

12 CFR Part 228

Banks, Banking, Community development, Credit, Investments, Reporting and recordkeeping requirements.

12 CFR Part 345

Banks, Banking, Community development, Credit, Investments, Reporting and recordkeeping requirements.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Chapter I

For the reasons discussed in the SUPPLEMENTARY INFORMATION section, 12 CFR parts 25 and 195 are amended as follows:

PART 25—COMMUNITY REINVESTMENT ACT AND INTERSTATE DEPOSIT PRODUCTION REGULATIONS

■ 1. The authority citation for part 25 continues to read as follows:

**Authority:** 12 U.S.C. 21, 22, 26, 27, 30, 36, 93a, 161, 215, 215a, 481, 1814, 1816, 1828(c), 1835a, 2901 through 2908, and 3101 through 3111.

■ 2. Section 25.12 is amended by revising paragraph (u)(1) to read as follows:

§ 25.12 Definitions.

\* \* \* \* \*

(u) \* \* \*

(1) *Definition.* *Small bank* means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than \$1.305 billion. *Intermediate small bank* means a small bank with assets of at least \$326 million as of December 31 of both of the prior two calendar years and less than \$1.305 billion as of December 31 of either of the prior two calendar years.

\* \* \* \* \*

PART 195—COMMUNITY REINVESTMENT

■ 3. The authority citation for part 195 continues to read as follows:

**Authority:** 12 U.S.C. 1462a, 1463, 1464, 1814, 1816, 1828(c), 2901 through 2908, and 5412(b)(2)(B).

■ 4. Section 195.12 is amended by revising paragraph (u)(1) to read as follows:

§ 195.12 Definitions.

\* \* \* \* \*

(u) \* \* \*

(1) *Definition.* *Small savings association* means a savings association

that, as of December 31 of either of the prior two calendar years, had assets of less than \$1.305 billion. *Intermediate small savings association* means a small savings association with assets of at least \$326 million as of December 31 of both of the prior two calendar years and less than \$1.305 billion as of December 31 of either of the prior two calendar years.

\* \* \* \* \*

FEDERAL RESERVE SYSTEM

12 CFR Chapter II

For the reasons set forth in the SUPPLEMENTARY INFORMATION section, the Board of Governors of the Federal Reserve System amends part 228 of chapter II of title 12 of the Code of Federal Regulations as follows:

PART 228—COMMUNITY REINVESTMENT (REGULATION BB)

■ 5. The authority citation for part 228 continues to read as follows:

**Authority:** 12 U.S.C. 321, 325, 1828(c), 1842, 1843, 1844, and 2901 *et seq.*

■ 6. Section 228.12 is amended by revising paragraph (u)(1) to read as follows:

§ 228.12 Definitions.

\* \* \* \* \*

(u) \* \* \*

(1) *Definition.* *Small bank* means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than \$1.305 billion. *Intermediate small bank* means a small bank with assets of at least \$326 million as of December 31 of both of the prior two calendar years and less than \$1.305 billion as of December 31 of either of the prior two calendar years.

\* \* \* \* \*

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

Authority and Issuance

For the reasons set forth in the SUPPLEMENTARY INFORMATION section, the Board of Directors of the Federal Deposit Insurance Corporation amends part 345 of chapter III of title 12 of the Code of Federal Regulations to read as follows:

PART 345—COMMUNITY REINVESTMENT

■ 7. The authority citation for part 345 continues to read as follows:

**Authority:** 12 U.S.C. 1814–1817, 1819–1820, 1828, 1831u and 2901–2908, 3103–3104, and 3108(a).

■ 8. Section 345.12 is amended by revising paragraph (u)(1) to read as follows:

§ 345.12 Definitions.

\* \* \* \* \*

(u) \* \* \*

(1) *Definition.* *Small bank* means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than \$1.305 billion. *Intermediate small bank* means a small bank with assets of at least \$326 million as of December 31 of both of the prior two calendar years and less than \$1.305 billion as of December 31 of either of the prior two calendar years.

\* \* \* \* \*

Dated: December 11, 2019.

**Jonathan V. Gould,**  
*Senior Deputy Comptroller and Chief Counsel.*

By order of the Board of Governors of the Federal Reserve System, acting through the Secretary of the Board under delegated authority, December 11, 2019.

**Ann E. Misback,**  
*Secretary of the Board.*

Dated at Washington, DC, December 11, 2019.

Federal Deposit Insurance Corporation.

**Annamarie H. Boyd,**  
*Assistant Executive Secretary.*

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FINANCIAL STABILITY OVERSIGHT COUNCIL

12 CFR Part 1310

RIN 4030–ZA00

Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies

**AGENCY:** Financial Stability Oversight Council.

**ACTION:** Final interpretive guidance.

**SUMMARY:** This final interpretive guidance, which replaces the Financial Stability Oversight Council’s existing interpretive guidance on nonbank financial company determinations, describes the approach the Council intends to take in prioritizing its work to identify and address potential risks to U.S. financial stability using an activities-based approach, and enhancing the analytical rigor and transparency in the processes the Council intends to follow if it were to consider making a determination to subject a nonbank financial company to supervision by the Board of Governors of the Federal Reserve System.

**DATES:** *Effective Date:* January 29, 2020.

**FOR FURTHER INFORMATION CONTACT:** Howard Adler, Office of Domestic Finance, Treasury, at (202) 622-2409; Eric Froman, Office of the General Counsel, Treasury, at (202) 622-1942; or Mark Schlegel, Office of the General Counsel, Treasury, at (202) 622-1027.

**SUPPLEMENTARY INFORMATION:**

**I. Background**

The statutory purposes of the Financial Stability Oversight Council (the “Council”) are to identify risks to U.S. financial stability, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. The Council’s authorities to accomplish these statutory purposes include authorities to facilitate information sharing and coordination among regulators, monitor the financial services marketplace, make recommendations to regulators, and require supervision by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) for nonbank financial companies that may pose risks to U.S. financial stability.

Section 111 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5321) (the “Dodd-Frank Act”) established the Council. The purposes of the Council under section 112 of the Dodd-Frank Act (12 U.S.C. 5322) are (A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (B) to promote market discipline, by 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; and (C) to respond to emerging threats to the stability of the United States financial system.

As a threshold matter, the Council emphasizes the importance of market discipline, rather than government intervention, as a mechanism for addressing potential risks to U.S. financial stability posed by financial companies. The Dodd-Frank Act gives the Council broad discretion to determine how to respond to potential threats to U.S. financial stability. The Council’s duties under section 112 of the Dodd-Frank Act include monitoring the financial services marketplace in order to identify potential threats to U.S. financial stability, and recommending to the Council member agencies general

supervisory priorities and principles reflecting the outcome of discussions among the member agencies. The Council’s duties under section 112 also include making recommendations to primary financial regulatory agencies<sup>1</sup> 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 spreading among financial companies and markets. The Council intends to seek to identify, assess, and address potential risks and emerging threats on a system-wide basis by taking an activities-based approach to its work, as further explained below.

The Dodd-Frank Act also authorizes the Council to determine that certain nonbank financial companies will be subject to supervision by the Federal Reserve and prudential standards. The Federal Reserve is responsible for establishing the prudential standards that will be applicable, under section 165 of the Dodd-Frank Act, to nonbank financial companies subject to a Council determination<sup>2</sup> under section 113 of the Dodd-Frank Act. The Council has previously issued rules, guidance, and other public statements regarding its process for evaluating nonbank financial companies for a potential determination. On April 11, 2012, the Council issued interpretive guidance (the “2012 Interpretive Guidance”) regarding the manner in which the Council makes determinations under section 113 of the Dodd-Frank Act, as an appendix to a final rule (together, the “2012 Final Rule and Interpretive Guidance”).<sup>3</sup> On May 22, 2012, the Council approved hearing procedures relating to the conduct of hearings before the Council in connection with proposed determinations regarding nonbank financial companies and financial market utilities and related emergency waivers or modifications under sections 113 and 804 of the Dodd-Frank Act (as amended in 2013 and 2018, the “Hearing Procedures”).<sup>4</sup> On February 4, 2015, the Council adopted

<sup>1</sup> “Primary financial regulatory agency” is defined in section 2(12) of the Dodd-Frank Act, 12 U.S.C. 5301(12).

<sup>2</sup> Section 113 of the Dodd-Frank Act, 12 U.S.C. 5323, refers to a Council “determination” regarding a nonbank financial company. This release refers to “determination” and “designation” interchangeably for ease of reading.

<sup>3</sup> The 2012 Final Rule and Interpretive Guidance added a new part 1310 to title 12 of the Code of Federal Regulations, consisting of final rules (12 CFR 1310.1–1310.23) and interpretive guidance (Appendix A to Part 1310—Financial Stability Oversight Council Guidance for Nonbank Financial Company Designations). See 12 CFR part 1310, app. A (2012).

<sup>4</sup> 77 FR 31855 (May 30, 2012); 78 FR 22546 (April 16, 2013); 83 FR 12010 (March 19, 2018).

supplemental procedures (the “2015 Supplemental Procedures”) to the 2012 Final Rule and Interpretive Guidance.<sup>5</sup> In June 2015, the Council published staff guidance with details regarding the methodologies used in Stage 1 thresholds in connection with the determination process under section 113.<sup>6</sup> On November 17, 2017, the Department of the Treasury issued a report to the President in response to a Presidential Memorandum directing the Secretary of the Treasury to conduct a thorough review of the determination and designation processes of the Council.<sup>7</sup>

On March 6, 2019, the Council approved proposed interpretive guidance (the “Proposed Guidance”), which incorporated certain provisions of the 2015 Supplemental Procedures, to revise and update the 2012 Interpretive Guidance.<sup>8</sup> The Proposed Guidance, which included a request for public comment and over 40 specific questions, was intended to enhance the Council’s transparency, analytical rigor, and public engagement. The comment period for the Proposed Guidance closed on May 13, 2019.

The Council received 26 comment letters in response to the Proposed Guidance, of which nine were from companies or trade associations in the asset management industry, four were from trade associations in the insurance industry, three were from other trade associations, seven were from various advocacy groups, one was from two previous Chairpersons of the Council and two previous Chairmen of the Federal Reserve, one was from an association of state insurance regulators, and one was from a group of academics.

<sup>5</sup> Financial Stability Oversight Council Supplemental Procedures Relating to Nonbank Financial Company Determinations (February 4, 2015), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf>.

<sup>6</sup> See Council, Staff Guidance Methodologies Relating to Stage 1 Thresholds (June 8, 2015), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf>.

<sup>7</sup> Treasury, Report to the President of the United States in Response to the Presidential Memorandum Issued April 21, 2017: Financial Stability Oversight Council Designations (November 17, 2017), available at <https://www.treasury.gov/press-center/press-releases/documents/pm-fsoc-designations-memo-11-17.pdf>.

<sup>8</sup> 84 FR 9028 (March 13, 2019). On the same date, the Council adopted a final rule stating that the Council shall not amend or rescind its interpretive guidance on nonbank financial company determinations without providing the public with notice and an opportunity to comment in accordance with the procedures applicable to legislative rules under the Administrative Procedure Act. See 84 FR 8958 (March 13, 2019).

(Comment letters are available online at <http://www.regulations.gov/docket?D=FSOC-2019-0001>.) Twenty of the commenters were generally supportive of the proposal, including the primary focus on the activities-based approach and analytical enhancements to the Council's designation process. Six commenters were generally opposed to the proposal, arguing it unnecessarily limited the Council's tools for addressing systemic risk. Some of the commenters generally opposed to the proposal nonetheless stated that an activities-based approach may be appropriate in certain circumstances.

This final interpretive guidance (the "Final Guidance") replaces in its entirety the 2012 Interpretive Guidance. In addition, in connection with the adoption of the Final Guidance, the Council has rescinded the 2015 Supplemental Procedures and the 2015 staff guidance regarding the Stage 1 thresholds. The Council's rules codified at 12 CFR 1310.1 to 1310.23 and the Council's Hearing Procedures remain in effect.

The Council expects that the Final Guidance will better enable the Council to:

- Leverage the expertise of financial regulatory agencies;
- Promote market discipline;
- Maintain competitive dynamics in affected markets;
- Appropriately tailor regulations to cost-effectively minimize burdens; and
- Ensure the Council's designation analyses are rigorous and transparent.

## II. Overview of Final Guidance

The Final Guidance revises the 2012 Interpretive Guidance to ensure that the Council's work is clear, transparent, and analytically rigorous, and to enhance the Council's engagement with companies, regulators, and other stakeholders. By issuing clear and transparent guidance, the Council seeks to provide the public with sufficient information to understand the Council's concerns regarding risks to financial stability, while appropriately protecting information submitted by companies and regulators to the Council.

### A. Key Changes From 2012 Interpretive Guidance and Proposed Guidance

#### 1. Key Changes From 2012 Interpretive Guidance

The Final Guidance substantially transforms the Council's previous procedures. Following are high-level descriptions of several of the most important changes, which are explained in greater detail below.

First, under the Final Guidance, the Council will prioritize its efforts to

identify, assess, and address potential risks and threats to U.S. financial stability through a process that begins with an activities-based approach. This approach is consistent with the Council's priorities of identifying and addressing potential risks and emerging threats on a system-wide basis, in order to reduce the potential for competitive market distortions that could arise from entity-specific determinations, and allow relevant financial regulatory agencies to address identified potential risks. The Council will pursue entity-specific determinations under section 113 of the Dodd-Frank Act only if a potential risk or threat cannot be adequately addressed through an activities-based approach. This approach will enable the Council to effectively identify and address the underlying sources of risks to financial stability on a system-wide basis, rather than addressing risks only at a particular nonbank financial company that may be designated.

Second, before issuing nonbinding recommendations to a primary financial regulatory agency under section 120 of the Dodd-Frank Act, the Council will ascertain whether the primary financial regulatory agency would be expected to perform a cost-benefit analysis of the actions it would take in response to the Council's contemplated recommendation. In cases where the primary financial regulatory agency would not be expected to conduct such an analysis, the Council itself will—prior to making a final recommendation—conduct an analysis, using empirical data, to the extent available, of the benefits and costs of the actions that the primary financial regulatory agency would be expected to take in response to the contemplated recommendation. When the Council conducts its own analysis, the Council will make a recommendation under section 120 only if it believes that the results of its assessment of benefits and costs support the recommendation.

Third, in the event the Council considers a nonbank financial company for a potential determination under section 113, the Council will perform a cost-benefit analysis prior to making a determination. The Council will make a determination under section 113 only if the expected benefits to financial stability from the determination justify the expected costs that the determination would impose.

Fourth, under the Final Guidance, the Council will assess the likelihood of a nonbank financial company's material financial distress when evaluating the firm for a potential determination, in order to evaluate the extent to which a

determination may promote U.S. financial stability.

Fifth, the Final Guidance condenses the prior three-stage process for a determination under section 113 into two stages, by eliminating prior stage 1 (as established by the 2012 Interpretive Guidance). Under prior stage 1, a set of uniform quantitative metrics was applied to a broad group of nonbank financial companies in order to identify nonbank financial companies for further evaluation and to provide clarity for other nonbank financial companies that likely would not be subject to evaluation for a potential determination. The Final Guidance eliminates prior stage 1, because it generated confusion among firms and members of the public and is not compatible with the prioritization of an activities-based approach.

Sixth, the Final Guidance further enhances the new, two-stage determination process by making numerous procedural improvements and incorporating several provisions of the 2015 Supplemental Procedures, which were intended to facilitate the Council's engagement and transparency. The Final Guidance will increase the Council's engagement with companies and their existing regulators during the determination process. One of the goals of this enhanced engagement is to provide a company under review with greater visibility into the aspects of its business that may pose risks to U.S. financial stability. Enhanced engagement will also allow the company to provide the Council with relevant information, which will help to ensure that the Council is making decisions based on a broad set of data and a rigorous analysis. By making a company aware early in the review process of the potential risks the Council has identified, the Council seeks to give the company more information and tools to mitigate those risks prior to any Council designation, thereby providing a potential pre-designation "off-ramp."

The Final Guidance also includes procedures intended to clarify the post-designation "off-ramp." The Final Guidance provides that in the event the Council makes a final determination regarding a company, the Council intends to encourage the company or its regulators to take steps to mitigate the potential risks identified in the Council's written explanation of the basis for its final determination. Except in cases where new material risks arise over time, if a company adequately addresses the potential risks identified in writing by the Council at the time of the final determination and in

subsequent reevaluations, the Council should generally be expected to rescind its determination regarding the company. By clarifying the “off-ramp” to rescission, and taking other steps to promote designated nonbank financial companies’ ability to reduce the threat they could pose to financial stability, the Council seeks to both protect the U.S. financial system and reduce the regulatory burden on the companies.

Seventh, the Final Guidance eliminates the six-category framework described in the 2012 Interpretive Guidance. As noted in the 2012 Interpretive Guidance, the Dodd-Frank Act requires the Council to take into account 10 considerations when evaluating a company for a potential determination, and authorizes the Council to consider “any other risk-related factors that the Council deems appropriate.”<sup>9</sup> The 2012 Interpretive Guidance established an analytic framework that grouped all relevant factors, including the 10 statutory considerations<sup>10</sup> and any additional risk-related factors, into six categories (size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny). The six-category framework did not prove useful in guiding the Council’s evaluations, and unnecessarily complicated the framework for the Council’s analysis. As a result, the Final Guidance eliminates this six-category framework.

**2. Key Changes From Proposed Guidance**

Following are high-level descriptions of several changes in this Final Guidance from the Proposed Guidance. These changes are explained in greater detail below.

First, in response to comments that the Council should provide more detail

on how it will conduct its analysis under the activities-based approach, the Final Guidance clarifies that the Council will consult with relevant financial regulatory agencies and will take into account existing laws and regulations that may mitigate a potential risk to U.S. financial stability. Among other factors, the Final Guidance provides that the Council will also take into account the risk profiles and business models of market participants engaging in the products, activities, or practices under evaluation.

Second, the Final Guidance provides additional clarity on the process by which the Council may issue recommendations under section 120, including the Council’s analysis of the costs and benefits associated with such recommendations.

Third, the Final Guidance has been revised in response to comments regarding the proposed interpretation of “nonbank financial company” as including any successor of a company that is subject to a final determination of the Council. In response to comments that the proposed interpretation was overly broad, the Final Guidance has been revised to state, more narrowly, that the Council intends to interpret the statutory term “nonbank financial company supervised by the Board of Governors” as including any nonbank financial company that acquires, directly or indirectly, a majority of the assets or liabilities of a company that is subject to a final determination of the Council. As a result, if a nonbank financial company subject to a final determination of the Council sells or otherwise transfers a majority of its assets or liabilities, the acquirer will succeed to, and become subject to, the Council’s determination. As noted below and in section V of the Final

Guidance, the Council may grant a designated nonbank financial company’s request for a reevaluation of the determination before the next annual reevaluation, in appropriate cases.

Fourth, the Final Guidance has been revised to add greater specificity regarding the Council’s assessment of costs and benefits in connection with a determination under section 113 of the Dodd-Frank Act. For example, the Final Guidance states that when possible, the Council will quantify reasonably estimable benefits and costs, using ranges, as appropriate, and based on empirical data when available.

Fifth, the description of the Council’s analytic process for assessing the likelihood of a company’s material financial distress has been revised. The Final Guidance provides that to conduct this assessment, the Council may consider factors such as leverage (both on and off balance sheet), potential risks associated with asset reevaluations (whether such reevaluations arise from market disruptions or severe macroeconomic conditions), reliance on short-term funding or other fragile funding markets, maturity transformation, and risks from exposures to counterparties or other market participants.

Sixth, the Proposed Guidance stated that the Council or its Deputies Committee<sup>11</sup> would vote to commence review of a nonbank financial company in Stage 1 of the determination process. In response to public comments, the Final Guidance provides that the Council will vote to commence any review of a nonbank financial company in Stage 1. The table below provides a summary of several key transition points under the Final Guidance:

Transition point	Persons voting	Voting threshold
Begin step one of ABA .....	No required vote .....	N/A.
Begin step two of ABA .....	No required vote .....	N/A.
Begin Stage 1 of Determination Process .....	Council member vote .....	Majority.
Begin Stage 2 of Determination Process .....	Council member vote .....	Majority.
Make Proposed Determination .....	Council member vote .....	Two-thirds. <sup>12</sup>
Make Final Determination .....	Council member vote .....	Two-thirds.

The following sections provide detailed descriptions of (1) the activities-based approach (section B); (2) the analytic framework for the Council’s evaluation of nonbank financial

companies for a potential determination under section 113 of the Dodd-Frank Act (section C); and (3) the process that the Council will generally follow when determining whether to designate, or

rescind the designation of, a nonbank financial company (section D).

<sup>9</sup> See Dodd-Frank Act section 113(a)(2), 12 U.S.C. 5323(a)(2).

<sup>10</sup> See section C(1) below for a list of the 10 statutory considerations.

<sup>11</sup> The Council’s Deputies Committee is composed of senior officials from each Council member and member agency. It coordinates and oversees the work of the Council’s other interagency staff committees.

<sup>12</sup> Under 12 CFR 1310.10(b)(2), any proposed or final determination requires the vote of not fewer than two-thirds of the voting members of the Council then serving, including the affirmative vote of the Chairperson of the Council.

## B. Activities-Based Approach

### 1. Overview

Under the Final Guidance, the Council will prioritize its efforts to identify, assess, and address potential risks and threats to U.S. financial stability through a process that begins with an activities-based approach. The Council will pursue entity-specific determinations under section 113 of the Dodd-Frank Act only if a potential risk or threat cannot be adequately addressed through an activities-based approach. This approach reflects two priorities: (1) Identifying and addressing, in consultation with relevant financial regulatory agencies,<sup>13</sup> potential risks and emerging threats on a system-wide basis, thereby reducing the potential for competitive distortions among financial companies and in markets that could arise from entity-specific determinations, and (2) allowing relevant financial regulatory agencies, which generally possess greater information and expertise with respect to company, product, and market risks, to address potential risks, rather than subjecting the companies to new regulatory authorities. The 2012 Final Rule and Interpretive Guidance did not address the concept of an activities-based approach.

As part of its activities-based approach, the Council will examine a diverse range of financial products, activities, and practices that could pose risks to U.S. financial stability. The Council's annual reports highlight the types of activities the Council will evaluate, including activities related to the extension of credit, maturity and liquidity transformation, market making and trading, and other key functions critical to support the functioning of financial markets.<sup>14</sup>

Most commenters supported the activities-based approach, stating that it is the most effective means to address potential risks that may arise in particular industries and would avoid competitive distortions from the entity-specific approach. Some commenters supportive of alternatives to the entity-specific approach stated that designating individual nonbank

financial companies could create inefficiencies and competitive disadvantages in capital markets. One commenter stated that primary regulators should tailor their regulations based on the unique attributes of each company and consider the cumulative effects of regulations on companies. By relying on the experience and expertise of relevant financial regulatory agencies during the activities-based approach, the Council expects that any response to an identified risk to financial stability will be tailored in a manner that reflects the unique attributes of affected companies and their existing regulatory framework. One commenter stated that the activities-based approach should cover activities, but not products and practices. The Council believes that the activities-based approach would be rendered less effective if it excluded products and practices, because activities that may pose risks to financial stability often involve the issuance of products or the conduct of practices.

Other commenters stated that there should be a high bar to Council actions. These commenters stated that the Council and primary regulators should bear the burden of proof in establishing the existence of a risk to financial stability and of demonstrating that the Council's proposed response to the risk is optimal from an effectiveness and efficiency standpoint. The Council expects that its analyses will sufficiently establish the existence of any potential risk or emerging threat to financial stability to which the Council seeks to respond. Further, any regulation adopted by relevant financial regulatory agencies in response to the Council's activities-based approach would generally be subject to existing federal or state administrative law requirements.

Several commenters opposed the prioritization of the activities-based approach, based on various legal, procedural, analytical, and other objections. Some commenters noted that the Council does not have authority to regulate financial activities, or stated that the proposal to rely on primary regulators to address potential risks has no basis in the Dodd-Frank Act. One commenter stated that Congress did not intend the Council's designation authority to be subordinate to or contingent upon an activities-based approach, and two other commenters stated that the Council's authority to make recommendations under section 120 of the Dodd-Frank Act cannot serve as a substitute for designations under section 113. One commenter stated that the Council's analysis should begin with

an activities-based approach, but that the activities-based approach should not be undertaken at the expense of designation, which the commenter stated is an important tool that should be used when warranted.

The Dodd-Frank Act gives the Council broad discretion to determine how to respond to potential threats to U.S. financial stability. The activities-based approach is consistent with the Council's priorities of identifying and addressing potential risks and emerging threats on a system-wide basis, allowing relevant financial regulatory agencies to address identified potential risks. The Council retains the authority to designate nonbank companies under the Final Guidance. The Council recognizes that its authority under section 120 of the Dodd-Frank Act is not a substitute for designations in all circumstances. However, consistent with the Council's prioritization of an activities-based approach, the Council's authority under section 120 may be a more effective means of addressing certain types of potential risks than designating one or more individual companies.

Two commenters stated that the activities-based approach cannot address risks that are tied to the funding and leverage or combination of activities within a specific firm. Another commenter stated that the Federal Reserve's regulatory authorities with respect to designated nonbank financial companies, such as capital and liquidity requirements, risk management requirements, and stress testing, are not available through an activities-based approach. In the activities-based approach, the Council anticipates identifying risks from activities such as the use of leverage, and working with relevant financial regulatory agencies to respond to identified risks. The Council expects that in many cases, relevant financial regulatory agencies will have authority to address risks identified by the Council in the activities-based approach. However, if a potential threat to U.S. financial stability cannot be adequately addressed through an activities-based approach, the Council may consider a nonbank financial company for a potential determination under section 113 of the Dodd-Frank Act.

One commenter stated that although the Proposed Guidance suggests that the activities-based approach will minimize competitive distortions that arise from firm-specific decisions, large, systemically important firms actually create competitive distortions, because of the perception that they will receive a bailout in a situation where their failure could create systemic risk.

<sup>13</sup> References in this preamble and guidance to "relevant financial regulatory agencies" may encompass a broader range of regulators than those included in the statutory definition of "primary financial regulatory agency." See Dodd-Frank Act section 2(12), 12 U.S.C. 5301(12).

<sup>14</sup> For example, the Council's 2018 annual report noted risks such as cybersecurity events associated with the increased use of information technology, the concentrations of activities and exposures in central counterparties, and transition issues related to the move away from LIBOR to an alternative, sustainable reference rate.

Another commenter stated that competitive market distortions are not among the statutory factors that the Council is required to consider when evaluating specific companies for a determination. One of the Council's priorities is to identify and address potential risks and emerging threats to financial stability on a system-wide basis, which, in turn, reduces the potential for competitive market distortions that could arise from entity-specific determinations. The activities-based approach is consistent with this system-wide perspective.

One commenter objected to the activities-based approach on the basis that it is easier for regulators to identify systemic firms *ex ante* than to predict which activities will threaten financial stability. Another commenter stated that jurisdictional gaps will impede the activities-based approach, including with respect to insurance companies, hedge funds, and nonbank financial technology companies. By leveraging the expertise and regulatory authorities of relevant financial regulatory agencies as part of its collaborative engagement in the activities-based approach, the Council expects to identify products, activities, and practices that may raise concerns and effectively address any jurisdictional gaps. Council members can, at their discretion, raise potential risks for consideration by the Council, including with respect to risks that are, or are migrating, outside a particular regulator's jurisdiction. Another commenter stated that the activities-based approach will incentivize firms to engage in regulatory arbitrage by seeking out activities that have not been identified or appropriately regulated. However, actions taken to address potential risks across an entire industry or market under the activities-based approach may be more effective in discouraging regulatory arbitrage than company-specific determinations under section 113. Two commenters stated that it would not be possible for the Council to undertake an activities-based approach effectively, given the reduction in funding and staff for the Office of Financial Research (OFR). The Council has confidence that Council members and member agencies, including the OFR, will be able to conduct the market monitoring, risk identification, information sharing, and analysis contemplated by the activities-based approach.

## 2. First Step of Activities-Based Approach

The Final Guidance establishes a two-step process for the Council's activities-based approach. In the first step, in an

effort to identify potential risks to U.S. financial stability, the Council intends to monitor diverse financial markets and market developments, in consultation with relevant financial regulatory agencies, to identify products, activities, or practices that could pose risks to financial stability.<sup>15</sup> The Council intends to continue to monitor a broad scope of financial markets and market developments, which may include corporate and sovereign debt and loan markets, equity markets, new or evolving financial products, activities, and practices, and developments affecting the resiliency of financial market participants. If the Council's monitoring of markets and market developments identifies a product, activity, or practice that could pose a potential risk to U.S. financial stability, the Council, in consultation with the relevant financial regulatory agencies, will evaluate the potential risk to determine whether it merits further review or action. The Final Guidance defines a "risk to financial stability" as a risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy.<sup>16</sup> One commenter stated that the Council should amend the proposed definition of "risk to financial stability" by evaluating the impact and likelihood of a potential risk, among other attributes. The definition in the Final Guidance is unchanged from the proposal, because the definition already addresses the scale of the risk by reference to the impact on the broader economy. The likelihood of the risk arising is more relevant to the consideration of any appropriate regulatory response than to this definition.

In its analysis in the first step of the activities-based approach, the Council will evaluate the extent to which certain characteristics could amplify potential risks to U.S. financial stability arising from products, activities, or practices. While these characteristics may not themselves present risks to U.S. financial stability, the Council will consider whether the combination or prominence of such characteristics in the products, activities, or practices under evaluation warrants further scrutiny. Such characteristics include asset valuation risk or credit risk;

<sup>15</sup> The Council has a statutory duty to monitor the financial services marketplace in order to identify potential threats to U.S. financial stability. See Dodd-Frank Act section 112(a)(2)(C), 12 U.S.C. 5322(a)(2)(C).

<sup>16</sup> The 2012 Final Rule and Interpretive Guidance did not define "risk to financial stability."

leverage, including leverage arising from debt, derivatives, off-balance sheet obligations, and other arrangements; and the transparency of financial markets, such as growth in financial transactions occurring outside of regulated sectors, among others. When evaluating the potential risks associated with a product, activity, or practice, the Council will take into account these characteristics and various other factors that may exacerbate or mitigate the risks. For example, activities may pose greater risks if they are complex or opaque, are conducted without effective risk-management practices, are significantly correlated with other financial products, or are either highly concentrated or significant and widespread. A trading activity in a market subject to a significant amount of asset valuation risk, for instance, may pose a greater threat to financial stability if the activity is also opaque. In contrast, regulatory requirements or market practices may mitigate risks by, for example, limiting exposures or leverage, enhancing risk-management practices, or restricting excessive risk-taking. Regulatory requirements associated with a lending activity, such as an asset concentration limit or repayment test, may reduce the potential risk to financial stability stemming from the activity. Council members can, at their discretion, raise potential risks for consideration by the Council, including with respect to risks that are, or are migrating, outside a particular regulator's jurisdiction.

Commenters offered numerous views regarding the proposed analytical components of the first step of the activities-based approach. Several commenters stated that the Final Guidance should take into account existing regulations implemented since the financial crisis, or consider the existing regulatory framework and work with the primary regulator to harmonize an approach to evaluating risk. As discussed below, the Final Guidance has been revised to make clear that the Council will consult with relevant financial regulatory agencies and will take into account existing laws and regulations that may mitigate a potential risk to U.S. financial stability. One commenter stated that the Council should tailor regulation to firms' risk profiles. The Council itself does not adopt financial services regulations, but it expects that actions that relevant financial regulatory agencies take to address potential risks to financial stability will be tailored to respond effectively and efficiently to the relevant risk. Further, the Final Guidance has

been revised to state that the Council will take into account the risk profiles and business models of market participants engaging in the products, activities, or practices under evaluation.

Other commenters recommended that the Council further specify how it will analyze potential risks in the activities-based approach, such as by clarifying the criteria or standards the Council will apply, or establishing an empirical connection between an identified risk and measures to address the risk. As discussed below, the Final Guidance has been revised to make clear that the Council will consider available evidence regarding the potential risk and the behavior of financial market participants. At the same time, empirical data may not be available regarding all potential risks, and the type and scope of the Council's analysis will be tailored to the potential risk under consideration.

Several commenters provided recommendations on the types of risks that the Council should focus on. Commenters stated that the Council should focus on new or emerging risks, or on substantially changed activities. Other commenters stated that the Council should focus on risks such as: Key service providers or market participants that could introduce new threats; cross-jurisdictional risks; or historical sources of financial disruptions. The Council expects that such risks and activities will be reviewed as part of the activities-based approach. One commenter stated that the activities-based approach should consider risks from sovereign entities, central banks, government agencies, and cyber threats. The activities-based approach will be sufficiently flexible to enable the Council to consider any relevant risks that may arise from these sources. One commenter stated that the Council should consider how to address risks that arise rapidly and require an expedited response from the Council and regulators. The Council will act expeditiously, as appropriate, to address emerging risks to financial stability.

One commenter stated that the Council should solicit public comment when identifying potential risks during the activities-based approach. During the activities-based approach, the Council will engage extensively with relevant financial regulatory agencies, which are generally in close contact with market participants and other stakeholders. In addition, the Final Guidance notes that the Council may engage with industry participants and other members of the public as it assesses potential risks. Further, as described below, if the Council

proposes to issue recommendations under section 120 of the Dodd-Frank Act, the Council will provide public notice and an opportunity to comment on proposed recommendations in accordance with its statutory obligations.

Several commenters raised considerations specific to certain industries. One commenter stated that insurance is not inherently a source of systemic risk and can be an effective tool of risk mitigation. Another commenter stated that property and casualty insurers do not create systemic risk due to their low levels of leverage and liquidity risk.

Several commenters discussed the application of the activities-based approach to the asset management industry. Commenters stated that private equity and private credit do not pose risks to financial stability, and highlighted the existing federal regulation of such firms. Another commenter stated that the Final Guidance should state that there is no historical evidence demonstrating that traditional asset management activities have threatened U.S. financial stability. One commenter stated that when the Council evaluates leverage in the investment funds sector, it should defer to existing regulation regarding funds' asset segregation and derivatives use.

One of the priorities of the activities-based approach is to allow relevant financial regulatory agencies, which generally possess greater information and expertise with respect to company, product, and market risks, to address potential risks, rather than subjecting companies to new regulatory authorities. The Council believes that this approach will enable the Council, working together with financial regulatory agencies, to appropriately consider specific attributes of particular industries, business models, and existing regulatory frameworks, including the factors highlighted in the public comments regarding insurance and asset management.

Several commenters provided additional views regarding the Council's analysis of specific risk factors. One commenter stated that the activities-based approach should consider risks and mitigants for each relevant industry, since each industry has distinct risk-mitigation techniques. Another commenter stated that leverage alone does not equal risk, and that some leverage can decrease risk. One commenter stated that the Final Guidance should distinguish between investor protection concerns and financial stability concerns. The Council expects to collaborate with relevant

financial regulatory agencies when evaluating the extent to which certain characteristics could amplify potential risks to U.S. financial stability arising from products, activities, or practices. Such characteristics include leverage, such as leverage arising from debt, derivatives, off-balance sheet obligations, and other arrangements. The Council will give due consideration to the attributes of particular risks during this collaboration.

One commenter stated that the Council should regularly survey financial firms on their sources of short-term funding. While the Council does not believe it is appropriate at this time to impose this additional reporting requirement on market participants, the Council will regularly rely on a wide range of data, research, and analysis from Council member agencies, the OFR, and public sources to inform its actions.

### 3. Four Framing Questions in First Step of Activities-Based Approach

The Council's analysis in the first step of the activities-based approach will generally focus on four framing questions, which analyze (1) triggers of potential risks (for example, sharp reductions in the valuation of particular classes of financial assets or significant credit losses); (2) how adverse effects of the potential risk may be transmitted to financial markets or market participants (for example, through direct or indirect exposures in financial markets to the potential risk or funding or trading pressures that may result from associated declines in asset prices); (3) the effects the potential risk could have on the U.S. financial system (for example, the scale and magnitude of adverse effects on other companies and markets, and whether such effects could be concentrated or diffused among market participants); and (4) whether the adverse effects of the potential risk could impair the U.S. financial system in a manner that could harm the non-financial sector of the U.S. economy (for example, through curtailed or interrupted provision of credit to non-financial companies).

Commenters that expressed a view on the four framing questions generally supported the proposed framework, in some cases with suggestions for additional factors or steps the Council should consider. Two commenters stated that the Council should consult with primary regulators regarding new dynamics that could fuel a financial crisis, such as risks that start in the broader economy and propagate to the financial system. Another commenter stated that the Council should provide

more detail on how it will analyze data under the four framing questions. In addition, three commenters stated that the Council's analysis under the four framing questions should be based on empirical and historical evidence. The Final Guidance has been revised to clarify that in its evaluation of the four framing questions, the Council will consult with relevant financial regulatory agencies and will take into account existing laws and regulations that may mitigate a potential risk to U.S. financial stability. The Council will also take into account the risk profiles and business models of market participants engaging in the products, activities, or practices under evaluation. The Council will consider available evidence regarding potential risks. However, the Final Guidance notes that empirical data may not be available regarding all potential risks, and the type and scope of the Council's analysis will be tailored to the potential risk under consideration.

Several other commenters stated that the analysis under the four framing questions should include an assessment of the likelihood, significance, dollar value, or magnitude of a potential risk to financial stability. The Council expects that the scale of the adverse effects a potential risk could have on companies and markets will be part of its evaluation under the four framing questions—particularly the third question, regarding the effects the potential risk could have on the U.S. financial system. However, the Council does not intend to introduce a separate assessment of the likelihood of a particular risk, which could unnecessarily restrict its ability to evaluate the framing questions.

#### 4. Second Step of Activities-Based Approach

If the Council identifies a potential risk to U.S. financial stability in step one of the activities-based approach, then in the second step, the Council will work with the relevant financial regulatory agencies at the federal and state levels to seek the implementation of appropriate actions to address the identified potential risk.<sup>17</sup> The goal of this step is for these regulators to take appropriate actions such as modifying their regulation or supervision of companies or markets under their jurisdiction in order to mitigate potential risks to U.S. financial stability

identified by the Council. Measures that regulators can take to address a particular risk may vary widely, based on their authorities and the urgency of the risk. The Council will seek to take advantage of these regulators' expertise and their regulatory and supervisory authorities to address the potential risk identified by the Council. Two commenters stated that the Council should vote on advancing from step one to step two of the activities-based approach. Because of the continued preliminary nature of any analysis and interagency collaboration at the outset of step two, the Council is not adopting a requirement to hold a vote at that time.

The Council expects that much of its initial identification and assessment of risks, and engagement with regulators, will be informal and nonpublic in nature. The staffs of Council members and member agencies will be responsible for much of the market monitoring, risk identification, information sharing, and analysis in the activities-based approach. This engagement may yield a range of diverse outcomes, including the sharing of data, research, and analysis among the Council and regulators, or the public issuance of recommendations by the Council in its annual reports. Potential risks that merit further attention may be raised at meetings of the Council members or with other stakeholders, and, as appropriate, may result in public statements or recommendations by the Council, as described above.

The Council anticipates that appropriate measures it may take to address an identified potential risk will also typically take the form of relatively informal actions, such as information sharing among regulators, but as deemed appropriate could also include more formal measures, such as the Council's public issuance of recommendations to regulators or the public. Such recommendations could be made in the Council's annual report. Alternatively, if after engaging with relevant financial regulatory agencies, the Council finds that those regulators' actions are inadequate to address the identified potential risk to U.S. financial stability, the Council has authority under section 120 of the Dodd-Frank Act to "provide for more stringent regulation of a financial activity" by publicly issuing nonbinding recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice conducted by bank holding companies or nonbank financial companies under

their jurisdictions.<sup>18</sup> The Council's authority under section 120 of the Dodd-Frank Act is discussed below.

Several commenters provided views regarding the Council's process and engagement with primary regulators in the activities-based approach. One commenter stated that the Council should separate responsibility among the Council staff for investigating an activity from responsibility for determining that the activity poses a systemic risk. The Council has limited staff and also relies on the resources of its members and member agencies, and therefore does not propose to restructure its staff in this manner. Two commenters stated that the Council should rely as much as possible on public or existing regulatory data. The Council will regularly rely on data, research, and analysis from Council member agencies, the OFR, industry participants, and other public sources to inform its actions. Consistent with its statutory obligations, the Council will, whenever possible, rely on information available from the OFR or primary financial regulatory agencies before requiring the submission of reports from any nonbank financial company or bank holding company that is regulated by a member agency or primary financial regulatory agency.<sup>19</sup> One commenter stated that the Council should report publicly on its activities-based approach evaluations and other Council activities, and include this reporting in the Council annual report. The issues the Council is likely to consider in the activities-based approach are often discussed in the Council's annual reports. In the event the Council issues recommendations in connection with the activities-based approach, such recommendations could also be made in the Council's annual report, which includes the Council's recommendations to enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets, to promote market discipline, and to maintain investor confidence.

One commenter stated that the Council should consider whether new regulatory requirements could have an unintended adverse impact on financial stability. The Council will coordinate among its members and member agencies and will follow up on supervisory or regulatory actions to ensure the potential risk is adequately addressed, with due consideration for

<sup>17</sup> The Council has a statutory duty to "recommend to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies." See Dodd-Frank Act section 112(a)(2)(F), 12 U.S.C. 5322(a)(2)(F).

<sup>18</sup> Dodd-Frank Act section 120(a), 12 U.S.C. 5330(a).

<sup>19</sup> See Dodd-Frank Act section 112(d)(3)(B), 12 U.S.C. 5322(d)(3)(B).

any identified, unintended adverse impact.

One commenter stated that the Council should further clarify the process it will follow during the activities-based approach. The Council believes the process set forth in the Final Guidance provides an appropriate level of specificity while also permitting sufficient flexibility for informal collaboration among financial regulators to identify, assess, and address potential risks. One commenter stated that the Council should publicly issue a written provisional determination regarding any identified potential risk to financial stability. The Council's collaboration with relevant financial regulatory agencies in the activities-based approach may yield a range of diverse outcomes, including the sharing of data, research, and analysis among the Council and these regulators, or the public issuance of recommendations by the Council in its annual reports. The approach described in the Final Guidance will enable robust analysis and collaboration, without unduly restricting the Council's ability to respond to potential risks to U.S. financial stability.

A number of commenters provided recommendations about the Council's engagement with regulators or industry stakeholders in the activities-based approach. Several commenters stated that engagement with primary regulators and companies should be a key component of the activities-based approach, and another stated that the Council should strengthen the role of the primary regulator in activities-based approach step one, with a presumption supporting the primary regulator's findings. The Final Guidance makes clear that the Council will seek to take advantage of existing regulators' expertise and regulatory authorities to address any potential risk identified by the Council during the activities-based approach. One commenter stated that the Council should communicate with the primary regulator about existing regulations applicable to companies engaged in financial activities that may be evaluated in connection with the activities-based approach, any possible changes to such regulations, and whether it can address the identified risk on an industry-wide basis. As discussed above, the Final Guidance has been revised to clarify that in its evaluation, the Council will consult with relevant financial regulatory agencies and will take into account existing laws and regulations that may mitigate a potential risk to U.S. financial stability. Several commenters stated that the Council should coordinate with

various other parties during the activities-based approach, including state insurance regulators, the National Association of Insurance Commissioners (NAIC), and other industry stakeholders. If the Council identifies a potential risk to U.S. financial stability in step one of the activities-based approach, then in the second step, the Council will work with the relevant financial regulatory agencies, including state regulators, to seek the implementation of appropriate actions to address the identified potential risk.

Several commenters stated that the Council or the relevant primary regulator should undertake a cost-benefit analysis in connection with the activities-based approach. Because the Council will not itself be adopting regulations or taking supervisory actions to address potential risks to U.S. financial stability identified in the activities-based approach, a cost-benefit analysis by the Council during the activities-based approach would not generally be appropriate. In addition, several commenters recommended that the Council undertake a cost-benefit analysis in connection with any recommendation the Council may issue under section 120 of the Dodd-Frank Act. As described below, the Council made changes to the Final Guidance in response to these comments, because it has determined that such an analysis would increase the rigor of the Council's recommendations under section 120.

#### 5. Recommendations Under Section 120 of the Dodd-Frank Act

Under section 120 of the Dodd-Frank Act, the Council has authority to "provide for more stringent regulation of a financial activity" by publicly issuing nonbinding recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice conducted by certain financial companies.<sup>20</sup>

The authority to issue recommendations to primary financial regulatory agencies under section 120 is one of the Council's most formal tools for responding to potential risks to U.S. financial stability. Given the importance of this tool, and consistent with the public comments on the Proposed Guidance, the Council believes that a cost-benefit analysis should be performed and made public in connection with any recommendations issued under section 120. The Final Guidance has been revised to provide additional clarity on the process by

which the Council may issue recommendations under section 120, and how the costs and benefits associated with such recommendations will be analyzed. Consistent with section 120, the Council will make these recommendations only if it determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, U.S. financial markets, or low-income, minority, or underserved communities.

In its recommendations under section 120, the Council may suggest broad approaches to address the risks it has identified. When appropriate, the Council may make a more specific recommendation. To promote analytical rigor and avoid duplication, before making any recommendation under section 120, the Council will ascertain whether the relevant primary financial regulatory agency would be expected to perform a cost-benefit analysis of the actions it would take in response to the Council's contemplated recommendation. In cases where the primary financial regulatory agency would not be expected to conduct such an analysis, the Council itself will—prior to making a final recommendation—conduct an analysis, using empirical data, to the extent available, of the benefits and costs of the actions that the primary financial regulatory agency would be expected to take in response to the contemplated recommendation. Where the Council conducts its own such analysis, the specificity of its assessment of benefits and costs would be commensurate with the specificity of the contemplated recommendation. In general, such an assessment by the Council will include a consideration of the benefits and costs to market participants and to the U.S. financial system and long-term economic growth. Where the Council conducts its own analysis, the Council will make a recommendation under section 120 only if it believes that the results of its assessment of benefits and costs support the recommendation.

Primary financial regulatory agencies have significant experience, knowledge, and expertise that can be useful in determining the most efficient way to address a particular risk within their regulatory jurisdiction. In every case, prior to issuing a recommendation under section 120, the Council will consult with the relevant primary financial regulatory agency and provide

<sup>20</sup>Dodd-Frank Act section 120(a), 12 U.S.C. 5330(a).

notice to the public and opportunity for comment as required by section 120.

In any case in which no primary financial regulatory agency exists for one or more nonbank financial companies conducting financial activities or practices identified by the Council as posing risks, the Council can consider reporting to Congress on recommendations for legislation that would prevent such activities or practices from threatening U.S. financial stability.<sup>21</sup> The Council intends to make recommendations under section 120 of the Dodd-Frank Act only to the extent that its recommendations are consistent with the statutory mandate of the relevant primary financial regulatory agency.

One commenter stated that the Council should use its authority under section 120 of the Dodd-Frank Act after informal and nonpublic actions have been tried and deemed insufficient. As noted above, if the Council, after engaging with relevant financial regulatory agencies, believes those regulators' actions are inadequate to address an identified potential risk to U.S. financial stability, the Council may make formal public recommendations to primary financial regulatory agencies under section 120. Another commenter stated that the consent of the primary financial regulatory agency should be required before the Council issues a recommendation under section 120. The Council expects to issue recommendations under section 120 only after engaging with relevant financial regulatory agencies, but the primary financial regulatory agency's consent is not required under section 120, and the Council believes that its consultation with regulators will be more effective than the commenter's proposed restriction on the Council's discretion.

#### 6. Transition From Activities-Based Approach to Determination Process

The Proposed Guidance stated that if the activities-based approach did not adequately address a potential risk identified by the Council, the Council may evaluate one or more individual nonbank financial companies for an entity-specific determination under section 113 of the Dodd-Frank Act.

Commenters provided various recommendations on the procedural steps that should be required for the Council to advance beyond the activities-based approach and commence an evaluation of a nonbank financial company for a potential

determination under section 113 of the Dodd-Frank Act. One commenter requested that the Council clarify that the activities-based approach is distinct from the determination process. The Final Guidance reflects the fact that the process for evaluating a nonbank financial company for a potential determination under section 113 of the Dodd-Frank Act is distinct from the process for an activities-based approach under section 112 of the Dodd-Frank Act. Commenters made a number of comments intended to ensure that sufficient analysis is conducted in the activities-based approach before the Council initiates a designation analysis. One commenter stated that before considering a nonbank financial company for a potential determination, the Council should explain in writing the empirical basis why the activities-based approach is insufficient. Several other commenters stated that the Council should only move from the activities-based approach to a designation analysis if the primary regulator of the relevant nonbank financial company states in writing that it cannot address the risk through an activities-based approach. Other commenters recommended that the Council and relevant primary regulator prepare a list of the regulator's findings in connection with the transition from the activities-based approach to a designation analysis and that the Council should make a "written finding" that it is moving to a designation analysis.

The Proposed Guidance stated that the Council or its Deputies Committee would vote to commence review of a nonbank financial company in Stage 1. Several commenters stated that the Council should vote on any decision to commence the review of a nonbank financial company for a potential determination, and that such a vote should not be delegable to the Deputies Committee. In light of the significance of a Council determination, the Council agrees with these comments. Accordingly, the Final Guidance has been revised to provide that the Council will vote to commence review of a nonbank financial company in Stage 1. The Council's vote before considering a nonbank financial company for a potential determination will help ensure that sufficient analysis has been conducted in the activities-based approach.<sup>22</sup>

#### C. Analytic Framework for Nonbank Financial Company Determinations

The Proposed Guidance stated that the Council expects to advance beyond the activities-based approach, and evaluate a nonbank financial company for a potential determination under section 113 of the Dodd-Frank Act, only in a limited set of circumstances—namely, if (1) the Council's collaboration and engagement with the relevant financial regulatory agencies using an activities-based approach does not adequately address the potential risk identified by the Council, or if the potential threat to U.S. financial stability is outside the jurisdiction or authority of financial regulatory agencies, and (2) the potential threat identified by the Council is one that could be addressed by a Council determination regarding one or more nonbank financial companies. Two commenters stated that the Final Guidance should be modified to state that the Council may consider a nonbank financial company for a potential determination only if a potential threat "can only be adequately addressed" through designation. While the Council believes that the commenters' proposed language would unduly restrict the Council's ability to respond to potential threats to financial stability, the Final Guidance has been revised, with respect to clause (2) above, to add that the Council will only evaluate a company for a designation if the potential threat identified is one that could be effectively addressed by a Council determination.

Following is a description of the substantive analysis the Council would undertake regarding any nonbank financial company under review for a potential determination.

#### 1. Statutory Standards and Considerations

Title I of the Dodd-Frank Act defines a "nonbank financial company" as a domestic or foreign company that is "predominantly engaged" in "financial activities," other than bank holding companies and certain other types of firms.<sup>23</sup> The Dodd-Frank Act provides that a company is "predominantly engaged" in financial activities if either (1) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated annual gross revenues of the company; or (2) the consolidated assets of the

<sup>21</sup> See Dodd-Frank Act section 120(d)(3), 12 U.S.C. 5330(d)(3).

<sup>22</sup> See also the chart of Council votes that would occur at significant transition points in the Council's analysis, in section II(A)(2) above.

<sup>23</sup> See Dodd-Frank Act section 102(a)(4), 12 U.S.C. 5311(a)(4).

company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated assets of the company.<sup>24</sup> The Dodd-Frank Act requires the Federal Reserve to establish the requirements for determining whether a company is “predominantly engaged in financial activities” for this purpose.<sup>25</sup>

Section 113 of the Dodd-Frank Act authorizes the Council to subject a nonbank financial company to supervision by the Federal Reserve and prudential standards if the Council determines that (1) material financial distress at the nonbank financial company could pose a threat to U.S. financial stability (the “First Determination Standard”), or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to U.S. financial stability (the “Second Determination Standard”). The analytic framework in the Final Guidance focuses primarily on the First Determination Standard, because risks to financial stability (such as asset fire sales or financial market disruptions) are most commonly propagated through a nonbank financial company when it is in distress.

The Council is statutorily required to take into account the following considerations in making a determination under section 113 of the Dodd-Frank Act:<sup>26</sup>

- The extent of the leverage of the company;
- The extent and nature of the off-balance-sheet exposures of the company;
- The extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- The importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the U.S. financial system;
- The importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have

<sup>24</sup> See Dodd-Frank Act section 102(a)(6), 12 U.S.C. 5311(a)(6).

<sup>25</sup> See Dodd-Frank Act section 102(b), 12 U.S.C. 5311(b). The Federal Reserve published a final rule in April 2013 establishing the requirements for determining if a company is “predominantly engaged in financial activities.” See 12 CFR 242.3.

<sup>26</sup> See Dodd-Frank Act section 113(a)(2), 12 U.S.C. 5323(a)(2). This list reflects the statutory considerations applicable to a determination with respect to a U.S. nonbank financial company. The Council is required to consider corresponding factors in making a determination with respect to a foreign nonbank financial company.

on the availability of credit in such communities;

- The extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- The nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- The degree to which the company is already regulated by one or more primary financial regulatory agencies;
- The amount and nature of the financial assets of the company;
- The amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
- Any other risk-related factors that the Council deems appropriate.

One commenter stated that the Council should make clear that designation of certain entities, like mutual funds and their managers, is inappropriate. Another commenter stated that designation is the wrong approach for capital markets firms, because it applies rules designed for banks to non-banks. Several commenters stated that the Federal Reserve should exempt from designation certain types of nonbank financial companies that do not exhibit certain risk factors, pursuant to section 170 of the Dodd-Frank Act. The Council does not intend to provide industry-based exemptions from potential determinations under section 113 of the Dodd-Frank Act. The Council would evaluate industry- or firm-specific factors as part of the assessment of any nonbank financial company for potential designation. Therefore, based on these comments, the Final Guidance has been revised to make clear that the information relevant to an in-depth analysis of a nonbank financial company may vary based on the nonbank financial company’s characteristics. One commenter stated that the Council should consider how the enhanced prudential standards that apply to designated nonbank financial companies should be tailored to specific types of nonbank financial companies. The Council has statutory authority to make recommendations to the Federal Reserve concerning the establishment and refinement of prudential standards and other requirements applicable to designated nonbank financial companies;<sup>27</sup> the Council may consider, at a future date, whether to issue such recommendations.

Several other commenters generally opposed to the proposal stated that the Council’s designation authority is a vital tool that should not be de-emphasized

<sup>27</sup> See Dodd-Frank Act section 115, 12 U.S.C. 5325.

in favor of the activities-based approach. One commenter stated that Congress intended that designation be the mandatory and primary mechanism for addressing risks to financial stability. Another stated that the Proposed Guidance imposed conditions that conflicted with section 113 of the Dodd-Frank Act. Several commenters stated that the proposed changes would make designation unworkably lengthy, or would preclude its use to address potential risks in advance of an emergency. Other commenters made similar arguments regarding the benefits of nonbank financial company designations. The Final Guidance is intended to ensure that the Council’s work is clear, transparent and analytically rigorous, and to enhance the Council’s engagement with companies, regulators, and other stakeholders. By issuing clear and transparent guidance, the Council seeks to provide the public with sufficient information to understand the Council’s concerns regarding risks to U.S. financial stability, while appropriately protecting information submitted by companies and regulators to the Council. The Final Guidance does not prohibit the Council from considering a nonbank financial company for potential designation, in appropriate circumstances. The Final Guidance makes clear that the Council may pursue entity-specific determinations under section 113 of the Dodd-Frank Act if a potential risk or threat cannot be adequately addressed through an activities-based approach. The Council anticipates it would consider a nonbank financial company for a potential determination under section 113 only in rare instances, such as if the products, activities, or practices of a company that pose a potential threat to U.S. financial stability are outside the jurisdiction or authority of financial regulatory agencies. Further, the Final Guidance does not limit the ability of the Council to waive or modify the procedural requirements related to nonbank financial company designations if the Council determines that such action is necessary or appropriate to prevent or mitigate threats posed by a nonbank financial company to U.S. financial stability.<sup>28</sup>

The Final Guidance clarifies several terms used in the Dodd-Frank Act that are not defined in the Act, including “company,” “material financial distress,” and “threat to the financial stability of the United States.” The Final Guidance defines “threat to the

<sup>28</sup> See Dodd-Frank Act section 113(f), 12 U.S.C. 5323(f), 12 CFR 1310.22.

financial stability of the United States” by reference to the potential for “severe damage on the broader economy,” in contrast to the definition in the 2012 Interpretive Guidance, which refers to “significant” damage. The Council intends to interpret the term “company” to include any corporation, limited liability company, partnership, business trust, association, or similar organization.<sup>29</sup> The Proposed Guidance stated that the Council intends to interpret “nonbank financial company” as including any successor of a company that is subject to a final determination of the Council. Several commenters stated that the Council should either eliminate the “successor” language, or limit successors to those entities that succeed to substantially all the designated company’s assets and liabilities.

The Council agrees with commenters that the proposed interpretation of “nonbank financial company” was overly broad. The Final Guidance has therefore been revised to narrow the proposed interpretation and further clarify which entity would be subject to a Council determination in the event of a sale that involves the transfer of a majority, but not all, of a designated nonbank financial company’s assets or liabilities. The Final Guidance states that the Council intends to interpret the statutory term “nonbank financial company supervised by the Board of Governors” as including any nonbank financial company that acquires, directly or indirectly, a majority of the assets or liabilities of a company that is subject to a final determination of the Council. As a result, if a nonbank financial company subject to a final determination of the Council sells or otherwise transfers a majority of its assets or liabilities, the acquirer, rather than the remaining small entity, will succeed to and become subject to the Council’s determination.<sup>30</sup> This new definition has the benefit of clarity, because it relies on a simple balance sheet-related test to determine whether an entity succeeds to, and becomes subject to, a Council determination. This definition also makes clear that the acquirer of a minority of a designated nonbank financial company’s assets or

liabilities will not be deemed to become subject to the Council determination. At the request of the designated nonbank financial company, the Council may engage in discussions with the company to evaluate the structure of any transaction involving a potential successor. Further, as discussed in section V of the Final Guidance, a nonbank financial company that is subject to a final determination of the Council may request a reevaluation of the determination before the next required annual reevaluation, in appropriate cases. The Final Guidance has been revised to make clear that if a nonbank financial company subject to a final determination of the Council sells or otherwise transfers a majority of its assets or liabilities, the acquirer can use this reevaluation process to seek a rescission of the determination upon consummation of its transaction.

Several commenters stated that the Council should add specificity regarding certain definitions in the Proposed Guidance, such as “impairment of financial intermediation or of financial market functioning,” “severe damage on the broader economy,” “overall stress in the financial services industry,” and “weak macroeconomic environment.” The Council believes that these definitions accurately reflect the statutory requirements and the nature of the threat that the Council’s authority under the Dodd-Frank Act seeks to mitigate. Attempting to define them with greater specificity could unacceptably limit the Council’s discretion in a situation that is not precisely foreseeable.

The Council received a number of comments regarding its analysis in the designation context. One commenter stated that the Council should defer to the nonbank financial company’s primary regulator during the analysis, and another stated that the Council should provide a key role on the Council analytic team to staff of the primary regulator, and solicit input from industry and academic economists. The Council will consult with a company’s primary financial regulatory agency (if any) when assessing a company for potential designation. A company under review in Stage 1 or Stage 2 may voluntarily submit to the Council any information it deems relevant to the Council’s evaluation. In consideration of the benefits that the Council will derive from extensive engagement with a company’s primary financial regulatory agency, the Council will actively solicit the regulator’s views regarding risks at the company and potential means to mitigate those risks, and will share its preliminary views regarding potential

risks at the company with the regulator. During the determination process, the Council will continue to encourage the regulator to address relevant risks using the regulator’s existing authorities.

Other commenters provided specific analytical recommendations to the Council, including that the Council should consider market risks in conjunction with the analysis of a nonbank financial company’s liquidity risk; the Council should assess the ability of financial markets to absorb asset fire sales; and, when analyzing leverage, the Council should distinguish between long and short exposures. The Council has not revised the Final Guidance to address these comments but intends to consider such factors in its analyses as appropriate.

## 2. Transmission Channels

The Final Guidance explains that the Council’s evaluation of a nonbank financial company for a potential determination will focus primarily on how the negative effects of the company’s material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities, could be transmitted to or affect other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning. The Council has identified three transmission channels as most likely to facilitate the transmission of these negative effects. These transmission channels are: (1) The exposure transmission channel; (2) the asset liquidation transmission channel; and (3) the critical function or service transmission channel. While these transmission channels were also described in the 2012 Interpretive Guidance, the Final Guidance substantially enhances and clarifies the Council’s analyses under these three channels. The Council may also consider other relevant channels through which risks could be transmitted from a particular nonbank financial company and thereby pose a threat to U.S. financial stability.

### *a. Exposure Transmission Channel*

Under the exposure transmission channel, the Council will evaluate whether a nonbank financial company’s creditors, counterparties, investors, or other market participants have direct or indirect exposure to the nonbank financial company that is significant enough to materially and adversely affect those or other creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability. Among

<sup>29</sup> The statutory definition of “nonbank financial company” excludes bank holding companies and certain other types of companies. Dodd-Frank Act section 102(a)(4), 12 U.S.C. 5311(a)(4).

<sup>30</sup> In narrowing and clarifying its interpretation of “nonbank financial company supervised by the Board of Governors,” the Council is guided by general principles of corporate law under which an acquirer of another company’s assets may be liable for obligations of the seller in certain situations, including if the purchaser is merely a continuation of the seller.

other factors, the Council expects to evaluate the amounts of exposures, the degree of protection for the counterparty under the terms of transactions, whether the largest counterparties include large financial institutions, and the company's leverage and size. The Council will also consider the exposures that counterparties and other market participants have to a nonbank financial company arising from the company's capital markets activities. The Council expects to consider a variety of factors in connection with this analysis, such as the amount and nature of, and counterparties to, the company's outstanding debt (regardless of term) and other liabilities, derivatives transactions (which may be measured on the basis of gross notional amount, net fair value, or potential future exposures), and securities financing transactions, among others. The Council will also consider applicable factors, including existing regulatory requirements, that may mitigate potential risks under the exposure transmission channel. The Final Guidance notes that the Council will consider the extent to which assets are managed rather than owned by the company, in recognition of the distinct nature of exposure risks when the company is acting as an agent rather than as principal. In particular, in the case of a nonbank financial company that manages assets on behalf of customers or other third parties, the third parties' direct financial exposures are often to the issuers of the managed assets, rather than to the nonbank financial company managing those assets. Finally, the Council will evaluate the potential for contagion in conjunction with other factors summarized above when evaluating risk under this channel. As part of this assessment, the Council will consider relevant industry-specific historical examples, the scope of the company's interconnectedness with large financial institutions, and market-based or regulatory factors that may mitigate the risk of contagion, among other factors.

#### *b. Asset Liquidation Transmission Channel*

Under the asset liquidation transmission channel, the Council will consider whether a nonbank financial company holds assets that, if liquidated quickly, could pose a threat to U.S. financial stability by, for example, causing a fall in asset prices that significantly disrupts trading or funding in key markets or causes significant losses or funding problems for other firms with similar holdings. The Council may also consider whether a

deterioration in asset pricing or market functioning could pressure other financial firms to sell their holdings of affected assets in order to maintain adequate capital and liquidity, which, in turn, could produce a cycle of asset sales that could lead to further market disruptions. The Council will also consider the extent to which assets are managed rather than owned by the company. The Council's analysis of the asset liquidation transmission channel will focus on three central factors: (1) Liquidity of the company's liabilities; (2) liquidity of the company's assets; and (3) potential fire sale impacts.

When analyzing the liquidity of the company's liabilities, the Council will assess the company's liquidity risk by reviewing factors such as the company's short-term financial obligations, financial arrangements that can be terminated by counterparties and therefore become short-term, and long-term liabilities that may come due in a short-term period, among other factors. The Council will also evaluate the company's leverage (for example, by assessing total assets and total debt measured relative to total equity, and derivatives liabilities and off-balance sheet obligations relative to total equity), as well as the company's short-term debt ratio. When analyzing the liquidity of the company's assets, the Council will consider which assets the company could rapidly liquidate, if necessary, to satisfy its obligations. Finally, when analyzing potential fire sale impacts, the Council will consider the potential effects of the company's asset liquidation on markets and market participants.

#### *c. Critical Function or Service Transmission Channel*

Finally, under the critical function or service transmission channel, the Council will consider the potential for a nonbank financial company to become unable or unwilling to provide a critical function or service that is relied upon by market participants and for which there are no ready substitutes and thereby pose a threat to U.S. financial stability. This analysis considers the extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity if a nonbank financial company withdraws from a particular market, a factor commonly known as "substitutability." Substitutability also captures situations in which a nonbank financial company is the primary or dominant provider of services in a market that the Council determines to be essential to U.S. financial stability. When evaluating this transmission

channel, the Council may consider the nonbank financial company's activities and critical functions and the importance of those activities and functions to the U.S. financial system, including how those activities and functions would be performed by the company or other market participants in the event of the company's material financial distress; the competitive landscape for markets in which a nonbank financial company participates and for the services it provides; the company's market share in specific product lines; and the ability of substitutes to replace a service or function provided by the company, among other factors.

The Council received a number of comments regarding the transmission channels. One commenter stated that the transmission channels should refer to existing regulations or policies that relate to financial stability. The Council is statutorily required to take into account the degree to which the nonbank financial company is already regulated by one or more primary financial regulatory agencies, and this analysis will focus on the extent to which existing regulation of the company mitigates the potential risks to financial stability identified by the Council.

One commenter stated that in the asset liquidation transmission channel, the Council should establish a basis for concluding that a decline in asset prices, and resulting disruptions or losses, poses a threat to financial stability. The Final Guidance has been revised to clarify that, under the asset liquidation channel, the Council will consider whether a nonbank financial company holds assets that, if liquidated quickly, could pose a threat to U.S. financial stability by, for example, causing a fall in asset prices that significantly disrupts trading or funding in key markets or causes significant losses or funding problems for other firms with similar holdings. Commenters also stated that the Council should establish a basis for concluding that the risks identified under each transmission channel could pose a threat to financial stability, and should take into account mitigating factors. The Final Guidance has been revised to provide that the analysis under each transmission channel relates to the potential threat to U.S. financial stability, and that the Council will consider applicable factors that may mitigate potential threats under each transmission channel.

Several commenters provided industry-specific comments with respect to the transmission channels.

One commenter stated that the Council should include examples of risk-mitigating features of the insurance sector, such as recognizing insurance separate accounts, and mechanisms that mitigate potential fire sales of assets resulting from policyholder withdrawals or surrenders. The Final Guidance has been revised to make clear that the Council will consider applicable factors that may mitigate potential risks under the exposure transmission channel, such as the use of insurance funds to limit counterparty exposures or other transactions that reallocate risk to well-capitalized entities. Several commenters supported the statement in the Proposed Guidance that the Council will consider the extent to which assets are managed rather than owned by the company. Other comments highlighted factors that may limit potential risks to financial stability arising from asset managers. The Final Guidance has been revised to make clear that in its analyses under the transmission channels, the Council will consider applicable factors that may limit the transmission of risk, such as existing regulatory requirements, collateralization, bankruptcy-remote structures, or guarantee funds that reduce counterparties' exposures to the nonbank financial company or mitigate incentives for customers or counterparties to withdraw funding or assets. The Council's determination with respect to a nonbank financial company will be based on an evaluation of whether the nonbank financial company meets the statutory standards, taking into account the statutory considerations set forth in section 113 of the Dodd-Frank Act, and any other risk-related factors that the Council deems appropriate. While the Council does not intend to provide industry-based exemptions from potential determinations under section 113 of the Dodd-Frank Act, the Council intends to give these types of mitigating factors due consideration in its analysis of any nonbank financial company for a potential determination.

### 3. Complexity, Opacity, and Resolvability

In addition to the three transmission channels, the Final Guidance explains that the Council also intends to consider a nonbank financial company's complexity, opacity, and resolvability when evaluating whether the company poses a risk to U.S. financial stability. As part of this analysis, the Council may assess the complexity of the nonbank financial company's legal, funding, and operational structure, and any obstacles to the rapid and orderly resolution of the company. One commenter requested

that the Final Guidance state that the Council expects to discuss these matters with the regulatory agency. The Final Guidance notes that the Council will consult with the relevant primary financial regulatory agency during both Stage 1 and Stage 2. When consulting with a company's primary financial regulatory agency (if any), the Council expects to discuss the company's complexity, opacity, and resolvability, as well as the likelihood of its material financial distress, taking into account a period of overall stress in the financial services industry and a weak macroeconomic environment (discussed in detail below).

### 4. Existing Regulatory Scrutiny

Consistent with section 113 of the Dodd-Frank Act, the Final Guidance explains that the Council will consider the degree to which a nonbank financial company is already regulated by one or more primary financial regulatory agencies. When considering existing regulatory scrutiny, the Council may weigh factors such as the comprehensiveness of the regulatory regime, the extent to which the company's primary financial regulatory agency has imposed risk-management standards as relevant to the type of company, regulators' processes for inter-regulator coordination, and the extent to which existing regulation of the company has mitigated the potential risks to financial stability identified by the Council.

### 5. Cost-Benefit Analysis and Likelihood of Material Financial Distress

#### a. Cost-Benefit Analysis

Under the Final Guidance, the Council will perform a cost-benefit analysis before making any determination under section 113. The Council proposes to make a determination under section 113 only if the expected benefits justify the expected costs that the determination would impose.<sup>31</sup> The key elements of regulatory analysis include (1) a statement of the need for the proposed action, (2) an examination of alternative approaches, and (3) an evaluation of the benefits and costs of the proposed action and the main alternatives.<sup>32</sup> The Council will conduct this analysis only in cases where the Council is concluding that the company meets one of the standards for a determination by

<sup>31</sup> See *MetLife, Inc. v. Financial Stability Oversight Council*, 177 F. Supp.3d 219, 242 (D.D.C. 2016) (quoting 12 U.S.C. 5323(a)(2)(K) and *Michigan v. Environmental Protection Agency*, 135 S. Ct. 2699, 2707 (2015)).

<sup>32</sup> See Office of Management and Budget Circular A-4 (Sept. 17, 2003).

the Council under section 113 of the Dodd-Frank Act, because in other cases doing so would not affect the outcome of the Council's analysis.

The Council will consider the benefits of a determination to the U.S. financial system, long-term economic growth, and the nonbank financial company due to additional regulatory and supervisory requirements resulting from the determination, including the benefits of the prudential standards adopted by the Federal Reserve under section 165 of the Dodd-Frank Act. When evaluating potential benefits to the U.S. financial system and long-term economic growth arising from a determination, the Council may consider whether the determination enhances U.S. financial stability and mitigates the severity of economic downturns by reducing the likelihood or severity of a potential financial crisis, among other factors. With respect to company-specific benefits, a company subject to a determination may derive benefits from anticipated new or increased requirements, including, for example, a lower cost of capital or higher credit ratings upon meeting its post-designation regulatory and supervisory requirements.

When evaluating the costs of a determination, the Council will consider not only the cost to the nonbank financial company from anticipated new or increased regulatory and supervisory requirements in connection with a determination, but also costs to the U.S. economy. Relevant costs to the company will likely include costs related to risk-management requirements, supervision and examination, and liquidity requirements. When evaluating the costs of a determination to the U.S. economy, the Council will assess the impact of the determination on the availability and cost of credit or financial products in relevant U.S. markets, among other factors.

The majority of the commenters supported the proposal to perform a cost-benefit analysis before making any determination under section 113. Several commenters provided recommendations regarding the Council's analysis, including that the Council's analysis should be empirically based or use historical data (not assumptions), with estimates of indirect costs. The Final Guidance has been revised to add greater specificity regarding the Council's cost-benefit analysis. The Final Guidance makes clear that when possible, the Council will quantify reasonably estimable benefits and costs, using ranges, as appropriate, and based on empirical

data when available. If such benefits or costs cannot be quantified in this manner, the Council will explain why such benefits or costs could not be quantified or estimated. The Council also expects to consider benefits and costs qualitatively. To the extent feasible, the Council will attempt to assess the relative importance of any such qualitative elements. At the same time, the Final Guidance recognizes that it may not be possible to assess with any degree of certainty certain potential benefits or costs, including indirect benefits or costs.

One commenter stated that the Council should not designate a nonbank financial company unless the Council can demonstrate that designation would effectively mitigate the risk posed by the firm. Another stated that the Council should make clear that the Council will not designate a nonbank financial company unless designation mitigates the risk to financial stability better than available alternatives. The Council believes these concerns are adequately addressed by the activities-based approach, as well as the Council's approach to making a determination under section 113 only if the expected benefits justify the expected costs that the determination would impose.

Several commenters stated that the Council should conduct its cost-benefit analysis based on the specific regulations that would apply to a nonbank financial company if it were designated. The Council declines to incorporate this requirement into its cost-benefit analysis, because it is not logistically practicable for the Federal Reserve, which must establish such prudential standards by rule or order, to provide this information to the Council before the relevant company has been designated. Another commenter stated that the Council should apply a cost-benefit analysis to any additional regulation the Council considers. However, the Council itself does not adopt regulations applicable to designated nonbank financial companies.

Several commenters opposed the proposal to perform a cost-benefit analysis before making determinations under section 113. Several commenters noted that the Dodd-Frank Act does not discuss a cost-benefit analysis in connection with section 113. Two commenters stated that the costs that will apply to a particular firm will depend on the supervisory and regulatory regime the Federal Reserve establishes after the designation. One commenter stated that cost-benefit analysis is a burdensome, time-consuming, and imprecise methodology.

One commenter stated that the costs and benefits of designation are difficult to predict in advance, in part because it is impossible to estimate the likelihood, magnitude, or timing of a future financial crisis. The Council believes that rigorous cost-benefit analysis is consistent with thoughtful decision-making, and that it is an important step to ensure that the Council makes a determination under section 113 only if the expected benefits justify the expected costs of the determination. Finally, two commenters stated that requiring cost-benefit analysis will make it easier for a designated company to litigate its designation. The Council will strive to perform analytically robust cost-benefit analysis in a timely manner.

#### b. Likelihood of Material Financial Distress

Consistent with sound risk regulation, the Council will consider not only the impact of an identifiable risk, but also the likelihood that the risk will be realized. The Council will therefore assess the likelihood of a company's material financial distress, based on its vulnerability to a range of factors, when evaluating the overall impact of a Council determination for any company under review under the First Determination Standard. The description of the Council's analytical process for assessing the likelihood of a company's material financial distress has been revised based on public comments. The Final Guidance provides that factors the Council may consider include leverage (both on and off balance sheet), potential risks associated with asset revaluations (whether such revaluations arise from market disruptions or severe macroeconomic conditions), reliance on short-term funding or other fragile funding markets, maturity transformation, and risks from exposures to counterparties or other market participants. The Council's assessment may rely upon historical examples regarding the characteristics of financial companies that have experienced financial distress, but may also consider other risks that do not have historical precedent. The Council's analysis of the vulnerability of a nonbank financial company to material financial distress will be conducted taking into account a period of overall stress in the financial services industry and a weak macroeconomic environment.

Several commenters supported the proposal that the Council will assess the likelihood of a company's material financial distress. One commenter stated that for any determination, the Council should be required to determine

that distress is reasonably likely to occur and that the distress is reasonably likely to inflict severe damage on the economy as a whole, using empirical and historical data. The criterion is not included in the Final Guidance, because it would impose an unduly high burden on the Council's ability to designate a nonbank financial company.

Several other commenters opposed the proposal that the Council will assess the likelihood of a company's material financial distress. Three commenters stated that the Dodd-Frank Act does not require that the Council assess the likelihood of a company's material financial distress. However, the Council believes that performing such a likelihood assessment is an important part of the Council's assessment of the extent to which a determination may promote U.S. financial stability. Several commenters stated that the Dodd-Frank Act requires the Council to assume the material financial distress of a nonbank financial company. One commenter stated that the Council has a duty to designate a nonbank financial company when the Council determines that the company could pose a risk to financial stability if it fails, and that the Council does not need to predict the probability of failure or the mechanism for that failure. The Council has authority under section 113 of the Dodd-Frank Act, including under section 113(a)(2)(K), which authorizes the Council to consider "any other risk-related factors that the Council deems appropriate," to consider the vulnerability of a nonbank financial company to material financial distress as part of the Council's analysis.

Commenters opposed to the Council's assessment of the likelihood of material financial distress raised a number of other objections, including that this assessment will be a significant barrier to designation; no accurate metrics exist that would enable the Council to measure the likelihood of a company's material financial distress; and it is difficult to anticipate the catalyst, dynamics, or timing of a financial crisis. The Council believes that its analysis, including its consultations with a company's primary financial regulatory agency and its assessment of the statutory considerations, will enable the Council to evaluate the likelihood of the company's material financial distress. Several commenters also stated that the Council's determination regarding the likelihood of a company's material financial distress could publicly signal concern regarding a firm's health, which could harm the company. The Council believes that the marketplace will, in most cases, consider the same fundamental factors that the Council

evaluates for purposes of independently assessing the likelihood of material financial distress at a company that is being evaluated for a potential determination. Finally, several commenters argued that the Council should interpret section 113 of the Dodd-Frank Act in a manner that is consistent with *MetLife v. FSO*,<sup>33</sup> while several others argued it should not. Where appropriate, the Final Guidance reflects the Council's view regarding the extent to which it should adopt the analysis from that judicial decision.<sup>34</sup>

#### D. Determination and Annual Reevaluation Process

As noted above, the Council will prioritize an activities-based approach for identifying, assessing, and addressing potential risks to financial stability. The Council may, however, subject a nonbank financial company to review for an entity-specific determination under section 113 of the Dodd-Frank Act if the activities-based approach would not adequately address potential risks to U.S. financial stability.<sup>35</sup> As noted above, the Final Guidance provides that the Council will vote to commence review of a nonbank financial company in Stage 1.

As proposed, the Final Guidance condenses the prior three-stage determination process into two stages by eliminating prior stage 1, makes other procedural improvements, and incorporates certain provisions of the 2015 Supplemental Procedures.<sup>36</sup> Following is a description of the processes set forth in the Final Guidance for the Council's evaluation of a nonbank financial company for a potential determination under section 113 and the Council's annual

reevaluations of any such determinations.

##### 1. Stage 1: Preliminary Evaluation of Nonbank Financial Companies

In the first stage of the determination process, the Council will notify nonbank financial companies identified as potentially posing risks to U.S. financial stability. Under the Final Guidance, the Council will engage extensively with the relevant company and its financial regulators during Stage 1. The Council's preliminary analysis will be based on quantitative and qualitative information available to the Council primarily through public and regulatory sources. In addition, a company under review in Stage 1 may voluntarily submit to the Council any information it deems relevant to the Council's evaluation and may, upon request, meet with staff of Council members and member agencies who are leading the Council's analysis. In order to reduce the burdens of review on the company, the Council will not require the company to submit information during Stage 1.

In consideration of the benefits that the Council will derive from extensive engagement with a company's primary financial regulatory agency, the Council will actively solicit the regulator's views regarding risks at the company and potential means to mitigate those risks, and will share its preliminary views regarding potential risks at the company with the regulator. The Final Guidance notes that the Council will consult with the primary financial regulatory agency during both Stage 1 and Stage 2. Several commenters expressed support for this approach, and stated that engagement with primary regulators should be a key component of the determination process.

Enhanced engagement in Stage 1 is intended to allow a company under review to provide the Council with relevant information, which will help to ensure that the Council is making decisions based on a diverse array of data and rigorous analysis, and to provide the company with greater visibility into the aspects of its business that may pose risks to U.S. financial stability. Another goal of the enhanced engagement in Stage 1 is to enable the company to take actions in response to the Council's concerns, thereby providing a pre-designation "off-ramp," while not burdening a company with the relatively higher costs that may be incurred during a Stage 2 evaluation. By making a company aware of the potential risks the Council has identified during its preliminary review, the Council seeks to give the company

more information and tools to mitigate those risks prior to any Council determination. One commenter recommended that the Final Guidance provide greater detail regarding the pre-designation "off-ramp." The Final Guidance has been revised to clarify that the Council will seek to enable a company under review to understand the focus of the Council's analysis, which may enable the company to act to mitigate any threats to U.S. financial stability and thereby potentially avoid becoming subject to a Council determination. One commenter stated that the Council should undertake early engagement with firms during the designation process. The Council believes that its approach in Stage 1, as described above, addresses this comment.

Following the preliminary evaluation in Stage 1, the Council may decide not to evaluate the company further, or it may vote to commence a more detailed analysis of the company by advancing it to Stage 2. One commenter recommended that if a Stage 1 review is terminated, there should be a waiting period before Stage 1 can be restarted. Because such a waiting period could prevent the Council from acting to address a potential threat to financial stability even if new developments or new information arose, this requested change has not been made.

As noted above, the Final Guidance condenses the prior three-stage process for a determination under section 113 into two stages, by eliminating prior stage 1, which had been established by the 2012 Interpretive Guidance. Under prior stage 1, a set of uniform quantitative metrics was applied to a broad group of nonbank financial companies in order to identify nonbank financial companies for further evaluation and to provide clarity for other nonbank financial companies that likely would not be subject to evaluation for a potential determination. Several commenters expressed views on the elimination of the stage 1 thresholds. Prior stage 1 had generated confusion among firms and members of the public and was not compatible with the prioritization of an activities-based approach, so it has been eliminated.

##### 2. Transition From Stage 1 to Stage 2

The Proposed Guidance did not specify whether a Council vote would be required to advance a nonbank financial company from Stage 1 to Stage 2. Based on public comments, the Final Guidance has been revised to specify that a Council vote is required to

<sup>33</sup> 177 F. Supp.3d 219 (D.D.C. 2016).

<sup>34</sup> The U.S. District Court for the District of Columbia in *MetLife v. FSO* held that the Council had acted in an arbitrary and capricious manner. Specifically, the court stated that "FSOC purposefully omitted any consideration of the cost of designation to MetLife. Thus, FSO assumed the upside benefits of designation (even without specific standards from the Federal Reserve) but not the downside costs of its decision." 177 F.Supp.3d 219, 230. The Final Guidance seeks to ensure that future Council determinations comport with the court's decision and consider costs.

<sup>35</sup> As noted above, the Council anticipates it would consider a determination under section 113 only in rare instances, such as if the products, activities, or practices of a company that pose a potential threat to U.S. financial stability are outside the jurisdiction or authority of financial regulatory agencies.

<sup>36</sup> As discussed in section II(A)(1) above, the Proposed Guidance eliminates the six-category framework described in the 2012 Interpretive Guidance.

advance a company to Stage 2.<sup>37</sup> For any company under review in Stage 1 that is regulated by a primary financial regulatory agency or home country supervisor, the Council will consult with the regulator, as appropriate, before the Council votes on whether to advance the company to Stage 2. One commenter stated that the primary regulator should have the primary role in advancing a firm from Stage 1 to Stage 2. As described above, the Final Guidance provides for extensive engagement between the Council and the primary financial regulatory agency during the determination process. The Council does not, however, believe it is appropriate to give the primary financial regulatory agency a specific additional role in advancing a firm from Stage 1 to Stage 2.

One commenter requested that the Council clarify that there is no obligation to advance a nonbank financial company from Stage 1 to Stage 2. The Council confirms that it will advance a nonbank financial company to Stage 2 only if the Council determines that the company merits further review after the analysis in Stage 1.<sup>38</sup>

### 3. Stage 2: In-Depth Evaluation

In Stage 2, the Council will conduct an in-depth evaluation of any company that the Council has determined in Stage 1 merits additional review. Under the Final Guidance, the Council would continue in Stage 2 to engage extensively with the relevant company and its existing regulators.

In Stage 2, the Council will request that the company provide information that the Council deems relevant to its evaluation, which will involve both qualitative and quantitative data. The Council will take certain preliminary steps before requiring the submission of reports from any nonbank financial company that is regulated by a Council member agency or any primary financial regulatory agency; acting through the OFR, the Council will coordinate with these agencies and, whenever possible, rely on information available from the OFR or these agencies.

The Council will take steps to facilitate a transparent review process with the company during Stage 2. During Stage 2, the company may

submit any other information that it deems relevant to the Council's evaluation, and the Council will make staff representing Council members available to meet with the representatives of the company, to explain the evaluation process and the framework for the Council's analysis. If the analysis in Stage 1 has identified specific aspects of the company's operations or activities as the primary focus for the evaluation, staff will notify the company of those issues. Several commenters stated that the Final Guidance should provide that Council members and their deputies are available to meet with nonbank financial companies in Stage 1 and Stage 2. The Final Guidance provides for the Council's Deputies Committee to meet with a company in Stage 2, to allow the company to present any information or arguments it deems relevant to the Council's evaluation. In addition, individual Council members may determine that it is appropriate to meet with a nonbank financial company under review, subject to the need to maintain a single administrative record and consistency in the information available to each of the Council members. In addition, the Council will seek to continue its consultation with the company's primary financial regulatory agency or home country supervisor in a timely manner before the Council makes any proposed or final determination, encouraging the relevant financial regulator to address relevant risks using the regulator's existing authorities. The Council will notify the company when the Council believes that the evidentiary record regarding the company is complete, before the Council either makes any proposed determination regarding the company, or alternatively, notifies the company that it is no longer being considered for a determination at that time.

Several commenters provided recommendations regarding the transparency of the determination process and the Council's procedures for providing information to nonbank financial companies under review. Two commenters stated that the Council should not consider information from primary regulators that cannot, due to confidentiality requirements, also be provided to the nonbank financial company under review. The Council expects to rely on data, research, and analysis from Council member agencies and the OFR, among other sources, in the determination process. Certain of these materials may include internal work product and analysis that are not intended for external distribution.

However, the Council expects that any information that the Council relies on to support a determination regarding a nonbank financial company under section 113 of the Dodd-Frank Act will be included in the Council's written explanation of the final determination, which will be provided to the company. Several other commenters stated that the Council should provide a nonbank financial company under evaluation with a written description of its potential threat to financial stability in Stage 1, or an explanation why an activities-based approach would not mitigate the potential threat. The Final Guidance provides that during Stage 1, the Council intends for staff of Council members and member agencies to explain to the company the key risks that have been identified in the analysis. However, because the review of the company is preliminary and continues to change until the Council makes a final determination, these identified risks may shift over time, so it is not practicable to provide a company with a written explanation of the potential threat to financial stability during Stage 1.

Several commenters stated that the Council should share all Council information with a nonbank financial company under review during Stages 1 and 2, including any cost-benefit analysis, expert, or regulatory analysis. Due to the preliminary nature of the Council's internal work product during Stages 1 and 2, sharing all of this information with the company under review would impose considerable burdens on the Council, while not necessarily providing the company with a clear understanding of the issues the Council is focusing on. Instead, the Final Guidance reflects numerous procedural improvements to the determination process compared to the 2012 Interpretive Guidance, which are intended to facilitate the Council's engagement and transparency. The Final Guidance increases the Council's engagement with nonbank financial companies and their regulators during the determination process, balanced with the Council's resources and need to perform the analysis in a timely manner.

Several commenters stated that the Council should provide a nonbank financial company with a written explanation of the reasons for advancing it from Stage 1 to Stage 2, and an opportunity to respond, before advancing it to Stage 2. The process under the Final Guidance for Stage 1 and Stage 2 provides extensive opportunities for a company to submit information to the Council and to

<sup>37</sup> Under the Dodd-Frank Act, unless otherwise specified in the statute, the Council must make all decisions that it is authorized or required to make by a majority vote of the voting members then serving. Dodd-Frank Act section 111(f), 12 U.S.C. 5321(f).

<sup>38</sup> See also the chart of Council votes that would occur at significant transition points in the Council's analysis, in section II(A)(2) above.

discuss that information with staff of Council members and member agencies. In particular, the Final Guidance provides that if the Council's analysis in Stage 1 has identified specific aspects of the company's operations or activities as the primary focus for the evaluation, staff will notify the company of those issues, although the issues will be subject to change based on the ongoing analysis. Further, during Stage 2, a company may submit any information that it deems relevant to the Council's evaluation, and the Council will make staff representing Council members available to meet with the representatives of the company, to explain the evaluation process and the framework for the Council's analysis. The Final Guidance also provides for the Council's Deputies Committee to meet with a company in Stage 2, to allow the company to present any information or arguments it deems relevant to the Council's evaluation.

#### 4. Proposed Determination; Hearing

The procedural steps related to the Council's proposed determinations, hearings, and final determinations are largely specified in section 113 of the Dodd-Frank Act.

A nonbank financial company may be considered for a proposed determination based on the analysis performed in Stage 2. In the event the Council votes to make a proposed determination, the Council will issue a written notice and explanation of the proposed determination to the company, and will also provide the company's primary financial regulatory agency or home country supervisor (subject to appropriate protections for confidential information) with the nonpublic written explanation of the basis for the proposed determination. In accordance with section 113(e) of the Dodd-Frank Act, a nonbank financial company that is subject to a proposed determination may request a nonpublic hearing before the Council to contest the proposed determination.

Several commenters stated that the Council should provide the full evidentiary record to a nonbank financial company in Stage 2 at least 30 days before a proposed determination, and give the company the opportunity to review and comment on the materials. The procedures under the Final Guidance provide extensive opportunities for engagement with companies under review, including during Stages 1 and 2 and after a proposed determination, so the Council is not adopting these recommended changes.

Several commenters requested additional changes to the procedures for the Council's hearings for nonbank financial companies subject to proposed determinations. The Council's Hearing Procedures, which are not being amended at this time, provide for transparent engagement between the Council and nonbank financial companies. Further, under the Final Guidance, a company has extensive opportunities to submit information to the Council and meet with representatives of Council members and member agencies during the Council's review in Stage 2, which will precede any proposed determination or hearing. The Council is therefore not adopting further changes related to its hearings.

#### 5. Final Determination

After making a proposed determination and holding any requested written or oral hearing, the Council may make a final determination in accordance with the Dodd-Frank Act that the company will be subject to supervision by the Federal Reserve and prudential standards. If the Council makes a final determination regarding the company, the Council will provide the company with a written notice of the Council's final determination, including an explanation of the basis for the Council's decision, and will also provide the company's primary financial regulatory agency or home country supervisor with the nonpublic written explanation of the basis of the Council's final determination, subject to appropriate protections for confidential information. Under the Final Guidance, the Council expects that its explanation of the final basis for any determination will highlight the key risks that led to the determination and include clear guidance regarding the factors that were most important in the Council's determination.

One commenter recommended that the Final Guidance state that the Council will assess all available alternatives before considering any nonbank financial company for potential determination. Two commenters stated that the Council should only designate a nonbank financial company with the consent of its primary regulator. Under the Final Guidance, Stage 2 will include numerous procedures to facilitate a robust and transparent review process with the company and its primary financial regulatory agency. For example, during Stage 2, the company may submit any information that it deems relevant to the Council's evaluation, and the Council will make staff representing Council members

available to meet with the representatives of the company. In addition, the Council will seek to continue its consultation with the company's primary financial regulatory agency or home country supervisor in a timely manner before the Council makes any proposed or final determination, encouraging the relevant financial regulator to address relevant risks using the regulator's existing authorities. These procedures should ensure adequate engagement between the Council, the company under review, and its primary financial regulatory agency.

Unchanged from the 2012 Interpretive Guidance, when practicable and consistent with the purposes of the determination process, the Council will provide a nonbank financial company with a notice of a final determination at least one business day before publicly announcing the determination. As a result, the Council generally will not issue any public notice regarding its determination vote on the day of the vote; instead, to enable the company adequately to prepare its public disclosures regarding the Council's determination, the first public announcement by the Council will generally be the day after the Council's vote. Although this approach will result in a short delay in the public announcement of a Council vote on a final determination, the benefit of enabling the company to prepare for the public announcement, and to review the Council's materials for confidential, sensitive business information before their public release, warrants the delay.

Other commenters provided recommendations related to the procedural steps for a final determination. Several commenters stated that the Council should separate Council staff responsible for reviewing a nonbank financial company from those responsible for determining whether designation is warranted, and one commenter stated that the Council should allow companies to examine the Council staff who conducted the analysis. While staff of the Council members and member agencies analyze nonbank financial companies, the decision makers are the voting members of the Council, and the Council is not adopting these recommendations regarding its staffing structure. One commenter stated that the Council should allow firms to appeal their designation to an "independent authority." The Dodd-Frank Act provides that any nonbank financial company subject to a final determination may challenge the Council's action in court, which

provides ample opportunity for an independent authority to review the determination.<sup>39</sup> Two commenters stated that before making a final determination regarding a nonbank financial company, the Council should receive from the Federal Reserve a detailed, company-specific supervisory plan. One of these commenters stated that the Council should share the plan with the relevant nonbank financial company. This recommendation has not been incorporated into the Final Guidance because it is not logistically practicable for the Federal Reserve, which must establish such prudential standards by rule or order, to provide this information to the Council before the relevant company has been designated.

Several commenters expressed support for the greater analytical rigor and process improvements reflected in the Proposed Guidance. For example, the Council will provide each designated nonbank financial company with an opportunity for an oral hearing before the Council once every five years at which the company can contest the determination.

#### 6. Annual Reevaluations of Nonbank Financial Company Determinations

For any nonbank financial company that is subject to a final determination, the Council is required by statute to reevaluate the determination at least annually, and to rescind the determination if the Council determines that the company no longer meets the statutory standards for a determination. The Final Guidance incorporates a number of additional procedural steps, not mandated by the Dodd-Frank Act, for annual reevaluations, in order to enhance engagement with companies and their regulators, and to increase transparency. One of the goals of these changes is to clarify the post-designation “off-ramp” process for a company, which would enable the company to identify changes it could consider making to address the potential threat to financial stability identified by the Council, and receive feedback regarding whether those changes may address the Council’s concerns. One commenter opposed to the off-ramp procedures stated that they would involve the Council in firms’ business decisions, thereby increasing litigation risk. The Council intends that this process should be flexible and tailored to the risks posed by designated companies, rather than hard-wired or overly prescriptive. The process is

intended to incentivize designated companies to address the key factors that led to designation, which would promote the Council’s goal of reducing risks to U.S. financial stability. The Council believes that this flexible approach will limit its involvement in a designated company’s business decisions and allow the company, rather than the Council, to identify the most appropriate means to mitigate risks.

The Final Guidance provides that in the event the Council makes a final determination regarding a company, the Council intends to encourage the company and, if appropriate, its regulators to take steps to mitigate the potential risks identified in the Council’s written explanation of the basis for its final determination. Except in cases where new material risks arise over time, if a company adequately addresses the potential risks identified in writing by the Council at the time of the final determination and in subsequent reevaluations, the Council should generally be expected to rescind its determination regarding the company. To facilitate this process, companies are encouraged during annual reevaluations to submit information regarding any changes related to the company’s risk profile that mitigate the potential risks identified in the Council’s final determination of the company and in reevaluations of the determination. If the company explains in detail potential changes it could make to its business to address the potential risks previously identified by the Council, staff of Council members and Council member agencies will endeavor to provide their feedback on the extent to which those changes may address the potential risks. Consistent with public comments, the Final Guidance provides that if a company contests the Council’s determination during the Council’s annual reevaluation, the Council will provide the company, its primary financial regulatory agency, and the primary financial regulatory agency of its significant subsidiaries with a notice explaining the primary basis for any decision not to rescind the determination. The notice will address each of the material factors raised by the company in its submissions to the Council contesting the determination during the annual reevaluation.

Several commenters expressed support for both the pre-designation and post-designation “off-ramps”. One commenter also stated that the Council should de-designate firms if the benefits of designation are not outweighing costs, and another stated that the Council should have a streamlined

process for doing so. The Council believes that the post-designation off-ramp described above provides for a robust and streamlined review process. As part of its review of a designated company, the Council does not believe it is appropriate to perform another cost-benefit analysis, in addition to the cost-benefit analysis performed prior to the designation, in light of timing and resource constraints in the context of annual reevaluations of previous determinations.

The Final Guidance also underscores that the Council applies the same standards of review in its annual reevaluations as the standard for an initial determination regarding a nonbank financial company: Either the company’s material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities, could pose a threat to U.S. financial stability. If the Council determines that the company no longer meets those standards, the Council will rescind its determination. The Final Guidance also stresses that, while the Council’s annual reevaluation of a company subject to a final determination will generally focus on changes since the Council’s previous review, the ultimate question the Council will seek to assess is whether changes in the aggregate since the company’s designation have caused the company to cease meeting the Determination Standards.<sup>40</sup>

Several commenters stated that the Council should adopt a framework for evaluating the impact of its designations, and assess the effectiveness of designation regularly. For any nonbank financial company that is subject to a final determination, the Council is required by statute to reevaluate the determination at least annually, and to rescind the determination if the Council determines that the company no longer meets the statutory standards for a designation. The Final Guidance incorporates a number of additional procedural steps for annual reevaluations to enhance engagement with companies and their regulators, and to increase transparency. The measures should ensure that a nonbank financial company is designated, or remains designated, only if it meets the statutory standard for designation.

<sup>40</sup> In a reevaluation of a determination, the Council may choose to consider only one Determination Standard, for example because changes that address the potential threats previously identified by the Council under one Determination Standard may also address potential threats relevant to the other Determination Standard.

<sup>39</sup> Dodd-Frank Act section 113(h), 12 U.S.C. 5323(h).

### E. Other Comments Received

Several commenters provided recommendations about international issues regarding the Proposed Guidance, including international regulatory coordination and the relationship between Council designations and the Financial Stability Board's (FSB's) identification of U.S. nonbank financial companies as global systemically important institutions. The Council supports the promotion of regulatory coordination at the international level, but is not expressing a view on its member agencies' roles in international discussions.

Several commenters stated that the Council should commit in the Final Guidance to ensuring the confidentiality of all collected information. The Final Guidance notes that the Council is subject to statutory and regulatory requirements to maintain the confidentiality of certain information submitted to it by a nonbank financial company or its regulators.<sup>41</sup> Under applicable law and the Council's rules, the Freedom of Information Act (FOIA) and the applicable exemptions thereunder apply to any data or information submitted under the rule. In addition, the Council's FOIA rule applies to data and information received by the Council.<sup>42</sup> The Council expects that nonbank financial companies' submissions will likely contain or consist of "trade secrets and commercial or financial information obtained from a person and privileged or confidential" and information that is "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." These types of information are subject to withholding under exemptions 4 and 8 of the FOIA (5 U.S.C. 552(b)(4) and (8)). To the extent that nonbank financial companies' submissions contain or consist of data or information not subject to an applicable FOIA exemption, that data or information would be releasable under the FOIA.

In addition, it should be noted that all members of the Council, including both its voting and non-voting members, will treat records of the Council in accordance with the Council's FOIA rule. When the Council and its members provide non-public information to each other in connection with Council functions and activities, the recipients

generally intend to treat such information as confidential and not publicly disclose such information without the consent of the providing party. However, such information may be used by the recipients for enforcement, examination, resolution planning, or other purposes, subject to any appropriate limitations on the disclosure of such information to third parties, taking into account factors including the need to preserve the integrity of the supervision and examination process. The Council believes that the additional confidentiality restrictions suggested by commenters generally would not materially increase the confidentiality of information collected by the Council, due to requirements under the FOIA, or would harmfully constrain the Council's ability to perform its evaluations of nonbank financial companies.

Finally, other commenters raised various comments related to the operations of the Council. One commenter recommended that the Final Guidance should state that any departure from the Final Guidance should be treated as a modification that requires public comment (other than in emergency situations affecting a single company that require immediate action). The Council previously adopted a rule stating that it will not amend or rescind its interpretive guidance on nonbank financial company determinations without soliciting public notice and comment,<sup>43</sup> which the Council believes addresses this concern.

### III. Legal Authority of Council and Status of the Final Guidance

The Council has numerous authorities and tools under the Dodd-Frank Act to carry out its statutory purposes.<sup>44</sup> The Council expects that its response to any potential risk or threat to U.S. financial stability will be based on an assessment of the circumstances. As the agency charged by Congress with broad-ranging responsibilities under sections 112 and 113 of the Dodd-Frank Act, the Council has the inherent authority to promulgate interpretive guidance under those provisions that explains and interprets the statutory factors that the Council will consider when employing the activities-based approach and undertaking the determination process.<sup>45</sup> The Council also has

authority to issue procedural rules<sup>46</sup> and policy statements.<sup>47</sup> The Final Guidance describes the Council's interpretation of the statutory factors and provides transparency to the public as to how the Council intends to exercise its statutory grant of discretionary authority. Except to the extent that the Final Guidance sets forth rules of agency organization, procedure, or practice, the Council has concluded that the Final Guidance does not have binding effect; does not impose duties on, or alter the rights or interests of, any person; does not change the statutory standards for the Council's decision making; and does not relieve the Council of the need to make entity-specific determinations in accordance with section 113 of the Dodd-Frank Act.

### IV. Paperwork Reduction Act

The collection of information contained in the Final Guidance has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control 1505-0244. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The collection of information under the Final Guidance is found in 12 CFR 1310.20-1310.23, which were added pursuant to the 2012 Final Rule and Interpretive Guidance.<sup>48</sup>

The hours and costs associated with preparing data, information, and reports for submission to the Council constitute reporting and cost burdens imposed by the collection of information. The estimated total annual reporting burden associated with the collection of information in the Final Guidance is 20 hours, based on an estimate of one respondent. We estimate the cost associated with this information collection to be \$9,000. These estimates are significantly lower than those in the Paperwork Reduction Act discussion in the 2012 Final Rule and Interpretive Guidance, because the Council expects

standards it intends to apply in exercising its discretion." See, for example, *Production Tool v. Employment & Training Administration*, 688 F.2d 1161, 1166 (7th Cir. 1982). The Supreme Court has acknowledged that "whether or not they enjoy any express delegation of authority on a particular question, agencies charged with applying a statute necessarily make all sorts of interpretive choices." See *U.S. v. Mead*, 533 U.S. 218, 227 (2001).

<sup>46</sup> See Dodd-Frank Act section 111(e)(2), 12 U.S.C. 5321(e)(2).

<sup>47</sup> See *Association of Flight Attendants-CWA, AFL-CIO v. Huerta*, 785 F.3d 710 (D.C. Cir. 2015).

<sup>48</sup> See note 3 above.

<sup>41</sup> See Dodd-Frank Act section 112(d)(5), 12 U.S.C. 5322(d)(5); see also 2012 Final Rule and Interpretive Guidance at 21648-21649 and 12 CFR 1310.20(e).

<sup>42</sup> See 12 CFR 1310.20(e)(3).

<sup>43</sup> 84 FR 8958 (March 13, 2019).

<sup>44</sup> See, for example, Dodd-Frank Act sections 112(a)(2), 113, 115, 120, 804, 12 U.S.C. 5322(a)(2), 5323, 5325, 5330, 5463.

<sup>45</sup> Courts have recognized that "an agency charged with a duty to enforce or administer a statute has inherent authority to issue interpretive rules informing the public of the procedures and

that, notwithstanding any additional reporting burden that financial companies participating in the activities-based approach may incur, the aggregate reporting burden on companies will be significantly reduced as a result of the Council's proposal to pursue entity-specific determinations under section 113 of the Dodd-Frank Act only if a potential risk or threat cannot be adequately addressed through an activities-based approach.

In making this estimate, the Council estimates that due to the nature of the information likely to be requested, approximately 75 percent of the burden in hours will be carried by financial companies internally at an average cost of \$400 per hour, and the remainder will be carried by outside professionals retained by financial companies at an average cost of \$600 per hour. In addition, in determining these estimates, the Council considered its obligation under 12 CFR 1310.20(b) to, whenever possible, rely on information available from the OFR or any Council member agency or primary financial regulatory agency that regulates a nonbank financial company before requiring the submission of reports from such nonbank financial company. The Council expects that its collection of information under the Final Guidance will be performed in a manner that attempts to minimize burdens for affected financial companies. The aggregate burden will be subject to the number of financial companies that participate in the activities-based approach or are evaluated in the determination process, the extent of information regarding such companies that is available to the Council through existing public and regulatory sources, and the amount and types of information that financial companies provide to the Council. The Proposed Guidance requested comment on the estimates and other assumptions in the proposed collection of information, but no comments were received in response to the questions presented.

#### V. Executive Orders 12866 and 13563

Executive Orders 12866 and 13563 direct certain agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. The Office

of Information and Regulatory Affairs within the Office of Management and Budget has designated this interpretive guidance as a "significant regulatory action" under section 3(f) of Executive Order 12866.

#### List of Subjects in 12 CFR Part 1310

Brokers, Investments, Securities.

The Financial Stability Oversight Council is amending 12 CFR part 1310 as follows:

#### PART 1310—AUTHORITY TO REQUIRE SUPERVISION AND REGULATION OF CERTAIN NONBANK FINANCIAL COMPANIES

■ 1. The authority citation for part 1310 continues to read as follows:

**Authority:** 12 U.S.C. 5321; 12 U.S.C. 5322; 12 U.S.C. 5323.

■ 2. Appendix A is revised to read as follows:

#### Appendix A to Part 1310—Financial Stability Oversight Council Guidance for Nonbank Financial Company Determinations

##### I. Introduction

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")<sup>1</sup> authorizes the Financial Stability Oversight Council (the "Council") to determine that a nonbank financial company will be supervised by the Board of Governors of the Federal Reserve System (the "Federal Reserve") and be subject to prudential standards in accordance with Title I of the Dodd-Frank Act if either of two standards is met. Under the first standard, the Council may subject a nonbank financial company to supervision by the Federal Reserve and prudential standards if the Council determines that material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States. Under the second standard, the Council may determine that a nonbank financial company will be supervised by the Federal Reserve and subject to prudential standards if the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to U.S. financial stability. Section 113 of the Dodd-Frank Act also lists considerations that the Council must take into account in making a determination.

Section II of this document describes the approach the Council intends to take in prioritizing its work to identify and address potential risks to U.S. financial stability using an activities-based approach. This approach reflects the Council's priorities of identifying potential risks on a system-wide basis, reducing the potential for competitive distortions that could arise from entity-specific determinations, and allowing

relevant financial regulatory agencies<sup>2</sup> to address identified potential risks. First, the Council will monitor markets to identify potential risks to U.S. financial stability and to assess those risks on a system-wide basis. Second, the Council will then work with relevant financial regulatory agencies to seek the implementation of actions intended to address identified potential risks to financial stability.

Section III of this appendix describes the manner in which the Council intends to apply the statutory standards and considerations in making determinations under section 113 of the Dodd-Frank Act, if the Council determines that potential risks to U.S. financial stability are not adequately addressed through the activities-based approach. Section III defines key terms used in the statute, including "threat to the financial stability of the United States." Section III also includes a detailed description of the analysis that the Council intends to conduct during its reviews, including a discussion of channels through which risks from a company may be transmitted to other companies or markets, and the Council's assessment of the likelihood of the company's material financial distress and the benefits and costs of a determination.

Section IV of this appendix outlines a two-stage process that the Council will follow in non-emergency situations when determining whether to subject a nonbank financial company to Federal Reserve supervision and prudential standards. In the first stage of the process, the Council will notify the company and its primary financial regulatory agency and conduct a preliminary analysis to determine whether the company should be subject to further evaluation by the Council. During the second stage of the evaluation process, the Council will conduct an in-depth evaluation if it determines in the first stage that the nonbank financial company merits additional review.

The Council's practices set forth in this guidance to address potential risks to U.S. financial stability are intended to comply with its statutory purposes: (1) To identify risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (2) to promote market discipline, by 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; and (3) to respond to emerging threats to the stability of the U.S. financial system.<sup>3</sup> Council actions seek to foster transparency and to avoid competitive distortions in markets for financial services and products. Further, nonbank financial

<sup>2</sup>References in this appendix to "relevant financial regulatory agencies" may encompass a broader range of regulators than those included in the statutory definition of "primary financial regulatory agency," which is defined in Dodd-Frank Act section 2(12), 12 U.S.C. 5301(12).

<sup>3</sup>Dodd-Frank Act section 112(a)(1), 12 U.S.C. 5322(a)(1).

<sup>1</sup> See Dodd-Frank Act section 113, 12 U.S.C. 5323.

companies should not benefit from an implicit federal financial safety net. Therefore, the Council emphasizes the importance of market discipline as a mechanism for addressing potential risks to U.S. financial stability posed by financial companies.

This interpretive guidance is not a binding rule, except to the extent that it sets forth rules of agency organization, procedure, or practice. This guidance is intended to assist financial companies and other market participants in understanding how the Council expects to exercise certain of its authorities under Title I of the Dodd-Frank Act. The Council retains discretion, subject to applicable statutory requirements, to consider factors relevant to the assessment of a potential risk or threat to U.S. financial stability on a case-by-case basis. If the Council were to depart from the interpretive guidance, it would need to provide a reasoned explanation for its action, which would ordinarily require acknowledging the change in position.<sup>4</sup>

## II. Activities-Based Approach

The Dodd-Frank Act gives the Council broad discretion in determining how to respond to potential threats to U.S. financial stability. A determination to subject a nonbank financial company to Federal Reserve supervision and prudential standards under section 113 of the Dodd-Frank Act is only one of several Council authorities for responding to potential risks to U.S. financial stability.<sup>5</sup> The Council will prioritize its efforts to identify, assess, and address potential risks and threats to U.S. financial stability through a process that begins with an activities-based approach, and will pursue entity-specific determinations under section 113 of the Dodd-Frank Act only if a potential risk or threat cannot be adequately addressed through an activities-based approach. The Council anticipates it would consider a nonbank financial company for a potential determination under section 113 only in rare instances, such as if the products, activities, or practices of a company that pose a potential threat to U.S. financial stability are outside the jurisdiction or authority of financial regulatory agencies. This approach reflects two priorities: (1) Identifying and addressing, in consultation with relevant financial regulatory agencies, potential risks and emerging threats on a system-wide basis and to reduce the potential

for competitive distortions among financial companies and in markets that could arise from entity-specific determinations, and (2) allowing relevant financial regulatory agencies, which generally possess greater information and expertise with respect to company, product, and market risks, to address potential risks, rather than subjecting the companies to new regulatory authorities.

As part of its activities-based approach, the Council will examine a range of financial products, activities, or practices that could pose risks to U.S. financial stability. These types of activities are often identified in the Council's annual reports, such as activities related to (1) the extension of credit, (2) the use of leverage or short-term funding, (3) the provision of guarantees of financial performance, and (4) other key functions critical to support the functioning of financial markets. The Council considers a risk to financial stability to mean a risk of an event or development that could impair financial intermediation or financial market functioning to a degree that would be sufficient to inflict significant damage on the broader economy. The Council's activities-based approach is intended to identify and address risks to financial stability using a two-step approach, described below.

### *a. Step One of Activities-Based Approach: Identifying Potential Risks From Products, Activities, or Practices*

#### Monitoring Markets

The Council has a statutory duty to monitor the financial services marketplace in order to identify potential threats to U.S. financial stability.<sup>6</sup> In the first step of the activities-based approach, to enable the Council to identify potential risks to U.S. financial stability, the Council, in consultation with relevant financial regulatory agencies, intends to monitor diverse financial markets and market developments to identify products, activities, or practices that could pose risks to U.S. financial stability. When monitoring potential risks to financial stability, the Council intends to consider the linkages across products, activities, and practices, and their interconnectedness across firms and markets.

For example, the Council's monitoring may include:

- Corporate and sovereign debt and loan markets;
- equity markets;
- markets for other financial products, including structured products and derivatives;
- short-term funding markets;
- payment, clearing, and settlement functions;
- new or evolving financial products, activities, and practices; and
- developments affecting the resiliency of financial market participants.

To monitor markets and market developments, the Council will review information such as historical data, research regarding the behavior of financial market participants, and new developments that

arise in evolving marketplaces. The Council will regularly rely on data, research, and analysis from Council member agencies, the Office of Financial Research, industry participants, and other public sources. Consistent with its statutory obligations, the Council will, whenever possible, rely on information available from primary financial regulatory agencies.<sup>7</sup>

#### Evaluating Potential Risks

If the Council's monitoring of markets and market developments identifies a product, activity, or practice that could pose a potential risk to U.S. financial stability, the Council, in consultation with relevant financial regulatory agencies, will evaluate the potential risk to determine whether it merits further review or action. The Council's work in this step may include efforts such as sharing data, research, and analysis among Council members and member agencies and their staffs; consultations with regulators and other experts regarding the scope of potential risks and factors that may mitigate those risks; and the collaborative development of analyses for consideration by the Council. As part of this work, the Council may also engage with industry participants and other members of the public as it assesses potential risks.

The Council will assess the extent to which characteristics such as the following could amplify potential risks to U.S. financial stability arising from products, activities, or practices:

- Asset valuation risk or credit risk;
- leverage, including leverage arising from debt, derivatives, off-balance sheet obligations, and other arrangements;
- liquidity risk or maturity mismatch, such as reliance on funding sources that could be susceptible to dislocations;
- counterparty risk and interconnectedness among financial market participants;
- the transparency of financial markets, such as growth in financial transactions occurring outside of regulated sectors;
- operational risks, such as cybersecurity and operational resilience; or
- the risk of destabilizing markets for particular types of financial instruments, such as trading practices that substantially increase volatility in key markets.

Various factors may exacerbate or mitigate each of these types of risks. For example, activities may pose greater risks if they are complex or opaque, are conducted without effective risk-management practices, are significantly correlated with other financial products, and are either highly concentrated or significant and widespread. In contrast, regulatory requirements or market practices may mitigate risks by, for example, limiting exposures or leverage, enhancing risk-management practices, or restricting excessive risk-taking.

While the contours of the Council's initial evaluation of any potential risk will depend on the type and scope of analysis relevant to the particular risk, the Council's analyses will generally focus on four framing questions:

<sup>4</sup> See *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009).

<sup>5</sup> For example, the Council has authority to make recommendations to the Federal Reserve concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies supervised by the Federal Reserve; make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice conducted by certain financial companies if the Council determines that such activity or practice could create or increase certain risks; and designate financial market utilities and payment, clearing, and settlement activities that the Council determines are, or are likely to become, systemically important. Dodd-Frank Act sections 115, 120, 804, 12 U.S.C. 5325, 5330, 5463.

<sup>6</sup> Dodd-Frank Act section 112(a)(2), 12 U.S.C. 5322(a)(2).

<sup>7</sup> Dodd-Frank Act section 112(d)(3), 12 U.S.C. 5322(d)(3).

1. How could the potential risk be triggered? For example, could it be triggered by sharp reductions in the valuation of particular classes of financial assets?

2. How could the adverse effects of the potential risk be transmitted to financial markets or market participants? For example, what are the direct or indirect exposures in financial markets to the potential risk?

3. What impact could the potential risk have on the financial system? For example, what could be the scale of its adverse effects on other companies and markets, and would its effects be concentrated or distributed broadly among market participants? This analysis should take into account factors such as existing regulatory requirements or market practices that mitigate potential risks.

4. Could the adverse effects of the potential risk impair the financial system in a manner that could harm the non-financial sector of the U.S. economy?

In this evaluation, the Council will consult with relevant financial regulatory agencies and will take into account existing laws and regulations that may mitigate a potential risk to U.S. financial stability. The Council will also take into account the risk profiles and business models of market participants engaging in the products, activities, or practices under evaluation, and consider available evidence regarding the potential risk. Empirical data may not be available regarding all potential risks, and the type and scope of the Council's analysis will be tailored to the potential risk under consideration.

If a product, activity, or practice creating a potential risk to financial stability is identified, the Council will work with relevant financial regulatory agencies to address the identified risk, as described in section II.b of this appendix.

#### *b. Step Two of Activities-Based Approach: Working With Regulators To Address Identified Risks*

If the Council identifies a potential risk to U.S. financial stability in step one of the activities-based approach, the Council will work with the relevant financial regulatory agencies at the federal and state levels to seek the implementation of appropriate actions to address the identified potential risk. The Council will coordinate among its members and member agencies and will follow up on supervisory or regulatory actions to ensure the potential risk is adequately addressed. The goal of this step would be for existing regulators to take appropriate action, such as modifying their regulation or supervision of companies or markets under their jurisdiction in order to mitigate potential risks to U.S. financial stability identified by the Council.<sup>8</sup> If a potential risk identified by

<sup>8</sup> The Dodd-Frank Act provides that the Council's duties include to recommend to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies and 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 spreading among bank holding companies, nonbank financial

the Council relates to a product, activity, or practice arising at a limited number of individual financial companies, the Council nonetheless will prioritize a remedy that addresses the underlying risk across all companies that engage in the relevant activity. If the Council finds that a particular type of financial product could present risks to U.S. financial stability, there may be different approaches existing regulators could take, based on their authorities and the urgency of the risk, such as restricting or prohibiting the offering of that product, or requiring market participants to take additional risk-management steps that address the risks.

If, after engaging with relevant financial regulatory agencies, the Council believes those regulators' actions are inadequate to address the identified potential risk to U.S. financial stability, the Council has authority to make formal public recommendations to primary financial regulatory agencies under section 120 of the Dodd-Frank Act. Under section 120, the Council may provide for more stringent regulation of a financial activity by issuing nonbinding recommendations, following consultation with the primary financial regulatory agency and public notice inviting comments on proposed recommendations, to the primary financial regulatory agency to apply new or heightened standards or safeguards for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their jurisdiction.<sup>9</sup> In addition, in any case in which no primary financial regulatory agency exists for the markets or companies conducting financial activities or practices identified by the Council as posing risks, the Council can consider reporting to Congress on recommendations for legislation that would prevent such activities or practices from threatening U.S. financial stability. The Council intends to make recommendations under section 120 only to the extent that its recommendations are consistent with the statutory mandate of the primary financial regulatory agency to which the Council is making the recommendation.

The authority to issue recommendations to primary financial regulatory agencies under section 120 is one of the Council's most formal tools for responding to potential risks to U.S. financial stability. The Council will make these recommendations only if it determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of the activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, U.S. financial markets, or low-income, minority, or underserved communities.

In its recommendations under section 120, the Council may suggest broad approaches to address the risks it has identified. When appropriate, the Council may make a more

companies, and United States financial markets. Dodd-Frank Act sections 112(a)(2)(F), (K), 12 U.S.C. 5322(a)(2)(F), (K).

<sup>9</sup> Dodd-Frank Act section 120(a), 12 U.S.C. 5330(a).

specific recommendation. To promote analytical rigor and avoid duplication, before making any recommendation under section 120, the Council will ascertain whether the relevant primary financial regulatory agency would be expected to perform a cost-benefit analysis of the actions it would take in response to the Council's contemplated recommendation. In cases where the primary financial regulatory agency would not be expected to conduct such an analysis, the Council itself will—prior to making a final recommendation—conduct an analysis, using empirical data, to the extent available, of the benefits and costs of the actions that the primary financial regulatory agency would be expected to take in response to the contemplated recommendation. Where the Council conducts its own such analysis, the specificity of its assessment of benefits and costs would be commensurate with the specificity of the contemplated recommendation. Furthermore, where the Council conducts its own analysis, the Council will make a recommendation under section 120 only if it believes that the results of its assessment of benefits and costs support the recommendation.

Primary financial regulatory agencies have significant experience, knowledge, and expertise that can be useful in determining the most efficient way to address a particular risk within their regulatory jurisdiction. In every case, prior to issuing a recommendation under section 120, the Council will consult with the relevant primary financial regulatory agency and provide notice to the public and opportunity for comment as required by section 120.

### **III. Analytic Framework for Nonbank Financial Company Determinations**

If the Council's collaboration and engagement with the relevant financial regulatory agencies during the activities-based approach does not adequately address a potential threat identified by the Council—or if a potential threat to U.S. financial stability is outside the jurisdiction or authority of financial regulatory agencies—and if the potential threat identified by the Council is one that could be effectively addressed by a Council determination regarding one or more nonbank financial companies, the Council may evaluate one or more nonbank financial companies for an entity-specific determination under section 113 of the Dodd-Frank Act, applying the analytic framework described below. This section describes the analysis the Council will conduct in general regarding individual nonbank financial companies that are considered for a potential determination, and section IV of this appendix describes the Council's process for those reviews.

#### *a. Statutory Standards and Considerations*

The Council may determine, by a vote of not fewer than two-thirds of the voting members of the Council then serving, including an affirmative vote by the Chairperson of the Council, that a nonbank financial company will be supervised by the Federal Reserve and be subject to prudential standards if the Council determines that (1) material financial distress at the nonbank

financial company could pose a threat to the financial stability of the United States (the “First Determination Standard”) or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States (the “Second Determination Standard,” and, together with the First Determination Standard, the “Determination Standards”).<sup>10</sup> The analytic framework described below focuses primarily on the First Determination Standard because threats to financial stability (such as asset fire sales or financial market disruptions) are most commonly propagated through a nonbank financial company when it is in distress.

Several relevant terms used in the Dodd-Frank Act are not defined in the statute. The Council intends to interpret the term “company” to include any corporation, limited liability company, partnership, business trust, association, or similar organization.<sup>11</sup> In addition, the Council intends to interpret “nonbank financial company supervised by the Board of Governors” as including any nonbank financial company that acquires, directly or indirectly, a majority of the assets or liabilities of a company that is subject to a final determination of the Council.<sup>12</sup> The Council intends to interpret the term “material financial distress” as a nonbank financial company being in imminent danger of insolvency or defaulting on its financial obligations. The Council intends to interpret the term “threat to the financial stability of the United States” as meaning the threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy. For purposes of considering whether a nonbank financial company could pose a threat to U.S. financial stability under either Determination Standard, the Council intends to assess the company in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment, with market developments such as increased

counterparty defaults, decreased funding availability, and decreased asset prices. The Council believes this is appropriate because in such a context, the risks posed by a nonbank financial company may have a greater effect on U.S. financial stability.

The Dodd-Frank Act requires the Council to consider 10 specific considerations when determining whether a nonbank financial company satisfies either of the Determination Standards. These statutory considerations help the Council to evaluate whether one of the Determination Standards has been met:<sup>13</sup>

- The extent of the leverage of the company;
- the extent and nature of the off-balance-sheet exposures of the company;
- the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- the importance of the company as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system;
- the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
- the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- the degree to which the company is already regulated by one or more primary financial regulatory agencies;
- the amount and nature of the financial assets of the company; and
- the amount and types of the liabilities of the company, including the degree of reliance on short-term funding.

The statute also requires the Council to take into account any other risk-related factors that the Council deems appropriate. Any determination by the Council will be made based on a company-specific evaluation and an application of the standards and considerations set forth in section 113 of the Dodd-Frank Act, and taking into account qualitative and quantitative information the Council deems relevant to a particular nonbank financial company. The Council anticipates that the information relevant to an in-depth analysis of a nonbank financial company may vary based on the nonbank financial company’s characteristics.

The discussion below describes how the Council will apply the Determination Standards in its evaluation of a nonbank financial company, including how the Council will take into account the statutory

considerations, and other risk-related factors that the Council will take into account. Due to the unique threat that each nonbank financial company could pose to U.S. financial stability and the nature of the inquiry required by the statutory considerations, the Council expects that its evaluations of nonbank financial companies will be firm-specific and may include quantitative and qualitative information that the Council deems relevant to a particular nonbank financial company. The transmission channels, sample metrics, and other factors set forth below are not exhaustive and may not apply to all nonbank financial companies under evaluation.

#### *b. Transmission Channels*

The Council’s evaluation of any nonbank financial company under section 113 of the Dodd-Frank Act will seek to determine whether a nonbank financial company meets one of the Determination Standards described above. In its analysis of a nonbank financial company, the Council will assess how the negative effects of the company’s material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities, could be transmitted to or affect other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning. Such a transmission of risk can occur through various mechanisms, or channels. The Council has identified three transmission channels as most likely to facilitate the transmission of the negative effects of a nonbank financial company’s material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness, or mix of the company’s activities, to other financial firms and markets: Exposure; asset liquidation; and critical function or service. These three transmission channels are described below. The Council may also consider other relevant channels through which risks could be transmitted from a particular nonbank financial company and thereby pose a threat to U.S. financial stability. The Council will take into account the 10 statutory considerations and any other risk-related factors the Council deems appropriate as part of its evaluation of a nonbank financial company under the three transmission channels and the other factors described below. Further, in its analyses under the transmission channels, the Council will consider applicable factors that may limit the transmission of risk, such as existing regulatory requirements, collateralization, bankruptcy-remote structures, or guarantee funds that reduce counterparties’ exposures to the nonbank financial company or mitigate incentives for customers or counterparties to withdraw funding or assets.

#### *Exposure Transmission Channel*

Under this transmission channel, the Council will evaluate whether a nonbank financial company’s creditors, counterparties, investors, or other market participants have direct or indirect exposure to the nonbank financial company that is significant enough to materially and adversely affect those or other creditors,

<sup>10</sup> If the Council is unable to determine whether the financial activities of a U.S. nonbank financial company pose a threat to the financial stability of the United States based on certain information, the Council may request the Federal Reserve to conduct an examination of the U.S. nonbank financial company for the sole purpose of determining whether the company should be supervised by the Federal Reserve for purposes of Title I of the Dodd-Frank Act. Dodd-Frank Act section 112(d)(4), 12 U.S.C. 5322(d)(4).

<sup>11</sup> The statutory definition of “nonbank financial company” excludes bank holding companies and certain other types of companies. Dodd-Frank Act section 102(a)(4), 12 U.S.C. 5311(a)(4).

<sup>12</sup> As a result, if a nonbank financial company subject to a final determination of the Council sells or otherwise transfers a majority of its assets or liabilities, the acquirer will succeed to, and become subject to, the Council’s determination. As discussed in section V below, a nonbank financial company that is subject to a final determination of the Council may request a reevaluation of the determination before the next required annual reevaluation, in appropriate cases. Such an acquirer can use this reevaluation process to seek a rescission of the determination upon consummation of its transaction.

<sup>13</sup> Dodd-Frank Act section 113(a)(2), 12 U.S.C. 5323(a)(2). This list of considerations is applicable to U.S. nonbank financial companies. With respect to foreign nonbank financial companies, the Council is required to take into account a similar list of considerations, in some cases limited to the companies’ U.S. business or activities. See Dodd-Frank Act section 113(b)(2), 12 U.S.C. 5323(b)(2).

counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability.

The Council expects that its analyses under the exposure transmission channel will generally include the factors described below. The potential threat to U.S. financial stability will generally be greater if the amounts of the exposures are larger; if the terms of the transactions provide less protection for the counterparty; and if the largest counterparties include large financial institutions.

The Council also will consider a company's leverage and size. A company's leverage can amplify the risks posed by exposures, including off-balance sheet exposures, by reducing the company's ability to satisfy its obligations to creditors in the event of its material financial distress. Size is relevant to this analysis, as material financial distress at a larger nonbank financial company would generally transmit risk on a larger scale than distress at a smaller company. Size may be measured by the assets, liabilities, and capital of the firm.

As required by statute, the Council will consider the extent to which assets are managed rather than owned by the company and the extent to which ownership of assets under management is diffuse. The Council's analysis will recognize the distinct nature of exposure risks when the company is acting as an agent rather than as principal.<sup>14</sup> In particular, in the case of a nonbank financial company that manages assets on behalf of customers or other third parties, the third parties' direct financial exposures are often to the issuers of the managed assets, rather than to the nonbank financial company managing those assets.

The Council will consider the exposures that counterparties and other market participants have to a nonbank financial company arising from the company's capital markets activities. This assessment includes an evaluation of the company's relationships with other significant nonbank financial companies and significant bank holding companies. In most cases, the Council will consider factors such as the amount and nature of, and counterparties to, the company's:

- Outstanding debt (regardless of term) and other liabilities (such as guaranteed investment contracts issued by an insurance company or Federal Home Loan Bank loans).
- Derivatives transactions (which may be measured on the basis of gross notional amount, net fair value, or potential future exposures).
- Securities financing transactions (*i.e.*, repurchase agreements and securities lending transactions).
- Lines of credit.
- Credit-default swaps outstanding for which the company or an affiliate is the reference entity (generally focusing on single-name credit-default swaps).

Relevant metrics may include the number, size, and financial strength of a nonbank financial company's counterparties, including the proportion of its

counterparties' exposure to the nonbank financial company relative to the counterparties' capital. The potential risk arising under this transmission channel depends not only on the number of counterparties that a nonbank financial company has, but also on the importance of that nonbank financial company to its counterparties and the extent to which the counterparties are interconnected with other financial firms, the financial system, and the broader economy. Therefore, the Council will focus on exposures of large financial institutions to the nonbank financial company under review. This analysis will take into account both individual counterparty exposures as well as aggregate exposures of other financial institutions to the company under review. The amount and types of other exposures that counterparties and other market participants have to a nonbank financial company is highly dependent on the nature of the company's business. The Council's analysis will take these other fact-specific considerations into account.

The Council also will consider applicable factors, including existing regulatory requirements, that may mitigate potential risks under the exposure transmission channel. For example, collateralization by high-quality, highly liquid securities, such as U.S. Treasury securities, the use of insurance funds to limit counterparty exposures, or other transactions that reallocate risk to well-capitalized entities, may reduce the potential for certain exposures to serve as a channel for the transmission of risk.

*Contagion.* The negative effects of the material financial distress of a large, interconnected nonbank financial company are not necessarily limited to the amount of direct losses suffered by the firm's creditors, counterparties, investors, or other market participants. In general, the wider and more interconnected a company's network of financial counterparties, the greater the potential negative effect of the material financial distress of the company. Aggregate exposures to a nonbank financial company can create a potential threat to U.S. financial stability if they lead to contagion among financial institutions and financial markets more broadly. Contagion has the potential to spread distress quickly and seemingly unexpectedly. Such transmission is associated with opaque balance sheets, closely correlated markets, and coordination failures among investors. In such circumstances, fire sales by a highly leveraged and interconnected nonbank financial company may result in a loss of confidence in other financial companies that are perceived to have similar characteristics. The Council will seek evidence regarding the potential for contagion, including relevant industry-specific historical examples and the scope of the company's interconnectedness with large financial institutions, among other factors. Various market-based or regulatory factors can strongly mitigate the risk of contagion. Contagion should be viewed in conjunction with other factors described above when evaluating risk under the exposure transmission channel.

#### Asset Liquidation Transmission Channel

Under this transmission channel, the Council will consider whether a nonbank financial company holds assets that, if liquidated quickly, could pose a threat to U.S. financial stability by, for example, causing a fall in asset prices that significantly disrupts trading or funding in key markets or causes significant losses or funding problems for other firms with similar holdings. This channel would likely be most relevant for a nonbank financial company that could be forced to liquidate assets quickly due to its funding and liquid asset profile. For example, this could be the case if a nonbank financial company relies heavily on short-term funding. The Council may also consider whether a deterioration in asset pricing or market functioning could pressure other financial firms to sell their holdings of affected assets in order to maintain adequate capital and liquidity, which, in turn, could produce a cycle of asset sales that could lead to further market disruptions. This analysis includes an assessment of any maturity mismatch at the company—the difference between the maturities of the company's assets and liabilities. A company's reliance on short-term funding to finance longer-term positions can subject the company to rollover or refinancing risk that may force it to sell assets rapidly at low market prices. The Council will also consider applicable factors that may mitigate potential risks under the asset liquidation transmission channel. As part of its analysis, the Council will consider the extent to which assets are managed rather than owned by the company.

The Council's analyses of the asset liquidation transmission channel will focus on three central factors, described below.

*Liquidity of the company's liabilities.* The first factor in the Council's assessment under this transmission channel is the amount and nature of the company's liabilities that are, or could become, short-term in nature. This analysis involves an assessment of the company's liquidity risk. Liquidity risk generally refers to the risk that a company may not have sufficient funding to satisfy its short-term needs. For example, relevant factors may include:

- The company's short-term financial obligations (including outstanding commercial paper).
- Financial arrangements that can be terminated by counterparties and therefore become short-term (including callable debt, derivatives, securities lending, repurchase agreements, and off-balance-sheet exposures).
- Long-term liabilities that may come due in a short-term period.
- Financial transactions that may require the company to provide additional margin or collateral to the counterparty.
- Products that allow customers rapidly to withdraw funds from the company.
- Liabilities related to other collateralized borrowings and deposits.

The Council will quantitatively identify the scale of potential liquidity needs that could plausibly arise at the company. As part of this analysis, the Council will apply counterparty and customer withdrawal rates based on historical examples and other relevant models to assess the scope of

<sup>14</sup> Dodd-Frank Act section 113(a)(2)(F), 12 U.S.C. 5323(a)(2)(F).

plausible withdrawals. In addition, any ability of the company or its financial regulators to impose stays on counterparty terminations or withdrawals is relevant, because it may reduce the company's liquidity needs in an event of material financial distress. The Council also will consider the company's internal estimates of potential liquidity needs in a context of material financial distress.

The company's leverage and short-term debt ratios are relevant to this analysis, as high leverage and reliance on short-term funding can increase the potential for a company to be subject to sudden liquidity strains that force it rapidly to sell assets. Leverage can be measured by the ratio of assets to capital or as a measure of economic risk relative to capital. The latter measurement can better capture the effect of derivatives and other products with embedded leverage on the risk undertaken by a nonbank financial company. Comparisons of leverage to peer financial institutions can help indicate the level of risk at the company. Metrics that may be used to assess leverage include:

- Total assets and total debt measured relative to total equity, which measures financial leverage.
- Derivatives liabilities and off-balance sheet obligations relative to total equity, which may show how much off-balance sheet leverage a nonbank financial company may have.
- Securities financing transactions and funding agreements that provide alternative sources of liquidity or operating income, which indicate the use of operating leverage.
- Changes in leverage ratios, which may indicate that a nonbank financial company is increasing or decreasing its risk profile.

*Liquidity of the company's assets.* The second factor under the asset liquidation transmission channel is an analysis of the company's assets that the company could rapidly liquidate, if necessary, to satisfy its obligations. In particular, the Council expects that this assessment will focus on the size and liquidity characteristics of the company's investment portfolio. The Council will assess the company's assets, grouped into categories such as highly liquid (for example, cash, U.S. Treasury securities, and U.S. agency mortgage-backed securities) and less-liquid (for example, corporate bonds, non-agency mortgage-backed securities, and mortgages and other loans) to determine if it holds cash instruments or readily marketable securities that could reasonably be expected to have a liquid market in times of broader market stress. To the extent that the company's assets are encumbered, those assets would generally not be considered to be available to satisfy short-term obligations.

*Potential fire sale impacts.* The third factor in the asset liquidation transmission channel analysis is the potential effects of the company's asset liquidation on markets and market participants. As described above, the Council will assess the scale of potential liquidity needs that could plausibly arise at the company and the amount and nature of financial assets the company could sell to satisfy its obligations. In this step of the asset liquidation transmission channel analysis,

the Council will apply quantitative models to assess how the company could satisfy the identified range of potential liquidity needs by rapidly selling its identified liquid assets. To assess this factor, the Council will compare the volume of the company's potential liquidation of particular categories of financial instruments with the average daily trading volume in the United States of those types of instruments. In general, a rapid liquidation of a significant amount of relatively illiquid financial instruments, or instruments that are widely held by other market participants, will have a greater effect on the market than a liquidation of the same amount of highly liquid instruments or instruments that are not widely held. The Council may also conduct an analysis to assess the relative impact of negative shocks to the equity or assets of certain financial institutions on other financial institutions. The Council expects that its analysis will generally focus on potential asset liquidation periods of 30 to 90 days.

The order in which a nonbank financial company may liquidate assets is a factor in the extent of any fire sale risk, but is subject to considerable uncertainties. A company could liquidate a significant portion of its highly liquid assets first, in order to reduce the likelihood that the company would be forced to liquidate illiquid assets in the event of its material financial distress. However, in the event of the company's material financial distress, a company may also be expected to seek to maintain compliance with any applicable risk-based capital ratios and other requirements. Doing so might require a company to sell a mix of assets across a number of asset classes, rather than proceed with the sale of assets in order from most liquid to least liquid. Further, in the event of a significant market disruption, there could be a meaningful first-mover advantage to selling less-liquid assets first. For example, markets for less-liquid assets, such as private and public corporate bonds and asset-backed securities, could be prone to disruption in the event that a seller liquidated a large portion of its portfolio of those assets. Given these potential discounts, in some circumstances a company may be incentivized to sell a portion of its less-liquid assets first and to hold U.S. government securities and agency mortgage-backed securities, which tend to increase in value during a period of market turmoil. To the extent that a company's highly liquid assets are encumbered (for example, under securities financing transactions or as collateral for loans), the company would also need to sell less-liquid assets to satisfy its liquidity needs. Further, a company's holdings of liquid assets could be reduced before the company enters material financial distress. As a result, the Council may take into account company-specific factors in assessing the order in which the company might liquidate assets. One approach the Council may take is to assess the potential effects if the company sells pro rata portions of the more-liquid segments of its investment portfolio (such as cash and highly liquid instruments, U.S. agency securities, investment-grade public corporate debt securities, publicly traded equity securities, and asset backed-securities).

Critical Function or Service Transmission Channel

Under this transmission channel, the Council will consider the potential for a nonbank financial company to become unable or unwilling to provide a critical function or service that is relied upon by market participants and for which there are no ready substitutes and thereby pose a threat to U.S. financial stability. This factor is commonly referred to as "substitutability." Substitutability captures the extent to which other firms could provide similar financial services in a timely manner at a similar price and quantity if a nonbank financial company withdraws from a particular market. Substitutability also captures situations in which a nonbank financial company is the primary or dominant provider of services in a market that the Council determines to be essential to U.S. financial stability. A risk under this transmission channel may be identified if a company provides a critical function or service that may not easily be substitutable. The Council's analysis will also consider applicable factors that may mitigate potential risks under the critical function or service transmission channel.

Concern about a potential lack of substitutability could be greater if a nonbank financial company and its competitors are likely to experience stress at the same time because they are exposed to the same risks. The Council may also analyze the nonbank financial company's activities and critical functions and the importance of those activities and functions to the U.S. financial system and assess how those activities and functions would be performed by the nonbank financial company or other market participants in the event of the nonbank financial company's material financial distress. The Council also will consider the substitutability of critical market functions that the company provides in the United States in the event of material financial distress of a foreign parent company.

The analysis of this channel incorporates a review of the competitive landscape for markets in which a nonbank financial company participates and for the services it provides (including the provision of liquidity to the U.S. financial system, the provision of credit to low-income, minority, or underserved communities, or the provision of credit to households, businesses and state and local governments), the ability of other firms to replace those services, and the nonbank financial company's market share. This analysis may focus on the company's market share in specific product lines and the ability of substitutes to replace a service or function provided by the company. The Council's evaluation of a nonbank financial company's market share regarding a particular product or service may include assessments of the ability of the nonbank financial company's competitors to expand to meet market needs during a period of overall stress in the financial services industry or in a weak macroeconomic environment; the costs that market participants would incur if forced to switch providers; the timeframe within which a disruption in the provision of the product or service would materially affect market participants or market

functioning; and the economic implications of such a disruption.

#### c. Complexity and Resolvability

The potential threat a nonbank financial company could pose to U.S. financial stability may be mitigated or aggravated by the company's complexity, opacity, or resolvability. In particular, a risk may be aggravated if a nonbank financial company's resolution under ordinary insolvency regimes could disrupt key markets or have a material adverse impact on other financial firms or markets. An evaluation of a nonbank financial company's complexity and resolvability entails an assessment of (1) the complexity of the nonbank financial company's legal, funding, and operational structure, and (2) any obstacles to the rapid and orderly resolution of the nonbank financial company:

- Legal structure factors may include the number of jurisdictions the company operates in, the number of subsidiaries, and the organizational structure.
- Funding structure factors may include the degree of interaffiliate dependency for liquidity and funding (such as intercompany loans or other affiliate support arrangements), payment operation (such as treasury operations), and risk-management.
- Operational structure factors may include the number of employees, the number of U.S. and non-U.S. locations, and the degree of inter-company dependency in regard to financial guarantees and support arrangements, the ability to separate functions and spin off services or business lines, the complexity and resiliency of intercompany and outsourced services and arrangements in resolution, and the likelihood of preserving franchise value in a recovery or resolution scenario.
- Cross-border operational factors may include size and complexity of the company's cross-border operations and impact of potential ring-fencing on an orderly resolution.

Factors that would tend to increase the risk associated with a company's complexity and resolvability include large size or scope of activities; a complex legal or operational structure; multi-jurisdictional operations and regulatory regimes; complex funding structures; the potential impact of a loss of key personnel; and shared services among affiliates. The opacity of a firm's structure—if the firm's structure and operations cannot readily or easily be determined—may present an obstacle to resolution.

#### d. Existing Regulatory Scrutiny

As noted above, one of the considerations the Council is statutorily required to take into account in making a determination under section 113 of the Dodd-Frank Act is the degree to which the nonbank financial company is already regulated by one or more primary financial regulatory agencies.<sup>15</sup> In its analysis of this statutory consideration, the Council will focus on the extent to which existing regulation of the company has mitigated the potential risks to financial

stability identified by the Council. For example, factors that may be used to assess existing regulatory scrutiny include:

- The extent to which the company's primary financial regulator has imposed risk-management standards such as capital, liquidity, and reporting requirements, as relevant to the type of company, and has authority to supervise, examine, and bring enforcement actions, with respect to the company and its affiliates.
- Regulators' processes for inter-regulator coordination.
- For non-U.S. entities, the extent to which the company is supervised and subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority.

#### e. Benefits and Costs of Determination; Likelihood of Material Financial Distress

Determining whether the expected benefits of a potential Council determination justify the expected costs is necessary to ensure that the Council's actions are expected to provide a net benefit to U.S. financial stability and are consistent with thoughtful decisionmaking.<sup>16</sup> Financial stability benefits may be difficult to quantify, and some of the costs may be difficult to forecast with precision. When possible, the Council will quantify reasonably estimable benefits and costs, using ranges, as appropriate, and based on empirical data when available. If such benefits or costs cannot be quantified in this manner, the Council will explain why such benefits or costs could not be quantified. The Council also expects to consider benefits and costs qualitatively.<sup>17</sup> To the extent feasible, the Council will attempt to assess the relative importance of any such qualitative elements. The Council will make a determination under section 113 only if the expected benefits to financial stability from Federal Reserve supervision and prudential standards justify the expected costs that the determination would impose. As part of this analysis, the Council will assess the likelihood of a firm's material financial distress, in order to assess the extent to which a determination may promote U.S. financial stability.

The key elements of regulatory analysis include (1) a statement of the need for the proposed action, (2) an examination of alternative approaches, and (3) an evaluation of the benefits and costs (quantitative and qualitative) of the proposed action and the main alternatives.<sup>18</sup> The Council will conduct this analysis only in cases where the Council is concluding that the company meets one of the standards for a determination by the Council under section 113 of the Dodd-Frank Act, because in other

cases doing so would not affect the outcome of the Council's analysis.

*Benefits.* With respect to the benefits of a Council determination, the Council will consider the benefits of the determination itself, both to (1) the U.S. financial system and long-term economic growth and (2) the nonbank financial company due to additional regulatory requirements resulting from the determination, particularly the prudential standards adopted by the Federal Reserve under section 165 of the Dodd-Frank Act.

One of the Council's statutory purposes is to respond to emerging threats to the stability of the U.S. financial system.<sup>19</sup> The primary intended benefit of a determination under section 113 of the Dodd-Frank Act is a reduction in the likelihood or severity of a financial crisis. Therefore, the Council will consider potential benefits to the U.S. financial system and the U.S. economy arising from a Council determination. To the extent that a Council determination reduces the likelihood or severity of a potential financial crisis, the determination could enhance financial stability and mitigate the severity of economic downturns. The Council may use various measures of systemic risk to assess any improvement in financial stability. Such measures include S-Risk (which attempts to quantify the amount of capital a financial firm would need to raise in order to function normally in the event of a severe financial crisis), conditional value at risk, and certain estimates of fire sale risk, among others. To assess the benefit to the U.S. financial system and the U.S. economy from a determination, the Council may also consider historical analogues to the nonbank under review. In addition, the Council may compare the risks to financial stability posed by a particular nonbank to the risks posed by large bank holding companies, in order to produce an assessment of the relative risks the company may pose. Further, the loss of any implicit "too big to fail" or similar subsidy would be considered a benefit to the economy, even if it increases the nonbank financial company's cost of capital.

Analysis of the benefits of a determination for the relevant nonbank financial company may include those arising directly from the Council's determination as well as any benefits arising from anticipated new or increased requirements resulting from the determination, such as additional supervision and enhanced capital, liquidity, or risk-management requirements. For example, a nonbank financial company subject to a Council determination may benefit from a lower cost of capital or higher credit ratings upon meeting its post-determination regulatory requirements.

*Costs.* With respect to the costs of a Council determination, the Council will consider the costs of the determination itself, both to (1) the nonbank financial company due to additional regulatory requirements resulting from the determination, including the costs of the prudential standards adopted by the Federal Reserve under section 165 of the Dodd-Frank Act; and (2) the U.S. economy.

<sup>19</sup> Dodd-Frank Act section 112(a)(1)(C), 12 U.S.C. 5322(a)(1)(C).

<sup>16</sup> See *MetLife, Inc. v. Financial Stability Oversight Council*, 177 F. Supp.3d 219, 242 (D.D.C. 2016) (quoting 12 U.S.C. 5323(a)(2)(K) and *Michigan v. Environmental Protection Agency*, 135 S. Ct. 2699, 2707 (2015)).

<sup>17</sup> The Council will also consider non-quantified benefits and costs. See Office of Management and Budget Circular A-4 (Sept. 17, 2003), section (E) (Developing Benefit and Cost Estimates) (7).

<sup>18</sup> See Office of Management and Budget Circular A-4 (Sept. 17, 2003).

<sup>15</sup> Dodd-Frank Act section 113(a)(2)(H), 12 U.S.C. 5323(a)(2)(H).

The Council will consider costs to the company arising from anticipated new or increased regulatory requirements resulting from the determination related to:

- Risk-management requirements, such as the costs of capital planning and stress testing.
- Supervision and examination, such as compliance costs to the firm of additional examination and supervision.
- Increased capital requirements, after accounting for offsetting benefits to taxpayers and to the holders of the firm's other liabilities.
- Liquidity requirements, such as the opportunity cost from any requirement to hold additional high-quality liquid assets, relative to the company's current investment portfolio.

Because the Federal Reserve is required to tailor prudential standards to a nonbank financial company subject to a Council determination after the Council has made a determination regarding the company, the new regulatory requirements that result from the Council's determination will not be known to the Council during its analysis of the company. In cases where the nonbank financial company under review primarily engages in bank-like activities, the Council may consider, as a proxy, the costs that would be imposed on the nonbank if the Federal Reserve imposed prudential standards similar to those imposed on bank holding companies with at least \$250 billion in total consolidated assets under section 165 of the Dodd-Frank Act.<sup>20</sup>

The Council also will consider the cost of a determination under section 113 of the Dodd-Frank Act to the U.S. economy by assessing the impact of the determination on the availability and cost of credit or financial products in relevant U.S. markets. To the extent that the markets in which the relevant nonbank participates have low concentration, the impact that the determination regarding one firm would have on credit conditions would generally be immaterial. However, if the relevant markets are concentrated, a Council determination regarding a significant market participant could have a material impact on credit conditions in that market. As part of this analysis, the Council may also consider the extent to which any reduction in financial services provided by the nonbank financial company under review would be offset by other market participants.

*Likelihood of Material Financial Distress.* As part of the assessment of the overall impact of a Council determination for any company under review under the First Determination Standard, the Council will assess the likelihood of the company's material financial distress based on its vulnerability to a range of factors. For example, these factors may include leverage (both on- and off-balance sheet), potential risks associated with asset revaluations (whether such revaluations arise from market disruptions or severe macroeconomic conditions), reliance on short-term funding or other fragile funding markets, maturity transformation, and risks from exposures to counterparties or other market participants.

This assessment may rely upon historical examples regarding the characteristics of financial companies that have experienced financial distress, but may also consider other risks that do not have historical precedent. The Council's analysis of the vulnerability of a nonbank financial company to material financial distress will be conducted taking into account a period of overall stress in the financial services industry and a weak macroeconomic environment. The Council may also consider the results of any stress tests that have previously been conducted by the company or by its primary financial regulatory agency.

#### IV. The Determination Process

As described in section II above, the Council will prioritize an activities-based approach for identifying, assessing, and addressing potential risks to financial stability. However, if a potential risk or threat to U.S. financial stability cannot be adequately addressed through an activities-based approach, the Council may consider a nonbank financial company for a potential determination under section 113 of the Dodd-Frank Act. The Council anticipates it would consider a nonbank financial company for a potential determination under section 113 only in rare instances, such as if the products, activities, or practices of a company that pose a potential threat to U.S. financial stability are outside the jurisdiction or authority of financial regulatory agencies. The Council expects generally to follow a two-stage process of evaluation and analysis, as described below.

In the first stage of the process ("Stage 1"), nonbank financial companies identified as potentially posing risks to U.S. financial stability will be notified and subject to a preliminary analysis, based on quantitative and qualitative information available to the Council primarily through public and regulatory sources. During Stage 1, the Council will permit, but not require, the company to submit relevant information. The Council will also consult with the primary financial regulatory agency or home country supervisor, as appropriate. This approach will enable the Council to fulfill its statutory obligation to rely whenever possible on information available through the Office of Financial Research (the "OFR"), Council member agencies, or the nonbank financial company's primary financial regulatory agencies before requiring the submission of reports from any nonbank financial company.<sup>21</sup>

Following Stage 1, nonbank financial companies that are selected for additional review will receive notice that they are being considered for a proposed determination that the company could pose a threat to U.S. financial stability (a "Proposed Determination") and will be subject to in-depth evaluation during the second stage of review ("Stage 2"). Stage 2 will involve the evaluation of additional information collected directly from the nonbank financial company. At the end of Stage 2, the Council may consider whether to make a Proposed

Determination with respect to the nonbank financial company. If a Proposed Determination is made by the Council, the nonbank financial company may request a hearing in accordance with section 113(e) of the Dodd-Frank Act and § 1310.21(c) of the Council's rule.<sup>22</sup> After making a Proposed Determination and holding any written or oral hearing if requested, the Council may vote to make a final determination.

#### *a. Stage 1: Preliminary Evaluation of Nonbank Financial Companies*

Stage 1 involves a preliminary analysis of nonbank financial companies to assess the risks they could pose to U.S. financial stability.

#### Identification of Company for Review in Stage 1

If, as described in section II, the Council's consultation with and any recommendations to a nonbank financial company's primary financial regulatory agency do not adequately address a potential risk identified by the Council, the Council may evaluate one or more individual nonbank financial companies for an entity-specific determination under section 113 of the Dodd-Frank Act. The Council will vote to commence review of a nonbank financial company in Stage 1. When evaluating the potential risks associated with a nonbank financial company, the Council may consider the company and its subsidiaries together. This approach enables the Council to consider potential risks arising across the consolidated organization, while retaining the ability to make a determination regarding either the parent or any individual nonbank financial company subsidiary (or neither), depending on which entity the Council determines could pose a threat to financial stability.

#### Engagement With Company and Regulators in Stage 1

The Council will provide a notice to any nonbank financial company under review in Stage 1. In Stage 1, the Council will consider available public and regulatory information; in addition, a company under review in Stage 1 may submit to the Council any information it deems relevant to the Council's evaluation and may, upon request, meet with staff of Council members and member agencies who are leading the Council's analysis. In order to reduce the burdens of review on the company, the Council will not require the company to submit information during Stage 1. In addition, staff representing Council members will, upon request, provide the company with a list of the primary public sources of information being considered during the Stage 1 analysis, so that the company has an opportunity to understand the information the Council may rely upon during Stage 1. Through this engagement, the Council will seek to enable the company under review to understand the focus of the Council's analysis, which may enable the company to act to mitigate any risks to financial stability and thereby potentially avoid becoming subject to a Council determination.

<sup>20</sup> Dodd-Frank Act section 165, 12 U.S.C. 5365.

<sup>21</sup> See Dodd-Frank Act section 112(d)(3), 12 U.S.C. 5322(d)(3).

<sup>22</sup> See 12 CFR 1310.21(c).

During the discussions in Stage 1 with the company, the Council intends for staff of Council members and member agencies to explain to the company the key risks that have been identified in the analysis. Because the review of the company is preliminary and continues to change until the Council makes a final determination, these identified risks may shift over time.

The Council will also consider in Stage 1 information available from relevant existing regulators of the company. Under the Dodd-Frank Act, the Council is required to consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for a determination before the Council makes any final determination with respect to such company.<sup>23</sup> For any company under review in Stage 1 that is regulated by a primary financial regulatory agency or home country supervisor, the Council will notify the regulator or supervisor that the company is under review no later than such time as the company is notified. As part of that consultation process, the Council will consult with the primary financial regulatory agency, if any, of each significant subsidiary of the nonbank financial company, to the extent the Council deems appropriate in Stage 1. The Council will actively solicit the regulator's views regarding risks at the company and potential mitigants. In order to enable the regulator to provide relevant information, the Council will share its preliminary views regarding potential risks at the company, and request that the regulator provide information regarding those specific risks, including whether the risks are adequately mitigated by factors such as existing regulation or the company's business practices. During the determination process, the Council will continue to encourage the regulator to address any risks to U.S. financial stability using the regulator's existing authorities; if the Council believes the regulator's actions adequately address the potential risks to U.S. financial stability the Council has identified, the Council may discontinue its consideration of the firm for a potential determination under section 113 of the Dodd-Frank Act.

Based on the preliminary evaluation in Stage 1, the Council may vote to commence a more detailed analysis of the company by advancing the company to Stage 2, or it may decide not to evaluate the company further. If the Council determines not to advance a company that has been reviewed in Stage 1 to Stage 2, the Council will notify the company in writing of the Council's decision. The notice will clarify that a decision not to advance the company from Stage 1 to Stage 2 at that time does not preclude the Council from reinitiating review of the company in Stage 1. For example, the Council may reinitiate review of the company if material changes affecting the firm merit further evaluation.

<sup>23</sup> Dodd-Frank Act section 113(g), 12 U.S.C. 5323(g).

#### *b. Stage 2: In-Depth Evaluation*

Stage 2 involves an in-depth evaluation of any company that the Council has determined merits additional review.

In Stage 2, the Council will review the relevant company using information collected directly from the nonbank financial company, through the OFR, as well as public and regulatory information. The review will focus on whether the nonbank financial company could pose a threat to U.S. financial stability because of the company's material financial distress or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company. The Council expects that the transmission channels and the other factors described above will be used to evaluate a nonbank financial company's potential to pose a threat to U.S. financial stability.

#### *Engagement With Company and Regulators in Stage 2*

Each nonbank financial company to be evaluated in Stage 2 will receive a notice (a "Notice of Consideration") that the nonbank financial company is under consideration for a Proposed Determination. The Council also will submit to the company a request that the company provide information that the Council deems relevant to the Council's evaluation, and the nonbank financial company will be provided an opportunity to submit written materials to the Council.<sup>24</sup> This information will generally be collected by the OFR. Before requiring the submission of reports from any nonbank financial company that is regulated by a Council member agency or any primary financial regulatory agency, the Council, acting through the OFR, will coordinate with such agencies and will, whenever possible, rely on information available from the OFR or such agencies. Council members and their agencies and staffs will maintain the confidentiality of such information in accordance with applicable law. During Stage 2, the company may also submit any other information that it deems relevant to the Council's evaluation. Information considered by the Council includes details regarding the company's financial activities, legal structure, liabilities, counterparty exposures, resolvability, and existing regulatory oversight.

Information requests likely will involve both qualitative and quantitative data. Information relevant to the Council's analysis may include confidential business information such as detailed information regarding financial assets, terms of funding arrangements, counterparty exposure or position data, strategic plans, and interaffiliate transactions.

The Council will make staff representing Council members available to meet with the representatives of any company that enters Stage 2, to explain the evaluation process and the framework for the Council's analysis. If the analysis in Stage 1 has identified specific aspects of the company's operations or activities as the primary focus for the evaluation, staff will notify the company of those issues, although the issues will be

<sup>24</sup> See 12 CFR 1310.21(a).

subject to change based on the ongoing analysis. In addition, the Council expects that its Deputies Committee<sup>25</sup> will grant a request to meet with a company in Stage 2 to allow the company to present any information or arguments it deems relevant to the Council's evaluation.

During Stage 2 the Council will also seek to continue its consultation with the company's primary financial regulatory agency or home country supervisor in a timely manner before the Council makes any proposed or final determination with respect to such nonbank financial company. The Council will continue to encourage the regulator during the determination process to address any risks to U.S. financial stability using the regulator's existing authorities; as noted above, if the Council believes the regulator's actions adequately address the potential risks to U.S. financial stability the Council has identified, the Council may discontinue its consideration of the firm for a potential determination under section 113 of the Dodd-Frank Act.

Before making a Proposed Determination regarding a nonbank financial company, the Council will notify the company when the Council believes that the evidentiary record regarding such nonbank financial company is complete. The Council will notify any nonbank financial company in Stage 2 if the nonbank financial company ceases to be considered for a determination. Any nonbank financial company that ceases to be considered at any time in the Council's determination process may be considered for a Proposed Determination in the future at the Council's discretion, consistent with the processes described above.

#### *c. Proposed and Final Determination*

##### *Proposed Determination*

Based on the analysis performed in Stage 2, a nonbank financial company may be considered for a Proposed Determination. A proposed determination requires a vote of two-thirds of the voting members of the Council then serving, including an affirmative vote by the Chairperson of the Council.<sup>26</sup> Following a Proposed Determination, the Council will issue a written notice of the Proposed Determination to the nonbank financial company, which will include an explanation of the basis of the Proposed Determination.<sup>27</sup> Promptly after the Council votes to make a proposed determination regarding a company, the Council will provide the company's primary financial regulatory agency or home country supervisor (subject to appropriate protections for confidential information) with the nonpublic written explanation of the basis of the Council's proposed or final determination. The Council also will publish the explanation of the basis of the Proposed Determination, subject to redactions to

<sup>25</sup> The Council's Deputies Committee is composed of senior officials from each Council member and member agency. It coordinates and oversees the work of the Council's other interagency staff committees.

<sup>26</sup> 12 CFR 1310.10(b).

<sup>27</sup> Dodd-Frank Act section 113(e)(1), 12 U.S.C. 5323(e)(1).

protect confidential information from the company or its regulators.

#### Hearing

A nonbank financial company that is subject to a Proposed Determination may request a nonpublic hearing to contest the Proposed Determination in accordance with section 113(e) of the Dodd-Frank Act. If the nonbank financial company requests a hearing in accordance with the procedures set forth in § 1310.21(c) of the Council's rule,<sup>28</sup> the Council will set a time and place for such hearing. The Council has published hearing procedures on its website.<sup>29</sup> In light of the short statutory timeframe for conducting a hearing, and the fact that the purpose of the hearing is to benefit the company, if a company requests that the Council waive the statutory deadline for conducting the hearing, the Council may do so in appropriate circumstances.

#### Final Determination

After making a Proposed Determination and holding any requested written or oral hearing, the Council may, by a vote of not fewer than two-thirds of the voting members of the Council then serving (including an affirmative vote by the Chairperson of the Council), make a final determination that the company will be subject to supervision by the Federal Reserve and prudential standards. If the Council makes a final determination, it will provide the company with a written notice of the Council's final determination, including an explanation of the basis for the Council's decision.<sup>30</sup> The Council will also provide the company's primary financial regulatory agency or home country supervisor (subject to appropriate protections for confidential information) with the nonpublic written explanation of the basis of the Council's final determination. The Council expects that its explanation of the final basis for any determination will highlight the key risks that led to the determination and include clear guidance regarding the factors that were most important in the Council's determination. When practicable and consistent with the purposes of the determination process, the Council will provide a nonbank financial company with a notice of a final determination at least one business day before publicly announcing the determination pursuant to § 1310.21(d)(3), § 1310.21(e)(3), or § 1310.22(d)(3) of the Council's rule.<sup>31</sup> In accordance with section 113(h) of the Dodd-Frank Act, a nonbank financial company that is subject to a final determination may bring an action in U.S. district court for an order requiring that the determination be rescinded.

The Council does not intend to publicly announce the name of any nonbank financial

company that is under evaluation prior to a final determination with respect to such company. However, if a company that is under review in Stage 1 or Stage 2 publicly announces the status of its review by the Council, the Council intends, upon the request of a third party, to confirm the status of the company's review. In addition, the Council will publicly release the explanation of the Council's basis for any nonbank financial company determination or rescission of a determination. The Council is subject to statutory and regulatory requirements to maintain the confidentiality of certain information submitted to it by a nonbank financial company or its regulators.<sup>32</sup> In light of these confidentiality obligations, such confidential information will be redacted from the materials that the Council makes publicly available.

#### V. Annual Reevaluations of Nonbank Financial Company Determinations

After the Council makes a final determination regarding a company, the Council intends to encourage the company or its regulators to take steps to mitigate the potential risks identified in the Council's written explanation of the basis for its final determination. Except in cases where new material risks arise over time, if a company adequately addresses the potential risks identified in writing by the Council at the time of the final determination and in subsequent reevaluations, the Council should generally be expected to rescind its determination regarding the company.

For any nonbank financial company that is subject to a final determination, the Council is required to reevaluate the determination at least annually, and to rescind the determination if the Council determines that the company no longer meets the statutory standards for a determination. The Council may also consider a request from a company for a reevaluation before the next required annual reevaluation, in the case of an extraordinary change that materially decreases the threat the nonbank financial company could pose to U.S. financial stability.<sup>33</sup>

The Council applies the same standards of review in its annual reevaluations as the standard for an initial determination regarding a nonbank financial company: Either the company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, could pose a threat to U.S. financial stability. If the Council determines that the company no longer meets those standards, the Council will rescind its determination.

The Council's annual reevaluations generally assess whether any material changes since the previous reevaluation and since the determination justify a rescission of the determination, based on the same transmission channels and other factors that are considered during a determination decision. The Council expects that its reevaluation process will focus on whether

any material changes—including changes at the company, changes in its markets or its regulation, changes in the Council's own analysis, or otherwise—result in the company no longer meeting the standard for a determination. In light of the frequent reevaluations, the Council's analyses will generally focus on changes since the Council's previous review, but the ultimate question the Council will seek to assess is whether changes in the aggregate since the Council's determination regarding the company have caused the company to cease meeting the Determination Standards. The Council expects that its analysis in its annual reevaluations will generally be organized around the three transmission channels described above as well as existing regulatory scrutiny and the company's complexity and resolvability.

Before the Council's annual reevaluation of a determination regarding a nonbank financial company, the Council will provide the company with an opportunity to meet with staff of Council members and member agencies to discuss the scope and process for the review and to present information regarding any change that may be relevant to the threat the company could pose to financial stability. Staff of Council members and member agencies will also be available to meet with the company during the annual reevaluation, at the company's request. In addition, during an annual reevaluation, a company may submit any written information to the Council the company considers relevant to the Council's analysis. During annual reevaluations, companies are encouraged to submit information regarding any changes related to the company's risk profile that mitigate the potential risks previously identified by the Council. Such changes could include updates regarding company restructurings, regulatory developments, market changes, or other factors. If the company has taken steps to address the potential risks previously identified by the Council, the Council will assess whether those risks have been adequately mitigated to merit a rescission of the determination regarding the company. If the company explains in detail potential changes it could make to its business to address the potential risks previously identified by the Council, staff of Council members and member agencies will endeavor to provide their feedback on the extent to which those changes may address the potential risks.

If a company contests the Council's determination during the Council's annual reevaluation, the Council will vote on whether to rescind the determination and provide the company, its primary financial regulatory agency, and the primary financial regulatory agency of its significant subsidiaries with a notice explaining the primary basis for any decision not to rescind the determination. If the Council does not rescind the determination, the written notice provided to the company will address each of the material factors raised by the company in its submissions to the Council contesting the determination during the annual reevaluation. The written notice from the Council will also explain in detail why the

<sup>28</sup> See 12 CFR 1310.21(c).

<sup>29</sup> Financial Stability Oversight Council Hearing Procedures for Proceedings Under Title I or Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, available at <https://www.treasury.gov/initiatives/fsoc/designations/Pages/Hearing-Procedures.aspx>.

<sup>30</sup> Dodd-Frank Act section 113(e)(3), 12 U.S.C. 5323(e)(3); see also 12 CFR 1310.21(d)(2) and (e)(2).

<sup>31</sup> See 12 CFR 1310.21(d)(3) and (e)(3) and 1310.22(d)(3).

<sup>32</sup> See Dodd-Frank Act section 112(d)(5), 12 U.S.C. 5322(d)(5); see also 12 CFR 1310.20(e).

<sup>33</sup> See note 12 above.

Council did not find that the company no longer met the standard for a determination under section 113 of the Dodd-Frank Act. In general, due to the sensitive nature of its analyses in annual reevaluations, the Council may not in all cases publicly release the written findings that it provides to the company.

Finally, the Council will provide each nonbank financial company subject to a Council determination with an opportunity for an oral hearing before the Council once every five years at which the company can contest the determination.

Dated: December 9, 2019.

**Howard Adler,**

*Deputy Assistant Secretary for the Financial Stability Oversight Council, Department of the Treasury.*

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## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 39

[Docket No. FAA-2019-0912; Product Identifier 2019-NE-33-AD; Amendment 39-21011; AD 2019-25-13]

RIN 2120-AA64

#### Airworthiness Directives; Engine Alliance Turbofan Engines

**AGENCY:** Federal Aviation Administration (FAA), DOT.

**ACTION:** Final rule; request for comments.

**SUMMARY:** The FAA is adopting a new airworthiness directive (AD) for all Engine Alliance (EA) GP7270 and GP7277 model turbofan engines with a certain low-pressure compressor (LPC) 1st-stage fan blade installed. This AD requires an ultrasonic inspection of the affected LPC 1st-stage fan blades and replacement of any affected fan blades that fail the inspection. This AD was prompted by a report of an in-flight shutdown (IFSD) of an engine due to the fracture of multiple fan blades. The FAA is issuing this AD to address the unsafe condition on these products.

**DATES:** This AD is effective January 14, 2020.

The Director of the Federal Register approved the incorporation by reference of a certain publication listed in this AD as of January 14, 2020.

The FAA must receive comments on this AD by February 13, 2020.

**ADDRESSES:** You may send comments, using the procedures found in 14 CFR 11.43 and 11.45, by any of the following methods:

- *Federal eRulemaking Portal:* Go to <https://www.regulations.gov>. Follow the instructions for submitting comments.

- *Fax:* 202-493-2251.

- *Mail:* U.S. Department of Transportation, Docket Operations, M-30, West Building Ground Floor, Room W12-140, 1200 New Jersey Avenue SE, Washington, DC 20590.

- *Hand Delivery:* U.S. Department of Transportation, Docket Operations, M-30, West Building Ground Floor, Room W12-140, 1200 New Jersey Avenue SE, Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

For service information identified in this final rule, contact Engine Alliance, 411 Silver Lane, East Hartford, CT, 06118; phone: 800-565-0140; email: [help24@pw.utc.com](mailto:help24@pw.utc.com); website: [www.engineallianceportal.com](http://www.engineallianceportal.com). You may view this service information at the FAA, Engine and Propeller Standards Branch, 1200 District Avenue, Burlington, MA 01803. For information on the availability of this material at the FAA, call 781-238-7759. It is also available on the internet at <https://www.regulations.gov> by searching for and locating Docket No. FAA-2019-0912.

#### Examining the AD Docket

You may examine the AD docket on the internet at <https://www.regulations.gov> by searching for and locating Docket No. FAA-2019-0912; or in person at Docket Operations between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this final rule, the regulatory evaluation, any comments received, and other information. The street address for the Docket Operations is listed above. Comments will be available in the AD docket shortly after receipt.

**FOR FURTHER INFORMATION CONTACT:** Matthew Smith, Aerospace Engineer, ECO Branch, FAA, 1200 District Avenue, Burlington, MA 01803; phone: 781-238-7735; fax: 781-238-7199; email: [Matthew.C.Smith@faa.gov](mailto:Matthew.C.Smith@faa.gov).

#### SUPPLEMENTARY INFORMATION:

##### Discussion

The FAA received a report of an IFSD that occurred during a revenue flight on March 10, 2019. The IFSD resulted from the fracture of two LPC 1st-stage fan blades. After an analysis of these fractures, the manufacturer determined the fan blades experienced cracks that originated on the internal surface of the convex airfoil and propagated to the point of failure. The cracks originated in a microtexture area that can result in a

low-cycle fatigue debit that may allow a crack to initiate and propagate to failure. This condition, if not addressed, could result in uncontained fan blade release, damage to the engine, and damage to the airplane. The FAA is issuing this AD to address the unsafe condition on these products.

#### Related Service Information Under 14 CFR Part 51

The FAA reviewed EA Service Bulletin (SB) EAGP7-A72-426, dated September 30, 2019. The SB describes procedures for performing an ultrasonic inspection of the LPC 1st-stage fan blades. This service information is reasonably available because the interested parties have access to it through their normal course of business or by the means identified in the **ADDRESSES** section.

#### FAA's Determination

The FAA is issuing this AD because the FAA evaluated all the relevant information and determined the unsafe condition described previously is likely to exist or develop in other products of the same type design.

#### AD Requirements

This AD requires an ultrasonic inspection of the affected LPC 1st-stage fan blades and replacement of any affected fan blades that fail the inspection.

#### Interim Action

The FAA considers this AD interim action. The root cause of the LPC 1st-stage fan blade fracture is still undetermined and the FAA will consider further rulemaking depending on the results of the investigation.

#### FAA's Justification and Determination of the Effective Date

Since there are currently no domestic operators of this product, notice and opportunity for public comment before issuing this AD are unnecessary. In addition, for the reason stated above, the FAA finds that good cause exists for making this amendment effective in less than 30 days.

#### Comments Invited

This AD is a final rule that involves requirements affecting flight safety and was not preceded by notice and an opportunity for public comment. However, the FAA invites you to send any written data, views, or arguments about this final rule. Send your comments to an address listed under the **ADDRESSES** section. Include the docket number FAA-2019-0912 and Product Identifier 2019-NE-33-AD at the