NFCs will be required to make even more significant investments in MIS systems and other risk infrastructure so that they will be able to comply with the Proposed Rules.

The case for an extended phase-in for NFCs is also supported by the fact that unlike BHCs, most NFCs will not have had extensive experience as entities subject to comprehensive consolidated supervision by the Board. For BHCs, complying with the Proposed Rules will, in many cases, require incremental (though substantial) changes to programs that are already in place; for NFCs, on the other hand, the Proposed Rules will be entirely new and require the development of new programs or wholesale changes to existing programs. Furthermore, most NFCs will not have the familiarity that comes from an established supervisory relationship and hence will take longer to adjust to the Board's expectations both with respect to supervision generally and with respect to implementation of the Proposed Rules in particular. In the context of the Board's new supervisory role with respect to savings and loan holding companies ("SLHCs"), the Board has recognized that it will take time for its supervisory staff to better understand the diverse operations and business models of SLHCs and that SLHCs will need time to make changes in response to Board supervisory expectations. These observations apply with equal, if not greater, force to the new supervisory regime for NFCs designated for enhanced supervision.

We note that in comparable contexts, substantial phase-in periods have been used by regulatory authorities when significant new regulatory or supervisory changes have been introduced. For example, the Basel III framework provides for a multi-year phase-in of increased capital requirements for affected banking organizations between 2013 and 2019. Similarly, the Basel III liquidity coverage ratio ("LCR") would not apply to banking organizations until 2015 and the net stable funding ratio ("NSFR") until 2018. The Board's separate rulemaking for NFCs should provide for a comparable phase-in of enhanced standards for NFCs with a minimum phase-in for all standards of no less than eight quarters. By providing for an appropriate extended phase-in of new standards for NFCs and an explicit minimum phase-in period, the Board will ensure that NFCs have sufficient time and resources to develop MIS systems and risk infrastructure that allow for compliance with the new standards and requirements under sections 165 and 166 as well as the other regulatory requirements such as resolution plan requirements to which they will be subject, and that NFCs, markets and the public have, or have the opportunity to develop, a better understanding of the impact that designation will have on them.

F. Intermediate Holding Company Provisions of Title I and Title VI

In the Dodd-Frank Act, Congress recognized that NFCs engage in both financial activities, including ownership of banks and thrifts, and nonfinancial activities, including manufacturing and retailing. Congress created a legal framework for such companies

providing that the financial activities of these companies could be regulated, but that their nonfinancial activities would not be subject to regulation. To that end, section 167(b) provides for the establishment of an intermediate holding company ("IHC") by a designated NFC when necessary to (i) appropriately supervise activities that are determined to be financial activities, and (ii) ensure that supervision by the Board does not extend to commercial activities.

Section 626 provides a parallel structure for unitary SLHCs permitted to have nonfinancial activities ("Unitary SLHCs") and uses the same language as section 167(b). Title VI further provides that when an IHC is established by a Unitary SLHC, the parent will cease to be regulated as an SLHC. The Dodd-Frank Act thus contemplates the establishment of an IHC by a Unitary SLHC to ensure that the parent's nonfinancial activities will not be regulated.

The corollary under the Dodd-Frank framework is that an IHC established under Title VI is the obvious and appropriate entity in that corporate structure to consider for possible designation under section 113. This is precisely the harmonization called for in a colloquy between Representative Himes and then Chairman Frank on the House floor at the final passage of the Dodd-Frank Act.[31] Accordingly, we urge the Board to undertake as promptly as possible the rulemaking required under section 167(c) to implement the IHC structure for NFCs that may be designated under section 113 and the rulemaking required under section 626(c) to implement the IHC structure for Unitary SLHCs. In order to advance the goal of facilitating appropriate supervision of an NFC without subjecting the nonfinancial activities of the company to enhanced requirements under section 165, an IHC must be established by an NFC at least simultaneously with its designation under section 113. The IHC structure is essential to meeting the mandate that supervision by the Board not apply to nonfinancial activities of the NFC. The IHC structure will also facilitate the tailoring of the enhanced prudential standards to the particular financial activities conducted through the IHC structure.

G. Proposed Application to Savings and Loan Holding Companies

As the Board notes in the preamble to the Proposed Rules, sections 165 and 166 of the Dodd-Frank Act generally do not apply to SLHCs.[32] Nevertheless, the Board indicates in the preamble that it intends to issue a separate proposal to apply the enhanced standards and early remediation requirements to any SLHC with "substantial banking activities," meaning any SLHC (i) that has total consolidated assets of $50 billion or more and (ii) that (A) has savings association subsidiaries which comprise 25 percent or

31 *See* Cong. Rec—House (June 30, 2010) at H5226.

32 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 598.

more of the SLHC's total consolidated assets or (B) controls one or more savings associations with total consolidated assets of $50 billion or more. The Board indicates that it will not issue such a proposal until such time as it has established risk-based capital requirements for SLHCs.

Other than the one instance (namely, subsection (i)(2)) where section 165 specifically provides for its application to SLHCs, we do not agree that Title I or HOLA provide the Board with the authority to impose enhanced standards on SLHCs. Instead, section 165 and section 166 and, indeed, Title I of the Dodd-Frank Act as a whole, clearly and unambiguously contemplate that the enhanced standards and early remediation requirements are meant to apply only to BHCs and designated NFCs. Nor does HOLA provide the Board with authority to impose Title I standards on SLHCs. By conflating two distinct prudential regimes, the Board seemingly obviates Congress's clear and deliberate decision to apply only one of the Title I requirements to SLHCs, rather than the enhanced standards and early remediation requirements in their entirety.

In signaling its intent to apply these standards to SLHCs with "substantial banking activities," the Board has effectively made a legislative determination that the Title I framework should be imposed on certain SLHCs, a determination that is at odds with the plain language of Title I. We submit that such an intent is also inconsistent with the Board's previous statement that it would develop a regulatory and supervisory framework for SLHCs that, "to the greatest extent possible [takes] into account [the] unique characteristics of SLHCs and the requirements of [HOLA]."[33] We request that the Board refrain from applying sections 165 and 166 to SLHCs.

H. International Coordination

Governor Tarullo has noted the importance of achieving both coordination and congruence to the extent possible of U.S. standards for systemically important financial institutions with international standards.[34] For the banking sector, the Basel Committee on Banking Supervision (the "BCBS") in November 2011 announced policy measures to address globally systemically important banks, including additional loss absorbency measures.[35] These measures are specifically designed by the BCBS for banking institutions. In the preamble to the Proposed Rules, the Board noted that it intends to

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[33] Board. Supervision and Regulation Letter 11-11: Supervision of Savings and Loan Holding Companies 2 (July 21, 2011), *available at* http://www.federalreserve.gov/boarddocs/srletters/2011/sr1111.htm.

[34] *See Tarullo June 2011 Remarks*, *supra* note 28, at 4.

[35] *See* BCBS, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Final Document* (Nov. 2011), *available at* http://www.bis.org/publ/bcbs207.htm.

propose a quantitative risk-based capital surcharge in the United States based on the BCBS approach consistent with the BCBS's implementation time frame.[36]

The Financial Stability Board (the "FSB") in November 2011 also announced that the FSB and the BCBS would begin work to define the modalities to extend the framework to all globally systemically important financial institutions and to foster global convergence of regulatory and supervisory approaches for other financial sectors, including insurance.[37] Because at least certain of the NFCs that may be designated by the Council will likely have significant international operations, the development of prudential standards for these NFCs under sections 165 and 166 should be coordinated with the policy measures that may be adopted by the FSB and other international standard-setting bodies, such as the International Association of Insurance Supervisors (the "IAIS"). These measures will undoubtedly reflect the differences in business models, activities and structures between the banking sector and other sectors such as insurance as may ultimately be encompassed by the work of the FSB.[38] Because these efforts are not as advanced as the efforts by the BCBS for banking institutions, an appropriate phase-in of any standards under sections 165 and 166 as requested in subsection I.E above will also allow for appropriate consideration of emerging international standards as established by international standard-setting bodies.

II. Enhanced Prudential Standards and Early Remediation Requirements

As noted above, an appropriate tailoring of the section 165 and section 166 standards and requirements to NFCs is essential to the implementation of the Dodd-Frank Act regime for NFCs. This tailoring should be accomplished pursuant to a process established by a separate rulemaking under section 165 and section 166 for NFCs. In the following sections, we offer comments on the specific proposed standards in the Proposed Rules to indicate why they would not be appropriate for application to NFCs and why any prudential standards to be made applicable to an NFC should be specifically tailored to the NFC pursuant to the separate rulemaking process that we propose.

A. Capital and Leverage

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36 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 604.

37 *See* FSB, Press Release, *Policy Measures to Address Systemically Important Financial Institutions* (Nov. 4, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

38 The IAIS, which is working with the FSB to develop a methodology to identify systemically important insurers, has noted that the insurance business model differs from the banking model, and that as a result requirements for loss absorbency should recognize these differences and should differentiate between banks and insurers. *See* IAIS, *Insurance and Financial Stability* 3-5 (Nov. 2011), *available at* http://www.iaisweb.org/view/element_href.cfm?src=1/14102.pdf.

The provisions of Subpart B of the Proposed Rules relating to capital and leverage requirements are the first and most prominent example of the failure of the Proposed Rules to tailor their application to NFCs. Subpart B simply imposes the existing capital and leverage requirements applicable to bank holding companies on NFCs. Indeed, proposed section 252.13(a), entitled "[b]ank holding companies," merely states that a BHC must comply with and hold capital commensurate with the requirements of any regulations adopted by the Board relating to capital plans and stress tests, which would of course be the case without regard to the addition of section 252.13(a). The Board has already adopted a capital plan rule applicable to BHCs and proposes to adopt a rule relating to stress tests for BHCs in Subpart F of the Proposed Rules.

The substance of Subpart B actually resides in section 252.13(b) and section 252.14, which apply to NFCs. Section 252.13(b) requires an NFC to:

- calculate minimum risk-based capital and leverage requirements *as if it were a bank holding company* in accordance with any minimum capital requirements established by the Board *for bank holding companies*;
- hold capital sufficient to meet a tier 1 risk-based capital ratio of 4 percent and a total risk-based capital ratio of 8 percent as calculated according to the general risk-based capital rules *applicable to bank holding companies* and a tier 1 leverage ratio of 4 percent as calculated under the leverage rule *applicable to bank holding companies*; and
- comply with and hold capital commensurate with the requirements of regulations adopted by the Board relating to capital plans and stress tests *as if the covered company were a bank holding company*.

Section 252.14 requires an NFC to report to the Board on a quarterly basis its risk-based capital and leverage ratios as calculated under section 252.13(b) and to notify the Board immediately upon ascertaining that it has failed to meet the capital and leverage requirements under section 252.13(b).

The provisions of section 252.13(b), which expressly treat NFCs *as if they were bank holding companies* and apply rules applicable to bank holding companies to NFCs *as if they were bank holding companies* are in direct conflict with the provisions of section 165, which require consideration of the differences among NFCs and BHCs and adapting the standards as appropriate to the predominant line of business of an NFC. The provisions of Subpart B simply assume away the differences between NFCs (none of which has been designated by the Council) and BHCs. This default approach is in conflict with the express language and Congressional intent reflected in the provisions of section 165. It will also result in inappropriate and ineffective standards being applied to NFCs. Instead of requiring an NFC to adhere to bank-centric capital requirements, the Board must, as part of the process established by a separate rulemaking, tailor its

application of the enhanced capital and leverage requirements to the specific structure, risk profile, activity mix, and predominant line of business or businesses of the particular NFC.

The relevant provisions of section 165(b)(1)(A)(i) themselves clearly envision that the Board in consultation with the Council may determine that risk-based capital requirements and leverage limits are not appropriate to an NFC because of the activities of the company such as investment company activities or assets under management or because of its structure. In that case the Board is to apply other standards that result in similarly stringent risk limits. This specific provision relating to the application of risk-based capital and leverage requirements to NFCs supplements and is reinforced by the general provisions of section 165(b)(3), requiring the Board, in prescribing prudential standards under section 165(b)(1), to take into account the differences among NFCs supervised by the Board and BHCs and to adapt the required standards as appropriate in light of any predominant line of business of the NFC, including assets under management or other activities for which particular standards may not be appropriate. Thus, in applying any of the prudential standards required by section 165(b)(1) the Board must take into account the factors listed in section 165(b)(3). On the basis of both provisions, the Board in designing risk-based capital requirements and leverage limits must take into account the fundamental differences between NFCs and BHCs.

The Board itself has recognized the need for such a tailored approach in its initial rulemaking under a related provision of the Dodd-Frank Act – the minimum risk-based capital and leverage requirements under section 171. In proposing an initial rule to implement the requirements of section 171, the Board observed that certain of the institutions subject to the provisions of section 171, such as NFCs to be designated by the Council, will be different from the bank holding companies subject to section 171 "with exposure types and risks that were not contemplated when the general risk-based capital rules were developed."[39] The Board further observed that the Council might "designate one or more companies whose activities are quite different than those addressed in the general risk-based capital rules" and that as a result the Board would need "to evaluate the risk-based capital treatment of specific exposures not typically held by depository institutions."[40] The Board specifically noted that going forward there might be situations "where exposures of a depository institution holding company or a nonbank financial company supervised by the Board not only do not fit within the terms of a risk-weight

39 Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II: Establishment of a Risk-Based Capital Floor, 75 Fed. Reg. 82,317, 82,319 (Dec. 30, 2010).

40 *Id.*

category, but also impose risks that are not commensurate with the risk-weight otherwise specified in the generally applicable risk-based capital requirements."[41]

As an example, the Board noted that there are material exposures of insurance companies that, while not riskless, would be assigned a 100 percent risk weight category because they are not explicitly assigned to a lower risk-weight category in the existing bank risk-weight rules.[42] This observation applies with equal force to other types of financial activities of NFCs and to commercial activities and assets of NFCs. As the Board observed, applying the risk-weights in the bank risk-based capital rules to such exposures "without consideration of an exposure's economic substance could overstate the risk of the exposure and produce uneconomic capital requirements for a covered institution."[43] We concur with each of these observations and note that they apply of necessity not only to the Board's implementation of the requirements of section 171, but also to the Board's implementation of section 165.

Any enhanced capital and leverage requirements for NFCs under section 165 as under section 171 must take into account the fundamental differences between NFCs and BHCs. The Board's capital rules, as well as its approach to capital regulation in general, do not account for these fundamental differences. In the insurance context, for example, the Board's capital rules do not sufficiently account for insurance-related assets such as separate account assets for certain variable insurance products. For these products, inherent risks and fund performance are driven by fluctuations in interest rates and equity markets, and are borne by policyholders rather than by the insurance company. Similarly, the Board's capital rules provide no weightings for insurance risks, such as exposure to mortality losses or fluctuations in claims reserves.

As discussed in a 2002 joint report authored by the Board and the National Association of Insurance Commissioners (the "NAIC"), the different capital frameworks for insurance companies and banking organizations reflect the "inherent differences between the insurance and banking industries."[44] As was further noted in the joint report, the "two frameworks differ fundamentally in the risks they are designed to assess, as well as in their treatments of certain risks that might appear to be common to both sectors."[45] The different capital frameworks "arise from fundamental differences between the two

41 *Id.*

42 *Id.* at 82.320.

43 *Id.*

44 Report of the NAIC and the Federal Reserve System Joint Subgroup on Risk-based Capital and Regulatory Arbitrage (May 24, 2002), at 1.

45 *Id.*

industries, including the types of primary risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."[46] Requiring an insurance-centric NFC to comply with bank-centric capital requirements would provide a misleading and inaccurate picture of the NFC's capital condition. Insurance companies differ significantly from banks in the structure of their liabilities and obligations, and hence capital frameworks applicable to insurance companies and banking organizations should differ significantly as well. Any capital framework imposed on an insurance-centric NFC must account for the fundamental differences in asset and liability structures between insurance companies and banks, and the provisions of the Proposed Rules imposing bank-centric capital and leverage requirements on NFCs fail to do so.

Fundamental differences also arise when comparing banking organizations to NFCs that have asset management businesses. For many mutual funds and their advisers, the Proposed Rules would impose capital requirements that would be entirely new and would be irreconcilable with their structures and business models. For example, funds and advisers today are not required to hold capital as a buffer against losses;[47] in fact, funds do not incur "losses" in the sense that banking institutions do. Fund investors absorb both declines and increases in asset values. They are not absorbed by the fund itself, a special class of creditors like depositors, or the Federal safety net. Thus, unlike the banking business model, which requires that capital be set aside not to protect the bank's shareholders but to protect depositors, other creditors, and the Federal safety net against the risk of losses in the bank's asset portfolio, there is no comparable class in need of protection in the asset management model. Funds' investors expect their assets to be invested, the risk of loss is fully disclosed, and investors accept that risk in return for the possibility of gains. Furthermore, unlike depositors in a bank, who know that their money (i) provides leverage; (ii) is backstopped by the Federal safety net; and (iii) will be vulnerable to losses only to the extent that their deposits exceed FDIC insurance levels and losses in the bank's asset portfolio exceed its capital, fund investors expect that their investments are not materially leveraged or protected by the safety net and accept the risk that they may lose the entire value of it. Similarly, funds' advisers are

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[46] *Id.* at 3.

[47] Based on public comments from officials at the Securities and Exchange Commission (the "SEC"), we recognize that the SEC is considering various potential reforms for money market mutual funds ("MMMFs"), including the possibility of a capital requirement; however, this is just one of many possible options, none of which has yet been proposed. Regardless of whether the SEC proposes some form of a capital requirement for MMMFs in the future, there is no change in the conclusion that the capital and leverage requirements in the Proposed Rules are inappropriate for asset management firms.

not required to hold capital against their managed assets because they do not guarantee the value of those assets as banks do for their deposits and other liabilities.[48]

We request that the development and application of tailored capital and leverage requirements for NFCs under a separate rulemaking process be coordinated with the development and application of capital and leverage requirements for NFCs in other contexts, such as the Board's ongoing development of a consolidated capital framework for SLHCs. Coordinated implementation will not only ease the administrative and implementation burden on both the Board and any NFCs subject to such requirements, but will also ensure that NFCs receive consistent, equitable, and theoretically sound capital treatment of their assets and activities, regardless of the capital framework applied.

Enhanced capital and leverage requirements for NFCs must also take appropriate recognition of the difficulties associated with gathering and aggregating the data necessary for the NFC to report its capital condition to the Board. NFCs currently do not file the FR Y-9C and the associated Schedule HC-R, which the Board will presumably require from NFCs in order to determine their capital condition. Needless to say, an NFC would be required to make significant investments in MIS systems and risk infrastructure in order to file the Schedule HC-R, burdens that would be magnified significantly in the absence of a capital framework appropriately tailored to the structure and activity mix of the NFC. It would make little sense to subject NFCs to capital and leverage requirements that bear little relation to their actual structures and mixes of activities, just as it would make little sense to require NFCs to aggregate and report data in support of such capital requirements when the data would be difficult to collect and would yield misleading and inaccurate information about the capital condition of the NFC. We request that any enhanced capital standards applied to NFCs take appropriate recognition of the burdens associated with aggregating and reporting data on an NFC's capital condition to the Board.

[48] Fundamental differences also arise when comparing banking organizations to broker-dealers. Broker-dealers have their own existing capital and leverage requirements, principally Rule 15c-1 under the Securities Exchange Act of 1934, also known as the "net capital rule." The rule has four principal components: (i) it defines "net capital"; (ii) it requires that a broker-dealer maintain a minimum amount of net capital; (iii) it requires a broker-dealer to limit its leverage by maintaining a minimum percentage of net capital to one of two measures of securities-business-related indebtedness; and (iv) the rule prohibits rapid withdrawals of funds from a broker-dealer by its parent company or other affiliated entities. Rule 15c-1 is supplemented by a number of other SEC rules directly or indirectly related to the regulation of a broker-dealer's capital (*i.e.*, Rules 17a-5 and 17a-11). Depending on their business, broker-dealers may also be subject to additional capital requirements imposed by the Financial Industry Regulatory Authority, the Department of the Treasury, and the Commodity Futures Trading Commission. Any consideration of a capital framework imposed on NFCs that are, or have subsidiaries that are, broker-dealers must take this existing framework into account as well as recognize fundamental differences between banks and broker-dealers.

In sum, to require NFCs to adhere to a bank-centric capital framework would be ill-conceived and unworkable. The Board should therefore remove NFCs from the Proposed Rules and engage in a separate rulemaking to design a process to tailor capital and leverage requirements, if necessary, to the business model, capital structure and risk profile of the range of NFCs that may be designated by the Council.[49] In designing any proposed capital and leverage requirements under section 165, the Board should in consultation with the Council demonstrate that any proposed risk-based capital requirement or leverage limit is required or appropriate to the activities or structure of the NFC. The activities and structure of asset managers and the funds that they advise strongly support the conclusion that bank-centric risk-based capital and leverage limits are not appropriate or necessary. Similarly, the activities and structure of insurance companies, particularly taken with the existing insurance risk-based capital requirements, strongly support the conclusion that bank-centric capital and leverage requirements are not appropriate or necessary. The Board, in consultation with the Council, should undertake the required analysis of each business line of an NFC that may be designated by the Council to demonstrate whether additional risk-based capital requirements or leverage limits are appropriate to it.

B. Liquidity

As a threshold matter, we wish to emphasize the importance of our joint comments with the other trade associations, in which we and other trade associations note that the provisions of the Proposed Rules relating to liquidity risk and liquidity risk management "are so detailed and prescriptive as to risk impeding directors' proper discharge of their oversight duties"[50] and "blur the distinction between the proper oversight role of the [covered company's] Board of Directors and management's responsibilities for day-to-day operations."[51] These comments ring particularly true with respect to NFCs. As we discuss in detail below, it is imperative that the Board adopt a less prescriptive approach, one that recognizes that the different business models, different mixes of financial activities, and different asset and liability profiles of NFCs will directly affect the nature and scope of the liquidity risks and appropriate liquidity risk management processes for NFCs. As currently drafted, the provisions of the Proposed Rules relating to liquidity appear to be premised on the assumption that NFCs face liquidity risks similar in nature and scope to those of BHCs and thus should take the

[49] Chairman Bernanke recently remarked that once an NFC is designated, "it will fall to the Federal Reserve to develop supervisory frameworks appropriate to each firm's business model and risk profile." Benjamin S. Bernanke, *Remarks at the Federal Reserve Bank of Atlanta Financial Markets Conference* (Apr. 9, 2012), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20120409a.pdf.

[50] Joint Trade Letter, *supra* note 4, at section I.F.

[51] *Id.*

same approach to liquidity risk management as BHCs. This assumption fails to appropriately account for differences between NFCs and BHCs. In order to properly account for these differences, the Board's separate rulemaking process should make explicit provision for a principles-based approach to liquidity and liquidity risk management for NFCs. NFCs already have policies, procedures and risk management frameworks in place relating to liquidity that have been tailored (based on long experience) to their actual risk profile and mix of activities. The Board's separate rulemaking process for NFCs should take appropriate recognition of and encourage NFCs to make use of these existing frameworks.

The differences between NFCs and BHCs are significant, *inter alia*, because NFCs often have significantly different mixes of liabilities on their balance sheets than BHCs. For example, insurance companies have predominantly long-dated (as in the case of a life insurance policy), rather than short-dated (as in the case of a bank deposit) liabilities on their balance sheets. The Proposed Rules, however, make little or no provisions for these differences. As noted below, several of the provisions of the Proposed Rules relating to liquidity risk and liquidity risk management seem designed specifically for a BHC:

- An NFC would be required to produce both comprehensive short-term cash flow projections on a daily basis, and long-term cash flow projections on a monthly basis, regardless of whether short-term cash flows are material to the NFC's business model. An asset management business, for example, will have little need to project short-term cash flows. Asset management is an agency business. The investments and redemptions in a managed fund accrue to the fund itself, not to the manager, and the cash flows accruing to a fund's assets under management pass through directly to the investors in that fund. When fund investors redeem their shares (a principal driver of a fund's cash needs), the fund satisfies those redemptions either from incoming investors or by selling fund assets. The manager does not provide cash to meet these redemption requests. For an NFC that is an insurance company, cash flow analysis focuses on ensuring that *long-term* cash flows arising from insurance company investment holdings (such as long-dated corporate bonds) are appropriately matched with the company's long-term liabilities. In both cases, short-term cash flow analysis is significantly less important to the company's predominant line of business. It is thus unsurprising that existing MIS systems of NFCs are currently not equipped to perform the bank-centric cash flow analyses contemplated by the Proposed Rules, when such analyses are of comparatively less importance to the NFC's actual liquidity risk profile. Building the MIS systems necessary to perform the cash flow analyses in the detail and with the frequency required by the Proposed Rules will thus impose significant costs on NFCs, with little if any benefit to their liquidity risk management practices.

- An NFC would be required to conduct monthly liquidity stress tests incorporating overnight, 30-day, 90-day and one-year time horizons, quarterly reviews and approvals of cash flow projections, and review liquidity practices, methodologies, assumptions and liquidity stress test results. These requirements need to be tailored to the profile of the NFC's liabilities, and afford sufficient recognition to the fact that differences in the activity mixes of NFCs and BHCs make the overall liability and liquidity profiles of NFCs much less volatile than that of BHCs. For example, for life insurers quarterly liquidity stress testing may be adequate in most cases since the balance sheet does not change so quickly, and time horizons longer than 90 days may need to be evaluated to account for the build-up of surrender activity over time. Because many NFCs engage in lower levels of trading and similar short-term activities than BHCs, they have much less volatile balance sheets, and hence have fundamentally different liquidity profiles than BHCs. Indeed, the liquidity risk profile of a typical NFC is likely to be, *ceteris paribus*, much less volatile than that of a typical BHC.

- The Proposed Rules would require an NFC to undertake annual reviews of the liquidity risk implications of existing significant business lines and products. In many instances, it is unclear how an NFC would undertake such a review. For example, it is unclear how an asset management firm would analyze the liquidity risk implications associated with sponsoring a new fund (as the asset manager would bear no liquidity risk with respect to the fund). In fact, because the liquidity available to the adviser is irrelevant, this task would likely create costs but few if any benefits.

- An NFC would be required to monitor its liquidity on an intraday basis. The actual scope of liquidity risk monitoring by NFCs will be much narrower for NFCs that are not engaged in significant trading or payment, clearing or settlement activities.

Liquidity risk management by NFCs is thus appropriately informed by the specific mix of assets and liabilities on their balance sheets and the liquidity risks that they actually face. It would therefore be inappropriate to apply liquidity risk requirements developed for a BHC to an NFC without appropriately tailoring the framework to the actual liquidity risks faced by the NFC. Imposing a bank-centric liquidity risk management framework on NFCs will present significant implementation challenges, challenges that the Board fails to account for under the Proposed Rules' implementation timeframe for NFCs. As illustrated by the examples noted above, the imposition of such a framework is likely to yield comparatively little benefit, and could even be counterproductive from a regulatory and supervisory perspective unless appropriately tailored to the specific risk profile of the underlying NFC.

We have additional views on specific provisions of the Proposed Rules relating to liquidity and liquidity risk management. We re-emphasize here our joint comments submitted with the other trade associations on the relationship between the provisions of the Proposed Rules relating to liquidity and the Basel III LCR and NSFR. As we note in our joint comments, the Proposed Rules improve upon the Basel III LCR and NSFR in several respects. Consistent with our joint comments, we request that the Board expand the definition of "highly liquid assets" in section 252.51 of the Proposed Rules to encompass additional categories of instruments and securities. The types of assets considered "highly liquid assets" should include committed lines of credit and other funding arrangements (including Federal Home Loan Bank advances) under which an NFC has a contractual right to access liquidity. In addition, we request that the Board clarify that an NFC will be able to calculate its projected funding needs for purposes of the 30-day liquidity stress scenario on a net basis. This approach would be consistent with the Basel III LCR, which provides that for purposes of its liquidity stress scenarios, a banking organization may assume that it will receive fully performing cash inflows from loans[52] and other transactional arrangements.[53]

Finally, we submit that the Board should not adopt a short-term debt limit for NFCs in addition to any other liquidity requirements that may be imposed on NFCs. The imposition of a short-term debt limit designed for traditional banking organizations would make little sense in light of the differences between banks and NFCs. A tailored application of the liquidity risk management requirements through a separate rulemaking for NFCs would be best designed to deal with any concerns from the perspective of short-term funding.

C. Single-Counterparty Exposure Limit

As is the case with the other provisions of the Proposed Rules, it is our belief that the provisions relating to the single-counterparty exposure limit do not account for the different structures and activity mixes of NFCs.

The Board's approach to the application of the single-counterparty exposure limit to NFCs does not sufficiently account for the fundamental differences between NFCs and BHCs. As a matter of implementation, compliance with the single-counterparty exposure limit will require an NFC to construct MIS systems which far exceed (in the case of many NFCs, by orders of magnitude) any MIS systems that these companies currently have. NFC MIS systems are predominantly geared towards monitoring direct exposures (*e.g.*, direct derivatives exposure to a central counterparty or other derivatives counterparty)

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52 *See Basel III: International framework for liquidity risk measurement, standards and monitoring*, pg. 23, para. 105 (Dec. 2010), *available at* www.bis.org/publ/bcbs188.pdf.

53 *Id.* at pg. 24, para. 114.

rather than indirect exposures (*e.g.*, indirect exposures arising from guarantees). Some NFCs have not traditionally been subject to lending limits or other counterparty exposure limits that banking organizations must adhere to. The Proposed Rules simply assume that an NFC can and should construct the necessary MIS systems and risk infrastructure to monitor compliance with the single-counterparty exposure limit on a daily basis, without affording appropriate recognition to the fact that the differing structures and activities of NFCs will warrant different approaches to compliance with the limit. NFCs will quite literally be required to build new MIS systems "from scratch" to monitor compliance with the limit, as existing systems will not be geared to the bank-centric approach taken in the Proposed Rules. Indeed, NFCs will likely need to expend significant resources to simply gather the information necessary to monitor compliance, as NFCs have traditionally engaged in data aggregation processes across affiliates and subsidiaries which differ significantly from what the Proposed Rules require.

The Board's approach also does not seem to account for clear Congressional intent with respect to implementation of the limit as evidenced by section 165(e)(7). Section 165(e)(7) specifically provides for an extended transition period for compliance with the single-counterparty exposure limit, and also grants the Board discretion to extend this compliance period. The purpose of this provision is to afford BHCs and NFCs sufficient time to build the MIS systems necessary to comply with the limit. Section 165(e)(7) stands as clear evidence that Congress understood the particular difficulties associated with building the MIS systems and risk infrastructure to comply with the concentration limit, and intended that covered companies have sufficient time to bring themselves into compliance. When crafting an extended phase-in of all the requirements for NFCs, as discussed in subsection I.E. above, we request that the Board remain particularly cognizant of the difficulties that NFCs will face in building the infrastructure to comply with the limit, and tailor its extended implementation and phase-in period accordingly.

Under the Proposed Rules, an NFC, together with its subsidiaries, would be prohibited from holding aggregate net credit exposure to any unaffiliated counterparty which exceeds 25 percent of the consolidated capital stock and surplus of the NFC. For purposes of the Proposed Rules, "subsidiary" is defined to include any company that is directly or indirectly "controlled" by the company. A company is deemed to "control" another company if the company (i) owns, controls, or has the power to vote 25% or more of a class of voting securities of another company; (ii) owns or controls 25% or more of the total equity of another company; or (iii) consolidates with the other company for financial reporting purposes.

We submit that for the Board to apply this definition of "control" to NFCs would lead to an unworkable rule. For example, NFCs would be unable to access the information necessary to determine which counterparties are subsidiaries of other counterparties (in which case the exposures would need to be aggregated) based on the

level of investment in the counterparty. From the perspective of an NFC, although the NFC would be able to determine which of its investments in other companies meets the proposed definition of "control," it would in many cases (especially in the case of minority equity investments) be unable to monitor and track the exposures of the investee company. For example, NFCs are often minority equity investors in mutual funds that hold thousands of positions and change these positions rapidly. It would be simply unworkable as a practical matter to require an NFC to monitor the exposures of the mutual fund in which it is a minority equity investor. To require an NFC to monitor the investments and exposures of companies in which it is only a passive minority investor would be to impose on the NFC an unworkable requirement that would give rise to nightmarish compliance costs and administrative burdens if attempted to be implemented.

In order to implement a workable standard, we respectfully request that the Board amend the definition of "control" to include only companies that are consolidated for financial reporting purposes. Amending the definition in this manner will allow for meaningful compliance with the single-counterparty exposure limit, both from the perspective of an NFC's ability to monitor and aggregate exposures to its counterparties and from the perspective of the NFC's ability to monitor and aggregate exposures of its subsidiaries themselves.

In the preamble, the Board inquires whether the Proposed Rules' definition of "subsidiary" should be expanded to include "any investment fund or vehicle advised or sponsored by a covered company or any other entity."[54] We strongly believe that the definition of "subsidiary" should not be expanded in this manner for an NFC, as to do so would be to disregard the legal and operational separateness of funds from their advisers and sponsors.[55] Existing legal, regulatory and business structures of asset management firms would be unable to accommodate such an expansion, as the legal and operational separateness of advised and sponsored funds means that various funds advised or sponsored by the same entity do not, and should not be required to, limit their activities to comply with an overstated measure of counterparty exposure. Funds and their advisers must adhere to strict fiduciary duties by putting the interest of the individual funds' shareholders ahead of their own interests and, with respect to each fund, ahead of the interests of other funds' shareholders. Artificial limits on counterparty exposure would not properly account for this fiduciary duty. Furthermore, expanding the definition of

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54 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, *supra* note 3, at 614-15.

55 Any determination to include advised and sponsored funds within the definition of subsidiary would also run directly counter to the Board's long-standing precedent, particularly in the context of SEC-registered funds. The Board has long viewed mutual funds as separate from the banking entity that provides such funds with advisory, administrative, sponsorship and other services. *See, e.g.*, Bankers Trust New York Corp., 83 Fed. Res. Bull. 780 (1997); Commerzbank AG, 83 Fed. Res. Bull. 679 (1997).

subsidiary to include advised or sponsored funds would produce a distorted view of counterparty exposure and likely lower inappropriately the effective limit for covered companies in the asset management business. In sum, to deem an advised or sponsored fund a "subsidiary" of an NFC would be to apply bank-centric principles of consolidated supervision in a context where consolidation does not exist and has never existed.

We note that the Proposed Rules contemplate that a covered company's gross credit exposure to a counterparty will be converted to net credit exposure by taking into account, *inter alia*, "eligible collateral" that secures a transaction between a covered company and a counterparty. The Proposed Rules define "eligible collateral" narrowly to include (i) cash on deposit with the covered company; (ii) debt securities (other than mortgage- or asset-backed securities) that are bank-eligible investments; (iii) equity securities that are publicly traded; and (iv) convertible bonds that are publicly traded. We request that the definition of "eligible collateral" be broadened to encompass additional categories of assets. As currently contemplated, the definition could significantly restrict the ability of NFCs to enter into secured transactions with counterparties. To avoid a potentially detrimental impact on the markets, the Board should expand the categories of eligible collateral to include, *inter alia*, any asset eligible for use as collateral under Section 23A of the Federal Reserve Act and the Board's Regulation W, including (but not limited to) loans, receivables and real or personal property, including securities directly and fully guaranteed as to principal and interest by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation. Expanding the categories of eligible collateral in this fashion will ensure consistency with market practice and the Board's own regulatory precedents.

The Proposed Rules would impose a more stringent single-counterparty exposure limit of 10 percent of capital and surplus on "major" covered companies, which would include BHCs with total assets greater than or equal to $500 billion and all NFCs. We strongly object to the blanket categorization of each NFC as a "major" counterparty without regard to the NFC's actual risk profile and mix of activities. We respectfully submit that the Board should take a more measured approach to its categorization of NFCs with respect to the single-counterparty exposure limit, one that appropriately accounts for the specific characteristics and risk profile of the NFC. It is simply inappropriate for the Board to deem every NFC, regardless of its size or complexity, to be a "major" covered company and subject it to the more stringent single-counterparty exposure limit. Indeed, as discussed in the Joint Trade Letter, the Board has not provided either in the preamble or the Proposed Rules a substantive basis for its determination that imposing the 10 percent limit on major covered companies is "necessary to mitigate risks to the financial stability of the United States," as required by subsection 165(e)(2). In addition to not being supported by the necessary statutory finding, the Board's broad application of the single-counterparty exposure limit does not take into account the significant differences in size and interconnectedness between NFCs and BHCs and the

significant differences in size and interconnectedness between and among the various NFCs themselves.

In recognition of the distinct differences in the levels of interconnectedness between NFCs as compared to BHCs, we submit that the Board should not require that all NFCs be subject to the more stringent single-counterparty exposure limit. We request that the Board develop a separate framework for applying the single-counterparty exposure limit to NFCs, one that considers the actual level of interconnectedness between NFCs and other financial companies.

D. Risk Management and Risk Committee

The provisions of the Proposed Rules relating to risk management and the risk committee are overly prescriptive and, like the provisions of the Proposed Rules relating to liquidity and liquidity risk management, presuppose that an NFC is similar in risk profile and has or should have a similar risk management framework to a BHC. This assumption fails to account for the variation between risks faced by NFCs and those faced by BHCs. The Proposed Rules do not contain risk management frameworks that are appropriately tailored to the risks faced by NFCs.

NFCs often face risks that are distinct from risks faced by BHCs. For example, insurance companies face risks that are largely uncorrelated with the risks arising from traditional banking activities, such as commercial and consumer lending and deposit-taking and their inherent risks. Insurance risks also exhibit a lower level of *intra-correlation* than risks facing banking organizations, meaning that liability and asset-specific risks facing life insurers generally exhibit less correlation than asset and liability risks facing banking organizations.

Risk management by asset management firms is informed by the fact that asset management is an agency business based on contractual relationships among separate legal entities and a robust regulatory regime. Consider, for example, an entity in a mutual fund complex. Although such an entity is unlikely to threaten U.S. financial stability, its relationships with other entities in the complex are illustrative of the inapplicability of the risk management provisions in the Proposed Rules to asset management entities more generally.

A mutual fund is a legal entity separate from its adviser and sponsor, with its own contractual relationships, shareholders, board of directors, and assets and liabilities. A mutual fund adviser's relationships with the fund (or funds) it manages are constrained by (i) the duties imposed by the laws of the state under which the fund is organized; (ii) each fund's advisory contracts; (iii) each fund's investment guidelines; and (iv) the legal restrictions applicable to each fund set forth in the Investment Company Act of

1940 (the "Investment Company Act").[56] Ultimately, legal and operational requirements dictate that the adviser provide investment management services to each mutual fund on an agency basis. An adviser is hired to manage the mutual fund, subject to the oversight of the fund's board of directors (a majority of whom are, as a practical matter, required to be independent of the investment adviser) and subject to the restrictions described above, but the assets of a fund never become assets of the adviser nor are they commingled with assets of other mutual funds managed by the investment adviser. In fact, the balance sheet of an adviser is typically small relative to the amount of assets managed by the adviser. The relatively small size of the adviser's balance sheet is appropriate because, although the adviser manages the fund's assets, it is not financially responsible for the fund's performance and the mutual fund's losses cannot threaten the adviser's solvency the way the performance of proprietary assets of a bank or other subsidiary can threaten the solvency of a BHC.[57]

Similarly, because the assets of mutual funds are not commingled and a mutual fund can have only very limited business relationships with affiliated mutual funds, the performance of one mutual fund's assets cannot directly threaten another fund.[58] If one fund in a group "fails," the other funds are prohibited from bailing it out.[59] In any event,

[56] For example, the Investment Company Act contains a number of provisions designed to prevent specific conflicts of interest between an adviser and the fund that it manages. For example, section 17(a) of the Investment Company Act generally prohibits "principal" transactions between a registered fund and its investment adviser or "affiliated persons" of the investment adviser (collectively "Affiliates"). *See* 15 U.S.C. § 80a-17(a) (2006). The definition of "affiliated person" is very broad and includes persons that control or own five percent or more of the voting securities of the investment adviser. *See* 15 U.S.C. § 80a-2(a)(3) Section 17(d) and Rule 17d-1 restrict joint transactions between a mutual fund and its investment adviser or its Affiliates. *See id.* § 80a-17(d). Section 17(e) and Rule 17e-1 restrict the compensation that an Affiliate of a mutual fund may receive when acting as an agent of or broker for a mutual fund. *See id.* § 80a-17(e). Finally, section 10(f) and Rule 10f-3 restrict a mutual fund's acquisition of securities that are being underwritten by an underwriting syndicate in which an Affiliate is participating. *See id.* § 80a-10(f). Thus, although the adviser may manage a variety of funds, it is bound by numerous obligations to each of them.

[57] This is not to suggest that an adviser or other fund service provider may not face liability for failing to perform its duties under the relevant contract; rather, the adviser has no obligation to make investors whole for a decline in their shares in the fund and investors have no such expectation. Nor is it intended to suggest that an investment adviser's revenues will not be reduced if the mutual fund loses assets (either because of market action, shareholder redemptions or both).

[58] For example, in the absence of an SEC exemptive order that imposes strict conditions designed to protect both the borrowing and lending funds, a mutual fund may not borrow or lend money from an affiliated mutual fund.

[59] Managed funds generally may lose assets through market losses and redemptions and may ultimately liquidate, but they do not typically "fail" in the same way banks and BHCs do. Money market funds may face liquidity pressure similar to that faced by banks but, like other funds, they would not become insolvent as a result of such pressure; rather, the value of the securities that they own may fall as a result of the need to dispose of such securities to raise cash to meet redemptions.

mutual funds typically do not "fail" because the Investment Company Act significantly restricts the amount of leverage that mutual funds can take on.

Conversely, BHCs often face risks that NFCs do not face. For example, asset management firms generally do not take positions as principal, and hence do not face principal risk to the same extent as BHCs. Banking organizations engage in significant amounts of lending, trading and derivatives activities, and thus face counterparty and interest rate risks that are orders of magnitude greater than similar risks faced by an NFC that is an insurance company or asset management firm.

As NFCs often face very different sets of risks than BHCs, it is unsurprising that NFCs have adopted risk management frameworks that differ from the frameworks prescribed by the Proposed Rules. For instance, because NFCs often face risks that are less likely to be correlated, they will design risk management frameworks to reflect this fact. The design of an enterprise-wide risk management framework should take into account the extent of the correlation of risks across the various activities conducted by the organization. Indeed, one element of an effective enterprise-wide risk management framework might well include the very diversity of the different financial activities engaged in by an organization. The Proposed Rules on the other hand simply assume that a consolidated, enterprise-wide approach to risk management designed for banking entities is also best for all NFCs, instead of providing that an NFC's risk management framework will be tailored to its actual risk profile, mix of activities, structure and existing governance framework. We submit that this assumption must itself be examined to determine the design of an enterprise-wide risk management framework that is appropriate for an NFC which faces uncorrelated risks across its various activities, activities which may differ significantly from traditional banking and trading activities.

Given the significant differences between the risks facing NFCs and the risks facing BHCs, it is puzzling that the Proposed Rules presuppose that an NFC takes the same approach to risk management as a BHC. We submit that the Board should not seek to apply the bank-centric risk management requirements of the Proposed Rules to NFCs, and should instead assess whether the specific risk profile of an NFC necessitates changes to the NFC's existing risk management framework. If so, the Board should promulgate a separate rulemaking to tailor the enhanced risk management requirements to the particular risks that the NFC faces and the framework by which the NFC actually manages these risks.

E. Stress Test Requirements

The Proposed Rules contemplate a stress testing regime based almost entirely on the Board's previous experiences with stress testing of BHCs.[60] Indeed, the Board states

[60] The proposed stress testing requirements are yet another example of the Board's use of a "one-size-fits-all" approach to the application of enhanced standards to NFCs. Governor Tarullo himself noted

explicitly in the preamble that the proposed stress test requirements are based on the Supervisory Capital Assessment Program and the Comprehensive Capital Analysis and Review ("CCAR"). We believe that the Board should not seek to apply a bank-centric stress testing framework to NFCs, as any such application would yield inaccurate and misleading results. The potential consequences of such an application are even more significant, given that the Proposed Rules contemplate that an NFC's stress test results would feed into potential restrictions on capital distributions and the potential application of the early remediation framework. An approach which requires the application of a bank-centric stress testing framework to firms which will likely be fundamentally dissimilar from large banking organizations, and then keys additional restrictions and requirements on the results of an application of that framework, is misguided. We submit that the entire premise of the stress testing provisions of the Proposed Rules, namely, that application of a bank-centric stress testing framework to an NFC will yield prudential regulatory benefits, should be re-examined.

We believe that in order to afford proper recognition to the differences between BHCs and NFCs, the Board should in its separate rulemaking tailor the stress test requirements of section 165 to NFCs. This stress testing framework should be tailored to the capital structure, risk profile, complexity, activities and size of the particular NFC in two crucial respects. First, as discussed in more detail below, any stress testing framework for NFCs should reflect assumptions and methodologies appropriate to the risks that the NFC actually faces. For example, a stress testing framework applied to an NFC that is an insurer should incorporate methodologies and assumptions related to the specific risks that insurers face, such as mortality or catastrophe risk. Second, any disclosure regime relating to the stress testing framework for NFCs should be appropriately tailored to the business model and capital structure of the NFCs. The recent disclosure of the CCAR 2012 results illustrate that misinformation can result when a bank-centric stress testing framework is applied to a firm whose predominant line of business is not bank-centric in focus. If the stress testing framework for NFCs appropriately differentiated between BHCs and NFCs along these and other metrics, it would be a significant improvement from the bank-centric stress testing framework provided for in the Proposed Rules.

We have several specific concerns with any potential application of the stress testing requirements in the Proposed Rules to NFCs. These concerns reinforce our views that the Board should not seek to subject NFCs to the bank-centric stress test

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in a recent speech on stress testing that even as among BHCs, "a one-size-fits-all approach is no more appropriate here than in most other areas of prudential supervision." Daniel K. Tarullo, Governor, Board, *Remarks at the Federal Reserve Bank of Chicago Annual Risk Conference: Developing Tools for Dynamic Capital Supervision* 11 (Apr. 10, 2012), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20120410a.pdf. It follows *a fortiori* that a one-size-fits-all approach is inappropriate for a group of companies that is likely to be as diverse in nature as NFCs.

requirements of the Proposed Rules, and should instead propose stress test requirements tailored to NFCs as part of a separate rulemaking.

First, the baseline, adverse, and severely adverse economic scenarios contemplated by the stress testing regime fail to account for the different types of risks that NFCs face. As discussed above, some NFCs face risks that are unique to their business models and risk profiles. To account for these unique risks, the Board should adopt scenarios for stress testing of an NFC which incorporate shocks relating to the exogenous factors that actually impact the particular NFC. The stress testing scenarios for NFCs should appropriately de-emphasize shocks arising from traditional banking activities, as NFCs may be unlikely to engage in these activities to a material extent. For example, stress tests related to variable insurance products should capture long-term stress impacts and the results thereof.

Second, the provisions of the Proposed Rules detailing the data and information required for the stress tests are tailored specifically to BHCs. Under the Proposed Rules, an NFC would be required to provide information that would allow the Board to derive comprehensive projections of the company's pre-provision net revenue and allowance for loan losses, a metric that, as discussed, is of great relevance to banking organizations but of little relevance to many NFCs such as insurers. The set of data and information required for stress testing should be tailored to the specific NFC conducting the stress tests.

Third, an NFC could potentially be subject to the supervisory stress testing regime only 180 days after it is designated by the Council, a relatively short time period that does not allow for appropriate implementation of the new requirements. We question the efficacy and utility of subjecting an NFC to a bank-centric stress testing framework only six months after it is designated as systemically important. As drafted, the Proposed Rules require NFCs to be evaluated based on data that is likely to yield confusing or misleading results.

Finally, we wish to raise the concern that the public disclosure of an NFC's stress test results could create additional problems that may not arise in the context of disclosure of a BHC's stress test results. The marketplace has familiarity with and thus will be better able to interpret a BHC's stress test results. By contrast, it is unclear whether disclosure of an NFC's stress test results could provide the marketplace with useful information concerning the NFC's overall risk profile. The Board should be cautious in concluding that public disclosure of an NFC's stress test results will provide the same benefit as public disclosure of a BHC's stress test results.

F. <u>Debt-to-Equity Limit</u>

Section 165(j) provides that the Board shall require a covered company to maintain a debt-to-equity ratio of no more than 15-to-1 upon a determination by the

Council that the company poses a grave threat to the financial stability of the United States and that the imposition of such a requirement is necessary to mitigate the risk that the company poses to the financial stability of the United States. Section 165(j) is intended as an extraordinary measure, which would be invoked only if the Council makes a finding that a particular covered company poses a grave threat to the financial stability of the United States. In making this finding, the Council is directed to consider the factors listed in subsections (a) and (b) of section 113.

Without explanation or discussion, the Proposed Rules provide that the term "debt" shall mean "total liabilities" and the term "debt-to-equity ratio" shall mean the ratio of a company's total liabilities to a company's total equity capital less goodwill. These definitions have the effect of substituting "total liabilities" for the statutory term "debt." We submit that section 165(j)(3), which authorizes the Board to promulgate regulations "to establish *procedures and timelines* for complying with the requirements of" subsection (j), does not provide the authority to rewrite the substantive requirements of subsection (j).[61] The statute provides a test based on "debt," not on "total liabilities."

The substitution of "total liabilities" for debt in the ratio calculation also does not take account of the differences in the liability structures between NFCs and BHCs. For example, insurers have different types of liabilities and account for liabilities in a significantly different manner than BHCs. Under applicable accounting principles, insurers must account for future liabilities arising from underwritten insurance policies and hold reserves in anticipation of those future liabilities. Reserves for future insurance policy liabilities represent a significant part of the total liabilities of an insurer and are not comparable in kind or relative size to the reserves held by banking entities. Likewise, many insurers maintain significant separate account balances, reflected as assets and offsetting liabilities on their balance sheets. The separate account category is unique to insurers and is not comparable to any category of asset or liability for a banking entity. Separate account liabilities reflect interest rate and equity market risks that are borne by policyholders, which are offset by related separate account asset balances for accounting purposes. Similarly, insurance reserves do not reflect the same liquidity mismatch as do banking liabilities (*e.g.*, deposit reserves), as industry practice is to match these (generally long-term) policyholder liabilities with assets of similar duration. Accordingly, neither of these liabilities presents significant leverage or liquidity risk.

Whatever conceivable arguments might be made for implementing section 165(j) by using total liabilities of a banking entity as a proxy for debt (and we note even as to banking entities that the phrase used in the statute is "debt" and not "total liabilities"), it is clear that the substitution of the phrase "total liabilities" for "debt" in application to NFCs such as insurance companies is not justified and reflects a failure to take account of the fundamental differences between insurance companies and banking entities. We

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[61] 12 U.S.C. § 5365(j) (emphasis added).

request that the Board in a separate rulemaking tailor the proposed rules for the debt-to-equity ratio to take into account differences among NFCs and banking entities and the predominant line of business of the NFC. We specifically submit that the substitution of "total liabilities" for the statutory term "debt" is inappropriate and unauthorized as applied to any NFC.

G. Early Remediation Requirements

The Proposed Rules contemplate an early remediation framework that is based on the prompt corrective action rules currently applicable to insured depository institutions under the Federal Deposit Insurance Act. Unsurprisingly, the proposed early remediation framework is largely bank-centric in focus. Each of the proposed early remediation triggering events is based on one of the proposed prudential standards in the Proposed Rules and so suffers from the same kinds of defects that affect the other proposed prudential standards. The first early remediation triggering event is based on the capital and leverage requirements in the Proposed Rules. For the reasons discussed above, the proposed capital and leverage requirements are inappropriate for application to NFCs. Similarly, the indirect application of these requirements through their incorporation into the early remediation framework is inappropriate as applied to NFCs. The other triggering events, which are based on the stress test, risk management, and liquidity requirements in the Proposed Rules, are likewise inappropriate for application in their current form to NFCs for the reasons discussed above. The indirect application of these requirements through their incorporation into the early remediation framework is likewise inappropriate as applied to NFCs.

There is a danger that the early remediation requirements will inappropriately restrict an NFC from taking actions necessary to mitigate its financial distress. A potential scenario could play out as follows: an NFC subject to Level 2 remediation could be prohibited from acquiring assets to hedge outstanding risks or engaging in activities that could enhance its overall liquidity position. An NFC unable to take such actions could experience financial distress, leading to the odd result that the early remediation framework would heighten the very problems it was intended to mitigate. The separate rule for NFCs promulgated by the Board should eliminate the possibility of this counterproductive result and should provide for greater discretion on the part of the Board. If the Board were concerned that an NFC could potentially experience financial distress, it would at all times retain the supervisory authority to impose restrictions on the NFC's acquisitions, asset growth or capital distributions pursuant to its supervisory authority. Because the early remediation framework is bank-centric in design, imposing bank-centric early remediation triggers on NFCs would not only fail to achieve the purpose of the early remediation framework, but would also give rise to false positives and negatives that would mislead the Board into believing that the financial condition of the NFC had deteriorated.

As part of its separate rulemaking, the Board should propose an early remediation framework for NFCs that is explicitly tailored to the capital structure, risk profile, and activities of the NFC. In particular, the Board should ensure that any remediation triggers based on an NFC's capital or leverage are tailored to the actual capital structures of the NFCs. NFCs that are asset managers and insurers have significantly different balance sheet structures, risk profiles and capital and liquidity needs from BHCs. Subjecting NFCs to automatic triggers tied to bank-centric regulatory capital and leverage standards could result in unwarranted early remediation actions taken against such companies, actions that would be inappropriate and detrimental to the safety and soundness of the NFC itself. We submit that a system of triggers based on bank-centric capital and leverage metrics fails to capture the actual financial condition of many NFCs, and thus should not be applied to these firms.

Any early remediation framework applied to an NFC that is an insurer should take account of existing early remediation protocols for insurers and these protocols' interactions with existing risk-based capital rules for insurers. Under existing early remediation frameworks for U.S. insurers, an insurer's risk-based capital ratios are monitored against four designated risk-based capital ratios. These risk-based capital ratios are tailored to the specific risks that insurers are likely to face, such as risks arising from liabilities associated with the underwriting of insurance policies. If an insurer's risk-based capital ratios trigger a mandatory control level event, the insurer's domestic state insurance regulator *must* seek to place the insurer into receivership. Triggering other control level events results in various remedial actions, including (i) the insurer identifying the problems with its business and preparing a remedial action plan to eliminate the capital deficiency, and (ii) the domestic state insurance regulator conducting a special examination or analysis of the insurer, with the assistance of outside consultants if desired, and the issuance of a corrective order with respect to the insurer.

In developing an early remediation framework that is appropriately tailored to NFCs, we request that the Board also remain mindful of current and ongoing international efforts to develop new frameworks for effective prudential regulation of NFCs,[62] as these efforts can assist the Board in designing an early remediation framework appropriately tailored to NFCs. The Board should seek to ensure that early remediation requirements for NFCs are harmonized with international regulatory standards to the greatest extent possible.

[62] *See, e.g.*, FSB, *Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision* (Oct. 27, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111104ee.pdf.

III. Conclusion

We conclude by re-emphasizing our view that the Proposed Rules are deficient, both as a matter of policy and as a matter of law. As a matter of policy, the Proposed Rules' "one-size-fits-all" approach to the application of the enhanced standards to NFCs contradicts Congress's policy judgment that any enhanced standards applied to an NFC must be tailored to the characteristics of the NFC. The Proposed Rules' approach to the application of enhanced standards to NFCs is in tension with the Council's express recognition in the Final Designation Rule that a carefully tailored analytical process is necessary to assess the "unique" nature of the threat that would be presented by any designated NFC. As such, the Proposed Rules seemingly contradict the policy judgment of both Congress, as expressed in Title I, and the Council itself, as expressed in its Final Designation Rule. By not providing any clarity in the Proposed Rules as to how application of the enhanced standards will be tailored to NFCs, the Board has abdicated its responsibility to apply the enhanced standards to NFCs in a manner that can achieve the underlying policy goal of Title I. As currently contemplated, the Proposed Rules thus stand little chance of mitigating any identified threat to financial stability with respect to NFCs.

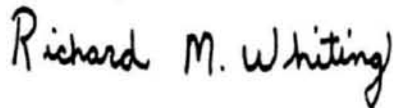
As a matter of law, the Board's approach to the application of enhanced standards to NFCs is fundamentally flawed. Section 165(b)(3), requires that the Board take into account differences among NFCs and BHCs and adapt the standards as appropriate to the predominant line of business of the NFC. Notwithstanding these clear directions, the Proposed Rules apply the same standards and requirements to NFCs and BHCs, and throughout the Proposed Rules expressly treat NFCs as if they were bank holding companies. This approach is in direct conflict with the provisions of section 165, which require consideration of the differences among NFCs and BHCs and adapting the standards as appropriate to the predominant line of business of an NFC.

It is our firm belief that if the Board continues with the approach of applying bank-centric standards to NFCs, the resulting outcome would increase, rather than decrease, risk in the financial system. The application of a bank-centric prudential regulatory framework to NFCs would be difficult (if not impossible) for the Board to effectively administer, could increase the risk that the NFC could become destabilized and would in any event have collateral consequences for the financial system as a whole and the real economy. Only by tailoring application of the enhanced standards can the Board ensure that its prudential regulatory regime for NFCs accomplishes its objective, and in so doing, achieve the Dodd-Frank's stated goal of identifying and mitigating risks to the financial stability of the United States that could arise from the financial distress of large, interconnected NFCs.

For these reasons, we request that the Board exclude NFCs from the Proposed Rules and commence a separate rulemaking to establish a process for designing appropriate standards under section 165 for any designated NFCs. The separate

rulemaking must describe the process by which the Board will meet its statutory obligations under section 165 to tailor the standards and requirements applicable to NFCs, and must also provide for appropriate comment by NFCs on any proposed standards as applied to a predominant line of business of an NFC or on an individual basis.

We thank the Board for the opportunity to comment on the Proposed Rules. If you have any questions, please contact me, Kenneth Bentsen, Jr. or Richard Foster at (202) 589-2424.



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Deputy Securities Administrator
North Carolina Department of the Secretary of State, Securities Division

Appendix A: Specific Questions Posed in the Preamble to the Proposed Rules

- *Question 1*: What additional characteristics of a nonbank covered company – in addition to its business model, capital structure, and risk profile – should the Board consider when determining how to apply the enhanced standards and the early remediation requirements to such a company?

  Please see section I.C of this letter.

- *Question 2*: What are the potential unintended consequences and burdens associated with subjecting a nonbank covered company to the enhanced prudential standards and the early remediation requirements?

  Please see sections I.C and II of this letter.

- *Question 3*: The Board seeks comment on its proposed approach to the application of the company-run stress test requirements, including the delayed effective date, to savings and loan holding companies. Also, what additional or alternative criteria should the Board consider for determining which savings and loan holding companies initially would be subject to the enhanced prudential standards and early remediation requirements?

  Please see section I.G of this letter.

- *Question 4*: Are there alternative approaches the Board should consider to phase in the proposed enhanced prudential standards for either bank holding companies or nonbank financial companies?

  Please see section I.E of this letter.

- *Question 5*: What factors should the Board consider in deciding whether to impose different capital planning or stress testing requirements on nonbank covered companies?

  Please see sections II.A and II.E of this letter.

- *Question 6*: What alternative enhanced capital requirements for nonbank covered companies should the Board consider? Should the Board consider a longer or shorter phase-in period for capital requirements for nonbank covered companies?

  Please see sections I.E and II.A of this letter.

- *Question 9*: If the BCBS framework were to be applied to nonbank covered companies, how should the framework be modified to capture the systemic footprint of those companies?

  Please see sections I.H and II.A of this letter.

- *Question 10*: Is the Board's approach to enhanced liquidity standards for covered companies appropriate? Why or why not?

  Please see section II.B of this letter.

- *Question 11*: Are there other approaches that would effectively enhance liquidity standards for covered companies? If so, provide detailed examples and explanations.

  Please see section II.B of this letter.

- *Question 12*: The Dodd-Frank Act contemplates additional enhanced prudential standards, including a limit on short-term debt. Should the Board adopt a short-term debt limit in addition to or in place of the LCR and NSFR? Discuss why or why not?

  Please see section II.B of this letter.

- *Question 13*: What challenges will covered companies face in formulating and implementing liquidity stress testing described in the proposed rule? What changes, if any, should be made to the proposed liquidity stress testing requirements (including the stress scenario requirements and required assumptions) to ensure that analyses of the stress testing will provide useful information for the management of a covered company's liquidity risk? What alternatives to the proposed liquidity stress testing requirements, including the stress scenario requirements and required assumptions, should the Board consider? What additional parameters for the liquidity stress tests should the Board consider defining?

  Please see section II.B of this letter.

- *Question 14*: The Board requests comment on all aspects of the proposed definitions of "highly liquid assets" and "unencumbered." What, if any, other assets should be specifically listed in the definition of highly liquid assets? Why should these other assets be included (that is, describe how the asset is easily and immediately convertible into cash with little or no loss in value during liquidity stress events)? Are there criteria for identifying additional assets for inclusion in

the definition of highly liquid assets appropriate? If not, how and why should the Board revise the criteria?

Please see section II.B of this letter.

- *Question 22*: Is the approach of including all subsidiaries of a covered company in the definition of covered company for purposes of the proposed rule appropriate? If not, explain why not.

  Please see section II.C of this letter.

- *Question 23*: Should the Bank Holding Company Act/Regulation Y definition of "control" be adopted for purposes of the proposed rule? Are there alternative approaches to defining when a company is a subsidiary of another the Board should consider?

  Please see section II.C of this letter.

- *Question 24*: Since a covered company may have strong incentives to provide support in times of distress to MMMFs and certain other funds or vehicles that it sponsors or advises, the Board seeks comment on whether such funds or vehicles should be included as part of the covered company for purposes of this rule. Is the proposed rule's definition of "control" effective, and should the proposal's definition of "subsidiary" be expanded to include and investment fund or vehicle advised or sponsored by a covered company or any other entity.

  Please see section II.C of this letter.

- *Question 30*: Should the Board adopt a more nuanced approach, like the BCBS approach, in determining which covered companies should be treated as major covered companies or which counterparties should be considered major counterparties?

  Please see section II.C of this letter.

- *Question 70*: Are the timing requirements of this proposal sufficient to allow a covered company or nonbank covered company to prepare, collect, and submit to the Board the information necessary to support the supervisory stress test? If not, what alternative timing should the Board consider?

  Please see sections I.E and II.E of this letter.

- *Question 71*: What is the potential burden on covered companies stemming from the requirements to submit internal data to support the supervisory stress tests?

Please see section II.E of this letter.

- *Question 73*: What are the benefits and drawbacks associated with company-specific disclosures? What, if any, company-specific items relating to the supervisory stress tests would present challenges or raise issues if disclosed, and what is the nature of those challenges or issues? What specific concerns about the possible release of a company's proprietary information exist? What alternatives to the company-specific disclosures being proposed should the Board consider?

  Please see section II.E of this letter.

- *Question 76*: Does the immediate effectiveness of the proposed rule provide sufficient time for an institution that is covered at the effective date of the rule to conduct its first annual stress test? Would over $10 billion companies, in particular, have sufficient time to prepare for the first annual stress test, under either the proposed initial or proposed ongoing applicability rules?

  Please see sections I.E and II.E of this letter.

- *Question 81*: The Board seeks comment on the proposed risk-based capital and leverage triggers. What alternative or additional risk-based capital or leverage triggering events, if any, should the Board adopt? Provide detailed explanation of such alternative triggering events with supporting data.

  Please see section II.G of this letter.