State AGs Challenge Legality of New Dodd-Frank Regulatory Group

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Three states have joined a lawsuit to challenge the constitutionality of the **Financial Stability Oversight Council (FSOC),** a **Dodd-Frank**-created regulatory body headed by the Treasury secretary. The panel, composed of top financial regulators, is charged with overseeing broad threats to the financial system, and has the power to liquidate failing non-bank financial institutions it views as a threat to the that system. The attorneys general of **Michigan, Oklahoma,** and **South Carolina** are challenging the legality of the FSOC, arguing that the panel is too powerful and should be subject to additional checks and balances.

The states are bringing their claim as a subset of a larger suit filed by the **Competitive Enterprise Institute**, a conservative think tank that is also challenging the constitutionality of the power granted to the **Consumer Financial Protection Bureau (CFPB)**. The states do not join the challenge to the CFPB but makes claims only against the FSOC. The state attorneys general argue that the FSOC's liquidation power creates "death panels for American companies" with little outside oversight.

However, the AGs' argument overlooks both the substance of the provision and the background against it was implemented. Far from lacking oversight, the FSOC must undergo a multi-level, multi-branch review in order to liquidate a financial institution. In order to initiate liquidation proceedings, first there must be a written recommendation for the Treasury Secretary to appoint the FDIC as a receiver for the failing company. The recommendation must contain a host of information including an evaluation of the likelihood of a private-sector alternative to prevent default. Then there must be a two-thirds vote of the Fed Board of Governors and a two-thirds vote of the FDIC or **SEC,** or the affirmative approval of the Director of the Office of Federal Insurance in order to appoint a receiver.

If the company does not consent to the appointment of the **FDIC** as a receiver, the matter goes to U.S. District Court for the District of Columbia, where a judge may strike the receivership if it determines that the secretary's decision was arbitrary and capricious. Finally, the Government Accountability Office must review and report to Congress on any receivership appointment.

This liquidation power is not entirely new. For decades, the FDIC has had the ability to take over failing federally insured banks. The difference is that this new provision extends to non-bank financial companies. This provision was enacted in direct response to the recent financial crisis, in which the federal government had to step in to save financial institutions whose risky investments threatened to collapse the American economy. The role of the FSOC is to eliminate the expectation that the U.S. government will shield the institutions from losses in the event of a future failure, while simultaneously ensuring an orderly liquidation for failed companies.

At this time, the FSOC has not taken action to liquidate any financial institutions. It has, however, designated a number of nonbank financial institutions as “**Systematically Important Financial Institutions” (SIFI).** Institutions designated as SIFI are subject to more stringent oversight, including stress tests, higher capital levels and tougher liquidity requirements.

The FSOC began making SIFI designations in July of this year, with the fairly uncontroversial designation of eight financial market utilities. On Monday the FSOC announced that it is considering a number of additional non-banks for SIFI designation. AIG has confirmed that it is one of the institutions under consideration, a development that the company said it both expected and welcomes. Other non-banks rumored to be under consideration as SIFIs include MetLife, Prudential, and General Electric.

It appears that the state AG’s are contesting the FSOC’s liquidity authority out of fear that it gives too much power to federal regulators. However, history has shown how economically dangerous it is for financial institutions to be left to their own devices with little oversight or accountability. The FSOC’s powers are constitutional and within the bounds of the law. The states’ challenge should not survive judicial scrutiny, and the FSOC’s liquidation power should be upheld.

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