XII. Reigning in Systemically Important Financial Institutions

A. Introduction

The recent Financial Crisis indicated the need for additional regulation and supervision of "systemically important" financial institutions.[1] During the Crisis, financial distress at certain of these institutions spread to others, crippling credit markets and causing the broader economy to fall into protracted recession.[2] In adopting the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Congress embraced the near consensus view that the Financial Crisis would have been less severe had regulation and supervision of systemically important financial institutions been more robust.[3] Indeed, among the Dodd-Frank Act's key provisions is one requiring the newly-created Financial Stability Oversight Council ("FSOC") to designate systemically important nonbank financial companies for regulation by the Board of Governors of the Federal Reserve System ("Board of Governors") and another directing the Board of Governors to implement enhanced prudential

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[1] *See* Arthur E. Wilmarth, *Reforming Financial Regulation to Address the Too-Big-To-Fail Problem*, 35 BROOK. J. INT'L L. 707, 718-33 (2010) (making the case that large, complex financial institutions were the primary private-sector catalysts for the Financial Crisis).

[2] *See generally* James B. Stewart, *Eight Days: The Battle to Save the American Financial System,* NEW YORKER, Sept. 21, 2009 (chronicling the week of September 12, 2008, in which the U.S. financial system nearly collapsed); s*ee also* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4555, 4556 (proposed Jan. 26, 2011) (to be codified at 12 C.F.R. pt. 1310) ("In the recent financial crisis, financial distress at certain nonbank financial companies contributed to a broad seizing up of financial markets, stress at other financial firms, and a deep global recession with a considerable drop in employment, the classic symptoms of financial instability.").

[3] *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: REVIEW OF REGULATORS' OVERSIGHT OF RISK MANAGEMENT SYSTEMS AT A LIMITED NUMBER OF LARGE, COMPLEX FINANCIAL INSTITUTIONS 4 (2009), *available at* http://www.gao.gov/new.items/d09 499t.pdf (finding "that regulators had identified numerous weaknesses in the institutions' risk management systems prior to the beginning of the financial crisis; however, regulators did not effectively address the weaknesses or in some cases fully appreciate their magnitude until the institutions were stressed").

standards for all financial institutions deemed systemically important.[4]

The details of this new authority, however, are still to be determined. By June 2011, FSOC and the Board of Governors will promulgate rules that will determine which nonbank financial companies will fall within the Board of Governors' new authority and set forth the substance of the enhanced prudential standards that will apply to all systemically important financial institutions.[5] The financial services industry and other stakeholders are influencing this process, and while FSOC and the Board of Governors should integrate the input of these groups, they must focus primarily on crafting rules that manifest the spirit of the Dodd-Frank Act's key provisions toward preventing a future financial crisis.[6]

B. Lightly Regulated, Systemically Important Financial Companies and the Financial Crisis

Nonbank financial companies were at the center of market tumult during the Financial Crisis. The failure of investment bank and securities brokerage house Bear Stearns in March 2008 was the inflection point in turmoil that, until that point, was predominately a housing market crisis.[7] The Board of Governors intervened by facilitating JPMorgan Chase's acquisition of Bear Stearns in an

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[4] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, sections 113, 12 U.S.C. § 5323, and 165, 12 U.S.C. § 5365 (mandating the creation of FSOC and calling for such enhanced prudential standards, respectively).

[5] *See* Board of Governors of the Federal Reserve System, Implementing the Dodd-Frank Act: The Federal Reserve Board's Role, Initiatives Planned: April to June 2011, http://www.federalreserve.gov/newsevents/reform_milestones201104.htm (describing the prudential standards being contemplated and explaining that FSOC is expected to issue a final rule regarding its authority to designate nonbank financial companies for enhanced, consolidated supervision by the Board of Governors).

[6] *See infra* notes 36, 38 (quoting industry participants' lobbying efforts).

[7] *Cf.* John Cassidy, *Anatomy of a Meltdown*, NEW YORKER, Dec. 1, 2008 (quoting Board of Governors Chairman Ben Bernanke that "[He] and others were mistaken early on in saying that the subprime crisis would be contained").

attempt to avert systemic crisis.[8] It surprised many, therefore, when the U.S. government permitted Lehman Brothers, another investment bank, to enter a bankruptcy proceeding after succumbing to a similar liquidity-turned-solvency crisis to the one that overcame Bear Stearns.[9] The actual and feared systemic consequences of Lehman Brothers' failure greatly disturbed financial markets and suspended lending activity.[10] The general economic contraction that ensued persists nearly two and a half years after Lehman Brothers' failure.[11]

As nonbank financial companies, Bear Stearns and Lehman Brothers were not subject to the kind of regulation and supervision applied to bank holding companies.[12] Instead, their primary supervisory regime, the Securities and Exchange Commission's ("SEC") Consolidated Supervised Entities Program ("CSEP") imposed lower minimum capital requirements than those applied to bank holding companies and effectively no limit on the investment banks' debt-to-

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[8] *See* JPMorgan Chase & Co. and the Bear Stearns Companies, Inc., Summary of Terms and Conditions (Mar. 28, 2008), *available at* http://www.ny.frb.org/news events/speeches/2008/Contract.pdf.

[9] *Compare* Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323, 352-53 (2011) ("Following the drop in value [of its mortgage-backed securities], Bear Stearns's creditors required the firm to post additional (or substitute) collateral and, in some cases, refused to roll over or extend credit altogether. These new requirements effectively forced Bear Stearns to sell assets quickly, often at fire-sale prices.") *with* Alison M. Hashmall, Note, *After the Fall: A New Framework to Regulate "Too Big to Fail" Non-Bank Financial Institutions,* 85 N.Y.U. L. REV. 829, 846-47 (2010) ("By the summer of 2008, Lehman's counterparties became anxious about Lehman's solvency and refused to do business with Lehman, leading to a growing loss of confidence among clients and counterparties that culminated in a run and bankruptcy filing on September 15, 2008").

[10] *See* David M. Barnes, Note, *Shotgun Weddings: Director and Officer Fiduciary Duties in Government-Controlled and Partially-Nationalized Corporations*, 63 VAND. L. REV. 1419, 1422 (2010) ("Lehman's bankruptcy would weaken an already fragile financial market, and lenders would stop providing crucial funding to firms with large exposure to mortgage-linked assets.").

[11] *See* Mike Maynard, *NABE: Stronger Growth, High Unemployment in 2011*, Feb. 28, 2011, http://www.marketwatch.com/story/nabe-stronger-growth-high-unemployment-in-2011-2011-02-28 (reporting that economists anticipate the national unemployment rate to remain above 9% through 2011).

[12] *See* Hashmall, *supra* note 9, at 845-47 (arguing that prudential regulation of nonbank financial institutions is either lacking or nonexistent).

equity.[13] An Inspector General report found that Bear Stearns was fully compliant with CSEP when it collapsed, even though it had a gross debt ratio of approximately 33:1.[14] The SEC terminated CSEP in September 2008, at which time it had no participants, because of the five investment banks that opted into CSEP (participation in CSEP was voluntary), three had failed and the other two—Goldman Sachs and Morgan Stanley—had converted into bank holding companies supervised by the Board of Governors.[15]

C. Primary Dodd-Frank Act Fixes and Their Implementation

The Dodd-Frank Act responded to the systemic risks posed by Bear Stearns, Lehman Brothers, and other potentially "Too-Big-to-Fail" firms principally by calling for enhanced regulation and supervision by the Board of Governors of all systemically important financial institutions. More specifically, section 113 of the Dodd-Frank Act grants FSOC the authority to designate nonbank financial companies for regulation and supervision by the Board of Governors

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[13] *See* Hashmall, *supra* note 9, at 846-47 (stating that CSEP did not impose any explicit limitation on participants' leverage, and, consequently, each of the five major investment banks that participated significantly increased their debt-to-equity leverage ratios after entering the program); Whitehead, *supra* note 9, at 343 n. 107 (noting that Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley each elected to compute regulatory capital for CSEP purposes using an alternative, less stringent formula than was applicable to bank holding companies).

[14] OFFICE OF INSPECTOR GENERAL, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM 5 n. 40 (2008), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf ("[T]he CSE program did not require a leverage ratio limit for the CSE firms. As a result, Bear Stearns was highly leveraged, with a gross leverage ratio of approximately 33 to 1 prior to its collapse.").

[15] Securities and Exchange Commission, Press Release 2008-230, Chairman Cox Announces End of Consolidated Supervised Entities Program, *available at* http://www.sec.gov/news/press/2008/2008-230.htm. Morgan Stanley and Goldman Sachs converted to bank holding companies in large part to gain access to Board of Governors liquidity facilities. *See* N.Y. TIMES DEALBOOK, Sept. 21, 2008, http://dealbook.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/ (reporting Goldman Sachs' and Morgan Stanley's conversion into bank holding companies).

if FSOC determines that material financial distress at such a company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of such a company's activities, could pose a threat to the financial stability of the United States.[16] Section 165 of the Dodd-Frank Act dovetails with section 113 by requiring the Board of Governors to establish and apply prudential standards to these nonbank financial companies and to bank holding companies with total consolidated assets of at least $50 billion (collectively, "systemically important financial institutions") that are more stringent than those applied to other nonbank financial companies and bank holding companies.[17]

A second key set of Dodd-Frank Act provisions designed to lessen the risks posed by systemically important financial institutions is contained in section 171—the so-called "Collins Amendment."[18] The Collins Amendment was originally drafted by the Federal Deposit Insurance Corporation ("FDIC") as an analog to the Basel III international capital standards.[19] It imposes, over time, heightened leverage and risk-based capital standards on systemically important

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[16] 12 U.S.C. § 5323. In making this determination, FSOC must consider, among other factors, the company's leverage, off-balance sheet exposures, and its relationships with other significant nonbank financial companies and significant bank holding companies. *Id.*

[17] 12 U.S.C. § 5365(a)(1)(A). These prudential standards must include concentration limits and requirements for risk-based capital, liquidity, overall risk management, resolution plans and credit exposure reporting. *Id.* The Dodd-Frank Act also prevents bank holding companies with over $50 billion in assets and nonbank financial companies that are supervised by the Board of Governors from acquiring ownership or control of any bank or financial company with total consolidated assets of at least $10 billion without providing the Board of Governors with prior written notice. 12 U.S.C. § 5363(b)(1). In addition to the standards that the Board of Governors ordinarily considers when reviewing an application under section 4(j)(3) of the Bank Holding Company Act, 12 U.S.C. § 1843(j)(3), the Dodd-Frank Act directs the Board of Governors to consider the extent to which the proposed acquisition would result in greater or more concentrated risks to global or U.S. financial stability or the U.S. economy. 12 U.S.C. § 5363(b)(4).

[18] 12 U.S.C. § 5371.

[19] *See* FDIC, Press Release 266-2010, *available at* http://www.fdic.gov/news/news/press/2010/pr10266.html (quoting FDIC Chairman Sheila Bair that "[t]he Collins Amendment appropriately ensures that large institutions operate with at least as much capital in proportionate terms as is required of thousands of Main Street banks nationwide").

financial institutions.[20] The Collins Amendment will affect nonbank financial companies most profoundly because many are currently not subject to leverage or risk-based capital standards of any kind.[21]

Details of the new authority will be determined by FSOC and Board of Governors rulemaking through June 2011.[22] On January 18, 2011, FSOC proposed a rule defining six broad categories that it will consider in designating nonbank financial companies for supervision by the Board of Governors.[23] On February 8, 2011, the Board of Governors requested comment on a proposed rule that would determine which companies qualify as "nonbank financial companies" and define "significant bank holding company" and "significant nonbank financial company" for purposes of the Dodd-Frank Act.[24] These definitions will bear on which nonbank financial

[20] 12 U.S.C. § 5371(b); 75 Fed. Reg. 82317 (Dec. 30, 2010) (to be codified at 12 C.F.R. pt. 325).

[21] *See supra* note 12 and accompanying text (arguing that regulation and supervision of nonbank financial companies is either deficient or nonexistent).

[22] Implementing the Dodd-Frank Act, *supra* note 5.

[23] 76 Fed. Reg. at 4560. These categories are: (i) size; (ii) lack of substitutes for the financial services and products the company provides; (iii) interconnectedness with other financial firms; (iv) leverage; (v) liquidity risk and maturity mismatch; and (vi) existing regulatory scrutiny. *Id.* FSOC was criticized for its lack of specificity in citing these six categories, which essentially reiterate the statutory factors that it must consider under 12 U.S.C. § 5323, and little else. *See, e.g.,* Comment Letter from the American Council of Life Insurers, et al. to Tim Geithner, Chairperson, FSOC, Supervision and Regulation of Certain Nonbank Financial Companies, Feb. 9, 2011, *available at* http://www.aiadc.org/AIAdotNET/docHandler.aspx?DocID=340926 ("[N]othing in the actual language of the Proposed Rule provides nonbank financial companies with any guidance as to the standards that the Council intends to apply in carrying out its functions to determine whether or not to subject a financial company to the Board's supervision and to enhanced prudential standards.").

[24] The Dodd-Frank Act defines a nonbank financial company as one that is "predominately engaged in financial activities." 12 U.S.C. § 5311(a)(4)(B). A company is predominately engaged in financial activities if, subject to certain exceptions, either (i) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as its ownership or control of an insured depository institution, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control

companies FSOC designates for supervision by the Board of Governors and will affect the reporting requirements imposed on systemically important financial institutions.[25] Between April and June 2011, the Board of Governors will request comment on a proposed rule establishing, pursuant to section 165 of the Dodd-Frank Act, stricter prudential standards for systemically important financial institutions.[26] In addition to the requirements noted above, this proposed rule would require that systemically important financial institutions, internally, and the Board of Governors, independently, conduct periodic "stress tests" designed to determine whether such institutions have sufficient capital to absorb losses resulting from adverse economic conditions.[27]

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of an insured depository institution, represent 85 percent or more of the consolidated assets of the company. The proposed rule defines the relevant time period for assessing a company's and its subsidiaries' gross revenues and makes clear which activities qualify as "financial activities." 76 Fed. Reg. 7731, 7738-39 (Feb. 11, 2011) (to be codified at 12 C.F.R. pt. 225). FSOC proposes to define "significant nonbank financial company" to mean (i) any nonbank financial company supervised by the Board of Governors; and (ii) any other nonbank financial company that had $50 billion or more in total consolidated assets as of the end of its most recently completed fiscal year. Similarly, it proposes to define "significant bank holding company" to mean any bank holding company, or foreign bank that is treated as a bank holding company that had $50 billion or more in total consolidated assets as of the end of the most recently competed calendar year. *Id.* at 7740.

[25] *See* 12 U.S.C. § 5323 (providing that FSOC's determination of which nonbank financial companies to designate for supervision by the Board of Governors must be based, in part, on the company's transactions and relationships with other significant nonbank financial companies and significant bank holding companies); 12 U.S.C. § 5365(d)(2) (requiring that nonbank financial companies supervised by the Board of Governors and bank holding companies with at least $50 billion in assets must submit reports to the Board of Governors, FSOC, and the FDIC on the nature and extent of (i) the company's credit exposure to other significant nonbank financial companies and significant bank holding companies, and (ii) the credit exposure of such significant institutions to the company).

[26] Implementing the Dodd-Frank Act, *supra* note 5.

[27] *See* 12 U.S.C. § 5365(i) (mandating such stress tests). The proposed rule would also introduce a Prompt Corrective Action regime for these institutions, comparable to that currently applicable to insured depository institutions. *See* 12 U.S.C. §5366(c) (requiring that this rule define measures of the financial condition of the company, including regulatory capital,

D. Responses to Enhanced Regulation

There is general financial industry consensus that the Dodd-Frank Act's imposition of enhanced regulation and supervision on some systemically important financial institutions is warranted.[28] Nonbank financial companies, many of which are the major players in the "Shadow Banking System" that in 2008 accounted for an estimated two-thirds of all lending activity in the United States, are largely unregulated.[29] Even after the Financial Crisis massively contracted their balance sheets, Shadow Banking System participants continue to hold approximately $16 trillion in liabilities, plainly indicating a need for regulatory scrutiny.[30]

While there is agreement that some nonbank financial companies should be subject to more regulation and supervision, there is much disagreement, particularly on the margins, over which nonbank financial companies are systemically important enough to warrant regulation and supervision.[31] It seems clear that FSOC will designate American International Group, Inc. ("AIG") and GE Capital—the exemplar systemically important nonbank financial companies—for supervision and regulation by the Board of

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liquidity measures, and other forward-looking indicators, and establish requirements that increase in stringency as the financial condition of the company declines).

[28] *Cf.* Comment Letter from the Securities Industry and Financial Markets Association to FSOC, Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (Nov. 5, 2010), *available at* http://www.sifma.org/Issues/item.aspx?id=22128 (expressing support for new tools to help the U.S. government monitor and reduce systemic risk).

[29] Comment Letter from the Independent Community Bankers of America to FSOC, Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (Nov. 5, 2010), *available at* http://www.icba.org/files/ICBASites/PDFs/cl110510.pdf.

[30] Brooke Masters and Jeremy Grant, *Finance: Shadow Boxes*, FINANCIAL TIMES, Feb 2. 2011, http://www.ft.com/cms/s/0/6431e2e0-2f09-11e0-88ec-00144feabdc0/ html#axzz1FBk0Rzci.

[31] *See id.* (reporting on the divergent views of which nonbank financial institutions should be designated for regulation and supervision by the Board of Governors).

Governors.[32] It is much less clear, however, whether and which somewhat smaller nonbank financial companies, such as hedge, private equity, and money market funds, and securities clearinghouses, will also be designated, particularly because these groups' respective advocates are vigorously lobbying to escape designation.[33] For example, Brevan Howard Asset Management, a UK-based hedge fund, has $36 billion under management, which is a fraction of the largest asset managers' assets under management, but is widely believed to be the most important fixed income trader in the world.[34] Whether Brevan Howard should be designated for regulation and supervision by the Board of Governors is thus an exercise in subjectivity; either outcome is reasonably defensible.

The question of which nonbank financial companies are systemically important is context for the broader policy question of the extent to which the Board of Governors should regulate the Shadow Banking System. Speaking at the 2011 World Economic Forum in Davos, Switzerland, Goldman Sachs' president Gary Cohn argued that with the Dodd-Frank Act's changes, "risk will move from the regulated, more transparent banking sector to a less regulated, more opaque sector" —a familiar refrain from groups such as large bank holding companies like Goldman Sachs that are subject to enhanced supervision and regulation under the Dodd-Frank Act.[35] Mr. Cohn and others in the banking industry suggest that without comprehensive regulation of the Shadow Banking System, systemic risk will persist and may even increase as regulatory arbitrage moves money from more tightly regulated banking institutions to unregulated nonbank financial institutions.[36]

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[32] *See* Ian Katz, *Non-bank Companies Poised for Fed Scrutiny on Systemic Risk,* BLOOMBERG, Oct. 7, 2010, http://www.bloomberg.com/news/2010-10-07/non-bank-companies-poised-for-fed-scrutiny-on-systemic-risk.html (reporting that Treasury Secretary Tim Geithner indicated that GE Capital and AIG will be designated).

[33] *See, e.g.,* Masters, *supra* note 30 (quoting Douglas Lowenstein, president of the Private Equity Growth Capital Council: "Private equity firms lack the scale, interconnectivity, dependence on short-term funding and most importantly taxpayer support that characterize systemically significant institutions").

[34] *See id.* ("Though it manages $36bn, a fraction of better known giants . . . it is one of the single most important fixed income traders in the world.").

[35] *Id.*

[36] Also at the World Economic Forum, Citigroup's CEO Vikram Pandit similarly argued that "[s]hifting risk into unregulated or differently regula-

Nonbank financial companies, meanwhile, are trying to convince federal regulators that they are not systemically important so as to avoid the onerous prudential standards that the Board of Governors will implement pursuant to section 165 of the Dodd-Frank Act.[37] Most of these companies are not currently subject to any of these kinds of standards, so initial compliance, especially with respect to capital requirements, would be costly.[38] The Collins Amendment will make complying with the Board of Governors enhanced capital standards all the more difficult because it effectively disqualifies hybrid debt/equity securities, most notably trust preferred securities, from counting toward these companies' regulatory capital, which could require even well-capitalized nonbank financial companies to raise new common equity. [39] In addition, the Board of Governors could require these companies to

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ted sectors won't make the banking system safer. On the contrary, overall risk in the system could actually rise."*Id.*

[37] *See* Comment Letter from the Managed Funds Association to Tim Geithner, Chairman, FSOC, MFA Comments on Systemically Important Institutions (Nov. 5, 2010), *available at* http://www.managedfunds.org/downloads/MFA%20letter%20on%20systemically%20important%20institutions.pdf (arguing that the hedge fund industry is too small for any of its members to warrant designation by FSOC as a systemically important financial institution); Rebecca Christie and Ian Katz, *Hedge Funds May Pose Systemic Risk in Crisis, U.S. Report Says,* BLOOMBERG, Feb. 17, 2011, http://www.bloomberg.com/news/2011-02-17/hedge-funds-may-pose-systemic-risk-in-crisis-u-s-report-says.html (reporting that Blackrock Inc., the world's largest money manager, has lobbied federal regulators that it is not important enough to the financial system to merit designation as a systemically important financial institution).

[38] *Cf.* Hashmall, *supra* note 9, at 845-47. A recent European Commission survey of EU derivatives clearinghouses found that clearinghouses hold wildly different amounts of capital, ranging from millions of Euros to nearly none. Masters, *supra* note 31.

[39] By imposing the same capital requirements on systemically important bank holding companies and nonbank financial institutions as are currently imposed on banks, the Collins Amendment effectively disqualifies trust preferred securities from these institutions' Tier 1 capital because banks are not permitted to count trust preferred securities toward their Tier 1 capital. ZERO HEDGE, Collins Amendment will Eliminate $108 Billion from Bank Holdco Regulatory Capital, Will Reduce Big Four Tier 1 Capital by 13%, http://www.zerohedge.com/article/collins-amendment-will-eliminate-108-billion-bank-holdco-regulatory-capital-will-reduce-big- (May 24, 2010, 13:45).

maintain a minimum amount of contingent capital, i.e., debt securities that convert into equity in times of financial stress (commonly known as "CoCos"), and will require them to conduct periodic stress tests to measure, among other things, their capital adequacy. [40] These capital requirements will be expensive to meet and are likely to constrain some nonbank financial companies' businesses, particularly those that rely on leverage.

Still, being designated as systemically important is not all downside. It is widely accepted that institutions that markets perceive to be Too-Big-to-Fail enjoy substantial competitive advantages in the form of a lower cost of capital.[41] This is because the implicit government support behind Too-Big-to-Fail institutions allows them to borrow more inexpensively than they otherwise could because their likelihood of default is less.[42] Accordingly, to the extent that markets perceive being deemed a systemically important nonbank financial company by FSOC as an indication that the government believes an institution is Too-Big-to-Fail, a designated institution is likely to enjoy lower borrowing costs.[43] If this cost savings exceeds the cost of regulatory compliance, ironically, being designated for regulation and supervision by the Board of Governors could result in a net cost benefit.

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[40] 12 U.S.C. §§ 5325(c), 5365(i)(2).

[41] *See, e.g.,* Cornelius Hurley, *Paying the Price for Too Big to Fail,* 4 ENTREPRENEURIAL BUS. L. J. 349, 386 (2010) ("The symbiotic relationship between TBTF firms and the financial system needs to be recognized, and the price advantage that accrues to such firms as a result of the public subsidy needs to be recouped."); Steven M. Davidoff, *The Too Big to Fail Quandary*, NYT DEALBOOK, Feb. 22, 2011, http://dealbook.nytimes.com/2011/02/22/a-quandary-over-deeming-behemoths-too-big-to-fail/ (reporting that that Too-Big-to-Fail banks enjoy competitive advantages).

[42] *See* DEAN BAKER AND TRAVIS MCARTHUR, THE VALUE OF THE "TOO BIG TO FAIL" BIG BANK SUBSIDY (2009), *available at* http://www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf (quantifying the Too-Big-to-Fail subsidy).

[43] *See* Peter J. Wallison, *Dodd-Frank's Threat to Financial Stability*, WALL ST. J., Mar. 25, 2011, at A17 ("The identification of firms as too big to fail is a mad policy: It will signal to the world, removing all doubt, that the government will take steps to prevent the failure of these firms, giving them advantages in the marketplace.").

E. Conclusion

The Dodd-Frank Act filled regulatory gaps that allowed systemically important financial institutions to operate in a manner which destabilized financial markets and contributed significantly to the Financial Crisis.[44] It authorizes FSOC to subject effectively unregulated nonbank financial companies to enhanced regulatory standards and supervision by the Board of Governors, and directs the Board of Governors to develop stringent new prudential standards applicable to such companies and to bank holding companies over $50 billion in consolidated assets.[45] Through June 2011, FSOC and the Board of Governors will develop the details of this new authority, which will largely determine the actual import of the Dodd-Frank Act's treatment of systemic risk.[46]

Stakeholders are shaping the process of designating nonbank financial companies for regulation and supervision by the Board of Governors. Nonbank financial companies and their trade groups are lobbying FSOC and the Board of Governors to escape the Dodd-Frank Act to the extent that its ambiguity permits.[47] Regulated groups, on the other hand, are advocating for the Board of Governors to designate many of the Shadow Banking System's participants, arguing that otherwise regulatory arbitrage will quickly outmode the new regime.[48] Neither group acknowledges that, paradoxically, designation for this regulatory regime could result in a net cost benefit based on the borrowing cost advantages that come with formal government acknowledgement of systemic importance.[49]

The Dodd-Frank Act responds to the risks posed by large, complex financial companies by directing that they be singled out and subjected to heightened regulatory scrutiny and prudential

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[44] *See supra* notes 8-17 and accompanying text (discussing how, during the Financial Crisis, nonbank financial companies operated largely unregulated, and how the Dodd-Frank Act now regulates them).
[45] 12 U.S.C. §§ 5323, 5365.
[46] Implementing the Dodd-Frank Act, *supra* note 5.
[47] *See supra* notes 34, 38 (citing private equity and hedge fund groups' efforts to avoid Dodd-Frank Act regulation).
[48] *See supra* notes 36-37 (citing bankers' efforts to persuade federal regulators to extend the Dodd-Frank Act's application to the Shadow Banking System).
[49] *See supra* notes 41-43 (describing the Too-Big-to-Fail subsidy and positing that nonbank financial institutions designated as systemically important might benefit from it by virtue of being designated).

standards.[50] Accordingly, federal regulators are tasked with choosing which financial institutions, from among the many with systemic characteristics, should be designated as "systemically important." This process is necessarily subjective and imperfect. More importantly, however, the process is ongoing and adaptive; as changes in the markets build-up risk at firms once thought insignificant, FSOC can change course and designate these firms as systemically important, subjecting them to the Board of Governors' forthcoming heightened prudential standards. Much lobbying effort is currently being directed at FSOC's and the Board of Governors' rulemaking processes, but it will be these regulators' ongoing efforts that will execute, or fail to execute, the Dodd-Frank Act's core mission: minimizing the likelihood that large, complex financial institutions will destabilize the U.S. and global economies.

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[50] *See* 12 U.S.C. §§ 5323, 5365 (describing these heightened regulatory standards).
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