April 11, 2016

Resistance Is Not Always Futile: The D.C. District Court Deals FSOC a Significant Blow by Rescinding MetLife's Designation

On March 30, the D.C. District Court issued an order rescinding the Financial Stability Oversight Council's (FSOC's) designation of MetLife, Inc., as a systemically important nonbank financial company. The Court's opinion was unsealed on April 7, and the government has already filed a notice of appeal. The Court's decision is a significant setback for FSOC and, if left to stand, could seriously hamper FSOC's future efforts to designate nonbank financial companies and retain the designations already in place.

More broadly, this decision is evidence that challenges to federal regulatory action—even challenges by large financial institutions suing in their own name—can and do succeed. As the decision shows, administrative law places a number of traps in an agency's way that a savvy challenger can put to effective use. And once in front of a judge, the merits and equities of a regulatory decision often take center stage, while abstract principles of deference and agency expertise sometimes recede into the background.

Below we provide background on FSOC, describe the key aspects of the Court's decision, and discuss some of the implications of the case. While the Court faulted FSOC for mistakes and omissions that appear fixable going forward, the Court's reasoning also strikes more fundamentally at FSOC's ability to perform its core mission.[1]

Background

The Financial Stability Oversight Council (FSOC) was established in 2010 by the Dodd–Frank Act.[2] FSOC was created on the theory that, prior to the financial crisis, federal regulators were siloed and there was no single federal entity charged with looking across the entire financial system to identify and address risks to financial stability. FSOC is chaired by the Treasury Secretary, and its nine other voting members are the heads of the federal financial regulatory agencies and a member with insurance expertise appointed by the President.

FSOC's most potent authority is its ability—after notice and a hearing and with a supermajority vote—to designate those nonbank financial companies whose material distress "could pose a threat to the financial stability of the United States."[3] Upon designation, a company becomes subject to prudential standards and supervision by the Federal Reserve, with significant implications for, among other things, its required capital. This authority was granted to FSOC on the rationale that, as the financial crisis showed, very large and interconnected nonbank financial institutions could be as dangerous to the country's financial stability in a distress scenario as large banks and, therefore, should be subjected to heightened federal safeguards.

FSOC has designated four nonbank companies pursuant to this authority: AIG, GE Capital, Prudential Financial, and MetLife.[4] Only MetLife chose to file suit to challenge its designation. Under Dodd–Frank, to prevail on this challenge, MetLife had to show that FSOC's decision was arbitrary and capricious.[5]

The Court's Decision Rescinding MetLife's Designation

Defying the expectations of many at the time MetLife first filed suit,[6] on March 30, Judge Rosemary Collyer of the D.C. District Court entered an order rescinding MetLife's designation.[7] The Court's opinion was sealed pending redactions, and the only clues to the Court's reasoning were the counts of the complaint referred to in the order. On April 7, the Court unsealed in full its thirty-three page opinion[8] and revealed the two major grounds for its decision:

- **FSOC departed from its interpretive guidance without "acknowledgement or explanation**." The Court faulted FSOC for departing in two ways from its Guidance for Nonbank Financial Company Determinations ("Guidance"), which it published in the Federal Register in 2012.

  - First, the Court agreed with MetLife that FSOC violated its Guidance by failing to assess MetLife's vulnerability to material financial distress before addressing the potential effects of that distress. FSOC's position was that Dodd–Frank permitted it to *assume* for purposes of analysis that a company was in a state of material financial distress and then determine whether such distress could pose a threat to U.S. financial stability. FSOC argued that this position was consistent with the Guidance. Judge Collyer, although having spoken positively at oral argument about FSOC's reading as a matter of statutory interpretation, found that FSOC's reading is "undeniably inconsistent" with the Guidance and that FSOC has "steadfastly refused" to acknowledge that there was a change in position and therefore did not explain the reasons for that change.[9] In doing so, FSOC ran afoul of *FCC* v. *Fox Television Stations, Inc.*, which held that agencies can change their interpretations so long as they acknowledge the change and explain the reasons for doing so.[10]

  - Second, FSOC's Guidance stated that a company's distress could threaten U.S. financial stability only "if there would be an impairment of financial intermediation or of financial market function that would be sufficiently severe to inflict significant damage on the broader economy."[11] The Court held that FSOC's designation decision did not abide by that standard and, in fact, "hardly adhered to any standard when it came to assessing MetLife's threat to U.S. financial stability."[12] The Court faulted FSOC for, among other things, focusing on the gross exposure of various counterparties to MetLife, without regard (according to the Court) for collateral and other mitigating factors. FSOC also more broadly failed to "quantify" its predictions. The Court stated: "FSOC never projected *what* the losses would be, *which* financial institutions would have to actively manage their balance sheets, or *how* the market would destabilize as a result."[13] The Court also observed that a "summary of exposures and assets is not a prediction."[14]

- **FSOC's failure to consider a relevant factor—the costs of designation**. MetLife also argued that FSOC's decision was arbitrary and capricious because it failed to consider the costs of designation on MetLife. FSOC argued that it was not required to undertake a cost/benefit analysis absent express congressional command, and that the costs to MetLife were not relevant under the statutory standard, which asked simply whether the company's material distress could pose a threat to financial stability. The statute did give FSOC a list of factors to consider in applying this standard, including a catch-all for "any other risk-related factors" that FSOC "deems appropriate,"[15] but FSOC argued that the costs to MetLife did not fit under any such factor. The Court, however, agreed with MetLife that the costs to MetLife of designation were a relevant risk-related factor, given that FSOC's Guidance stated that it would assess the company's vulnerability to distress. MetLife argued that the designation's imposition of billions of dollars in regulatory costs could actually make MetLife *more* vulnerable to financial distress, not less vulnerable. The Court also focused on the statute's use of the term "appropriate" and relied on the Supreme Court's decision in *Michigan* v. *Environmental Protection Agency*, which faulted the EPA for not considering billions of dollars in regulatory costs in exercising its authority to regulate power plants if "regulation is appropriate and necessary."[16] Because FSOC refused to consider costs to MetLife, the Court concluded, it is impossible to know whether its designation of MetLife "does significantly more harm than good."[17]

As these flaws warranted rescinding the designation, the Court did not address MetLife's numerous other arguments. [18]

Implications

This decision is undeniably a major setback for FSOC, and the government has already filed a notice of appeal.[19] A key question is how damaging the decision, if left to stand, will be over the long term for this central element of the Dodd-Frank Act.

On the one hand, the grounds of decision could be viewed as classic administrative law "foot faults" in the sense that FSOC was found to have committed mistakes, such as departing from previous guidance without explaining why, that it could have avoided, and certainly could avoid going forward, if it attempted to designate MetLife again. On this view, FSOC need only go through the appropriate procedures to amend its Guidance to conform to its current interpretations, and the next time that it performs a designation analysis, it should weigh the costs to the company of designation.

On the other hand, some of the Court's reasoning struck more substantively at the heart of FSOC's mission—and, indeed, at the viability of financial-stability regulation more generally—such as when the Court found wanting the core of FSOC's analysis and predictions about the mechanisms by which MetLife's distress could destabilize markets and threaten U.S. financial stability. Notably, the Court's relatively brief evaluation and criticism of FSOC's methodology and predictions were done under the heading of faulting FSOC for departing from its Guidance. Had this issue been approached as an arbitrary-and-capricious review of the merits of FSOC's analysis, however, the Court likely would have needed to address in detail the large volume of analysis produced by both parties regarding the scenarios by which MetLife's distress could impact the broader market, as well as the case law concerning the deference owed to an agency's expert predictions and methodological judgments.

In any event, the Court's criticism of FSOC's analysis—for, essentially, involving worst-case guesswork and not quantifying or modelling the scenarios that it conjured—calls into question whether FSOC will ever be able to provide an analysis that passes muster. As FSOC and its amici argued, predicting whether one company's distress could threaten U.S. financial stability is an inherently difficult task, unsusceptible to mathematical proof. This is why, the argument goes, Congress established the relatively generous "could" standard, vesting FSOC with significant discretion, and insulated its decisions with the arbitrary-and-capricious standard of review. As Treasury Secretary Lew stated in reference to the Court's decision, "It is FSOC's duty to address the risks associated with very low probability events, just as the failure of AIG or Lehman Brothers would have been considered highly unlikely before the financial crisis."[20] On FSOC's view, it may seem unclear how it can make future designations under the Court's reasoning absent a great methodological advance that would allow for greater quantification and certainties in its predictions. On the other hand, MetLife had faulted FSOC for not employing methods that have been used in other contexts, such as bank stress-testing; it could be that FSOC, going forward, attempts to adapt and build on those methods.

The second major ground of decision—FSOC's failure to take into account the projected costs of designation on the company—also implicates a fundamental issue for the agency. There is significant doubt as to how FSOC would be able to predict—at the designation stage and prior to the Federal Reserve's determinations about what enhanced prudential standards should apply—the costs of designation on a company and, moreover, weigh those costs in a meaningful manner against the benefits of designation (which involve marginally reducing the chances of a low-probability, high-impact event).

The difficulty of predicting the costs of designation is particularly acute because companies are not static and actively manage their capital and other costs in reaction to, among many other things, regulation. MetLife, for example, had announced prior to the Court's decision that it would separate its U.S. retail segment from the rest of the company, in part to avoid the capital costs of its FSOC designation for that business.[21] As this example illustrates, costs of designation may be avoided in many instances through spinoffs or other reorganizations that make the regulated entity smaller or otherwise less systemically important. If a weighing of cost and benefit is required under Dodd-Frank, how this dynamism should be considered is an open question. For example, if the costs of Federal Reserve supervision and enhanced prudential standards are so great that the regulated entity breaks itself up or divests assets or businesses in response, thereby arguably achieving a benefit to the economy as a whole in the form of less systemic risk, do the costs at the designation stage (when the company's reaction to designation is unknown) outweigh the benefits, or vice versa? The decision leaves questions such as these unresolved.

Thus, as this case heads into an appeal, the stakes are high for both FSOC and those nonbank companies that have been, or may be, in the agency's regulatory cross-hairs.

The Court's opinion is available here.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Roberto J. Gonzalez	Brad S. Karp	Elizabeth M. Sacksteder
202-223-7316	212-373-3316	212-373-3505
rgonzalez@paulweiss.com	bkarp@paulweiss.com	esacksteder@paulweiss.com

Associate Damon Andrews contributed to this client memorandum.

[1] One of the co-authors of this memorandum, Roberto J. Gonzalez, previously participated in this litigation while he was Deputy General Counsel of the Treasury Department.

[2] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] 12 U.S.C. § 5323(a)(1).

[4] In its Final Designation decision, FSOC focused on MetLife's status as the largest publicly traded insurance company, with approximately $900 billion in assets, and what FSOC viewed as its extensive capital markets and institutional financial activities that exceeded the traditional business of insurance. FSOC, by a 9-1 vote, found that MetLife satisfied the designation standard because its "material financial distress," were it to occur, "could pose a threat to the financial stability of the United States." 12 U.SC. § 5323(a)(1). FSOC's decision had three primary grounds. First, FSOC concluded that MetLife's financial distress could expose its counterparties to significant losses, and a resulting contagion effect could cause broader destabilization across markets. Second, FSOC determined that the same financial distress could prompt MetLife to liquidate assets quickly, thereby leading to a fire sale dynamic that could broadly disrupt capital markets. And third, MetLife's size and high degree of complexity could hamper its resolution and thus prolong uncertainty. FSOC's public summary of its designation decision is available here: https://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf.

[5] 12 U.S.C. § 5323(h).

[6] *See, e.g.*, Leslie Scism, *For MetLife Chief, Clock Ticks on Showdown with U.S.*, WALL ST. J., Jan. 12, 2015, at C3 ("Legal scholars and analysts have said it is tough, though not impossible, to win a lawsuit against a regulator."); John Heltman & Joe Adler, *Four Takeaways from MetLife's SIFI Legal Challenge*, AM. BANKER, 1 L. & REG. NO. 7, Jan. 13, 2015 ("MetLife faces an uphill battle in convincing the court[.] The record of plaintiffs suing federal agencies over administrative decisions and winning is not great."); Mary Williams Walsh, MetLife Sues Over Being Named Too Big to Fail, N.Y. TIMES, Jan. 13, 2015, § B (Dealbook), at 1 (noting that one "credit ratings agency[ ] called the legal challenge 'an uphill battle' that 'could serve as a distraction to MetLife's management resources'").

[7] Order, MetLife, Inc. v. Fin. Stability Oversight Council, No. 1:15-cv-00045 (D.D.C. Mar. 30, 2016), ECF No. 106.

[8] Sealed Opinion, MetLife, Inc. v. Fin. Stability Oversight Council, No. 1:15-cv-00045 (D.D.C. Mar. 30, 2016), ECF No. 105 ("Slip Op.").

[9] Slip Op. at 20, 21.

[10] 556 U.S. 502, 529–30 (2009). The Court reasoned that, even if the Guidance were an interpretive rule, the Supreme Court's decision in *Perez v. Mortgage Bankers Ass'n,* 135 S. Ct. 1199 (2015), made clear that *FCC v. Fox Television* applies to interpretive rules as well as legislative rules. *See* Slip Op. at 8 n.6.

[11] FSOC, Guidance for Nonbank Financial Company Determinations, *available at* https://www.treasury.gov/initiatives/fsoc/Documents/Nonbank%20Designations%20-%20Final%20Rule%20and%20Guidance.pdf (PDF page 77).

[12] Slip Op. at 25.

[13] *Id.* at 25–26.

[14] *Id.* at 26.

[15] 12 U.S.C. § 5323(a)(2)(K).

[16] 135 S. Ct. 2699, 2711 (2015).

[17] Slip Op. at 30. FSOC also argued that an analysis of the costs to MetLife would be premature given that, after designation, the Federal Reserve would initiate a notice-and-comment process to design prudential standards for MetLife, which would largely determine those costs. The court rejected this argument, citing *Michigan*, on the ground that FSOC's decision denied any role for costs, rather than deferring that issue to a later date. *Id.* at 32.

[18] On the positive side for FSOC, the Court rejected MetLife's threshold argument that it did not qualify as a "nonbank financial company" and was thus ineligible for designation. *See* Slip Op. at 14–18. A loss on this ground could have more directly endangered one or more of FSOC's other designations. Additionally, although at oral argument Judge Collyer showed interest in MetLife's due process and separation-of-powers challenges to FSOC's designation process, the Court did not address those grounds in its opinion.

[19] Notice of Appeal to D.C. Circuit Court, MetLife, Inc. v. Fin. Stability Oversight Council, No. 1:15-cv-00045 (D.D.C. Apr. 8, 2016), ECF No. 111.

[20] Press Release, *Statement from Treasury Secretary Jacob J. Lew on MetLife* v. *Financial Stability Oversight Council* (Apr. 7, 2016), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0410.aspx.

[21] Press Release, MetLife, Inc., *MetLife Announced Plan to Pursue Separation of U.S. Retail Business* (Jan. 12, 2016), *available at* https://www.metlife.com/about/press-room/index.html?compID=192215.