M E M O R A N D U M

To: Members of the Committee on Financial Services

From: Digital Assets, Financial Technology, and Inclusion Subcommittee Staff

Date: January 5, 2023

Subject: Subcommittee on Digital Assets, Financial Technology, and Inclusion Hearing: "Regulatory Whiplash: Examining the Impact of FSOC's Ever-changing Designation Framework on Innovation"

On Wednesday, January 10, 2024, at 2:00 p.m. the Subcommittee on Digital Assets, Financial Technology, and Inclusion will hold a hearing entitled: "Regulatory Whiplash: Examining the Impact of FSOC's Ever-changing Designation Framework on Innovation." The following witnesses will testify:

- Jeffrey Dinwoodie, Partner, Cravath, Swaine & Moore LLP
- Bill Hulse, Senior Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce
- Ji Kim, General Counsel & Head of Global Policy, Digital Assets, Crypto Council for Innovation
- Paul Kupiec, Senior Fellow, American Enterprise Institute
- Amias Gerety, Partner, QED Investors

Overview and History of FSOC

FSOC was established in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act as an interagency body comprised of the heads of U.S. financial regulators.[1] The Council is chaired by the Secretary of the Treasury and has 10 voting members, as well as five non-voting members:

Voting Members

- The Chair of the Board of Governors of the Federal Reserve System;
- The Comptroller of the Currency;
- The Director of the Consumer Financial Protection Bureau (CFPB);
- The Chair of the Securities and Exchange Commission (SEC);

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

- The Chairman of the Federal Deposit Insurance Corporation (FDIC);
- The Chairman of the Commodity Futures Trading Commission (CFTC);
- The Director of the Federal Housing Finance Agency (FHFA);
- The Chairman of the National Credit Union Administration (NCUA); and
- An independent member with insurance expertise who is appointed by the President and confirmed by the Senate for a six-year term.[2]

Non-Voting Members

- The Director of the Office of Financial Research;
- The Director of the Federal Insurance Office;
- A state insurance commissioner designated by the state insurance commissioners;
- A state banking supervisor designated by the state banking supervisors; and
- A state securities commissioner (or officer performing like functions) designated by the state securities commissioners.

FSOC's purpose is to identify and address potential threats to financial stability. FSOC is required by statute to submit an annual report to Congress, which provides an overview of the Council's activities, describes significant financial market and regulatory developments, analyzes potential emerging threats, and makes certain recommendations.

Since it was created, FSOC has designated four nonbanks as SIFIs. The four nonbanks include American International Group, Inc.; General Electric Capital Corporation; Prudential Financial, Inc.; and MetLife, Inc. MetLife was the only entity to challenge its FSOC designation. In the case, *MetLife Inc. v. Financial Stability Oversight Council*, the District Court for the District of Columbia held that FSOC's decision to designate MetLife as a SIFI was arbitrary and capricious because FSOC did not consider the costs of designating MetLife.[3] The case was eventually set aside following a mutual agreement under the Trump Administration.[4]

SIFI Designation Process 2012 - 2019

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[2] This position is currently held by Thomas E. Workman, who was appointed by President Trump in 2018. He previously served as President and Chief Executive Officer of the Life Insurance Council of New York, Inc. from 1999 to 2016.

[3] *MetLife Inc. v. Financial Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016). On remand, the district court denied a motion to vacate the portion of its opinion that held FSOC was required to perform a cost-benefit analysis. *See* Order, *MetLife, Inc. v. Fin. Stability Oversight Council*, No. 1:15-cv-00045-RMC, Dkt. 129 (D.D.C. Feb. 28, 2018).

[4] See Pete Schroeder, *MetLife, U.S. regulators agree to set aside legal fight*, Reuters, (Jan. 19, 2023), https://www.reuters.com/article/us-usa-metlife-fsoc/metlife-u-s-regulators-agree-to-set-aside-legal-fight-idUSKBN1F8064/

The Dodd-Frank Act permits FSOC, subject to a two-thirds vote, to determine if a nonbank financial company poses a systemic risk to the U.S. financial system and should therefore be supervised by the Board of Governors of the Federal Reserve System and subject to prudential standards.[5] "Systemic risk" is not defined under Dodd-Frank. However, the statute requires the Council to consider ten factors when considering whether an entity poses systemic risk to the U.S financial system.[6]

In 2012, FSOC published its final rule and interpretive guidance describing how it intended to implement its statutory authority under Dodd-Frank with respect to SIFI designations.[7] At the time, FSOC presented a three-stage analytical process that would apply the ten statutorily required considerations.

The Council stated that it did not intend to conduct any cost-benefit analysis when making a SIFI designation determination.[8] Further, the initial final rule applied a one-size fits all quantitative analytical framework to all examined companies, thus failing to consider a company's specific activities.

In March 2019, the Council approved proposed interpretive guidance to revise and update the 2012 Interpretive Guidance. In December 2019, following the rescinded designations for the remaining SIFI's made during the Obama Administration, FSOC finalized and published updated guidance. This updated guidance required FSOC to follow a more rigorous analytical designation process.[9] Under the revised guidance, FSOC would evaluate a financial company's potential systemic risk by taking an activities-based approach "in order to reduce the potential for competitive market distortions that could arise from entity-specific determinations, and allow relevant financial regulatory agencies to address identified potential risks."[10] FSOC would make recommendations to a primary regulatory agency based on its findings if it a determination was made that potential systemic risk existed. If the activities-based approach proved insufficient in mitigating the identified risk, the Council would exercise its authority to designate an entity for enhanced supervision under the Federal Reserve.

Additionally, the 2019 guidance required FSOC to determine whether a cost-benefit analysis was necessary when considering designation. Specifically, FSOC was required to determine whether

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[5] 10 C.F.R. § 1310.1 (FSOC also retains authority to designate Systematically Important Financial Market Utilities in a similar manner as its authority to designate SIFIs.)
[6] Dodd-Frank § 113.
[7] 77 Fed. Reg. 21637(Apr. 11, 2012).
[8] Id. at 21640.
[9] 84 Fed. Reg. 71740 (proposed Dec. 29, 2019).
[10] *Id*. at 71742.

a cost-benefit analysis was necessary prior to issuing a nonbinding recommendation to a primary financial regulator.[11]

The 2019 revised guidance also consolidated the three-stage process into two stages.[12] Collectively, the changes to the designation process remedied many stakeholder concerns. This included making FSOC less susceptible to abusing its designation process to target specific companies.

November 2023 Revised Guidance

In May 2022, Treasury Secretary Janet Yellen reiterated her concerns with the 2019 revised guidance for FSOC designations before the Senate Banking Committee.[13] In April 2023, FSOC voted unanimously to issue for public comment a proposed framework that would essentially undo the 2019 revised guidance.

On November 3, 2023, FSOC issued its final guidance revising the designation process and analytical framework.[14] Under the 2023 guidance, a nonbank financial company being considered for designation would go through two stages of analysis, a vote on a proposed designation, a hearing (if requested by the company), and a vote on final designation. Justifying its revision, FSOC stated that the "[c]ost-benefit analysis is not in the list of considerations Congress specifically required the Council to consider in a designation."[15]

<u>FSOC's Approach Towards Digital Assets and Financial Technology</u>

FSOC Report on Digital Asset Financial Stability Risks and Regulation and 2022 Annual Report

In October 2022, FSOC published its "Report on Digital Asset Financial Stability Risks and Regulation,"[16] which was in response to Executive Order 14067, Ensuring Responsible Development of Digital Assets. The report called on the Treasury Secretary to convene FSOC and produce a report outlining the specific financial stability risks and regulatory gaps posed by various types of digital assets and to provide recommendations to address such risks.[17]

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[11] *Id.* If the primary financial regulator was not instructed to conduct a cost-benefit analysis in a nonbinding recommendation, then FSOC would conduct the analysis itself.
[12] *Id*. (stating "The Final Guidance eliminates prior stage 1, because it generated confusion among firms and members of the public and is not compatible with the prioritization of an activities-based approach.")
[13] *The Financial Stability Oversight Council Annual Report to Congress: Hearing,* S. Comm. on Banking, Housing, and Urban Affairs, 117th Cong. (2022).
[14] Guidance on Nonbank Financial Company Determinations, 88 Fed. Reg. 80110 (codified at C.F.R. pt. 1310).
[15] *Id.* at 80111.
[16] U.S. Dept. of Treasury, *Financial Stability Oversight Council Release Report on Digital Assets Financial Stability Risks and Regulation* (Oct. 3, 2022), https://home.treasury.gov/news/press-releases/jy0986.
[17] Exec. Order No. 14067, 87 Fed. Reg. 14143, (Mar. 9, 2022).

The report identified various regulatory gaps and called on Congress to enact legislation to provide a regulatory framework over the spot market for digital assets that are not securities and create a comprehensive regulatory framework for stablecoins. The report also emphasized concerns regarding the potential growing risks arising from digital assets.
The report further asserted that digital assets must be addressed to prevent the "build-up of systemic risk."[18] It further recommended that Council members continue to build their respective capacities related to data and to the analysis, monitoring, supervision, and regulation of crypto-asset activities.[19]

FSOC reiterated its concerns and recommendations two months later in the 2022 Annual Report, which closely mirrored the Executive Order report with respect to digital assets. Notably, in the time between the Executive Order report and the 2022 Annual Report published in December, FTX had collapsed. FSOC acknowledged this in its 2022 Annual Report and stated that "the turmoil in the crypto-assets ecosystem did not have notable effects on the traditional finance system."[20]

FSOC's 2023 Annual Report

At the beginning of 2023, FSOC emphasized that digital assets remained one of its top four priority areas to address risks and vulnerabilities in the financial system.[21] According to FSOC's 2023 Annual Report, the digital assets working group[22] continues to serve as a forum for member agencies to facilitate information sharing about market developments and analysis related to digital assets.[23] Further, the Council explained that digital asset markets and their connections to the traditional financial system continue to be not "significant."[24] The Council urged Congress to pass legislation that gives regulators rulemaking authority over the spot market for digital assets, in addition to a comprehensive regulatory framework for stablecoins.

Additionally, FSOC addresses fintech service providers more thoroughly compared to the 2022 Annual Report. The 2023 report highlighted the growth in bank-fintech partnerships and the

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[18] Id. at 3.
[19] *Id.* at 111.
[20] FSOC, *Annual Report 2022* (Dec. 16, 2022), https://home.treasury.gov/system/files/261/FSOC2022AnnualReport.pdf.
[21] U.S. Department of Treasury, *READOUT: Financial Stability Oversight Council Meeting*, (Feb. 10, 2023) https://home.treasury.gov/system/files/261/FSOC_20230210_Readout.pdf. These priorities comprised of: (1) nonbank financial intermediation, (2) Treasury market resilience, (3) climate-related financial risk, and (4) digital assets.
[22] In 2017, the Council established a digital assets working group to facilitate coordination among financial regulators.
[23] FSOC, *Annual Report 2023* (Dec. 14, 2023), https://home.treasury.gov/system/files/261/FSOC2023AnnualReport.pdf.
[24] *Id*. at 40.

degree to which many fintech companies are not subject to the same regulatory oversight and compliance as their banking partners.[25]

Artificial Intelligence (AI)

In the 2022 Annual Report, FSOC acknowledged that AI's growth within financial services "introduces certain risks."[26] The report then specifies that "[p]otential risks associated with AI include safety-and-soundness risks – such as cyber and model risks – and consumer compliance risks."[27] In FSOC's 2023 Annual Report, the Council extrapolated further on AI's growing presence within financial services. In addition to reiterating the risks stated in the 2022 Annual Report, the 2023 Annual Report extrapolated further on "generative AI," acknowledging its rapid growth throughout 2023.[28] The report ultimately recommended FSOC continue to monitor, noting that some risk management requirements already in place could be applicable to a company's use of AI. [29]

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[25] *Id.* at 96. Stating that "[m]any fintech service providers are not subject to the same compliance requirements as financial institutions, such as requirements related to consumer protection and anti-money laundering." Additionally, the Council also noted that it "has identified the financial services sector's reliance on third-party service providers, such as cloud service providers (CSPs), as a potential risk to financial stability because of the significant role these entities serve in the financial sector.

[26] *Supra* note 23, at 72.

[27] *Id.*

[28] *Supra* note 23, at 92.

[29] *Id.* at 93.