

Written Testimony of Robert Hockett

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**“OVERSIGHT OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL: DUE PROCESS AND
TRANSPARENCY IN NON-BANK SIFI DESIGNATIONS”**

I. SCOPE OF TESTIMONY AND QUALIFICATIONS

Thank you for inviting me to speak with you here today. My understanding is that you would like my testimony to discuss two matters of concern to you and to all Americans. Those are the constitutional due process and public transparency of Financial Stability Oversight Council (FSOC or the Council) designations of non-bank financial companies as Systemically Important Financial Institutions (SIFIs).

My understanding is also that you have invited my testimony in light of my academic and other occupational credentials. Those are, in brief, as follows. I hold the Edward Cornell Endowed Chair in Law at Cornell University,¹ where I have taught since 2004. (My office was previously Jon Macey’s.) I am also a Member of the Executive Committee, and former Chair, of the Association of American Law Schools’ Section on Financial Institutions and Consumer Financial Services;² a Member of the New York City Bar Association’s Committee on Banking Law;³ a Fellow of The Century Foundation,⁴ a long-established public policy institute with which I have been associated for nearly four years; and a former Fellow and ongoing associate of

¹ Webpage available at http://www.lawschool.cornell.edu/faculty/bio_robert_hockett.cfm.

² Webpage available at http://memberaccess.aals.org/eWeb/dynamicpage.aspx?webcode=ChpDetail&chp_cst_key=a99dc504-4ef4-43e4-bd35-7f0eb1083b7b.

³ Webpage available at <http://www.nycbar.org/banking-law>.

⁴ Webpage available at <http://tcf.org/experts/detail/robert-c.-hockett>.

Americans for Financial Reform (AFR), a finance-regulatory think tank. Finally, I am a Senior Consultant with Westwood Capital Group, an investment bank in New York.⁵

My principal fields of research, writing, teaching, and practical expertise lie in the realms of enterprise-organizational, monetary, and finance-regulatory law. The functions of macroprudential finance-regulatory councils like the FSOC and central banks like the Federal Reserve (the Fed or FRB) figure with particular importance in much of what I do in these connections, from academic research and writing to conference-organizing and -participating. I am also the author of what soon will be one of the only two or three American law school coursebooks that treat financial regulation in a comprehensive and integrated fashion,⁶ while most of my other academic writing since 2008 has been on (a) the causes of our recent financial difficulties and (b) plausible cures to the ills that have occasioned them.⁷

Prior to entering the legal academy and then again during my sabbatical year of 2012-13, I worked at the International Monetary Fund (IMF, also “the Fund”). As you know, the Fund is one of a small number of intergovernmental organizations through which governments with jurisdiction over the world’s most financially developed economies act in concert to oversee the now globally integrated international monetary and financial systems.⁸ During my first stint there in 1999-2000, my work was on corporate- and finance-regulatory reform proposals under consideration in the wake of the Asian, Russian, and then-gathering Argentine financial difficulties of the era.⁹ During my second stint in 2012-13, which I arranged during my sabbatical in order to help “keep my feet wet,” my work was primarily on how best to implement, harmoniously and through law, new proactively crisis-preventive, “macroprudential”

⁵ Webpage available at <http://www.westwoodcapital.com/ourpeople/robert-hockett/>.

⁶ ROBERT HOCKETT, CASES AND MATERIALS ON FINANCE AND ITS REGULATION (West, 2016) (forthcoming).

⁷ See, e.g., Robert Hockett, *A Fixer-Upper for Finance*, 87 WASH. U. L. REV. 1213 (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1367278; Robert Hockett, *The Macroprudential Turn: From Institutional “Safety and Soundness” to “Systemic Stability” in Financial Supervision*, 9 VA. L. & BUS. REV. 1 (2014) (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2206189.

⁸ See Robert Hockett, *Bretton Woods 1.0: A Constructive Retrieval*, 16 N.Y.U. J. LEGIS. & PUB. POL’Y 1 (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1805962.

⁹ See, e.g., Robert Hockett and Barry A.K. Rider, *The Regulation of Insider Dealing*, IMF White Paper, March 2000 (available on request).

approaches to financial regulation that had been adopted post-2008 in the U.S., the U.K., the E.U., and other jurisdictions.¹⁰

I have also worked, again to “keep my feet wet,” at the Federal Reserve Bank of New York (FRBNY) during my academic career. From the early summer of 2011 to the early autumn of 2012, I worked there in a continuous consultative capacity, both in the Legal Department and with economist colleagues in the Research and Statistics Group. The projects on which I worked at FRBNY were numerous and fell under a variety of categorical headings. They included, *inter alia*, helping to identify existing regulatory provisions through which to implement new macroprudential finance-regulatory tools, helping to draft formal Comment Letters in connection with proposed rulemakings by other finance-regulatory agencies, and legal analyses tracing and assessing the likely domestic consequences of possible currency regime changes abroad.

My work at Westwood Capital also is in some cases concerned with or informed by macroeconomic and associated macroprudential finance-regulatory considerations, though it is in other cases more concerned with helping to finance specific transactions that we think likely to yield broader market and other social benefits. It is accordingly another way of “keeping the feet wet,” even if not in every case quite as policy-focused as my academic and other practical work. I believe, then, that I am able to speak from both a scholarly and a practical angle in what I will address here today. But I should emphasize before proceeding that what I shall say I say solely in my individual capacity and not on behalf of any institution with which I am or have been affiliated.

¹⁰ See, e.g., Robert Hockett et al., *Implementing Macroprudential Finance-Oversight Policy: Legal Considerations*, Draft IMF White Paper, February 2013, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2340316; also Robert Hockett et al., *Implementing Macroprudential Policy – Selected Legal Issues*, IMF Board Paper, June 17, 2013, available at <http://www.imf.org/external/np/pp/eng/2013/061713.pdf>; and Robert Hockett, *Practical Guidance on Macroprudential Finance-Regulatory Reform*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, November 22, 2013, available at <http://blogs.law.harvard.edu/corpgov/2013/11/22/practical-guidance-on-macroprudential-finance-regulatory-reform/>.

II. BACKGROUND TO TODAY’S HEARING: THE NEED TO INTEGRATE CONSTITUTIONAL VALUES WITH EFFICIENT GOVERNANCE IN GENERAL, AND WITH EFFICIENT FINANCIAL GOVERNANCE IN PARTICULAR

The concerns to be discussed here today are in a certain sense “hardy perennials.” They implicate two longstanding and related dilemmas we face in governing ourselves as a nation. The first dilemma is how to reconcile our fundamental constitutional separation of powers and due process values with efficient governing of our nation and its markets in general. The second dilemma is how to reconcile sector-specific expertise with the need for cross-sectoral awareness and understanding of our financial markets in particular. Both of these dilemmas have always been with us, and always will be. Today’s discussion is only the latest in a never-ending conversation that will continue for as long as we value governance that is both constitutionally bounded yet efficient on the one hand, and both “deep” and “wide” in its understanding of what we aim to regulate on the other hand.

A. First Dilemma: Efficient Governance and Constitutional Constraints

With respect to the first dilemma, the nation reached a stable equilibrium, where the balancing of constitutional values with efficient government is concerned, some seventy to eighty years ago. You all know the story. On the one hand our Founders, learning from Montesquieu, wisely decided that republican freedom was best safeguarded when the legislative, executive, and adjudicative functions of national government were vested in distinct “branches” thereof. On the other hand our subsequent forebears, less than one hundred years later, found that governing a rapidly growing, dynamically changing, and increasingly complex economy could not be efficiently done on a day-to-day basis by Congressionally legislating every executive action.

For one thing, in highly technical areas – like, e.g., nuclear energy or modern “rocket science” finance – a great deal of highly specialized expertise was necessary. For another thing, Congress was simply too busy and highly placed a body to meet upon and debate, every day, each discrete action a regulator might take in regulating a field – like, again, nuclear energy or modern “rocket science finance” – in which disaster-avoidance was literally a daily imperative.

The first response to this dilemma, late in the 19th and early in the 20th centuries, was to opt in favor of streamlined government efficiency, on the theory that the Congress which established and empowered specialized regulatory agencies was, after all, itself democratically elected. Congress thus empowered specialized executive agencies to regulate specific industries in relation to which highly developed expertise and rapid-response regulatory authority was necessary.¹¹ Sometimes it carefully laid out the boundaries of such agencies' mandates, however, while other times it delegated rather more loosely.¹² When it did the latter, the link between democratically elected legislators and unelected regulators could of course loosen. For the looser the mandate, the easier it was for any rule articulated by an agency as the basis for regulatory action to pass muster as having been "okayed" by Congress. What, then, was the optimal degree of legislative bounding of executive agency action?

The definitive reply to that question began as a mixed jurisprudence under the heading of a court-developed "non-delegation" doctrine.¹³ Pursuant to some early cases decided under this doctrine, Congress was said to be categorically prohibited from delegating legislation-reminiscent rulemaking functions to executive agencies.¹⁴ During its heydays, the nondelegation doctrine accordingly saw courts opting routinely to sacrifice government efficiency wholesale at the altar of a particularly cramped understanding of constitutional purity.¹⁵ That made the exercise of public authority over a huge, complex, and dynamically changing economy all but impossible. Courts were treating the Constitution, some accordingly said, as a "suicide pact."

By 1928, however, courts had begun frequently to recognize that we could have our cake and eat it too where efficient governance and constitutional fidelity were concerned.¹⁶ As long as our democratically elected Congress provided an "intelligible principle" on the basis of which regulatory agencies could ascertain the boundaries of their mandates, it was held, and as long as both Congress and the courts maintained ultimate oversight authority over the conduct of

¹¹ An accessible history here is THOMAS K. MCCRAW, *PROPHETS OF REGULATION: CHARLES FRANCIS ADAMS; LOUIS D. BRANDEIS; JAMES M. LANDIS; ALFRED E. KAHN* (1986).

¹² *Id.*

¹³ See, e.g., Andrew J. Ziaja, *Hot Oil and Hot Air: The Development of the Nondelegation Doctrine through the New Deal, a History 1813-1944*, 35 *HASTINGS CONST. L.Q.* 921 (2008).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ See, e.g., *J. W. Hampton, Jr. & Co. v. United States* (1928). Earlier antecedents include *Field v. Clark*, 143 U.S. 649 (1892); and *Wayman v. Southard* (1825).

regulatory activity, efficient regulatory activity would be consistent with our constitutional values. That is effectively the settlement with which we have lived ever since. Its definitive codification is found not only in post-1928 jurisprudence, but also in the Administrative Procedure Act of 1946 (APA),¹⁷ itself upheld and interpreted over time by our courts.

The APA regime effectively recognizes the need of efficient governance on the one hand, while safeguarding basic constitutional values in the carrying out of that governance on the other hand. Hence it recognizes, for example, that when Congress prohibits in broad language the “use or employ[ment], in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors,”¹⁸ and establishes a specialized agency – the Securities & Exchange Commission (SEC) – to determine over time what new schemes and scams developed by sharp operators should *count* as devices or contrivances of this kind, this need not offend constitutional values. At the same time, it establishes procedures – required public notice and comment periods, responsive alterations of proposed regulatory text, reviewability in federal courts, etc. – aimed at ensuring public input into, and the legislative and constitutional propriety of, all regulatory output.

By the same token, the APA regime recognizes that Congress might see fit, again in the name of efficient deployment of government resources, to afford preliminary adjudications of disputes between regulators and regulated parties before administrative law judges (ALJs), in the event resolution might be had before taking up the time of the courts and incurring the heavy costs of lawyered up litigation. Again at the same time, however, the Act and the courts recognize and enforce the rights of aggrieved parties to resort to the courts when they remain unsatisfied by the remedies had within agency adjudications themselves. This is how we reconcile efficient governance with unimpaired access to the judicial branch of our government – our Article III courts.

One could go on, but the central point is now made. For nearly a century we have operated with a workable settlement that reconciles the imperatives of modern and efficient

¹⁷ Codified at 5 USC ch. 5, subch. 1.

¹⁸ See 15 USC 78j, codifying Section 10(b) of the Securities Exchange Act of 1934.

governance of a vast, dauntingly complex, and ever-growing economy with hundreds of distinct sectors on the one hand, and those of our founding 18th-century political document on the other hand. The Financial Stability Oversight Council (FSOC), more on which below, must be examined within the context of that delicate but longstanding balance on which we settled as a nation quite long ago. Its basic functions and operations are in no way unfamiliar within that habitat. Hence we shall have to distinguish between claims that the FSOC can be improved on the one hand, and claims to the effect that it is somehow constitutionally or administratively extraordinary or anomalous on the other hand.

B. Second Dilemma: Sector-Specific Expertise and Cross-Sectoral Awareness

Our nation's answer to the first dilemma – that of reconciling efficient governance with basic constitutional constraints – I noted to be of long standing. Our answer to the second – that of reconciling sectoral expertise with cross-sectoral understanding – is of more recent vintage, at least where the regulation of finance is concerned. It is the FSOC, established just over five years ago.

As many of you know, the U.S. is more or less unique among comparably developed jurisdictions in the number of distinct financial regulators that have overseen its complex and sprawling financial system for decades. At least three distinct regulatory agencies (the Fed, FDIC, and OCC¹⁹) oversee federally-chartered or -insured commercial banks, for example, while state regulators supervise state-chartered commercial banks alongside those banks' federal insurer, the FDIC. Other regulators (primarily the NCUA and, until 2011, the OTS²⁰) have, along with the Fed in the case of some holding companies,²¹ helped supervise some of the nation's noncommercial ("thrift" and "credit union") banking institutions, while still others

¹⁹ The FDIC is the Federal Deposit Insurance Corporation, which insures all federally chartered and nearly all state chartered depository institutions. The OCC is the Office of the Comptroller of the Currency, housed in the Department of Treasury, which charters national banks and administers the lending-limit and other portfolio-shaping regimes to which those banks are subject, among other things. Its counterpart in the case of state-chartered banks is typically called the state "banking commissioner."

²⁰ The NCUA is the National Credit Union Administration, charged with regulating that form of noncommercial (i.e., non-shareholder-owned) depository institution known as the "credit union." The OTS was the Office of Thrift Supervision, which used to regulate other forms of noncommercial ("thrift") institutions, and whose former duties since 2011 have been parceled out among the other depository institution regulators.

²¹ See below for more on the Fed's supervisory role vis-à-vis holding companies that own depository institutions of various stripes – commercial banks, thrifts, etc.

(FHA and FHFA²²) oversee the nation’s system of home mortgage finance. Meanwhile, another regulator (the SEC²³) has primary responsibility for overseeing the nation’s securities markets and the firms, including broker-dealers (“investment banks”) and investment companies (“mutual” and “closed-end” funds) that operate therein. And yet another regulator (the CFTC²⁴) oversees the derivatives markets. Finally, under the McCarran-Ferguson Act of 1945, state insurance commissioners take primary responsibility for regulating the nation’s (since 2010, non-SIFI²⁵) insurance firms, including the actions they take in their capacities as financial intermediaries.

The fragmented or “siloed” character of our financial regulators, which was quite stark before 2010 and remains pronounced even after, does carry with it certain advantages. A regulator that focuses on a particular sector of the financial system – e.g., commercial banks, investment banks, or insurance companies – is able to develop over time a “deep” expertise when it comes to understanding the value added by and the challenges faced or raised by the businesses that operate in that sector. It is also able to develop an ongoing rapport with the firms that it regulates, which can assist it in gathering information and responding to regulated entities’ concerns while also reassuring those entities’ of the regulator’s good faith.

At the same time, however, when firms in one sector begin increasingly to offer new products and services reminiscent of those more familiar to another sector,²⁶ the traditional argument in favor of siloed regulators begins to lose purchase. When, in addition, firms in one sector begin adopting risk-occasioning practices long familiar to another sector,²⁷ the siloed

²² FHA is the Federal Housing Authority, which since 1934 has provided default insurance on qualifying mortgages (the now familiar 30-year fixed rate was its invention) and assisted with home refinance and home borrower education. FHFA is the Federal Housing Finance Agency, which primarily regulates such secondary mortgage market makers as Fannie Mae.

²³ The SEC, again, is the Securities and Exchange Commission, which since 1934 has regulated the securities markets, the broker-dealer firms that operate in those markets, and the investment companies, including mutual funds, that specialize in investing in those markets. It also regulates those who serve as investment advisors to such companies, as defined by the Investment Advisors Act of 1940.

²⁴ The CFTC is the Commodity Futures Trading Commission, which is the SEC’s counterpart in the derivatives markets.

²⁵ SIFIs are “Systemically Important Financial Institutions,” a category that embraces two subcategories of institution defined under the Dodd-Frank Act, more on which infra.

²⁶ As in the case, for example, of money market mutual funds (MMFs) increasingly offering bank-like products and services through the 1980s and after.

²⁷ As in the case, for example, of insurance companies funding long maturity investments with short maturity borrowings like repos or cashable policies.

approach to financial regulation becomes not only less justifiable, but downright dangerous.²⁸ Finally, where “financial convergence,” as it was called in the 1990s, involves not only cross-sectoral product- and transaction-replication but also cross-institutional transacting or affiliating, yet another challenge is posed to the siloed form of financial regulation, for the risks associated with one sector’s business model can now be transmitted – if not indeed intentionally transferred – to another, less appropriately regulated sector’s balance sheets.

The dangers of siloed financial regulation became particularly apparent during the financial meltdown of 2008. Many nonbank financial institutions, for example, found means of borrowing short term in order to invest long term, this with a view to profiting on the spreads between low short term borrowing costs and higher long term investment returns. In so doing these institutions effectively replicated the maturity-transformation properties of bank balance sheets, thereby rendering themselves vulnerable to bank-run-remniscent liquidity risk. The problem, of course, was that these institutions were neither protected against such risks as banks are by deposit insurance, nor compensatingly regulated against such risks as banks are by their insurer, the FDIC. Indeed in many cases, these institutions’ regulators weren’t even primed to be on the lookout for maturity-mismatch-associated liquidity risk. Lehman Brothers, an investment bank, was of course the poster child for this vulnerability.

Relatedly but distinctly, by 2008 many financial firms of many nominally distinct kinds had become so interdependent upon one another’s solvencies that the failure of one firm of one type could significantly threaten the solvencies of other firms of other types. In some cases these webs of interdependency had become so dense, with so many distinct forms and sheer quantities of interconnection, that no regulator of one institution type was able adequately to assess such institutions’ vulnerabilities to the possible failures of other firms of other types. Here the poster child surely was American Insurance Group (AIG), which had purported to insure multiple other institutions against risks associated with the assets they carried, such that its insolvency threatened the solvency of countless other large institutions. But the money market mutual funds that had made short term loans to institutions like Lehman were likewise conspicuous instances of this form of vulnerability, and their looming failures in 2008 were particularly ominous in

²⁸ For regulators in the newly risky sector will not, unless they communicate well, know immediately how best to regulate the new sources of risk in the way that their more seasoned peers in other sectors do.

view of their having come to function as bank substitutes for millions of Americans by the time of the crisis.

It is against this backdrop that Congress devoted the very first sections of The Dodd-Frank Act – Title I – to the FSOC. There was broad consensus post-2008 that the crisis had conclusively demonstrated once and for all that the eccentric and haphazardly siloed character of American financial regulation was dysfunctional, no longer adapted to a no longer siloed financial system. But that left a question: what form should non-siloed regulation take? Many suggested that a single financial regulator – something like Britain’s or Japan’s Financial Service Authority (FSA) should be instituted, and that this plenary regulator would work in tandem with the Fed as its regulatory twin.²⁹ Dodd-Frank’s framers, however, operated in a more conservative, pragmatically incrementalist manner. They did so by maintaining the separate sectoral regulators, but bringing them together into a periodically convening single council in which they could all “get on the same page,” so to speak, where developing an overview of the financial system as a whole and its systemic risks were concerned.

In constructing the FSOC in this particular manner, Dodd-Frank endeavors to “have the cake and eat it too” in respect of the “depth versus breath” dilemma rather as the APA does in respect of the “efficient governance versus constitutional safeguards dilemma.” This is readily apparent both in the structure and in the functions and authority conferred by Dodd-Frank on the FSOC. With respect to structure, the Council comprises all ten of the primary federal financial regulators, each of whom has voting authority on the Council, including the Chair of the FRB and the Secretary of the Treasury.³⁰ It also includes five non-voting members from government entities lacking in federal regulatory jurisdiction, in order to have the benefit of their knowledge of other corners of the financial system.³¹ This structure is not unlike that of other interagency government councils such as the National Security Council,³² suggesting that Congress in

²⁹ Such is the so-called “twin peaks” model of financial and monetary regulation, pursuant to which the “prudential regulator” maintains financial stability while the central bank maintains monetary stability. See Hockett, *Macroprudential Turn*, supra note 7.

³⁰ See 12 USC 5321(b)(1).

³¹ See 12 USC 5321(b)(2).

³² See 50 USC 3021(a),(b) (Supp. I 2013).

enacting Dodd-Frank had taken specific cognizance of the potentially cataclysmic character of financial “meltdowns” – the latter term imported, of course, from the nuclear power industry.

With respect to functions and authority, the FSOC plays two principal roles and is endowed with only such authority as is necessary to carry out those roles. The first role is that of identifying “risks to the financial stability of the U.S. that *could* arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies” (emphasis supplied), and responding to such threats by making recommendations to Congress, to the separate regulators whose head constitute the Council itself, or both.³³ The authority that it has in connection with this role is that of collecting information from regulators and market participants that can aid it in its systemic-risk-monitoring tasks – information that the new Office of Financial Research (OFR), FSOC’s ancillary institutions also instituted by Dodd-Frank, assists it in gathering and assessing.³⁴

The second role played by FSOC is complementary to the first: it is to identify particular *firms* whose size, operations, or connections could render *them themselves* “threat[s] to the financial stability of the U.S.” in the event of insolvency.³⁵ These are the so-called “Systemically Important Financial Institutions,” or “SIFIs.” Designating them is one instance of FSOC’s more general mandate to “require supervision . . . for nonbank financial companies that *may* pose risks to the financial stability of the United States.”³⁶ The authority that FSOC has in connection with this role is, again, to gather information germane to its deliberations over whether to designate any firm a SIFI.³⁷

SIFI designation carries with it two important consequences for any designated firm. For the designation activates authority on the part of the Fed to take two important regulatory measures. The first is to promulgate enhanced prudential standards akin to those to which it already subjects large, interconnected banks under its authority as administrator of the Bank

³³ See 12 USC 5322. See also FSOC’s rule promulgated under this authority, requiring the Council to conduct “robust analysis of the *potential* threat that . . . nonbank financial companies *could* pose to U.S. financial stability.” 12 CFR Part 1310 (emphases supplied).

³⁴ Id.

³⁵ See 12 USC 5323(a)(1). Once again “could” is the operative word.

³⁶ See 12 USC 5323(a)(1) (emphasis again supplied).

³⁷ See sources cited *supra*, note 33.

Holding Company Act of 1956 and the Gramm-Leach-Bliley Act (GLBA) of 1999.³⁸ The second is to require designated firms to map their complex asset and liability structures carefully in advance so that the FDIC can liquidate them in an orderly manner in the event of an insolvency – the so-called “living will” and “orderly liquidation” authorities (OLA) laid out by Dodd-Frank Title II.

These two consequences are intimately related, which is part of why they appear consecutively in Dodd-Frank’s very first two Titles. Their relation is this: they are meant to operate from both the front-end (enhanced prudential regulation) and the back-end (orderly liquidation) to prevent a cascade of 2008-style bailouts from happening ever again. Enhanced prudential standards are aimed to prevent externality-causing insolvency. Orderly liquidation is aimed at preventing the need, in the event that insolvencies do occur, to extend federal moneys to “prop up” failing institutions so as either to prevent or to postpone failure when such would impose catastrophic costs upon innocent third parties.

It is no accident that both the FSOC’s very existence and these two primary functions are laid out in Dodd-Frank’s very first two Titles. They are the single most important set of contributions made by Dodd-Frank itself, addressed to what were universally acknowledged to have been the principal two weaknesses in our siloed form of financial regulation as revealed by the crisis of 2008. The first of those, again, was the fragmented system’s failure to see in advance that nonbank institutions were now occasioning risk of a kind that the banking system alone had done back in the days prior to FDIC deposit insurance and expedited liquidation authority. The second, relatedly, was this same system’s incapacity to resolve failing nonbank institutions in the same expeditious manner as it could banking institutions – notwithstanding that these nonbank institutions, aptly and now famously dubbed “shadow banks” by my friend Paul McCulley, just *were* the present era’s new banks where liquidity risk and messy liquidation risk were concerned.

The FSOC’s SIFI designation regime, then, lies at the very core of Dodd-Frank. It is narrowly targeted at preventing bank-like risks and associated systemically catastrophic bank-like failures from occurring among nonbank institutions, when these come to replicate banks in

³⁸ Id.

their systemic significance. In this respect SIFI-designation can be viewed as a sort of “flip side” to chartering decisions made by the OCC when promoters seek permission to start up new banking organizations. These charters are matters of privilege, not right, for systemic consequences – and hence potential public expenditures – follow the granting of bank charters. The strings that come attached to national bank charters include subjection to enhanced forms of prudential regulation to which other firms are not subject, as well as subjection to FDIC-style expedited liquidation authority in the event of insolvency notwithstanding those forms of regulation.

SIFI-designation functions as a sort of retroactive attachment of similar strings when it turns out that a financial institution that does not call itself a bank nevertheless *amounts* to a bank where its systemic importance is concerned. It is accordingly no surprise that the degree of discretion legally afforded FSOC SIFI-designation is reminiscent of that afforded OCC decisions to grant or refrain from granting bank charters. (In fact, as I’ll indicate, the SIFI-designation process is actually much more painstakingly bounded than are OCC chartering decisions – but this is by statute rather than court-developed rule.) Nor is it any surprise that, just as those who do not operate like banks need not procure bank charters, so do large financial institutions that do not impose bank-like risks upon the broader financial system not need worry about SIFI designation.

In any event, to undo or substantially impede the SIFI-designation and associated orderly liquidation regime would be effectively to return to the financial system we lived under prior to 2008. Fine-tuning it to enable it to function with yet greater effectiveness without ignoring the constitutional settlement described in Section A above, or to afford yet more constitutional safeguards without impeding its effectiveness, would be one thing. Throwing constitutional cautions or regulatory efficiency to the winds would be another. Any future tinkering with FSOC’s structure, functions, or authorities must take very special care that would-be improvements not upset the delicate constitutional/efficiency balance, or the nearly as delicate depth/breadth balance, that we have striven so hard to establish and maintain.

As things stand, I believe both balances well maintained by the current FSOC SIFI-designation regime. For the protections against arbitrariness and capriciousness in the designation of SIFIs are much more robust even than we find in the case of OCC bank-

chartering. For one thing, final SIFI-designation requires a supermajority vote – at least 2/3 – of the FSOC’s members, including an affirmative vote by the Treasury Secretary.³⁹ For another thing, SIFI designation requires separate consultation with any nonbank SIFI’s sector-specific regulator,⁴⁰ and annual reevaluation of its designation decision.⁴¹ For yet another thing, Dodd-Frank affords detailed guidance as to what sorts of consideration the FSOC is to take into account in determining SIFI status. Among these are the exposure of the prospective SIFI’s creditors, counterparties, investors, or other market participants to its possible failure; the proneness of the SIFI’s assets to “firesale”-style price plummets if liquidated quickly; and the degree to which market participants rely upon the prospective SIFI’s continued functioning in order to access a critical function or service.⁴²

Finally, Dodd-Frank on the one hand, and the FSOC itself via its rulemaking on the other, imposes a multi-step sequence upon the process of SIFI-determination, each step aimed both at enhancing the aptness of decisions and the due process interests of prospective SIFI-designees.⁴³ At Stage 1 the Council applies uniform and publicly available quantitative thresholds to develop a broad list of firms that *might* warrant SIFI designation. It operates pursuant to six quantitative thresholds calculated under six qualitative criteria, and posts on its website the components of the six thresholds, its methodologies for calculating them, and its methods of estimating them when less than complete data is available.⁴⁴

At Stage 2 the Council analyzes, on an individualized basis, companies identified in Stage 1. It now employs both quantitative and qualitative methodologies to determine company risk profiles. It may use non-public information at this point in the process where confidences need be maintained, including confidential supervisory information that a firm’s primary regulator has supplied. The Council now notifies a company within 30 days of an analytical team’s being assembled to begin active review of the company. It also provides to the company

³⁹ See 12 USC 5323(a)(1).

⁴⁰ See 12 USC 5323(g).

⁴¹ See 12 USC 5323(d).

⁴² See 12 USC 5323(a)(2), (b)(2).

⁴³ See 12 USC 5323(e); 12 CFR Part 1310, Subpart C. Also Staff Guidance, Financial Stability Oversight Council, Methodology Relating to Stage 1 Thresholds (June. 8, 2015), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf>.

⁴⁴ See Staff Guidance, *id.*

all “primary public sources of information being considered.” The Council also commences engagement with prospective SIFIs’ primary regulators at this stage. Before any final decision is made to move the company to Stage 3, the company is given the opportunity to present information to the Council. If the company announces publicly that it is under active review, the Council also confirms that such review is ongoing if requested by a third-party.⁴⁵

Finally at Stage 3, FSOC contacts non-bank financial company that it believes merits further review to collect information directly from the company that was not available in the prior stages. An analytical team staff then meets with the company’s representatives to explain the evaluation process and the framework for the Council’s analysis. The company is now also afforded an opportunity to submit written materials pertinent to the FSOC’s determination. The Council may also grant any timely request for an oral hearing or a hearing before the Council members. The Council also disclose the numbers of non-bank financial companies that, since the publication of its previous annual report, it has voted to advance to Stage 3, not to advance to Stage 3, and to designate a SIFI.⁴⁶

This three-stage process, which in view of the internally sequenced character of each stage itself amounts to something more like a ten-stage process, is much more detailed and solicitous of aggrieved parties’ concerns than is that, say, of bank charter decisions, which under the APA itself is reviewable by courts only under the highly deferential “arbitrary and capricious” standard.⁴⁷ It is scarcely surprising, then, that Dodd-Frank itself specifies that this standard also is applicable to review of FSOC SIFI-designations.⁴⁸ Indeed, in view of the complex, technical, and dynamic nature of the subject of FSOC regulatory expertise,⁴⁹ as well as the consequently unavoidably predictive character of its determinations,⁵⁰ court review of its

⁴⁵ See sources cited supra, note 43.

⁴⁶ Id.

⁴⁷ See *Camp v. Pitts*, 411 US 138 (1973). On the deference mandated by the arbitrary and capricious standard, see *Motor Vehicle Mfrs. Ass’n of the U.S. v. State Farm Mut. Auto. Ins. Co.* 463 U.S. 29, 43 (1983) (Court “is not to substitute its judgment for that of the agency.”); also *Rural Cellular Ass’n v. FCC*, 588 F.3d 1095, 1105 (D.C. Cir. 2009).

⁴⁸ See 12 USC 5323(h).

⁴⁹ See *Cablevision Sys. Corp. v. FCC*, 597 F.3d 1306, 1311 (D.C. Cir. 2010); *Domestic Sec., Inc. v. SEC*, 333 F.3d 239, 248 (D.C. Cir. 2003); *Appalachian Power Co. v. EPA*, 251 F.3d 1026, 1035 (D.C. Cir. 2001).

⁵⁰ *Rural Cellular*, supra note 47; also *BellSouth Corp. v. FCC*, 162 F.3d 1215, 1221 (D.C. Cir. 1999); *Melcher v. FCC*, 134 F.3d 1143, 1151 (D.C. Cir. 1998).

decisions are meant to be highly deferential even relative to the already deferential baseline of ordinary cases subject to arbitrariness and capriciousness review.

In light of all of this background, I have no doubt whatever that no federal court in the U.S. would find anything constitutionally or regulatorily problematic about the structure or functions of the FSOC as a general matter. Nor do I believe that a court would find any regular exercise of its authorities by the FSOC legally problematic save in the most extreme and egregious disregard of or violation of the standards that I have just articulated. I also suspect that the vast majority of finance-regulatory experts would agree that the FSOC as currently constituted represents a reasonably conservative, pragmatically incrementalist move in the direction of non-siloed regulatory consolidation at the present stage of our financial and finance-regulatory development. I doubt that many, if any, finance-regulatory experts would argue that we should either return to the pre-2008 environment of siloed regulators or rocket immediately forward to a single, FSA-style prudential regulator.

In short, then, I think that courts will agree that the FSOC regime is consistent with our longstanding settlement with respect to the balance of regulatory efficiency and constitutional constraint, and that finance-regulatory experts will agree that the same regime is consistent with the balance we desire between “deep” sectoral expertise and “wide” cross-sectoral understanding. This does not, however, by any means entail that the present regime is perfect. Certainly constructive criticisms and corresponding proposals for improvement can in good faith be made. That takes me to some of the specific criticisms that I take to have prompted today’s hearing.

III. CRITICISMS OF FSOC THAT APPEAR TO HAVE OCCASIONED TODAY’S HEARING

Today’s hearing appears to be primarily concerned with the FSOC’s SIFI-designation process, pursuant to which four designations have been made to date – those of AIG (of 2008 crisis renown), General Electric Capital Corporation, Inc. (“GE Capital”), Prudential Financial, Inc. (“Prudential”), and MetLife, Inc. (“MetLife”).⁵¹ They seem to have been occasioned in part

⁵¹ See Financial Stability Oversight Council, Designations, available at <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>. For MetLife’s Designation in particular, see Basis for the Financial Stability Oversight Council’s Final Determination Regarding MetLife, Inc., December

by criticisms levelled at FSOC by MetLife in particular, the only SIFI-designee to have challenged its designation in court.⁵² In addition to MetLife’s criticisms, there have been several others levelled by *Amici Curiae* offering opinions to the court on behalf of MetLife in connection with its case. As suggested above, I do not believe any of these criticisms to have legal merit as any court is apt to define it. This does not preclude some such criticism’s possibly having policy merit, however, so I will address each criticism from each of those angles.

A. Separation of Powers

In its complaint, MetLife attempts to impugn the constitutional propriety of the FSOC’s very existence, arguing that the “extraordinary design in the Dodd-Frank of FSOC itself” constitutes a violation of the Constitution’s separation of legislative, executive, and judicial powers in Articles I through III of the Constitution.⁵³ The Complaint elaborates by explaining that FSOC “identifies individual companies for designation, establishes the standards that govern the designation decision, and then sits in judgment of its own recommendations, relying each step of the way on the same staff that identified the company for designation in the first place.”⁵⁴ This is a surprising claim because it both “proves too much” and appears to call into question the APA settlement itself.

As noted above, that about executive agencies which occasioned concern in the first place, commencing in the late 19th century, was their combining, in the name of efficiency, executive, quasi-legislative, and quasi-adjudicative functions within the same organ of government. The means we chose to prevent such arrangements’ violating constitutional separation of powers while streamlining governance were those of the APA and associated caselaw – intelligible legislative directives, public notice and comment in rulemaking, and recourse to the courts when in-house adjudications did not afford satisfaction. There is no argument that the FSOC’s mandate and procedures as prescribed by Dodd-Frank are in any way out of step with that settlement, unless the “same staff” observation is meant to make the

18, 2014, available at

<http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf>.

⁵² See *MetLife, Inc. v. Financial Stability Oversight Council*, No. 15-45 Civ. (D.D.C., filed Jan. 13, 2015), available at <http://www.chamberlitigation.com/sites/default/files/cases/files/2015/Complaint%20--%20MetLife%20v.%20FSOC%20%28DDC%29.pdf> (hereinafter “Complaint”).

⁵³ Complaint, *id.*, at 6-7; also at 73, 76.

⁵⁴ *Id.*

difference. But no reason is given as to why the latter would or should in the absence of formal in-house adjudication; and the fact that FSOC is no more required to provide formal adjudications, complete with administrative law judges (ALJs) than is the OCC with respect to bank chartering decisions suggests that no legal such reason could ever be found.⁵⁵

MetLife's quarrel seems accordingly to be with our longstanding settlement itself. It would seem as applicable to each of the distinct regulatory agencies whose heads constitute the Council as it is to the Council itself. Indeed it would seem applicable to all administrative agencies, and in that sense to the post-19th century administrative state itself. No court is going to dismantle the latter – nor, of course, is any Congress. The complaint is quite literally a nonstarter. This is not to say, however, that there is no reason for Congress to consider requiring formal adjudications with respect to all agency actions within agencies themselves, and to require that these be conducted by specialized ALJs as occurs within some agencies. I have no opinion to offer on whether this would be a good idea or not, and leave it to Congress and administrative law scholars to vet any such prospect.

B. Due Process

MetLife also argues that the FSOC SIFI-designation process is incompatible with 5th Amendment due process rights, on several grounds.⁵⁶ The first ground is simply a restatement of the aforementioned separation of powers claim, and accordingly fares not better as a legal matter.⁵⁷

The second ground is that “FSOC has never identified the thresholds that result in SIFI designation and how the various statutory and regulatory factors are being balanced against one another,” which MetLife argues prevent “the government ... provid[ing] adequate notice of what is required and what is prohibited,” as well as from “provid[ing] explicit standards for those who apply them.”⁵⁸ This argument too “proves too much,” inasmuch as it appears to claim that due process requires not only regulatory agencies, but also Congress, to provide precise algorithms enabling machine calculations of outputs of all multifactor “totality of the circumstances”

⁵⁵ See again *Camp v. Pitts*, supra note 47.

⁵⁶ Complaint, supra note 52, at 73-75.

⁵⁷ Id. at 73.

⁵⁸ Id. at 74.

inquiries and “balancing tests” found in statutes, regulatory provisions, and court-developed criteria for the application of legal concepts.

That is of course wildly inaccurate as a statement of law, as not only the National Bank Act’s and OCC’s associated criteria in deciding on bank charters make clear,⁵⁹ but also hundreds if not thousands of other longstanding statutory, regulatory, and court-developed pragmatic balancing tests do too.⁶⁰ It also is doubtful that any legislator would wish to *make* any such standard the law, inasmuch as this would seem to require that all proper legal questions now ultimately decidable by judges be decidable by computing machines. This is not to say that something resembling a more algorithmic form of clarity might not be feasible and desirable with respect to some regulatorily important questions, however, and indeed it even is there to be had in connection with some – including some addressed by FSOC itself.⁶¹ Whether and where to mandate more such machine-calculable precision is a difficult question whose answer is apt to vary from regulatory context to regulatory context. But neither the question nor its answer will likely have anything to do with due process as contemplated by our Constitution and interpreted by our courts.

The third ground on which MetLife claims FSOC to have violated its due process rights is that FSOC “repeatedly and improperly denied MetLife access to the full record on which its Notice of Proposed Determination and Final Designation were based.”⁶² This claim is effectively a rehash of the first ground and, accordingly, the separation of powers argument as well. The reason is that, again, FSOC is no more constitutionally or statutorily required to conduct a formal adjudication of SIFI determinations than is the OCC of bank chartering decisions.⁶³ Hence there is no requirement that every internal deliberation or piece of evidence that the Council found germane in making its determination be made public.

⁵⁹ See 12 USC 1816; 12 CFR 5.20(c); and *Camp v. Pitts*, supra, note 47. The criteria, which are not assigned comparative weights or lexicographically ordered, and no one of which is categorically dispositive, are (1) the bank’s future earnings prospects, (2) the general character of its management, (3) the adequacy of its capital structure, (4) the convenience and needs of the community to be served by the bank, (5) the financial history and condition of the bank, and (6) the regulatory compliance to date of the bank.

⁶⁰ Consider veil-piercing in corporate law, for example, pursuant to which courts look to unobserved corporate formalities, comingled funds, undercapitalization, assumption of risk by creditors, and other factors in determining whether to disregard the limited liability of corporate owners in some cases.

⁶¹ See, e.g., supra, note 44, and accompanying text.

⁶² Complaint, supra note 52, at 74.

⁶³ See again *Camp v. Pitts*, supra, note 47.

Nor is Congress's declining to prescribe differently in Dodd-Frank particularly surprising. In examining a prospective SIFI's interconnections with other financial institutions, the FSOC accesses proprietary information about other private institutions with which the prospective SIFI transacts, some of which is no business of the prospective SIFI or of other private parties. Similar remarks hold of some of the data and opinions FSOC receives from other regulators that have interacted with the prospective SIFI. Hence there are good policy reasons for neither Congress's nor the courts' ever having mandated that all information whatever that enters into a regulator's deliberations in deciding how to regulate a particular institution be turned over to any regulated entity that demands it.

Congress could of course decide that a regulated entity's desire of all such information trumps the privacy interests of all other private institutions directly or indirectly affected by the regulated entity's financial health. But I doubt that would go over well with the other institutions in question, or that most legislators would ever decide that it is a categorically good idea.

C. Arbitrariness, Capriciousness, "Irrationality"

In addition to its "constitutional" arguments, MetLife argues that FSOC's SIFI-designation fails the highly deferential "arbitrary and capricious" standard of review prescribed by the APA in cases such as its own.⁶⁴ It does so on multiple grounds that it would be tedious to rehearse and assess comprehensively here – that's what the trial process is for – so instead I shall point simply to several related themes that appear to recur through most of the separate counts asserted by MetLife against FSOC. The themes I identify are worth pointing out because, even while I am quite confident they will avail MetLife nothing as a matter of law in the courts, one can imagine good faith disagreements of policy over how best to frame or amend law going forward in light of them.

One prominent theme both in MetLife's complaint and in the writings of some who support MetLife is that of the "speculative" character of FSOC's modeling of hypothetical worst-case scenarios in determining whether a MetLife insolvency event could imperil the stability of the larger financial system.⁶⁵ As a matter of law, these claims are likely to go nowhere – both in

⁶⁴ Complaint, *supra*, note 52, at 40-72.

⁶⁵ See, e.g., *id.* at 47 (Count 4), 51 (Count 6)

virtue of the “could” and “may” language that permeates the statutory guidance provided FSOC by Congress,⁶⁶ and in virtue of FSOC’s having carefully traced specific plausible transaction paths with a view both to known types and to known volumes of financial claims held by, and held against, MetLife.⁶⁷ As a matter of policy, however, it is worth considering why it might be that Congress drafted Dodd-Frank Title I so as to mandate FSOC assessment of possible but not certain scenarios.

Some who complain of modeling like that done by FSOC appear to want to require that FSOC and other regulators assign precise and determinate actuarial likelihoods to all contemplated scenarios, so as to render assessments of dangers more precise. Others appear to want even more than this, suggesting that only likelihoods beyond a certain threshold – e.g., 10% - should be considered plausible concerns. Congress could of course attempt to mandate something like this in connection with all manner of risk regulation in all manner of context, from environmental law to nuclear regulation to financial regulation. It would not likely prove successful, however, for the quite simple reason that actuarial probabilities simply are not available for many, if not most, of the most troubling prospects. “Precisely” how likely, for example, was the 2008 crash? How about BP’s oil spill in the Gulf of Mexico two years later? How would we ever have calculated a number?

The difficulty of assigning precise probability measures to the possible outcomes also undermines prospective requirements that some probability threshold be crossed before an undesired outcome is deemed “plausible,” for the obvious reason that there would seem no basis on which to be confident that any determination that the ersatz-precise threshold had been reached is in fact correct. But there is also another problem with any such requirement: even in cases where a probability measure might reasonably be derived, the actual magnitude of the possible loss might *not* be. Consider the calamity of September 11, 2001, for example. It is hard to imagine how anyone might have assigned a precise numeric probability to measure to the possibility of that event prior to its happening; it is at least as hard to imagine how anyone one might have calculated a dollar value (or “disvalue”) assignable to the event even were s/he able to assign a precise probability.

⁶⁶ See *supra*, notes 33-36, and accompanying text.

⁶⁷ See MetLife Designation as cited *supra*, note 51.

It would surely be incorrect, however, in the face of these observations to conclude that it is somehow “irrational” to attempt to provide against occurrences like 9/11. Yet that is what calling regulatory measures not advocated by reference to precise expected value or disvalue measures “arbitrary and capricious” amounts to. Our law accordingly declines to call them that for good reason. But so should we, I suggest, when it comes to determining what the law *ought* to mandate.

D. Cost-Benefit Analysis

Closely related to the demand for “non-speculative” modeling of risk scenarios is that for “cost-benefit analysis” (CBA) of prospective regulations or determinations. MetLife and some of its supporters seem to want this of FSOC.⁶⁸ As with the demand for “non-speculative” risk modeling, so here the demand is a non-starter if proffered as an interpretation of the “arbitrary and capricious” standard of review – and for essentially the same reasons. Also as with that case, however, I think it ill-advised as a policy prescription as well. Consider again the case of 9/11, for example. In the wake of that calamity, Congress enacted the U.S. Patriot Act, which worked a massive overhaul of the domestic security regime, including a great deal of consolidation of previously fragmented law enforcement agencies. The comparison to Dodd-Frank in the wake of 2008 is actually quite striking.

Now ask whether it would have made sense to subject the Patriot Act to CBA. To go about such an analysis, one would have to calculate the likely costs imposed by the enactment and compliance therewith, then compare these to the likely benefits brought by it. To calculate the latter one would have to calculate (a) the likelihoods of all possible terrorist acts – plane crashes, bombings, shootings, nuclear “dirty bombs,” etc. – at which the Patriot Act Regime would take aim, (b) the “costs” – monetary?, psychological?, other? – of such acts when they succeeded, and (c) the likelihood, in connection with each such possible act, that the Patriot Act regime would prevent or mitigate it – and if the latter, by how much.

The suggestion seems absurd on its face. It is no different where what is in contemplation is not nuclear core meltdowns but financial system meltdowns. *Attempts* at cost-benefit analysis can be useful exercises in such cases, if only to begin to get a handle on the

⁶⁸ See, e.g., Complaint, *supra*, note 52, at 71 (Count 7).

many elements that might jointly constitute the anticipated problem. But to require that the “benefits” outweigh the “costs” in such cases before regulating can proceed, as if the “exercise” had yielded actual probability-weighted values, would itself amount to a sort of legislated suicide pact.

E. Compliance Costs

A final theme I have seen aired in connection with the MetLife case constitutes a proper part of the CBA motif. That is the theme of “compliance costs” and the likelihood that these will be “passed on to consumers,” the latter apparently meant to be taken for damning.⁶⁹ Because it is a proper part of the CBA claim, this claim has no legal significance where the litigation of FSO C SIFI-designations is concerned. It does have a policy significance, however, that I think worth commenting on.

The principal compliance cost that a large financial institution designated a SIFI will incur is that of having to maintain higher capital levels which serve both to buffer creditors of the institution against loss occasioned by insolvency and to lower the leverage rates that raise insolvency risk. Limiting leverage in this way of course potentially lowers profits and hence shareholder returns, but this is simply another way of saying that shareholder opportunities to profit by imposing risk upon creditors will be lessened. Since the creditor cascade effects that interconnectedness enables, and that ultimately prompt SIFI-designation in the first place, amount to that risk’s spreading beyond primary creditors, it is also another way of saying that shareholder opportunities to profit by imposing negative externalities upon innocent third parties will also be lessened. But now we should ask ourselves, is this not precisely the *point*? In other words, is not the whole object of post-crisis financial reform legislation like Dodd-Frank to put an end to the socialization of risks wrought by those who reap merely privatized gain?

Our objection to “too big to fail” in 2008 was precisely the fact that “we, the people” had to swallow the losses occasioned by a comparative few who “minimized compliance costs” precisely by externalizing their risks upon others and thereby maximized gains. The gains, in other words, they kept for themselves and didn’t share; the losses, by contrast, they shared – indeed they deliberately exported – to all of us. The only way to avoid that obnoxious outcome,

⁶⁹ Again see, e.g., Complaint, *supra*, note 52, at 71 (Count 7).

of course, is to prevent firms being too “big,” in the relevant sense, in the first place. That is, it is to eliminate their capacity to externalize costs upon innocent third parties – costs the need to avoid which prompt “*bailouts*” in the first place. But to do this just *is* to lower their profits, for externalizing costs in the form of systemic risk is the *source* of a large chunk of their profits.

When an institution like MetLife gives voice to the truism that greater prudential risk regulation through higher capital requirements represents a “compliance cost,” then, we should remember that this is simply another way of saying that designating it a SIFI will render it no longer “too big to fail.” For it will then have but two choices, neither of which will offer it the option of remaining too big to fail: either it restructures so as to avoid capital regulation and no longer pose systemic risks of the kind that necessitate bailouts in the first place, or it lives with the enhanced capital standards that prevent its failing and thereby avoids necessitating bailouts. It is that simple.

I’ll close with an analogy that might render the point more graphically clear. If you irresponsibly play with matches in your barn and inadvertently set it alight, we are less likely to rescue your barn should it be isolated than if it is shedding sparks that can set other, innocent people’s barns alight. If the latter prospect is that which occurs, such that we *must* save you in order to save innocent others, we are apt to grow irritated in the event you repeat the offense. At some point we will become so impatient that we will issue you this ultimatum: either move your barn far away where its burning will not affect others, or you coat it with new flame-retardant paint straightaway. We are unlikely to be moved if you now complain that this confronts you with a “compliance cost.” That cost is precisely the point of our ultimatum. Henceforth either you, not us, now incur the cost of fire-prevention, or you move your barn to where your match games inside it won’t threaten the rest of us.

CONCLUSION

I hope that the foregoing written testimony serves as a useful supplement to my oral testimony before you today. Please do not hesitate to let me know if I might be of further assistance. I am happy to elaborate further on anything said orally or written above in this supplement, as I have tried to keep myself as brief as possible in both. Thank you again for inviting my thoughts on the matters under discussion.