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Via Federal eRulemaking Portal

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: **Docket No. R–1438, RIN 7100 AD 86 // Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, Proposed Rule, 77 Fed. Reg. 76628 (Dec. 28, 2012)**

Dear Mr. deV. Frierson:

We represent companies that may be impacted by the proposed rules[1] released by the Board of Governors of the Federal Reserve System (the "Board") on December 28, 2012, regarding enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies (the "Proposal"). The Proposal would implement section 165 (enhanced prudential standards) and section 166 (early remediation requirements) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") as those sections apply to foreign banking organizations ("FBO") and foreign nonbank financial companies ("FNFC") supervised by the Board. We appreciate the opportunity to participate in the rulemaking process, and we submit this comment letter to help inform the Board about issues relating to the Proposal that may affect the regulated community, and, particularly, the insurance industry.

As part of the financial regulatory reforms adopted under the Dodd-Frank Act, Congress directed the Board to establish prudential standards that "are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies [with assets equal to or greater than $50,000,000,000] that do not present similar risks to the financial stability of the United States."[2] In doing so, Congress provided a

[1] Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 Fed. Reg. 76627 (Dec. 28, 2012).

[2] Dodd-Frank Act § 165(a)(1)(A).

statutory framework to ensure that the prudential standards applicable to any designated nonbank financial company ("NFC"), whether foreign or domestic, would build directly on existing NFC regulation and not impose inapt standards developed for banking organizations. The Dodd-Frank Act mandates that the Board "take into account differences ***among*** nonbank financial companies supervised by the Board of Governors and bank holding companies," giving particular consideration to factors described in Section 113(a) and (b), including whether the company owns an insured depository institution and other risk-related factors.[3] Congress also required that the Board "adapt the required standards as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate."[4] Further, Congress specifically provided for tailoring of the standards by authorizing the Board to "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate."[5]

By proposing to subject FNFCs to prudential standards developed for banking organizations, the Board's current Proposal does not implement Congress's plainly expressed intent in the Dodd-Frank Act that standards should be based on existing nonbanking regulation and also be tailored to reflect differences among companies. In addition, the Proposal is inconsistent with congressional intent in how it treats domestic and foreign NFCs.

As discussed more fully below, we offer the following comments for the Board's consideration:

(1) **Re-proposal of a rule specific to FNFCs:** Because the Proposal fails to implement the statutory framework applicable to FNFCs, the Board must exclude FNFCs from the current Proposal and re-propose a separate rule directed at FNFCs. The substance of the Proposal only addresses banking organizations and discusses in varying detail the application of enhanced prudential requirements with respect to FBOs and their U.S. operations. It ignores the provisions of the Dodd-Frank Act that call for the Board to base section 165 standards for FNFCs on existing regulatory

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[3] Dodd-Frank Act § 165(b)(3)(A) (emphasis added).

[4] Dodd-Frank Act § 165(b)(3)(D).

[5] Dodd-Frank Act § 165(a)(2)(A).

standards for comparable nonbanking firms.[6] And it provides no substantive discussion of how the section 165 framework would apply to FNFCs. In proposing a new rule consistent with the statutory framework, the Board must address the applicability, including risk-based aspects, of existing nonbanking standards for FNFCs, and propose new regulations that fully take into account existing regulatory schemes as part of the Board's efforts to reduce systemic risk. The Board must also, as required by section 165(b)(2), take into account the extent to which an FNFC is subject to comparable home country standards on a consolidated basis and give due regard to the principle of national treatment and equality of competitive opportunity. Only in this way will FNFCs be given adequate notice of how the enhanced prudential requirements will apply to them.

The Administrative Procedure Act ("APA")[7] also requires a re-proposal because the Proposal: (1) fails to give the public sufficient notice of the Board's intentions; (2) ignores precedent from the U.S. Supreme Court and the federal Courts of Appeals that discourages agencies from creating regulations through individual orders; and (3) fails to provide a sufficient basis from which the Board could produce a final rule that would both provide FNFCs with a clear understanding of the process by which the Board will apply enhanced prudential standards and still be a "logical outgrowth" of the Proposal.

(2) **The importance of tailoring regulations and requirements to specific industries and firms:** In a brief discussion in the preamble to the proposed rule, the Board appropriately acknowledges Congress's intent that regulations be tailored to fit the risks posed by various nonbanking industries and individual companies. We urge the Board, however, to provide specific details about how it would tailor regulations in a re-proposed rule. Congress directed the Board to consider nonbanking firms and BHCs separately when imposing these enhanced prudential requirements, to base section 165 regulation on existing nonbank industry regulation, and to carefully weigh distinguishing factors between different types of regulated entities. It is imperative that the Board take Congress's intent into account by proposing rules tailored at least to the unique attributes of the principal FNFC industry groups and to consider how to apply the section 165 enhancement requirement in the context of existing nonbank company regulation. Joint working groups of insurance regulators and the Federal Reserve have identified such distinguishing risk factors for the

[6] Dodd-Frank Act § 165(a)(1)(A).

[7] 5 U.S.C. §§ 701 *et seq.*

insurance industry and reviewed existing insurance regulation addressing these risks. The application of enhanced prudential requirements to designated insurance companies must be grounded in this existing comprehensive insurance regulatory regime, with reference to banking regulation as, at most, a secondary consideration to provide an appropriate level of comparability across the board under section 165.

(3) **The need to reconsider the intermediate holding company ("IHC") requirement**: The Board included a provision in the Proposal that would permit the Board, at its discretion, to require an FNFC to establish an IHC. While establishing an IHC would not be mandatory for an FNFC, the Proposal appears to contemplate requiring FNFCs to use a single IHC to consolidate their U.S. activities as a matter of course. In so doing, the current Proposal does not adequately consider the severe disruptions and other problems that such a requirement could engender. For example, insurance regulation is focused on specific chartered insurance companies. It would be contrary to fundamental aspects of such regulation to require consolidation of multiple insurance companies under a single IHC for purposes of section 165 regulation.

A re-proposed rule should specifically address the range of identifiable legal issues and business considerations presented by a possible IHC requirement, make clear that a single U.S. IHC would not be the default approach, and discuss factors supporting the use of more than one IHC in a given FNFC structure, such as when existing affiliates now operate separately and independently, and indeed, may be competitors.

In addition, the $10 billion size threshold for a U.S. IHC for foreign banks and nonbank financial companies is contrary to "national treatment" practices—the fundamental international trade principle of "giving others the same treatment as one's own nationals," which is "found in all the three main WTO agreements"[8]—and could result in a significantly uneven playing field for FNFCs.

(4) **The importance of tailoring the "control" definition:** For the purposes of this rule, the Board should tailor the "control" definition to the specific provisions of Title I of the Dodd-Frank Act instead of defaulting to the definition of "control" in the Bank Holding Company Act of 1956 (the "BHCA"). The purposes animating Title I differ significantly from those behind the BHCA, and control determinations regarding FNFCs should be based on evidence of an actual—as opposed to a

[8] "Principles of the Trading System," World Trade Organization, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm.

"theoretical"—control relationship. Use of the BHCA definition in a Title I context would lead to "false-positive" results in specific corporate structures and relationships. Defining "control" properly is essential to this Proposal because it determines what entities are FNFC affiliates and thus could become subject to the Board's enhanced prudential standards. Because of the requirements and burdens for affected companies from the application of such standards, FNFCs and other stakeholders have a strong interest in accurate "control" determinations. Moreover, applying an overbroad definition of control in the context of Title I will not help to protect the U.S. financial system from potential systemic risk and instead could subject firms that are not systemically risky to unnecessary, and potentially counter-productive, enhanced prudential standards.

I. The Board Should Issue a Separate Notice of Proposed Rulemaking Directed at Foreign Nonbank Financial Companies.

The Board's current Proposal devotes 74 pages of the Federal Register to set forth an extensive regulatory regime for FBOs. In contrast, it addresses FNFCs in fewer than 2 pages. The Proposal simply asserts that the FBO provisions "will apply to a foreign nonbank financial company supervised by the Board, unless the Board determines that application of those subparts, or any part thereof, would not be appropriate."[9] This approach of incorporation by cross-reference to regulatory requirements designed for banking institutions does not follow appropriate rulemaking procedures, and is contrary to the terms of section 165.

As discussed in more detail below, Congress has directed the Board to impose more stringent standards on designated NFCs and certain banking organizations—but not the same standards on banks and nonbanks. Title I of the Dodd-Frank Act provides for regulation of banks and nonbanks to occur on parallel tracks based on standards developed for each type of regulated industry. Section 165(a)(1) provides that the Board must establish enhanced prudential standards for "nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that . . . are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States." There are no existing standards and requirements that apply equally to banks and NFCs. In fact, NFCs, including most notably insurance companies, and bank holding companies are regulated under separate regimes that take into account their unique business and financial characteristics and operations.

[9] 77 Fed. Reg. at 76,679 (Proposed 12 C.F.R. § 252.2(d)(1)).

Title I recognizes that NFCs often operate in fundamentally different ways from banking institutions. The Proposal's failure to even attempt to build on existing nonbank regulatory standards in order to fashion section 165 standards for NFCs violates both express congressional intent in the Dodd-Frank Act and the APA. To satisfy minimal rulemaking requirements, the Board must provide a fully-reasoned discussion of how section 165 requirements should be applied in the context of an existing regulated nonbank industry, such as insurance, including how to increase the stringency of existing nonbanking regulations as appropriate to achieve the objectives of section 165. In furtherance of this goal, the Board must exclude FNFCs from the current Proposal and issue a new proposed rulemaking that addresses such companies.

A. The Current Proposal Thwarts Congressional Intent Because It Fails to Give Meaningful Consideration to How Enhanced Prudential Requirements Will be Applied to Foreign Nonbank Financial Companies.

The Board's current proposal describes in detail how the Board plans to apply enhanced prudential standards to foreign banks and its rationale for selecting those standards. In stark contrast, however, the Proposal provides no explanation of how the Board expects to apply the requirements of sections 165 and 166 to FNFCs. It is telling that the Federal Register release uses the words "bank" and "banking" 1,347 times, but uses the words "nonbank" and "nonbanking" a total of only 90 times. With regard to FNFCs, the Board only says that "the proposal would also apply the enhanced prudential standards" to the FNFCs designated by the Financial Stability Oversight Council (the "FSOC" or "Council")[10] and that the Proposal "would establish the general framework for application of the enhanced prudential standards and the early remediation requirements" for FNFCs.[11]

Paraphrasing the Dodd-Frank Act, the Board adds that it "expects 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 any other risk-related factors that the Board deems appropriate."[12] But the Proposal includes no such tailoring and instead states that certain enhanced standards "will apply . . . unless the Board determines that application . . . would not be appropriate."[13]

[10] *Id.* at 76,632.

[11] *Id.* at 76,634.

[12] *Id.* (paraphrasing Dodd-Frank Act Sec. 165(a)(2)).

[13] *Id.* at 76,679.

Making matters worse, the Proposal includes virtually no discussion of under what circumstances and how these enhanced standards—ranging from risk-based capital requirements to single-counterparty credit limits to an early remediation framework—would apply to FNFCs. Those FNFCs that soldier through the 76-page Proposal are left with almost no sense of what to prepare for in case the final rule mirrors what has been proposed.

In addition to ignoring the requirement that section 165 standards applicable to NFCs must build on existing regulations applicable to such NFCs, the Proposal provides no specificity or guidance about how rules designed to apply to banking entities might be applied to nonbanking firms, such as insurance companies, for which banking is plainly not the predominant line of business. It makes no attempt to explain how its proposed approach could satisfy the statutory requirement for applying section 165 standards to FNFCs.

The Proposal's cursory treatment of how new prudential standards for banking organizations could be applied to FNFCs thwarts congressional intent that regulations under Title I applicable to FNFCs must be based on existing nonbank regulation and designed to address specific nonbanking risks. This intent is clearly embodied in the pertinent provisions of Section 165 discussed herein. The Proposal paraphrases statutory language when stating that the Board intends to tailor the regulations to various industries and firms,[14] but it wholly ignores the substantive statutory mandate as reflected in section 165(b)(3)(A) and (D).

Section 165(b)(3) directs the Board: "In prescribing prudential standards . . . the Board of Governors ***shall***—(A) take into account differences ***among*** nonbank financial companies supervised by the Board of Governors and bank holding companies" based on several factors, including "whether the company owns an insured depository institution" and "nonfinancial activities and affiliations of the company." (emphasis added). Section 165(b)(3)(D) reinforces this requirement by providing that the Board ***shall*** "adapt the required standards as appropriate in light of any predominant line of business of such company, including assets under management or other activities for which particular standards may not be appropriate."

The Proposal, however, does not explain how it would take differences between NFCs and bank holding companies into account, nor does it explain how the Board plans to adapt the enhanced prudential standards based on companies' predominant lines of business. The Proposal also does not reflect consideration of the requirements to take into account comparable home country standards to which an FNFC is subject on a consolidated basis and to give due regard to the principle of national treatment and equality of competitive

[14] *Id.* at 76,634.

opportunity. To meet all these statutory requirements, the Board must offer a new proposal that accounts for these business and regulatory-based factors and that affords FNFCs and other stakeholders the opportunity to comment on the proposal.

B. The Current Proposal Violates the Administrative Procedure Act Because It Fails to Give FNFCs Adequate Notice of How Enhanced Prudential Requirements May Apply to Them.

Not only does the Proposal fail to implement the statutory requirement to build on existing nonbanking regulatory regimes, its treatment of FNFCs violates several well-established requirements of the APA. As discussed below, the Proposal: (1) fails to give the public sufficient notice of the Board's intentions; (2) ignores precedent from the U.S. Supreme Court and the federal Courts of Appeals that discourages agencies from creating regulations through individual orders; and (3) fails to provide a sufficient basis from which the Board could produce a final rule that would both provide FNFCs with a clear understanding of the process by which the Board will apply enhanced prudential standards and still be a "logical outgrowth" of the Proposal.

1. Insufficient Notice.

Under the APA, regulatory agencies must provide parties notice of the "terms or substance of the proposed rule or a description of the subjects and issues involved."[15] An agency rulemaking must inform the public of the proposed regulatory approach and allow the public to provide meaningful input through written communications.[16] The D.C. Circuit has advised that an agency must "fairly apprise interested persons of the nature of the rulemaking,"[17] and that "it must be possible for the regulated class to perceive the principles which are guiding agency action."[18] The Second Circuit has stressed the importance of alerting persons of "likely alternatives so that they know whether their interests are at stake."[19] A leading treatise on administrative law explains that a proper notice of proposed rulemaking "should disclose all of the questions the agency has and the issues the agency feels it must resolve in order to issue a final rule. In addition the agency should disclose its

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[15] 5 U.S.C. § 553(b)(3).

[16] *Id.* at § 553(c).

[17] *USW v. Marshall*, 647 F.2d 1189, 1221 (D.C. Cir. 1980) (internal quotation marks omitted).

[18] *Pearson v. Shalala*, 164 F.3d 650, 661 (D.C. Cir. 1999).

[19] *Nat'l Black Media Coal. v. FCC*, 791 F.2d 1016, 1023 (2d Cir. 1986) (internal quotations omitted).

preliminary thinking on these questions and issues so that participants will know how to confront them."[20]

The Proposal does not meet these standards. In six paragraphs, the Board asserts its intention to impose 76 pages of substantial bank-centric regulations on FNFCs, including enhanced prudential standards, and to exercise its discretion to require FNFCs to establish an IHC as it determines. In those paragraphs, the Board gives no sense of the "principles guiding agency action" nor its "preliminary thinking on these . . . issues," nor does it provide "likely alternatives." The Board does not explain why it believes that the prudential standards it has designed for banks would apply equally well to nonbanks. It also does not explain how the standards would be applied or the process by which it would tailor the standards to fit each regulated industry and firm. Nor does the Board discuss how or why it would require an IHC for an FNFC or regulatory factors it would consider in structuring such an IHC. It is the Board's task to make initial determinations of how the various section 165 requirements are to be applied to the various types of NFCs.

The Proposal asks few questions specifically concerning FNFCs, and the ones it does pose are very general and deal only with basic, threshold matters:[21]

> "*Question 1:* Should the Board require a foreign nonbank financial company supervised by the Board to establish a U.S. intermediate holding company? Why or why not? What activities, operations, or subsidiaries should the foreign nonbank financial company be required to conduct or hold under the U.S. intermediate holding company?"
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> "*Question 2:* If the Board required a foreign nonbank financial company supervised by the Board to form a U.S. intermediate holding company, how should the Board modify the manner in which the enhanced prudential standards and early remediation requirements would apply to the U.S. intermediate holding company, if at all? What specific characteristics of a foreign nonbank financial company should the Board consider when determining how to apply the enhanced prudential standards and the early remediation requirements to such a company?"

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[20] CHARLES H. KOCH, JR., ADMINISTRATIVE LAW & PRACTICE 342 (3d ed. 2010).

[21] 77 Fed. Reg. 76,635.

These questions do not provide the public with any sense of the Board's "preliminary thinking" about these issues, nor the principles guiding the Board in its decision-making process to require FNFCs to establish IHCs. Indeed, these questions implicitly recognize the deficiency of the Proposal. Instead of presenting a reasoned justification for imposing the same regulatory framework on NFCs, the Proposal offers only threshold questions, analytically preliminary to an actual rulemaking. Such questions would be more appropriate to pose in an advance notice of proposed rulemaking ("ANPRM"), which is the proper mechanism agencies use to collect initial background information from the public to help inform their regulatory proposals. Moreover, the lack of other questions directed at FNFCs among the 103 questions included in the Proposal reveals the lack of actual consideration the Board has given such companies in the context of sections 165 and 166 of the Dodd-Frank Act.

2. Regulation By Individual Orders.

Rather than giving proper notice of the Board's principles or the alternatives the Board is considering, the Board announced in the Proposal that it "expects to issue an order that provides clarity on how the enhanced prudential standards would apply to a particular foreign nonbank financial company once the company is designated by the Council."[22] But this is no substitute for proper agency rulemaking; simply, it will not suffice for the Board to interpret section 165 as applied to FNFCs solely through individual orders. As the D.C. Circuit has put it, the APA does not permit agencies "to promulgate mush and then give it concrete form only through subsequent less formal 'interpretations.'"[23]

Although agencies are allowed to proceed through individual adjudication, the Supreme Court has emphasized that agencies should act through rulemaking, rather than individual adjudications, wherever possible.[24] It is also important for agencies to explain why individual treatment is preferable to more generalized rulemaking.[25] The Board has not offered any rationale here for why individual orders would be a better mechanism for regulation of FNFCs than a more transparent rulemaking process.

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[22] *Id.*

[23] *Paralyzed Veterans of Am. v. D.C. Arena L.P.*, 117 F.3d 579, 584 (D.C. Cir. 1997).

[24] *SEC v. Chenery Corp.*, 332 U.S. 194, 202 (1947) ("Since the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making powers, it has less reason to rely upon ad hoc adjudication to formulate new standards of conduct within the framework of the Holding Company Act. The function of filling in the interstices of the Act should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future.").

[25] *See Shays v. FEC*, 424 F. Supp. 2d 100, 115 (D.D.C. 2006).

Further, the Supreme Court has declined to defer to an agency when the agency attempts to apply its interpretations of its own regulations in specific circumstances when the regulation does not add clarity or detail to statutory text. In *Gonzalez v. Oregon*, the Court declined to defer to the U.S. Attorney General's interpretation of his own regulation because "the underlying regulation does little more than restate the terms of the statute itself. The language [the Attorney General's interpretation] addresses comes from Congress, not the Attorney General, and the near equivalence of the statute and regulation belies the Government's argument for *Auer* deference."[26] The Court went on: "Simply put, the existence of a parroting regulation does not change the fact that the question here is not the meaning of the regulation but the meaning of the statute. An agency does not acquire special authority to interpret its own words when, instead of using its expertise and experience to formulate a regulation, it has elected merely to paraphrase the statutory language."[27]

The Proposal, as it relates to FNFCs, does little more than defer its responsibilities by repeating the Dodd-Frank Act's statutory text regarding its authority and then stating that the Board expects to issue orders applying the new requirements to specific companies. Notice that an agency later and informally will provide clarity about how it will apply significant regulations to a particular regulated entity does not satisfy the APA.

3. Logical Outgrowth.

The deficiencies discussed above cannot be cured in a final rule—the only proper recourse is a new proposal that contains the required analysis and descriptive details of the regulatory approach the Board would propose to follow. Any attempt to address these fundamental deficiencies in a final rule without allowing for meaningful public input would fall short of established APA standards.

Indeed, a final rule must be a "logical outgrowth" of a proposed rule.[28] The D.C. Circuit has held that "[a] final rule qualifies as a logical outgrowth if interested parties should have anticipated that the change was possible, and thus reasonably should have filed their comments on the subject during the notice-and-comment period."[29] "By contrast," the court

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[26] *Gonzalez v. Oregon*, 546 U.S. 243, 257 (2006).

[27] *Id.*

[28] *Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 174 (2007).

[29] *CSX Transp., Inc. v. Surface Transp. Bd.*, 584 F.3d 1076, 1079-80 (D.C. Cir. 2009) (internal quotations omitted).

explained, "a final rule fails the logical outgrowth test and thus violates the APA's notice requirement where interested parties would have had to divine the agency's unspoken thoughts because the final rule was surprisingly distant from the proposed rule."[30] And even if commenters do manage to divine the Board's unspoken thoughts about how it plans to apply these banking regulations to NFCs, such foresight will not save a final rule from the Board's failure to give proper notice to the public. The D.C. Circuit has rejected such "bootstrap arguments predicating notice on public comments alone."[31] The court emphasized: "Ultimately, notice is the agency's duty because comments by members of the public would not in themselves constitute adequate notice. Under the standards of the APA, notice necessarily must come—if at all—from the Agency."[32]

It would be impossible for any final rule relating to FNFCs that might satisfy other APA requirements to meet the logical outgrowth standard. The Proposal does not describe how its proposed rules, developed wholly in the context of banking organizations, would be applied to nonbanks. It does not explain how the prudential standards would be tailored—or even could be tailored—to apply to categories of nonbanks, let alone specific NFCs. Nor does it address the appropriateness of applying the IHC concept to the many types of nonbank organizational structures, and, if so, how such an IHC requirement would be implemented. Although the Proposal reiterates the statutory language that the Board would take into account a firm's "capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Board deems appropriate," it adds nothing to the elements already prescribed by the statute. The Proposal's terms regarding non-bank firms are so vague that a final rule adding any substance to the terms could not be a "logical outgrowth" of the Proposal.

In light of the clear requirements and standards in the Dodd-Frank Act and the APA, the Board must issue a new proposal addressing enhanced prudential standards and IHCs specifically for FNFCs. These are critical issues for companies that will be subject to the enhanced prudential requirements and, perhaps, required to establish an IHC. The current regulatory approach could lead to numerous unintended and costly consequences—but the paucity of discussion in the Proposal means that potentially regulated entities would not be able to predict the consequences that would result from a final rule based on the Proposal.[33]

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[30] *Id.* at 1080 (internal quotations omitted).

[31] *Horsehead Res. Dev. Co., Inc. v. Browner*, 16 F.3d 1246, 1268 (D.C. Cir. 1994).

[32] *Id.* (internal citation and quotation marks omitted).

[33] In addition, any final rule that could be considered a "logical outgrowth" of this Proposal could not provide sufficient detail about the process the Board would use to impose enhanced prudential standards on specific industries and companies to satisfy due process concerns. As the Fifth Circuit has explained, "Due process

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II. A New Proposal Should Provide Clear Standards and Procedures Regarding How Enhanced Prudential Requirements Will be Tailored to Specific Industries and Companies, Such as Insurance.

As discussed above, the current Proposal fails on several distinct and fundamental grounds: it ignores the statutory mandate to develop section 165 standards for NFCs, including FNFCs, based on existing nonbanking regulatory regimes; it fails to give FNFCs any indication regarding the analytical process and procedures that it would employ to impose enhanced prudential requirements on them; and it correspondingly provides no opportunity for the robust substantive dialogue through informed public comments addressed to specific proposals offered by the Board. The Board must issue a new proposed rule addressing regulation of FNFCs, as contemplated by section 165 of the Dodd-Frank Act, that addresses the following:

(1) how the Board plans to tailor enhanced prudential standards to specific industries, such as the insurance industry;

(2) the extent to which existing risk-based standards, regulations, and supervision as applied to FNFCs may already meet, or provide the basis for, section 165 "enhanced"

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. . . requires that [an agency] provide notice which is reasonably calculated to inform all those whose legally protected interests may be affected by the new principle." *Mobil Exploration & Producing N. Am., Inc. v. FERC*, 881 F.2d 193, 199 (5th Cir. 1989) (internal citation omitted). The D.C. Circuit has further explained that "statutes and regulations which allow monetary penalties against those who violate them . . . must give [a regulated entity] fair warning of the conduct it prohibits or requires . . . . If a violation of a regulation subjects private parties to criminal or civil sanctions, a regulation cannot be construed to mean what an agency intended but did not adequately express." *Gates & Fox Co. v. OSHRC*, 790 F.2d 154, 156 (D.C. Cir. 1986) (quoting *Diamond Roofing Co. v. OSHRC*, 528 F.2d 645, 649 (5th Cir. 1976)).

These same considerations of fairness and due process apply here to support a re-proposal for FNFCs, particularly given that failure to comply with section 165's enhanced prudential standards can lead to early remediation actions under Section 166. A new proposal should explain the basic procedural steps for imposing enhanced prudential standards on FNFCs, including how the Board will collect pertinent information about individual companies; how the Board will present initial findings to designated companies; how companies may make written submissions to help inform the Board's determinations and address any perceived risks identified by the Board; whether the Board intends to hold hearings in connection with these determinations; and the procedures to reassess any prudential standards if they are no longer necessary. *See* Part II. C. below.

requirements, and thus the extent to which additional requirements may be needed so that FNFCs designated by the FSOC will meet section 165 requirements; and

(3) the process by which the Board plans to tailor specific section 165 requirements to address risks posed by each designated company.

Previous work by banking-insurance regulatory working groups provides a sound starting point for the Board to address these matters in a re-proposed rule.

A. Background: Federal Reserve-NAIC Joint Working Groups' Reports Comparing Bank and Insurance Risks and Regulation.

The Board already should be familiar with the various risks in the major types of insurance underwriters and the existing thorough regulation of the insurance industry. Between 2000 and 2005, representatives of the Federal Reserve System participated in working groups with a number of state insurance commissioners and the National Association of Insurance Commissioners ("NAIC") and prepared several reports to identify and assess the similarities and differences in risks and regulatory practices for banking and insurance company activities. The report issued by one of these groups states that the "Federal Reserve staff learned more about the nature of risks faced by insurers, and the tools utilized by insurance company management and state insurance regulators to monitor these risks, including the emphasis of state regulation on examining insurance companies on a legal entity level."[34]

The reports of these joint working groups are pertinent to this rulemaking and the implementation of section 165 in a number of ways: (1) the approach to risk identification and regulatory tools for addressing risk described by these joint working groups embodied the same conceptual approach as enacted in section 165;[35] (2) the Federal Reserve-NAIC working groups carefully examined and compared risks posed by banking and insurance and determined that different types of insurance companies pose significant and different types of risk both from banks and from each other;[36] (3) correspondingly, they identified in detail

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[34] "Report of the National Association of Insurance Commissioners (NAIC) and the Federal Reserve System Joint Subgroup on Financial Issues," NAIC Risk Assessment Working Group of the Financial Condition (E) Subcommittee, at 2 (June 10, 2003).

[35] *See id.* at 1-2.

[36] *See id.* at 3-4. Included in the 2003 report is a detailed set of matrices that separately "map" life insurance company risks and property/casualty company risks in the categories of risks used by the Board for banking companies, as well as numerous risks in risk categories used by the NAIC and insurance regulators

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numerous elements of insurance regulation that specifically addressed those unique insurance risks and determined that nothing in banking regulation addressed such risks;[37] (4) they pointed out that the types of risks associated with each insurance company depend upon its particular facts and circumstances;[38] and (5) the reports of these working groups should provide a good foundation for the Board to build on when developing a re-proposed rule, as we believe is legally and practically necessary.

The 2003 joint working group report found, for example, that there are "different types of counterparty exposures inherent in the transactions or products associated with the different sectors," and that liquidity, operational, legal, and reputational risks "are viewed somewhat differently in the context of the organization and management of the business operations of banks and insurance companies."[39] It noted that the NAIC currently had in place three "RBC [risk-based capital] formulae in recognition of the different risk profiles associated with three different types of insurers—life and health, property/casualty, and managed care organizations."[40] In addition, this report identified a major risk category unique to property/casualty insurers, stating that "catastrophe risk management methods deserved separate, in-depth study apart from discussions of more general underwriting and other risks faced by the property/casualty and life insurance industries."[41]

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in supervising and regulating insurers that "do not fit readily" into any of the Board's banking risk categories. *See id.* at 12-26.

[37] *See id.* at 3. "As shown in the last part of both matrices, certain unique risks, including the principal risks in insurance products generally associated with pricing/underwriting and reserving processes that take the pure insurance risks of mortality, morbidity, property and liability exposure into consideration, remain unmatched when slotted against the Federal Reserve's risk categories." *Id.* at 4.

[38] *See id.* at 4.

[39] *Id.* at 3.

[40] *See id.* at 3, n. 3.

[41] *Id.* at 2. A report prepared by the American Academy of Actuaries' Catastrophe Management Work Group, attached to the NAIC 2003 report as Appendix 5, states in its executive summary that: "Catastrophes represent significant financial hazards to an insurer, including the risk of insolvency, an immediate reduction in earnings and statutory surplus, the possibility of forced asset liquidation to meet cash needs, and the risk of a ratings downgrade. Insurers manage catastrophe risk through a continuous learning process that can be described in five steps. The steps are identifying catastrophe risk appetite, measuring catastrophe exposure, pricing for catastrophe exposure, controlling catastrophe exposure, and evaluating ability to pay catastrophe losses." *Id.* at 30.

The 2005 working group issued a report entitled *A Comparison of the Insurance and Banking Regulatory Frameworks for Identifying and Supervising Companies in Weakened Financial Condition* (April 19, 2005) (the "2005 Report"). While finding many parallels in the overall approaches to identifying and managing weakened firms and insolvencies, this report also makes clear a number of fundamental differences between banking and insurance regulation. For example, with respect to insurance financial reporting, the report states:

> Insurance company statutory financial reports are based on statutory accounting principles (SAP), which are designed to address the concerns of regulators. SAP stresses measurement of the ability to pay claims of insurers in the future, while generally accepted accounting principles (GAAP) stresses measurement of earnings of a business from period to period, and the matching of revenues and expenses for the measurement period. Conservatism serves as a major principle in SAP. For example, some assets are not allowed to be included in an insurer's surplus; these are referred to as nonadmitted assets. Another example of conservatism is the prohibition against discounting reserves, and the fact that specific tables approved by regulators are required to establish reserves for various life insurance products.[42]

The Board should build from these efforts to better understand how the insurance industry differs from the banking industry and tailor the re-proposed rule accordingly.

B. The Re-Proposed Rule Must Tailor Enhanced Prudential Standards By Industry.

1. A New Proposal Must Articulate A Plan To Establish Enhanced Prudential Standards For Designated Nonbank Financial Companies That Are Built on Standards Applicable To Nonbank Financial Companies Not Presenting Similar Risks.

The Dodd-Frank Act calls for the Board to establish enhanced prudential standards for designated FNFCs that are more stringent than the standards that would otherwise apply to FNFCs that do not present similar systemic risks.[43] Under this approach, an existing

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[42] 2005 Report at 10.

[43] Dodd-Frank Act § 165(a)(1)(A) (The Board must establish prudential standards that "are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States").

nonbanking regulatory regime that is risk-based and imposes more stringent requirements on companies that pose greater systemic risk should be viewed as satisfying some or all of the enhanced standards called for under section 165.

However, the Proposal ignores this plain statutory requirement by proposing to base standards for FNFCs on standards that would otherwise apply to *bank holding companies*. The Dodd-Frank Act repeatedly makes clear that the benchmark for the enhanced standards must be the existing regulatory standards for each type of NFC. In section 165(b)(2), the Dodd-Frank Act states that in applying the enhanced prudential standards to an FNFC, the Board must "take into account the extent to which" the FNFC is subject to standards "comparable to those applied to financial companies in the United States." The Act therefore refers to "financial company" standards, recognizing the numerous industries that are within that category, and not just the narrower "bank holding company" standards. Again, in section 165(b)(3)(A), the Dodd-Frank Act states that the Board must "take into account differences *among* nonbank financial companies supervised by the Board of Governors and bank holding companies."[44]

In establishing a clear framework for the treatment of nonbanking firms distinct from the treatment of banking organizations under section 165, Congress further instructed the Board to take industry differences into account. The Dodd-Frank Act provides that the Board "may . . . differentiate among companies on an individual basis or by category."[45] The Board must "adapt the required standards as appropriate in light of any predominant line of business of such company,"[46] and consult with the primary regulator of a functionally-regulated subsidiary of a NFC[47]—for example, an insurance subsidiary. These numerous references to the broader term "financial companies" underscore the congressional requirement that the Board create prudential standards for designated NFCs that are more stringent than the prudential standards that would have otherwise applied to non-designated NFCs.

The Dodd-Frank Act requires the Board to address a specific financial industry's existing regulation and explain what enhanced standards, if any, should be applied to a firm that may be designated in that industry. Without such a discussion, it is impossible for the

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[44] Dodd-Frank Act § 165(b)(3)(A) (emphasis added). Use of "among" rather than "between" in this provision clearly demonstrates that Congress understands the plurality of industries within the set of NFCs.

[45] Dodd-Frank Act § 165(a)(2).

[46] Dodd-Frank Act § 165(b)(3)(D).

[47] Dodd-Frank Act § 165(b)(4).

public to assess and comment on whether the Board's plan to tailor the enhanced standards to various industries appropriately takes into account distinct industry characteristics, such as an industry's business model and current regulatory requirements. Indeed, some nonbank financial companies already may be properly viewed as subject to "enhanced" standards due to existing regulatory structures, such as the tiered RBC requirements for insurance companies that already impose more stringent requirements on riskier insurers.

Section 165 requires the Board to address NFCs differently than banking organizations[48] and permits the Board to "tailor" requirements by industry "category."[49] The Board's current approach is insufficient because it fails to tailor enhanced prudential standards by industry. A re-proposed rule for NFCs under section 165 should thus provide tailoring by category, which takes into account the "predominant line[s] of business" of major categories of NFCs. Insurance organizations, for example, should be given the opportunity to review and comment on the reasoning, requirements, and procedures for the creation and application of insurance prudential standards that are as least as stringent as the insurance standards that currently apply to a non-designated insurance organization.

Therefore, in issuing a new proposed rule addressed to FNFCs, the Board must follow both the statute and its stated intention to tailor enhanced prudential requirements to specific "categories of companies," such as insurance organizations, as authorized by the "Tailored Application" provisions of section 165(a)(2) and as required by section 165(b)(3)(A) and (D). The Dodd-Frank Act specifies that the Board should do so by building on existing nonbanking regulatory regimes.

2. Insurance Companies Should Not Be Regulated As Banks.

Insurance companies already are heavily regulated by state regulatory agencies; therefore, development of section 165 standards applicable to this industry should reflect and incorporate that existing insurance regulatory framework. Congressional intent that insurance companies and organizations should not be subject to bank-centric enhanced prudential standards was confirmed recently in letters from Congress to the bank regulators. For example, Senator Collins sent a letter on November 26, 2012 to the Board, Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") stating:

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[48] *See* Dodd-Frank Act § 165(a)(1)(A).

[49] Dodd-Frank Act § 165(a)(2); *see also* Dodd-Frank Act § 165(b)(3)(A) and § 165(b)(3)(D).

> It was not Congress's intent that federal regulators supplant prudential state-based insurance regulation with a bank-centric capital regime. Instead, consideration should be given to the distinctions between banks and insurance companies, a point which Chairman Bernanke rightly acknowledged in testimony before the House Banking Committee this summer. For example, banks and insurers typically have a different composition of assets and liabilities, since it is fundamental to insurance companies to match assets to liabilities, but this is not characteristic of most banks. I believe it is consistent with my amendment that these distinctions be recognized in the final rules.

Similarly, twenty-four U.S. senators sent a letter to the Board, FDIC, and OCC on October 17, 2012 emphasizing that they are "concerned that applying a bank-focused regime to insurance companies could undermine prudential supervision and unintentionally harm insurance policyholders, savers, and retirees." Further, they urged that "[a]ny final regulations should reflect the will of Congress to respect the distinctions between insurance and banking."[50] And on April 25, 2013, Chairman Jon Tester and Ranking Member Mike Johanns of the Senate's Subcommittee on Securities, Insurance, and Investment sent a letter to Secretary Lew, in his capacity as Chairman of the FSOC, stating:

> We strongly support the efforts of the Council to differentiate among industries and to publish industry-specific guidance and metrics that it devises. We believe that this is appropriate given the distinct differences between the banking business model, on which the SIFI designation authority and regulatory scheme are based, and the business models of other financial services industries such … [as] insurance.

In developing section 165 standards, the Dodd-Frank Act calls for the Board to build on—not override—the foundation of state insurance regulation. During the recent financial crisis, insurance companies and organizations remained stable and performed strongly under the existing state regulatory regime. Indeed, the success of insurance regulation demonstrated by such industry-wide performance underscores that the existing risk-based insurance regulatory regime, including its tiered risk-based capital requirements, may already satisfy requirements under section 165. Regarding the longstanding system of state insurance regulation, the NAIC's Deputy Director and Superintendent of Insurance and Banking testified before Congress:

[50] While these letters focus on Board implementation of the "Collins Rule" in section 171, these same considerations are reflected in section 165, as discussed herein.

> The strength of this system was evident during the financial crisis. For example, in 2009, 140 banks failed, but only 18 insurers did. The system's fundamental tenet is to protect policyholders by ensuring the solvency of the insurer and its ability to pay insurance claims. To fulfill this mission, insurers are subject to stringent laws and regulations and insurance regulators have broad authorities to examine all licensed insurers to identify and address issues before they become a threat to insurer solvency.[51]

The NAIC and state insurance regulators have developed a sophisticated and detailed risk-based regulatory regime for the industry, including RBC and accounting standards tailored to the business of insurance companies. As demonstrated below, insurance companies are sufficiently regulated already, and in ways that address the issues that motivated the Dodd-Frank Act's new requirements:

	Proposal	Current NAIC Requirement
Risk-Based Capital and Leverage Limits	($50B+ globally) FBO's U.S. IHC must meet U.S. BHC capital adequacy standards, minimum RBC capital and leverage requirements, and any capital adequacy restrictions ($50B+) U.S. IHC must comply with Reg Y capital plan rule ($50B+ globally) FBO must certify that it meets Basel Capital Framework capital adequacy standards at consolidated level ($50B+ globally) FBO must provide certain information (e.g., RBC ratios, assets, leverage ratio) on a consolidated basis ($50B+ globally) FBO must certify	"The NAIC's RBC regime began in the early 1990s as an early warning system for U.S. insurance regulators. The adoption of the U.S. RBC regime was driven by a string of large-company insolvencies that occurred in late 1980s and early 1990s. The NAIC established a working group to look at the feasibility of developing a statutory risk-based capital requirement for insurers. The RBC regime was created to provide a capital adequacy standard that is related to risk, raises a safety net for insurers, is uniform among the states, and provides regulatory authority for timely action. It has two main components: 1) the risk-based capital formula, that established a hypothetical minimum capital level that is compared to a company's actual capital level, and 2) a risk-based capital model law that

[51] Testimony of the National Association of Insurance Commissioners Regarding Insurance, Before the Subcommittee on Insurance, Housing and Community Opportunity Committee, Committee on Financial Services, United States House of Representatives, Joseph Torti, III, NAIC Deputy Director and Superintendent of Insurance and Banking (Nov. 16, 2011). Furthermore, as the NAIC wrote to the Board in 2012, "[t]raditional insurance activities do not add systemic risk to the financial system—they generally do not involve the transformation of short term liabilities into long term assets and do not lend themselves to run risk." Docket No. 1438, RIN 7100-AD86: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, NAIC, Apr. 20, 2012.

	Proposal	Current NAIC Requirement
	compliance with Basel III international leverage ratio	grants automatic authority to the state insurance regulator to take specific actions based on the level of impairment."[52] *See* Risk-Based Capital for Insurers Model Act (Volume II-312)[53]
Liquidity Requirements	($50B+ U.S.) FBO must conduct monthly liquidity stress tests separately on its U.S. IHC and its U.S. branch and agency network ($50B+ U.S.) FBO must maintain a liquidity buffer for its U.S. operations to meet cash flow needs identified in stress tests ($50B+ U.S.) FBO must maintain a contingency funding plan for its U.S. operations ($50B+ U.S.) FBO must maintain limits on potential sources of liquidity risk ($50B+ U.S.) FBO must monitor liquidity risk related to collateral positions of U.S. operations ($50B+ globally, <$50B U.S.) FBO must report to the Board annually results of internal liquidity stress test for either consolidated operations or combined U.S. operations only	"Regulators assess liquidity quarterly and annually as part of the financial analysis process, in addition to assessing liquidity as part of the examination process. More specifically, the financial examination process is focused on the actual liquidity strategy and processes used by the insurer or the insurance group to mitigate this risk. The NAIC Financial Condition Examiners Handbook includes a section dedicated to liquidity with respect to financial examinations that requires the examiner to assess the inherent risk of the portfolio and any risk strategies. The purpose is to ascertain liquidity exposure as it relates to expected and unexpected cash demands."[54]
Single-Counterparty Credit Limits	25% net credit exposure limit between U.S. IHC or FBO's combined U.S. operations and a single unaffiliated counterparty More stringent net credit limit between	"The purpose of this regulation is to set standards for the prudent use of derivative instruments . . ." (Section 2) and requires "counterparty exposure limits and credit quality standards." (Section 4(A)(2)).

[52] "Risk-Based Capital," National Association of Insurance Commissioners, Dec. 10, 2012, *available at* http://www.naic.org/cipr_topics/topic_risk_based_capital.htm.

[53] *Available at* http://www.naic.org/store/free/MDL-312.pdf.

[54] "U.S. Insurance Company Asset Liquidity," Capital Markets Special Report, NAIC, available at http://www.naic.org/capital_markets_archive/130306.htm.

	Proposal	Current NAIC Requirement
	($500B+) U.S. IHC or FBO and major counterparties	*See* Derivative Instruments Model Regulation (Volume III-282)[55]
Risk Management	($10B+ public, or $50B+ generally) FBO must certify annually that it maintains a U.S. risk management committee ($50B+ U.S.) FBO must appoint a U.S. CRO to oversee U.S. risk management ($50B+ U.S.) FBO's U.S. risk committee must include at least one independent member	"The purpose of this Act is to provide the requirements for maintaining a risk management framework . . ." (Section 1). *See* Risk Management and Own Risk and Solvency Assessment Model Act (Volume III-505)[56]

Insurance companies are also subject to laws and regulation that extend beyond the enhanced prudential standards in the Proposal. These include, for example, criminal sanctions for failure to report impairment,[57] limits on investments in medium grade and lower grade obligations,[58] and an extensive market conduct surveillance law.[59] The section 165 regulatory requirements for insurance companies and organizations should be tailored accordingly to reflect this reality. For example, the Board could appropriately conclude that insurers that meet insurance RBC requirements under the tiered risk-based standards already in force also satisfy section 165 capital requirements. In other words, the capital enhancements for insurers provided under applicable insurance rules would be viewed as meeting the section 165 standards, unless the Board specifically finds otherwise in a particular case.[60]

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[55] *Available at* http://www.naic.org/store/free/MDL-282.pdf. As of April 2011, this model regulation has been adopted by Alaska, Arkansas, California, Connecticut, Illinois, Iowa, Maryland, New York, and Pennsylvania.

[56] *Available at* http://www.naic.org/store/free/MDL-505.pdf. As of September 2012, this model act had not yet been adopted by any state.

[57] *See* Criminal Sanctions for Failure to Report Impairment Model Bill (Volume III-510), available at http://www.naic.org/store/free/MDL-510.pdf.

[58] *See* Investments in Medium Grade and Lower Grade Obligations Model Regulation (Volume III-340), available at http://www.naic.org/store/free/MDL-340.pdf.

[59] *See* Market Conduct Surveillance Model Law (Volume V-693), available at http://www.naic.org/store/free/MDL-693.pdf.

[60] The clear thrust of the Proposal is to require FNFCs, such as insurance organizations, to adapt to banking standards and approaches, which would be a classic "square peg/round hole" "solution."

C. A New Proposal Should Explain the Tailoring Process for Individual Companies Designated by the Financial Stability Oversight Council.

As reflected by our comments above, we support the Board's stated intention to use its authority under section 165(a)(2) and section 165(b)(3)(A) of the Dodd-Frank Act to tailor enhanced prudential standards to individual companies and have offered specific comments to help improve the regulatory process in accordance with congressional intent. A tailoring approach that takes into account the risk factors posed by individual companies will best protect the country's financial stability while, at the same time, guard against overburdening companies with unnecessary regulation.

The Board should also explain, in a new proposed rule, the *process* by which it plans to undertake individual tailoring. Section 165(a)(2) allows the Board to "differentiate among companies on an individual basis," as well as by category, and section 165(b)(3)(A) requires the Board to consider a variety of factors that can distinguish companies, including: "(i) the factors described in subsections (a) and (b) of section 113; (ii) whether the company owns an insured depository institution; (iii) nonfinancial activities and affiliations of the company; and (iv) any other risk related factors that the Board of Governors determines appropriate." The section 113(a) and (b) factors include, *inter alia*, a company's leverage, its off-balance-sheet exposures, its transactions and relationships with other institutions, the nature of a company's activities, and the degree to which a company already is regulated. The Act also mandates that the Board "adapt the required standards as appropriate in light of any predominant line of business of such company."[61] With respect to an FNFC, the statute also requires the Board to take into account the extent to which an FNFG is subject to comparable home country standards on a consolidated basis, and give due regard to the principle of national treatment and equality of competitive opportunity.

The Dodd-Frank Act calls for the Board to include in a new rule proposal an explanation of the process it will use to take the statutory factors into account when determining what specific section 165 requirements will apply to each specific designated nonbank company. We suggest that any such process should involve several stages, including: (1) a Board presentation of proposed findings supported by a detailed explanation; (2) an opportunity for a designated company to respond in writing to those findings; (3) an opportunity for other regulators of the company—including state, federal, and international regulators—to provide input on the findings; and (4) a final, detailed explanation of how the Board plans to impose enhanced prudential standards on a designated company, taking into account the provisions of sections 165(a)(2), 165(b)(3)(A), and 165(b)(3)(D).

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[61] Dodd-Frank Act § 165(b)(3)(D).

III. The Board Should Carefully Reexamine the IHC Framework to Ensure That in Every Case the Benefits Clearly Outweigh Disruptions and Adverse Consequences for Affected Companies.

The Proposal would generally "mandate" FBOs to establish an IHC as "a more standardized structure for the U.S. bank and nonbank subsidiaries . . . in order to enhance regulation and supervision of their combined U.S. operations."[62] It states that the Board could determine to require an IHC for an FNFC under section 167 of the Dodd-Frank Act,[63] but also asks questions regarding whether and if so, how, to require an IHC for an FNFC. Although a "standardized" IHC may be necessary and useful for both the Board and affected FNFCs in certain cases, in many instances, such a standardized approach would cause unintended, and potentially serious, adverse consequences. Moreover, imposing an IHC structure could result in inconsistencies with appropriate regulation and supervision of the U.S. activities of a designated FNFC. Stated simply, not enough is known about whether and how the IHC concept should apply to FNFCs to proceed to a final rule.

A. A Re-Proposed Rule for FNFCs Should Address When an IHC, or More Than One IHC, May be Appropriate.

Questions 1 and 2 in the Proposal pose threshold questions regarding the use of an IHC for FNFCs. As we noted above, these questions are the sort typically posed in an ANPRM, and we request the Board to view them and the responses to them as such. The discussion below addresses these questions.

As a threshold matter, we believe that any IHC proposed for an FNFC should not call for a "standardized" structure using a single IHC. The variety of business lines and structures for FNFCs requires a case-by-case determination of whether one or more existing U.S. subsidiaries of an FNFC should be deemed to be IHCs for purposes of regulation under section 165. The significant possibility of collateral legal effects and adverse consequences, as discussed below, calls for such an approach. Consolidation of an FNFC's U.S. activities under a single IHC often may cause significant disruption of existing business and could destabilize a company or group of related companies.

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[62] 77 Fed. Reg. at 76,635. In "exceptional circumstances," the Proposal would allow the Board to require more than one IHC. *See id.* at 76,638.

[63] *Id.* at 76,634.

B. Applicability of Section 167(b).

Under Dodd-Frank Act section 167(b), the Board has discretion to require a designated FNFC "to establish an intermediate holding company if the Board of Governors makes a determination that the establishment of such intermediate holding company is necessary—(i) to appropriately supervise activities that are determined to be financial activities; or (ii) to ensure that supervision by the Board of Governors does not extend to the commercial activities of such nonbank financial company."[64] The Proposal refers to this provision as a basis for requiring a FNFC to establish an IHC, but does not discuss the terms or purpose of that provision.

The terms of section 167(b)(1)(B)(ii) and the Dodd-Frank Act's legislative history are clear that this IHC provision was primarily intended to ensure that the Board would not supervise nonfinancial or commercial activities of a designated company. It thus would be clearly applicable to a designated FNFC with commercial activities, and on its face, would appear inapplicable to the many FNFCs engaged solely in financial activities.

If, however, the Board determines that it should implement an IHC provision for FNFCs, section 167(b)(1)(B)(ii)'s core principle should guide application of the IHC concept. That principle is that the Board must make a "determination that the establishment of such intermediate holding company is **necessary to— (i) appropriately supervise activities that are determined to be financial in nature** . . ." (emphasis added).

Accordingly, we suggest that any implementation of the IHC concept for FNFCs to advance "appropriate supervision" must include the following elements:

1. A case-specific determination that an IHC is "necessary", starting with an assessment of the existing corporate structure of the FNFC;

2. A determination of why an IHC may be needed—for example, to provide a more efficient vehicle for gathering information about the U.S. activities of the FNFC or to provide an entity (or entities) for ongoing regulation under section 165;

3. A determination that existing corporate structures are inadequate. The Board should seek to use existing corporate structures as much as possible and require corporate

[64] Dodd-Frank Act § 167(b)(1)(B). We note that the parallel provision in section 626 in Title VI uses the phrase "not financial activities," instead of "commercial activities." Dodd-Frank Act § 626 (revising 12 U.S.C. 1467b(b)(1)(B)(ii)).

changes only if it determined that it is otherwise unable to "appropriately supervise" the FNFC's financial activities. Designation of existing entities as "IHCs" for purposes of section 165 regulation should be preferable to requiring new entities to be created; and designating more than one existing U.S. subsidiary of a FNFC as an IHC should be a clearly available possibility, not an "exceptional" outcome;

4. An assessment of collateral and unintended adverse consequences and a determination that the proposed IHC requirement would result in benefits significantly outweighing any adverse effects; and

5. If a company will be required to establish an IHC, specific and detailed notice to the FNFC and each affected subsidiary with the opportunity for such entities to comment, at a hearing if requested, prior to the issuance of an IHC determination.

In addition, before requiring FNFCs to create an IHC, the Board should examine and apply its authority under the Dodd-Frank Act to collect information about the U.S. operations of FNFCs from other regulators. For example, insurance companies are thoroughly regulated by their primary regulators, the state insurance agencies. As demonstrated in the table above, state insurance regulators already impose a comprehensive regulatory framework on insurers, including rules related to risk-based capital, liquidity, derivative instruments, and risk management. Insurers are required to file combined annual statements for their insurance groups to both their state regulator and to the NAIC. Moreover, state regulators conduct examinations of insurers and regularly issue field examination reports. Accessing information from these existing regulatory sources may obviate the need to create a new IHC if information about the U.S. operations of an FNFC is readily available.

Under this suggested approach, the Board could impose data reporting requirements on the entity's top *existing* U.S.-based entity or entities. Although the entities would have to collect and provide to the Board new categories of information, this approach would allow the companies to avoid the unnecessary restructuring costs and the numerous potential negative implications arising from an IHC-forced reorganization, while still ensuring that the Board has the means to evaluate the potential for risks to the U.S. financial system.

C. If Applied to Insurance Companies, the Proposed Use of IHCs Could Cause Market Disruption and Regulatory Confusion.

Although the Proposal contemplates that use of an IHC would simplify regulation of the U.S. business of a foreign company by consolidating regulation of multiple subsidiaries, it may instead lead to complicated unintended results for a firm's U.S. operations. For example, insurance regulation is focused on each separately chartered insurer and its ability

to meet its contractual obligations to policyholders and does not provide for any type of consolidated regulation of insurance holding companies. Therefore, it is unclear whether it is even possible to consider a single IHC by combining more than one insurance company for section 165 regulatory purposes.

Even assuming that significant obstacle can be cleared, there are a number of potential adverse effects of implementing an IHC requirement in an insurance company context that would have to be addressed. Forcing designated foreign insurance organizations to create an IHC to consolidate regulation of the companies' U.S. activities could have unintended disruptive consequences on third-party contracts, financial filings, and regulatory systems. Specifically, the following issues may confront the insurance industry:

Required approval from state regulators. "Control" is clearly defined under state insurance law and any "change in control" requires explicit regulatory approval. For example, section 1215.2 of the California Insurance Code permits a change of control regarding a California insurer only if the California Insurance Commissioner approves the change.[65] All 50 U.S. states and the District of Columbia "have adopted substantially similar language" regarding changes of control.[66] These provisions may apply to an IHC, as establishment of an IHC may constitute a "change in control" for insurance companies under state holding company regulations.

Difficulties for global consolidated capital management. The Proposal would subject the U.S. operations of designated insurance organizations to onerous U.S. capital requirements, which may differ significantly from their current capital regulatory obligations that permit global consolidated capital management. Specifically, the Board would require certain insurers' IHCs to meet U.S. bank holding company capital adequacy requirements and to comply with Regulation Y's capital plan. In the absence of an IHC requirement, the FNFC would be permitted to comply with capital standards on a global consolidated basis, a fact the Board confirms, stating that its "current approach to capital regulation of the U.S. operations of foreign banking organizations was designed to provide them with the flexibility to manage capital on a global consolidated basis."[67] The IHC requirement would obstruct that approach by requiring

[65] C. I. C. § 1215.2(d).

[66] "Self Assessment of IAIS Insurance Core Principles," IMF Financial Sector Assessment Program, National Association of Insurance Commissioners, p. 17 (Aug. 2009), http://www.naic.org/documents/topics_iais_fsap_assessment.pdf.

[67] 77 Fed. Reg. 76,639.

certain amounts of capital to be committed to U.S. entities and thus be unavailable for satisfying non-U.S. obligations.

Interference with existing, established insurance group structures, such as mutual or reciprocal insurance companies, which are owned by their policyholders. Subpart K of the Proposal requires that the designated FNFC "must hold *its interest in* any U.S. subsidiary through the U.S. intermediate holding company."[68] If the Proposal relies on the "control" definition under the BHCA, including the "controlling influence" test to determine what is a "subsidiary," scenarios may emerge where a U.S. insurer could be deemed to be "controlled" by an FNFC, even though the FNFC has no equity or voting *interest* in the insurer. The Board has not addressed how an independent insurer could integrate itself into another company's corporate structure, where the other company has no ownership interest in the insurer. Indeed, it is unclear how this independent company could be required to be owned by an IHC, despite any "control" finding. To avoid these adverse consequences, we recommend that the Board tailor its "control" definition to the purposes of Title I instead of defaulting to the BHCA definition.[69]

Interference with existing credit agreements and other means of accessing finance. Companies' existing third-party agreements often have specific, well-defined "change of control" provisions, the violation of which could negate the contract or create negative financial repercussions for the designated company. Subpart K of the Proposal would require certain insurers to "establish" a U.S. IHC and "hold its interest in any U.S. subsidiary through" the IHC.[70] This could create adverse tax consequences for companies that are forced to restructure their U.S. business interests. Additionally, this requirement to create a new entity and move existing interests into it, as well as the limited explanation of any relevant procedures and the brief timeline permitted for companies to make this reorganization, present serious logistical and financial challenges for insurers that may face designation. A designated company may find that its credit arrangements are no longer available, or worse that it may be liable for financial penalties, at exactly the time it must be taking steps to ensure its financial stability. At the very least, being subject to an IHC requirement could require many companies to redraft existing contracts to account for the IHC change, at significant expense and without furthering the purpose of the Dodd-Frank Act.

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[68] *Id.* at 76,680 (proposed § 252.201(b)) (emphasis added).

[69] *See* Part IV below for additional discussion of this issue.

[70] 77 Fed. Reg. at 76,680 (proposed § 252.201(a)(1) & (b)).

> *Operational and compliance issues due to multiple and differing capital regimes.* Many FNFCs are subject to unique home country capital standards that assess the company's capital requirements on a global consolidated basis. U.S. insurers are subject to standardized insurance-specific capital requirements, regulated at a state level. The Dodd-Frank Act has instead introduced a third set of capital requirements that, if the company was required to create an IHC, would then subject the company to simultaneous U.S.-only, federal-level capital requirements. This creates serious planning obstacles and interferes with a common sense capital structure, without advancing the purposes of the Dodd-Frank Act.

As these issues illustrate, the need for flexibility to tailor an IHC structure to the individual activities and operations of a FNFC is of great importance. FNFCs have structured their U.S.-based operations in many different ways. The Board appears to recognize this in the preamble discussion and in the inclusion of § 252.202 (alternative organizational structure), but it should expand and clarify the availability of this option, including by explicitly permitting dual-IHC structures. Companies often have dual or multiple-track corporate structures in the U.S. for a variety of business and regulatory purposes. The market has an interest in well-run, efficient financial companies that operate in a safe manner, compliant with their applicable regulatory systems. The IHC requirement could erase this careful planning, done on an individual basis often over many years by each financial company, and instead impose a central IHC for the corporate structure. There are advantages to permitting companies to work within their existing structures, as the Board seems to acknowledge in the questions it has asked in the Proposal, and we recommend that the Board expand on the possibilities for alternative organizational structures discussed in § 252.202.[71]

The Proposal in its current form does not reflect full consideration by the Board of the implications of the IHC requirement for NFCs. Before going down this path, the Board should review these issues carefully, and provide the public an opportunity to comment on a re-proposed rule addressing in substance all these issues and matters.

D. Exemptions from the IHC Framework.

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[71] If an IHC requirement is included in the final rule, the Board should specify appropriate procedures and timeframes with respect to the implementation of an IHC by an FNFC. It should clarify the timing and notification deadlines related to the request for an alternative structure, with the implementation deadlines for establishing an IHC generally. Moreover, the Board should permit, at a minimum, 24-months to phase in an IHC from the date the IHC is established, in order to allow sufficient time for changes to reporting mechanisms and systems.

In addition, the Board has asked whether broader exemptions from the IHC framework may be necessary. The unintended consequences discussed above support such an exemption for insurance. The Board asks in Question 8:

> "*Question 8*: Should the Board provide an exclusive list of exemptions to the intermediate holding company requirement or provide exceptions on a case-by-case basis?"[72]

In accord with our comments above, the Board should exempt insurance companies from the IHC requirement, and it should preserve its discretion to make case-by-case exceptions to the rule as well.

The Board also asks in Question 10 whether broader "categories of companies" should be excluded from the requirement:

> "*Question 10*: Should the Board consider exempting any other categories of companies from the requirement to be held under the U.S. intermediate holding company, such as controlling investments in U.S. subsidiaries made by foreign investment vehicles that make a majority of their investments outside of the United States, and if so, which categories of companies?"[73]

In response to this question, we also recommend that the Board exempt from the IHC requirement any company that is not actually owned by the other company—for example, where company A owns 0% of company B, but the Board finds that "control" exists under the "controlling influence" prong of the BHCA control test (discussed in greater detail below). Providing this exemption will help avoid requiring that a wholly independent company be consolidated into the ownership structure of a separate, independent company.

E. The IHC and International Trade Principles.

Finally, the IHC requirement may violate international trade principles and Dodd-Frank Act statutory requirements. "National treatment," the fundamental international trade principle of "giving others the same treatment as one's own nationals" is "found in all the three main WTO agreements (Article 3 of GATT, Article 17 of GATS and Article 3 of

[72] 77 Fed. Reg. at 76,638.

[73] *Id.*

TRIPS)."[74] Congress explicitly required that the Board "give due regard to the principle of national treatment and equality of competitive opportunity."[75] Federal Reserve Governor Daniel K. Tarullo recently emphasized the Board's interest in upholding this principle, stating that "a modified regulatory system should maintain the principle of national treatment and allow foreign banks to continue to operate here on an equal competitive footing, to the benefit of the U.S. banking system and the U.S. economy generally."[76] Additionally, the U.S. government has recently initiated negotiations with 20 trading partners "representing nearly two-thirds of global trade in services," including financial services, to create "a new trade agreement aimed at promoting international trade in services."[77]

Yet, at the same time, the Proposal includes a requirement that would require an IHC and impose section 165 requirements on U.S. operations of foreign firms that are substantially smaller than U.S.-based firms, subject to the same requirements, with which they compete—just $10 billion in assets, as opposed to $50 billion. No U.S. subsidiary of an FNFC should be subject to section 165 requirements unless it has at least $50 billion in assets.

IV. Application of Control Principles.

The use of the broad BHCA definition of "control" for purposes of section 165 would result in a "false-positive" finding of control in some cases and cause an unwarranted extension of section 165 requirements to entities that would be wrongly found to be controlled by a company subject to section 113 designation. We offer the following comments on this important issue.

A. Control Determinations Regarding Foreign Nonbank Financial Companies Should be Based on Evidence of an Actual Control Relationship.

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[74] "Principles of the Trading System," World Trade Organization, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm.

[75] Dodd-Frank Act § 165(b)(2)(A).

[76] "Regulation of Foreign Banking Organizations," Speech by Governor Daniel K. Tarullo at the Yale School of Management Leaders Forum, New Haven, Connecticut (Nov. 28, 2012), http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.htm.

[77] Letter from U.S. Trade Representative Ron Kirk to Speaker of the House of Representatives John Boehner, Jan. 15, 2013.

The Proposal incorporates the BHCA definition of control, which we submit is both overbroad and inappropriate in a section 165 context. Under the BHCA approach, the ultimate parent company in any organization is deemed to control every entity that any subsidiary of that parent may be deemed to "control." The BHCA definition of control provides:

> (2) Any company has control over a bank or over any company if--
>
> > (A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;
> >
> > (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or
> >
> > (C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.

Thus, under the BHCA definition, "control" exists whenever an entity may be found to exercise a "controlling influence" over another, even when there is an insufficient ownership or board membership for actual control to exist. In the context of sections 165 and 166, use of such a "controlling influence" approach would lead to the possibility of unwarranted and inappropriate control findings that would subject such "controlled" entities to section 165 requirements contrary to the actual intent of the Dodd-Frank Act. We believe that in specific structures used by certain FNFCs the application of such an approach would result in an erroneous finding of control. Accordingly, the Board should adopt a definition of control and a process for determining actual control that can take such structures into account and reach a "non-control" result in appropriate cases.

By way of hypothetical example, there may be cases where economic ownership does not lead to actual control of an entity that has a non-ownership management relationship with a subsidiary in a multi-tier organization. For example, Corporation A owns 100% of Corporation B. Corporation B, while having no ownership interest in Corporation C, has contractual obligations with respect to a significant aspect of the management of Corporation C. Simple reliance on the BHCA's delineated criteria may suggest that the Board could find that Corporation B has a controlling influence over Corporation C, and thus that Corporation A controls Corporation C (through Corporation B), when that is not the case in reality.

In this example, posit that Corporation B's obligations with respect to Corporation C are delineated by agreements between the two corporations, agreements that Corporation A is powerless to change. In that context, if the standard BHCA approach were followed, Corporation A could be deemed to "control" Corporation C, when in fact it would have no ability to exercise any control over Corporation C. We believe that, in the context of Title I of Dodd-Frank, the Board should adopt an approach to control that does not allow for "control" findings to be made when the actual nature of the corporate relationships does not support such a finding.

B. Control Applied Under Section 165 Should be Distinct from BHCA Concepts.

A statutory default to the BHCA definition of "control" is inappropriate in the context of section 165 and 166 because the broad purpose underlying the BHCA's definition of control does not apply to sections 165 and 166 of the Dodd-Frank Act. The BHCA casts a wide "control" net to ensure the Board will have jurisdiction over all entities that may be able to exercise control over an insured bank. In contrast, sections 165 and 166 of the Dodd-Frank Act should apply to only those limited number of entities that have been determined to pose a threat to the stability of the U.S. financial system and to related entities that are in fact controlled by the designated firm and consolidated with it under GAAP. Other relationships between legally separate, unconsolidated entities should not become subject to section 165 requirements solely because it might be possible for the Board to determine that one such entity might be able to exercise an indirect "controlling influence."

Accordingly, the Board should not base a control definition for purposes of sections 165 and 166 off the overbroad BHCA provision. Instead, the Board should develop and apply control principles in a tailored way for the specific purpose of calibrating the appropriate level of regulation to the risk posed by an entity. The Board should avoid using a control definition that would lead to the blanket application of prudential regulations across companies that pose different levels of risk. In the context of this Proposal, the Board should only find that control exists between entities if doing so furthers the purposes of section 165 and other relevant sections of Title I of the Dodd-Frank Act.

For example, the Board might apply the counterparty definition of control from the prior released section 165 proposed rule for domestic NFCs. As that proposal states, "[c]ontrol would have a different meaning under the proposed rules concerning single-counterparty credit limits."[78] In setting permitted counterparty credit exposure limits for a

[78] 77 Fed. Reg. 76,602, n. 47.

company and its subsidiaries, that proposed rule sets forth a "simpler, more objective definition of control"[79] than is contained in the BHCA. Notably, under that approach, control would exist if (a) the ownership or voting interest that a company holds in another entity equals or exceeds 25 percent, or (b) if a company and another entity prepare consolidated financial statements for financial reporting purposes.

The Proposal specifically asks commenters in Question 9 whether "the definition of U.S. subsidiary [is] appropriate for purposes of determining which entities should be held under the U.S. intermediate holding company."[80] The definition of "subsidiary" would incorporate the BHCA definition of control so that each entity "controlled" by another would be its subsidiary, and as a result, each such "subsidiary" could be swept into an IHC. Again, in the context of section 165, an IHC subject to section 165 requirements should only include entities that are actually controlled. As noted above, requiring an IHC to be established could fundamentally change the structure of the organization. It also could directly interfere with its operations, and the Board's question in the Proposal suggests that it is aware of this issue. The Board should apply an approach to "control" that takes into account the actual (rather than theoretically possible) relationships that exist in a particular foreign nonbank financial company structure and not default to the use of the BHCA definitions of "subsidiary" and "control."

C. Defining Control Properly Is Essential to Well-Functioning Regulatory Regime.

Properly defining issues of control is important because of the severe consequences that could occur from improperly applied section 165 prudential standards. Such standards could impose costs on a company and its many stakeholders that would have to bear the regulatory burdens of unnecessary prudential requirements. These costs may compel a company to restructure, again incurring costs not justified by goals set by the Dodd-Frank Act. Regulatory costs may also lead to diminished services and impaired market competitiveness with other similarly situated companies that avoid the regulatory requirements due to different organizational structures.

Imposing prudential regulations on a company that do not genuinely correspond to the level of systemic risk posed by the company may result in inappropriate allocation of limited regulatory resources. In other words, over-regulation of less systemically-risky

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[79] *Id.* at 76,654.

[80] *Id.* at 76,638.

companies could lead to under-regulation of actual or greater threats to overall financial instability and could produce adverse consequences for the system as a whole. Instead of further diverting already scarce resources by applying regulatory pressure to companies that do not pose as large a threat, the Board should focus its activities on entities that have the highest likelihood of affecting the nation's financial system.

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We are grateful for the opportunity to comment on these important issues. Should you have any questions or want to discuss any issues raised in this comment letter, I would be happy to speak with you.

Sincerely,

Michael D. Bopp

MDB/on