CENTER FOR CAPITAL MARKETS COMPETITIVENESS
OF THE
UNITED STATES CHAMBER OF COMMERCE

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February 25, 2011

Financial Stability Oversight Council
Attn: Lance Auer
1500 Pennsylvania Avenue. NW
Washington, DC 20220

Re: Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies

Dear Mr. Auer:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation representing over three million companies of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in the 21st century economy. The CCMC welcomes the opportunity to comment on the Notice of Proposed Rulemaking (the "Proposal") issued by the Financial Stability Oversight Council (the "Council") on January 26, 2011 regarding authority to require supervision and regulation of certain nonbank financial companies by the Board of Governors of the Federal Reserve System.

The CCMC supports the Council's efforts to monitor systemic risk and believes that greater access to comprehensive market and industry information will assist the Council in identifying emerging threats to the stability of U.S. financial system. However, we have significant concerns with several aspects of the Proposal and generally, with the designation of companies pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"):

- The Council's process for developing the Proposal lacks transparency, and the Proposal itself fails to provide any meaningful guidance to stakeholders.

- The Proposal is drafted before the Council is fully constituted, and thus fails to consider the views of all aspects of the financial system. It also precedes, unnecessarily, the establishment and operation of other foundational elements

of the systemic risk regulatory regime.

- No cost – benefit analysis was conducted to determine the impact of the Proposal on individual entities, industries, or the U.S. economy. In fact, the Council failed to conduct a regulatory flexibility analysis to assess the likely impact on small businesses, which is of great concern particularly in light of their job creating capacity in a recession-emerging economy.

These concerns are discussed in further detail below, and we strongly urge the Council to address them prior to finalizing the rule or making any designation decision under Section 113 of the Dodd-Frank Act.

Lack of Transparency in the Process and Meaningful Guidance in the Proposal

The Council's failure to conduct a transparent rulemaking and to provide clear guidance within the proposed rule about the designation process are fatal flaws that should be corrected before the Council finalizes the rule or makes a designation. The flaws are fatal because their severity is matched only by the importance of the decisions the rule must guide and the signals it should send to all participants in the U.S. economy. These decisions and therefore the rule will, by definition, impact the financial stability of the United States.

The lack of transparency by the Council in developing the Proposal is evident in multiple ways, but we will limit our comments to two clear and troubling examples. First, despite receiving dozens of comment letters containing hundreds of substantive comments in response to the advance notice of proposed rulemaking that the Council published on October 6, 2010 (the "ANPR"), the Council simply catalogues those comments in the Proposal and fails to address any of them on their merits. Second, the Proposal states that the Council expects to begin assessing the systemic importance of nonbank financial companies using a "framework that would be adapted for the risks presented by a particular industry sector and the business models present in each sector" beginning "shortly after adopting a final rule" and to "screen" them on a regular basis thereafter.[1] These statements suggest that the assessment and subsequent screening processes and the industry-specific adjustments to the "framework," which

[1] Proposal, p. 23.

is itself articulated outside of the actual rule, either have been developed or will be developed outside of the public rulemaking process and without the "open exchange of information and perspectives" called for by fundamental principles of administrative law, fairness, and the executive order that the President released the same day that the Council released the Proposal. Therefore, although we commend the Council for formally recognizing that each financial services industry and activity has its own unique set of risk characteristics, we also strongly encourage the Council to solicit public comment on its proposed assessment and screening processes, including the industry-specific adjustments to the framework.

In addition to the lack of transparency in its development, the Proposal itself provides no meaningful guidance regarding the designation process. Although the lack of guidance is apparent in many ways, we will again limit our comments to two clear and illustrative shortcomings. First, the proposed rule simply recites the statute. Instead of providing meaningful guidance within the rule, the Proposal provides only the most minimal guidance, which is contained in the preliminary text. Specifically, the only guidance comes in the form of the vague framework mentioned above. The framework is briefly discussed in the Supplementary Information section that precedes the rule, but is not incorporated in the rule itself.

This framework merely groups eleven considerations mandated by the Dodd-Frank Act into six broad categories without any explanation of the groupings. We note that these categories will be subjectively weighed and supplemented by the use of quantitative metrics where possible. We also note that the metrics will vary for each industry. However, the Council fails to define precisely what metrics may be used, does not clarify how the categories may be weighted, or provide any meaningful guidance in the discussion of the framework or in the rule itself.

The Council again fails to provide meaningful guidance when it does not define key terms in the Dodd-Frank Act that are integral to any designation decision. Specifically, the Council refuses to define the terms "material financial distress" and "financial stability." The Council concedes that it may only invoke the designation authority granted by Section 113 of the Dodd-Frank Act if it determines that "material financial distress" at a nonbank financial company or the nature of the nonbank financial company's activities could threaten the "financial stability" of the United States. However, the Council does not define these key terms but rather asserts that the framework "incorporates the concepts . . . without the need to explicitly define

them in the rule." Yet, the Council offers no explanation or additional guidance beyond that statement.

The lack of transparency and absence of meaningful guidance render the Proposal wholly deficient, especially in light of the subject matter, and create serious problems that have material costs. First, and perhaps most obviously, they create tremendous uncertainty for financial companies and hinder their planning. Many financial companies spend significant time and resources developing and managing their businesses according to multi-year business plans. They need predictability, particularly with respect to costs, including the cost of regulatory compliance. Due to the flaws described above, financial companies and their stakeholders, including customers, investors, and creditors have no reasonable means to assess whether they may be subject to heightened supervision and faced with bank-like regulations that would undoubtedly increase costs. To date, these companies and their stakeholders have not had the opportunity to participate fully in a transparent and thorough rulemaking process and, based on the Proposal, they will not be interpreting a clear and comprehensive rule going forward. Rather, they will have the nearly impossible task of reading the minds and interpreting one-off statements of members of the Council rather than engaging in a process that instills confidence, order and certainty.

In addition to the costs imposed on nonbank financial companies and their direct stakeholders, there are indirect costs imposed on the U.S. economy. Specifically, these flaws frustrate the public comment process, as described above, other regulatory processes, as described below, and Congressional oversight, since the Council refuses to establish standards against which its own decisions can be evaluated. Regulatory processes that are being frustrated or inappropriately impacted by these flaws include those dealing with issues that are best addressed at the activity level, by functional regulation, outside of the designation process. Due to an absence of guidance from the Council, some market participants are discussing these issues in the context of designation. The discussions can create confusion and distort or frustrate efforts to resolve issues through the appropriate channels.

One such issue is the money market fund regulatory change made in response to the financial crisis. The CCMC believes that, when the Rule 2a-7 regulatory changes are considered together with other regulatory efforts that are strengthening individual institutions and regulation of the capital markets, including other provisions of the Dodd-Frank Act, adoption of Basel III, and changes in the tri-party repo market,

enough has been done to address any potential systemic concerns that federal financial regulators may have regarding money market funds. However, if the Council believes that some additional step should be taken to address those concerns, the CCMC agrees that the Council has proceeded appropriately by asking the functional regulator to solicit public comments to thoroughly explore possible solutions. Such an approach (i) correctly places the responsibility on the primary functional regulator, who supervises the industry and is best positioned to implement an industry-wide solution, (ii) recognizes the importance of engaging with industry experts, who understand the markets best, and (iii) avoids the inefficiencies, ineffectiveness, and opacity that designation would entail.

The lack of clarity regarding potential use of the extraordinary power of systemic designation also imposes inefficient costs, potentially creates systemic risk, and undermines public confidence in the Council and its decisions. Inefficient costs arise not only due to uncertainty created for nonbank financial companies and their stakeholders and injected into other regulatory efforts, but also for the public to the extent that the uncertainty inappropriately alters the cost of funding for nonbank financial companies and distorts other relationships between nonbank financial companies and their stakeholders. Uncertainty causes such distortions because people must guess at the likelihood of designation and, equally importantly, because the rule lacks the clarity necessary to deter companies from creating systemic risks and to incentivize them to reduce their risk profiles. Thus, these flaws may create additional systemic risk.

Finally, in addition to the costs already enumerated, these flaws will (i) undermine confidence in the Council and its decisions, (ii) make them more susceptible to challenges, (iii) continue to divert resources from productive activities, (iv) and render the newly created agency and one of its most significant authorities substantially less effective than Congress intended them to be.

In light of the flaws described above, we strongly recommend that the Council address them through a transparent and open process before proceeding. To that end, we also strongly reiterate our earlier comment to the Advance Notice of Proposed Rulemaking that the Council should heed caution and err on the side of non-designation. The Council should consider a combination of **clearly defined** criteria for designation and avoid applying a blanket designation to capture a larger number of financial companies for fear that they may pose a systemic risk. Below, we provide

again considerations for the designation process.

Factors for Designation

While Section 113 of the Dodd-Frank Act sets out a list of factors to be considered by the Council when determining whether a financial institution should be subject to enhanced supervision, CCMC encourages the Council to apply a holistic view when making determinations. Size alone is not indicative of systemic significance. Accordingly, the Council should avoid using an arbitrary threshold for nonbank financial institutions, such as the $50 billion threshold applied to bank holding companies in the Dodd-Frank Act. The approach should include the consideration of a combination of clearly defined criteria for designation. We believe that it would be appropriate for the Council to focus on the following areas in developing these criteria:

- The proprietary activities of the financial institution, including whether an institution engages in financial activities primarily on its own behalf or as an agent on behalf of its clients or customers and specifically whether the assets the institution uses in its financial activities are owned funds (such as the case at a bank or insurance company) or managed funds (such as the case of hedge funds, private equity funds, and mutual funds)[2];

- The degree of leverage within a financial institution; provided, however, that because leverage is a more useful measure when applied to capital intensive proprietary businesses (especially for financial institutions that have a high-level of interconnectedness) and less useful when applied to agency businesses such as the custody and management of customer funds, any leverage measure should be tailored for the type of financial institution to which it will be applied

[2] This criterion was included in the Dodd-Frank Act to underscore the lower potential of companies that manage assets to pose systemic risk when compared to companies that primarily use their own assets and balance sheets in their activities. Typically, the assets of individual funds are legally separate from one another and from the assets of the manager; and, therefore, they do not pose a direct risk to the balance sheets of their managers or to one another. Finally, managed assets themselves generally do not threaten the financial stability of the United States unless the fund holding them is interconnected and the asset management strategy presents an unacceptable level of risk to its counterparties because of uncollateralized assets, hard-to-value assets or other risk factors.

and be risk-sensitive so as to disregard or discount the effect of no- or very-low-risk assets that are required to be consolidated on an institution's balance sheet;

- The degree of interconnectedness to major financial institutions (i.e., counterparty exposure) and the extent to which the interconnectedness is uncollateralized;

- The substitutability of the financial institution within the financial system, in other words, the extent to which a financial service or mechanism that it provides is or is not essential and readily available from other firms;

- The extent to which the institution's executives and managers own it or have their own capital at risk and invested in its activities for the long term; and

- Whether a financial institution has an ongoing government guarantee (e.g., FDIC deposit insurance or liquidity guarantee programs) or access to or actual receipt of government funded capital or other assistance (e. g., TARP or Fed's discount window).

Additionally, we believe that the Council should define criteria (without establishing hard and fast numerical targets) or clarify under what circumstances a nonbank financial company will never be designated for enhanced supervision (for example, if an organization is not engaged in any financial activities other than true captive finance activities, as discussed below). This would establish a safe harbor based on certain factors or a combination of factors. We also encourage the Council to examine the feasibility of setting clearly defined criteria or conditions under which a financial company already designated for enhanced supervision may become "undesignated."

One Size Does Not Fit All

A "one size fits all" approach will not produce more effective oversight, and may, in fact, increase systemic risk. Each financial services industry has its own unique set of risk characteristics. For example, the mutual fund industry is already heavily regulated and lacks key elements such as a reliance on short-term funding, asset/liability mismatch, leverage and overall interconnectedness that play an integral role in increasing systemic risk, while private equity firms are unique from other

financial service industries because they do not face liquidity concerns (i.e., they use long-term capital commitments from investors to make long-term investments in companies rather than complex securities), and they are not deeply interconnected with banks or other nonbank financial companies. Meanwhile, hedge funds obtain most of their financing on a secured basis, typically by posting collateral with their counterparties, which constrains hedge funds' use of leverage and limits their ability to pose systemic risk.

In this regard, the CCMC opposes bank-like regulation for large nonbank financial company and believes that shoehorning a nonbank financial company into a banking regulatory framework will disrupt how these companies compete in and out of their industry. Each financial company fills the need for a specific product or service in the marketplace. In the long run, imposing bank-like regulations on a diverse group of financial institutions will force these companies to alter their business model to the point that the financial services industry becomes overly homogenous. Instead of mitigating systemic risk, such regulation would increase it exponentially, while reducing competition, customer choice and economic efficiency, accelerating the flight to less regulated products and jurisdictions and expanding the moral hazard. Accordingly, the utility and unique functions of different business and industry models and likely costs of applying such regulation to them need to be carefully analyzed in developing and considering criteria for designation and the prudential standards and supervisory tools that would be applied to a designated company. Ultimately, as discussed below, activity-based regulation and effective risk management at that level are likely to be more appropriate and efficient methods of mitigating most risks and should be critical factors in these considerations.

Focus on regulation of activities as much as possible, before utilizing the designation authority for nonbank financial companies

Designation is one tool among many and should be used carefully. The Dodd-Frank Act supplements existing regulatory regimes and provides multiple tools for addressing systemic risk, including the authority to: (1) collect the information required to monitor activities and markets in order to identify systemic risk, (2) supervise institutions and (3) recommend additional regulation of activities, including activities relating to the payment, clearing, and settlement of financial transactions. These tools allow the Council and the other financial regulators to detect and limit the creation of risk in a company or industry and the likelihood that it will impact other institutions or

industries and thereby threaten the financial stability of the United States.

For example, the Dodd-Frank Act promotes a functional, activity-based approach in Sections 112 and 120. Section 112 lists among the duties of the Council the requirements that it "facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions;" and "recommend to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies." If the Council is unable to accomplish its goals by performing these duties, Section 120 empowers the Council to impose more stringent standards on activities or practices within an industry that is functionally regulated. The Dodd-Frank Act also addresses potential mechanisms for transmitting the effects of losses in the provisions of Title VIII on payment, clearing and settlement activities. Given the authority of financial regulators under existing regulatory regimes and the Council's authority under Sections 112 and 120 and Title VIII, the exercise of its authority under Section 113 should be reserved for those situations where an institution's interconnectedness and other risk factors render the other tools available under the Dodd-Frank Act and functional regulation insufficient.

Too Big to Fail List Will Increase Cost of Capital

The CCMC more fundamentally believes that designation of a single company for heightened supervision would be a detriment to all market participants. Designating nonbank financial companies for special prudential regulation will inevitably create a list of "too big to fail" institutions. Some companies will become safer bets than others and receive funding and other advantages, making it more difficult for others to remain competitive. This, in turn, could potentially spawn a new "moral hazard" and effectively recreate the problem of implicit government guarantees on a broader scale. Other companies may face increased funding costs as a result of designation, especially if the automatic application of provisions such as the Volcker Rule that were designed specifically for banks are applied to nonbank financial companies and force them to exit or materially modify core businesses.

Enhanced Supervision Stifles Innovation and Stunts Growth

In many cases, a financial institution's primary functional regulator already has

the appropriate tools to address systemically risky activities. With the Dodd-Frank Act requirement that investment advisors of private funds register and report to the U.S. Securities and Exchange Commission, nearly all financial institutions are already heavily regulated by one, and frequently many more, functional regulators. Thus, any additional supervision by the Federal Reserve may stifle the innovation and stunt the growth of these companies, constraining the lifeblood to a currently sluggish economy. The CCMC opposes any action that would have the effect of placing a government-imposed ceiling on the expansion of U.S. companies. By placing defined restrictions in terms of size and activities of U.S. businesses, the growth of domestic companies may be hampered, thereby decreasing America's global economic competitiveness.

Captive Finance

Captive finance organizations provide financing for the purchase of goods or services from an affiliate of a captive finance organization. This is an important method of financing that is used by manufacturers to help facilitate sales and production. While providing credit, captive finance organizations and their affiliates are not engaged in financial activities in the same manner or to the same extent as depository institutions or other financial services companies, and Congress addressed this issue from one perspective – namely, relative significance within an otherwise non-financial enterprise – during the consideration of the Dodd-Frank Act.

Section 102(a) (6) of the Dodd-Frank Act states:

"(6) PREDOMINANTLY ENGAGED.—A company is ''predominantly engaged in financial activities'' if—
(A) the annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, from the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated annual gross revenues of the company; or
(B) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated

assets of the company."

By requiring that a company derive 85% of its revenues from financial activities, or that 85% of its assets come from financial activities, in each instance on an enterprise-wide basis, Congress made clear that it did not intend for non-financial services companies engaged in entirely ancillary financial activities like captive finance to be subject to regulation as if they were systemically significant bank holding companies. Given the severe disruptive effects that uncertainty in this area could cause for captive finance companies and their manufacturing affiliates, Congress spoke very clearly in providing that a company, no matter its size, need not fear costly new regulation intended for the largest bank holding companies and similar businesses if the company is not predominantly financial. It is therefore incumbent on the Council to work with the Federal Reserve Board to clearly and narrowly define the revenue and especially the asset thresholds that will be considered "financial in nature" for these purposes. The asset test in particular creates uncertainty absent additional guidance. We believe that, in providing that guidance, the Federal Reserve Board's final rule on the topic should explicitly classify as non-financial assets or exclude from the calculation items such as cash and short-term high-quality investments that are available to meet an institution's short-term liquidity needs and customer or other non-proprietary assets that are required to be consolidated for GAAP purposes, but are not owned by the institution from an economic perspective. This certainty is critical for enterprises seeking to put capital towards hiring and research, rather than regulatory capital charges. Furthermore, in light of Congress's clear voice with respect to captive finance companies, the Council should make clear that it does not anticipate subjecting non-financial companies for enhanced supervision by the Federal Reserve where such companies are not engaged in any financial activities other than true captive finance activities.

Minimize Regulatory Burden for Designated Financial Institutions

All financial institutions, regardless of bank or nonbank status, are currently heavily regulated by one or more regulators. As such, financial institutions already face significant scrutiny and expend tremendous resources providing regulators with substantial information. Financial institutions that are designated for enhanced supervision by the Federal Reserve will likely face greater regulatory burdens and have to comply with additional requests for information that may have already been provided to its primary regulator. To the extent possible, members of the Council

should share information already in their possession with each other to minimize the additional costs incurred by and the burdens placed on those financial institutions designated for enhanced supervision.

Rulemaking is Premature

The CCMC continues to be very concerned that the Council is engaged in this rulemaking prematurely. For example, the Council is not yet properly constituted, and other critical elements of the systemic risk regime that should inform all of the Council's efforts have not yet been defined or established, let alone begun to operate. The Council is a collaborative body of different federal and state regulators charged with identifying and responding to emerging threats to the stability of the financial system. The current rulemaking is a part of the Council's responsibility. However, the Council still does not have a voting member with insurance experience who has been nominated by the President or confirmed by the Senate for a six-year term. The Director of the Consumer Financial Protection Bureau has also yet to be nominated by the President and confirmed by the Senate, leaving another void within the Council. Moreover, other advisory members, such as the Director of the Office of Financial Research or the Director of the Federal Insurance Office, have not been appointed either. Accordingly, the Council is not fully constituted as required under the Dodd-Frank Act, and it cannot take full advantage of a collaborative discussion of all stakeholders that can bring a more comprehensive understanding of the entire marketplace. Furthermore, the current narrow focus of the Council may skew the discussions and decisions of the Council, potentially harming the economy with unintended consequences.

In addition to key terms noted above that have not been defined, such as "financial stability" and "material financial distress," other critical rules have not yet been written, and key institutions have not yet been established. For example, the Federal Reserve Board has not yet promulgated the rule required under Section 170 of the Dodd-Frank Act that will expressly exempt certain types and classes of nonbanks from supervision by the Federal Reserve Board. The rulemaking under Section 170 is inextricably connected to the rulemaking under Section 113. They should be conducted simultaneously and with greater transparency and meaningful engagement with the public than has occurred to date with respect to the Proposal. Furthermore, the Office of Financial Research and Federal Insurance Office are in their nascent stages and still lack the capability to collect and analyze the data necessary to inform

the Council's decisions as Congress intended them to do. The absence of these critical elements of the systemic regulatory regime makes the Proposal premature.

Lack of Any Cost-Benefit Analysis

As discussed earlier, the costs of the uncertainty created by an opaque rule and rulemaking process are substantial and only add to the costs that will be imposed by designating a company. It seems logical therefore that great care should be taken to minimize them where possible and, in every case, to balance them against the purported benefits. Unfortunately, the Council does not appear to have done [any cost-benefit analysis in connection with the Proposal, let alone] the sort of thorough and transparent evaluation that should accompany a rulemaking such as this; nor has the Council indicated in the Proposal that it will conduct such an evaluation at any point during the designation process.

In fact, the Council only addresses costs in the Proposal when it asserts that a regulatory flexibility analysis is not required. Fundamentally, the Regulatory Flexibility Act, requires federal agencies to review regulations for their impact on small businesses and consider less burdensome alternatives. In order to satisfy that requirement, any rule such as this must be accompanied by an analysis of its impact on small businesses or the agency promulgating the rule must certify that there is none. Rather than conducting the analysis, the Council certifies in the Proposal that it "...does not expect the rule to directly affect a substantial number of small entities" and therefore, an analysis is not required.[3] This conclusion misses the point and ignores the public policy goals that underlie the regulatory Flexibility Act requirement.

By limiting its consideration to **direct** effects, the Council avoids the analysis and the real point, namely, that designation will not only directly increase costs for the designated firm, but will indirectly impose costs on its counterparties, customers and vendors – many of which are small businesses, and ultimately on the U.S. economy as a whole. By definition, the designation authority and the rule implementing it will impact the U.S. economy. Therefore, jobs – not only at the designated firms but also at these other entities – are at risk. As the U.S. economy emerges from a prolonged recession, it makes sound regulatory sense for the Council to conduct meaningful analysis of the likely direct and indirect costs of designation on designated firms, other

[3] Proposal, p. 24

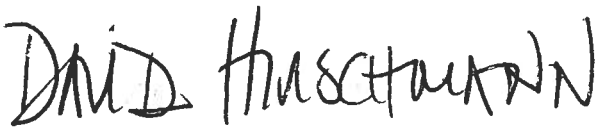
entities and customers, as well as the markets and the economy as whole, before issuing an opaque rule or placing a nonbank financial company under bank-like regulations and simply hoping for the best.

Conclusion

In conclusion, the CCMC supports the Council's efforts to monitor systemic risk and identify threats to the financial stability of the nation. However, we have serious concerns that flaws in the Proposal and the process surrounding it impose significant costs on nonbank financial companies, other stakeholders, and the U.S. economy, that over-designation of nonbank financial companies for regulation by the Federal Reserve will have severe unintended consequences, and that overregulation in the marketplace will stunt economic growth. Thus, we encourage the Council to correct the specified flaws before proceeding with this rulemaking process and ultimately to apply any heightened supervision designation sparingly to ensure ongoing diversity in the financial services industry where innovation and healthy competition continues to meet the needs of investors and consumers without limiting their choices. Only by addressing these issues and proceeding judiciously can the Council fulfill its mandate in a manner that promotes stability without unduly inhibiting growth and allows businesses to bring the U.S. economy back to vibrancy.

We thank you for your consideration and would be happy to discuss these issues with you or your staff.

Sincerely,



David T. Hirschmann
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