ORAL ARGUMENT NOT YET SCHEDULED

No. 16-5086

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

METLIFE, INC.,

Plaintiff-Appellee,

v.

FINANCIAL STABILITY OVERSIGHT COUNCIL,

Defendant-Appellant.

On Appeal from the United States District Court
for the District of Columbia
No. 15-CV-45-RMC (Collyer, J.)

BRIEF OF AMICI CURIAE ACADEMIC EXPERTS IN FINANCIAL REGULATION IN SUPPORT OF APPELLEE AND AFFIRMANCE

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August 22, 2016

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to Circuit Rule 28(a)(1), *amici curiae* Academic Experts in Financial Regulation file the following Certificate as to Parties, Rulings, and Related Cases.

Parties, Intervenors, and *Amici*

Except for the following, all parties, intervenors, and *amici* appearing before the District Court and in this Court are listed in the Brief for Appellant Financial Stability Oversight Council ("Council") and Brief for Appellee MetLife, Inc.:

1. Court of Appeals

The following is a list of parties, intervenors, and *amici* that have appeared before this Court that have not been identified in the briefs for either Appellant or Appellee:

Amici Curiae Supporting Appellee:

American Council of Life Insurers

Cato Institute

Chamber of Commerce of the United States of America

Investment Company Institute

National Association of Insurance Commissioners

Washington Legal Foundation

Rulings Under Review

The rulings under review are the March 30, 2016, opinion and accompanying order of the District Court in *MetLife, Inc. v. Financial Stability Oversight Council*, No. 15-CV-45 (Collyer, J.), denying the Council's motion to dismiss or for summary judgment and granting in part MetLife's cross-motion for summary judgment. ECF Nos. 105 and 106.

Related Cases

Amici adopt the statement of related cases set forth in Brief for Appellee MetLife, Inc.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 26.1 and 29(c)(1), *amici curiae* submit that no party to this brief is a publicly held corporation, issues stock, or has a parent corporation.

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GLOSSARY

SIFI	Systemically Important Financial Institution

SEPARATE BRIEFING CERTIFICATION

Pursuant to Circuit Rule 29(d), the undersigned counsel for *amici curiae* Academic Experts in Financial Regulation certifies that a separate brief is necessary because the *amici* will draw on their collective expertise in identifying the accepted principles of risk regulation and social-science methodology that inform the correct interpretation of section 113 of the Dodd-Frank Act and the arbitrary-and-capricious review of the Financial Stability Oversight Council's decision to designate MetLife as a systemically important financial institution. To the best of the undersigned counsel's knowledge, none of the other amici supporting Appellee will focus on those issues. Filing a joint brief will therefore not be practicable.

/s/ William M. Jay
William M. Jay

Dated: August 22, 2016

STATUTES AND REGULATIONS

All applicable statutes and regulations are contained in the Brief for Appellee MetLife, Inc. and the Addendum thereto.

STATEMENT OF AMICI CURIAE REGARDING IDENTITY, INTEREST IN CASE, AND SOURCE OF AUTHORITY TO FILE

Pursuant to Federal Rule of Appellate Procedure 29 and Circuit Rule 29(b), *amici curiae* state that all parties have consented to the filing of this brief. *Amici curiae* filed a notice of intent to participate on August 22, 2016.

Amici are professors who study and teach corporate law, corporate finance, and the regulation of the financial system at leading law and business schools.[1] (Affiliations are listed only for purposes of identification.) Their academic work includes extensive experience studying the regulation of risk, including in the context of the U.S. financial system. They are familiar with the principles of sensible risk regulation followed in other contexts, principles that should inform the correct interpretation of section 113 of the Dodd-Frank Act. *Amici* submit this brief urging the Court to construe section 113 consistently with those principles of sound risk regulation; to review the decisions of the Financial Stability Oversight Council ("Council") and the District Court in light of those principles; and to recognize the Council's repeated and significant departures from those principles. This brief draws on the authors' research and expertise in these areas to analyze this issue for the benefit of the Court.

[1] No counsel for a party authored this brief in whole or in part. No counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. In addition to *amici curiae* and their counsel, the Judicial Education Project contributed money that was intended to fund preparing this brief.

Jonathan R. Macey is the Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law at Yale University, and a Professor in the Yale School of Management. He has authored or co-authored several books on corporate governance and banking laws, including *Macey on Corporation Laws*, *Corporations: Including Partnerships and Limited Liability Companies*, and *Banking Law and Regulation.* His work on risk includes "Regulation and Disaster: Some Observations in the Context of Systemic Risk," 1998 Brookings-Wharton Papers on Financial Services 405 (with M. Wayne Marr and S. David Young), and "The Glass-Steagall Act and the Riskiness of Financial Intermediaries," 14 Research in Law and Economics 19 (1991).

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D. Bruce Johnsen is a Professor of Law at George Mason University's Antonin Scalia Law School. He has taught and written on financial markets and institutions, financial regulation, investment management, and law and economics.

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SUMMARY OF ARGUMENT

Systemic risk is not a new concept. Under accepted principles, a regulator charged with managing systemic risk must start with a two-part threshold inquiry: first, whether it is likely that an entity will suffer material distress in the first place; and second, if such distress should occur, whether it will cause harm to the system as a whole. In declaring MetLife a systemically important financial institution ("SIFI")—*i.e.*, an entity that poses "a threat to the financial stability of the United States"—the Financial Stability Oversight Council ("Council") ignored the first consideration completely and gave short shrift to the second, refusing to use accepted objective methodologies to determine MetLife's potential to cause systemic harm.

Instead, the Council chose to assume the worst in both respects. Without taking account of the nature of MetLife's business, it assumed that MetLife would suffer material financial distress and further assumed that the company and its counterparties would lose everything as a result. As the District Court correctly recognized, assessing risk in such a speculative manner is irresponsible and does a disservice to entities like MetLife that are exposed to burdensome and costly regulation as a result. "Predictive judgment must be based on reasoned predictions," JA 804, yet the Council offered none.

Had the Council utilized available objective methodologies, it could not have made the determination that it did. At an institutional level, the Council would have found it improbable that an insurance company like MetLife would suffer material financial distress, because there are structural reasons why an insurance company's risk of liquidity crisis is far less than that of a bank's. As a matter of both economic science and actual history, the mythical "run on the insurance industry" has never actually occurred and is unlikely ever to happen. This is particularly true for MetLife, given the nature of its business and the structure of its balance sheet. The Council failed to take any of this into consideration (along the way, sidestepping evidence of the nature of MetLife's assets, which are unusually liquid, and of its liabilities, which are scientifically predictable). Instead, it asserted that it could not and need not determine the likelihood of MetLife's distress. *See* JA 389 (determining the likelihood of distress would impose "an unduly high and falsely precise threshold"); JA 390 (the Council's Guidance neither "requires [n]or states that [the Council] will evaluate the probability or likelihood of material financial distress at a nonbank financial company"). This runs afoul of both the Council's own guidance and fundamental principles of risk assessment.

Proceeding improperly on the assumption that MetLife would encounter material financial distress, the Council explored how a failed MetLife would affect

the nation's financial system, which should have been the next step to identifying systemic risk. But even there, the Council's analysis was woefully inadequate and devoid of any objective methodology. The Council could have measured what effect a failed MetLife would have on the financial system by using tools such as Value-at-Risk models and the Federal Reserve's own stress tests for MetLife's counterparties. But again, the Council claimed the task was impossible, assuming instead that MetLife's counterparties would lose everything—with no mitigation of loss or calculation of recovery—and from that, concluding that the financial market would destabilize. Rather than carefully calibrating its analysis and relying on reasonable assumptions about MetLife's systemic exposure, the Council glossed over the details, grossly undermining the credibility of its SIFI determination for MetLife. Much like it did with the Council's analytical failures at the institutional level, the District Court correctly held that its systemic analysis, too, was fatally flawed. Accordingly, this Court should affirm the District Court's grant of summary judgment in MetLife's favor.

ARGUMENT

I. The District Court correctly determined that the Council was obligated to consider the likelihood of MetLife's financial distress.

A. Any system of risk regulation, including Dodd-Frank's statutory scheme, requires assessing the likelihood of potential contingencies.

Section 113 of the Dodd-Frank Act is a risk-regulation statute. It gives the Council the power to determine whether a nonbank financial company poses "a threat to the financial stability of the United States" for one of two reasons—either due to "material financial distress at the . . . company," or due to the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the . . . company." 12 U.S.C. § 5323(a)(1). To make this determination, the Council must look at "risk-related factors," including ten that are specifically enumerated in the statute. *Id.* § 5323(a)(2).

When Congress gave the Council this power, it assumed that in assessing contingencies at both the institutional and systemic levels, the Council would consider the likelihood—or unlikelihood—that those contingencies might occur. Dodd-Frank, after all, is about addressing real risks, not bogeymen. Section 113 is part of a "well-integrated set of rules that meaningfully *reduces the probability of failure* of [the country's] largest, most complex financial firms." *Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability: Hrg. Before the S. Comm. on Banking, Hous. & Urban Affairs*, 112th Cong. 43

(2011) (statement of Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.) (emphasis added).

Every accepted form of risk regulation requires an assessment of not only the consequences of a possible contingency, but also the likelihood of that contingency—in other words, both the "probability of failure" and "the losses to the . . . system." *Id.* In order for a risk-regulation regime like section 113 to operate effectively, a regulator must do more than simply assume that everything that *can* go wrong *will* go wrong, defaulting to the worst-case scenario as a baseline for regulation. Rather than relying on a presumption of pessimism, risk regulation must be based on an objective assessment of *which risks to regulate*, based on empirical evidence and a reasoned judgment as to a particular risk's likelihood of occurrence. Mere hypothetical conceivability is not enough.

Context is critical in determining whether a particular risk is likely and therefore deserving of regulation. For instance, in certain circumstances, flooding can be a real possibility. But atop a mountain in the desert, a flood is a near impossibility. And certain contingencies cannot exist together with others—for instance, sensitive equipment is unlikely to be exposed simultaneously to both extreme outdoor heat and extreme outdoor cold.

Federal agencies understand that assessing the probability of risk is part and parcel of risk regulation, even if a statute does not overtly require the agency to

gauge that probability. As the Office of Management and Budget notes, risk regulation entails risk assessment, risk management, and risk communication. Risk assessment, in turn, is a "useful tool for estimating *the likelihood* and severity of risks . . . and for informing decisions about how to manage those risks." Proposed Risk Assessment Bulletin, 71 Fed. Reg. 2,600 (Jan. 17, 2006) (emphasis added).

Agencies have often turned that principle into practice. The Nuclear Regulatory Commission, for instance, uses a probabilistic risk assessment to determine how to regulate the country's nuclear power plants. As part of that assessment, it considers *both* "the likelihood that an accident will occur (probability) and the level of damage or loss that will result (consequences)." U.S. Gen. Accounting Office, *Probabilistic Risk Assessment: An Emerging Aid to Nuclear Power Plant Safety Regulation* 3 (June 19, 1985). The Commission does not prepare for the worst possible scenario for every power plant in the country. Similarly, the Federal Reserve Board—tasked with regulating "large complex institutions"—has noted that its own risk assessments should "[c]onsider the relationship between the likelihood of an adverse event and the potential impact on an institution." Fed. Reserve Sys., Framework for Risk-Focused Supervision of Large Complex Institutions 1, 25 (1997).

At bottom, risk regulation rests on two pillars: (1) the likelihood of a negative contingency and (2) the impact of that contingency on the system at large. Federal agencies regularly conduct this two-step analysis, even without explicit statutory instruction. It is therefore puzzling that the Council and its *amici* have all but given up on conducting both parts of this basic risk-assessment framework, instead arguing either that (1) a company's individual likelihood of distress is irrelevant to systemic risk,[2] or (2) it is impossible to determine that likelihood.[3] Their solution is to ignore one pillar, focusing only on the other—the impact of the contingency, on the assumption that the contingency will be a certainty.[4] But the Council's approach to risk assessment saps all meaning from the word "risk," i.e., "*the possibility* of loss, injury, or other adverse or unwelcome circumstance." Oxford English Dictionary (2d ed. 1991) (emphasis added). All catastrophes

[2] Opening Br. at 34 ("Nothing in the statutory standard or in the list of required considerations . . . contemplates an assessment of the likelihood of a company's financial distress . . . ."); Br. of Amicus Curiae Better Markets, Inc. ("Better Markets Br.") at 13 ("'Vulnerability' does not mean the likelihood of financial distress occurring in the first place."). If vulnerability excludes probability, then we are vulnerable to—indeed, critically unprepared for—a large number of threats that would be catastrophic *if they happened*, from asteroid impact to zombie invasion.

[3] Br. of Amici Curiae Professors Viral V. Acharya et al. ("Acharya Br.") at 12 ("Quantifying the likelihood of a firm's distress for systemic reasons might be useful, but is not possible.").

[4] Opening Br. at 24 ("Indeed, the statute directs the Council to assume a company's material financial distress and to assess risks that the company might pose to the financial system as a result."); Acharya Br. at 12 ("[T]he prudent approach is to focus on the consequences of extreme events . . . .").

would be catastrophic *if* they occurred. But assuming a catastrophe is the equivalent, in risk-regulation terms, of assuming the can opener. It is not a shortcut—it is a rejection of the entire exercise.

B. Both Dodd-Frank and the Guidance rest on risk-regulation principles that incorporate consideration of probability, and therefore contemplate that the Council must examine whether a nonbank financial institution is likely to encounter material financial distress.

As the District Court recognized, even the Council's own interpretive guidance requires an assessment of the likelihood of risk. Although the District Court's reading of the guidance is reason enough to hold that "FSOC did indeed commit to 'evaluat[ing] the . . . likelihood of material financial distress' at a target company," JA 801, there are other telling signs that the Council committed itself to evaluating the probability of institutional distress.

To implement section 113, the Council promulgated a "Guidance for Nonbank Financial Company Determinations," 12 C.F.R. pt. 1310, app. A. In that Guidance, it re-categorized the statutory factors listed in section 113(a)(2) and set forth six different factors to consider in determining whether a U.S. nonbank financial company "poses a threat to the financial stability of the United States": macroeconomic considerations such as (1) size, (2) suitability, and (3) interconnectedness, along with company specific considerations such as (4) leverage, (5) liquidity risk and maturity mismatch, and (6) existing regulatory

scrutiny. *Id.* The Council's selection of the fifth factor, in particular, indicates that the likelihood of individual institutional distress should be considered in a systemic risk analysis. *See id.* app. A.II.d.1 ("Nonbank financial companies that are highly leveraged, have a high degree of liquidity risk or maturity mismatch, and are under little or no regulatory scrutiny *are more likely* to be more vulnerable to financial distress." (emphasis added)).

1. *One of the Guidance's key categories—liquidity risk and maturity mismatch—not only reveals systemic risk but also an individual company's likelihood of distress.*

In modern finance, two of the chief potential causes of systemic risk are asset-price contagion and counterparty contagion. An asset-price contagion is "a shock causes one or more financial institutions to have to sell large amounts of assets at temporarily depressed prices (e.g., through 'fire sales'), thereby further depressing prices and market values of institutions that hold similar assets." A counter-party contagion consists of "shocks to some firms [that] make them unable to honor commitments to counterparties, thereby causing some of the counterparties to likewise default on their commitments, with repercussions that cascade through the financial markets." Scott E. Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, 76 J. Risk & Ins. 785, 802 (2009). These elements can overlap to trigger a systemic financial crisis.

Part of the process of evaluating whether an entity is susceptible to one of these contagions (and thus regarded as a source of systemic risk) is determining how likely it is that the entity will be one of the first dominoes to fall. An exceptionally stable first domino is an exceptionally good way of reducing the risk of the domino effect. Consider, for example, the FDIC's implementation of Basel III, "a global regulatory framework for more resilient banks and banking systems." *See* Basel Comm. on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* 2 (2010) (explaining that the framework is intended "to help contain systemic risks arising from procyclicality and from the interconnectedness of financial institutions"). To complement Basel III's goal of systemic risk management, the FDIC strengthened bank leverage requirements "as a means to reduce *the likelihood of distress* at the largest banking organizations," which in turn would "lessen the effects of such distress on the U.S. economy." Opening Statement of FDIC Director Jeremiah O. Norton to the Board of Directors of the Federal Deposit Insurance Corporation at 2 (Apr. 8, 2014), *available at* https://www.fdic.gov/news/news/speeches/spapr0814b.pdf (emphasis added).

That determination as to the probability of individual distress, in turn, rests in large part on analyzing liquidity risk and maturity mismatch. Liquidity risk "generally refers to the risk that a company may not have sufficient funding to

satisfy its short-term needs." 12 C.F.R. pt. 1310, app. A.II.d.1. A maturity mismatch "generally refers to the difference between the maturities of a company's assets and liabilities." *Id.* The two concepts are closely related.

Broadly speaking, a maturity mismatch "affects a company's ability to survive a period of stress that may limit its access to funding and to withstand shocks in the yield curve." *Id.* A maturity mismatch can therefore cause liquidity risk. JA 377. When the financial system encounters liquidity problems, companies are forced to sell their assets at prices that are cheaper than they otherwise would be under normal conditions of liquidity—colloquially referred to as a "fire sale." Those lower asset prices lead to capital-depleting losses, which further compromise liquidity. Franklin Allen & Douglas Gale, *Financial Intermediaries and Markets*, 72 Econometrica 1023 (2004). What results is a feedback loop, a classic example of an asset-price contagion—liquidity problems cause fire sales, which in turn result in capital depletion, which in turn causes further liquidity problems.

a. Banks face considerable liquidity risks because maturity mismatches are inherent to their business model.

In a liquidity-based risk assessment analysis, the greater the likelihood of maturity mismatch and resulting illiquidity, the greater the chance that an institution will suffer material financial distress. Banks, for example, are particularly at risk because they engage in the business of transforming

maturities—turning short-term liabilities into longer-term assets. There is therefore an asymmetry to the assets and liabilities handled by banks: demand depositors may have instant access to their funds (thus exposing a bank to immediate short-term liability), but the bank cannot immediately liquidate its long-term assets, such as loans made to consumers and businesses for an extended period of time, at their full value. This asymmetry between assets and liabilities makes the likelihood of a maturity mismatch not only considerable, but inherent in a bank's business model.

This structural mismatch could plausibly lead to two outcomes. Either depositors maintain confidence in the bank and make withdrawals in the normal course without forcing the bank to sell any of its long-term assets; or, if there is a loss in confidence, there could be a "run on the bank"—depositors rush to withdraw their deposits, forcing the bank to sell its long-term assets at fire-sale prices.[5] A further complication is the very real possibility of an irrationality contagion—the self-fulfilling prophecy driven by depositors' baseless fears that if they do not immediately withdraw their deposits, their money will be forever

[5] *See, e.g.*, Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. Political Econ. 401, 403 (1983).

gone.[6] These are credible risks that have painfully materialized in recent memory—risks on which economists have opined for decades.

b. Insurance companies like MetLife are far less likely than banks to encounter illiquidity from maturity mismatch.

Insurance companies, however, are not banks. The likelihood of material financial distress is considerably less for an insurance company than a bank, mostly because the maturity and liquidity analyses are drastically different.

Insurance companies operate by pooling and managing risk. They take on long-term liabilities and are well-positioned to estimate the duration of their liabilities, which in turn enables them to assign probabilities to payouts. This allows insurers to buy assets with maturities that correspond to their liabilities and to hold such assets to maturity. The nature of the companies' long-term liabilities, combined with the stiff disincentives to early withdrawal, make a "run on the insurance company" improbable. *See* View of Director John Huff, the State Insurance Commissioner Representative 2 (disincentives to early withdrawal include "federal income tax liability, federal income tax penalties, surrender penalties, and the loss of guarantees"). Although the Council's amici contend that "withdrawals, cash-surrender values, or policy loans" could trigger the insurance

[6] Diamond & Dybvig, *supra* note 5, at 404; Morgan Ricks, *A Regulatory Design for Monetary Stability*, 65 Vand. L. Rev. 1289, 1317 (2012) (describing the "self-fulfilling aspect" of the bank run under the Diamond-Dybvig model—"money-claimants will run if they expect other money-claimants to run").

analogue of a run on the bank,[7] at least one amicus has acknowledged in the recent past that "contagious risks are limited because the most common forms of life insurance—term life insurance and basic annuities—do not permit policyholders to withdraw funds." Daniel Schwarcz, *Regulating Insurance Sales or Selling Insurance Regulation?: Against Regulatory Competition in Insurance*, 94 Minn. L. Rev. 1707, 1753 n.212 (2010). As that amicus noted in 2010, "there has never been a run on the life insurance industry, despite occasional predictions of such runs in the popular press." *Id.*

Unlike banks, insurance companies have not predicated their business models on maturity mismatch. Whereas banks pair short-term liabilities with long-term assets, insurers actively attempt to *limit* asset-liability mismatch by matching their long-term liabilities with long-term assets. *See* JA 646; Anthony Saunders & Marcia Millon Cornett, *Financial Institutions Management: A Risk Management Approach* 171 (McGraw-Hill 6th ed. 2006) ("[B]anks and thrifts traditionally hold longer-term assets than liabilities, whereas life insurance companies tend to match the long-term nature of their liabilities with long-term assets."). This makes life insurance companies "generally buy-and-hold investors, with the goal of generating predictable and stable income in the long run, and having sufficient

[7] Br. of Amici Curiae Scholars of Insurance and Financial Regulation ("Scholars Br.") at 25.

funds available to pay claims when due." Nat'l Ass'n of Ins. Comm'rs, Capital Markets Bureau, *Securities Investment Strategies and Return on Invested Assets*, *available at* http://www.naic.org/capital_markets_archive/140911.htm (last visited Aug. 22, 2016).

Given this business model, insurance companies are less likely to face an immediate need for liquidity. MetLife is no different, even as a large insurer. It manages $458 billion in its general account investment portfolio, over 20 percent of which is held in "[c]ash, short-term investments, U.S. Treasury securities, agencies, and agency RMBS." JA 646. Liquidity risk is therefore "negligible in the insurance sector," Guillaume Plantin & Jean-Charles Rochet, *When Insurers Go Bust: An Economic Analysis of the Role and Design of Prudential Regulation* 92 (2007), and MetLife is no exception.

C. The Council erred in completely disregarding the importance of risk probability.

It is improbable that an insurer like MetLife would suffer a liquidity crisis, thus posing a risk to the national financial system. And a standard system of risk regulation would consider that ascertainable improbability. Yet the Council opted to depart from the ordinary principles and to base its decision about MetLife on sheer speculation. S. Roy Woodall, the Council's independent member with insurance expertise, stated the point well: the Council's analysis under the Asset Liquidation Transmission Channel "relies on implausible, contrived scenarios as

well as failures to appreciate fundamental aspects of insurance and annuity," such as the ones described above. JA 736. Adam Hamm, the Council's State Insurance Commissioner Representative, said the same—"the Basis implicitly assumes material financial distress at all insurance entities at the same time, yet the Basis cites no historical examples of that having ever occurred." JA 669.

The Council and its amici defend this decision to rely on speculation by asserting that calculating the probability of an individual company's distress is (1) impossible and (2) unnecessary in any event, as the statute and its regulations do not require it. But the Council's Guidance belies both of these points. It specifically calls for the use of metrics that help determine a nonbank financial company's vulnerability to financial distress. For instance, the Guidance directs the Council to look at "[s]hort-term debt as a percentage of total debt and as a percentage of total assets," which "indicates a nonbank financial company's reliance on short-term debt markets." 12 C.F.R. pt. 1310, app. A.II.d.1. Moreover, the Council has acknowledged that "[a]sset-liability duration and gap analysis . . . indicate[s] how well a nonbank financial company is matching the re-pricing and maturity of the nonbank financial company's assets and liabilities." *Id.*

Had the Council seriously engaged in asset-liability duration and gap analysis, it would have concluded that MetLife's probability of distress is low because it has little liquidity risk. Instead, the Council glossed over the fact that

MetLife's short-term debt is only 0.27 percent of its assets. JA 648. It virtually ignored the fact that any risk posed by existing maturity mismatch could be easily mitigated by the liquidity of MetLife's assets, which the Council also must consider. 12 C.F.R. pt. 1310, app. A.II.d.1. That analysis would have shown that MetLife "has a substantial portfolio of highly liquid assets," diminishing the likelihood that MetLife's maturity mismatch would lead to the company encountering material financial distress. JA 379.

Rather than addressing these facts, the Council opted to focus on MetLife's securities-lending program, raising the specter of counterparty contagion in the process of doing so. Opening Br. at 32. But it is doubtful that the program would significantly distress MetLife, as its transactions are heavily collateralized—something the Council itself has acknowledged. "Approximately 88 percent of the securities lent by MetLife are U.S. government and agency securities, whose liquidity helps to protect counterparties." JA 518. "MetLife invested $6.6 billion of the cash collateral in U.S. Treasury and agency securities, which would be sold to satisfy any cash requirements due to the termination of securities lending agreements." JA 519.

The role of collateral in combating risk is well established. Collateral serves "as security for credit exposure." Jon Gregory, *Counterparty Credit Risk: The New Challenge for Global Financial Markets* 60 (2011). In the event that the

counterparty defaults and is "unable to make future commitments," an institution can call for the collateral and recover its value. *Id.* at 23, 60. On a systemic level, collateralization dramatically "reduces overall exposure" and the possibility of counterparty risk and contagion. *Id.* at 59-60.

Despite making these findings, the Council gave no weight to MetLife's access to liquid assets. Instead, it jumped to the erroneous conclusion that MetLife "could transmit material financial distress to other market participants as a result of rapid liquidation of invested collateral to produce the necessary liquidity to return cash collateral to its securities lending counterparties." JA 519.

* * *

The notion that liquidity risk and maturity mismatch serve as indicia of company distress should not be foreign to the Council, *see, e.g.*, 12 C.F.R. pt. 1310 app. A.II.d. It has long been understood and accepted in the fields of corporate finance, banking, accounting, and insurance. *See* Richard Carnell, Jonathan Macey & Geoffrey Miller, *The Law of Banking and Financial Institutions* (5th ed. 2014). There are objective ways of determining how likely it is that a company will find itself in material financial distress. A company with opaque, illiquid, and difficult-to-value assets combined with transparent, liquid, and readily valued liabilities is more likely to suffer material financial distress than a company with liquid assets and long-term liabilities. Or, if a company's balance sheet has assets with long-

term maturities and liabilities due immediately or in the near-term, vulnerabilities can emerge quickly in times of stress. Jonathan Macey & Maureen O'Hara, *The Corporate Governance of Banks*, Fed. Reserve Bank of N.Y. Econ. Pol'y Rev., Apr. 2003, at 91, *available at* https://www.newyorkfed.org/medialibrary/media/research/epr/2003/EPRvol9no1.pdf.

Yet despite the tools available to the Council to help it make a reasonable prediction about the likelihood of MetLife's financial distress, the Council has opted to maintain that such a calculation is both impossible and unnecessary. Its decision to do so is contrary not only to statutory intent and the Council's own regulatory guidance, but also elementary principles of risk regulation that require some consideration of an individual participant's likelihood of distress, even if the risk being regulated is a systemic one. The District Court correctly determined that the Council's decision to disregard MetLife's likelihood of financial distress was arbitrary and capricious. JA 802.

II. The District Court also correctly held that the Council failed to support its conclusion that MetLife's hypothetical material financial distress could result in a threat to our nation's financial system.

The Council's determination that MetLife's hypothetical financial distress would "pose a threat to the financial stability of the United States" was bereft of proper methodological support. The Council should have measured MetLife's "nature, scope, size, scale, concentration, interconnectedness, or the mix of its

activities" using objectively verifiable criteria. Instead, it abandoned scientific objectivity altogether, violating basic principles of cost-benefit analysis by "focus[ing] exclusively on the presumed benefits of its designation" while "ignor[ing] the attendant costs." JA 779. As the District Court put it, the Council's "methodology" was simple: "assume[] the upside benefits of designation (even without specific standards from the Federal Reserve) but not the downside costs of its decision." JA 792. The Council erred by disregarding minimum standards of social-science methodology in classifying MetLife as a SIFI, and the District Court correctly called out that error.

A. MetLife's potential impact on the financial market was quantifiable and objectively verifiable.

The Council and its amici chant a familiar glum refrain to defend the Council's failure to substantiate the assertion that MetLife's financial distress would impair market functioning: "there is no plausible way for the Council . . . to meaningfully quantify [that] likelihood," they say.[8] But that is not true. There are widely accepted methods, particularly Value-at-Risk models and stress tests, that could be used to determine whether MetLife poses a threat to the nation's financial stability.

[8] Scholars Br. at 5; *accord* Opening Br. at 46-48.

Economists at the Federal Reserve have long recognized that "an underlying principle of modern financial risk management is that statistical models can be used to estimate the distribution of possible future financial outcomes, such as changes in interest rates or a firm's credit quality." Jose A. Lopez, *Stress Tests: Useful Complements to Financial Risk Models*, Fed. Reserve Bank of S.F. Econ. Letter, at 1 (June 24, 2005), *available at* http://www.frbsf.org/economic-research/publications/economic-letter/2005/june/stress-tests-useful-complements-to-financial-risk-models/; *see also* Jonathan Macey, *The Regulator Effect in Financial Regulation*, 98 Cornell L. Rev. 591, 628-29 (2013).

Value-at-Risk is one method of statistically modeling the risk of investments, such as the investments reflected on the asset side of the balance sheet of a company such as MetLife. Value-at-Risk estimates how much such investments might lose, under various market conditions, over a designated period of time, such as a week. Value-at-Risk is used by firms and regulators in the financial industry to gauge the amount of assets needed to cover possible losses. Darryll Hendricks, *Evaluation of Value-at-Risk Models Using Historical Data*, Fed. Reserve Bank of N.Y. Econ. Pol'y Rev., Apr. 1996, at 39, 40.

Stress testing, a widely used risk-management tool that evaluates the impact of unlikely events or movements of financial variables on companies such as MetLife, complements the use of Value-at-Risk in measuring risk exposure. Stress

tests provide information in addition to that which can be gleaned from Value-at-Risk models on expected losses to a company over any given time horizon. Accordingly, "stress testing is used increasingly as a complement to the more standard statistical models used for [Value-at-Risk] analysis." Lopez, *supra*, at 1.

The Council could simply have used these tests on other SIFIs to determine whether and how they would be affected by financial distress at MetLife, particularly because the Federal Reserve's Board of Governors conducts stress tests on these institutions already. 12 U.S.C. § 5365(i). At a minimum, these methods would have provided a better idea, even if the quantification were inexact in some respects.

But the Council chose the path of least resistance by simply assuming "that any [material losses by MetLife] would affect the market in a manner that 'would be sufficiently severe to inflict significant damage on the broader economy.'" JA 803. Had it bothered to conduct any sort of meaningful empirical testing to determine what effect MetLife's worst-case-scenario would have on its counterparties, it could not have come to the conclusion that a materially distressed MetLife would be "a threat to the financial stability of the United States." *See* Appellee's Br. at 35-36 (discussing record evidence showing that "even in the highly implausible event that counterparties lost their full exposures to MetLife,

those counterparties would not be materially impaired and the losses would not produce systemic effects").

At the very least, the Council should have seriously considered using one of the most basic tools available to federal agencies: a cost-benefit analysis. *See* Exec. Order 12,866, 3 C.F.R. § 638 (1994) (mandating federal agencies to "assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating" and "to the extent reasonable, the degree and nature of the risks posed by various substances or activities within [their] jurisdiction"); *Michigan v. EPA*, 135 S. Ct. 2699, 2707 (2015) ("Agencies have long treated cost as a centrally relevant factor when deciding whether to regulate."). In such a framework, "potential gains and losses from a proposal are identified, converted into monetary units, and compared on the basis of decision rules to determine if the proposal is desirable from society's standpoint." Tevfik F. Nas, *Cost-Benefit Analysis: Theory and Application* 1-2 (1996). With respect to systemic risk management, "regulation is desirable only if the costs of regulation are smaller than the benefits from mitigating a market failure"—in this case, the Council's imposition of federal supervision of MetLife must outweigh the marginal costs. Plantin & Rochet, *supra*, at 74. If the plaintive assertion by the Council and its amici—that there is no way to meaningfully quantify these risks—reflected reality in the modern administrative state, this entire apparatus of cost-benefit analysis would not exist.

Cost-benefit analysis regularly measures contingencies that the Council and its amici would have the Court believe are "unquantifiable." And again, the question is not whether *perfect* quantification is possible. The question is whether the task is so impossible that the Council was justified in replacing analysis with assumption.

Applying cost-benefit principles has the added benefit of transparency, "ensuring that the consequences of regulation are not shrouded in mystery but are instead made available for public inspection and review." Cass R. Sunstein, *The Cost-Benefit State* 4, Univ. of Chi. Law & Economics, Olin Working Paper No. 39 (May 1996). The Council dropped the "cost" component of the cost-benefit analysis, focusing only on the benefits of regulation. That result-oriented approach was analytically unsound.

B. An objective analysis would have accounted for the insurance industry's lesser degree of interconnectedness.

Under the Guidance (and general principles of systemic risk management), one of the key factors in determining whether an institution poses a systemic risk is its interconnectedness. An objective analysis would have revealed that MetLife did not pose a threat to the nation's financial system because of its relatively weak connections to other insurance companies and the financial system as a whole.

At the systemic level, insurance companies are considerably different (and far less interconnected) than banks. Banks are institutionally interconnected. They

extend loans to one another through the interbank lending market and transact in over-the-counter derivatives. Because these transactional relationships are so fundamental to individual banking institutions and the banking industry as a whole, they make the nation's financial system susceptible to systemic risk. In other words, financial distress at one large bank could trigger distress at another and so on, with the domino effect posing a threat to national financial stability.

Banks are particularly susceptible to counterparty contagion. Counterparty risk comes in various forms, such as default risk, replacement risk, and settlement risk. And the more banks are interconnected with one another, the greater the magnitude of counterparty risk. During the 2008 financial crisis, "increased counterparty risk contributed to" the unfolding of the financial market turmoil. John B. Taylor & John C. Williams, *A Black Swan in the Money Market*, 1 Am. Econ. J. Macroeconomics 58, 58 (2009).

Insurance companies, on the other hand, do not have the same degree of interconnectedness. For one, they lack intra-industry interconnectedness—insurance companies are less connected with one another. There is no "insurance system" that is comparable to the banking system. Insurance companies are not directly linked to one another through their balance sheets. Although insurance companies cede some of their risks through reinsurance agreements, reinsurers only take up a portion of the primary risks of insurers, acting as a backstop. Even

accounting for reinsurance arrangements, intra-industry interconnectedness does not indicate a systemic risk. *See* Scott E. Harrington, *Capital Adequacy in Insurance and Reinsurance, in Capital Adequacy Beyond Basel: Banking, Securities, and Insurance* 87, 88 (Hal Scott ed., 2004) (concluding that market discipline is greater in reinsurance than both primary insurance and banking).

Insurance companies are also not as interconnected with the rest of the financial system as banks are. As an initial matter, there is little question that "typical insurance activities do not pose any systemic risk." Geneva Ass'n, *Systemic Risk in Insurance: An Analysis of Insurance and Financial Stability* 63 (2010), *available at* https://www.genevaassociation.org/media/99228/ga2010-systemic_risk_in_insurance.pdf. Although insurance companies often act as financial intermediaries and are investors in financial markets, "the degree to which insurance companies are interconnected with other financial institutions is generally less significant than the interconnection among banks and brokerage firms." Nat'l Ass'n of Ins. Comm'rs, Capital Markets Bureau, *U.S. Insurance Industry's Investment Exposure to the Financial Sector*, *available at* http://www.naic.org/capital_markets_archive/130405.htm (last visited Aug. 22, 2016). Insurance companies may, for instance, participate in securities lending as a low-risk investment strategy, but they do not engage in interbank lending. *See* Nat'l Ass'n of Ins. Comm'rs, Capital Markets Bureau, *Securities Lending in the*

Insurance Industry, *available at* http://www.naic.org/capital_markets_archive/110708.htm (last visited Aug. 22, 2016). So long as insurers maintain an adequate level of liquidity, as MetLife has, "nontraditional" insurer activities such as securities lending should be cause for self-vigilance, not burdensome regulation. *See* Geneva Ass'n, *supra*, at 63, 73-74 (recommending strengthened liquidity risk management to guard against the "potential systemic risk" caused by "extreme circumstances" involving "mis-management of short-term funding").

Because insurance companies are less interconnected both with one another and with the financial system as a whole, their exposure to the financial system is more limited compared to banks. Insurance companies do not pose the same level of counterparty risk to the financial system as banks do. And empirical studies validate this; they illustrate the lack of "any evidence in favor of contagion failures in insurance." Plantin & Rochet, *supra*, at 92.

C. This Court does not owe unquestioning deference to the Council's determination.

Lacking an objectively verifiable basis for its conclusion that MetLife poses a threat to the nation's financial system, the Council and its amici fall back on judicial deference to an agency's expertise and predictive judgments.[9] But as this Court has often noted, naked assertions of agency expertise and judgment are not

[9] Opening Br. at 6, 7, 45, 49; Better Markets Br. at 17.

reasons enough to overlook fundamental lapses in the agency decisionmaking process. *Cf. Sorenson Commc'ns Inc. v. FCC*, 755 F.3d 702, 708 (D.C. Cir. 2014) ("Though an agency's predictive judgments . . . are entitled to deference, deference to such judgments must be based on some logic and evidence, not sheer speculation. . . . [T]he wisdom of agency action is rarely so self-evident that no other explanation is required." (citation, internal quotation marks, and alterations omitted)). The Council's determination was based on little more than a string of assumptions, hypotheticals, and "what-ifs," running contrary to not only the Council's own regulatory guidance, but also long-established fundamentals of finance and risk management. Deference to an agency's expertise does not stretch that far.

CONCLUSION

The District Court correctly determined that the Council should have considered the likelihood that MetLife would suffer material financial distress. It also correctly recognized that the Council's lopsided analysis of MetLife's position in the financial system was completely ungrounded in any sort of objective methodology, which would have revealed that the company did not pose a threat to the country's financial system. This Court should therefore affirm the District Court's grant of summary judgment in MetLife's favor.

Respectfully submitted,

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Dated: August 22, 2016

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS, AND TYPE STYLE REQUIREMENTS

1. This brief complies with the type-volume requirement of Federal Rule of Appellate Procedure 29(d) because this brief contains 6,995 words, as determined by the word-count function of Microsoft Word, excluding the parts of the brief exempted by Federal Rule of Appellate Procedure 32(a)(7)(B)(iii) and Circuit Rule 32(e)(1).

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CERTIFICATE OF SERVICE

I hereby certify that on this 22nd day of August 2016, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the District of Columbia Circuit using the appellate CM/ECF system. Counsel for all parties to the case are registered CM/ECF users and will be served by the appellate CM/ECF system.

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