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Too Big for Administrative Law? FSOC Designations and the Fog of "Systemic Risk"

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Executive Summary

The Dodd-Frank Act empowers the Financial Stability Oversight Council to designate nonbank financial companies as systemically important, and thus subject them to enhanced prudential supervision and regulation by the Federal Reserve, if the FSOC finds that the company "could" pose a "threat" to U.S. financial stability.

Questions of systemic financial risk require profoundly difficult predictive judgments, based on hypothetical judgments and worst-case scenarios, as evidenced not just by the 2007–2008 financial crisis that precipitated the law, but also by the broader intellectual and philosophical questions raised by the specter of low-probability, high-impact events—or, as they're often called, "Black Swans."

This paper traces the evolution of that statutory and regulatory framework, beginning with the 2007–2008 financial crisis and requiring the FSOC to push the limits of arbitrary-and-capricious agency action—and, most likely, to exceed these limits.

I. Introduction

It can be difficult to guard against known threats. But it is exponentially more difficult to guard against *unknown* ones.[2] How can we

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[2] Defense Secretary Donald Rumsfeld captured the point colorfully in a 2002 press conference, when he distinguished between "known unknowns" and "unknown unknowns": "Reports that say that something hasn't happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that

draw lessons from yesterday's crises, in order to take action today that is necessary to protect us tomorrow?

For example: it is of course gross understatement to observe that al Qaeda's attacks on the United States in 2001 caught the nation entirely by surprise. As the 9/11 Commission observed in its formal report, "September 11, 2001, was a day of unprecedented shock and suffering . . . The nation was unprepared."[3] But three years later, the Commission further observed, "with the benefit and handicap of hindsight," one could see clearly the pre-9/11 warning signs.[4]

Quoting Roberta Wohlstetter's seminal Cold War analysis of the intelligence forewarning of Japan's attack on Pearl Harbor, the 9/11 Commission observed that it is "much easier *after* the event to sort the relevant from the irrelevant signals. After the event, of course, a signal is always crystal clear; we can now see what disaster it was signaling since the disaster has occurred. But *before* the event it is obscure and pregnant with conflicting meanings."[5] The challenge, then, is to establish a framework to maximize our ability to see the warning signs clearly next time—to separate the "signal" from the "noise"—*before* the next catastrophe strikes.[6]

One elected official had a particularly blunt post-9/11 plan for preventing another disaster. In November 2001, as the United States was still commencing its initial military, intelligence, and homeland-security responses to al Qaeda's attacks, Vice President Cheney argued that when the nation perceives even a small possibility of catastrophe, then the risk-weighted cost-benefit calculus necessarily calls for immediate action. "If there's a one percent chance that Pakistani scientists are helping al Qaeda build or develop a nuclear weapon, we have to treat it as a certainty in terms of our response."[7]

Seven years after the 9/11 Commission issued its report, another commission issued another report, on another crisis. Analyzing the financial meltdown of 2007–2008, the Financial Crisis Inquiry Commission surveyed

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tend to be the difficult ones." Donald Rumsfeld, Sec'y of Defense, Press Briefing (Feb. 12, 2002) *at* http://archive.defense.gov/Transcripts/Transcript.aspx?TranscriptID=2636.

[3] NAT'L COMM'N ON TERRORIST ATTACKS UPON THE UNITED STATES, THE 9/11 COMMISSION REPORT xv (2004).

[4] *Id.* at 339.

[5] *Id.* (quoting Roberta Wohlstetter, Pearl Harbor: Warning and Decision 387 (1962) (second emphasis added)).

[6] Wohlstetter, *supra*, at 3; *see also* NATE SILVER, THE SIGNAL AND THE NOISE (2014).

[7] *See* RON SUSKIND, ONE PERCENT DOCTRINE: DEEP INSIDE AMERICA'S PURSUIT OF ITS ENEMIES SINCE 9/11, at 62 (2006) (quoting Cheney); *see also* Cass R. Sunstein, *Beyond Cheyneyism and Snowdenism*, 83 U. Chi. L. Rev. 271, 280 (2016).

the events leading up to the crisis, and the evidence at hand before the crisis, and found:

> [K]ey policy makers—the Treasury Department, the Federal Reserve Board, and the Federal Reserve Bank of New York—who were best positioned to watch over our markets were ill prepared for the events of 2007 and 2008. Other agencies were also behind the curve. . . . Time and again, from the spring of 2007 on, policy makers and regulators were caught off guard as the contagion spread . . . We had allowed the system to race ahead of our ability to protect it.[8]

Congress and the President enacted the Dodd-Frank Act[9] specifically to improve the federal government's ability to anticipate catastrophic financial risks and to mitigate those risks preemptively, before crisis strikes again. The Act created the Financial Stability Oversight Council ("FSOC") "to monitor potential threats to the financial system, and provide for more stringent regulation of nonbank financial companies and financial activities that the Council determines, based on consideration of risk-related factors, pose risks to financial stability."[10] Once the FSOC identifies nonbank financial institutions capable of threatening the nation's financial stability, they would be "supervised" with "prudential standards" by the Federal Reserve.

In one sense, this new approach to financial regulation seemed well-precedented: the Federal Reserve would simply be taking a "prudential supervision" framework well known to banks, and extending it beyond banks to nonbank financial companies. But in another sense, this framework is truly unprecedented, for it empowers the FSOC to reach out and "grab" individual nonbank institutions for heightened regulatory treatment, based on one of the most challenging and controversial economic questions of our age: how to define "systemic risk" in our markets, and in turn to ascertain which companies truly meet that standard—but to do so under the well established standards of modern administrative law.

That latter question is the ultimate focus of this paper. While legal scholars, economists, and others continue to debate larger questions of "systemic risk" at length, there has been all too little discussion of how

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[8] NAT'L COMM'N ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, THE FINANCIAL CRISIS INQUIRY REPORT xxi (2011) (hereinafter "FCIC REPORT").

[9] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[10] House Report No. 517, 111th Cong., 2d Sess., at 865 (Conf. Rep.).

federal officials administer that standard under the rule of modern administrative law. This question recently took on much greater attention and urgency due to the MetLife litigation, in which an FSOC-designated insurance company convinced a federal district court to overturn the FSOC's determination.[11]

Dodd-Frank tasked the FSOC with seeing through the fog of systemic risk and answering immensely difficult predictive questions. But are those questions *too big* for administrative law?

II. Background: The Financial Crisis and Proposals for Reform

The financial crisis of 2007–2008 was "the worst financial meltdown since the Great Depression," according to the Financial Crisis Inquiry Commission.[12] It is at least the second most thoroughly studied meltdown: the Commission alone "reviewed millions of pages of documents and questioned hundreds of individuals—financial executives, business leaders, policy makers, regulators, community leaders, people from all walks of life—to find out how and why it happened."[13] And the Commission's investigation is just the tip of an iceberg's worth of investigations and analyses undertaken by Congress,[14] former government officials,[15] scholars,[16] investors, and journalists.[17] Comparing those myriad analyses to the conflicting viewpoints depicted in director Akira Kurosawa's 1950 film, *Rashomon*, M.I.T.'s Andrew W. Lo laboriously reviewed twenty-one books analyzing the financial crisis and concluded that "no single account of this vast and complicated calamity is sufficient to describe it. Even its starting date is unclear. . . . Only by

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11 MetLife, Inc. v. FSOC, 177 F. Supp. 3d 219 (D.D.C. 2016). The FSOC has appealed. MetLife, Inc. v. FSOC, No. 16-5086 (D.C. Cir. filed Apr. 20, 2016). The D.C. Circuit heard oral arguments on Oct. 24, 2016; the case is still pending.

12 FCIC REPORT at 3.

13 *Id.*

14 *See*, *e.g.*, U.S. Senate Perm. Subcomm. on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority & Minority Staff Report (Apr. 13, 2011).

15 *See*, *e.g.*, Ben S. Bernanke, *The Federal Reserve and the Financial Crisis* (2013); Henry M. Paulson, Jr. *On the Brink* (2010); Timothy F. Geithner, *Stress Test* (2014).

16 *See*, *e.g.*, John B. Taylor, *Getting Off Track* (2009); Alan Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* (2013); Peter J. Wallison, *Bad History,Worse Policy* (2013); Jeffrey Friedman, ed., *What Caused the Financial Crisis* (2011).

17 *See*, *e.g.*, Andrew Ross Sorkin, *Too Big to Fail* (2009); Bethany McLean & Joe Nocera, *All the Devils Are Here* (2010).

collecting a diverse and often mutually contradictory set of narratives can we eventually develop a more complete understanding of the crisis."[18]

And those competing narratives are certainly "diverse," as analysts ascribe the financial crisis's "cause" to everything from the recklessness of private mortgage lenders, to hyperactive securitization-and-distribution of mortgages,[19] to the repeal of Glass-Steagall and the increasing complexity and consolidation of federally insured commercial banking with other financial activities,[20] or even to ideologically driven housing finance policies.[21] Yet for all of that diversity as to root causes, analysts uniformly recognized that the financial crisis highlighted the need to better understand the role of "systemic risk" in modern financial markets and regulation.[22]

A. Recognizing a Crisis, in the Middle of the Crisis

If today we recognize the 2007–2008 financial crisis as one in which national financial stability truly was threatened, that fact was not clear to government officials at the outset. Indeed, in early 2007 the Federal Reserve Chairman emphatically downplayed concerns that the housing market's downturn might portend greater systemic threats. Testifying before the Joint Economic Committee in March 2007, Fed Chairman Bernanke reassured Congress that the problem could be "contained": "Although the turmoil in the subprime mortgage market has created severe financial problems for many individuals and families," he explained, "the implications of these developments for the housing market as a whole are less clear." True, he conceded, tighter lending standards would reduce demand for housing, and foreclosures would increase the supply of unsold home; but at "this juncture, however, the impact on the broader economy and financial markets of the

[18] Andrew W. Lo, *Reading About the Financial Crisis: A Twenty-One-Book Review*, 50 J. Econ. Lit. 151, 153–54 (2012); *see also* Mark Jickling, *Causes of the Financial Crisis*, Cong. Res. Serv. Report No. R40173 (2009) (collecting theories of the financial crisis's "cause").

[19] Bethany McLean & Joe Nocera, *All the Devils Are Here* (2010).

[20] Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (2010).

[21] Peter J. Wallison, *Bad History, Worse Policy* (2013).

[22] Even Peter Wallison, unrivaled in his willingness to take a stand at odds with conventional wisdom on the financial crisis, agreed that systemic financial risk is a significant issue—he just disagreed on the ramifications of that issue. *See id.* at 172 ("The systemic risk idea was not new. I and many others had argued that the failure of Fannie or Freddie would be a systemic even; given their centrality to the housing finance system, that seemed plausible to me, but it did not seem likely that the bankruptcy of a single large nonbank institution like Lehman would produce the same result.").

problems in the subprime market seems likely to be contained."[23] But, he added, "[w]e will continue to monitor this situation closely."[24]

Before long, however, Chairman Bernanke and others began to fundamentally reconsider this original diagnosis. By late 2008 he was pressing Sheila Bair, chairwoman of the Federal Deposit Insurance Corporation ("FDIC"), to recognize that the collapse of Washington Mutual could threaten significant harm to the broader financial system, justifying the FDIC's exercise of exceptional powers authorized by statute to avoid systemic harms.[25] While he failed to persuade her of systemic harm threatened by a "WaMu" collapse, he succeeded shortly thereafter in convincing her that the collapse of another bank, Wachovia, could have grave systemic harms justifying the FDIC's exercise of its exceptional statutory powers.[26] Years later, after Bernanke's term as Fed Chairman ended, he delivered a series of lectures on the financial crisis, in which he stressed the issue of systemic risk and the need for heightened regulation of nonbank financial companies that would otherwise slip through the cracks of federal oversight.[27]

But more importantly, Bernanke's own (belated) focus on the systemic-risk aspects of the financial crisis was shared by those most directly responsible for formulating the legislative response to the crisis: the Treasury Department and Congress. Indeed, this was a focus of the Treasury Department early in the crisis. In March 2008, Treasury's *Blueprint for a Modernized Financial Regulatory Structure* stressed that the federal government's myriad financial regulatory agencies, "segregated" across "functional lines of financial services," had grown "[l]argely incompatible with" modern markets.[28] Of all the problems that this regulatory structure entailed, "the *most significant*" problem was that "no single regulator possesses all of the information and authority necessary to monitor systemic risk," and "the inability of any regulator to take coordinate action throughout the financial system makes it more difficult to address problems related to financial market stability."[29]

This problem, Treasury argued, required the creation of new regulatory agency powers to protect markets against systemic risk. In

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[23] Testimony of Federal Reserve Chairman Ben S. Bernanke (Mar. 28, 2007), *at* https://www.federalreserve.gov/newsevents/testimony/bernanke20070328a.htm.

[24] *Id.*

[25] Ben S. Bernanke, *The Courage to Act* 323 (2015).

[26] *Id.* at 329.

[27] Ben S. Bernanke, *The Federal Reserve and the Financial Crisis* 119 (2013).

[28] U.S. Dep't of the Treas., *Blueprint for a Modernized Financial Regulatory Structure* 5 (Mar. 2008).

[29] *Id.* (emphasis added).

addition to urging that the pre-existing President's Working Group on Financial Markets be reinforced to "facilitate better inter-agency coordination" and to "mitigat[e] systemic risk to the financial system,"[30] the Treasury Department proposed that the Federal Reserve Board of Governors be given formal authority to "take corrective actions when necessary in the interest of overall financial market stability," a "new role" that "would replace its traditional role as a supervisor of certain banks and all bank holding companies."[31]

Yet even in proposing this new systemic-risk regulatory role for the Federal Reserve, Treasury conceded the practical limits of systemic-risk regulation: "In a dynamic market economy it is impossible to fully eliminate instability through regulation. At a fundamental level, the root causes of market instability are difficult to predict, and past history may be a poor predictor of future episodes of instability."[32] But vesting the Fed with "enhanced regulatory authority along with clear regulatory responsibilities would complement and attempt to focus market discipline to limit systemic risk."[33]

The Federal Reserve's leaders did not hesitate to join the call for greater systemic risk regulation. Bernanke's increasing focus on systemic risk in 2008 was not limited simply to the crisis at hand; in speeches he stressed the need to improve macroprudential systemic risk mitigation going forward. In an address at the Kansas City Fed's annual Jackson Hole summit, Chairman Bernanke stressed that although "effective government oversight of individual institutions increases financial resilience and reduces moral hazard by attempting the ensure that all financial firms with access to some sort of federal safety net . . . maintain adequate buffers of capital and liquidity and develop comprehensive approaches to risk and liquidity management," a firm-specific focus is ultimately insufficient. "Going forward, a critical question for regulators and supervisors is what their appropriate 'field of vision' should be." Rather than looking at "the financial conditions of individual firms in isolation," a systemwide or macroprudential approach to oversight "would broaden the mandate of regulators and supervisors to encompass consideration of potential systemic risks and weaknesses as

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[30] *Id.* at 6; *see also id.* at 75–77 (further explaining recommendation). The President's Working Group was established in 1988, by Executive Order 12631.

[31] *Id.* at 15.

[32] *Id.*

[33] *Id.* at 15; *see also id.* at 100–106, 139–140 (further explaining recommendation). Treasury noted previous agreement among the President's Working Group, the Federal Reserve Bank of New York, and the Office of the Comptroller of the Currency that "market discipline is the most effective tool to limit systemic risk." *Id.* at 15 n.2 (citing 2007 inter-agency agreement).

well."[34] Bernanke also acknowledged the need to look beyond just the banks already subject to oversight; there must be "at least periodic surveillance and information-gathering from a wide range of *nonbank* institutions."[35]

In August 2008, Bernanke was still reluctant to expressly endorse specific legislative reform; "[f]or the most part," he told Jackson Hole, "I will leave for another occasion the issues of broader structural and statutory change, such as those raised by the Treasury's blueprint for regulatory reform."[36] But six months later, Bernanke shed at least some of those inhibitions. In a March 2009 speech to the Council on Foreign Relations, he stressed the need for "a more explicitly macroprudential approach to financial regulation and supervision in the United States," and suggested that one means for achieving this approach would be "for the Congress to direct and empower a governmental authority to monitor, assess, and, if necessary, address potential systemic risks within the financial system." This new regulatory structure and approach would not be simplistic—it "would present a number of significant challenges." It would require the supervisory authority to develop "a great deal . . . of market and institutional knowledge, analytical sophistication, capacity to process large amounts of disparate information, and supervisory expertise." It would require the supervisory authority to work closely with the myriad other financial regulators in our "currently decentralized system of financial regulation." It would require vesting the supervisory authority with authority to actually implement policy by "tak[ing] measures to address systemic risks." And it would implicate not just systemically important banks, but also "systemically important *nonbank* financial firm[s]." For all of this, he stressed, responsibility would fall to Congress to carefully "defin[e] the role and responsibilities of the authority."[37]

Chairman Bernanke was joined in these calls by his colleague, the New York Federal Reserve Bank's president, Timothy Geithner. In a June 2008 speech, President Geithner applauded the Treasury Department's "Blueprint" for "outlin[ing] a sweeping consolidation and realignment of responsibilities," stimulating "a very constructive set of discussions," and helping to "lay the foundation for action when the dust [of the 2008 crisis] settles." While not expressly endorsing all of the Treasury Department's

[34] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, "Reducing Systemic Risk," Address at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, Wyoming (Aug. 22, 2008), *at* https://www.federalreserve.gov/newsevents/speech/bernanke20080822a.htm.

[35] *Id.* (emphasis added).

[36] *Id.*

[37] Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, "Financial Reform to Address Systemic Risk," Address at the Council on Foreign Relations, Washington, D.C. (Mar. 10, 2009) (emphasis added), *at* https://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.

proposals, Geithner did go further than Bernanke by arguing that "[t]he most fundamental reform that is necessary is for *all* institutions that play a central role in money and funding markets—including the major globally active banks and investment banks—to operate under a unified framework that provides a stronger form of consolidated supervision, with appropriate requirements for capital and liquidity." It could also ultimately require supervision of at least some "hedge funds or private equity firms," even if those types of firms might necessarily require supervisory tools different from those employed at banks. ("I do not believe it would be desirable or feasible to extend capital requirements to institutions such as hedge funds or private equity firms," Geithner noted.)[38]

Almost precisely a year after delivering that address, Geithner himself would have an opportunity to actually build out the framework he had envisioned. Having been appointed Treasury Secretary by President Obama,[39] Geithner's Treasury Department released a "blueprint" of its own in June 2009, titled "A New Foundation: Rebuilding Financial Supervision and Regulation."[40] While its contents ranged widely—from consumer financial protection to international regulatory cooperation—the New Foundation echoed and expanded on the basic points that Geithner had advanced in 2008, by proposing to create a new systemic risk regulator, the "Financial Services Oversight Council."

Looking back to the events precipitating the 2007–2008 crisis, Treasury found that, "on a systemic basis, regulators did not take into account the harm that large, interconnected, and highly leveraged institutions could inflict on the financial system and on the economy if they failed." And looking beyond bank holding companies, it further lamented that "investment banks operated with insufficient government oversight," "[m]oney market mutual funds were vulnerable to runs," and "[h]edge funds and other private pools of capital operated completely outside of the supervisory framework."[41]

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38 Timothy F. Geithner, President and C.E.O. of the Federal Reserve Bank of New York, "Reducing Systemic Risk in a Dynamic Financial System," Address to the Economic Club of New York, New York City (June 9, 2008), *at* https://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html.

39 And having received a major vote of confidence from the President, when Obama announced, barely a week after the Inauguration, that "[s]oon my Treasury Secretary, Tim Geithner, will announce a new strategy for reviving our financial system." *See* President Barack Obama, Address of the President to the Nation (Jan. 31, 2009), *at* https://www.whitehouse.gov/blog/2009/01/31/moving-forward.

40 U.S. Dep't of the Treas., *A New Foundation: Rebuilding Financial Supervision and Regulation* (June 2009), *at* https://www.treasury.gov/press-center/press-releases/Pages/20096171052487309.aspx.

41 *Id.* at 19.

To remedy those perceived shortcomings, Treasury proposed the creation of a "Financial Services Oversight Council," chaired by the Treasury Secretary but also including "the heads of the principal federal financial regulators."[42] The Council's job would be "to help fill gaps in supervision, facilitate coordination of policy and resolution of disputes, and identify emerging risks in firms and market activities."[43]

Specifically, Treasury proposed that the Council would be empowered to "recommend" that the Federal Reserve designate particular financial firms—including not just bank holding companies but also non-banks—as "Tier 1 Financial Holding Companies" (or "Tier 1 FHCs"), if the Fed were to conclude that the firm "could pose a threat to financial stability if it failed." Tier 1 FHC status would in turn subject such companies to new or stricter prudential supervision by the Federal Reserve.[44]

Singling out AIG as an example of a non-bank firm that had contributed to the financial crisis,[45] Treasury suggested that insurance companies would be among the firms that might be subject to this new framework of prudential supervision,[46] as would investment banks (which had "operated with insufficient government oversight"), money market funds (which "were vulnerable to runs"), and hedge funds and "other private pools of capital" (which had "operated completely outside of the supervisory framework").[47]

But in addition to proposing this legal framework, the Treasury's "New Foundation" took one further step. Unlike Treasury's previous "Blueprint," or Bernanke's and Geithner's aforementioned speeches, Treasury's "New Foundation" actually attempted to name substantive criteria to be used by the Federal Reserve to ascertain whether a financial company could, in fact, pose a threat to financial stability.

"Those factors," Treasury explained, "would include":

- "the impact the firm's failure would have on the financial system and the economy";

42 *Id.*; *see also id.* at 20 (naming member agencies).

43 *Id.* at 19.

44 *Id.* at 21–22.

45 *Id.* at 21.

46 *Id.* at 40.

47 *Id.* at 19. Treasury's mention of hedge funds in this context seemed, at least, to be in tension with Geithner's 2008 speech on systemic risk regulation, where he had expressly noted that he did not think it would be desirable or feasible to extend capital requirements to hedge funds or private equity firms. *See supra* note 38 and accompanying text.

- "the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding"; and

- "the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system."[48]

Still, Treasury stressed, those factors would not be the *only* factors that the Federal Reserve might elect to rely upon in evaluating a given firm's systemic status. In defining standards for identifying Tier 1 FHCs, the Federal Reserve "should be allowed to consider *other* relevant factors and *exercise discretion* in applying the specified factors to individual financial firms," in order to "allow the regulatory system to adapt to inevitable innovations in financial activity, and in the organizational structure of financial firms."[49]

B. The Dodd-Frank Act's Financial Stability Oversight Council

The Treasury Department's recommendations became part of the foundation for Congress's legislative process, and much of it was ultimately reflected in Dodd-Frank's Title I, which created the Financial Stability Oversight Council ("FSOC").[50] Some details of the systemic-risk regulatory proposal fared better than others, however. For example: from the beginning, the bill's co-sponsor and others expressed great skepticism toward committing this new systemic-risk regulatory authority to the Federal Reserve. "I share my colleagues' concerns about giving the Fed additional authority to regulate systemic risk," Senator Chris Dodd stressed in his opening remarks at one hearing on systemic risk regulation.[51] "The Fed has not done a perfect job, to put it mildly, with the responsibilities it already has. This new authority could compromise the independence the Fed needs to carry out effective monetary policy."[52] And, he added, "systemic risk regulation involves too broad of a range of issues, in my view, for any one

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48 *Id.* at 23.

49 *Id.* (emphasis added).

50 But it was, to be sure, only one part of that foundation. Senator Dodd circulated a "discussion draft" of comprehensive financial regulatory reform legislation, which proposed the creation of an "Agency for Financial Stability." *See* Sen. Dodd, "Restoring Financial Stability Act of 2009" (discussion draft), *available at* http://www.llsdc.org/assets/DoddFrankdocs/bill-111th-s3217-discussion-draft.pdf.

51 *Establishing a Framework for Systemic Risk Regulation*, U.S. Senate Committee on Banking, Housing, and Urban Affairs, S. Hrg. 111-297, at 3 (July 23, 2009) (Stmt. of Sen. Dodd), *at* https://www.gpo.gov/fdsys/pkg/CHRG-111shrg55278/pdf/CHRG-111shrg55278.pdf.

52 *Id.*

regulator to be able to oversee."[53] He and others welcomed recommendations to place this regulatory authority not in the Federal Reserve but rather in "a council with real authority that would effectively use the combined knowledge of all of the regulatory agencies."[54]

But in proposing these reforms, Congress debated whether "systemic risk" could even be defined with meaningful specificity, so that theoretical definitions might actually be translated into a workable regulatory reality.

The bill's sponsor, Senator Dodd, acknowledged that the very term "systemic risk" was "a new term in our national vocabulary," one that he himself could not recall previously using.[55] He attempted to describe it in the most general of terms: "It is the idea that in an interconnected global economy, it is easy for some people's problems to become everybody's problems, and that is what systemic risk is."[56]

Even senators who favored the establishment of a systemic risk regulator seemed less than convinced, expressing concerns about how precisely to define "systemic risk" itself. Senator Mark Warner noted in a floor speech that "systemic risk" is "a term that, quite candidly, probably most of us even around the financial markets had not even heard of or thought very much about until the last couple years."[57] He continued:

> Systemic risk is a tricky concept. Systemic risk is not a specific kind of risk at all. It is a catchall phrase that includes risks of all kinds, united only by the possibility that if left uncontrolled, they could have consequences for entire markets or even our entire financial system. Counterparty exposures can present systemic risk. So can interest rate shifts. So can bad laws and regulations. Because they come in all shapes and sizes, we should not expect to control systemic risks with a rigid, one-size-fits-all approach.[58]

Sen. Warner still firmly endorsed the proposed systemic-regulator structure, but he took care to "acknowledge at the outset that there are many details that still need to be worked out."[59]

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[53] *Id.*
[54] *Id.*
[55] *Id.* at 2.
[56] *Id.*
[57] 155 Cong. Rec. S6636 (June 16, 2009) (Sen. Warner).
[58] *Id.*
[59] *Id.* at S6637.

But others challenged their colleagues' failure to grapple more specifically with what "systemic risk" ought to entail. Senator Richard Shelby, the ranking member on Sen. Dodd's Senate Banking Committee, put such concerns bluntly:

> At the core of the Administration's financial regulatory reform proposal is the concept of systemic risk. The President believes that it can be regulated and that the Fed should be the regulator. But as we begin to consider how to address systemic risk, my main concern is that while there appears to be a growing consensus on the need for a systemic risk regulator, there is no agreement on how to define systemic risk, let alone how to manage it.
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> I believe that it would be legislative malfeasance to simply tell a particular regulator to manage all financial risk without having reached some consensus on what systemic risk is and whether it can be regulated at all.

This dynamic characterized the debate as a whole. Proponents of the creation of a systemic-risk regulatory council acknowledged that "systemic risk" was a very general term, one that would need to be further developed by the regulators themselves.[60] Critics argued that "systemic risk" was simply too indeterminate to meaningfully guide and limit the regulators' discretion in the first place.

III. The Financial Stability Oversight Council: on Paper, and in Practice

Yet Congress ultimately concluded that that the Council would not need specific legislative direction as to the definition of "systemic risk." In the Dodd-Frank Act, Congress established the Financial Stability Oversight Council in terms of structure and procedure, but it stopped short of defining the "systemic risk" inquiry; rather, it gave the FSOC effectively open-ended statutory discretion to define the systemic-risk inquiry on a case-by-case basis. And the FSOC has not hesitated to make maximum use of its statutory discretion in designating nonbank financial institutions as systemically

60 SEC Chairwoman Schapiro, for example, urged Senators to create the proposed systemic-risk regulatory council, despite the absence of a generally accepted, specific definition of "systemic risk": "[W]e can come up with a definition of systemically important. It is an institution whose failure puts at risk other institutions or the financial system as a whole. But I do not think it tells us very much because it is, in fact, so general. So I think a council will actually have the ability, and it will have to be an incredibly dynamic process[.]" *Establishing a Framework for Systemic Risk Regulation*, U.S. Senate Committee on Banking, Housing, and Urban Affairs, S. Hrg. 111-297, at 38 (July 23, 2009), *at* https://www.gpo.gov/fdsys/pkg/CHRG-111shrg55278/pdf/CHRG-111shrg55278.pdf.

important, in a set of decisions that has given rise, in one case, to federal litigation.

A. Congress Establishes the FSOC

Congress enacted its systemic-risk regulatory framework in the Dodd-Frank's Title I.[61] Consistent with the post-crisis skepticism of the Federal Reserve voiced by various legislators and hearing witnesses, Congress made Treasury the dominant voice in this new systemic-risk regulatory framework, although the Federal Reserve plays the lead role in overseeing firms that have been designated as systemically important.

The Act established the FSOC as a fifteen-member body, chaired by the Treasury Secretary. Nine of its ten voting members are the heads or chairs of major financial regulatory agencies: the Treasury Secretary, Federal Reserve Chairman, Comptroller of the Currency, Consumer Financial Protection Bureau Director, SEC Chairman, CFTC Chairman, Federal Housing Finance Agency Director, and National Credit Union Administration Board Chairman. The FSOC's tenth voting member is "an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise,"[62] who serves a six-year term.[63]

In addition to the ten voting members, the FSOC has five nonvoting members: the Director of the newly created Office of Financial Research; the Director of the Federal Insurance Office; "a State insurance commissioner, to be designated by a selection process determined by the State insurance commissioners"; "a State banking supervisor, to be designated by a process determined by the State banking supervisors"; and "a State securities commissioner (or an officer performing like functions), to be designated by a selection process determined by such State securities commissioners."[64] These nonvoting members are statutorily entitled to attend any "proceedings, meetings, discussions, or deliberations of the Council," except where the Treasury Secretary and majority of voting members deem it "necessary to safeguard and promote the free exchange of confidential supervisory information."[65]

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[61] 12 U.S.C. §§ 5311 *et seq.*; *see also* H.R. Rep No. 111-517, at 865 (2010) (Conf. Rep.) ("Title I, which establishes a specific framework for ensuring financial stability, consists of three subtitles. Subtitle A establishes a Financial Stability Oversight Council to monitor potential threats to the financial system and provide for more stringent regulation of nonbank financial companies and financial activities that the Council determines, based on consideration of risk-related factors, pose risks to financial stability.").

[62] 12 U.S.C. § 5321(b)(1).

[63] *Id.* § 5321(c)(1).

[64] *Id.* § 5321(b)(2).

[65] *Id.* § 5321(b)(3).

The Council is given a wide range of responsibilities, from "monitor[ing] the financial services marketplace in order to identify potential threats to the financial stability of the United States," to "identify[ing] gaps in regulation that could pose risks to the financial stability of the United States," to simply "provid[ing] a form for . . . discussion and analysis of emerging market developments and financial regulatory issues."[66]

But the FSOC's primary role and responsibility is the identification and designation of certain nonbank financial companies as systemically important, a designation that subjects those firms to enhanced prudential supervision by the Federal Reserve. For U.S. bank holding companies, by contrast, Congress *itself* set the criterion for identifying such banks as systemically important and thus subject to heightened prudential supervision: a simple $50 billion threshold.[67] But for *nonbank* financial companies,[68] Congress tasked the FSOC with making such determinations on a case-by-case basis.

Specifically, the Act authorizes the FSOC to decide to subject individual nonbank financial companies to prudential supervision by the Federal Reserve—a determination commonly described as a designation that the financial institution is "systemically important," or a "SIFI"[69]—if one of two standards is met: if a two-thirds supermajority of the Council's ten voting members "determines [1] that material financial distress at the U.S. nonbank financial company, or [2] the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States," then the nonbank financial company will be designated a SIFI and subjected to the Fed's prudential oversight.[70]

On its own terms, then, the Act sets a seemingly low bar for SIFI designations: the FSOC must only determine that the company "*could*" pose a threat to financial stability.[71] The Act further provides a nonexhaustive list of qualities for the FSOC to "consider" in making its determination, including the company's "leverage," its "off-balance-sheet exposures," and its

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66 *See id.* § 5322(a)(2).

67 *Id.* §§ 5325(a)(1), 5365(a)(1); *see also id.* § 5327 (maintaining coverage of bank holding companies that fall back under the $50 billion threshold); *but see id.* § 5325(a)(2)(B) (authorizing FSOC to recommend higher quantitative thresholds for the Federal Reserve's application of certain prudential standards).

68 A "nonbank financial company" is a U.S. company (with certain exceptions) that is "predominantly engaged in financial activities." *Id.* § 5311(a)(4)(B). And, in turn, a company is "predominantly engaged in financial activities" if 85 percent of its annual gross revenues, or 85 percent of its consolidated assets, are "financial in nature." *Id.* § 5311(a)(6).

69 *See*, *e.g.* DAVID SKEEL, THE NEW FINANCIAL DEAL 6, 79, 80 (2011)

70 12 U.S.C. § 5323(a)(1).

71 *Id.* § 5323(a)(1).

"importance . . . as a source of credit."[72] Another of these ten considerations simply parrots one of the two aforementioned standards for a SIFI determination: "the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company."[73] And the tenth authorizes the FSOC to consider "*any other* risk-related factors that the Council deems appropriate."[74]

Once designated as systemically important by the FSOC pursuant to this process, the nonbank systemic financial institution will register with the Federal Reserve,[75] and the Fed will subject the company to "enhanced supervision and prudential standards."[76]

Consistent with Congress's repeated (and aforementioned) acknowledgments that regulators needed deeper and broader understanding of modern markets and systemic risk, the Dodd-Frank Act also established within the Treasury Department an Office of Financial Research ("OFR")[77] to support the FSOC and its member agencies by collecting data, undertaking research, and developing risk-measurement tools.[78] The Dodd-Frank Act created the OFR to serve as the FSOC's primary source of data and research,

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[72] *See id.* § 5323(a)(2)(A)–(K). The full list of ten considerations (with slightly modified formatting) is: "**(A)** the extent of the leverage of the company; **(B)** the extent and nature of the off-balance-sheet exposures of the company; **(C)** the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; **(D)** 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 United States financial system; **(E)** 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; **(F)** 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; **(G)** the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; **(H)** the degree to which the company is already regulated by 1 or more primary financial regulatory agencies; **(I)** the amount and nature of the financial assets of the company; **(J)** the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and **(K)** any other risk-related factors that the Council deems appropriate."

[73] *Id.* § 5323(a)(2)(G).

[74] *Id.* § 5323(a)(2)(K) (emphasis added).

[75] *Id.* § 5324.

[76] *Id.* § 5365 (empowering the Federal Reserve Board of Governors to establish prudential standards for FSOC-designated nonbank SIFIs); *id.* § 5325 (empowering the FSOC to recommend prudential standards for the Fed to apply); *see also id.* §5331 (empowering the Federal Reserve Board of Governors, upon a two-thirds vote by the FSOC, to set even stricter limits on FSOC-designated nonbank SIFIs if the company "poses a grave threat to the financial stability of the United States").

[77] *Id.* § 5342(a). The OFR is funded by the "Financial Research Fund," a separate fund within the Treasury, permanently funded not by appropriations but by fees levied upon certain bank holding companies and FSOC-designated nonbank institutions. *Id.* § 5345. Moreover, the OFR also funds the FSOC's own operations. *Id.* § 5328.

[78] *Id.* § 5343.

and even allows the OFR to demand information from bank holding companies and nonbank financial companies at the FSOC's direction, although the FSOC can invite the Federal Reserve Board to undertake research on specific firms if the OFR's own data and research proves an insufficient basis for the FSOC's determinations.[79] The OFR's researchers already have examined a wide array of subjects, ranging from "A Survey of Systemic Risk Analytics,"[80] to (controversially) "Asset Management and Financial Stability"[81] to even "Stopping Contagion with Bailouts: Microevidence from Pennsylvania Bank Networks During the Panic of 1884."[82]

B. The FSOC Further Elaborates Standards for Nonbank SIFI Designations

As noted above, Congress set a specific quantitative threshold ($50 billion) at which bank holding companies would be subjected to heightened prudential supervision by the Federal Reserve in order to limit their possible threat to systemic financial stability. For *nonbank* financial companies, by contrast, Congress did not attempt to set the criterion or criteria for such systemic-risk designations; instead, it listed a number of factors and considerations for the FSOC to consider—while also freeing the FSOC to base its decision on "any other risk-related factors that the Council deems appropriate."[83]

Thus, in the absence of Congress's specific judgment, the FSOC noted shortly after Dodd-Frank's enactment that the FSOC itself would need to take the initiative to "develop the specific criteria and analytical framework by which it [would] designate nonbank financial companies for enhanced supervision."[84] Its final rule and guidance, however, did more than simply add a margin of substantive and procedural content to the basic statutory framework; rather, it *significantly reconstituted* the statutory framework, attempting to sketch out theories of systemic risk.[85]

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79 *Id.* § 5322(d).

80 https://www.financialresearch.gov/working-papers/files/OFRwp0001_BisiasFloodLoValavanis_ASurveyOfSystemicRiskAnalytics.pdf

81 https://www.financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf; *see also*, *e.g.*, Emily Stephenson & Sarah N. Lynch, "U.S. senators slam study on systemic risks posed by asset managers," *Reuters* (Jan. 24, 2014).

82 https://www.financialresearch.gov/working-papers/files/OFRwp-2016-03_Stopping_Contagion_in_the_1884_Panic.pdf.

83 *Id.* § 5323(a)(2).

84 75 Fed. Reg. 61653, 61653 (Oct. 6, 2010) (Advanced NPRM); *see also* 76 Fed. Reg. 4555 (Jan. 26, 2011) (First NPRM); 76 Fed. Reg. 64264 (Oct. 18, 2011) (Second NPRM and Proposed Interpretive Guidance).

85 77 Fed. Reg. 21637 (Apr. 11, 2012) (Final Rule and Interpretive Guidance).

With respect to the latter point—a theory of how individual companies might someday pose a threat to systemic financial stability—the FSOC hypothesized three "channels" that "the Council believes are most likely to facilitate the transmission of the negative effects of a nonbank financial company's material financial distress or activities to other firms and markets[.]"[86] The FSOC effectively took Dodd-Frank's two-pronged inquiry and fused it to a new three-pronged inquiry: regardless of whether the FSOC is investigating the possibility that the nonbank financial company could be a threat to financial stability due to the possible impacts of the company's "material financial distress," or due to the possible impacts of the company's nature, scope, size, and other characteristics, the FSOC stated that its evaluation of those two bases for a SIFI determination would focus on three "channels" of systemic risk:

Its first channel is "*exposure*"—*i.e.*, the extent to which other market participants are exposed to impacts from the nonbank financial company's actions. The second channel is "*asset liquidation*"—*i.e.*, the extent to which the nonbank financial company's liquidation of assets might "cause a fall in asset prices" sufficient to "disrupt trading or funding in key markets or cause significant losses or funding problems" for other parties. And the third channel is "*critical function or service*"—*i.e.*, the extent to which the nonbank financial company provides a critical market function or service for which there are no ready substitutes.[87] But in identifying these three channels for systemic risk, the FSOC conceded that "it is not possible to provide broadly applicable metrics defining these channels or to identify universally applicable links between the channels and the statutory considerations,"[88] and it stressed that it "intends to continue to evaluate additional transmission channels and may, at its discretion, consider other channels" through which systemic financial stability could be threatened.[89]

Having decided to apply Dodd-Frank's two categories of SIFI designations—"material financial distress" and "nature/scope/size"—through this new framework of three systemic-risk "channels, the FSOC next revisited the nonexhaustive list of ten statutory considerations that Dodd-Frank had directed it to apply in determining that a nonbank financial company qualifies as systemically important.[90] While insisting that FSOC still intends to "consider each of the statutory considerations,"[91] the guidance took "all relevant factors, including the 10 statutory considerations and any additional risk-related factors," and subsumed them within a different set of

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86 *Id.* at 21641.
87 *Id.* at 21657.
88 *Id.* at 21641.
89 *Id.* at 21657.
90 *See supra* note 72 (listing the ten statutory considerations).
91 *Id.* at 21657.

six "categories": *size*; *substitutability*; *interconnectedness*; *leverage*; *liquidity risk and maturity mismatch*; and *existing regulatory scrutiny* of the nonbank financial company.[92]

The FSOC went so far as to supplement the guidance with a table that mapped each of Dodd-Frank's ten statutory considerations on to one or more of the FSOC's new analytical "categories." For example, where Dodd-Frank requires the FSOC to 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,"[93] the FSOC's guidance suggests that that consideration will be incorporated into the Council's "size," "interconnectedness," "substitutability" categories of analysis.[94]

While the FSOC suggested that its final rule and guidance would help to "offer[] greater transparency, consistency, and ease of application for the Council,"[95] its caveats and disclaimers helped to highlight the fact that the Council's systemic-risk inquiry would often reduce to a know-it-when-I-see-it approach.[96] The FSOC expected to "engage in a flexible, company-specific analysis that will reflect the unique risks posed by each nonbank financial company."[97]

To that end, for example, the FSOC warned that even its own procedural framework would not be written in stone. While its Final Rule established a basic three-stage procedural framework for reviewing prospective nonbank SIFIs—wherein a company would face increasingly greater scrutiny as it passes from Stage 1 to Stage 2 and finally Stage 3—the FSOC might depart from that procedure in any given case if the FSOC felt that extraordinary review of a particular company was appropriate. "In all instances, the Council reserves the right, at its discretion, to subject any nonbank financial company to further review if the Council believes that further analysis of the company is warranted to determine if the company could pose a threat to U.S. financial stability, irrespective of whether such company meets the thresholds in Stage 1."[98] In short, the FSOC recognized

92 *Id.* at 21658.

93 12 U.S.C. § 5323(a)(2)(F).

94 77 Fed. Reg. at 21658.

95 *Id.* at 21642.

96 Cf. *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) ("I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it[.]"),

97 77 Fed. Reg. at 21642

98 *Id*. Indeed, the FSOC has continued to supplement the Final Rule's procedures with additional guidance documents. FSOC, *Supplemental Procedures Relating to Nonbank Financial Company Determinations* (Feb. 4, 2015); FSOC, *Staff Guidance: Methodologies Relating to Stage 1 Thresholds* (June 8, 2015).

that systemic-risk inquiries would necessarily require a much more free-ranging *ad hoc* approach, precisely because it is difficult to know *ex ante* precisely what a threat to systemic financial stability might look like.

C. From Theory to Action: the FSOC Designates Four Nonbank Financial Companies as Systemically Important

It would not take long for the FSOC to move from theory to action, exercising its Dodd-Frank powers to investigate and designate nonbank financial companies as potential threats to systemic financial stability. It would make its first SIFI designations within fifteen months of publishing its final rule and guidance, and two more within the next fifteen months.

But those decisions—especially the latter two—confirmed the FSOC's warning, in its final rule and guidance, that the systemic-risk inquiry would not easily be undertaken pursuant to rules and standards prescribed *ex ante*. Instead, the FSOC increasingly relied on an *ad hoc* approach, and its view of systemic financial stability grew increasingly divisive among its members.

To describe the FSOC's approach as "*ad hoc*" is not intended to disparage the agency. Rather, the FSOC's experience in designating its first four nonbank SIFIs exemplifies the profound challenge inherent in attempting to regulate in service of preventing systemic financial collapse, for which the central consideration is not a market's recent fluctuations, let alone the market's ordinary operation, but rather a future crisis that exceeds the bounds of the market's experience, and thus its imagination.

1. *American International Group, Inc. ("AIG")*

The FSOC's first SIFI designation surprised no one. The American International Group, Inc. ("AIG"), a company whose complex operations began with insurance, had played a central role in the financial crisis, having made enormous bets on the continued inflation of the housing market by selling "credit default swaps" that exposed AIG to massive losses once the housing market began to collapse. As the Financial Crisis Inquiry Commission later concluded, "AIG failed and was rescued by the government primarily because its enormous sales of credit default swaps were made without putting up initial collateral, setting aside capital reserves, or hedging its exposure—a profound failure in corporate governance, particularly its risk management practices."[99] And AIG's financial losses became a threat to the entire financial system, the Commission concluded, because those losses would ultimately be felt by AIG's myriad counterparties. "The government

99 FINANCIAL CRISIS INQUIRY REPORT at 352.

concluded that AIG was too big to fail and committed more than $180 billion to its rescue."[100]

Had the government not bailed it out, the Commission asserted, "AIG's default and collapse could have brought down its counterparties, causing cascading losses and collapses throughout the financial system."[101] While the Commission's conclusions were aided by hindsight, they certainly had been shared by many government officials during the crisis. According to *Too Big to Fail*, a prominent account of the crisis, in 2008 Treasury Secretary 7Paulson and Fed Chairman Bernanke "both knew" that "AIG had effectively become a linchpin of the global financial system," as did New York Federal Reserve Bank President Timothy Geithner.[102] When the government extended a $180 billion in loans to AIG, it did so under the firm belief that, in one Treasury official's words, "the global economy was on the brink of collapse and there were only hours in which to make critical decisions."[103]

Given that history, the FSOC surprised no one in July 2013 when it designated AIG for prudential supervision as a nonbank SIFI, concluding that "material financial distress" at AIG "could pose a threat to the financial stability of the United States."[104] *First*, with respect to the "exposure" channel, the FSOC found that a "large number of corporate and financial entities have significant exposures to AIG, in its capacity as a leading multi-line insurer,"[105] and thus could suffer collateral damage if AIG were to suffer material distress—damage that "potential[ly]" could "transmit material financial distress to the broader economy" through other market actors' "direct and indirect capital markets exposures" to AIG.[106] *Second*, with respect to the "asset liquidation channel," the FSOC found that although AIG's obligations to pay claims and benefits are generally seen as long-term liabilities, many of them could quickly become short-term liabilities—and if that were to occur, AIG might need to liquidate significant assets to make the payments, thus depressing the market for those assets.[107] And *third*, with respect to the "critical function or service channel," AIG predominant role as an insurer of "the largest U.S. corporations, including 98 percent of the Fortune 500," raised concerns that AIG's sudden departure from the market

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[100] *Id.*
[101] *Id.*
[102] TOO BIG TO FAIL at 394.
[103] FINANCIAL CRISIS INQUIRY REPORT at 350 & n.53 (quoting Treasury spokesman Andrew Williams in 2010).
[104] FSOC's AIG Determination, at 4.
[105] *Id.* at 6.
[106] *Id.* at 7.
[107] *Id.* at 7–8.

would injure the myriad companies that would lack a substitute for AIG's services.[108]

Only after concluding that analysis, as well as its analysis of the lack of "existing supervision and regulation" that could mitigate the identified risks,[109] did the FSOC expressly consider the statutory considerations specified by Dodd-Frank,[110] in short, one-paragraph descriptions of "the extent of AIG's leverage," "the extent and nature of AIG's off-balance-sheet exposures," and the other statutory criteria.[111]

AIG accepted the FSOC's determination. After receiving the FSOC's initial determination a month earlier, it declined to exercise its right to contest the determination in an administrative hearing.[112] Nor would it exercise its statutory right to judicial review.[113]

2. *General Electric Capital Corporation, Inc. ("GE Capital")*

The FSOC issued its AIG decision on the same day that it issued a similar decision for General Electric Capital Corporation, Inc. ("GE Capital"). As it did with AIG, the FSOC analyzed GE Capital in terms of the possibility that material financial distress at the company could pose a threat to financial stability.[114] Focusing on the sheer magnitude of GE Capital's financial holdings—"one of the largest holding companies in the United States by assets . . . a large portfolio of on-balance sheet assets comparable to those of the largest U.S. bank holding companies"[115]—the FSOC found that distress at GE Capital could cause significant collateral damage.

In the "exposure channel," other large financial institutions' exposure to GE Capital "could serve as a mechanism by which material financial distress at [GE Capital] could be transmitted to those firms and to financial markets more broadly";[116] moreover, if GE Capital were to suffer material distress, investors in other companies might fear that those companies have exposure to GE Capital, causing the investors to run from their own investments.[117] Similarly, in the "asset liquidation channel," if GE Capital needed to liquidate its massive asset holdings, a fire sale could depress

108 *Id.* at 8.
109 *Id.* at 9–10.
110 *See* 12 U.S.C. § 5323(a)(2)(A)–(K), *supra* note 72.
111 FSOC's AIG Determination at 11–14.
112 *Id.* at 1; *see* 12 U.S.C. § 5323(e).
113 *Id.* § 5323(h).
114 FSOC's GE Capital Determination at 1.
115 *Id.* at 2.
116 *Id.* at 6.
117 *Id.* at 7.

market prices.[118] Finally, in the "critical function or service" channel, the FSOC found that the "breadth of [GE Capital's] role in providing credit" raised concerns that GE Capital's exit from markets might be mitigated by the entry of other similar companies, leaving GE Capital's customers without ready substitutes.[119]

As with its AIG determination, the FSOC's GE Capital determination further found GE Capital's existing supervision and regulation to be insufficient protection against these systemic risks.[120] And the FSOC concluded its analysis with a brief recitation of Dodd-Frank's statutory considerations.[121]

Like AIG, GE Capital accepted the FSOC's determination. After receiving the FSOC's initial determination a month earlier, it declined to exercise its right to contest the determination in an administrative hearing.[122] Nor would it exercise its statutory right to judicial review.[123]

3. ***Prudential Financial, Inc.***

The FSOC's first two designations—AIG and GE Capital—were relatively uncontroversial, both among the FSOC's members and outside the FSOC; indeed, neither AIG nor GE Capital challenged their own designations. But the FSOC's next designation, in September 2013, broke the unanimity.

Prudential Financial, Inc. was, according to the FSOC, "one of the largest financial services companies in the United States."[124] But unlike AIG and GE Capital, Prudential specialized primarily in more traditional forms of insurance and other financial services: "group and individual life insurance, annuities, retirement-related products and services, and asset management."[125] Observing that Prudential is one of "the largest U.S. insurance companies,"[126] and as manager of "a significant amount of off-balance sheet, third-party assets,"[127] the FSOC found that Prudential could

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[118] *Id.* at 7–8.

[119] *Id.* at 8–9.

[120] *Id.* at 9–10.

[121] *Id.* at 11–14.

[122] *Id.* at 1; *see* 12 U.S.C. § 5323(e).

[123] *Id.* § 5323(h). Three years after the FSOC designated GE Capital as a nonbank SIFI, the FSOC rescinded that designation in light of GE Capital's divestiture of many of the business lines that had given rise to its SIFI designation in the first place. FSOC, *Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding GE Capital Global Holdings, LLC* (June 28, 2016).

[124] FSOC's Prudential Determination at 2.

[125] *Id.*

[126] *Id.*

[127] *Id.*

pose a threat to financial stability if the company were to suffer material financial distress.[128]

With respect to the "exposure channel," the FSOC found that market participants faced significant exposure to Prudential due to the fact that many of Prudential's activities—its retirement and pension products, its life and other group insurance products, its derivatives portfolio, and its long-term debt—present "a high degree of interconnectedness" with counterparties and other beneficiaries.[129] Even if individual companies' exposures to Prudential are small and the companies might mitigate their losses, the FSOC noted, the aggregate impact of Prudential's financial distress could be much larger, because "correlations across asset classes and similar exposures and holdings by many of Prudential's key counterparties and peers *could* spread the financial contagion triggered by material financial distress at Prudential."[130]

With respect to the "asset liquidation channel," the FSOC found that if Prudential suddenly needed to liquidate assets—if, *e.g.*, Prudential's ordinarily long-term liabilities suddenly became immediate liabilities due to early withdrawals or other events—then the sheer magnitude of Prudential's asset liquidations could depress market prices.[131] But with respect to the "critical function or service channel," the FSOC found that Prudential's relative share of the markets it serves was not so large that its exit would leave the markets unserved.[132] (Notably, the FSOC's review of the three "channels" was not followed, as in AIG or GE Capital's decisions, with an explicit review of Dodd-Frank's ten statutory considerations.)

The FSOC further found that Prudential's existing supervision and regulation was insufficient to mitigate these alleged systemic risks.[133] Although Prudential, as an insurance company, already faces significant regulation by state insurance officials, the FSOC concluded that this traditional insurance regulation was insufficiently focused on Prudential's threat to national financial stability: the laws undergirding state insurance regulation "do not provide regulators with the same authorities to which [Prudential] would be subject if the Council determines that [it] shall be subject to supervision by the [Federal Reserve], including consolidated, enterprise-wide supervision."[134] In other words, because state insurance regulation did not replicate the Federal Reserve's enhanced prudential

[128] *Id.* at 6.
[129] *Id.* at 8.
[130] *Id.* at 8 (emphasis added).
[131] *Id.* at 9.
[132] *Id.* at 10–11.
[133] *Id.* at 11–12.
[134] *Id.* at 11.

standards for systemically important companies, the state regulation was insufficiently protective of U.S. financial stability.

The FSOC's findings with respect to the nature of Prudential's assets and liabilities, and the existing regulatory structure for insurance companies, split the Council's voting members. Unlike the unanimous AIG and GE Capital decisions, the Prudential case was decided by a 7-2 vote; in dissent were the Federal Housing Finance Agency's acting director, and the independent member with insurance expertise.[135] The FHFA acting director criticized the majority for, *inter alia*, failing to "fully take account of the stability of Prudential's liabilities, the quality of its assets, or the strength of its equity capital"—that is, an insurance company's traditional combination of reliable assets (*i.e.*, premium payments) and long-term liabilities (*i.e.*, payouts).[136] He also warned that designating Prudential for SIFI treatment would subject one insurance company to materially different regulation than its competitors companies, which "could distort market equilibrium and competition."[137]

The dissenting opinion of the FSOC's Independent Member with Insurance Expertise was all the more emphatic. He criticized the FSOC for insufficiently quantifying how small, aggregate losses among Prudential's many counterparties and customers could possibly add up to systemic risk in the aggregate: "such a line of reasoning," he argued, "would inevitably lead to a conclusion that *any* nonbank financial company above a certain size is a threat—contradicting [FSOC's] pronouncements that 'size alone' is not the test for determination."[138]

And the Independent Member criticized the hypothetical fire-sale scenario upon which the FSOC's "asset liquidation transmission channel" analysis was implicitly premised upon. "The Council's asset liquidation channel hinges on an assumed run by *millions* of life insurance policyholders,"[139] a hypothetical scenario for which "no historical, quantitative, or qualitative evidence exists in the record."[140] The FSOC's decision "provides no support for why such a construct is warranted or reasonable," he concluded; "[o]ther more plausible failure hypotheses could have been used."[141] Furthermore, the FSOC had presumed that Prudential (as the holding company) would face the simultaneous financial distress of *all* of its major insurance subsidiaries—an "unfathomable and inexplicable"

135 *See* FHFA Dissent; Independent Insurance Member Dissent.
136 FHFA Dissent at 1.
137 *Id.* at 2.
138 *Id.* at 2 (emphasis added).
139 *Id.* at 3 (emphasis in original).
140 *Id.*
141 *Id.*

scenario that "confuses failure at the holding company level with failure at the operating insurance entity level."[142] "[A]bsent a catastrophic mortality event," the Independent Member concluded, "such a corporate cataclysm could not and would not occur."[143] The Independent Insurance Member's criticisms would echoed in a statement by the FSOC's Nonvoting State Insurance Commissioner Representative.

Unlike AIG and GE Capital, Prudential challenged the FSOC's initial determination (which was issued the same day as AIG's and GE Capital's determinations).[144] But its administrative appeal was rejected, and after the FSOC's final decision Prudential did not seek judicial review.

4. *MetLife, Inc.*

Fifteen months after its Prudential determination, the FSOC issued a similar determination for MetLife, Inc.—"the largest publicly traded U.S. insurance organization and one of the largest financial services companies in the United States, based on total assets,"[145] as well as the U.S. insurance industry's leader "in certain institutional products and capital markets activities."[146]

The FSOC began by outlining ways in which MetLife's products and activities extended beyond traditional insurance,[147] and by recounting how MetLife—which was a bank holding company during the 2007–2008 financial crisis—used "several emergency federal government-sponsored facilities" to help it endure the crisis.[148] It then conducted its analysis of the three transmission channels, to analyze the possible systemic effects of MetLife suffering material financial distress.[149]

As with Prudential and the other nonbank SIFIs, the FSOC concluded that markets faced systemic risk from MetLife through the "exposure" transmission channel. Given the extent to which MetLife's capital markets activities, and its various insurance and annuity products, connected it with a volume of counterparties and customers; even if each counterparty or customer faced only small exposure individually, material financial distress at MetLife could have systemic impacts in the aggregate.[150] Moreover, if MetLife were to suffer distress, it could cause "contagion" if markets begin to

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142 *Id.*
143 *Id.* at 4.
144 FSOC's Prudential Determination at 1.
145 FSOC's MetLife Determination at 7 (footnotes omitted).
146 *Id.* at 9.
147 *Id.* at 9–14.
148 *Id.* at 14–15.
149 *Id.* at 15.
150 *Id.* at 17–21.

fear that other companies suffer exposure to MetLife or to the markets in which MetLife operates.[151]

And also as with Prudential and the other nonbank SIFIs, the FSOC concluded that MetLife could have systemic impacts through the "asset liquidation" transmission channel, because if MetLife were to suddenly face material financial distress, then it might need to liquidate assets "at discount prices," depressing the markets for those assets.[152] But as with Prudential, the FSOC concluded that MetLife's share of the markets for particular services and products was small and fragmented enough to not present a systemic risk through the "critical function or service transmission channel."[153]

Finally, as with Prudential, the FSOC concluded that MetLife's existing supervision and regulation under the state insurance laws was insufficient to mitigate the possible systemic risks that the FSOC had identified. Once again, the FSOC concluded the state insurance regulation, however rigorous it might be with respect to the standards traditionally applicable to insurance companies, fell short of the heightened prudential oversight that the Federal Reserve devotes to nonbank SIFIs under Dodd-Frank.[154]

The FSOC made the MetLife determination by a 9-1 vote. The Independent Member with Insurance Expertise once again dissented. While acknowledging "concerns about some of MetLife's activities, particularly in the non-insurance and capital markets activities spheres,"[155] he rejected the FSOC's "asset liquidation" analysis as "[un]supported by substantial evidence in the record, or by logical inferences from the record."[156] And, echoing his Prudential dissent, he urged that the FSOC's analysis "relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation[.]"[157] The nonvoting State Insurance Commissioner Representative also filed a statement criticizing the FSOC's analysis.

MetLife, like Prudential, sought administrative reconsideration of the FSOC's initial determination.[158] But upon receiving the FSOC's final determination, MetLife took the unprecedented step of appealing the FSOC's

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151 *Id.* at 21.
152 *Id.* at 21–25.
153 *Id.* at 25–26.
154 *Id.* at 26–29.
155 Dissent at 1.
156 *Id.* at 2.
157 *Id.*
158 FSOC's MetLife Determination at 3.

determination in federal district court, pursuant to the Dodd-Frank Act's provision empowering the U.S. District Court for the District of Columbia to review whether the FSOC's "final determination . . . was arbitrary and capricious,"[159] among various other legal grounds.

In March 2016, the district court struck down the FSOC's MetLife determination.[160] First, it held that the FSOC's analysis unreasonably departed from the FSOC's own previous interpretation of the Act, because it failed to apply the six analytical categories that FSOC had established in its Final Rule and Interpretive Guidance (*i.e.*, the six categories that had interpreted and subsumed the nonexhaustive list of ten factors that the Dodd-Frank Act had directed the FSOC to consider in its systemic-risk analyses).[161] The court stressed that the FSOC had established three of the six categories precisely in order to assess the nonbank financial company's actual "*vulnerability* to material financial distress"[162]; but the FSOC, in analyzing MetLife, has simply presumed the possibility of MetLife's material financial distress and skipped ahead to the question of what "the potential effect of that distress" could be.[163]

"Indeed," the district court further concluded:

> the Final Determination hardly adhered to *any* standard when it came to assessing MetLife's threat to U.S. financial stability . . . FSOC assumed that any such losses would affect the market in a manner that 'would be sufficiently severe to inflict significant damage on the broader economy.' *These kinds of assumptions pervade the analysis*; every possible effect of MetLife's imminent insolvency was summarily deemed grave enough to damage the economy.[164]

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159 12 U.S.C. § 5323(h).

160 MetLife, Inc. v. FSOC, 177 F. Supp. 3d 219 (D.D.C. 2016).

161 *Id.* at 233–39.

162 *See id.* at 233 (quoting FSOC Guidance § A.II.d.1) (emphasis added).

163 *Id.*

164 *Id.* at 237 (emphasis added; citations omitted). The district court held in the alternative that the FSOC's determination unlawfully failed to consider the cost that MetLife's SIFI designation would impose upon the company. Citing the Supreme Court's recent decision in *Michigan v. EPA*, 135 S. Ct. 2699 (2015), the district court held that cost was a mandatory consideration for FSOC's nonbank SIFI designations under Dodd-Frank. The court noted that the Dodd-Frank Act authorizes the FSOC to consider "any other risk-related factors that the Council deems *appropriate*." 12 U.S.C. § 5323(a)(2)(K) (emphasis added). Because the Supreme Court had held in *Michigan* that cost is presumptively an "appropriate" regulatory criterion, and because the district court concluded that cost is sufficiently "risk-related" in the present context, the district court held that the FSOC was obligated to consider the cost of its determination.

At the D.C. Circuit's oral arguments a few months later, the judges raised similar questions about the FSOC's operative assumptions. Judge Millett, for example, recognized that "[t]he assumption for the analysis here is we kind of have to assume things are really going badly and MetLife is at least on the brink of insolvency or severe financial failings and the rest of their partners, or those that they interconnect with are themselves facing maybe not as far down the road as MetLife is hypothesized to be, but facing a severe economic downturn."[165] She later pressed the FSOC's counsel on this point, stressing that "you've already [baked] into the question you're asking in the first place, a pretty scary economic situation and that is that everybody in the economy is facing a severe downturn and that MetLife, a company of that size is on the brink of insolvency. . . . [Y]ou're not specific enough when you say well, it's really, really a bad situation here so we assume bad things are going to happen."[166]

IV. The Challenge of Analyzing "Systemic Risk"

As noted at the outset of Part III.C, the FSOC's four nonbank SIFI designations merit review not simply for their own sake, but rather because the FSOC's experience in analyzing those companies, and in drawing conclusions based on its analysis and the hypothetical scenarios and other assumptions undergirding the analysis, exemplifies the fundamental challenge of regulating in terms of systemic financial risk. The task inherently requires regulators to think beyond the bounds of recent experience, to try to ascertain how future crises might impact the market—and how we should guard against those crises—when we cannot know what the next crisis might be.

Indeed, the FSOC recognized this basic challenge at the outset of its MetLife designation.

> As history has shown, including in 2008, financial crises can be hard to predict and can have consequences that are both far-reaching and unanticipated. Consistent with the Council's mission under the Dodd-Frank Act to identify potential threats before they occur, and as described in the Interpretive Guidance, the Council's analysis focuses on the potential consequences of material financial distress at MetLife "in the context of a period of overall

[165] Tr. of Oral Arg. at 23–24, *MetLife, Inc. v. FSOC*, No. 16-5086 (D.C. Cir. filed Apr. 20, 2016, oral argument heard Oct. 24, 2016), *at* https://www.metlife.com/assets/cao/sifiupdate/DC_Circuit_Transcript.pdf; *see also* Oral Argument Recording (.mp3 format), *at* https://www.cadc.uscourts.gov/recordings/recordings2017.nsf/1DB5F399570581DB85258056005D81F7/$file/16-5086.mp3. As of December 1, 2016, no decision has issued.

[166] Oral Arg. Tr. at 46.

> stress in the financial services industry and in a weak macroeconomic environment." As a result, the Council considered a range of outcomes that are possible but vary in likelihood. The Council's approach is consistent with the statutory standard set forth in the Dodd-Frank Act; it considers the range of potential outcomes of MetLife's material financial distress, rather than relying on a specific worst-case scenario. There may be scenarios in which material financial distress at MetLife would not pose a threat to U.S. financial stability, but there is a range of possible alternatives in which it could do so.[167]

In short, an analysis focused exclusively on familiar or recent experience will be of limited value, because the ultimate goal of guarding against systemic financial risks is to prevent ruinous effects of the *next* crisis, which may bear little or no resemblance to recent experience.

But by the same token, regulators' forward-looking analyses today may be of little or no value tomorrow, when the crisis occurs, precisely because regulators' *ex ante* assumptions or hypotheticals will almost certainly prove incomplete, and quite possibly wrong. Indeed, this point was made by Treasury Secretary Geithner himself, during his prior term as President of the Federal Reserve Bank of New York, in an interview with the Special Inspector General for the Troubled Asset Relief Program ("SIGTARP"):

> Secretary Geithner told SIGTARP that he believed creating effective, purely objective criteria for evaluating systemic risk is not possible: "What size and mix of business do you classify as systemic? . . . *It depends too much on the state of the world at the time. You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock" the economy is undergoing*. Secretary Geithner also suggested that whatever objective criteria were developed in advance, markets and institutions would adjust and "migrate around them." If the Secretary is correct, then systemic risk judgments in future crises will again be subject to concerns about consistency and fairness, not to mention accuracy.[168]

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[167] FSOC's MetLife Determination at 5 (emphases added).

[168] SIGTARP, *Extraordinary Financial Assistance Provided to Citigroup, Inc.*, at 43 (Jan. 13, 2011) (emphasis added), *available at* https://www.sigtarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf.

Very generally, the practical limits of foreseeing and guarding against systemic risk operate at two levels: *first*, the difficulty of identifying practices or circumstances that tend to implicate systemic risk; and *second*, even if one takes for granted that we know the practices or circumstances that tend to implicate systemic risk, there remains the difficulty of predicting which specific entities or practices presents a substantial likelihood of actually threatening financial stability at a future date.[169]

A. Identifying the Practices or Circumstances that Tend to Implicate Systemic Risk

When the FSOC issued its Final Rule for the designation of nonbank SIFI determinations, as recounted above, its Interpretive Guidance began by identifying three "channels" through which threats to financial stability might be transmitted: "exposure," "asset liquidation," and "critical function or service."[170] It was a fitting place to start, because it reflected the first challenge inherent in prospectively guarding against systemic risk: identifying the practices or circumstances that tend, in theory, to facilitate threats to financial stability.

But the FSOC did not suggest that its three "channels" exhausted the possibilities. Quite the contrary: the FSOC stressed that these three marked the beginning, not the end, of its attempt to identify such channels of systemic risk: "The Council intends to continue to evaluate additional transmission channels and may, at its discretion, consider other channels through which a nonbank financial company may transmit the negative effects of its material financial distress or activities and thereby pose a threat to U.S. financial stability."[171]

Nevertheless, at least two of the FSOC's first three "channels" did reflect the most prominent theories of systemic risk. "Exposure," as applied by the FSOC in its four nonbank SIFI designations so far, seems to

[169] Others have attempted to draw lines within the broad concept of "systemic risk" in slightly different ways. In his essay on "Defining Systemic Risk Operationally," for example, Stanford's John Taylor divides the inquiry into three parts, rather than two: "Any definition of systemic risk must be based on three considerations. The first is the *risk of a large triggering event*. The second is the *risk of financial propagation* of such an event through the financial sector by contagion or chain reaction. The third is the *macroeconomic risk* that the financial disruption will severely affect the whole economy." John B. Taylor, *Defining Systemic Risk Operationally*, in KENNETH E. SCOTT ET AL., ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 36 (2013) (emphasis added). Very roughly stated, Taylor's second and third categories correspond roughly with my own first category (*i.e.*, the practices or circumstances that *tend* to facilitate systemic threats), while his first category (the "triggering event") corresponds roughly with my second (*i.e.*, predicting whether a particular entity or practice will actually trigger the systemic threat someday).

[170] 77 Fed. Reg. at 21657.

[171] *Id.*

encompass what is commonly called "connectedness" or "contagion." "Connectedness," by one definition, "is the concern that the failure of one financial institution will provoke a chain reaction of failures by other financial institutions with direct credit exposures [or, perhaps other direct contractual relationships] to the failed institutions."[172] But by other accounts, connectedness need not involve a single large firm connected to many small firms; it could involve interconnections among many smaller firms.[173] Either way, interconnectedness resembles a row of dominos: "When the first domino falls, it falls on others, causing them to fall and in turn to knock down others in a chain or 'knock-on' reaction."[174]

"Contagion," by contrast, is a form of exposure that "involves run behavior, whereby *fears* of widespread financial collapse lead to the withdrawal of funding from banks and other financial institutions."[175] Contagion can happen to occur among interconnected companies, but it can also occur among entirely unconnected companies. "During a contagious and indiscriminate run . . . investors may also withdraw funding from multiple institutions or markets that are not themselves facing any objective business distress."[176] As seen above, these two types of exposure— "connectedness" and "contagion"—appear in the FSOC's decisions.

The FSOC's second transmission channel, "asset liquidation," also reflects one example of another prominent theory of systemic risk: "common shock," in which a market event is felt widely by many market participants, due to correlations in their respective holdings or exposures.[177] By some

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[172] HAL S. SCOTT, CONNECTEDNESS AND CONTAGION 3 (2016).

[173] ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES 219 (2013) ("Even if the largest banks become smaller, the interconnectedness of the financial system . . . will still be likely to create excessive fragility unless more is done to control this fragility.").

[174] George G. Kaufman & Kenneth E. Scott, *What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?*, INDEP. REV., Winter 2003, at 373.

[175] SCOTT, CONNECTEDNESS AND CONTAGION, at 5.

[176] *Id.* (emphasis omitted). That said, these definitions and distinctions are not yet universally accepted. One of the Financial Crisis Inquiry Commission's dissenting reports, for example, defined "contagion" as involving only the connections among counterparties, whereby distress at one firm could cause distress at one of its counterparties. FINANCIAL CRISIS INQUIRY COMMISSION, *supra*, at 431 (Dissenting Statement of Hennessey, Holtz-Eakin, and Thomas). Elsewhere, another recent study of "contagion" published by the Office of Financial Research analyzed "contagion" in terms of *both* the aforementioned phenomenon of one event having collateral impacts on unrelated firms, *and* the direct "knock-on" effect among interconnected firms. *See* Paul Glasserman & H. Peyton Young, "Contagion in Financial Networks," Office of Fin. Res. Working Paper 15-21 (Oct. 20, 2015); *see also* Prasanna Gai & Sujit Kapadia, *Contagion in Financial Networks*, 10 PROC. ROYAL SOC'Y A 2401, 2401–02 (2010).

[177] *See also*, *e.g.*, PETER J. WALLISON, BAD HISTORY, WORSE POLICY 492 (2015) (defining "common shock" as "a condition in which a large number of financial institutions are hit by the sudden loss of value in a widely held asset"); CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 241–42 (2009); *see*

accounts, this was a major part of the 2007–2008 financial crisis, when the collapse of housing prices inflicted "concentrated losses on housing-related assets in large and midsize financial firms in the United States and some in Europe," which "wiped out capital throughout the financial sector." Policymakers were not just dealing with a single insolvent firm that might transmit its failure to others," but rather "with a scenario in which many large, midsize, and small financial institutions took large losses at roughly the same time."[178]

As the FSOC concedes, there may be other "channels" for transmission of systemic risk. One such theory of systemic risk pertains to the government's own interactions with the market. (Perhaps uncoincidentally, the FSOC has not yet highlighted this as one of its systemic risk channels.) This is in part the "too big to fail" phenomenon: if government is seen as being willing to prevent a particular firm or class of firms from failing, that implicit backstop can be expected to "compromis[e] market discipline in good times, encouraging excessive leverage and risk taking" by the implicitly protected company.[179]

B. Applying Theories of Systemic Risk to Specific Companies

Those are just three theories of the practices and circumstances that tend to give rise to systemic risk; there are others.[180] But even when regulators and policymakers can settle on a theory of what *tends* to facilitate

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also Kenneth E. Scott, *The Context for Bankruptcy Resolutions*, *in* KENNETH E. SCOTT ET AL., MAKING FAILURE FEASIBLE 12–13 (2015).

[178] FINANCIAL CRISIS INQUIRY COMM'N, *supra*, at 432–33 (Dissenting Statement of Hennessey, Holtz-Eakin, and Thomas); *see also*, *e.g.*, PETER J. WALLISON, HIDDEN IN PLAIN SIGHT (2015) ("In reality, as shown in previous chapters, the financial crisis was caused not by interconnections among large financial firms, but by a phenomenon known to scholars as common shock or contagion.").

[179] Viral V. Acharya *et al.*, *Measuring Systemic Risk*, in VIRAL V. ARCHARYA ET AL., REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 87 (2011); *see also*, *e.g.*, CHARLES W. CALOMIRIS & STEPHEN H. HABER, FRAGILE BY DESIGN 247 (2014) ("[Alan Greenspan] worried about the systemic risk being created by GSEs [*e.g.*, Fannie Mae and Freddie Mac] and called for the establishment of a new regulatory authority to limit the growth and risks of the GSEs"); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 Ore. L. Rev. 951, 980 ("Government bailouts demonstrated that [large, complex financial institutions] benefit from huge [Too-Big-To-Fail] subsidies" (capitalization modified)).

[180] One student note summarizes the wide diversity of views as to what constitutes systemic risk, as follows: "Despite how frequently systemic risk comes up in economic debate, there is no universal concept of systemic risk, although the notion of cascading market failure is consistently present. . . . Systemic risk is often classified according to several difference types of categories, some of which are casually-based while others are impact-based." Emily Kehoe, *Hedge Fund "Regulation" for Systemic Risk: Largely Impossible*, 14 J. BUS. & SEC. L. 35, 55–56 (2013) (footnotes omitted).

systemic risk, there remains the even more challenging task of identifying the specific entities that actually *do* present a sufficient risk to someday threaten financial stability, and to regulate them accordingly. That is, the regulators still must decide whether a particular company could either cause or exacerbate a "triggering event" that threatens financial stability.[181]

As then-president of the Federal Reserve Bank of New York, Timothy Geithner, observed, the task of designating individual companies as having "systemic" importance is extremely difficult in this respect, because it "depends too much on the state of the world at the time" of the eventual crisis. "You won't be able to make a judgment about what's systemic and what's not until you know the nature of the shock" the economy is suffering.[182]

This is a point that has been analyzed thoroughly, in legal scholarship and beyond. "To reduce the systemic risk caused by a single firm," one skeptic rights, "a prudential regulator must diagnose the symptoms of the risk, identify its source, and prescribe an appropriate measure before the problem spreads to other market participants. Attaining this level of knowledge about even a single firm is no easy task." It requires the regulator to "extrapolate firm-specific measures across the *entire financial system*, with its thousands of firms and millions of participants, in something approaching real time. This task is orders of magnitude more difficult."[183]

At root, this is not a new insight, of course. One hundred and fifty years ago, Walter Bagehot's classic banking tract, *Lombard Street*, observed that markets are susceptible to disruption by "[a]ny sudden event which creates a great demand for actual cash," and unfortunately "[s]uch accidental events are of the most various nature: a bad harvest, an apprehension of foreign invasion, the sudden failure of a great firm which everyone trusted,

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[181] Taylor, *supra* note 169, at 36.

[182] SIGTARP, *Extraordinary Financial Assistance Provided to Citigroup, Inc.*, at 43 (Jan. 13, 2011), *supra* note 168.

[183] Michael T. Cappucci, *Prudential Regulation and the Knowledge Problem*, 9 VA. L. & BUS. REV. 1, 16 (2014); *see also*, *e.g.*, Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 217 (2008) ("[B]ecause the same trigger can foreshadow small consequences sometimes and large consequences other times, regulation intended to avert panics should take into account what it is beyond the triggering event that sorts the magnitude of the consequences and should apply only to deter panics that trigger larger consequences. It is questionable, though, whether such a sorting mechanism is always discernable ex ante."); *id.* at 231 ("It may be hard to quantify in advance, for example, the likelihood that the failure of a given firm or other triggering event would cause a systemic meltdown."); Joshua S. Wan, *Systemically Important Asset Managers: Perspectives on Dodd-Frank's Systemic Designation Mechanism*, 116 COLUM. L. REV. 805, 820 (2016) ("But when systemic risk is targeted at a firm-specific rather than industry-wide level, it is crucial to question whether the bank regulatory principles potentially imposed on asset managers is actually furthering the underlying goal of systemic risk mitigation or simply unfairly burdening a small number of firms.").

and many other similar events . . . There is little difference in the effect of one accident and another upon our credit system. We must be prepared for all of them[.]"[184]

In other words, this is a context of "Knightian uncertainty." Named for Frank Knight's seminal work, *Risk Uncertainty and Profit* (1921), Knight contrasts "risk" with outright "uncertainty":

> The practical difference between the two categories, risk and uncertainty, is that in the former the distribution of the outcome in a group of instances is known (either through calculation *a priori* or from statistics of past experience), while in the case of uncertainty this is not true, the reason being in general that it is impossible to form a group of instances, because the situation dealt with is in a high degree unique.[185]

In recent years, this problem has largely been recast in terms of "Black Swan" phenomena. The term reflects the title of Nassim Taleb's influential study of risk, uncertainty, and the fundamental problem that inferences drawn from a lifetime's experience can swiftly be disproven by a single event to the contrary. "Before the discovery of Australia," Taleb writes, "people in the Old World were convinced that *all* swans were white, an unassailable belief as it seemed completely confirmed by empirical evidence." But "[o]ne single observation can invalidate a general statement derived from millennia of confirmatory sightings of millions of white swans. All you need is one single (and, I am told, quite ugly) black bird."[186]

Taleb's greater point is that some subjects of prediction may be quite reliably based on past experience. (We are unlikely to wake up tomorrow and

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[184] WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 122–23 (1873). Bagehot wryly noted that such vagaries of life are "why Lombard Street is often very dull, and sometimes extremely excited." *Id.* at 122 (capitalization modified). *See also*, BERTRAND DE JOUVENEL, THE ART OF CONJECTURE 95 (1967) ("New and unforeseen causes will intervene, whose effects we could not calculate even if we were forewarned."); *id.* at 118 ("Thus we cannot *fore*see the future scene in the way we see the present scene. We can fasten our attention on powerful currents transforming the present scene, but even if we have understood them well, any inferences we draw about the future may be upset through the influence of unforeseen, volatile elements.").

[185] FRANK H. KNIGHT, RISK UNCERTAINTY AND PROFIT 233 (1921). Knight continues, "[t]he best example of uncertainty is in connection with the exercise of judgment or the formation of those opinions as to the future course of events, which opinions (and not scientific knowledge) actually guide most of our conduct." *Id. See also*, *e.g.*, David Weisbach, *Legal Decision Making Under Deep Uncertainty*, 44 J. L. STUDIES S319 (2015).

[186] NASSIM TALEB: THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE 1 (2007). I have written on Taleb's books are arguments at greater length elsewhere. Adam J. White, *The Signal and the Silence*, CITY JOURNAL (Spring 2013).

meet someone twelve feet tall.) And for other subjects of prediction, past experience may prove less reliable but the impact of an outlier event is insignificant. (The Australian "black swan" mentioned by Taleb is a novelty, but hardly crisis-inducing.) But other realms of prediction may be particularly susceptible to outlier events with *immense* impact—and financial markets, Taleb writes, are a classic example.[187] Visualized as a bell curve, these realms have "fat tails"[188]; in acting today, we must take care to avoid overconfidence with respect to either end of the distribution—that is, for worse and for better. For these reasons, it is extremely difficult to predict which companies or activities will give rise to a systemic crisis, and which will not.

Cass Sunstein has echoed these themes in his own writings on risk and uncertainty,[189] as have Richard Posner and others.[190] Others in a range of fields have studied at length the best approaches for making decisions under such uncertainty—from risk management theory,[191] to "scenarios analysis,"[192] to "systems analysis,"[193] to war-gaming.[194]

But for all of the wealth of discussion, both general and specific, of how to grapple with such uncertainty in those contexts, there has been precious

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[187] *Id.* at 274–85.

[188] *Id.* at 170.

[189] *See*, *e.g.*, CASS R. SUNSTEIN, WORST-CASE SCENARIOS 118–75 (2007); Cass R. Sunstein, *The Catastrophic Harm Precautionary Principle* (2007), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2532598; CASS R. SUNSTEIN, RISK AND REASON 129 (2002) ("Regulators are sometimes acting in a situation of 'risk,' where probabilities can be assigned to various outcomes, but sometimes there are acting in a situation of 'uncertainty,' where no such probabilities can be assigned."); *id.* at 39 ("Often people focus on small pieces of complex problems, and causal changes are hard to trace."); Cass R. Sunstein, *Beyond Cheneyism and Snowdenism*, 83 U. CHI. L. REV. 271, 284 (2016) (citing John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 888 (2015)).

[190] RICHARD A. POSNER, CATASTROPHE 171–86 (2004); Richard A. Posner, *Thinking About Catastrophe*, *in* FRANCIS FUKUYAMA, BLINDSIDE: HOW TO ANTICIPATE FORCING EVENTS AND WILD CARDS IN GLOBAL POLITICS 7–19 (2007).

[191] *E.g.*, RICHARD FRIBERG, MANAGING RISK AND UNCERTAINTY: A STRATEGIC APPROACH (2015).

[192] *E.g.*, PETER SCHWARTZ, THE ART OF THE LONG VIEW: PLANNING FOR THE FUTURE IN AN UNCERTAIN WORLD (1991); Robert Lempert, *Can Scenarios Help Policymakers Be Both Bold and Careful?*, *in* FRANCIS FUKUYAMA, BLINDSIDE: HOW TO ANTICIPATE FORCING EVENTS AND WILD CARDS IN GLOBAL POLITICS 109–19 (2007); *see also* ANDREW KREPINEVICH & BARRY D. WATTS, THE LAST WARRIOR: ANDREW MARSHALL AND THE SHAPING OF MODERN AMERICAN DEFENSE STRATEGY (2015).

[193] *E.g.*, Albert Wohlstetter, *Systems Analysis Versus Systems Design*, RAND Memo P-1530 (Oct. 29, 1958), *at* http://www.rand.org/about/history/wohlstetter/P1530/P1530.html; Herman Kahn & Irwin Mann, *Techniques of Systems Analysis*, RAND Memo RM-1829-1-PR (June 1957), *at* http://www.rand.org/pubs/research_memoranda/RM1829-1.html.

[194] *See* Mehrsa Baradaran, *Regulation by Hypothetical*, 67 VAND. L. REV. 1247, 1319–24 (2014).

little discussion of how to navigate such concerns in the context of administrative decision-making under the Administrative Procedure Act or similar statutes—including the Dodd-Frank Act's provision for judicial review of FSOC determinations to prevent "arbitrary and capricious" SIFI designations.[195] That, briefly, is the subject of this paper's final section.

V. The FSOC's SIFI Designations and the Traditional Standard of "Arbitrary and Capricious" Agency Action

Proponents of the Dodd-Frank Act often assert that the Act's creation of the FSOC's SIFI-designation process simply takes the framework for prudential supervision of *banks* and applies it to functionally equivalent activities by *nonbanks*. For example, one scholar who assisted in the framing of Dodd-Frank writes that "[t]he Act provides for major firms to be supervised based on what they do, rather than on their corporate form."[196]

But in fact, adaptation of the banks' traditional prudential-supervision regulatory model to nonbanks, through the FSOC's system of SIFI designations, entails a profound difference: unlike banks, which *choose* the regulatory and supervisory regime that will govern them, through the banks' own acts of chartering a bank or opting in to the FDIC insurance program,[197] nonbanks do not become SIFIs through their own volition. Rather, they become SIFIs through *agency action*—and thus implicate basic principles of administrative law.

Indeed, the Dodd-Frank Act itself recognized this when it expressly subjected the FSOC's nonbank SIFI designation decisions to judicial review under an "arbitrary and capricious" standard of review.[198]

Thus, while valuable scholarship has been written on how the Federal Reserve should go about designing prudential standards to govern banks and nonbanks that are already subject to the Fed's systemic-risk jurisdiction,[199]

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[195] 12 U.S.C. § 5323(h).

[196] Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. REG. 91, 91–92 (2012); *see also id.* at 94 ("Entities performing the same market functions as banks escaped meaningful regulation on the basis of their corporate form [in the years leading up to the 2007–2008 crisis], and banks were able to move activities, liabilities, and assets off their balance sheet and outside the reach of more stringent regulation."); *id.* at 91 n.† (describing the author as "a key architect" of the Act).

[197] *See, e.g.*, Edward V. Murphy, Cong. Res. Serv., *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets* (Jan. 30, 2015); Sumit Agrawal *et al.*, *Inconsistent Regulators: Evidence from Banking*, 129 Q. J. ECON. 889, 895–98 (2014).

[198] 12 U.S.C. § 5323(h).

[199] *See, e.g.*, Cheryl D. Block, *A Continuum Approach to Systemic Risk and Too-Big-to-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 289 (2012); Robert Hockett, *The Macroprudential Turn: From Institutional 'Safety and Soundness' to Systemic 'Financial Stability' in*

there remains the antecedent question of the legal standards governing the FSOC's decision to commit nonbank financial companies to the Federal Reserve's prudential authority in the first place, by taking action to designate them as systemically important under Dodd-Frank's Title I.

A. SIFI Designations: Asking the FSOC to Simply Prove a "Could," and the Company to Prove a Negative

1. As this essay notes in its initial discussion of the Dodd-Frank framework, Title I sets a seemingly low bar for the FSOC to clear in designating a nonbank financial company as systemically important: the FSOC need only find that the company's material financial distress, or its other qualities, "*could* pose a threat to the financial stability of the United States."[200]

And, indeed, the FSOC has argued (in the MetLife litigation) that "could" must be read literally—*i.e.*, that Dodd-Frank requires no showing of even a *minimal likelihood* that the given nonbank financial company will actually harm financial stability, but rather that it requires only that the FSOC *not* designate a company as a SIFI when there is *no* possibility of future systemic harm.[201]

The FSOC's approach—whether justified by the statute's best reading or not—requires a nonbank financial company to prove a negative: to prove that there is *no* chance that it could ever harm U.S. financial stability. Given the breadth of considerations set forth in the Act, it is effectively impossible for *any* large or interconnected financial company to disprove the hypothetical possibility that it "could" someday threaten financial stability. But the Senate itself warned against construing or administering the act in that way: "Size alone should not be dispositive in the Council's determination," the Senate explained in its report on what would become Dodd-Frank.[202] "[I]n its consideration of the enumerated factors, the Council should also take into account other indicia of the overall risk posed to U.S. financial stability, including the extent of the nonbank financial company's

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Financial Supervision, 9 VA. L. & BUS. REV. 201 (2015); Michael T. Cappucci, *Prudential Regulation and the Knowledge Problem: Toward a New Paradigm of Systemic Risk Regulation*, 9 VA. L. & BUS. REV. 1 (2014).

200 12 U.S.C. § 5323(a)(1).

201 FSOC Brief at 26, *MetLife Inc. v. FSOC*, D.C. Cir. No. 16-5086 (June 16, 2016) (arguing that the statutory language requires only that FSOC consider what "could" occur, and not how likely that occurrence is).

202 S. Rep. 111-176, at 48.

interconnections with other significant financial companies and the complexity of the nonbank financial company."[203]

2. But even setting that concern aside, there remains the fact that Dodd-Frank requires the FSOC to provide substantial evidence for its nonbank SIFI determinations. The Act requires this not through express reference to a "substantial evidence" test, but rather through its express incorporation of the "arbitrary and capricious" standard of review.[204]

As the D.C. Circuit has explained, even when the Administrative Procedure Act's "substantial evidence" test does not directly apply by its own terms,[205] the equivalent substantive standard applies as a component of the larger "arbitrary and capricious" test.[206] Thus, "[w]hen the arbitrary or capricious standard is performing that function of assuring factual support, there is no *substantive* difference between what it requires and what would be required by the substantial evidence test, since it is impossible to conceive of a 'nonarbitrary' factual judgment supported only by evidence that is not substantial in the APA sense."[207] Accordingly, Dodd-Frank's arbitrary-and-capricious test inherently requires the FSOC to base its decision on substantial evidence, and to "articulat[e] a rational connection between its factual judgments and its ultimate policy choice."[208]

And, crucially, that standard cannot be met by the FSOC's mode of analysis in its nonbank SIFI designations. The FSOC's determinations, as described above, lay out present facts about the company and then, invoking a hypothetical set of tumultuous financial or economic circumstances, concludes that the nonbank institution "could" contribute to financial instability. But this approach does not satisfy the "arbitrary-and-capricious" standard. That standard requires something more concrete: it requires "a

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[203] *Id.* at 48–49; *see also* FSOC's Prudential Determination, Dissent of Independent Member Having Insurance Expertise, at 2 ("such a line of reasoning would inevitably lead to a conclusion that any nonbank financial company above a certain size is a threat – contradicting pronouncements that 'size alone' is not the test for determination"); Ltr. from Sen. Warner to Treas. Sec'y Lew at 1–2 (May 9, 2014) ("In drafting Dodd-Frank, Members of Congress specifically enumerated size as the determinant in subjecting banks to heightened prudential standards, while leaving the process of non-bank SIFI consideration to FSOC. . . . For non-bank SIFI determination, size alone should not be dispositive."), *at* http://www.mfdf.org/images/DirResPDFs/Warner_letter_to_Lew.pdf.

[204] 12 U.S.C. § 5323(h).

[205] *See* 5 U.S.C. § 706(2)(E).

[206] Ass'n of Data Processing Serv. Orgs., Inc. v. Bd. of Governors of the Fed. Res. Sys., 745 F.2d 677, 683 (D.C. Cir. 1984); *see also*, *e.g.*, Ctr. for Auto Safety v. FHA, 956 F.2d 309, 313 (D.C. Cir. 1992) (citing *ADPSO*); Am. Radio Relay League, Inc. v. FCC, 524 F.3d 227, 243 (D.C. Cir. 2008) (same); Butte County, Cal. v. Hogen, 613 F.3d 190, 194 (D.C. Cir. 2010) (same).

[207] *Id.* at 683–84 (emphasis in original).

[208] *Ctr. for Auto Safety*, 956 F.2d at 313.

statement of reasons that is supported by concrete inferences from substantial evidence, and is not to be snatched from the air on a purely hypothetical 'worst case' analysis[.]"[209]

Moreover, to the extent that the FSOC constructs hypothetical scenarios in which economic turbulence strains the nonbank financial institution, the FSOC must at the very least ensure that its hypothetical is rational and sufficiently connected to facts in the record.[210] Even if courts owe substantial deference to an agency's predictive expertise, such deference does not overcome these basic factual requirements. "[S]uch deference," according to the D.C. Circuit, does not leave the court "to abdicate the judicial duty carefully to 'review the record to ascertain that the agency has made a reasoned decision based on 'reasonable extrapolations from some reliable evidence,' to ensure that the agency has examined "the relevant data and articulate[d] a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"'[211]

Thus, even while the D.C. Circuit has elsewhere acknowledged an agency may not need to provide "*complete* factual support in the record" in cases centering on "agency predictions of uncertain future events," it has in recent decades stopped short of eliminating altogether the need to root predictions in concrete record facts.[212] Rather, "when an agency's decision is

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[209] Memphis Light, Gas & Water Div. v. FPC, 504 F.2d 225, 234 (D.C. Cir. 1974); *see also* Pub. Serv. Comm'n for State of N.Y. v. FPC, 543 F.2d 874, 888 (D.C. Cir. 1976) (Robinson, J., dissenting) (same).

[210] Teamsters Local Union No. 175 v. NLRB, 788 F.2d 27, 32 (D.C. Cir. 1986).

[211] Am. Mining Cong. v. EPA, 907 F.2d 1179, 1187 (D.C. Cir. 1990) (citations omitted); *see also*, *e.g.*, Time Warner Entertainment Co. v. FCC, 240 F.3d 1126, 1133 (D.C. Cir. 2001) ("Substantial evidence does not require a complete factual record—we must give appropriate deference to predictive judgments that necessarily involve the expertise and experience of the agency. . . . But the FCC has put forth no evidence at all that indicates the prospects for collusion."); Elec. Consumers Res. Council v. FERC, 407 F.3d 1232, 1241 (D.C. Cir. 2005) (deferring the FERC's predictive judgment "[b]ecause the Commission's predictive judgment that the ICAP Demand Curve will result in long-term savings is supported by substantial evidence in the record"); cf. BellSouth Telecomm. Inc. v. FCC, 469 F.3d 1052, 1060 (D.C. Cir. 2006) ("We cannot overlook the absence of record evidence . . . simply because the Commission cast its analysis as a prediction of future trends—a prediction the Commission insists merits special deference. . . . It is certainly true that an agency's predictive judgments about areas that are within the agency's field of discretion and expertise are entitled to particularly deferential review, as long as they are reasonable. . . . That said, the deference owed agencies' predictive judgments gives them no license to ignore the past when the past relates directly to the question at issue. . . . Given this ample record, the Commission should either have shown how the large companies had nonetheless been harmed in the past five years or offered some reason for believing that the future is likely to differ from the past. It did neither.") (quotation marks omitted).

[212] Rural Cellular Ass'n v. FCC, 588 F.3d 1095, 1105 (D.C. Cir. 2009) (emphasis added); *see also* Melcher v. FCC, 134 F.3d 1143, 1152 (D.C. Cir. 1998); FCC v. Nat'l Citizens Comm. for Broadcasting, 436 U.S. 775, 813–14 (1978) ("However, to the extent that factual

primarily predictive," the arbitrary-and-capricious test still requires "that the agency acknowledge factual uncertainties and identify the considerations it found persuasive."[213] That is, the agency may draw "deductions" based on its "expert knowledge," but those deductions must be based on at least a modicum of record evidence, and not simply hypotheticals—as the D.C. Circuit earlier aforementioned precedents stressed.[214]

In short, agencies often urge the D.C. Circuit and other courts to let them "rely on [their] predictive judgment to ignore [critical] questions."[215] But as the D.C. Circuit often reminds them, to the extent that "an agency's predictive judgments about" the future effects of its decision "are entitled to deference," any judicial "deference to such ... judgments must be based on *some* logic and evidence, not sheer speculation[.]"[216]

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determinations were involved in the Commission's decision . . . they were primarily of a judgmental or predictive nature . . . In such circumstances *complete* factual support in the record for the Commission's judgment or prediction is not possible or required; 'a forecast of the direction in which future public interest lies necessarily involves *deductions* based on the expert knowledge of the agency[.]'" (emphasis added). That said, the Supreme Court and D.C. Circuit have suggested that pure *policy* questions might be sustainable based exclusively on the agency's predictive judgment in the absence of evidence. FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1, 29 (1961) ("[W]e do not think that the Commission is so limited in its formulation of policy considerations. Rather, we think that a forecast of the direction in which future public interest lies necessarily involves deductions based on the expert knowledge of the agency."); CNA Financial Corp. v. Donovan, 830 F.2d 1132, 1155–56 (D.C. Cir. 1987) ("an agency's 'judgmental or predictive' determinations need not be supported by record evidence," such as "in the context of formal rulemaking regulations").

[213] *Rural Cellular Ass'n*, 588 F.3d at 1105.

[214] *Id.*

[215] Sorenson Comm'cns, Inc. v. FCC, 755 F.3d 702, 708 (D.C. Cir. 2014).

[216] *Id.* (alterations omitted, emphasis added). It must be recognized, as Adrian Vermeule recognizes, that some statutory frameworks, such as the National Environmental Policy Act (42 U.S.C. § 4321 *et seq.*), will sometimes bring agencies to a point of effective impasse or stalemate in trying to make the "best" judgment on matters of complete "Knightian" uncertainty, such that it may effectively be "rational" for an agency to make an effectively arbitrary decision. *See generally* Adrian Vermeule, *Rationally Arbitrary Decisions in Administrative Law*, 44 J. L. STUDIES S475 (2015) (citing, *inter alia*, Balt. Gas & Elec. Co. v. NRDC, 462 U.S. 87 (1983) (applying NEPA). But it is important to keep in mind that NEPA is an exclusively *procedural* statute; it imposes no substantive requirements on agencies, but rather "imposes only procedural requirements to 'ensure that the agency, in reaching its decision, will have available, and will carefully consider, detailed information concerning significant environmental impacts.'" Winter v. NRDC, 555 U.S. 7, 23 (2008) (alteration omitted) (quoting Robertson v. Methow Valley Citizens Council, 490 U.S. 332, 350 (1989); *see also*, *e.g.*, Dep't of Transp. v. Public Citizen, 541 U.S. 752, 756–57 (2001) ("Rather, NEPA imposes only procedural requirements on federal agencies with a particular focus on requiring agencies to undertake analyses of the environmental impact of their proposals and actions."). Where a statute such as NEPA is just "an 'essentially procedural' statute intended to ensure 'fully informed and well-considered' decisionmaking, but not necessarily the *best* decision," it makes sense to require an agency to go only so far in its analysis before concluding that the agency has done sufficient homework to pass judicial muster. New York

The FSOC's determinations place the agency at the frontier of these standards, at the very least. While the FSOC identifies record evidence regarding the present state of the company, the scenarios that the FSOC constructs to illustrate how the company "could" become a systemic threat have been sheer hypotheticals, without record evidence showing, for example, that the specific company's counterparties or customers actually *would* react to market turmoil in the ominous ways hypothesized by the FSOC—as the FSOC's dissenting member stressed in the MetLife decision.[217] Such an approach seems to exceed the minimal limits on agency discretion imposed by the D.C. Circuit.

B. Congress's Failure—A Framework "Famously Underinstructed by the Law"

If the foregoing analysis proves correct—if the FSOC's nonbank SIFI designation framework falls short of the requirements of administrative law—then fault does not lie primarily with the FSOC. Rather, it reflects Congress's failure to make the substantive policy decision itself.

This point was made bluntly in a recent analysis of the 2008 financial crisis and subsequent reform. In *To the Edge: Legality, Legitimacy, and the Responses to the 2008 Financial Crisis*, the Brookings Institution's Philip A. Wallach criticizes the FSOC as "famously underinstructed by the law":

> Its procedures are minimally defined, and it is given enormous discretion to fashion policies regulating systematically important financial institutions and to deal with their failures. Although FSOC might use its discretionary power productively, it is unfortunate that the law did not help it achieve legitimacy by providing a

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v. NRC, 681 F.3d 471, 476 (D.C. Cir. 2012); cf. Adam J. White, *Thinking About the "Practically Unthinkable": Energy Infrastructure and the Threat of Low-Probability, High-Impact Events*, ENGAGE: THE JOURNAL OF THE FEDERALIST SOCIETY PRACTICE GROUPS (Nov. 2011) (reviewing NEPA's application to forecasts of terrorist threats against proposed nuclear infrastructure projects).

[217] *See*, *e.g.*, FSOC's MetLife Determination, Dissent of the Independent Member with Insurance Expertise, at 2 ("I do not believe that the analysis' conclusions are supported by substantial evidence in the record, or by logical inferences from the record. The analysis relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran-Ferguson Act. It presumes that all current operations and activities are static without consideration of any dynamics or responses occurring before a presumed insolvency.") (footnote omitted).

> better-defined process, clear accountability, and a clear statement of the outer limits of its authorities.[218]

In that respect, Dodd-Frank's thin framework for the FSOC reflects a more fundamental problem of Congress delegating power to agencies—one highlighted by C. Boyden Gray.[219] As Gray explains, the Supreme Court warned in the "Benzene Case" that Congress would raise problematic constitutional questions if it were to empower an agency to impose regulatory burdens on a party without showing that such impositions are actually necessary to prevent "significant risks of harm" to the public. To allow an agency to exercise such open-ended regulatory discretion would be to allow "such a 'sweeping delegation of legislative power" that it might be unconstitutional."[220]

In short, Congress cannot constitutionally authorize an agency to regulate-by-hypothetical.[221] If the current FSOC structure inherently relies too much on arbitrary and capricious judgments, then, as Wallach argues, Congress should write more substantive content into the statute, informed by the FSOC's expert advice. The issue of systemic financial risk might be too big for administrative law, but it is not too big for Congress.

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218 PHILIP A. WALLACH, TO THE EDGE: LEGALITY, LEGITIMACY, AND THE RESPONSES TO THE 2008 FINANCIAL CRISIS 203 (2015).

219 C. Boyden Gray, *The Nondelegation Canon's Neglected History and Underestimated Legacy*, 22 GEO. MASON L. REV. 619 (2015); *see also id.* at 636–42 (applying this rule to proposals that the FSOC regulate mutual funds strictly on the basis of their size).

220 *See id.* at 625–26 (quoting Indus. Union Dep't, AFL-CIO v. Am. Petroleum Inst., 448 U.S. 607, 641–42, 646, 683 (1980)).

221 Cf. Mehrsa Baradaran, *Regulation by Hypothetical*, 67 VAND. L. REV. 1247 (2014).