VI. Financial Stability Oversight Council

A. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") established the Financial Stability Oversight Council ("FSOC") to monitor and safeguard the U.S. from future financial crises.[1] Congress tasked the FSOC with identifying threats to U.S. financial stability, promoting market discipline and responding to emerging risks to U.S. financial stability.[2] Prior to the FSOC, there was no single government entity responsible for monitoring the entire financial sector.[3] Rather, various government regulators were in charge of segmented fractions of the financial market, thus leaving room for regulatory gaps.[4] By creating the FSOC, Congress adopted an integrated approach toward regulating the financial market because the FSOC is responsible for "facilitating information sharing and coordination among the member agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions."[5] According to the Secretary of the Treasury Timothy Geithner, the Financial Stability Oversight Council should "establish an integrated road map for the first stages of reform" and these reforms "will fundamentally reshape the entire financial system.[6]

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[1] *See Financial Stability Oversight Council Created Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Frequently Asked Questions*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/Documents/FAQ%20-%20FinancialStabilityOversightCouncil October2010FINALv2.pdf (last visited Feb. 20, 2011).

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5322(a)(1) (2010) ["Dodd-Frank"]. *See also*, HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 3 SEC. & FED. CORP. LAW § 1:402 (2d ed. 2010) ("The purposes of the Council include identifying risks to U.S. financial stability, promoting market discipline by eliminating expectations that the government will provide bailouts, and responding to threats to the stability of the U.S. financial system.").

[3] U.S. DEP'T OF THE TREASURY, *supra* note 1.

[4] *Id*.

[5] *Id*.

[6] Rebecca Christie, Geithner Says Financial Oversight Council to Offer 'Road Map', BUS. WK., Aug. 2, 2010, http://www.businessweek.com/news/

In an effort to close existing regulatory gaps, Congress granted the FSOC broad powers to restrain risky business practices in the financial sector.[7] Currently, the FSOC can require a financial market utility or financial institution to submit information, submit to register with the Federal Reserve System ("Fed"), submit to Fed supervision, and meet prudential standards.[8] The FSOC may also vote to have the Fed place severe restrictions as well as stringent prudential standards on nonbank financial companies or bank holding companies with $50 billion or more in assets that pose serious risks to U.S. financial system.[9] This article examines the composition of the FSOC, its purposes, its powers, and some current issues the FSOC faces today.

B. What Is the FSOC?

The FSOC is composed of ten voting members and five nonvoting members.[10] Each voting member holds a single vote, and all nonvoting members serve in an advisory capacity.[11] Voting members include, the Secretary of the Treasury, the Chairman of the Board of Governors of the Fed, the Comptroller of the Currency, the Director of the Bureau, the Chairman of the Commission, the Chairperson of the Corporation, the Chairperson of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration Board, and an independent member with insurance expertise appointed by the President and approved by the Senate.[12] In addition, the five nonvoting members include, the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a State insurance commissioner, a State banking supervisor, and a State securities commissioner.[13] Generally, the FSOC makes decisions based on a majority vote of serving members.[14] An

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[7] U.S. DEP'T OF THE TREASURY, *supra* note 1.

[8] Dodd-Frank, *supra* note 2, § 5323(a)(1).

[9] *Id*. § 5331(a).

[10] *Id*. § 5321(b)(1),(2).

[11] *Id.*

[12] *Id*. § 5321(b)(1).

[13] *Id*. § 5321(b)(2).

[14] *Id*. § 5321(f).

interesting point to note is that the balance of power in the FSOC is heavily tilted towards federal regulators because State regulators serve in peripheral nonvoting positions only.

The FSOC is required to hold meetings at least on a quarterly basis; however, the FSOC may hold meetings more frequently at the discretion of the Chairperson of the FSOC.[15] In general, nonvoting members can participate in all FSOC meetings and activities.[16] But, with "an affirmative vote of member agencies," the Secretary of the Treasury, who also serves as the Chairman of the FSOC, may exclude nonvoting members if it is "necessary to safeguard and promote the free exchange of confidential supervisory information."[17]

1. Purposes of the FSOC

The overall goal of the FSOC is to monitor and ensure the financial stability of the US, and to that end, Congress identified three specific purposes of the FSOC.[18] The FSOC's three main purposes are: 1) identifying threats to U.S. financial stability; 2) promoting market discipline; and 3) responding to emerging risks to U.S. financial stability.[19] While Dodd-Frank specifies three distinct purposes of the FSOC, these purposes are fundamentally intertwined because the FSOC will have to rely heavily on its ability to gather information and take enforcement measures to fulfill each purpose.[20]

i. Identifying Threats

The FSOC is charged with identifying threats to U.S. financial stability from both inside and outside the financial services marketplace.[21] Potential threats may stem from "material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or … outside the financial services marketplace."[22]

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[15] *Id*. § 5321(e)(1).
[16] *Id*. § 5321(b)(3).
[17] *Id*.
[18] *See* U.S. DEP'T OF THE TREASURY, *supra* note 1.
[19] Dodd-Frank, *supra* note 2.
[20] *Id*. *See generally* 11 AM. JUR. 2D Banks and Financial Institutions § 1141.50 (2010).
[21] Dodd-Frank, *supra* note 2, § 5321(a)(1)(A).
[22] *Id*.

A nonbank financial company is "a company 'predominantly engaged' in financial activities," and "[a] company is 'predominantly engaged' if 85 percent of its consolidated revenues or assets are derived from activities that are 'financial in nature'."[23] If the FSOC identifies that "material financial distress…or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of a nonbank financial company could pose a threat to U.S. financial stability, the FSOC will commit that firm to Fed supervision.[24] In determining whether a particular nonbank financial firm should be subject to Fed supervision, Dodd-Frank requires the FSOC to consider a number of factors including: the nature and size of operations, extent of the company's leverage and liabilities, extent of off-balance sheet exposures, and whether it is already regulated by another primary regulatory agency, among several other factors.[25]

In a recent release, the FSOC announced that when determining whether a nonbank financial company is systemically important, it proposes to consider six categories of information: 1) "Size; 2) Lack of substitutes for the financial services and products the company provides; 3) Interconnectedness with other firms; 4) Leverage; 5) Liquidity risk and maturity mismatch; and 6) Existing regulatory scrutiny."[26] Despite industry concern over Dodd-Frank's lack of express quantitative metrics to guide the FSOC in determining whether a particular nonbank financial company should be regulated by the Fed, the FSOC takes the position that all of the Dodd-Frank factors fit into one or more of these six qualitative categories and does not provide explicit quantitative standards.[27] The FSOC does, however, express intent to use some variety of quantitative metrics in evaluating nonbank financial companies, but

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[23] BLOOMENTHAL & WOLFF, *supra* note 2.

[24] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4555-01, 4560 (proposed Jan. 26, 2011) (to be codified at 12 C.F.R. pt. 1310) ["FSOC Release"].

[25] Dodd-Frank, *supra* note 2, § 5323(a)(2) (listing factors FSOC considers in making determinations on whether nonbank financial companies should be subject to Fed regulation).

[26] *Id*.

[27] WILLKIE FARR & GALLAGHER LLP, FINANCIAL STABILITY OVERSIGHT COUNCIL RELEASES NOTICE OF PROPOSED RULEMAKING REGARDING SUPERVISORY AUTHORITY OVER CERTAIN NONBANK FINANCIAL COMPANIES (2011), *available at* http://www.willkie.com/files/tbl_s29 Publications%5CFileUpload5686%5C3663%5CFinancial-Stability-Oversight-Council-Releases.pdf.

it has yet to clarify what those quantitative measures will be.[28] The lack of quantitative metrics in evaluating nonbank financial companies will likely lead to prolonged industry confusion over which nonbank financial companies will be regulated by the Fed.[29]

ii. Promoting Market Discipline

One of the reasons for identifying and subjecting certain large and interconnected nonbank financial companies to Fed supervision is that Congress charged the FSOC with promoting market discipline.[30] Promoting market discipline means "eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure."[31] Essentially, the FSOC will attempt to end the "too big to fail" era. By identifying large, interconnected financial institutions and subjecting these firms to Fed supervision, the FSOC can impose more stringent requirements than "those applicable to other nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States."[32]

Once the FSOC subjects a nonbank financial company to Fed supervision, the Fed can require reports, examine the company and enforce standards against the firm.[33] Additionally, the Fed can set prudential standards proportionate to the level of risk the particular nonbank financial company poses to the U.S.'s overall

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[28] FSOC Release, *supra* note 24 ("The Council would evaluate nonbank financial companies in each of the six categories, using quantitative metrics where possible."). *See also* WILLKIE FARR & GALLAGHER LLP, *supra* note 27 ("The Release does not include concrete, quantitative metrics or state whether quantitative metrics will be adopted by the FSOC or will be made available to the public before the adoption of a final rule.").

[29] *Cf.* WILLKIE FARR & GALLAGHER LLP, *supra* note 27 ("Since the passage of the Dodd-Frank Act, many interested parties have expressed concern that the legislation does not provide enough quantitative detail regarding the analytical process that the FSOC will rely upon in designating nonbank financial companies for additional supervision and regulation by the Federal Reserve.").

[30] Dodd-Frank, *supra* note 2, § 5322(a)(1),(2) (listing duties of the FSOC in connection with FSOC's stated purposes.").

[31] *Id*. § 5322(a)(1).

[32] *Id*. § 5325(a)(1).

[33] *Id*. § 5330(c)(1)(A).

financial system.[34] If the FSOC by two-thirds vote concludes that a nonbank financial institution with total consolidated assets of over $50 billion poses a serious risk to the US financial markets, then the Fed has the authority to impose severe restrictions on that firm in an effort to promote market discipline.[35] The Fed may restrict the risky nonbank financial institution from becoming affiliated with another company; restrict the offering of new or existing products, require the termination of an existing activity, impose conditions on existing activities, or even require the company to transfer assets or off-balance sheet items.[36]

iii. Responding to Emerging Risks to U.S. Financial Stability

The final purpose of the FSOC is to respond to emerging risks to U.S. financial stability.[37] The FSOC's Systemic Risk Committee and two sub-committees will provide analysis of emerging threats to financial stability.[38] The FSOC's method of dealing with emerging risks seeks to blend expertise with an interdisciplinary and cross-cutting approach.[39] The Systemic Risk Committee is composed of senior staff and serves as the nexus of identifying and prioritizing emerging risks.[40] The two sub-committees are the Institutions Sub-committee and the Markets Sub-committee.[41] The two sub-committees deal with different types of cross-cutting emerging risks; the Institutions Sub-committee deals with immediate risks while the

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[34] GIBSON, DUNN & CRUTCHER LLP, THE DODD-FRANK ACT: APPLICATION OF HEIGHTENED BANK-LIKE SUPERVISION AND REGULATION TO SYSTEMICALLY SIGNIFICANT FINANCIAL COMPANIES (2011), *available at* http://www.gibsondunn.com/Publications/Pages/Dodd-FrankAct-Applicationof HeightenedBank-LikeSupervisionandRegulationtoSystemicallySignificant FinancialCompanies.aspx.

[35] Dodd-Frank, *supra* note 2, § 5331(a). *See also* GIBSON, DUNN & CRUTCHER LLP, *supra* note 32.

[36] *Id*.

[37] Dodd-Frank, *supra* note 2, § 5322(a)(1)(C).

[38] *Financial Stability Oversight Council Committee Structure*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/Documents/X%20-%20Committee %20Structure%20111910.pdf (last visited Feb. 20, 2011).

[39] *Id*.

[40] *Id*.

[41] *Id*.

Markets Sub-committee focuses on intermediate and long-term emerging risks.[42]

At present, there exists little public information on the activities of the FSOC committees that deal with emerging risks. Still, it is clear that Congress conferred ample information gathering powers on the FSOC to enable the FSOC to carry out its purpose of identifying, monitoring and responding to emerging risks.[43] Specifically, the FSOC may request "any data or information from the Office of Financial Research, member agencies, and the Federal Insurance Office as necessary…to monitor the financial services marketplace to identify potential risks to the financial stability of the United States."[44]

2. FSOC's Powers

Congress has equipped the FSOC with broad discretionary powers to preserve financial stability.[45] The FSOC can request assistance from federal agencies by appointing any department or agency of the U.S. to provide "services, funds, facilities, staff, and other support services."[46] Because this paper has already discussed the FSOC's power to subject nonbank financial companies to Fed supervision,[47] and its ability to impose severe restrictions on risky institutions,[48] this section will focus on the FSOC's information gathering powers.

The FSOC may employ its information gathering powers to fulfill the purposes that Congress assigned it.[49] The FSOC has broad information gathering authority because it can collect information directly from financial institutions or financial market utilities as well as collect information indirectly through other government agencies including the Office of Financial Research.[50] Directly, the FSOC can require a bank holding company or a nonbank financial company, with $50 billion or more in total consolidated assets, to submit

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[42] *Id*.
[43] *See generally* Dodd-Frank, *supra* note 2, § 5322(a), (d).
[44] *Id*. § 5322(d). *See infra* p. 8.
[45] *Id*. § 5322(a), (d).
[46] *Id*. § 5321(h).
[47] *See supra* p. 4-5 and notes 23-25.
[48] *See supra* p. 5-6 and notes 32-35.
[49] *See* Dodd-Frank, *supra* note 2, § 5322(a),(d).
[50] *Id*.

reports concerning the: "1) financial condition of the company; 2) systems for monitoring and controlling financial, operating, and other risks; 3) transactions with any subsidiary that is a depository institution; and 4) the extent to which the activities and operations of the company and any subsidiary thereof, could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the United States."[51] Indirectly, the FSOC can request practically any data or information it deems necessary from member agencies, the Office of Financial Research, and the Federal Insurance Office.[52]

The FSOC serves as a locus for financial data and information.[53] Prior to the FSOC, there was no government agency with access to a large volume of cross-cutting financial information. By granting the FSOC access to practically all available financial information and requiring the FSOC to report its studies to Congress, Congress hopes to remain informed of the effects of financial institutions on U.S. economic health.[54]

3. Current FSOC Issues

Chief among the FSOC's duties is its duty to "make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems…"[55] On that front, the FSOC recently released a study of the Volcker Rule,[56] and a study of risk retention requirements for securitizers.[57]

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[51] *Id*. § 5326(a).
[52] *Id*. § 5322(d).
[53] *See id*. § 5322(a).
[54] *See id*. § 5333.
[55] *Id*. § 5322(a)(2)(K).
[56] *See generally* FIN. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS (2010), *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf. *See also* SATISH M. KINI ET AL., DEBEVOISE & PLIMPTON LLP, FINANCIAL STABILITY OVERSIGHT COUNCIL ISSUES PROPOSAL ON DESIGNATION OF SYSTEMATICALLY IMPORTANT FIRMS, VOLCKER RULE STUDY AND STUDY ON FINANCIAL SECTOR CONCENTRATION LIMITS (2010), *available at* http://www.debevoise.com/files/Publication/e1ffc9a1-a0b6-441b-a2f2-

i. The Volcker Rule

The FSOC Volcker Rule study recommends a vigorous implementation of the Volcker Rule.[58] The Volcker Rule prohibits banking entities from engaging in proprietary trading and from acquiring or retaining "any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."[59] The FSOC recommends a proprietary trading ban throughout the entire banking entity and not just within specific businesses within the entity.[60] The study concedes that there are grey area activities such as portfolio hedging, which can be difficult to distinguish from proprietary trading and suggests that agencies give additional consideration to portfolio hedging activities.[61] The FSOC study raises concerns over the challenges banking entities will invariably confront in complying with the robust proprietary trading ban.[62]

ii. Risk Retention Requirements

The FSOC study acknowledges that securitization played an important role in the recent financial crisis.[63] The FSOC study states that risk retention may mitigate some of the risks of securitization and may promote safe and efficient lending.[64] Risk retention requirements would prevent securitizers from removing, selling, or hedging a portion of the underlying credit risk associated with a loan.[65] By exposing originators to some of the underlying risk associated with securitized loans, the FSOC's risk retention

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[57] *See generally* TIMOTHY F. GEITHNER, FIN. STABILITY OVERSIGHT COUNCIL, MACROECONOMIC EFFECTS OF RISK RETENTION REQUIREMENTS (2010), *available at* http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk% 20Retention%20Study%20%20(FINAL).pdf.

[58] KINI ET AL., *supra* note 56, at 2.

[59] 12 U.S.C.A § 1851(a)(1),(2) (West 2010).

[60] KINI ET AL., *supra* note 56, at 3.

[61] FIN. STABILITY OVERSIGHT COUNCIL, *supra* note 56, at 21.

[62] KINI ET AL., *supra* note 56, at 3.

[63] GEITHNER, *supra* note 57, at 10.

[64] *Id*. at 16.

[65] *Id*.

requirement should provide an incentive for originators to lend responsibly.[66]

According to the FSOC study, these risk retention requirements may prevent "the sort of credit expansion that led to the home price bubble in the recent financial crisis."[67] Currently, the FSOC recommends implementing risk retention requirements that allow for a robust securitization market in developing the framework for risk retention.[68]

C. Conclusion

The FSOC has the ability to reshape the current financial system because Congress granted the FSOC broad discretionary authority over the financial industry. The FSOC's studies and recommendations have already attracted much attention from the financial industry, though the lack of clear quantitative measures for evaluating a nonbank financial firm has created some uncertainty. Whether legislators were prudent to concentrate so much authority in the voting members of FSOC has yet to be determined.

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[66] *Id*.
[67] *Id*.
[68] *Id*. at 19.
[69] Student, Boston University School of Law (J.D. 2012).